Investor succeeds in ECT renewable energy arbitration (Eiser v Spain)

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Arbitration analysis: Elvezio Santarelli and Andrew Savage, partners at Watson Farley & Williams LLP, examine the background to the Eiser award in an International Centre for Settlement of Investment Disputes (ICSID) arbitration under the Energy Charter Treaty (ECT), concerning claims arising out of a series of energy reforms undertaken by the Spanish Government affecting the renewable energy sector, and assess its implications and impact.

Original news

Eiser Infrastructure Limited and Energia Solar Luxembourg Sarl v Kingdom of Spain, ICSID Case No. ARB/13/36, 4 May 2017 (award published in Spanish only)

What was the factual background to the claim?

Between 2007 and 2011, Eiser Infrastructure Limited (a London-based multinational asset manager) and its Luxembourg-incorporated subsidiary Energía Solar Luxemburg Sàrl (together, the claimants) invested approximately €126m (as shareholders) in the construction and operation of three thermo-solar power plants in Spain. This case arose out of those Spanish Concentrated Solar Power (CSP) sector investments, which ultimately failed following Spain's introduction of a panoply of disputed austerity measures in 2013/2014 modifying the economic regulatory regime for renewable energy projects. The evolution of Spain's economic regulatory regime, culminating in those disputed measures, was at the heart of the case.

Spain's policies favouring renewable energy and Royal Decree 661/2007 (RD 661/2007)

Spain, for its part, had determined that an extensive regime of state subsidies was required to build on climate change treaties, comply with Directive 2001/77/EC setting out binding targets for the development of renewable energy and, in particular, to promote CSP, which because of its intensive capital costs had not been economically competitive with traditional forms of power generation. To this end, the General Electricity Law 54/1997 (1997 Electricity Law) distinguished between an 'ordinary regime' of energy production and a 'special regime'. The special regime favoured generation from renewable sources of energy by authorising tariffs above market prices.

After earlier measures (1998 to 2004) adopted pursuant to the 1997 Electricity Law were unsuccessful in attracting the desired level of investment in renewables, the Spanish Government promulgated RD 661/2007 in order to further regulate and facilitate electricity production from renewable sources and to provide incentives to producers. RD 661/2007 was a complex regime aimed principally at establishing a stable subsidy system that guaranteed attractive profitability for electricity production under the special regime. The state expected financial returns to rise to between 7% and 11% for facilities under the special regime participating in the wholesale market

The effect of RD 661/2007 was to create a right to a special remuneration sum in exchange for energy produced by facilities operating under the special regime, ie those with an installed power capacity of less than 50 MW. It had the following elements:

- guaranteed 'priority of dispatch' assuring that all production could be introduced into the grid subject to the established tariff
- allowed producers to annually elect between two different tariffs, a fixed tariff per unit of production (the fixed tariff option) and a premium for each unit on top of the market price (the premium option)
- provided for tariffs solely based on production for the entire operational life of the facility, and without setting limits on total lifetime payments
- established caps and floors for payments under the premium option
- allowed use of gas for up to 15% of total generation

RD 661/2007 was integral to the claimants' assessment of a possible investment in CSP in Spain. The contemporaneous documents indicated that those responsible for the claimants' initial decision to invest were keenly aware of the features of the RD 661/2007 regime, and that their assessment of the feasibility of the investment, and that of the banks that loaned money to finance it, were all based on that regime, which was viewed as 'stable and predictable'. In the upshot, both the investment and its financing were structured in expectation of stable cash flows that would be provided by RD 661/2007.

Several years of planning and work ensued before the CSP plants began operations in March and May 2012, and were definitively registered under the special regime in that year. During the period from 2007 to 2011, the claimants' representatives had multiple interactions with Spain's regulatory and licensing authorities in which those authorities repeatedly confirmed that the investments were subject to the RD 661/2007 regime.

The 2013/2014 disputed measures

As the claimants' CSP plants neared completion and entry into service, they crossed additional licensing and regulatory thresholds, which were completed in November 2012, during which time the Spanish authorities again affirmed their participation in the special regime under RD 661/2007. The Spanish Government, however, had become increasingly concerned by a large and growing cumulative 'tariff deficit', the financial gap between the costs of subsidies paid to renewable energy producers and revenues derived from energy sales to consumers, and from 2009 sought to limit the number of future projects potentially eligible for the RD 661/2007 regime.

