



Russian Electric Power Sector: Legislative Overview at a Glance

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Russian Electric Power Sector: Legislative Overview

The Russian electric power sector consists of generation (divided into wholesale and retail markets), transmission and distribution. The majority of generation facilities in Russia operate on natural gas and associated petroleum gas and are both privately and state owned. The nuclear and hydroelectric power facilities as well as the major transmission facilities are controlled by the state.

The current structure of the power sector is a result of reforms that began over 10 years ago. Prior to the beginning of these reforms, all the facilities operating in the power sector were part of a fully integrated state monopoly, RAO UES, and the prices in the power sector were fully regulated by the state. The reforms unbundled the holdings of RAO UES into entities with diversified ownership and began the formation of a competitive market.

The prices at the power market have been gradually liberalized during the recent years, and currently about 80% of electric power is traded at nonregulated market prices. While the reforms envisage that all electric power will be traded at market prices in the future, the population is likely to continue to receive electric power at state-regulated prices. Moreover, the competitive market will not extend to certain geographically isolated regions of Russia (namely, the Russian Far East, Kaliningrad and Arkhangelsk regions).

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Structure of the Russian Power Market

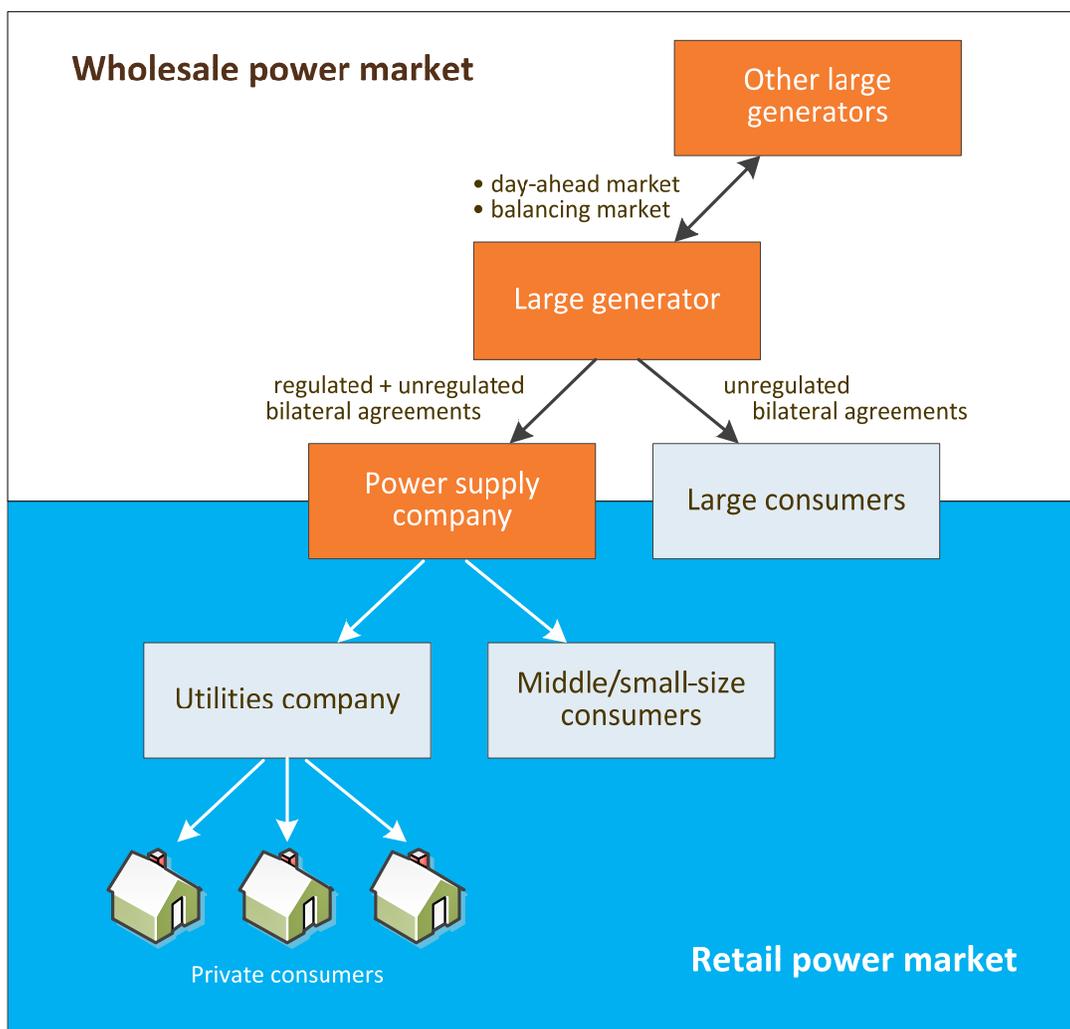
The Russian power market is divided into two separate levels: wholesale and retail.

