

4. ENERGY

Legal Aspects of Application of a “Green” Tariff as a Tool for Development of the Alternative Energy Sector in Ukraine.



Legal Framework

Considerable attention has recently been paid to introduction of energy efficient technologies and accordingly to improvement of the current laws in Ukraine. Thence there can be observed an existing trend of legislative amendments aimed at promoting development and attraction of investments in the renewable (alternative) energy sector of Ukraine.

Nowadays adaptation of the Ukrainian laws to the EU laws is a priority component of the Ukrainian policy given Ukraine’s aspirations to eventually gain full membership in the European Union. The Law of Ukraine “On the National Program of Adaptation of the Ukrainian Laws to the European Union Laws” provides for gradual adaptation of Ukraine’s own laws to those of Europe, so in the alternative energy sector, Ukraine is governed specifically by the provisions of Directive 2001/77/EC of the European Parliament and Council on the Establishment of Favourable Conditions for Sales of the Electric Energy, as Generated by Renewable Energy Sources at the Domestic Electric Energy Market” dated September 27th, 2001.

The principal legislative acts regulating the issues related to the introduction and development of the renewable energy industry in Ukraine are as follows:

- the Law of Ukraine “On Energy Saving” dated July 1st, 1994, as amended and modified by the Law of Ukraine “On Amendment of Certain Legislative Acts

of Ukraine Concerning the Promotion of Energy Efficiency Measures” dated March 16th, 2007;

- the Law of Ukraine “On Electric Energy” dated October 16th, 1997, as amended and modified by the Law of Ukraine “On Amendment of Certain Legislative Acts of Ukraine Concerning the Establishment of “Green” Tariff” dated September 25th, 2008, and by the Law of Ukraine “On Amendment of the Law of Ukraine “On Electric Energy” in order Encourage the Use of Alternative Energy Sources” dated April 1st, 2009;
- the Law of Ukraine “On Alternative Fuels” dated January 14th, 2000;
- the Law of Ukraine “On Alternative Energy Sources” dated February 20th, 2003;
- the Law of Ukraine “On the Combined Generation of Heat and Electric Energy (Cogeneration) and the Use of Waste Energy Potential” dated April 5th, 2005, etc.

The main principles of the state policy of Ukraine in the electric energy sector consist particularly in promoting the alternative energy industry as an environmentally friendly and fuel free energy subsector. To date, there exist the following mechanisms to encourage the alternative energy sector development:

- Establishment of a “Green” tariff – a special tariff rate – at which there is purchased the electric energy, as gen-

- erated by power generation facilities using alternative energy sources (except for blast furnace and coke gases, and as regards the use of hydro power it only pertains to that generated by small hydro power plants of installed capacity not exceeding 10 MW);
- commitment by the Wholesale Electricity Market of Ukraine to purchase the electric energy, as generated by power generation facilities using alternative energy sources, at the “Green” tariff;
 - establishment of the State Energy Conservation Fund in order to provide for funding of measures for the efficient use of fuel and energy resources (being of declarative nature);
 - tax and customs exemptions, namely:
 - (a) exemption from taxation of the profits realised by enterprises from sales, in the customs territory of Ukraine, of goods produced and of equipment operating on alternative and renewable energies, of energy efficient equipment and materials, the essential condition being the obligation to appropriately apply the funds released due to such a tax exemption having been granted, i.e. for the taxpayer to assign the funds to increase the production output;
 - (b) exemption from taxation of profits of the enterprises, which are put on the State Register of the Enterprises, Institutions and Organisations Engaged in Development, Implementation and Application of Energy Saving Measures and Energy Efficiency Projects, but in the amount not exceeding 50 per cent of the profit total subject to taxation;
 - (c) exemption from VAT of imports, into the customs territory of Ukraine, of the equipment operating on alternative and renewable energies or materials and components to be used to manufacture such equipment, energy efficient hardware and materials, with mandatory compliance with the prescribed conditions;
 - (d) exemption from duty of equipment operating on alternative and renewable energies, energy efficient hardware and materials, as well as supplies and equipment to be imported and used to manufacture the equipment operating on alternative and renewable energies, with mandatory compliance with the prescribed conditions;
 - Government subsidies to encourage development and application of energy efficient technologies, equipment and supplies (being of declarative nature) etc.

