

# RES Tariff Indexation Formulas in Kazakhstan and Their Shortcomings

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## Tariff indexation formulas

The existing financial risks of investors in the renewable energy market of Kazakhstan, associated with the volatility of the Kazakhstani tenge against the US dollar, led to the introduction of a tariff indexation system. Therefore, in order to cover the currency risks of investors, the Decree of the Government of Kazakhstan dated February 3, 2016<sup>i</sup> determined and approved the indexation formula for fixed tariffs. Now, taking into account all the changes made, this formula looks like this:

i. 30% to 70%<sup>ii</sup> (formula in footnotes), where:

30% - changes in the exchange rate of the tenge against the US dollar;

70% - changes in the level of inflation in Kazakhstan (with changes in the level of the consumer price index).

After the introduction of the auction mechanism<sup>iii</sup>, the auction price indexation formula was the same as that of the fixed tariff. However, in order to attract investors of cheaper debt financing and the corresponding development of the renewable energy market in Kazakhstan, the formula for indexing auction prices, taking into account the estimates of international rating agencies, was calculated inversely:

i. 70% by 30%<sup>iv</sup> (formula in footnotes), where:

70% are related to the change in the exchange rate of the tenge against the US dollar;

30% with the level of inflation in Kazakhstan (with changes in the level of the consumer price index).

## Current situations

At the moment, there is a question of attracting international investors in order to implement large renewable energy projects in Kazakhstan, over 500 MW with an energy storage system. The need to hold auctions for these large facilities is due to (i) the phased replacement of fossil fuel generation, and (ii) the goal of reducing renewable energy tariffs.

The implementation of such large projects also involves the attraction of debt financing, as well as consideration of the risks associated with them, including currency ones. Therefore, taking into account (i) the purchase from foreign suppliers of equipment and components for the construction of renewable energy facilities in US dollars, (ii) the geopolitical situation in the world that has an impact on the volatility of the Kazakhstani tenge, and (iii) the time period, after which the provision of the Rules on the indexation of tariffs for renewable energy facilities is applied, it should be assumed that the currently available auction price indexation formula does not fully cover the currency risks of investors. Therefore, under such conditions, large international investors may not be interested in the implementation of large renewable energy projects.

## Proposed solutions

To attract investors, various RES market players and RES associations proposed the following changes to the Rules:

- in terms of changing the indicator on the level of the consumer price index. Namely, to replace the indicator of the consumer price index of the Republic of Kazakhstan from 30% to the indicator of the US producer price index. That is, it is 10% for solar power plants and 25% for wind power plants.

- to consider the possibility of applying indexation formula for the period of (i) planning the construction of a renewable energy facility, (ii) the construction of the facility itself and (iii) the commissioning of the facility. According to the current provisions of the Rules, indexation is applied no earlier than one calendar year after the start of the supply of electricity from renewable energy facilities to the settlement and financial centre<sup>v</sup>. That is, the current provisions of the Rules do not consider the currency risks of investors for the period of planning the construction, construction and commissioning of a renewable energy facility.
- in terms of (i) the frequency of application of indexation and (ii) the methods for determining the value of the average exchange rate of the Kazakhstan tenge against the US dollar.

## Public discussions

As of today, there have been many hearings on the indexation formula issues. Kazakhstani renewable energy players and associations are actively discussing and proposing possible changes to the indexation formula to create a favourable financial climate for potential and existing investors. We believe that through these hearings and the proposed changes, the tariff indexation formula will undergo changes in terms of reducing financial risks for investors.

In general, the issue of changing the tariff indexation formulas, eliminating their shortcomings and their corresponding impact on the final consumer requires careful study and analysis in order to reduce the possible foreign exchange risks of investors and to avoid a significant increase in tariff prices for the final consumer.

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<sup>i</sup> Decree of the Government of the Republic of Kazakhstan dated February 3, 2016 No. 50 On amendments and additions to the Decree of the Government of the Republic of Kazakhstan dated March 27, 2014 No. 271 “On approval of the Rules for determining fixed tariffs”

<sup>ii</sup> paragraph 11-2 of the Decree of the Government of the Republic of Kazakhstan “on approval of the Rules for determining fixed tariffs and marginal auction prices” dated March 27, 2014 (hereinafter referred to as the “Rules”)

$$T_{t+1} = T_t * (1 + 0,7 * \text{ИПЦ}_t - 100\% + 0,3 * \text{USD}_{t+1} - \text{USD}_t / \text{USD}_t)$$

<sup>iii</sup> Decree of the Government of the Republic of Kazakhstan dated May 10, 2018 No. 249 On amendments to the Decree of the Government of the Republic of Kazakhstan dated March 27, 2014 No. 271 “On approval of the Rules for determining fixed tariffs and marginal auction prices”

<sup>iv</sup> paragraph 18 of the Rules

$$T_{t+1} = T_t * (1 + 0,3 * \text{ИПЦ}_t - 100\% + 0,7 * \text{USD}_{t+1} - \text{USD}_t / \text{USD}_t)$$

$T_{t+1}$  – indexed auction price calculated according to the above formula, rounded down to whole tiyns;

$T_t$  is the auction price, taking into account the earlier indexation, if such indexation was previously carried out;

$\text{CPI}_t$  - consumer price index accumulated for the twelve months preceding October 1 of the year of indexation, determined according to the data of the authorized body in the field of state statistics;

$\text{USD}_{t+1}$  is the current exchange rate of tenge against the US dollar as of October 1 of the year of indexation, determined according to the data of the National Bank of the Republic of Kazakhstan;

$\text{USD}_t$  is the average exchange rate of tenge against the US dollar, calculated for the period of twelve months preceding the date of indexation, determined according to the data of the National Bank of the Republic of Kazakhstan

<sup>v</sup> paragraph 13-1 of the Rules