Foreign Investors’ Options to Deal with Regulatory Changes in the Renewable Energy Sector

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Overview
Renewable energy is an increasingly vital source of electricity for the modern world. Indeed, the International Energy Agency estimates that such energy will account for 25% of gross power production by 2018, rising from 20% in 2011. Many states have implemented legislation to promote the generation of renewable energy. In particular, some states set targets pursuant to which a certain percentage of electricity generation had to come from renewable energy. They also provided for the purchase of renewable energy on terms favourable to the generator of renewables. However, a significant number of these states later amended their legislation when they considered that these incentives were overly burdensome on them. By way of introduction, three categories of foreign investors have been particularly affected by this legislation and its subsequent reform:

- Foreign investors operating in the renewable energy sector (Renewable Investors) – reform of renewable energy legislation has often had severe consequences for the economic viability of their investment
- Foreign investors operating in the traditional energy sector (Traditional Investors) – both the initial introduction and subsequent reform of renewable energy legislation has often significantly undermined the economic basis on which they had invested
- Foreign investors whose investments consume large amounts of electricity (Consuming Investors) – the totality of renewable energy legislation and reform and the resultant increases in energy prices have had a substantial effect on such investors

This advisory introduces the extent to which these categories of foreign investors may be able to commence international arbitration against the relevant state to seek compensation pursuant to investment treaties.

The Main Changes to Renewable Energy Policies on Foreign Investors

In general, two core components of legislation governing the production of renewable energy have had significant effects on foreign investors:
- **Binding renewable energy national production targets (Production Targets).** First, the initial introduction of such targets will often have adversely affected Traditional Investors as it altered the economic basis on which they invested. Second, subsequent changes to Production Targets affected both Renewable and Traditional Investors: in states that have *reduced or phased out* their Production Targets, Renewable Investors have been adversely affected by a decreased demand for their energy (with Traditional Investors benefitting from a corresponding benefit); meanwhile, in states that have *increased* their Production Targets, Traditional Investors have suffered while Renewable Investors have benefitted.

- **Feed-in tariffs (FiTs).** FiTs involve long-term contracts and guarantee electricity purchase prices (at rates higher than retail value) as well as grid access. Many states have subsequently come to consider their FIT policies to be overly burdensome on the state. The burden arises because the income received by the state through the sale of electricity is less than its fixed costs in relation to the sector (including the cost of its FIT policy): this creates what is known as the “tariff deficit.” Some have reacted by withdrawing or drastically reducing FiTs. Such variation can have a significant effect on Renewable Investors, and may well render their investment economically unviable. Some states have sought to reduce the effect of withdrawing FIT policies by instead replacing them with a return on investment model; however, depending on the model adopted (and specifically what financial metrics it takes into account), such change may still leave Renewable Investors with an economically unviable investment.

Further, a direct consequence of renewable energy policies and their reform in many states has been a substantial increase in electricity prices. This has a significant impact on Consuming Investors (for example producers of aluminium) whose investments use large amounts of electricity.

**Investor-State Arbitration**

Foreign investments are often undermined or impeded by wrongful state conduct, such as in the manners described above. Generally, national courts are of little use in resolving such matters, either due to delays, political interference with proceedings, or simply a lack of competence to interfere with legislative decisions. By contrast, such state actions may often be in breach of the state’s international legal obligations. Those obligations are contained in an extensive network of international legal instruments: notably, bilateral investment treaties (BITs), and the multilateral Energy Charter Treaty.

These protections can be used as a basis for preventing wrongful state conduct in the first place. As such, they may be a highly important tool for foreign investors and industry associations in advocating against legislative changes to renewable energy regulations. Further, when regulatory changes have been made that are in breach of international treaty obligations, it is often possible for foreign investors affected by them to seek remedies for any wrongful conduct before an independent, international arbitral tribunal. Indeed, a number of claims have been brought in relation to renewable energy legislative reform in recent years.

**Outline of Potential Treaty Claims**

It is possible that all of the issues facing foreign investors as a consequence of the changes in renewable energy regulation canvassed above would amount to breaches of any applicable investment treaty. Two of the protections that are frequently granted by such treaties are particularly relevant.

**The Fair and Equitable Treatment Standard**

The first is that foreign investors and their investments must be accorded “fair and equitable” treatment. This is a very wide protection. In essence, foreign investors must be treated in a consistent manner, free from ambiguity, transparently, and in accordance with the investor’s legitimate expectations.

The most common situation in which states are found to have breached the fair and equitable treatment standard is where the implementation and maintenance of a particular regulatory regime (e.g., relating to royalties, pricing, and taxes) is promised to the investor by the State before the investment is made, but is subsequently unilaterally changed by the state after the investment has been made. However, one issue that is often raised in this context is the extent to which states have an unfettered right to alter the regulatory framework so as to preclude the wrongfulness of such variation; existing tribunals have taken differing positions on this matter, but the existence of a specific assurance to an investor may be decisive in that investor’s favour. The fair and equitable treatment standard may also be breached by a frequent occurrence of regulatory changes which undermine that stability and predictability of the business environment for investors.

In the context of changes in renewable energy regulation:

Depending on the particular circumstances, Renewable Investors may well have strong arguments that changes in Production Targets and FiTs amount to a breach of this standard.

Traditional Investors may be able to argue that the introduction of and changes to a Production Target breaches this standard. Depending on the circumstances, such breaches may be on the basis of the initial introduction of a Production Target shortly after their investment in the traditional energy sector was sought. Further, it is arguable that an initial Production Target gave such investors legitimate expectations that the proportion of energy from non-renewable sources would not be decreased during the period for that Target’s application, and that a premature variation of the Target amounts to a breach of the fair and equitable treatment standard.
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Consuming Investors adversely affected by high energy costs may also be able to assert that state actions in the renewable energy sector have caused them increased production costs, and that those actions amounted to a breach of the fair and equitable treatment standard.

**Indirect Expropriation**

BITs usually require that a foreign investor’s investment will not be subject to expropriation unless certain criteria are met. The requisite criteria permitting expropriation are usually that the expropriation is for a public purpose, on a non-discriminatory basis, follows due process, and is against “prompt, adequate and effective compensation”.

Expropriations can be direct or indirect. An indirect expropriation occurs when there is an interference with an investment that amounts to a substantial deprivation to the economic substance of the protected investment; it need not be an outright deprivation of the title to or possession of the investment. It is arguable that a number of the changes to renewable energy regulations amount to indirect expropriations of foreign investors’ investments, in that their effect is to substantially deprive the investment of its economic substance.

**Conclusion**

Investment treaty protections should be carefully considered by foreign investors operating in the energy sector (be it in renewables or traditional sources) and by those operating in areas significantly affected by increased energy prices. It may well be possible to use such protections as a tool to assist lobbying efforts to prevent wrongful regulatory change, or they may prove essential in obtaining compensation. For those unfamiliar with investor-state arbitration and the legal instruments that give rise to them, we recommend reading our previous advisory for an overview of this subject, and how such instruments can be a useful tool for minimising political risk.

**Practices**

**International Arbitration**

**WTO Disputes**