Application of “Green” Tariff

Business entities that have applied to the National Electricity Regulation Commission of Ukraine meet all the required conditions and have provided all the necessary information in full are entitled to have the “Green” tariff applicable thereto.

De jure the “Green” tariff may be established for the electric energy to be generated by alternative energy sources, which include solar, wind, geothermal, wave and tidal energy, hydropower, energy of biomass, organic waste gas, gas from sewerage treatment facilities, biogases, methane from coal deposit degassing, conversion of the waste energy potential of technological processes.

However, the fact that the Law of Ukraine “On Electric Energy” prescribes a mechanism of calculation of the “Green” tariff rate only for the electric energy to be generated from alternative energy sources such as energy of wind, biomass (i.e. of plant origin), solar radiation and hydropower, the latter only being generated by small hydro power plants, causes that de facto the “Green” tariff may be established for the electric energy, as generated at the power generation facilities using only these alternative energy sources.

However on April 29th, 2010, it was for the first time for the years of the “Green” tariff existence that the National Electricity Regulation Commission adopted a resolution approving a “Green” tariff for one of the enterprises generating the electric energy from an alternative energy source such as biogas.

The resolution is a precedent not only for the electric energy producers using biogas but also for the producers using all other kinds of alternative energy, as settled in the laws (geothermal, wave and tidal energy, energy of organic waste gas, the gas of sewerage treatment plants, methane from coal deposit degassing, conversion of the waster energy potential of technological processes), despite the lack of a mechanism for calculating the “Green” tariff for those energy sources.

Thus we can conclude that the position of the National Electricity Regulation Commission regarding the electric energy sector regulation is that a “Green” tariff may be approved for business entities generating electric energy with the use of any kind of the alternative energies, as provided by the laws of Ukraine, and the mechanism for calculating the “Green” tariff, failing its settlement in the laws, shall be prescribed immediately by the National Electricity Regulation Commission.

The “Green” tariff shall apply upon the following conditions:

- when electric energy is generated with the use only of alternative energy sources. In the event that electric energy is generated with simultaneous use of alternative energy sources and use of traditional kinds of energy, no “Green” shall be applicable;
- the share of raw materials, supplies, fixed assets, works and services of the Ukrainian origin in the cost of construction of an electric power facility generating electric energy with the use of alternative energy sources is not less than 30% - starting

from January 1st, 2012 – and at least 50% - starting from January 1st, 2014. In the production of electric energy with the use of solar power, already starting from January 1st, 2011, the share of the supplies and raw materials of the Ukrainian origin in the cost of manufacture of solar modules must be at least 30%;

- existence of a certificate witnessing the conformity of the electric power facility generating electric energy with the use of alternative energy sources to its design documentation, the requirements of the Government standards, and the construction norms and regulations.

For the “Green” tariff to be approved for them, business entities shall:

- apply to the National Electricity Regulation Commission of Ukraine (NERC) for a license;
- file an application in NERC for the “Green” tariff approval;
- become a player of the Wholesale Electricity Market of Ukraine.

Obtaining of a License to Engage in Electric Energy Generation, Transmission and Supply

The laws provide that in case a business entity owns or uses equipment generating electric energy with the use of alternative sources of installed capacity of not less than 10 MW or intend to sell the generated electric energy at the Wholesale Electricity Market of Ukraine it shall obtain a license to engage in electric energy generation, transmission and supply. Such a license shall be issued by an authorised Government agency – the National Electricity Regulation Commission of Ukraine.

Thus, before applying to NERC for a “Green” tariff, a business entity must obtain a license for generation of electric energy from alternative energy sources.

