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Financing Renewable Energy Projects in Kazakhstan: Key Legal Challenges

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Applicable Legal Framework

1) The Law "On Electric Power", No. 588-II dated 9 July 2004 (the "**Electric Power Law**").
2) The Law «On support of the use of renewable energy sources", No. 165-IV ЗРК dated 4 July 2009 (the "**RES Law**").
3) The Land Code, No. 442-II dated 20 June 2003 (the "**Land Code**").
4) The Water Code, No. 481-II dated 9 July 2003 (the "**Water Code**").
5) The Law "On natural monopolies and regulated markets", No. 272-I dated 9 July 1998 (the "**Natural Monopolies Law**").
6) The Law "On the ratification of the Charter of the International Renewable Energy Agency (IRENA)", No. 82-V ЗРК dated 22 March 2013.

COMPETENT AUTHORITIES

1) The **Government of Kazakhstan**, among other authorities, approves the feed-in tariffs (see article 5 of the RES Law).
2) The **Ministry of Energy** is the authorized agency in the area of state support for the use of renewable energy sources (the "**RES**") and, among other authorities, it is responsible (i) for supervision of the connection of RES-using facilities to the electric or thermal networks of power transmitting entities in accordance with the electric power legislation of the Republic of Kazakhstan; (ii) development and approval of the rules of formation of the so-called placement plan for the RES objects; (iii) approval of the development targets of the renewable energy sector; (iv) development and approval of a model contract on connecting RES objects, as well as the order and time of its conclusion; (v) development and approval of the rules of formation and use of the so-called reserve fund of the FSC, as defined below (see articles 6 and 6-1 of the RES Law).
3) Local governments (**Akimats**) are responsible for certain functions in the area of the use of RES, including the approval of construction projects in respect of facilities using RES for the generation of thermal energy to be delivered to the centralized heat supply system, and the reservation and allocation of land for the construction of RES-using facilities (see article 7 of the RES Law).

THE CONCEPT OF RENEWABLE ENERGY SOURCES

Renewable Energy Sources (RES) mean sources of energy which are renewable

either through natural processes, including:

1) the energy of solar radiation energy;
2) wind energy;
3) the hydrodynamic energy of water;
4) geothermal energy (the heat of soil, ground water, rivers and water bodies);

OR

man-made sources of primary energy resources, like:
5) biomass;
6) biogas;
7) and other fuels from organic waste used in electric and/or thermal power generation.

(see section 1 of article 1 of the RES Law)

STATE SUPPORT

Guaranteed off-take of electric power

Power generated by a RES-using producer (the "**Supplier**") shall be purchased by a so-called special financial settlement center (the "**FSC**"). A power purchase contract with the FSC must be valid for 15 years (see section 4 of article 7-1 of the RES Law).

Suppliers may, at their discretion, sell generated electric power using one of the following options:

1) to the FSC at a fixed tariff indexed for inflation in the procedure determined by the Government of Kazakhstan; OR

2) to customers at negotiable prices.

Suppliers selling power to customers at negotiable prices may not sell generated power through the first option (see section 1 of article 9 of the RES Law).

STATE SUPPORT

Feed-In Tariffs

Fixed tariffs are approved by the Government of Kazakhstan for a period of fifteen years separately for each type of RES enjoying state support (see section 1 of article 8-1 of the RES Law). Approved fixed tariffs are subject to annual indexation for inflation in the procedure determined by the Government of Kazakhstan (see section 2 of article 8-1 of the RES Law).

In accordance with the Decree of the Government of Kazakhstan "On Approval of Fixed Tariffs“ № 645 dated 12 June 2014, the approved fixed tariffs for supply of electrical energy produced from RES are as follows:

1) wind power - 22.68 tenge / kWh (excluding VAT);
2) solar power - 34.61 tenge / kWh (excluding VAT;
3) small hydro - 16.71 tenge / kWh (excluding VAT);
4) biogas plants - 32.23 tenge / kWh (excluding VAT).

To encourage implementation of the low-power RES objects, as well to encourage implementation of the RES projects in areas with tough climate, technical etc conditions, fixed tariffs will be differentiated in proportion to their capacity. This rule does not apply to existing sale contracts of the FSC concluded with the energy producing organizations (see section 3 of article 8-1 of the RES Law).

Guaranteed Tenor of the Feed-In Tariffs and of the Off-Take Agreement

The RES Law provides two types of stabilisation commitments to renewable energy investors.

Firstly, the RES Law requires the FSC to purchase the output of renewable energy generating facilities "at the fixed tariff existing at the date of conclusion of the power purchase agreement (PPA) with the FSC." (see paragraph 1 of section 3 of article 7-1 of the RES Law). This implies that future tariff changes do not apply to existing installations.

