

Reaching full potential

Ayse Yüksel and Turgut Cankorel of Chadbourne & Parke outline the risks and rewards of investing in Turkey's fast-expanding renewable energy sector

The role of renewable energy in the Turkish economy is growing – a trend driven by concerns about import dependency and clean energy on the supply side, and robust growth in power use on the demand side. The country's rich resources in hydro, wind, solar and geothermal energy are further driving forces behind this growth. From a transactional point of view, the visible results of this trend include development and financing of additional greenfield projects, as well as acquisitions of existing projects at various stages of development, whether in private sales or privatisations.

From a business standpoint, prospective investors often focus on construction and operation risk, the pricing of the power output, and the terms of financing and credit support, if any. However, various additional legal risks and incentives applicable to the Turkish renewable market should also be considered – examples include licensing and permitting matters, interconnection advantages, balancing, settlement and payment mechanisms, environmental and real estate risks and incentives, expropriation, various anti-corruption risks primarily concerning foreign investors, certain special regulations, and transaction approval issues.

There are certain common issues that arise in considering an investment investing in Turkish renewable energy, both at the initial decision-making stage and in the allocation

of risks among parties while negotiating the terms of such investment.

Pricing and incentives under the new law

Earlier this year, Turkey enacted the much-anticipated amendment of the renewable energy law, which put in place new feed-in tariffs and other incentives. The new law provides feed-in tariffs for licensed renewable generators that opt into the “renewable energy support mechanism,” which will become operational following the promulgation of implementing regulations by the energy regulatory body (Emra).

These new tariffs (see table on page 87) have provided some pricing comfort to investors, but are generally lower than expected. In addition, the new tariffs are available for only the first 10 years of operation (as opposed to the 20 years that was proposed in the draft law for certain types of projects). Finally, the new law does not provide special feed-in tariffs for photovoltaic solar projects or offshore wind projects, even though these were proposed in the draft law.

In addition to the feed-in tariffs, the new law provides incremental price incentives for renewable generators that benefit from the feed-in tariffs and use certain domestically-manufactured mechanical or electro-mechanical components in their projects. These incremental incentives are available only to facilities that commence

operations before December 31 2015 and only for five years after the commencement date. The incremental incentives range from the Turkish lira equivalent of \$4 to \$35/MWh, depending on the type of project. For example, it is \$6/MWh for reflective surface panels used in solar thermal projects, \$13/MWh for turbines used in hydroelectric projects, and \$35/MWh for photovoltaic modules used in solar projects.

The Ministry of Energy and Natural Resources is responsible for promulgating the regulations implementing these incentives. As of the date this article was written, such regulations were in draft form prepared by the Electrical Power Resources Survey Administration (EIE). The draft regulations require renewable generators to apply to the EIE for a domestic production certificate, submitting a number of documents including evidence that at least 2% of the renewable generator's gross power sales for the past three years have been spent on R&D activities. Upon approving an application, the EIE grants a domestic production certificate, which is valid for three years from the date of purchase of the subject component. The draft regulations are expected to be finalised soon, following the period of public comment.

Licensed renewable generators also benefit from licencing fee exemptions and sale and interconnection advantages. Generally, independent power generators must pay a one-time licensing fee that can run as high as the Turkish lira equivalent of over \$150,000, and additional annual fees of nominal amounts. However, generators proposing to build power plants that use renewables are exempted from the application fee except for 1% of application fees otherwise payable. Once they obtain a licence, they remain exempted from paying annual licence fees for the first eight years of commercial operation.

Emra requires licensed utilities to give priority to energy generated by renewable generators with respect to certain purchases. In addition, the state-owned electricity transmission company (TEIAS) and privately-owned transmission companies must provide priority to renewable generators when connecting them to the grid.

Prospective investors should note that TEIAS requires electricity producers to finance and build grid connections and substations (which are then turned over to TEIAS) and then deducts the total investment amount from the system usage fees it charges from generators. If the grid connection proves inadequate over time, requiring a further investment that cannot

“The new tariffs have provided some pricing comfort to investors, but are generally lower than expected”

be financed by TEIAS or the relevant distribution company, then such new investment may also be financed or carried out by the relevant generator on behalf of TEIAS or the relevant distribution company. The total investment amount is then deducted from the system usage fee under the grid connection and/or the system usage agreement.

Another advantage introduced by the new law is the pooling mechanism for making payments to renewable generators. In particular, utilities buying renewable power from a generation company that has opted into the “renewable energy support mechanism” must make their payments directly to a pool that is managed by the state-run Market Financial Settlement Centre (or PMUM). Funds are then distributed from the pool to the renewable generators according to the amount of electricity they have sold. The formulae to be used in the calculation of the payments, and other implementing rules, will be promulgated in Emra regulations, which were in draft form as of the date this article was written.