The wholesale market is primarily intended for the trade in power between generating companies and suppliers, as well as certain large end-consumers. The participants in the wholesale market also trade in capacity (separately from trading in power per se).

At the retail market, power is sold by suppliers to consumers (both industrial and domestic).

The Russian power market generally prohibits a single company from combining generation, transmission and dispatch activities.

Scheme 1. Wholesale and Retail Power Markets

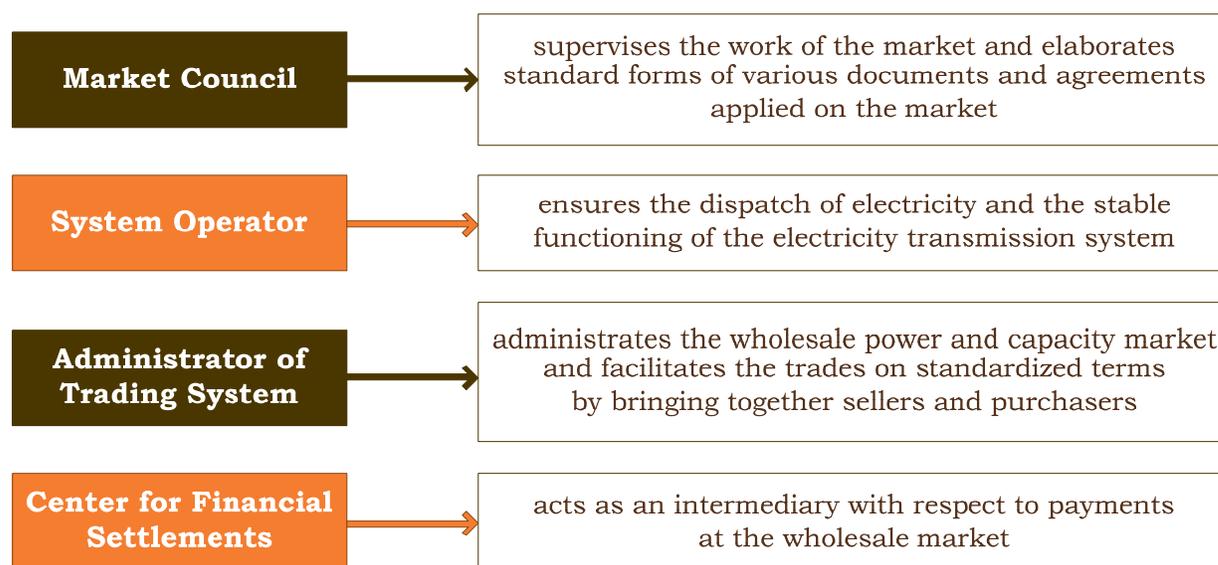


Market Infrastructure Bodies

The Ministry of Industry and Energy is primarily responsible for the electric power sector. The physical operation of the power system is produced by the following market infrastructure bodies:

- **Market Council:** a non-commercial partnership of the wholesale market participants that supervises the work of the market and elaborates on standard forms of various documents and agreements applied on the market. The Market Council is governed by a supervisory board that comprises representatives of market participants, of the Russian Government and of other market infrastructure bodies.
- **System Operator:** joint-stock company “System Operator – Centralized Dispatching Administration” (“System Operator”) has been set up to ensure the dispatch of electricity and the stable functioning of the electricity transmission system. The System Operator is currently 100% state-owned.
- **Administrator of Trading System:** joint-stock company “Administrator of Trading System” (“Administrator of Trading System”) is a nonprofit entity established as a fully owned subsidiary of the Market Council. The Administrator of Trading System administrates the wholesale power and capacity market and facilitates the trades on standardized terms by bringing together sellers and purchasers.
- **Center for Financial Settlements:** closed joint-stock company “Center for Financial Settlements” (“Center for Financial Settlements”) is a fully owned subsidiary of the Administrator of Trading System and acts as an intermediary with respect to payments at the wholesale market.