Secondly, the RES Law recognises the right of the Kazakh Government to change the renewable energy tariff level, but explicitly provides that these tariff changes "do not apply to existing PPAs between the FSC and renewable energy generating facilities." (see section 3 of article 8-1of the RES Law).

The RES, therefore, provides clear stability commitments to investors that the tariff existing at the moment of concluding the PPAs with the FSC will remain unchanged for a period of fifteen years and it provides protection against the risk of a unilateral reduction of the PPA's or the tariff's duration by the Government, the Ministry of Energy or the FSC.

Unilateral changes to renewable energy feed-in tariffs have resulted in investment arbitration claims based on the Energy Charter Treaty (e.g. against Spain) or even political issues (e.g. Ukraine).

STATE SUPPORT

Investment Preferences

In accordance with article 283 of the Commercial Code, local companies (i.e. it can be existing Kazakh company) that operate in eligible areas (including RES) are entitled to the following benefits (on the basis of the so-called investment contract):

1) an exemption from customs duties on imported equipment and components, and raw materials required for investment projects (the exemption can be granted for up to five years) and an exemption from VAT for import;
2) state in-kind grants (land plots, buildings, equipment, machinery, etc.), which are granted for gratuitous use for the duration of the contract. Total amount of such state in-kind grant shall not exceed 30% of the total investment in fixed assets of such local company.

Projects in eligible areas (including RES) with investment exceeding approximately USD 12.3 million are considered to be so-called "priority investment projects". Newly created local companies that have entered into investment contracts relating to priority investment projects are entitled to the following benefits (in addition to those two listed above):

3) tax exemptions (corporate income tax - 0% for 10 years, land-tax-0% for 10 years, property tax-0% for 8 years);
4) an investment subsidy of compensation by the Government of up to 30% of the costs relating to construction, assembly and acquisition of equipment; and
5) stability of tax law and labor laws (see article 289 of the Commercial Code).

STATE SUPPORT

Guaranteed access to the points of connection to the electrical grids

New and reconstructed RES facilities have the right to free and non-discriminatory access to the nearest point of connection to the electrical or thermal grids of transmission companies (see article 10 of the RES Law).

Transmission companies are required to provide Suppliers with free access to energy transmission grids, while Suppliers shall be exempted from (i) the payment for the transmission of energy to the power transmission companies and (ii) the payment for the transmission of heat to the heat supplying companies (see sections 6 and 7 of article 9 of the RES Law).

In case of limited capacity of the transmission network, a transmission company is obliged to give preference for transmission of the electric power generated on the RES facilities before conventional power plants (see section 3 of article 10 of the RES Law).

STATE SUPPORT

No license required

Starting from 2012, the production, transmission and distribution of electrical and thermal energy, as well as the operation of power plants, electrical grids and substations, and the RES use are not subject to licensing.

However, the purchase of electricity for resale requires a license (see Schedule 1 of the Law “On Permits and Notifications” No. 202-V ЗРК dated 16 May 2014).

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BANKABILITY ISSUE N.1

Creditworthiness of the Single Off-taker

In practice, current mechanism of guaranteed off-take may not provide sufficient comfort for the lenders and investors, because the FSC is, apparently, not creditworthy enough as a single off-taker to make the renewable energy projects bankable in Kazakhstan. FSC is incorporated by KEGOC (national transmission grid operator of Kazakhstan) as a limited liability company (LLC) and its paid in charter capital is not known, but, generally, the legal minimum for LLCs in Kazakhstan is about 600 USD.

The FSC's only source of income is reselling (i.e. acquired from the Suppliers) generated power to the so-called "conventional customers" (the "**Conventional Customers**"), which mean (see section 2 of article 1 of the RES Law):

1) power generating organizations using coal, gas, sulfur-containing compound, oil products and nuclear fuel;
2) electric market participants acquiring electricity outside the Republic of Kazakhstan;
3) hydro-electric power stations (HPPs) located in one hydro-electric power complex with capacity of over 35 MW (save for HPPs put into operation after 1 January 2016).

It is evident, therefore, that FSC on its own does not have sufficient assets, whereas generated cashflows from the Conventional Customers are not assured.

In order to address this issue, the RES Law has been amended in April 2016, so that the so-called reserve fund is formed by the FSC at the expense of an additional component of the tariff value which is paid by the Conventional Customers. The reserve fund will be kept by the FSC in a special bank account and will be used only to cover financial gaps and debt of the FSC due to Suppliers. The debt arises from non-payment or delayed payment of the Conventional Customers to the FSC for supplied electricity generated by the Suppliers (see section 9-2 of article 1 of the RES Law). Relevant bylaws on how this reserve fund of the FSC would be formed and used, are not yet adopted as of July 2016.