In November 2011, Spain held elections, resulting in the formation of a new government in December 2011. In his inaugural address, the President pointed to the accumulated tariff deficit, then amounting to more than €22bn, and called for structural reforms in the energy system. The new government quickly took a number of measures aimed at reducing the tariff deficit, including by significantly reducing the level of subsidies paid to CSP and other renewable generators.

In February 2013, Royal Decree Law 2/2013 (RDL 2/2013) eliminated the premium option under RD 661/2007, leaving CSP producers the option of either the market price or the fixed rate tariff. RDL 2/2013 also cancelled the mechanism for updating feed-in tariffs in accordance with the consumer price index, substituting a different index lower than the CPI.

The most dramatic change adopted by the Spanish Government came in July 2013, with the enactment of Royal Decree Law 9/2013 (RDL 9/2013). It amended article 34 of the 1997 Electricity Law (which created the special regime for renewables producers) and repealed RD 661/2007. It eliminated the entire regime of fixed tariffs and premiums, and substituted a system providing for 'specific remuneration' based on 'standard' (but not actual) costs per unit of installed power, plus standard amounts for operating costs. Then, in December 2013, Spain adopted Law 24/2013, which superseded the 1997 Electricity Law and eliminated the distinction between the ordinary and special regimes.

In June 2014, Spain adopted Royal Decree 413/2014 (RD 413/2014) to replace the old regime. This provided for a regulatory regime intended to attain a prescribed reasonable return calculated by reference to a hypothetical 'efficient' plant. Ministerial Order IET/1045/2014 then set the remuneration parameters to be applied under that new regulatory regime. In sum, under the new regime:

- the tariff regime in RD 661/2007 was abandoned, substituting a new regime of reduced remuneration based on a hypothetical 'standard' investment and operating costs and characteristics of hypothetical 'efficient' plants, with remuneration limited to an operating life of 25 years
- remuneration was calculated based on regulators' projections of the revenues required to attain a prescribed lifetime pre-tax return of 7.398% based on the hypothetical costs of a hypothetical standard installation
- remuneration was based on capacity, not production, eliminating the incentive potentially available under RD 661/2007 to build more expensive but more productive plants—remuneration was capped at the hypothetical production of a 'standard plant'
- payments already received by a facility under the prior regime could be credited against the lifetime remuneration due under the new one, thus allowing clawback of 'excess' amounts received under the prior regime

The new regulatory regime culminating in Ministerial Order IET/1045/2014 applied to existing plants constructed and financed under the principles of the prior regime, which included the claimants' investment. As a result, the claimants' revenues dropped sharply from those projected by the investors and their lenders under the prior regime. The sharp fall of revenues from the levels anticipated under the RD 661/2007 regime forced the operating companies into debt rescheduling negotiations with their external lenders so that, by the end of 2014, the investment was valued at only €4m.

In December 2013, the claimants commenced arbitral proceedings against Spain under the auspices of the ICSID for violating the ECT by enacting the 2013/2014 disputed measures.

What were the issues for the tribunal?

The claimants' position, in essence, was that they had invested approximately €126.2m to develop three CSP plants in Spain. In doing so, they reasonably relied upon inducements and promises by the Spanish Government and, in particular, on the regime established in RD 661/2007, which conferred immutable economic rights protected by the ECT. They submitted that their expectations of a stable regulatory regime when they made their investment, which were based on both Spanish expert advice and Spain's 'road shows' promoting solar power to investors, were reasonable. Banks were prepared to provide the non-recourse funding required because, like the claimants, they had confidence in the stability of Spain's regulatory regime. As a result, they leveraged their investments with substantial non-recourse borrowings.

However, from 2012 to 2014, Spain took a series of measures drastically altering the regulatory regime, culminating in the elimination of the RD 661/2007 regime and its substitution with an entirely new regime. This dramatically reduced the cash flows necessary to sustain the investment, which Spain had offered to long-term investors through the RD 661/2007 regime. These changes left the plants with revenues barely sufficient to cover operations and maintenance and financing costs after rescheduling.