“Green” Tariff Approval

The National Electricity Regulation Commission of Ukraine shall exercise the powers, as vested therein, to approve the “Green” tariff, to establish or revise the “Green” tariff in order to encourage the generation of electric energy from alternative energy sources.

For a “Green” tariff to be approved for it, a business entity must file an application and a package of documents, as specified in NERC’s Resolution “On the Approval of the Procedure for Establishing, Revising and Terminating the “Green” Tariff for Business Entities” dated January 22nd, 2009.

The application and the documents shall be considered by NERC within 30 calendar days and, within the subsequent 15 calendar days, NERC shall adopt, at a public session, a resolution approving or refusing to approve a “Green” tariff for that specific business entity.

In case a “Green” tariff shall have been approved for a business entity, it must report quarterly to NERC on its activities of generation of electric energy from alternative energy sources.

Acquisition of the Status of a Player of the Wholesale Electricity Market of Ukraine.

The Wholesale Electricity Market of Ukraine is a market established by business entities to transact electric energy purchase and sale under the Wholesale Electricity Market Membership Agreement.

Upon obtaining the required licenses for electric energy generation and supply, in order to access Wholesale Electricity Market (WEM), a business entity must file an application and a prescribed list of documents in the Board of the WEM.

A resolution admitting the application to WEM or refusing to admit the same shall be adopted by the WEM Board within 30 days.

In case the WEM Board shall have adopted a positive resolution regarding a business entity, it shall be granted a 28-day period to sign the Wholesale Electricity Market of Ukraine Membership Agreement and thereafter such business entity shall acquire a full WEM membership.

Mechanism of Sales of the Electric Energy Generated from Alternative Energy Sources at the “Green” Tariff

According to the laws of Ukraine, a business entity that generates electric energy from alternative energy sources and that has had a “green” tariff approved for itself shall be entitled to make sales of such electric energy:

- immediately to the consumer;
- to State-Owned Enterprise “Energorynok” through the Wholesale Electricity Market of Ukraine.

However, though the right of a business entity to sell electric energy immediately to consumers is formal and provided by the Ukrainian laws, in reality, due to the immediate consumers lacking economic, social or administrative incentives to market the electrical energy generated from alternative energy sources, the cost of which is considerably more expensive as compared to the cost of the electric energy generated from traditional energy sources, it is almost impossible.

Thus, in practice nowadays, producers of the electric energy from alternative energy sources may only sell electric energy to SE “Energorynok” through the Wholesale Electricity Market.

Pursuant to the laws, SE “Energorynok” shall purchase, through the Wholesale Electricity Market, the electric energy, as generated at power generation facilities using alternative energy sources, at the “Green” tariff.

Essential Aspects of “Green” Tariff Application:

- the laws of Ukraine provide for a fixed minimum rate of the “Green” tariff and binds the “Green” tariff on Euro, thus, in case of implementation of a project of generation of electric energy from alternative energy sources, the investor is protected against UAH potential inflation;
- the “Green” tariff rate will be gradually reduced, due to reduction of ratio, which is one of the elements of the “green” tariff calculation formula. Thus, for the electric power facilities that generating electric energy from alternative energy sources, which are commissioned (or significantly upgraded) after 2014, 2019 and 2024, the ratio will be respectively reduced by 10%, 20% and 30% of its base rate;
- the whole amount of the electric energy generated shall be paid in full at the “Green” tariff through the Wholesale Electricity Market in cash, without application of any kinds of set-off of arrears in the payments for electric energy;
- in case of amendment of the laws governing the procedure for encouraging the generation of electric energy from alternative energy sources (namely the “Green” tariff application) business entities shall be subject to the previous procedure as in effect on the date of commissioning of the electric power facilities generating electric energy from alternative energy sources, unless such business entities wish to select a new procedure;
- the “Green” tariff shall be applicable until January 01, 2030.

