
Escalation of Ukraine’s Renewable Energy Crisis: A Year in Review

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As we previously [reported](#), by the end of 2019, Ukraine faced difficulties in complying with its feed-in-tariff (“FiT”) regime for the renewable energy sector because the FiT that the government owed to renewable energy producers substantially exceeded market prices.

In June 2020, the Ukrainian government and industry associations representing some (but not all) producers of renewable energy signed a Memorandum of Understanding (the “MoU”). The primary goal of the MoU was to solidify the financial position of the State-owned entity “Guaranteed Buyer” (“GB”), which is the offtaker responsible for paying FiTs to producers. The MoU contemplated that the FiT would be reduced and was implemented into legislation enacted in August 2020. The Ukrainian government, in turn, undertook to ensure GB’s timely payment of the (reduced) FiT and gradually repay the existing debt to renewable energy producers that had accrued since the beginning of 2020.

However, a year after the MoU, the payment crisis has not been resolved, but indeed has worsened. Ukraine is currently facing the first¹ of what may be numerous claims by foreign investors under bilateral and multilateral investment treaties in relation to Ukraine’s changes to the FiT regime. As discussed below, recent developments could give rise to additional investor-State disputes and claims against the Ukrainian government before national courts.

Ukraine attempts to impose an excise tax that would effectively further reduce the FiT

The Ukrainian government introduced a 3.2% excise tax for electricity in 2015, but renewable energy producers have been exempt from the tax to date. Renewable energy producers can only sell electricity to GB under a fixed tariff and cannot transfer the financial burden of an excise tax to consumers by increasing the selling price. Accordingly, imposing an excise tax on renewable energy producers would be tantamount to a reduction of the FiT by the rate of the excise tax. In recent years, the Ukrainian government has twice attempted to impose an excise tax on renewable energy producers.

During the 2019 renewable energy crisis, the Ukrainian government initially sought to deal with the FiT deficit by considering imposing an excise tax. A draft law providing for an excise tax for renewable energy producers at the rate of 30-40% leaked to the public but was never formally submitted to the Parliament. Nonetheless, renewable energy investors and producers were on alert

¹ In March 2021, Modus Energy International BV submitted a notice of arbitration to Ukraine under the Energy Charter Treaty. The arbitration is being administered by the Stockholm Chamber of Commerce.

for a possible shift from the *status quo*. Following pressure from renewable energy investors, the government agreed to include a stabilization clause in the MoU. In particular, under the MoU, the government undertook to refrain from introducing new legislation that could worsen business conditions for renewable energy producers, including in particular the imposition of additional taxes, fees or fines or further reductions in the FiT. Subsequently, this undertaking was codified in statutory provisions that guaranteed that: (1) the FiT as determined as of 1 August 2020 would not be reduced further; and (2) legislation in force on 1 August 2020 would continue to apply to renewable energy producers throughout the duration of the FiT regime, with certain exceptions (such as any subsequent legislation that would improve the economic position of producers).

Notwithstanding the stabilization provisions, the Ukrainian government tried again to impose an excise tax on renewable energy producers. On 1 July 2021, the Ukrainian Parliament adopted in the first reading Draft Law No. 5600, which provided for a 3.2% excise tax on renewable energy producers. Renewable energy investors, foreign creditors, and industry experts have expressed strong opposition to the Draft Law. On 17 September 2021, the Energy Committee of the Ukrainian Parliament, which is preparing the Draft Law for its second reading, excluded the excise tax provision from the Draft Law. Subsequent developments in the Parliamentary process will determine whether the excise tax could be re-introduced and ultimately enacted.

In the event the Ukrainian government imposes an excise tax on renewable energy producers, it may face additional investor-State claims by foreign investors under the Energy Charter Treaty and/or applicable bilateral investment treaties. For example, foreign investors in Ukraine's renewable energy sector may point to the stabilization provisions in the legislation in effect at the time of their investment to argue that, by effectively reducing the FiT rates through an excise tax, Ukraine breached the investors' legitimate expectations that they would receive the FiT guaranteed to them under the existing regulatory regime.

GB's delayed repayment of debt for renewable electricity generated in 2020

In the MoU, the Ukrainian government committed to ensure repayment of GB's debt to renewable energy producers that had accrued in 2020. In particular, GB was required to repay 40% of the debt in the fourth quarter of 2020 and 15% of the debt in each quarter of 2021. The repayments are significantly behind the agreed schedule. As of July 2021, only around 26% of the debt has been repaid (as opposed to the 70% repayment progress envisaged in the MoU). As a result, renewable energy producers have brought more than one hundred lawsuits against GB before the Kyiv Commercial Court seeking repayment of the debt and penalties under the applicable power purchase agreements. The producers' claimed damages in these lawsuits total approximately EUR 46 million.

In addition to the lawsuits described above, it is possible that certain renewable energy producers whose applicable power purchase agreements contain arbitration agreements may commence arbitration proceedings against GB in relation to the delayed debt repayments.

Concerns about the sustainability of the mechanism for financing the FiT

During the renewable energy crisis, one of investors' and producers' key concerns – and one of the main goals of the MoU – was to provide a sustainable mechanism for funding the offtaker, GB, and to ensure timely FiT payments for the renewable energy generated by the producers. Little progress has been achieved in this respect.

The burden of funding GB remains on Ukrenergo, the Ukrainian transmission system operator ("TSO"). In other words, the FiT owed to producers is financed solely from the TSO tariff (although the government undertook to finance 20% of the FiT directly, it has failed to do so – see para. (ii) below). The failure of the Ukrainian energy regulator to establish a TSO tariff sufficient to fully finance the FiT was among the key reasons for the very significant debt that GB accumulated in 2020.

