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SOLAR BOOM IN HUNGARY

RES financial incentive scheme in Hungary – Impacts on the regulatory and investment environment of the development of photovoltaic power plants

1. INTRODUCTION

New developments in the Hungarian regulatory framework on electricity generation from renewable energy sources ("**RES**") are changing the investment environment for the development of photovoltaic power plants ("**PVPP**") in Hungary.

The most important pillars of the relevant regulatory framework are the financial incentive schemes aiming to promote electricity generation from RES. These financial incentive schemes have been fundamentally reviewed and amended, taking effect on 1 January 2017 causing landslide changes on the PVPP market in Hungary.

The purpose of this Client Alert is to briefly describe the most important features of the "old" and "new" financial incentive schemes and the market impacts of the regulatory changes in question.

2. POLICY AIMS REGARDING ELECTRICITY GENERATION FROM RES

Hungary has undertaken to cover 14.65% of its gross energy consumption from RES, beginning at latest with 2020. As the Government was behind schedule with this target, a new supporting scheme for electricity generation from RES was adopted in June 2016 in order to overhaul the existing one and to accelerate the growth of the Hungarian renewable energy industry.

The recently adopted legislation on the new support scheme aims at contributing to various energy policy goals in Hungary, such as the promotion of building new generation capacities with special regard to renewable projects, the improvement of the security of supply, as well as providing proper and predictable income for the generators. Finally, it strives to secure the sustainability of the system by preventing other market participants from bearing unnecessary extra costs. The costs of the renewable energy promotion scheme is entirely financed by the green energy levy imposed on businesses and industrial electricity consumers in order to keep the end-user electricity prices for households low.

It is important to note that the declared policy of the Hungarian Government privileges the development of photovoltaic and biomass-fired power plants over other RES technologies.

3. THE "OLD" FINANCIAL INCENTIVE SCHEME FOR THE PROMOTION OF ELECTRICITY GENERATION FROM RES

Under the "old" regime (such entitlements could only be applied for until

31 December 2016), the promotion of electricity generation from renewable energy sources is facilitated through a mandatory off-take (feed-in) system. It means that the eligible producers can sell the electricity generated to the Hungarian electricity TSO, MAVIR, at a fix, statutory determined price (that is, a price well above market prices).

Prior to 31 December 2016, a RES-electricity producer who wished to sell electricity generated from RES or some part of it in the mandatory off-take system had to submit an application to the Hungarian Energy Authority ("**HEA**") to determine the duration and the amount of electricity falling under the mandatory off-take system.

Based on the documents attached to the application (e.g. business plan, description of planned PV modules, etc.), the HEA determined the duration of the mandatory off-take on the basis of the return of investment period. The HEA calculated the return time by energy source and generation procedure, taking into account the (domestic and international) data of investment implemented and operated in accordance with the rational choice of seat, the principle of lowest cost, the best available technology and the statutory defined off-take prices based on the discounted cash flow (DCF) valuation method (e.g. the standard payback period for PVPPs with a capacity of below 2 MW was 20-25 years). Furthermore, if the RES-Electricity producer received other financial support (e.g. individual investment aid), the HEA would modify the return time on the basis of the current value of the ratio of such support to the total costs of investment.

MAVIR, as the primary off-taker of electricity falling under mandatory off-take, has the obligation to off-take all such electricity. The eligibility for mandatory off-take shall terminate either with the expiry of the duration defined for mandatory off-take or when the installation has sold all the quantity of electricity benefiting from the mandatory off-take (there is no kWh/year production limit).

Differentiated off-take prices apply based on, for example, the installed capacity, energy source and the issue date of the entitlement regarding the quantity and the duration of the mandatory off-take. The currently applicable off-take prices (for 2017) are the following (excluding VAT):

MANDATORY OFF-TAKE PRICES FOR PVPPs APPLICABLE FROM 1 JANUARY 2017 (applicable to entitlements applied for between 1 January 2008 and 31 December 2016)			
POWER PLANT UNIT	PEAK PERIOD HUF/KWH	LOW PERIOD HUF/KWH	DEEP LOW PERIOD HUF/KWH
PVPP under 20 MWp	31.58	31.58	31.58
PVPP between 20 and 50 MWp	28.22	25.27	10.30
PVPP above 50 MWp	21.94	14.05	14.05

Notes:

- "Peak Period" means the period of 07:00 - 23:00 (CETS) on workdays.
- "Low Period" means the period of 23:00 – 02:30 and 06:00 – 07:00 (CETS) on workdays and the period of 07:00 – 02:30 (CETS) on non-workdays.
- "Deep Low Period"' means the period of 02:30 – 06:00 (CETS) on workdays and 02:30 – 07:00 (CETS) on non-workdays.

The mandatory off-take prices applicable to a specific installation are subject to an annual indexation, based on the consumer price index last published by the Central Statistics Office of Hungary relative to the same period of the previous year, subject to an annual efficiency reduction of one percent (1%)

Every application for a licence to participate in the mandatory off-take system submitted by 31 December 2016 will be assessed according to the "old" rules. Those entitlements issued by the HEA under the old regime will remain in force (with the same pricing system) and will also remain transferable after 1 January 2017.

4. THE "SOLAR RUSH" AT THE END OF 2016

Pursuant to the information shared by the HEA, at the end of 2016, more than 2,000 applications were submitted for participation in the mandatory-off take system under the "old" regime. The applications together covered nearly 1,000 MW (!) of planned new electricity generation capacity. An overwhelming majority of the applications were submitted by developers wishing to build new PVPPs with an inbuilt peak generation capacity of less than 0.5 MW (due to the simplified licensing rules applicable).

