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NEW RULES OF THE GAME IN UKRAINE'S RENEWABLE ENERGY MARKET: IMPLICATIONS FOR INVESTORS AND THE INDUSTRY

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This week, on July 21, the Ukrainian Parliament (Verkhovna Rada) adopted the Law[1] on the Improvement of Support Measures for the Production of Electricity from Alternative Energy Sources. The Law is the compromise outcome of long-running negotiations between the Government and international renewable energy investors in Ukraine, reached under the Energy Community Dispute Resolution and Negotiation Centre.

The Law provides a reduction in tariffs for solar power plants and wind power stations and so alters the investment conditions in the green energy space, since their stability until 2030 had previously been guaranteed. Investors were forced to agree to the new conditions in the face of spiralling State debt from the sector and protracted lobbying by influential industrial consumers of electricity for even greater renewable tariff reductions.

The Government has long been arguing that the recent explosive growth in green energy production had made the previous tariff system unsustainable, so will be relieved to have brokered a resolution at this week's extraordinary Rada sitting. The issue had become even more pressing during the pandemic crisis, with the resulting fall in energy demand bringing even greater imbalance to the national energy market.

To sweeten the deal to investors, the Government has granted new guarantees of the immutability of the legislation as of the date of its adoption, as well as partial payment to green energy producers from the budget. However it has resisted investors' requests to extend the tariff agreement by to 2032. Below, we take a more detailed look at the background to the conflict that has been resolved, at least for now, by the new Law.

1 Law 3658 as for "Improving the conditions for supporting the production of electricity from alternative energy sources"

Background

What are Green Tariffs and how do they impact the country's energy balance?

Green tariffs are state subsidies for renewable energy facilities – solar power plants, wind turbines, small hydroelectric power stations and biomass power plants. In 2009, the law «On Alternative Sources of Energy» laid down special conditions for alternative energy production until 2030, fixing Ukraine's green tariff rate (in Euros, so passing the f/x risk to the Government) at one of the highest levels in the world, with an annual decrease until 2030.

A comfortable environment for alternative energy investors provided relatively quick returns on projects (4-7 years) but provoked exponential growth in renewable energy capacity, which exceeded the capacity of the energy system to balance the respective shares of renewable and conventional energy within the market: the capacity of renewable energy facilities increased by 30% in 2017, by 66% in 2018, and almost tripled in 2019.

The National Plan for Renewable Energy, adopted in 2014, provided for an increase in the share of green energy to 20% in 2020 (12 GW). As of the beginning of June, the installed capacity of renewable energy facilities connected to the Ukrainian electrical grid is 7 GW. This accounts for 8% of the total market in volume and 26% in revenue terms. According to the calculations of the National Commission for State Regulation of Energy and Public Utilities for the period of 2020-2022, green power production could increase by another 12 GW.

In this case, the share of renewable energy in the overall market could increase to 57%, at which point the Government would no longer be able to meet its obligations to purchase this increased supply, even on discounted tariffs. As of early July, **the State debt to the sector had already reached 15 billion hryvnias (over $550 million) and by the end of the year, it could exceed 26 billion hryvnias (about $960 million)**. To put this in context, this second amount is almost 25% of all "green" investments in Ukraine in 2019, and as much as 50% of the city of Kyiv's total annual budget for 2020.

What prompted the Government to change the market landscape?

The issue of alternative energy prospects in Ukraine became critical in spring-summer of this year. The accelerated launch of new green energy facilities against a sharp drop in demand due to the coronavirus pandemic (up to 15-20% in transport and mechanical engineering, for example) and decline in business activity has worsened the structural fragility of the energy market. There is a major over-supply in the market and some capacity must be withdrawn, intensifying the struggle between the groups of influence behind the different types of energy generation.

In April & May of this year, due to the energy surplus on the market, two units of nuclear power plants in southern Ukraine, at the Zaporizhia Nuclear Power Plant and the South Ukraine Nuclear Power Plant, were forced to halt production, with the remaining stations switched to reduced production volumes. This was due to a complex of reasons, including an increase in green energy production and a drop in consumption. Nuclear power generation fell by 35% in just one month and reached an historic low (49% of the total capacity): a major shift in a sector that strives to avoid sharp fluctuations in supply, partly for safety reasons.

The market situation has therefore contributed to the emergence of the so-called «green-coal paradox», whereby a growing share of renewable energy on the market has actually led to a parallel rise in demand for thermal (and more easily controllable) energy, which is needed to balance the market and ensure a regular flow of energy at all times. In Ukraine this easily controllable flow of energy is sourced from thermal power plants, meaning the market is in contravention of decarbonization targets established within the framework of Ukraine's obligations to the Energy Community and Paris Climate Agreement: the low emission development strategy of Ukraine adopted in 2018 targeted a reduction in carbon emissions of approximately 54% by 2030, compared with the baseline scenario for emissions growth if energy-efficient measures are implemented.

Key features of the Law

The new Law is based on a Memorandum of Understanding on the Resolution of Renewable Energy Problems signed on June 10th between the Ministry of Energy and both the European-Ukrainian Energy Agency and the Ukrainian Wind Energy Association from the business side. The Memorandum became the basis for a compromise between the Government and many (but not all) major green energy investors and was approved through the mediation of the Energy Community.

The key points of the Law are as follows:

- Reduction in tariffs for solar power plants by 15% and for wind farms by 7.5%
- Financing by the State budget for a "Guaranteed buyer" to pay for electricity at a "green" tariff in the amount of at least 20% of the forecast electricity generation from alternative sources
- The State also has confirmed the immutability of legislation in the field of alternative energy since the adoption of the law.

Notably, however, the Government resisted a request by a significant number of investors (acting via a number of industry associations and the American Chamber of Commerce) to extend the tariff agreement by an additional two years to 2032.

Government calculations show that the reduction in tariffs will reduce the deficit of the State "Guaranteed Buyer" by $230 million per year. The total amount of payments for "green" tariffs will decrease by 2 billion euros over the lifetime of the new structure, and the Government has committed to pay outstanding debts to investors by the end of 2021

The new Law was also supported by the large, influential industrial consumers of electricity (mainly ferroalloy plants)**, who had previously been lobbying hard for even greater renewable tariff reductions.** Their support was secured by an amendment exempting them from a green tariff surcharge, included in the tariff of the system operator Ukrenergo, for ten years (ie the lifetime of the new tariff agreement).

While the adopted Law is a welcome resolution to a major stand-off that was harming Ukraine's international reputation as an investor-friendly destination, it remains to be seen whether it will resolve situation fully. The State debt to renewable investors is considerable and must now be repaid by the end of 2021. At the same time, the Law changes the parameters of projects that are already being implemented (payback periods) and may lead to a revision of the terms of lending to projects by banks, which will entail additional costs for investors. In addition, future investment decisions cannot be taken with the same level of confidence as before.

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For further discussion or for advice on how to engage with relevant authorities, please contact: *ukraine@kesarev.com*

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