

## **Renewable energy projects – next destination for investments in Kazakhstan**

### **I. Why renewable energy?**

Renewable energy development has recently become hot topic in Kazakhstan that is actively being discussed among market existing and potential participants, relevant state bodies including the Ministry of Energy of the Republic of Kazakhstan (the “**MoE**”), international development institutions and other stakeholders.

In 2017, Kazakhstan has introduced auction mechanism for the selection of eligible RES projects that is aimed to ensure best prices for the consumers of energy and on transparency in the process of selection RES projects.

First auctions have been conducted in May-June this year. According to the MoE<sup>1</sup>, 8 sessions out of 10 have been successfully completed, with 42 participants from different companies (Russia, France, Bulgaria, Turkey, China and Kazakhstan). As a result, the tariffs for the consumers have decreased for wind stations by 20%, small hydro stations by 23%, solar stations by 25.5%. 19 companies have been announced as winners of auctions. Next round of auctions is planned for October 2018<sup>2</sup>, according to the following schedule:

Schedule of autumn auction trades:

No.	Type of RES	Volume of capacity to be purchased, mWt		Zone	Time of trades	Date of trades
		Small	Large			
1	Wind	50		Northern	14.00-17.00	03.10.2018
2	Wind		250	Northern	14.00-17.00	04.10.2018
3	Solar		30	Western	14.00-17.00	08.10.2018
4	Wind		50	Western	14.00-17.00	09.10.2018
5	Hydro		55	Northern, Southern	14.00-17.00	10.10.2018
6	Bio	10		All zones	14.00-17.00	11.10.2018
7	Wind	30		Southern	14.00-17.00	15.10.2018
8	Wind		100	Southern	14.00-17.00	16.10.2018
9	Solar	30		Southern	14.00-17.00	17.10.2018
10	Solar		150	Southern	14.00-17.00	18.10.2018

<sup>1</sup> [https://www.inform.kz/ru/ob-yavleniy-itogi-pervyh-kazahstanskih-torgov-po-vie\\_a3281055](https://www.inform.kz/ru/ob-yavleniy-itogi-pervyh-kazahstanskih-torgov-po-vie_a3281055)

<sup>2</sup> <http://energo.gov.kz/index.php?id=18005>

Why an investor shall consider financing a renewable energy project in Kazakhstan?

First of all, Kazakhstan has a huge untapped capacity of renewable energy sources (“**RES**”) due to suitable natural conditions. According to estimate of the MoE, the potential of wind power is 920 bln kWh per year, hydro power is 62 bln kWh per year, solar power is 3,000 solar hours per year<sup>3</sup>.

Secondly, the Government of Kazakhstan has a quite ambitious strategy for development of RES sphere (and, accordingly, tries to facilitate implementation of RES projects). Kazakhstan plans to increase the share of alternative energy in domestic electricity generation to 50% by 2050 with interim targets 3% by 2020 and 10% by 2030 (the current share is 1.1% in 2017).

Thirdly, within the recent years, Kazakhstan has developed quite favorable legal framework for foreign investments in general and in RES in particular (e.g. guaranteed offtake of the energy produced by RES stations at auction prices for the period of 15 years). General RES legal framework is discussed in more details below.

Fourthly, there is an increased interest of international development institutions to develop regulatory framework of RES and invest in RES in Kazakhstan. For example, the European Bank for Reconstruction and Development (EBRD) plans to invest approximately \$244.2 million in Kazakh RES projects.

We note, however, that notwithstanding advantages listed above, there are still legal and commercial obstacles for implementation of a RES project as discussed below. In practice the largest wind and solar projects developed in Kazakhstan so far (e.g. the Yereymentau wind farm in north-central Kazakhstan and the Burnoye solar power plant in southern Kazakhstan) have been financed by Kazakh state companies and the ADB, EBRD, EABR, i.e. by the players that are interested in development and not focused on income. There is an open question whether commercial investors (i.e. institutional investors which prioritize returns above all) will come to implement RES projects in Kazakhstan.

## *II. Legal Framework of RES in Kazakhstan*

### *No license is required*

Under Kazakh law, no license is required for the production of RES energy.

### *Guaranteed Offtake and PPA*

Kazakh Government provides guaranteed offtake of the energy produced by RES power station by a single off-taker.

Relevant power purchase agreement (the “**PPA**”) is concluded between the winner of auction – organisations that produces energy using RES (the “**RES producer**”) and LLP “Settlement Financial Center” (the “**Financial Center**”), the single quasi-state off-taker. Under

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<sup>3</sup> <http://energo.gov.kz/index.php?id=18005>



the PPA, the Financial Center is obliged to purchase 100% of energy produced by RES power station for the period of 15 years. The price at which the Financial Center purchases energy from RES producers, is determined at the auction conducted by the Government among RES producers (“**auction price**”). The auction price cannot be unilaterally changed by the Government once PPA is signed<sup>4</sup>.