Scheme 2. Power Market Infrastructure Bodies



Wholesale Market

The wholesale market is open to generators and suppliers satisfying applicable minimum requirements and to large end-consumers.

In order to enter into the market an applicant must:

- demonstrate that the volume of planned electricity generation or consumption is high enough to be eligible for the wholesale market;
- enter into an agreement on accession to the trading system of the wholesale market and complete certain conditions in such agreement (the conditions usually include connecting to the closest transmission facilities and installing special metering equipment);
- enter into a number of other agreements required for functioning of the wholesale market, including agreements for transmission and dispatch services; and
- become a member of the Market Council.

There are four principal mechanisms by which power can be traded on the wholesale market:

Scheme 3. Power Trade at Wholesale Market



Regulated Price Agreements

While the Russian power market is gradually transitioning from regulated power tariffs to free-market prices, a certain amount of power (currently about 20%) continues to be sold at regulated prices. The regulated agreements are viewed by the Russian authorities as a temporary measure to ensure a smooth transition to free-market pricing.

The entry into regulated agreements for a defined volume of power is compulsory for wholesale market participants. The regulated tariffs are set for each

generating company by the Federal Tariffs Service. The term of regulated agreements varies from one to three years depending on the category of purchaser.

Free Price Trading

The wholesale market participants may trade power at free prices (i) on the day-ahead market, or (ii) pursuant to bilateral unregulated agreements.

The day-ahead market is based on competitive selection of bids submitted by suppliers and purchasers for the following day. On the basis of submitted bids an equilibrium price is determined by the market infrastructure bodies. Such price also takes into account system constraints and line losses.

Unregulated bilateral agreements may be concluded between the participants within the same pricing zone. They must contain certain key terms and be registered according to the prescribed procedure. For technological reasons, the wholesale power and capacity market is divided into three independent geographic zones:

Scheme 4. Pricing Zones



This division is important for a number of reasons; in particular, power can be traded at free prices only between participants within the same pricing zone.

In case of imbalance between the scheduled and actual generation/consumption, each market participant must sell or purchase power at the balancing market in order to correct any deviations.

The amount payable or receivable by the participant as a result of trading at the balancing market, with respect to its deviations occurring in each billing period, is calculated as the sum of the value of deviations occurring in each hour of that billing period.

Capacity Market

In Russia a separate capacity market exists with respect to participants in the wholesale market. The purpose of the capacity market is to encourage investment into renovation of old infrastructure and construction of new power infrastructure facilities through capacity payments. The capacity trade is reported to bring up to 40% of the annual income of wholesale power market generators.

Formally, the product which is traded as “capacity” is the obligation of generating companies to maintain a certain level of generating capacity, which can involve obligations to maintain or repair existing generating facilities as well as to construct new ones, and the corresponding obligation of consumers at the wholesale power market to pay for availability of the relevant level of capacity. All wholesale power market consumers are obliged to purchase, on an annual basis, capacity in the volume corresponding to their actual peak demand.

About 80% of capacity is traded through competitive bidding process conducted by the System Operator on an annual basis. The wholesale market participants bid in the current year for the capacity supply to happen in the following three years and determine through such bidding process the supply terms, including the capacity price.

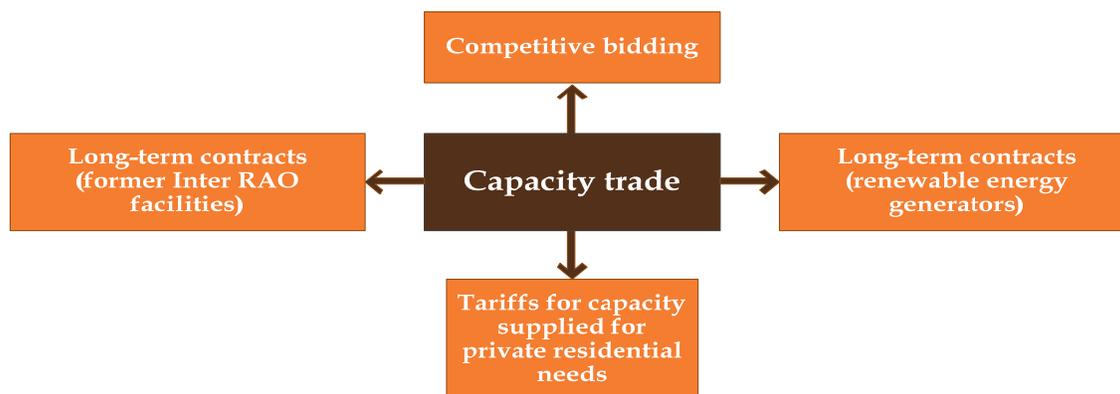
In certain areas of Russia with low competition and/ or domination of one or more suppliers, the Federal Antimonopoly Service establishes the maximum price for capacity that cannot be exceeded regardless the results of the bidding process.