Accordingly, the claimants contended that Spain's actions in entirely eliminating and replacing the RD 661/2007 regime violated Spain's obligations under the ECT by:

- expropriating their investment contrary to article 13
- denying fair and equitable treatment contrary to article 10(1)
- subjecting the claimants' investments to unreasonable measures, contrary to article 10(1), and
- failing to honour undertakings entered into with the claimants' investments, again contrary to article 10(1)

For its part, Spain contended that the claimants had not been denied fair and equitable treatment, and there had been no expropriation or any other violation of the ECT:

- the claimants retained their minority shareholdings in the Spanish companies that own the solar plants that receive substantial revenues from energy sales and subsidies
- the claimants were only ever entitled to receive a reasonable return on their investment under the 1997 Electricity Law, which they were now assured under the new regime—by contrast, they had no property right to receive the RD 661/2007 regime, which over-compensated CSP plants
- like any State, Spain was entitled to change its regulatory regime to meet compelling economic challenges, such as Spain's tariff deficit, in order to serve the public welfare—the current regime is fair and assures the operators of efficient solar plants a reasonable return
- the claimants invested in overpriced and overleveraged plants—the substantial remuneration available under the current regime does not provide the claimants a satisfactory return on their investment, this results from their unsound structuring and financing decisions

It should also be noted, although it is not addressed below, that Spain advanced no less than six alternative jurisdictional challenges, all of which the tribunal ultimately dismissed, except for an objection with respect to a claim that certain taxation measures in 2012 (a 7% tax on the value of electric energy production created by Law 15/2012) violated the ECT, which it held was a taxation measure that had been carved out of the ECT.

What did the tribunal decide?

The tribunal, comprised of Professor John R Crook as president, Dr Stanimir A Alexandrov and professor Campbell McLachlan QC, rendered its final award on 4 May 2017, holding that Spain had violated the article 10(1) of the ECT by failing to accord fair and equitable treatment to the claimants. Article 10(1) of the ECT provides in relevant part:

'Each Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area. Such conditions shall include a commitment to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment. [...]'

The tribunal commenced by acknowledging that, absent explicit undertakings directly extended to investors and guaranteeing that States will not change their laws or regulations, article 10(1) of the ECT cannot eliminate states' rights to modify their regulatory regimes to meet evolving circumstances and public needs. No explicit undertakings were given by Spain directly to the claimants. However, this did not mean that Spain had or has an unfettered right to change legislation without incurring liability. Thus, the critical question for the tribunal was the extent to which treaty protections, and in particular, the obligation to accord fair and equitable treatment under the ECT, may give rise to a right to compensation as a result of the exercise of a state's acknowledged right to regulate.

In this regard, the tribunal acknowledged that Spain faced a legitimate public policy problem with its tariff deficit, and did not question the appropriateness of Spanish authorities adopting reasonable measures to address the situation. However, in doing so, Spain had also to act in a way that respected the obligations it had assumed under the ECT, including the obligation to accord fair and equitable treatment to investors.

The tribunal expanded on the legal principles applicable in this context, as follows:

- in accordance with the object and purpose of the ECT, which is to establish a legal framework that promotes long-term cooperation through legal stability and transparency in the energy field, the obligation under article 10(1) of the ECT to accord fair and equitable treatment necessarily embraces an obligation to provide 'fundamental stability in the essential characteristics of the legal regime relied upon by investors in making long-term investments'
- regulatory regimes can evolve, but the obligation under article 10(1) of the ECT to accord fair and equitable treatment means that regulatory regimes cannot be 'radically altered' as applied to existing investments, particularly not in ways that deprive investors who invested in reliance on those regimes of their investment's value

Applying those principles to this case, the ECT did not as a general rule bar Spain from making appropriate changes to the regulatory regime of RD 661/2007. Thus, the tribunal did not accept the claimants' contention that RD 661/2007 gave them immutable economic rights that could not be altered by changes in the regulatory regime. The claimants could not reasonably expect that there would be no change whatsoever in the RD 661/2007 regime over three or four decades. As with any regulated investment, some changes had to be expected over time.

However, at the same time, the ECT did protect the claimants against the 'total and unreasonable change' that they experienced. In particular, the claimants were protected from a 'fundamental change to the regulatory regime in a manner that does not take account of the circumstances of existing investments made in reliance on the prior regime'. Thus, article 10(1) of the ECT entitled the claimants to expect that Spain would not drastically and abruptly revise the regime on which their investment depended, especially not in a way that destroyed its value. But this was the result of RDL 9/2013, Law 24/2013, RD 413/2014 and implementation of the new regime through Ministry Order IET/1045/2014.

According to the tribunal, the evidence showed that Spain had changed its regulatory regime in 2013/2014 in a drastic fashion. It adopted and implemented an entirely new regulatory approach, applying it to existing investments in a manner that washed away the financial underpinnings of the claimants' investments. The new regime was based on different assumptions, and utilised a new and untested regulatory approach, all intended to significantly reduce subsidies to existing plants.