Once the energy produced by RES power station is purchase by the Financial Center under the PPA, the Financial Center sells it to the so-called “conditional consumers” (energy producers that use traditional sources of energy such as coal, gas etc.) at the tariffs established by the Government. The conditional consumers are obliged to purchase RES energy from the Financial Center by the RES Law.

At the stage of PPA conclusion, the developer of RES project shall secure its obligations under PPA by provision of financial security in a form of guarantee deposit, bank guarantee or a standby letter of credit issued by the bank with high credit rating for the amount equal to KZT 10,000 per kWt of established capacity multiplied on capacity indicated in the register of auction winners<sup>5</sup>.

30% of the financial security will be withdrawn by the Financial Center if the RES producer does not start the construction of the station within 12 months from the moment of PPA conclusion.

The rest of financial security will be withdrawn by the Financial Center if the RES producer does not complete the construction of the station within: (i) 24 months for solar projects; (ii) 36 months for wind and biogas projects; and (iii) 48 months for hydro projects.

It is not clear if the financial security can be withdrawn by the Financial Center in case of breach by the RES producer of any other provisions of PPA.

#### *Auction Mechanism*

The auction mechanism of selection RES projects eligible for the guaranteed off-take has been recently introduced by amendments<sup>6</sup> to the Law of the Republic of Kazakhstan “On Support of the Use of Renewable Energy Sources” No. 165-IV dated 4 July 2009 (the “**RES Law**”).

The schedule of actions is developed by the MoE and placed on its website. The auction is organised and conducted online in the electronic system by Joint-Stock Company “Kazakhstan Electricity and Power Market Operator” (“**KOREM**”). In order to participate in the auction, the bidders shall meet qualification requirements for legal capacity (by provision of general corporate documents) and solvency (by provision of financial security). Financial security of the bidder can be provided either as a bank guarantee or a standby letter of credit issued by the bank with high credit rating and is KZT 2,000 per kWt of established capacity multiplied on capacity indicated in the application of the bidder.

The lots offered at the auction are divided by type of RES, location and volume of capacity. The bidders cannot see applications of each other. The only auction criterium is the price, i.e. the bidder who gives the lowest price shall be announced as the winner of auction irrespective of any

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<sup>4</sup> Article 8-1.3 of the RES Law

<sup>5</sup> Article 96 of the Order 164

<sup>6</sup> The Law of the Republic of Kazakhstan “On Introduction of Amendments and Additions to Certain Legal Acts on Electric Energy Issues” dated 11 July 2017 No. 89-VI (the “**Law 89-VI**”)



other criteria (e.g. the bidder that has a land plot and ready technical documentation for the project will lose to the bidder who does not have anything if the latter will offer the lower price). The auction prices offered by the bidders shall not exceed the maximal auction prices established by the Ministry of Energy.

Once the auction is completed and the winner of auction is determined, the Financial Center shall conclude PPA with the winner of auction. Based on the PPA, the winner enjoys the guaranteed off-take at the auction price (determined during the auction) from the moment of first energy supply to the electrical lines of energy transmission organisations<sup>7</sup>.

#### *Currency Indexation of Auction Price*

Auction prices are subject to annual indexation due to inflation and national currency (Tenge) fluctuations. Tenge/foreign currency indexation applies only for RES projects with loan obligations in foreign currency<sup>8</sup>.

#### *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.

Transmission companies are required to provide RES producers with free access to energy transmission grids, while RES producers 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.

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.

#### *Investment preferences*

Kazakh Government offers investment preferences for the investors implementing investment projects (including RES projects) in Kazakhstan. Such investment preferences include tax, customs preferences, grants etc. In order to enjoy such preferences, investor shall, in addition to PPA, conclude a so-called investment contract with the Ministry for Investments and Development of the Republic of Kazakhstan. Investment contract can be concluded only with Kazakh legal entity (including Kazakh legal entity with foreign participation).

### **III. Key Legal Obstacles for RES Projects Implementation**

Notwithstanding support provided for RES projects by the Kazakh Government, there are still certain legal and commercial concerns that investors shall consider before making a decision to implement a RES project in Kazakhstan.