Capacity is also traded on the following basis:

- (i) long-term (up to 10 years) capacity supply contracts concluded with respect to certain generating facilities of the former Inter RAO that have “inherited” modernization and/or construction obligations from the investment program of Inter RAO. Such long-term capacity supply contracts are aimed at supporting the investment in relevant facilities. The list of such facilities is specified in Resolution of the Government No. 1334-r dated 11 August 2010;
- (ii) tariffs established by the authorities with respect to capacity supplied for private residential needs;
- (iii) long-term (up to 15 years) capacity supply contracts concluded with eligible renewable energy generators (more details in Section “Renewable Energy” below).

The payments under the capacity supply contracts are done through the intermediary of the Center for Financial Settlements, acting as an agent among generators and consumers on the basis of agency agreements concluded by each wholesale power market participant as prerequisite for accessing to the wholesale power market.

Scheme 5. Capacity Trade and Wholesale Market



Retail Market

The main participants in the retail market are consumers of electricity, suppliers, distribution companies and generators that do not have the right to participate on the wholesale market, because the volume of their power generation or consumption is not high enough to be eligible for the wholesale power market. The retail market generally operates on the basis of “translation” of prices from the wholesale market to the retail market, i.e., power price deregulation on the retail market proceeds in tandem with that on the wholesale market. The residential tariffs, however, will continue to be regulated by the Federal Tariffs Service until the Government decides otherwise.

In order to ensure that every consumer has access to power, the regulatory regime provides for a network of “guaranteeing suppliers”. A guaranteeing supplier has an obligation to enter into a supply agreement with any customer within its territory. The initial guaranteeing suppliers were appointed by default from among the successors of RAO UES in each particular region. Currently, the guaranteeing suppliers are appointed pursuant to an open tender organized by local authorities once every three years.

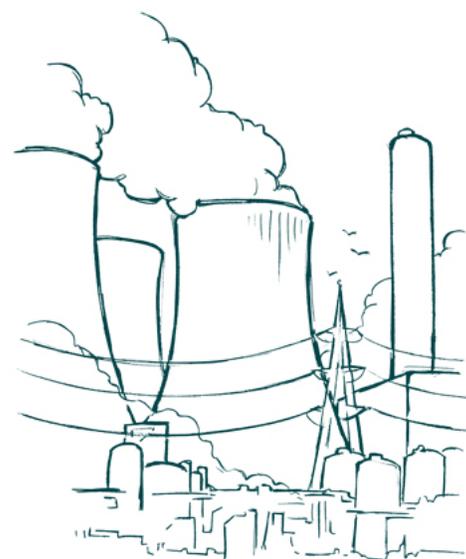
Consumers at the retail market are free to choose their supplier and to change their previously selected supplier at any time. In May 2012, amendments were made to the regulation of the retail power market that significantly simplified the procedure for such change. Among other things, consumers are no longer required to pay a sales mark-up to the guaranteeing supplier provided that the change takes place after providing a nine months’ notice to such supplier. When a retail customer changes its supplier, the new supplier is entitled to buy power from the former supplier to meet the consumer’s demand on a transitional basis.

Either consumers of power contract for transmission services themselves, or their supplier procures transmission on their behalf. An agreement for provision of transmission services must contain certain terms, including the obligation for parties to install and maintain metering equipment.

Transmission and Distribution

Transmission and distribution of electric power are classified under Russian law as natural monopoly activities. Therefore, access to transmission and distribution should be provided on a nondiscriminatory basis and cannot be denied as long as the respective facilities are capable of such provision.

