UKRAINE'S RENEWABLE ENERGY CRISIS RUMBLES ON

Government looking to ratify further levy on renewable investors

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Issues & Sectors	**Green Tariff, Green Energy, Decarbonisation, Debt Crisis, Investment Climate**
Stakeholders	**Foreign investors, EU, EBRD, Government, Parliament**

In the coming days the Ukrainian Parliament (Verkhovna Rada) may begin to consider a draft law levying an increase in taxes on a range of business sectors, controversially including the renewable energy segment. The draft law removes electricity renewable energy sources (RES) from the list of sectors exempt from excise duty, effectively bringing in a new tax for solar and wind power plants at a rate 3,2% of the cost of renewable energy production. Despite the fact the solar and wind power accounts only for 7% and hydropower accounted for 5% of electricity generation, the green energy sector accumulated 26% of all monetary settlements between buyers and sellers of electricity as of May 2020 making the sector an important sphere from the financial standpoint.

Green energy producers have opposed the move, stating the new tax violates the Memorandum of Understanding (MoU) signed between the Government and RES investors in June 2020[1] to ease the conflict around the growing state debt to renewable energy producers (although not all RES investors signed the Memorandum[2], the Government effectively applied the new measures across the entire sector). The MoU provided guarantees against the deterioration of business conditions, scheduling the gradual repayment of state liabilities in exchange of voluntary reduction of green tariffs. It also enables RES producers to sue for changes in legislation that occurred after the MoU's legal framework came into force, should the investment conditions be ajudged to have worsened.

The stand-off between the Government and RES investors has become an issue impacting relations between Ukraine and the EU business community. At the end of April 2021, Lithuanian company Modus Energy International B.V. notified of its intention to file the first claim in international arbitration against Ukraine concerning the payment of debts for electricity produced but not paid for.

[1] Please see here for our earlier memo on the background to the renewable energy crisis.

[2] The MoU was signed by representatives of the Euro-Ukrainian Energy Agency and the Ukrainian Wind Energy Association. The Ukrainian Renewable Energy Association and individual companies are not signatories to the Memorandum.

The conflict between the State and investors is rooted in the systemic problems of the Ukrainian green energy sector. Solving the problem of green investments has already become a litmus test for Ukraine, suffering from a strong outflow of foreign direct investment[3]. In December 2020, the National Bank of Ukraine noted the further 'contraction of investment remains a key factor behind the drop in GDP' in Q3 2020 and 'unresolved issues in alternative energy also had a negative impact'.

Below we take a more in-depth look at the crisis that has gripped the sector since 2020 and try to analyse potential ways out of the impasse for the Government.

The memo will cover:

Position of business and international organisations

On June 22, 2021 the Secretariat of the Energy Community, the European Bank for Reconstruction and Development, the Black Sea Trade and Development Bank, the Netherlands Development Finance Company and the Institute for Development Financing sent a joint letter to the Rada, the Government and the Ministers of Energy and Finance of Ukraine, stating their view that the removal of the excise tax exemption represents a clear violation of the agreement signed by the Government last year (intended as a guarantee of a stable business environment) and that any further one sided legislative changes to impose or increase taxes will likely expose Ukraine to additional monetary claims for compensation.

This exchange took place against a backdrop of the ongoing dispute between the State and international RES investors, with one foreign investor already having announced its intention to pursue litigation against Ukraine and others having frozen their projects or being unable to draw on their financing:

- In April this year, the Lithuanian company Modus Energy *(which owns three solar power plants with a capacity of 40 MW)* announced[4] financial claims against Ukraine for EUR11.5m. Several other investors have since announced their intention to file similar claims[5].
- In early June, the Nordic Environment Finance Corporation (NEFCO) halted funding for new renewable energy projects due to the Government's failure to comply with previous agreements.
- In mid-June, Norwegian investor Scatec Solar *(which owns and operates six solar power plants with a capacity of 401 MW)* announced that, due to state debts to the company and the likely imposition of the excise tax, the company has lost 10% of its value.

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[3] According to data of the National Bank of Ukraine, the outflow of foreign direct investment (FDI) in 2020 amounted to USD868m, setting an unwelcome record over the past 20 years (in 2013-16 Ukraine attracted at least USD3.7bn annually). According to the head of the National Council, Bogdan Danylyshin, the outflow of FDI continued in the first half of 2021.

[4] In mid-June, the Ministry of Justice of Ukraine rejected all claims of government violations of its obligations under the Energy Charter Treaty alleged by the Lithuanian investor Modus Energy; Ukraine also denies the jurisdiction of the Arbitration Institute of the Stockholm Chamber to consider this dispute, but says it is ready to present its detailed position in 2022 after receiving a full claim from the plaintiff.

[5] In December 2020, the Kiev Commercial Court granted the claims of a number of companies to the «Guaranteed Buyer». Among the plaintiffs are «Vinsolar», «Biogas Energo», «Hydropower» and others. Total amount of claims - about $7.5 million.