Balancing and settlement

Turkey is moving towards a well-organised market for the sale of electricity. As an alternative to bilateral contracts between electricity producers and buyers, in 2009 a day-ahead planning mechanism was established for the pricing and settlement of trades, whereby market participants could place their offers of sale or purchase of electricity for the next day, which would be processed by PMUM to maintain the system balance. In addition, there will be a day-ahead market effective as of December 1 2011, which will be a wholesale market for the purchase and sale of power that will be delivered the following day. Due to the volatility of their production, run-off-river hydropower plants, wind farms, solar power plants, tidal and wave power plants and geothermal plants are exempt from the balancing requirements, but may elect to be subject to the balancing mechanism, upon approval of the system operator, the National Load Dispatch Center.

Environmental assessment

Turkish law categorises renewable projects in two different environmental risk profiles, and treats the approvals process accordingly. Projects require not only pre-approval assessment, but also ongoing monitoring by the environmental regulators, and prospective investors should be aware of the risks and processes involved. Hydropower plants have attracted the most unfavourable

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public opinion in Turkey from an environmental standpoint, including various legal challenges due to alleged negative impacts on the natural habitat, archaeological heritage, agricultural lands or forest regions.

The first category includes projects that are likely to have significant adverse effects on the environment, such as nuclear plants, run-off river hydropower plants with an installed capacity of 25MW and above, and facilities discharging hazardous materials. These projects require an environmental impact assessment (EIA) report.

The report must analyse the impacts of the project on the environment (with respect to water, soil, air, noise, the natural habitat, and so on) as well as on the architectural and archaeological heritage. The project sponsor is responsible for preparing the report and

submitting it to the Ministry of Environment and Forestry and the relevant local governorship for review. After a process of review by a special committee and public consultation meetings, the Ministry of Environment issues an EIA Affirmative or EIA Negative decision. In case of an EIA Negative decision, the project may not be developed.

The second category includes projects that may have less serious impact on the environment, such as run-off river hydropower plants with an installed capacity of 0.5MW and above, wind power plants with a capacity of 10MW and above, and geothermal plants with a heat capacity of 5MWt (megawatt thermal) and above. The assessment procedure for these projects is less burdensome compared to the EIA process.

“The new law contemplates the protection of renewable energy projects from urban development”

Feed-in tariffs

The following feed-in tariffs are available for the first 10 years of operation, for any project commencing operations after May 18 2005 and before December 31 2015:

- Hydraulic \$73 /MWh
- Wind \$73 /MWh
- Geothermal \$105 /MWh
- Solar \$133 /MWh
- Biomass \$133 /MWh

Sponsors are responsible for preparing and filing a project file (less detailed than an EIA report) with the Ministry of Environment, which will determine whether an EIA process should be commenced. If the Ministry of Environment issues an EIA Not Necessary decision, then the project may be carried out without further assessment. If it issues an EIA Necessary decision, however, then the more burdensome EIA process described above is triggered.

Once a project is approved, the Ministry of Environment monitors the development of the project to ensure the sponsor duly complies with its commitments under the EIA report or project file. The sponsor must submit periodical monitoring reports covering the construction, operation and post-operation phases of the project.

Land issues

Under the new law, renewable projects enjoy certain monetary incentives for using state-owned land. Specifically, the permit costs, rent and costs of gaining rights of access and usage of state-owned land are subject to an 85% reduction where the property is used for a renewable energy project. This incentive is available only to projects that are in operation before December 31 2015. The incentive on rent or easement fees runs for 10 years after a project commences operation. If a forest region is allocated to a renewable energy project, the sponsor is exempt from paying certain fees that are otherwise applicable to the use of forest regions.

In addition, the new law contemplates the protection of renewable energy projects from urban development. Specifically, it provides that state-owned land cannot be allocated for zoning or development plans that adversely affect renewable energy resources. While this protection is welcomed by prospective investors, the basis for determining, prioritising and protecting such land is yet to be promulgated in implementing regulations.

Turkish real estate regulations impose certain restrictions on ownership of real estate by companies with foreign capital. Accordingly, if the entity owning the land on which a project is or will be built has foreign capital, then its acquisition of real estate may be subject to an approval process.

Under the applicable rules, whenever real property is owned by an entity with foreign capital, the local governorship must affirmatively approve (i) that the real property is used for an activity identified in the entity's organisational documents, and (ii) that the property is not located in a military forbidden zone, military or private security zone, or strategic zone.

The second prong of this approval requires notification of the relevant military authorities requesting their confirmation as to the nature of the real property, and involves a process which may take some time in the context of an acquisition. It should be noted that the relevant rules may have different applicability in a share sale context as opposed to an asset sale context, and each transaction should be analyzed specifically.