Statistics

As of late October 2010, in the Register of Electric Power Facilities Using Alternative Energy Sources (except for blast furnace and coke gases, and as regards the use of hydro power it only pertains to small hydro power plants) there stand 53 business entities that use, in their electric energy generation, wind energy, energy of biomass, biogas, hydropower, solar energy, energy of coal gas, conversion of the waster energy potential of technological processes and of an atmospheric residue of the oil viscosity breaking process.

Among these 53 business entities generating electrical energy at electric power facilities with the use of alternative energy sources, 31 have had a “Green” tariff approved for themselves.

Kind of Alternative Energy Source				
Small hydro power plants	Wind power plants	Solar power plants	Bio-mass power plants	Biogas power plants
21	5	2	2	1

For comparison purposes, at the end of 2009 there were 42 business entities generating electric energy with the use of alternative energy sources, and 19 of them had a “Green” tariff applicable thereto.

Thus, today in Ukraine there is a tendency to increased interest of investors for such sector as generation of electric energy from alternative energy sources, primarily due to the introduction of Government incentives, which has significantly improved the profitability of such business entities.

Cogeneration in Ukraine

Cogeneration technologies that provide simultaneous generation of electricity and heat are being developed and implemented

all over the world. The economic efficiency of such technologies and their potential to reduce pollution make cogeneration

projects attractive for investors and for governments.

A few advantages of cogeneration technologies include:

- Inexpensive electricity due to high fuel efficiency and lower production costs;
- Reduction of hazardous pollutants and greenhouse gas emissions;
- Reduction of costs for electricity and heat transportation; and
- The possibility to use traditional types of fuel (coal, natural gas and oil) and also renewable power sources (biomass and geothermal energy).

In general, Ukraine has great potential for developing cogeneration projects. It has already created and is constantly updating a legal framework for implementing and managing cogeneration projects.

Legal Basis for Cogeneration in Ukraine

On the legislative level, cogeneration is governed primarily by the laws “On Electricity Industry”, “On Power Saving” and “On Combined Generation of Heat and Electricity (Cogeneration) and Use of Exhaust Power Potential” (the Cogeneration Law).

The first two laws regulate activities connected with generation, transmission and the supply of power and establish the legal, economic and social framework for activities in the field of electricity industry. The Cogeneration Law is more specific and regulates specific aspects of generation, transmission and supply of electricity and heat generated by cogeneration facilities.

Other areas of cogeneration that are regulated relate to investment, construction, tax and such other issues.

www.chamber.ua

Recommended for corporate matters in Ukraine by *The Legal 500 EMEA.*



Squire Sanders combines local experience and global resources to guide companies in Ukraine and around the world. We handle a full array of representations, from cross-border transactions to strategic planning. We advise international banks, manufacturers, mining companies, energy groups, communications enterprises, transportation companies, grain producers and traders, and many others throughout the region.

SQUIRE SANDERS

LEGAL
COUNSEL
WORLDWIDE

32 OFFICES | 15 COUNTRIES

BEIJING • BRATISLAVA • BRUSSELS • BUDAPEST • CARACAS • CINCINNATI • CLEVELAND • COLUMBUS • FRANKFURT
HONG KONG • HOUSTON • KYIV • LONDON • LOS ANGELES • MIAMI • MOSCOW • NEW YORK • PALO ALTO
PHOENIX • PRAGUE • RIO DE JANEIRO • SAN FRANCISCO • SANTO DOMINGO • SÃO PAULO • SHANGHAI
TALLAHASSEE • TAMPA • TOKYO • TYSONS CORNER • WARSAW • WASHINGTON DC • WEST PALM BEACH
INDEPENDENT NETWORK FIRMS: BEIRUT • BOGOTÁ • BUCHAREST • BUENOS AIRES • LA PAZ • LIMA • PANAMÁ • RIYADH • SANTIAGO

SQUIRE, SANDERS & DEMPSEY L.L.P.

WWW.SSD.COM

There are a number of regulatory acts adopted by the Cabinet of Ministers of Ukraine and other government bodies that are important for implementation of projects and use of electricity and heat produced at cogeneration facilities, especially, the acts of the National Electricity Regulatory Committee of Ukraine (the NERC), the regulatory authority responsible for issuing licenses and determining tariffs for electricity and heat produced by cogeneration facilities.