- At the end of June, American investor VR Capital *(which owns solar and wind power plants with a total capacity of 576 MW)* stated it would freeze four projects if the draft Law on the introduction of the excise tax is supported by the Parliament.

Additionally, some green electricity generators are suing the state Guaranteed Buyer (the contracted state purchaser of renewable energy at pre-agreed tariffs) in the Ukrainian courts for unpaid debts: in May, 2021 a group of investors won a case in the court of the first instance against the Guaranteed Buyer, having sued for UAH800m (USD29m). The largest Ukrainian state-owned banks (PrivatBank, OshchadBank, UkrEximBank, UkrGazBank) have all suspended loans to renewable energy projects until the crisis is resolved, while the EBRD has not financed a single new project in the industry since early 2020.

Impacted investors now view the incoming excise duty as yet another attempt by the Government to renege on last year's renegotiated agreement and to yet again effectively lower the green tariffs. The new tax also comes in the middle of the first round of what promises to be a series of protracted legal battles between the Government and investors.

Despite these developments, some enterprising investors are still showing interest in the sector: since April 2021, Qatar's Nebras Power and French Total Eren purchased six solar power plants each. Seemingly motivated by lower prices demanded by less resilient, fleeing investors, these companies are buying already operating assets avoiding construction costs and driving further consolidation in the sector.

Green tariffs in Ukraine background

In 2009, Ukraine became a member of the Energy Community, the same year the Green Tariff mechanism was introduced. Since then, the State has guaranteed higher purchasing rates for suppliers of electricity from renewable sources, thereby stimulating the development of green energy: the Ukrainian Renewable Energy Association estimates that the industry has attracted USD12.3bn in investment since 2010, almost a quarter of all investment in Ukraine's economy since 1991.

In 2016, Ukraine joined the Paris Climate Agreement, committing herself to reducing atmospheric emissions and working towards alternative energy development. Two years earlier, the National Plan for Renewable Energy provided for an increase in the share of the green energy to 20% in 2020 (12,1 G), including large hydropower stations. As of 2020, however, solar and wind power accounted for just 7% of electricity generation, while hydropower accounted for 5%.

Despite this, the development of the renewable energy sector has been stalled since late 2019. The Government was effectively blindsided by the rapidly increasing share of electricity from renewable sources, to a level it was unable to afford under the Green Tariff structure: **despite its relatively small installed capacity, the RES sector accumulated 26% of all monetary settlements between buyers and sellers of electricity as of May 2020.** 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, increasing the share of renewable energy in the overall market to 57%.

Alarmed by the financial implications of this trend, the Government initiated discussions on the reduction of the green tariff, which resulted in the signing of the Memorandum last year with part of the market participants, as well as a number of actions that made it difficult to further implement the already agreed construction of already-planned solar and wind power plants.

Under the Green Tariff system, renewable energy is purchased by the State Enterprise (the "Guaranteed Buyer") at fixed (and inflated) tariffs and then supplied to consumers at market prices. However, the low market price (driven by state subsidies to households) has meant that the Government became locked into a multi-year system, purchasing at way over the market value and incurring spiralling losses year after year for state energy provider UkrEnergo as well as state nuclear (EnergoAtom) and hydro (UkrHydroEnergo) power producers, where most of the financial burden has fallen. Years of subsidized thermal power through subsidized coal prices[6] have further distorted the system, reducing the attractiveness of RES compared to traditional sources.

Rather than step back and try to reform the system for State energy companies, the Government has instead tried in vain to placate both sides, throwing financial support to EnergoAtom, coal-fired generation and to RES, allowing the crisis to grow.

Debt problem

In 2020, the Government proposed a reduction to green tariffs in exchange for the gradual payment of its unpaid commercial invoices owed by the Guaranteed Buyer to the green generator, which as of August 1, 2020 had reached UAH22bn (USD 800bn). The Government and some investors then agreed on a schedule for the payment of debt for electricity: 40% to be paid in Q4 2020 and the remaining 60% in equal 15% instalments throughout 2021.

Despite the agreement, the Government has not kept its full commitments: a**s of June 1, only 66% of the debt for 2020 has been paid and current payments for electricity are also not made in full.**

In 2019, Ukraine switched to a new energy market model, which implies free trade in electricity and a gradual transition to bilateral contracts between producers and big industrial consumers. At the same time, **the new model was distorted by the introduced mechanism of public special obligations (PSO), which imposed on state energy companies and industrial consumers the obligation to finance low electricity tariffs for the population**. The market imbalance has further increased due to the boom in the construction of solar and wind power plants, only increasing the burden on the state and the industrial sector. At the same time, large electricity consumers (mainly ferroalloy plants and other industrial entities) successfully pushed for a ten year exemption from a green tariff surcharge, included in the tariff of the system operator Ukrenergo.

The preservation of the system of cross-subsidies created severe distortions in the market, which caused the accumulation of total debts in the industry by about UAH70bn (about USD2.6bn).