On the other hand, renewable generators may benefit from expedited expropriation. Under extraordinary circumstances or upon a determination of the Council of Ministers, certain public authorities may carry out an expedited expropriation, whereby a competent court determines the consideration within seven days and all other necessary formalities are carried out after the expropriation. Emra is one of these public authorities, and it is permitted to expropriate privately-owned land upon request of a generation or distribution licence holder. All costs related to the expropriation are borne by the requesting licence holder. While this expedited process is not exclusive to renewable energy projects, it may be a significant opportunity to consider in connection with greenfield projects.

Anti-corruption and other risks

Investors often look to minimise their risk in respect of a project company's pre-acquisition activities that may be in violation of applicable anti-corruption rules, especially if a project was developed under a PPP structure with close government involvement. A common issue in this context is that the parties may not appreciate the broad scope of prohibited activity, the extensive territorial reach of the applicable rules, or the magnitude of the potential risk.

For example, the US Foreign Corrupt Practices Act (FCPA) has an unusually extensive territorial reach. While most US criminal laws require some nexus between

the prohibited conduct and the territory of the United States, the FCPA also employs the nationality principle, meaning that criminal jurisdiction can be established even if there is no US territorial connection whatsoever. FCPA violations can result in significant penalties, including criminal fines and civil penalties (including profit disgorgement penalties) for entities, and imprisonment of up to five years for individuals.

Other than the FCPA, investors should also consider the implications of applicable anti-money laundering laws, anti-boycott laws, anti-terrorism controls, trade and investment sanctions, export controls, and foreign direct investment controls. Obligations can also arise from international treaties such as the OECD Convention on Combating Bribery of Foreign Government Officials in International Business Transactions.

Depending upon the nature of the renewable project, there may also be special domestic regulations imposing additional requirements or risks for a prospective investor. For example, in the context of wind projects, a recent protocol among the Ministry of Energy, Emra, the Turkish Armed Forces General Staff, and the Scientific and Technological Research Council of Turkey requires the monitoring of interference of wind turbines with the communication, navigation and radar systems of military aircraft.

This protocol establishes a new pre-approval procedure for future power generation licences, and obliges Emra to make necessary amendments in the existing Electricity Market Law to establish a roadmap for reviewing existing licences and operating wind farms. As of the date this article was written, these amendments or new regulations were not yet promulgated.

However, the protocol states that operating wind farms have until the end of 2011 to apply for assessment, even if such new regulations are not promulgated. In any event, the costs of any alterations or changes that may be required by the Turkish Armed Forces are required to be borne by the project itself.

Approving the acquisition transaction

Acquisition of any energy project is subject to the pre-approval of Emra if it involves the direct or indirect acquisition of the shares exceeding 10% (5% in case of a public company) of the share capital of a company holding a licence. In addition, Emra's prior approval must also be obtained (i) if the shareholding of an existing shareholder

exceeds 10% or falls below 10%; (ii) if a change of control occurs in the shareholding structure; or (iii) in case of establishment or removal of preferences on a company's shares. These provisions are also applicable to the acquisition of voting rights.

Furthermore, the total installed power generation capacity that a real person or a legal entity holds through its controlled entities cannot exceed 20% of the total national power generation capacity announced in the previous year by TEIAS.

In addition, investors should be aware that production licences are not transferable assets, except with respect to transfers to an entity having the same shareholding structure as the transferor. However, the applicable licensing rules provide for a step-in mechanism for lenders of limited or non-recourse project financings secured by licence holders. Lenders may request Emra to issue a new licence in the name of another entity, which will assume the licence holder's obligations and fulfil any other obligations set out under the applicable licensing rules.

Apart from energy regulatory approvals, acquisitions may also be subject to the pre-approval of the Turkish Competition Board, depending upon the respective turnovers of the parties under the applicable rules.

Finally, third-party consents under

existing contracts may raise deal execution or cost issues. Particular attention should be given to contracts with government entities (such as grid connection agreements or system usage agreements with TEIAS and land usage agreements with the Ministry of Environment). Even if these contracts do not technically require consent under the particular structure of the proposed transaction, parties may still want to approach the governmental counterparty with an eye to maintaining good relations.

The future

Various hydro assets of the Turkish Electricity Generation Company have been privatised and others are ready to be privatised in the near future. The risk-profile of a project and the allocation of such risks between the purchaser and the seller tend to be different in the context of a privatisation sale. The competitive nature of the bidding process tends to lead to higher risk allocation to the purchaser.

However, given the large number of such expected privatisation sales, it is likely that some of these assets will change hands again over the next few years, and some of the risks taken by the purchaser in the privatisation sale would be subject to renegotiation with the new prospective investor at that future time.

“Turkish policy makers have set aggressive goals for renewable energy over the next decade”

Turkish policy makers have set aggressive goals for renewable energy over the next decade. These include realising Turkey's entire hydro potential, increasing total installed wind capacity to 20GW, bringing online 600MW of geothermal capacity, encouraging solar and other forms of renewable energy, and establishing a carbon trade exchange, all by 2023. On the path to reaching these goals, both greenfield development and acquisitions are expected to take an active role in Turkey between now and then.

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