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<sup>7</sup> Article 104 of the Order of the Minister of Energy of the Republic of Kazakhstan “On Approval of the Rules for Centralised Purchase and Sale by the Settlement Financial Center of Electric Energy Produced by the Objects Using RES, Recalculation and Redistribution of by the Settlement Financial Center of the Relevant Share of Electric Energy per One Qualified Conditional Consumer Based on the Results of the Year” dated 2 March 2015 No 164

<sup>8</sup> Article 8-1.2 of the RES Law

(i) *Creditworthiness of the single off-taker*

As mentioned above, Financial Center, the single off-taker under PPA, purchases RES energy from RES producers and then sells it to the so-called “conditional consumers” (energy producers that use traditional sources of energy such as coal, gas etc.) at the established tariffs. Financial Center is established solely for purchase/sale of RES energy and does not have its own assets or profit other than payments received from conditional consumers. Accordingly, the ability of Financial Center to pay for RES energy under PPA depends on payments by conditional consumers.

In order to address the risk of non-payment or delayed payments for RES energy by conditional consumers, so called reserve fund has been established. The reserve fund of the Financial Center contemplates 3% out of annual expenses of the Financial Center for the purchase of RES energy from RES producers. It seems that this amount is not sufficient to address the risk entirely. There were suggestions to appoint another legal entity with better financial position as a single off-taker (e.g. KEGOC that is system operator of electricity network in Kazakhstan), however, with no success.

(ii) *The terms of PPA cannot be changed*

PPA shall be concluded between the winner of auction and the single off-taker in a standard form established by the Kazakh Government. It is uncertain whether PPA standard form can be amended that makes it non - bankable since it is governed by Kazakh law and does not contain standard provisions required by international investors (step-in rights, international arbitration, compensation in case of early termination, insurance etc.).

(iii) *No tax preferences for RES projects*

As mentioned above, RES producers can apply for investment preferences. The following investment preferences are generally available under Kazakh law:

- (i) in relation to the so-called “investment projects”: exemption from custom fees and import VAT, state natural grant (e.g. free land plot); and
- (ii) in relation to the so-called “priority investment projects”: exemption from customs fees and taxes, investment subsidy.

Under current Kazakh law, RES projects cannot be qualified as priority investment projects and, accordingly, no tax preferences are available.

(iv) *Absence of proper legal liability of conditional consumers*

As discussed above, on paper the conditional customers are obliged to purchase all generated electric power from the Financial Center so to enable the Financial Center to pay in full and in time the auction price to RES producers under PPA.

The RES Law, however, fails to give clear guidance on the potential liability of the conditional consumers in case they would refuse or delay the conclusion of the PPA with the Financial Center.

(v) *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 RES producers free of charge.

The RES Law, however, fails 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 RES producers or even decline from conclusion of service contracts with them.

(vi) *Obtaining of a land plot*

Under PPA, RES producer shall start construction within 12 months from the date of signing of PPA, otherwise the Financial Center is authorised to withdraw 30% of the financial security provided by the RES producer at the auction stage. This deadline is challenging for RES producers that do not own a land plot/land use right at the time of PPA conclusion due to substantial time required in order to procure legal ownership for the land plot (e.g. land plots used for RES projects shall have appropriate designated use and it takes time to change it).

(vii) *It is not possible to conclude PPA with affiliate of the winner*

Under Kazakh law, the PPA shall necessarily be signed with the legal entity – winner of the auctions<sup>9</sup>. Accordingly, it is not possible to conclude PPA with, for example, 100% subsidiary of the winner or its affiliate. It makes it impossible for a foreign investor to participate in the auctions without establishing a local subsidiary first.

#### *IV. Key Commercial Obstacles for RES Projects Implementation*

(i) *Liquidity*

There is lack of cheap and long-term liquidity (i.e. Tenge) in Kazakhstan.

(ii) *Inconsistent governmental policy*

There is certain extent of political uncertainty and changes of governmental policy and legislation in Kazakhstan. PPA does not have legislation stability clause that may put at risk the whole guaranteed off-take structure and other incentives currently provided by the Government.

(iii) *Excess of power capacity in Kazakhstan.*

According to public sources, the production of energy in Kazakhstan in 2017 constituted 102 bln. kWh with consumption of 97 bln. kWh. Given the fact that the costs of renewables remain significantly above conventional power, the excess of power capacity in Kazakhstan may put at risk successful development of RES sphere in absence of sufficient level of demand in the market.

#### *V. Conclusion*

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<sup>9</sup> Article 60 of the Order of the Minister of Energy of the Republic of Kazakhstan dated 21 December 2017 No 466 “On Approval of the Rules of organization and Conducting Auctions, Including Qualification Requirements to the Participants of the Auctions, Contents and Order of Application Submission and Conditions of their Submission and Return and, Order of Summing Up the Results and Determination of the Winners”



The renewable energy legal and regulatory framework in Kazakhstan shall generally meet expectations of international investors, though certain legal and commercial risks still exist and shall be thoroughly considered. We expect that the Government will continue to consistently support RES sphere and undertake further improvements in consultation with international development institutions and market participants. In these circumstances we believe that RES sphere in Kazakhstan has good chances to be a success story.