

Legal Update

Concept Paper on Reduction of Energy Crisis

May 8, 2016

The Ministry of Energy ("MOF") has declared the decade 2016-2026 as the National Energy Crisis Reduction and Electricity Development Decade ("Energy Emergency Decade"). In this regard, the MOF has issued a Concept Paper on Elimination of Energy Emergency and Electricity Development Decade, 2015 (2072) ("Concept Paper") on February 18, 2016, with the objective to substantially end the power outage within the next one year, completely end power outage (even in the dry season) within the next two years, and to ensure energy security within the next decade.

It is relevant to note that this is the third time the Government of Nepal ("GON") has declared "Energy Emergency" in the last eight years. However, this time around, the GON has identified a detailed action plan with timelines, to ensure that the aforesaid objectives are met. Listed below are some of the key reforms proposed by the Concept Paper:

A. Force Majeure Event

The Concept Paper recognizes the earthquake and flood / landslides that occurred during the fiscal year 2015/16 as "Force Majeure Event" and requires the following facilities to be provided:

- (i) Force Majeure provisions under the contracts for projects damaged by the earthquake of April 2015 April shall be triggered.
- (ii) In case of projects under construction that have been damaged or affected by the earthquake, the timeline for their required commercial operation date ("RCOD") shall be extended by a maximum of 1 year. In case of projects that have already commenced commercial operation, the term of relevant PPA shall be extended by a maximum of 1 year.
- (iii) The term of the Electricity Generation License of such projects shall also be extended by up to 1 year to enable extension of the RCOD or the PPA, as applicable.
- (iv) Work procedure shall be formulated to provide appropriate concessions to projects that had halted their operation due to damage caused to the electricity chamber by flood / landslides, and have resumed operation during fiscal year 2015-16.

In this regard, the Power Trade Department of the Nepal Electricity Authority ("NEA") on April 24, 2016 has issued a work procedure outlining the procedures for extension of RCOD of private projects under construction that have been affected by the earthquake. The said procedures however do not provide for the extension of the term of the PPA or the term of the Electricity Generation License as contemplated by the Concept Paper.

The Concept Paper does not address the following significant consequences that the damages / delay caused by the earthquake could have on energy projects:

- Firstly, in case of projects that have commenced commercial production, the delay may have consequence on the rate of royalty. By way of a background, the Electricity Act, 1992 (2049) ("Electricity Act") provides a lower rate of royalty for the first 15 years from Commercial Operation Date ("COD") in comparison to the rate

of royalty applicable to the period thereafter. For affected projects that have already commenced production but have not completed 15 years from COD, the force majeure benefits should also provide for the extension of the term for applicability of the lower rate of royalty for the period during which the commercial production by the project has been affected.

- Secondly, the force majeure event could have an implication on the tax exemptions available. Currently, entities which commercially commence generation, transmission or distribution of electricity by April 12, 2024 (Chaitra, 2080) can benefit from full tax exemption for the first 10 years, and 50% income tax exemption for the following 5 years. Since the tax holiday provisions do not provide for extension of holiday period to cover the time lost due to situations like force majeure event and, affected projects would not be able to benefit from the aforesaid tax exemptions. Therefore, the applicability of the tax exemptions should be extended by such period of delay.

In this regard, it is important to note that the Concept Paper requires the income tax exemptions to be applicable during the entire term of the Energy Emergency Decade; consequently, the current provision of the tax holiday would need to be amended to provide for extension up to the year 2026.

B. Convertible Currency denominated PPA:

The Concept Paper provides for entering into Power Purchase Agreement ("PPA") denominated in convertible currency by the NEA subject to certain conditions. As a background, there was uncertainty surrounding the issue of whether, going forward, NEA should be entering into foreign currency denominated PPA given the huge losses cited by NEA on account of the existing US\$ PPAs.