Unusually high prices for electricity, which recently settled on the Ukrainian electricity market, have to a certain extent relieved the burden placed on the TSO tariff. However, the long-term sustainability of this funding mechanism is susceptible to further crises due to the following:

- (i) First, in addition to the obligation to purchase renewable electricity under the FiT regime, the Ukrainian government has imposed upon GB the public service obligations (“PSO”) to supply electricity to households at a below-market price. The resulting deficit (i.e., the difference in the price GB charged to households and the prices utilities could charge for electricity) is also covered by – and creates an additional burden for – the TSO tariff. As of June 2020, Ukrenergo owed approximately EUR 120 million to GB for this PSO deficit. The government has considered a new PSO mechanism that would relieve GB and Ukrenergo from the PSO of supplying electricity to households, but it is not likely that this new mechanism will be implemented soon.
- (ii) Second, at the end of 2020, the energy regulator increased the TSO tariff to a level that was sufficient to cover 80% of FiT payments for **current** renewable energy generation. Funds to cover the remaining 20% of FiT payments were supposed to be injected into GB directly by the government, but the government has not yet done so (however, it provided the state guarantees to Ukrenergo for issuing bonds in order to finance the entire debt). Notably, additional renewable energy generation facilities will be commissioned in 2021-2022. It is not clear whether the energy regulator will increase the TSO tariff further to cover additional FiTs.
- (iii) Third, the current level of the TSO tariff does not cover the amounts necessary to repay the debt to renewable energy producers that GB accrued in 2020. That debt will be repaid with borrowed money. In particular, at the end of 2020, Ukrenergo borrowed approximately EUR 300 million from Ukrainian State-owned banks to repay a portion of GB’s PSO and FiT debts. Ukrenergo has also declared that it will issue bonds for EUR 500-750 million to repay those debts in full. While this measure may resolve the problem in the short term, it does not completely eliminate the burden placed on the TSO tariff but rather carries it over to future years. As of June 2021, Ukrenergo owed approximately EUR 520 million to GB to finance the FiT deficit (this amount includes debts accrued in both 2020 and 2021).

The government has discussed alternative options for financing the FiT deficit (e.g., a carbon tax). However, no meaningful steps to detail or implement those options have been taken.

Electricity curtailments

With additional renewable energy generation facilities commissioned in recent years (and with little maneuvering capacity installed), electricity curtailments (i.e., the TSO’s dispatch instructions ordering electricity not to be delivered) have become a serious problem for renewable energy producers in Ukraine. As agreed in the MoU, in 2021, the government implemented a mechanism for the partial compensation of the FiT price for electricity not delivered due to curtailed output. Ukrenergo has been designated as the company responsible to compensate producers for such curtailments. This has created yet another burden for the TSO tariff.

Ukrenergo may curtail renewable electricity generation either through the specially designed Curtailment Management System (“CMS”) (in which case producers registered in the CMS are entitled to compensation) or through emergency dispatching commands (which do not entitle producers to compensation). In public statements, some renewable energy producers have argued that Ukrenergo abused its authority to order curtailments through emergency dispatching commands to avoid payment of compensation to producers. Ukrenergo has denied such allegations.

The Ukrainian government’s conduct with respect to electricity curtailments could give rise to investor-State disputes under the Energy Charter Treaty and bilateral investment treaties to which Ukraine is a Contracting Party. These treaties include an obligation to provide “fair and equitable treatment” (“FET”) to foreign investments and typically provide for investor-State disputes to be resolved through international arbitration. The FET obligation has often been interpreted to prohibit abuses of authority by the host State; to impose a duty on the host State to act in a consistent, transparent, and even-handed manner in exercising its administrative powers; and to protect foreign investors’ legitimate expectations regarding the regulatory framework in effect at the time the investments are made.

Foreign investors whose investments in the renewable energy sector have been adversely affected by Ukrenergo's electricity curtailment measures may argue that these measures violate Ukraine's FET obligation under the Energy Charter treaty or applicable bilateral investment treaty. For example, investors may argue that Ukrenergo acted arbitrarily and abused its power to issue emergency dispatch commands in order to avoid paying compensation that would otherwise be owed to producers. Investors who made their investments after Ukraine's enactment of the compensation regime for electricity curtailments may also argue that Ukrenergo's conduct breached the investors' legitimate expectations that they would receive partial compensation of the FiT price in accordance with this regime.

Conclusion

A year after the MoU was enacted into law, Ukraine's renewable energy crisis continues. Contrary to the government's commitments under the MoU, GB's debt to renewable energy producers accrued since the beginning of 2020 remains outstanding. The mechanism for financing the FiT deficit through the TSO tariff also necessitates improvement. Although thus far only one foreign investor has commenced investor-State arbitration against Ukraine concerning the recent changes to the FiT regime, further attempts by the government to reduce the FiT through imposition of an excise tax or to avoid its obligation to compensate producers for electricity curtailments, as well as continuous failure to ensure full repayment of the FiT (all contrary to the government's commitments under the MoU) may lead other renewable energy sector investors to consider legal actions against the State. The investors apparently will look at whether Ukrenergo will be able to raise financing through issuance of bonds in the amount sufficient to repay all debts of 2020 and 2021. This is likely to be critical for their choice to move ahead with legal actions.

Wilmer Cutler Pickering Hale and Dorr LLP and INTEGRITES have significant experience in advising and representing clients in international investment disputes, including in particular in the energy sector, and can provide more detailed advice on recent and new developments in Ukraine relating to the issues discussed in this alert.

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