BANKABILITY ISSUE N.2

Currency Risk

Fixed tariff payable by the FSC to the Suppliers for generated power is established in local currency (Kazakhstan Tenge) and, from April 2016, approved fixed tariffs are now subject to annual indexation based on changes in the exchange rate of the national currency against foreign currencies (see section 2 of article 8-1 of the RES Law).

Importantly, from April 2016 the fixed tariff rates can also be changed by the Government of Kazakhstan on annual basis and at the Government's whole discretion, however, such new fixed tariffs would take legal effect only in two years from the date of their first official publication (see section 3 of article 8-1 of the RES Law).

Before April 2016 amendments of the RES Law took legal effect, a major disincentive for the investors and lenders to participate in renewable energy projects in Kazakhstan was a currency risk. Once relevant bylaws on the procedure/mechanism of the currency indexation will be adopted (they are not yet promulgated as of July 2016), the legal framework in Kazakhstan should, generally, make the RES projects bankable.

BANKABILITY ISSUE N.3

Absence of Proper Legal Liability of the Conventional Consumers

As discussed above, on paper the Conventional Consumers are obliged to purchase all generated electric power from the FSC so to enable the FSC to pay in full and in time the fixed tariffs to the Suppliers. The RES Law, however, failed to give clear guidance on the potential liability of the Conditional Consumers in case they would refuse or delay the conclusion of the power purchase agreement with the FSC.

Moreover, the producers of “grey power” are expected eventually recoup the cost of their green power purchases from their end consumers. Increases of end user electricity tariffs are, however, a politically sensitive issue and electricity prices are capped by law. In this context, electricity producers could be prevented from recovering their renewable energy related costs in order to protect consumers from short term price increases. This political and regulatory risk affects the credibility and thus effectiveness of the Kazakh renewable energy scheme.

This, evidently, may lead to potential inability of FSC to meet its obligations to pay feed-in tariffs in time or even to insolvency of the FSC, whereas Kazakh law does not provide any state guarantee for obligations of the FSC to duly pay the feed-in tariffs and KEGOC’s liability for FSC as its only participant is limited by law to already paid-in charter capital (i.e. apparently 600 USD).

The concept of the reserve fund of the FSC introduced into the RES Law in April 2016 shall, evidently, mitigate this risk.

BANKABILITY ISSUE N.4

Absence of Proper Legal Liability of Transmission Companies

As discussed above, network operators (i.e. power transmission companies) are obliged to provide their services to the Suppliers free of charge.

The RES Law, however, failed to give clear guidance on the potential liability of the network operators in case they refuse or delay the conclusion of the agreement for transmission services.

This in practice may lead to the network operators being reluctant to provide free services to the Suppliers or even decline from conclusion of service contracts with the Suppliers.

In order to address this issue, the RES Law has been amended in April 2016 so that the form of the model contract on connecting RES objects, as well as the procedure and terms of its conclusion will be approved by a separate order of the Ministry of Energy of the Republic of Kazakhstan (this order of the Ministry is not yet promulgated as of July 2016) (see section 1-1 of article 10 of the RES Law).

Inclusion of the Renewable Energy Producers and RES Facilities into the Official List of Suppliers

In order for an investor to be able to conclude the off-take agreement with the FSC, such investor and proposed RES facility itself shall be first included into the list of eligible renewable energy producers kept by the Ministry of Energy (see section 4 of article 7-1 of the RES Law). Before April 2016, however, there were no clearly established procedure and time frame that investor shall follow to make such application to be included in such list of the eligible Suppliers.

Moreover, because the law was silent on this matter, in practice the Ministry of Energy could in its own discretion (i.e. criteria were not obvious) to make decision on inclusion or not of certain renewable energy producers to the official list.

