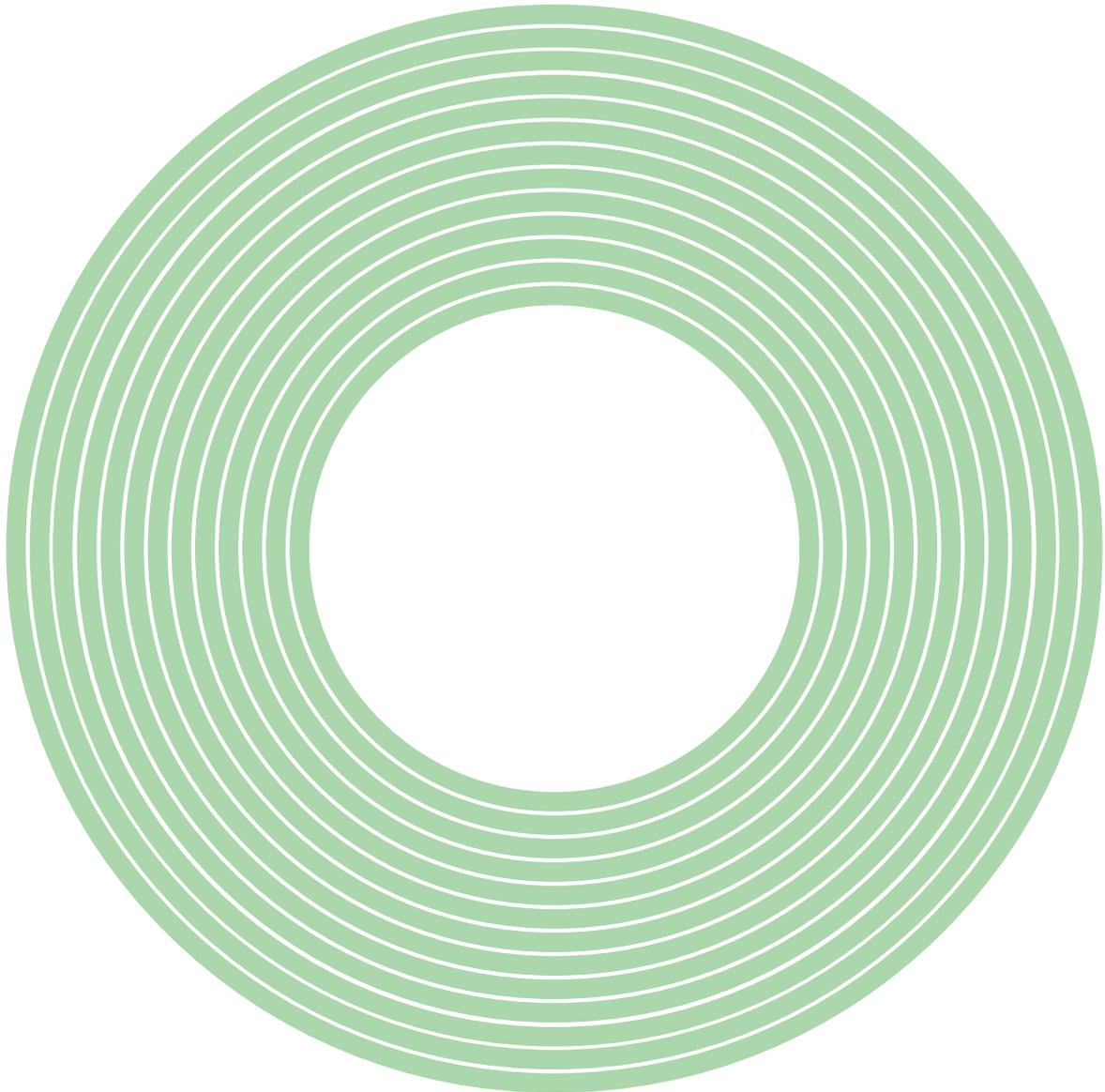


15 KEY THINGS TO KNOW

BEFORE INVESTING IN ENERGY SECTOR IN UZBEKISTAN



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15 KEY THINGS TO KNOW BEFORE INVESTING IN ENERGY SECTOR IN UZBEKISTAN

OVERVIEW

Uzbekistan is introducing reforms in the legislation, offering foreign investors opportunities to provide investments in its developing and largely untapped energy sector. Nevertheless, practice shows that some issues are slowing down the process of implementation of energy projects. Here is a list of key considerations investors should take into account before starting the energy project in Uzbekistan.

1. ENERGY PROJECT IMPLEMENTATION

There are two major instruments an energy project may be implemented in Uzbekistan:

- Investment agreements ("IA");
- Public private partnerships ("PPP").

IA is a field-tested tool of implementation, whereas, PPP is a relatively new concept, which has not been widely applied to investment projects yet. However, Uzbek government is supporting PPP format by all means.

Both instruments may provide carve-outs for investors to facilitate in implementation of investment projects.

2. SOLE OFF-TAKER

In Uzbekistan, the sole off-taker of energy is National Electric Networks of Uzbekistan JSC ("NENU"). It is a state-owned enterprise that enters into the power purchase agreement ("PPA") on the basis of tenders, private initiative or direct negotiations.

Notably, the government is planning to delegate the authority of procurement and distribution of energy from NENU to another company. The step is highly likely to result in issues connected with amendments of documentation in existing energy projects.