The market also suffers from technological problems. The uncontrollable increase of the share of weather-dependent solar and wind power plants forced traditional power plants to reduce production, yet the absence of necessary infrastructure (in particular, high-capacity electricity storage systems) deprives the energy system of the required flexibility and often creates disbalances. The irony is that environmentally neutral nuclear plants are forced to decrease production, while coal and gas powered thermal plants remain fully operational, at least in part due to the lobbying efforts of influential local players.

Possible scenarios

Below we present the most likely, the negative and a more *optimistic* scenarios of how the situation may play out in Ukraine's alternative energy sector in the near future.

The likely scenario is characterised by halfway measures. The cancellation or postponement of the introduction of the excise duty on renewable energy will give the Government a respite in disputes with RES

[6] One way of subsidizing was the so-called formula "Rotterdam+", which was applied in Ukraine in 2016-2019. According to it, the prices on coal were defined as the sum of its price in Europe (in particular on the Rotterdam Exchange) plus the cost of delivery in Ukraine (although in fact coal was of Ukrainian origin).

companies. A slight increase in the cost of electricity for some categories of households (from July 1, 2021), as well as a general increase in taxes on the raw materials business (in particular, taxes on mining, etc.), will allow the Government to reduce debts to green generation and avoid massive claims for international arbitration. This scenario also assumes that companies will accept further delays in the payment of electricity already generated.

The foreign companies entering the Ukrainian market will stimulate the solution of the debt repayment problems for those renewable power assets already built. At the same time, this scenario implies the potential stagnation of the renewable energy segment: the absence or minimisation of the number of new projects will be perceived by the State as an additional burden on the industry and the budget. The existing technological limitations and the absence of market conditions for the sales of produced green energy considerably complicates further development of the sector in Ukraine.

We estimate the probability of this scenario at 50% due to the political turbulence in the country, which reduces the political will for reforms and provokes only halfway measures.

The negative scenario is characterised by the absence of reforms in the energy sector, the de facto halting of development of new renewable energy projects and considerable reductions of profitability for pre-existing solar and wind power plants. It could even lead to defaulting under their financing, leading to major negative repercussions for the whole financial sector of Ukraine.

Such a scenario does not imply a resolution to the problem, merely a postponement: the filing of substantial claims by foreign companies against Ukraine could delay the resolution of these disputes for 3 or 4 years. The very existence of such lawsuits, as well as any court victory for investors would contribute to a decrease in the investment attractiveness of Ukraine and a further outflow of investments.

We estimate the likelihood of this development at 15%. The actions of the Government and Parliament indicate attempts to come up with simple solutions to problems in the energy sector. At the same time, we are witnessing growing pressure from international organisations and business associations on the Ukrainian Government, which gives hope that a negative scenario will be avoided.

The optimistic scenario assumes the subordination of reforms in the energy market to the environmental agenda, the adherence to which is already declared at the level of the President of Ukraine and the Government. This scenario includes a set of strategic and tactical measures:

Tactical actions

- Creation of a legislative framework stimulating projects to create energy storage systems;
- Transition to market prices for electricity for the population and industry, elimination of subsidy mechanisms for population and coal-fired generation as well;
- Fulfilment of the terms of the memorandum with investors in RES (repayment of old debts and invariability of business conditions until 2030);
- Launching green auctions for new renewable energy projects.

Strategic actions

- Development and implementation of programmes for reforming the nuclear and coal industries. Determination of the place of traditional and alternative generation in the country's energy balance;
- Identification of sources of financing for programmes to decarbonise the economy (including by launching an internal Ukrainian analogue of the EU carbon tax).

The European Union is pushing Ukraine to adopt a set of “environmental” laws (in the field of waste management, environmental protection, industrial pollution, environmental control), which are part of

Ukraine's obligations under the Association Agreement with the EU. On June 11, 2021 the EU Ambassador to Ukraine, Matti Maasikas, said that the Ukrainian industry and the private sector should bear part of the burden of environmental transformation. Maasikas claimed the Ukrainian industry pays only 15 euro cents for one ton of CO_2 emissions, while in the EU the price has reached €50.

It is worth mentioning here that at the end of July, Germany and the United States (within the framework of the Nord Stream 2 agreement) announced that they intend to create a Green Fund for Ukraine (EUR 1 bn) to support the green transition. Receiving money from this fund is likely to be partly determined by Ukrainian government policy towards the alternative energy sector.

We estimate the likelihood of such a scenario at 35%. On the one hand, the Government and relevant ministers demonstrate an understanding of energy issues, although mostly taking the form of statements and declarations rather than specific policy measures.

In summary what happens next will be viewed as a key milestone in terms of strategy the Ukrainian Government will choose in terms of its relations with renewable energy companies. Decisions that violate the rights of investors can delay Ukraine's financial problems but may lead to a drop in investment attractiveness and a decrease in the competitiveness of the country's economy. And, conversely, adhering to agreements with investors and decisive reforms can bring the economy and relations with the EU and renewable energy investors as a whole to a new qualitative level, particularly given how critical both energy transformation and combating climate change have become to the EU agenda.

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