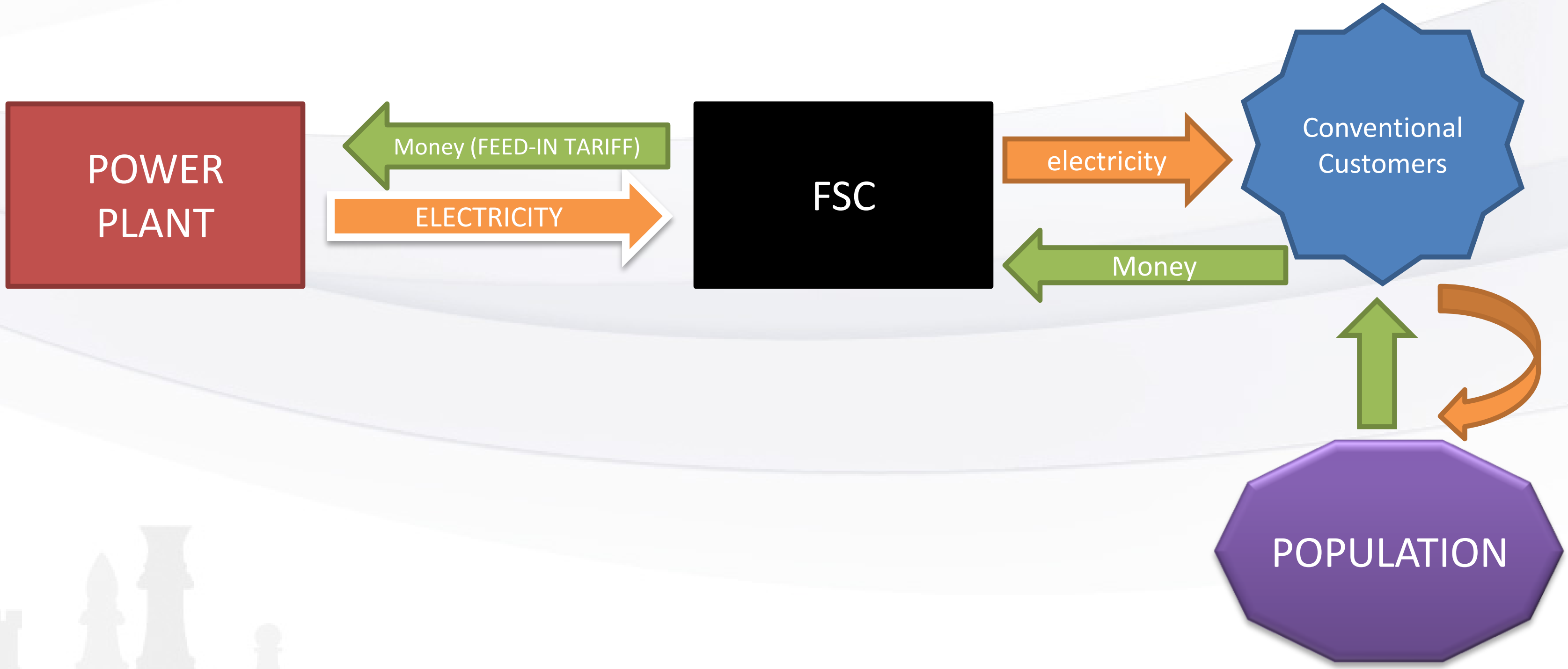
In particular, to the best of our knowledge, the Ministry of Energy in practice applies non-official deadline (apparently, 15 November of each year) in each particular year for applications for inclusion into the official list of Suppliers for the next year to be submitted by the investors with the Ministry. Furthermore, it seems there are certain non-official limitations on the number of renewable energy producers that can be included to such official list in each particular year.

Lack of State Control Over Volume of the RES-Generated Eclectic Power

The RES Law, evidently, does not provide clear tools for the Kazakh Government to control the volumes of renewable energy investments. The RES Law refers to a “scheme for the location of renewable energy installations” (see, for instance, paragraph 1, section 2 of article 3 of the RES Law), but it does not provide that this scheme can be used to limit the amount of renewable energy projects in Kazakhstan. An unexpected success of feed-in tariff schemes may result in a situation when the State is confronted with massive and excessive volumes of renewable energy projects that would, evidently, lead to pressure on consumer prices (e.g. as in European Union), inflation or even social unrest. Moreover , 15 years fixed tariffs and PPAs suggest that if, for example, the expected return of investments requires just 5 years of state subsidies, an investor will abuse state subsidies (i.e. feed-in tariffs) for additional 10 years that put the Government at risk of wasting budget funds.

In order to address this issue, the RES Law has been amended in April 2016, so that the so-called placement plan of the RES objects will be adopted by the Ministry of Energy taking into account the development targets of renewable energy sector (see section 5 of article 6 of the RES Law). The plan is aimed to identify the areas recommended for placement of RES objects for more effective state regulation for RES support. The rules for the placement plan of RES objects will be approved by separate order of the Ministry of Energy of the Republic of Kazakhstan (i.e. these rules are not promulgated yet as of July 2016).

SIMPLIFIED SCHEME OF RENEWABLE PROJECT IN KAZAKHSTAN



ANY QUESTIONS?

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