3. GOVERNING LAW

In Uzbekistan, use of foreign law as the governing law in agreement is not allowed without presence of a foreign element. However, Uzbek law does not define the term 'foreign element'. From a practical perspective, it is difficult to determine what a foreign element is. Applying foreign governing law between two residents might be almost impossible.

Even if the parties choose a foreign governing law, it may be unenforceable in public policy matters, such as those concerning taxes, licenses and regulatory matters etc.

4. DISPUTE RESOLUTION

Most disputes can be resolved through arbitration, including international arbitration.

Recourse to arbitration with Uzbekistan as a party is only possible if arbitration provision is stipulated in either the bilateral investment treaty or other commercial contracts with Uzbekistan.

That being said, Uzbek courts have exclusive jurisdiction over land, corporate and intellectual property disputes.

5. LAND ALLOCATION

Land is generally always owned by the state. There are three key issues to consider.

Firstly, in practice, IA or PPP projects usually imply the entry into a land lease agreement. The rationale is that only the rights over land lease could be pledged to provide a security for foreign lenders.

Secondly, payment for the land use rights is made in the form of either land tax or rent. Both are regulated identically and are interchangeable. Therefore, the revision of land tax rates may affect the land lease price. Hence, the risk of volatility of land lease rates should also be addressed in the respective IA or PPP.

Thirdly, the land lease agreement must be registered through an online registration system, which is, however, not operational yet. In practice, the land lease agreement is registered at the local department of cadaster.

6. TAX AND ACCOUNTING

Uzbek government is extremely reluctant to provide individual tax exemptions. Tax Code directly prohibits such practice. However, certain tax incentives may be provided under the Law on Investments and Investment Activity, although this may also be disputable due to conflict between this law and the Tax Code.

Tax Code does allow tax incentives for certain categories of taxpayers, which may be relied on as a justification for providing individual incentives, when one investor can represent a separate category of taxpayers. But yet, again, this is subject of further discussions with the government.

Refund of incentives. In case of early termination of IA or PPP due to the fault of the investor, the government will require the

refund of tax incentives and other mandatory payments that were disbursed to the budget due to additional guarantees and support measures provided under IA or PPP.

IFRS vs NAS. Uzbekistan is currently in the process of transition to IFRS standards. However, the current tax legislation does not fully recognize IFRS and still requires compliance with National Accounting Standards ("NAS").

It may lead to disputes with tax authorities.

Therefore, it is advisable to run accounting for taxation purposes under the NAS.

7. CURRENCY DENOMINATION

The Currency Law prohibits the denomination of goods (services, works) in foreign currency, but certain exemptions exist if the goods (services, works) are rendered within the framework of IA or PPP on the basis of the respective decree of the President of Uzbekistan. Such currency restriction does not apply to provision of foreign or local loans.

8. ENFORCEMENT OF SECURITY

If the borrower defaults, non-resident creditors might face challenges with respect to enforcement of the secured local assets.

Under the Uzbek laws the process of enforcement of the secured local assets requires active involvement of the borrower, which might not be always cooperative and this can jeopardize the enforcement process. This, however, could be facilitated by the power of attorney issued to the pledgee.

9. OFFSHORE ACCOUNT

Uzbek residents must obtain government decision in order to open offshore accounts. The purpose and use of offshore accounts, as well as the establishment of security over such accounts, must be authorized by such government decision.

10. PARALLEL DEBT STRUCTURE

Despite its extensive use in Uzbek project finance transactions, the parallel debt system is yet to be tried in Uzbek courts. The position of local courts is yet to be ascertained, but it may be the case that they might fail to accept a single lender's assignment, which essentially doubles the debt due under a general agreement with the appointed creditor and separate agreements with individual creditors.

11. WORLD BANK NEGATIVE PLEDGE

Uzbekistan obtained funds from the World Bank ("WB") in conjunction with WB loan terms, which have a negative pledge clause. Under the negative covenant, Uzbek borrowers are forbidden from offering state properties as security to foreign creditors. Such restriction is incompatible with internal policies of most international creditors, and as a result loans to state-owned enterprises ("SOE") face securitization challenges. In addition, there is no clear definition of 'state assets' under Uzbek laws, which adds more ambiguity into the procedure.

12. THE GRID CODE

There is no grid code in Uzbekistan.

The absence of a grid code affects the operational activity of investors the energy sector, as there are no general technical standards and regulations. The application of best practices as a carve-out in PPAs could be the remedy for such a technical omission.

13. PERMITS AND LICENSES

As a matter of general practice, permits and licenses are not transferable in Uzbekistan.

Acquisition of Uzbek legal entity that holds all permits and licenses can be a solution, unless such acquisition triggers change of control terms. In order to facilitate the process, the transfer of such documents may be stipulated in the IA or PPP. There are also plans to introduce license for the production of electric power in Uzbekistan.

14. DIRECT NEGOTIATIONS OR PUBLIC TENDERS

As a general rule, PPPs are tendered. However, the law also envisages the entry into PPPs following direct negotiations or private initiative. Direct negotiations are permissible in case of:

- defense and security matters;
- when the investor has the exclusive rights over PPP's object; or
- authorization by the President or the Cabinet of Ministers.

15. ENERGY STANDARDS

Although Uzbekistan is implementing reforms in the energy sector, the energy standards are far behind those accepted internationally. This may result in challenges by investors in implementing their energy project due to technical handicaps.