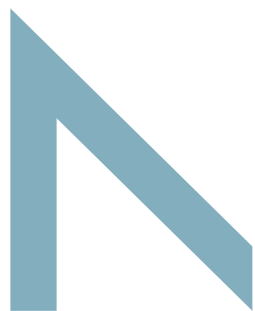
The Concept Paper appears to provide some protection to potential foreign lenders and shareholders by clarifying that convertible currency denominated PPAs may be entered into in proportion to the foreign loan / investment in the project for a maximum period of 10 years during which such foreign loan or investment, as the case may be, subsists. The Concept Paper also contemplates providing of certain measures to protect the NEA against foreign currency risks, including basis and mode of payment, and hedging fund requirements.

C. Certain provisions under the PPA

Currently, in case of purchase of electricity by the NEA from private sector hydropower projects having investment in Nepalese currency, and capacity of up to 25 MW, yearly price escalation at the rate of 5% to the posted rate is provided, and in case of such projects having capacity of above 25MW and up to 100MW, yearly price escalation at the rate of 8% is provided. The Concept Paper provides that, during the Emergency Decade, even projects having captive capacity of up to 25 MW developed with local investment that achieve COD within the RCOD shall benefit from the yearly price escalation at the rate of 8%. The Concept Paper also provides protection against hydrology risk for projects up to 10 MW by prohibiting any imposition of penalty for any shortfall in electricity supply to NEA arising due to reduction in river water discharge.

D. Government Guarantee for NEA Payments

In a bid to attract foreign investment in energy projects, the Concept Paper provides that the GON shall, under the relevant Project Development Agreement ("PDA"), guarantee the payments to be made by NEA for purchase of power from projects that are developed for internal consumption with foreign investment. Such GON guarantee would provide recourse to the project company in the event of NEA's payment default under the PPA. The Concept Paper however is silent on the GON guarantee against adverse change in law or political force majeure; both of which are important guarantees that the project developer as well as the project lenders would seek from the GON in relation to both domestic and export projects.



E. One-Time Recommendation for Foreign Currency Payments

Currently, recommendation of the Nepal Rastra Bank ("NRB") is required for each instance of payment to be made in foreign currency. In case of payments under contracts entered between hydropower companies and foreign consultants / contractors, such requirement often causes payment delays and consequent delays in compliance with the performance of obligations under the contract. To provide certainty of payment repatriation under such contracts, the Concept Paper requires necessary provisions to be made for providing one-time blanket recommendation from the NRB for the entire payments under the relevant contract.

F. Shares to Public

The Concept Paper requires arrangements to be made for the energy project affected population to subscribe to 10% of the shares of the project company. Further, the Concept Paper also requires that as compensation for acquisition of land, land-owners shall be given an option to acquire shares of the project company. In this regard it is relevant to note that, while the existing laws do not require local participation in energy projects, in practice the GON has implemented the requirement to issue 10% of the shareholding to the project affected population under the provisions of the project development agreement.

G. Land Acquisition

Nothing that land acquisition continues to remain a major hurdle in development of hydropower power projects, the Concept Paper has proposed a number of reforms to simplify the process of acquisition of land. These include (i) inapplicability of the land ceiling to hydropower projects provided that such area of land has been approved in the course of obtaining the necessary environmental clearances, and (ii) formation of special committees at the district level to review consideration for acquisition of land.

The Concept Paper also provides for some flexibility in the payment of consideration for acquisition of land in the following manner:

- Currently, in exchange for acquisition of any forest land, the developer is required to provide the forest department another piece of land having the same measurement. Such requirement has made the acquisition of forest land rather challenging. The Concept Paper eases the process of acquisition of forest land by providing for an option to the developer to pay for such land in cash as per the rate fixed by the GON.
- In the context of acquisition of land for construction of transmission line and sub-station, the Concept Paper contemplates formulation of procedures for acquisition of land for full or partial consideration (with the requirement to pay rent on an annual basis).

H. Environmental Clearances

To ensure that energy projects are not delayed due to delay in obtaining regulatory clearances, the Concept Paper attempts to ease and clarify the process for obtaining environmental and social clearances by prescribing timelines for environmental and other agencies to process applications and review / approve relevant documents and provide necessary clearances.



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