Considering the peculiarities of state regulation in the area of cogeneration, companies planning to invest in cogeneration projects must pay close attention to the following issues, especially when determining the economic feasibility of a project:

- The general implementation strategy for a cogeneration project involves construction of a cogeneration unit on the basis of certain power facilities or independently from such facilities. In the first case, special attention should be paid to controlling power and heat generating facilities and choosing the most effective form of cooperation with their owners, especially since most of the heat facilities/infrastructure are in municipal or state ownership with specific use limitations.
- Licenses, permits and other authorization documents are required by law before or during construction of a cogeneration unit and its operation.
- Prices and tariffs for electricity and heat produced at a cogeneration unit under certain terms are subject to state regulation.
- Land acquisition for the plant is also an important consideration.

Strategies to Implement Cogeneration Projects

If the cogeneration project is implemented through a modernization of state or mu-

nicipality-owned heat or electricity generators, the investor can choose one of the following strategies for acquiring rights to the assets: lease, concession or purchase of such facility (privatization). Alternatively, an investor may obtain use of the necessary assets through an agreement on joint activity without creating a separate legal entity, a joint venture with the creation of a legal entity or an asset management agreement.

Lease – Long-term lease is one of the most common and straight-forward strategies for construction of a cogeneration unit using objects that are in local or state ownership.

Despite its simplicity, this strategy has issues that can make it more complicated and less attractive for cogeneration activities. First, under the law “On State Budget for 2010” property that is in local or state ownership may be leased only pursuant to a competitive tender, which involves bureaucratic competition procedures. Second, the law restricts the flexibility of the terms and conditions of the lease agreement that may be entered into with the local or state authorities.

As to cogeneration projects that are leased, the issue of ownership right to upgrades and improvement of a leased object or compensation for such improvements are particularly important. Such issues should be clearly addressed in the lease agreement, taking into account restrictions imposed by law. For example, the Law of Ukraine “On Lease of State and Municipal Property” entitles a lessee to retain the upgrades made at its expense if they can be separated from the property without damage.

Concession – Concession is less commonly used than leasing. Concessions can only be applied in certain areas specified by the law. The Law of Ukraine “On Concessions” specifies that generation and/or transmission of electricity objects may be operated pursuant to a concession.

A concession is designed to protect state and local authorities' rights (i.e. the plant's owner) more than the investor's rights. However, one of the advantages of a concession over the other approaches with the owners of state or municipal property is the right of purchase of the object of concession. The law allows a purchase pursuant to privatization rules if under a concession agreement such property was created or built or upgraded for no less than 25 % of its value as of the date of privatization.

Purchase – Current law in Ukraine allows the state or local authorities to sell state or local property through privatization, provided that certain procedures are carried out. As a rule, privatization involves transfer of ownership rights to state and municipal property on a competitive basis.

However, the law prohibits certain objects from being privatized, such as heat distribution networks and infrastructure. Local authorities may also prohibit sale purchase of certain municipal enterprises or other municipal entities.

Partnership With Owners – Instead of acquiring rights to the assets themselves, investors may consider entering into a partnership with the municipal or state entity, to share in the ownership and management rights. Establishing a joint venture through the creation of a limited liability company is the most tested approach.

Public-Private Partnership

With respect to projects involving state or municipal enterprises, Ukraine has taken certain steps towards facilitating cooperation between state/municipal authorities and private investors. On October 30, 2010 the new Ukrainian Law "On Public-Private Partnership" (PPP Law) took effect. This law defines the principles, procedures and forms of contractual partnership between state and local authorities and private partners in different areas, including the area of production and supply of heat and electric-

ity. As part of such partnership, state/local and private partners may enter into agreements on concession, joint activity, product distribution and other agreements.

One of the advantages of the PPP Law is that it secures investors' rights. Under the PPP Law, rights and liabilities of the parties under a public-private partnership agreement are governed by the laws of Ukraine in effect on the date of its execution.