The reason behind this "solar rush" was that those who have submitted their applications until 31 December 2016 under the "old" regime, if accepted, will receive an entitlement providing a much longer guaranteed profit margin (subject to electricity prices in the next 25 years) than what will likely be available under the new legislation. Again, the entitlements issued according to the old regime will remain in force until their expiry (i.e. for 15-25 years) with the same pricing system, and they are also to be considered as transferable.

It is a question for the next few months whether the license holders would want to develop their micro projects alone or whether they are willing to sell these entitlements to professional investors or try to find business partners in other ways to implement the projects.

5. THE REVISED RES SUPPORT SCHEME

The revised RES support scheme – in force since 1 January 2017 – is a more sophisticated system differentiating between electricity generators with regard to their inbuilt electricity generation capacities.

With regard to the above, the new regulatory framework provides different rules for the below categories of PVPPs:

- power plants with a peak capacity below 0.5 MW ("**Micro PPs**");
- power plants with a peak capacity between 0.5 MW and 1 MW ("**Small PPs**");
- power plants with a peak capacity above 1 MW ("**Major PPs**").

Financial incentive scheme for Micro PPs

Newly built Micro PPs (i.e. projects <500 kWp) will remain eligible for the participation in the mandatory off-take system (i.e. the "old" financial incentive scheme) even after the new regulation enters into force. Developers applying for a new entitlement after 1 January 2017, however, will face a significantly less generous regulatory framework.

The reason for this is that the benchmarks used to calculate the return of investment period – as set out in the relevant decree of the HEA – has become much stricter. The most notable change is that the reference return of investment period for PVPPs has been decreased to 13 years (the benchmark applied by the HEA for applications submitted before 31 December 2016 was 22-25 years in this respect). Another important amendment is that the budget of the mandatory off-take system is now capped: between 1 January 2017 and 31 December 2021 only a maximum of HUF 20 billion of support can be provided to new entries on a first-come, first-served basis.

Further to the above, stricter rules have been introduced with regard to the bundling of power plant units. According to the provisions of the new system, the capacities of those power plants will have to be added together as they are considered as neighbouring establishments and which are at the same time operated by linked enterprises or partner enterprises as detailed in the respective pieces of legislation.

The rules on the bundling or unbundling of certain power plant capacities are relevant in relation not only to the eligibility for the mandatory off-take system but also to the licensing of new generation capacities: the licensing regime for power plant units with an inbuilt peak generation capacity below 0.5 MW is considered a simplified licensing regime.

Financial incentive scheme for Small PPs and Major PPs

Pursuant to the recently enacted legislation, the electricity generation facilities using renewable energy sources with a peak capacity of more than 0.5 MW (Small PPs and Major PPs) will no longer be eligible to participate in the mandatory off-take system. For them, the new premium-based supporting scheme will apply.

The Small PPs and the Major PPs will be obliged to sell the electricity generated individually, on a free-market basis. The expected sale prices will be determined by the MAVIR as a so-called "reference market price" based on the prices of the Hungarian Power Exchange (HUPX). Parallel to this, the HEA will set the "support prices" for the electricity generated from renewable sources taking into consideration the production costs and the concept of the fair return of the project.

The margin between the support price and reference market price will be the "green premium", which will be paid to the generators by MAVIR.

In the case of **Small PPs**, the support price (and the annual indexation) will be the same as currently applicable in the mandatory off-take system. In case of generation facilities with a capacity of less than 1 MW, the HEA will decide upon on the amount of the electricity to be supported as well as the duration of the support via individual requests and administrative procedures.

For such new generation facilities, the main difference compared to the current situation will be that the operators will have to facilitate the trading of the electricity generated by themselves. More importantly, the benchmarks applicable for calculating the return of investment period have become much stricter (generally the same benchmarks apply as in the case of Micro PPs).

The budget for new entitlements to be awarded to the developers of new Small PPs is also capped: until the end of 2021, HUF 10 billion is to be distributed among new entries as support on a first-come, first-served basis.

For the **Major PPs**, the support price will be the subject of competitive tendering (taking into account the current market prices, the support price for Major PPs will be significantly lower than the currently applicable prices of the mandatory off-take system). Accordingly, pursuant to the adopted legislation, the generation facilities with an output of more than 1 MW will only be eligible to participate in the new financial support scheme if they are awarded through proper tender proceedings that aim to select the most competitive and most effective projects. The detailed rules of these competitive tendering procedures are available in pieces of secondary legislation already enacted. The publication of the first tenders is expected in the summer of 2017 at earliest.

The budget for new entitlements to be distributed among new entry Major PPs is also capped: HUF 15 billion is to be awarded until the end of 2021 through competitive tendering proceedings.

New rules on bundling also apply to Small PPs and Major PPs: the capacities of those power plants will have to be added together as they are considered as neighbouring establishments and which are at the same time operated by linked enterprises or partner enterprises as detailed in the respective pieces of legislation.

This latter rule may have significant relevance in case some of the PVPPs are located at approximately the same geographic location, as the generation capacities of such instalments might be required to be aggregated. In case of Major PPs, this issue may be critical, as the licensing of PVPPs above an aggregated capacity of 50 MW may be subject to a very complex licensing regime.

Wolf Theiss and its highly experienced Energy Regulatory and M&A teams are pleased to assist our clients with any questions in relation to RES investments in Hungary.

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