The tribunal devoted substantial passages of the award to analysing the different regimes. In the upshot, it concluded that Spain's repeal of RD 661/2007, and its decision to apply an entirely new method in 2014 by Ministerial Order IET/1045/2014 to reduce the remuneration for the claimants' existing plants, deprived the claimants of essentially all of the value of their investment. Doing so violated Spain's obligation to accord fair and equitable treatment. The tribunal, therefore, held that the claimants were entitled to compensation for the loss they had sustained in order to ensure full reparation of the loss caused by the violation of article 10(1) of the ECT.

As to remedies, the tribunal determined that damages should be awarded based on the reduction in the fair market value of the investments, to be determined by calculating the current value of the past and present cash flows that had been lost on account of the disputed measures (ie, a discounted cash-flow analysis). The claimants sought €196m for lost future cash flows for the period after June 2014. The tribunal's analysis on damages was largely in accordance with the claimants' expert evidence, although it deducted €68m from the amount sought on the basis that the claim of a 40-year service life for the plants had not been established. Thus, Spain was ordered to pay a principal amount of €128m. In making that order, the tribunal considered that the fact the claimants had invested in the order of €126m provided a 'reality check' on the reasonableness of the tribunal's conclusion regarding compensation due to the claimants.

Furthermore, the tribunal awarded the claimants both pre- and post-award interest, calculated on a monthly compounding basis at an interest rate of 2.07% for the period between 20 June 2014 and the date of the award and an interest rate of 2.50% for the period between the date of the award and the ultimate date of payment. Finally, the tribunal decided that it was 'fair overall' that each party should bear its own costs.

For completeness, it should be noted that, in view of its decision that Spain had breached its obligation to accord the claimants fair and equitable treatment, the tribunal decided that it did not need to determine the various other substantive claims for violation of the ECT advanced by the claimants.

What are the practical implications of the award and what impact does this decision have on the wider context?

In both Italy and Spain, the renewable energy sector (and especially the photovoltaic solar power sector) has been adversely affected by subsequent governmental measures that have unilaterally modified previous stable—and more generous—regimes. In Spain, the measures have now given rise to around 30 ICSID cases as well as treaty claims in arbitrations under the rules of United Nations Commission on International Trade Law (UNCITRAL) and the Stockholm Chamber of Commerce (SCC). Likewise, the adoption by Italy of the so-called 'Spalma-Incentivi' Decree in 2014 has produced a significant number of appeals before the domestic administrative courts, and has generated a number of arbitral proceedings (SCC and ICSID).

In this context, given the large number of extant arbitral proceedings in both Spain and Italy concerning retroactive measures designed to substantially scale back incentive regimes in the renewable energy sector, the *Eiser* award is both relevant and timely. Indeed, *Eiser* is the only known award on the merits rendered by an ICSID tribunal in relation the 2012/2013 CSP reforms in Spain.

Counsel acting for claimants are undoubtedly going to seek to rely on this award as a persuasive decision that ought to be followed by other tribunals in these cases, while Spain and Italy can be expected to seek to distinguish the award (eg, where measures other than the ones directly considered by the award are in issue) or persuade tribunals that it should not be followed. Whatever the outcome, it can be expected that the award will be closely analysed by tribunals constituted to determine the numerous arbitral proceedings relating to Italy and Spain that are still pending. However, as matters stand, it can credibly be said that the award gives investors bringing claims against Italy and Spain for drastic regulatory changes in the renewable energy sector the upper hand.

Investment claims under the ECT for violation of the fair and equitable treatment standard predicated on changes to a State's regulatory framework tend to be notoriously complex. In these cases, a balance has to be struck between the legitimate power of the state to change its regulatory framework in the public interest and the constraints that should be placed on that power in order to ensure that a foreign investor is accorded fair and equitable treatment in respect of its investment in the absence of any specific undertakings by the state towards that investor.

The award in *Eiser* makes an important jurisprudential contribution. It confirms that even in the absence of either a specific representation by a state as to the stability of a regulatory regime or a stabilisation clause, an investor may nevertheless be entitled to rely on the fair and equitable treatment standard when subjected to fundamental changes in the regulatory regime. As the tribunal itself emphasised, regulatory regimes can surely 'evolve', but at the same time, they 'cannot be radically altered as applied to existing investments in ways that deprive investors who invested in reliance on those regimes of their investment's value'.

Award details

ICSID Case No. ARB/13/36

Tribunal: Professor John R Crook (presiding), Dr Stanimir A Alexandrov and professor Campbell McLachlan QC

Date: 4 May 2017

Interviewed by Susan Ghaiwal.