The high-voltage transmission and distribution facilities that meet certain criteria form part of the Unified National Electrical Grid (“UNEG”). The UNEG is the collective name for the transmission and distribution facilities that are of particular importance for power transmission and distribution in Russia. The UNEG is managed by the Federal Grid Company, a joint stock company controlled by the state. The law does not require the UNEG facilities to be fully owned by the Federal Grid Company. However, the entities that own transmission or distribution facilities that qualify as forming part of the UNEG must lease them to the Federal Grid Company and accept its management with respect to such facilities. This obligation results from the general prohibition for a company to combine generation of power with its transmission and distribution. The generating companies that own transmission or distribution facilities that do not qualify as part of the UNEG (i.e., that are not high-voltage transmission or distribution facilities) are required to rent these facilities to local transmission and distribution companies.



The payment for transmission and distribution services is established by the Federal Tariffs Service and does not form part of the envisaged transition to market prices. The tariffs are established annually with respect to each constituent entity of the Russian Federation in accordance with the methodology established by the Government. As part of transmission tariff, the users of transmission services also pay for normative levels of line losses.



Renewable Energy

During the period of 2009 to 2013, Russia introduced legislation supporting the development of renewable energy projects by allowing renewable generators to bid, through a competitive selection process, for the opportunity to enter into long-term contracts for supply of capacity which is traded as a separate commodity independent from trade in power.

The capacity supply agreements, in essence, are intended to ensure that the investors to secure a return on their investment into renewable energy projects through guaranteed capacity payments payable over a term of 15 years.

The capacity supply agreements are concluded pursuant to a standard form between an eligible renewable energy generator and wholesale power market consumers through an intermediary of a regulator, the Center for Financial Settlements. In order to become eligible for entering into the capacity supply agreements, a generator must undergo a competitive selection process through a renewable energy auction. The projects must meet rather stringent local content requirements and are selected solely with regard to planned capital costs.

To comply with the local content regulations, selected wind, solar and hydro projects in 2015 had to be able to source 55, 50 and 20% of production equipment from within Russia's borders, respectively. In 2016, those figures increased to 65, 70 and 45%.

Supporters argue capacity auctions encourage investment in new generating capacity by providing a guaranteed financial return on investment and thereby enhancing projects' 'bankability'. Critics argue that capacity auctions incentivise inefficient investment because projects are developed primarily to cash-in on capacity payments and may not meaningfully generate power (albeit developers should naturally have an incentive to maximise investment return by doing both).

Annex 1

Primary Legislative Framework

The legislative framework with respect to the electric power market in Russia consists of a significant number of legislative acts; the key legislation is listed below.

General regulation	Federal law No. 35-FZ “On Electric Power,” dated 26 March 2003	<i>provides the general framework for the regulation of the electric power market in Russia</i>
	Federal law No. 36-FZ “On Specifics of Functioning of the Electric Power in the Transitional Period and Amending Certain Legislative Acts of the Russian Federation...,” dated 26 March 2003	<i>outlines how the power market should function during the power sector’s transition from state control to market regulation</i>
Wholesale market	Government Resolution No. 1172 “On Approval of the Rules for the Wholesale Market of Electric Power and Capacity and on Amending Certain Acts of the Government...,” dated 27 December 2010	<i>provides the rules and procedures for the functioning of the wholesale power and capacity market</i>
Retail market	Government Resolution No. 442 “On Functioning of Retail Markets for Electric Power, Full and (or) Partial Limitation of Electric Power Consumption Regime,” dated 4 May 2012	<i>provides the rules and procedures for the functioning of the retail power market</i>
Transmission	Government Resolution No. 861 “On Approval of the Rules for Nondiscriminatory Access to the Services on Transmission of Electric Power...,” dated 27 December 2004	<i>provides the procedure for obtaining access to transmission facilities and services</i>
Price Formation	Government Resolution No. 109 “On Determination of Prices for Electric and Heat Power in the Russian Federation,” dated 26 February 2004	<i>regulates the price determination for state-regulated power prices</i>
Renewable Generation	Government Resolution No. 449 “On Procedure for Incitement of Use of Renewable Energy Sources At Wholesale Power Market,” dated 28 May 2013	<i>regulates state support of renewable energy generation</i>

There are also numerous special regulations that apply to other aspects of the power market, such as nuclear power and hydropower, energy efficiency, etc.