However, in joining a public-private partnership project one should remember that the private investor does not obtain ownership to the state or municipal property and the property must be returned to the state or municipal owners after the termination of the public-private partnership.

Licenses and Permits

Activities involving combined heat and electricity generation are subject to licensing by the NERC (the Cogeneration License). The owner of a cogeneration plant that supplies electric power and heat to other entities must obtain a license to supply electricity under a non-regulated tariff. Notably, the legislation that regulates licensing of supply of electric and heat power by cogeneration plants contains gaps that are covered under clarifications issued by NERC.

To obtain a Cogeneration License the owner of a cogeneration plant must submit to the NERC the following documents: (i) application; (ii) confirmation of fee payment; (iii) certified copies of state registration certificate and certificate for inclusion in the Unified State Register of Enterprises and Organizations of Ukraine; (iv) certified copies of statutory documents of owner-legal entity; (v) description of the business activity, including the list of cogeneration facilities; (vi) a copy of the permit for hazardous works and operation of hazardous machines, mechanisms and equipment; and (vii) a copy of the document confirming title to the cogeneration facility and such other documents.

The NERC has 30 days to decide whether to issue a license to the applicant or reject an application. The term of the license is determined by the NERC; however, it may not be less than three years.

While conducting cogeneration activities the licensee must adhere to the rules (licensing terms) for combined heat and electricity generation established by NERC Regulation # 997, dated November 2nd, 2005 (Licensing Terms). Among other issues, licensing terms prohibit “cross-subsidizing,” using profit gained from electricity sales for financial support of (i) heat generation or other, (ii) other activities of the licensee or (iii) affiliated companies of the licensee.

Construction and operation of the cogeneration facility also require a number of other permits, consents and authorizations from state or local authorities, including construction permit, permit for hazardous works and operation (use) of hazardous machines, mechanisms and equipment, etc.

Depending on to whom the owners of cogeneration facility want to supply electricity, the facility may be subject to “qualification,” which is conducted by the National Agency on Efficient Consumption of Energy Resources to confirm that the cogeneration facility complies with efficiency requirements provided in the Cogeneration Law.

If the owners of the cogeneration plant generate electricity for their own needs, or supply directly to particular customers there is no need to qualify the unit. However, supplying electricity to a wider range of customers or to the wholesale market will require qualification of the cogeneration facility.

Tariffs

Tariffs for electricity and heat generated by the cogeneration plant should be approved by the NERC.

Calculation and approval of tariffs on electric and heat power produced by the cogeneration plant is based on the Procedure of Calculation of Tariffs on Electric and Heat Power approved by the Regulation of NERC # 897 on October 12th, 2005 as amended (the Tariffs Procedure).

Tariffs are approved by the NERC for a year. The company must file with the NERC, at least 90 days prior to each year, the following documents: (i) calculation of tariffs; (ii) calculation of expenses per one unit of product; (iii) explanatory note; (iv) calculation of tariffs (monthly); (v) technical characteristics; (vi) reports forms of which established by NERC; (vii) data about number of the cogeneration plant staff; and (viii) data about the accounting value of the cogeneration plant. The applicant should also provide NERC with the investment program which is subject to approval by governmental energy authorities.

Tariffs on supply of electric power under non-regulated tariffs should be determined by an agreement between a supplier and purchaser of electricity. However, the NERC must approve the tariff for wholesale power if the cogeneration plant supplies the electric power to the Ukrainian Wholesale Electricity Market.

Rights to Land

An investor in a cogeneration facility should pay special attention to land issues at an early stage, as acquiring land-use rights for building a cogeneration facility is often a tricky process. If the land will be subleased, any defects in the original lease or registration of the original lease must be resolved. Also, land is often leased from local authorities, meaning that negotiations and approval for a lease or sublease can take a long time as well as a number of steps and approvals. Finally, if the land is owned by state or local authorities, then a competitive tender process may be required before the land can be legally leased or sold to a third party.