

Balancing Interests in the Renewable Energy Sector Through a Radical Change Criterion: Let the Wolf Guard the Hen House?

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July 25, 2022

The *Spanish Cases Saga* illustrates the arduous task of balancing the host state's right to regulate and an investor's economic interests. This post summarizes the tribunal's reasoning in *Novenergia v. Spain* and *Stadtwerke München v. Spain* regarding FET breaches in the energy sector. The post argues that the latter case adopts a clearer analysis of FET breach which should be adopted for renewable energy related cases going forward. In particular, the analysis in *Stadtwerke* concerning legitimate expectations and radical legislative policy changes, offers a viable method for balancing investor and state interests regarding renewable energy investments. To develop this argument, this post first explains the difference between expected and unexpected or radical changes in a host state's legal framework under the FET obligation. Second, it introduces the theory of efficient breach to explain how this concept assists in explaining how tribunals should balance competing interests. Third, the post exemplifies this theory in practice by reference to the reasoning of the tribunal in *Stadtwerke München v. Spain*.

I. FET Breach: Expected versus Radical or Unexpected Changes

The investment dispute in *Novenergia v. Spain* derives from the changes implemented by the Country in its renewable energy sector. In 2007, in reliance to Spain's regulatory incentives, Novenergia built eight photovoltaic projects in the country. Later, in 2014, Spain rolled back on its Feed-in Tariff (FiT) incentives arguing that this measure was necessary to achieve economic sustainability of the market. Novenergia claimed that it had legitimate expectations of regulatory stability and that this sudden change to the regulatory framework violated the fair and equitable treatment (FET) standard under the Energy Charter Treaty (ECT, Treaty). (paras.153-155). The Tribunal engaged with similar cases, namely *Isolux*, *Eiser* and *Charanne*, and sided with Spain, concluding that Article 10(1) of the ECT does not grant investors, *ipso lege*, a legitimate expectation for a regulatory framework of a particular industry to remain unchanged (paras. 685-688). Despite this initial assertion, the tribunal in *Novenergia* ruled against Spain, arguing that the investor had legitimate expectations of stability that arose from other government actions and assurances (para.695, 697, 860).

The ruling in *Novenergia v. Spain* is consistent with that of *Antaris v. Czech* regarding the expectations of an investor to a fixed regulatory framework. In the latter case, the tribunal determined that the investors in the solar energy market in Czech Republic should have known that they were investing in a bubble market and, thus, could not have expected the regulation of the market to remain unchanged. Instead, the tribunal noted

that press and industry discussions indicated that a change was likely, such that any specialist professional would have been aware that eventually the host state might withdraw their initial incentives (para 434).

In both *Novenergia* and *Antaris*, the tribunals held that a prudent investor cannot have legitimate expectations for an absolutely stable regulatory regime. Instead, investors must anticipate “*expected changes*” in the form of regulatory measures (*Antaris* para. 360, *Novenergia* para.688)

The arbitral tribunal in *Novenergia* went further than that in *Antaris* and outlined the limits of a state’s right to regulate. It attempted to determine whether the host state measures constituted a fundamental, radical, or unexpected change. Ultimately, the tribunal held that “*radical or unexpected changes*” causing severe economic impacts for investors, despite not entirely obliterating the claimant’s investment, would constitute an FET breach. Nonetheless, the tribunal also noted that the economic effect on the claimant’s investment, while an important factor, is not the only factor to consider when conducting a balancing test under the FET standard (para. 694).

II. Efficient Breach: Balancing Interests to Assess Whether a Change is Radical, Unexpected, or Efficient

In his most recent book, **Federico Ortino** explains that a balancing test is often used by arbitral tribunals to clarify what constitutes a radical or unexpected change (*see p. 40*). Ortino draws a sharp distinction between an “*unreasonable or disproportionate change*” versus a “*strict sense regulatory change*”. The author notes that these distinctions arise from the different notions of legal stability, where a strict notion of legal stability would entail that any regulatory change would amount to an FET breach, whereas a soft notion of regulatory stability demands the tribunal to conduct a balancing test on the merits of the regulatory reform to determine the fairness and reasonableness of the measure under review (*see p.41*).

At this point, it is necessary to consider why a balancing approach is even desirable. In terms of efficiency, according to the theory of efficient breach, a host State’s measure leading to an investor’s “sacrifice” must bring about a greater benefit to be considered legitimate. Even if there is no adequate compensation (which Kaldor-Hicks calls hypothetical compensation), the host State’s measure is still efficient in terms of net benefits if the benefits outweigh the costs. This efficiency approach leads to a cost-benefit analysis and encourages the consideration of implementing less intrusive measures, and thus, fosters a balancing of different competing interests. In this regard, Thorge F Leander Ketelhodt argues that the FiT framework in the renewable energy sector provides the highest incentive scheme for foreign investors by creating a low-risk regulatory environment through a market-independent fixed FiT price of long duration, commonly, for the entire life of the project. However, as the author notes, the flip side is that the initial circumstances are likely to vary fundamentally throughout the life of the investment. The contract equilibrium may decline, and the host State should have the

right to modify the circumstances relevant to the contract within a reasonable limit. That limit cannot purely originate from the investor's expectations but must be based on an overall balancing of multiple factors.

For these reasons, the Tribunal's decision in *Novenergia v. Spain* – regarding the need to balance competing interests- is not convincing; since it ultimately favored a test that focused on the economic impact of the measure on the investor, while ignoring the pressing needs of policy adjustment in the name of public interest in Spain at the time. The FET language in Article 10(1) of the ECT suggests that the Treaty favors a strict notion of legal stability. Nevertheless, in *Novenergia*, the tribunal seems to interpret the FET clause as favoring a soft notion of legal stability, requiring the tribunal to conduct a balancing test. Yet, it is still questionable the extent to which the ECT calls for a balancing test and to what extent an ECT tribunal should consider competing interests. Nevertheless, the balancing test in the ruling of *Novenergia*, assigned the heaviest weight to the economic impact on investor, affecting its initial intention to commit to the soft notion of legal stability.

III. Efficient Breach and Balancing Interests in Practice: Stadtwerke München v. Spain

The tribunal in *Stadtwerke München v. Spain* carried out a comprehensive balancing test to evaluate the economic impact of the regulatory measures on the foreign investor, beginning with the analysis of whether Spain had acted in bad faith when modifying its FiTs scheme. Since the investor has "*asset specificity*", the host country has a dominant position to change its regulatory framework. This may lead to a "*classic bait and switch*" behavior. The Tribunal discussed Spain's behavior thoroughly and ruled that Spain did not modify its FiT regime in bad faith. (para 319-323)

Further, considering the investor's plea, Spain could have increased electricity prices to protect the renewable energy sector. In this case, the Tribunal carried out a subtest of the proportionality test to determine whether – considering the Spain's domestic context – *was there a less damaging alternative it could have adopted?*

By indirectly assessing two measures – (i) increasing electricity prices or (ii) cutting off incentives (FiT) – the Tribunal rejected the investor's argument and held that Spain's measures were reasonable. The latter outweighed the former. Presumably, the marginal benefits generated for electricity consumers (in addition to the benefits of reducing the host country's budget deficit) were more important than the marginal costs to foreign investors due to modifying FiT incentives.

As *Ortino* argues, under a soft notion of legal stability, an FET violation would not be established because of a detrimental change in the host State's legal framework but because such legal change will be deemed "unreasonable"(p.32). The reasonableness analysis will thus examine the merits of the regulatory change. The Tribunal in *Stadtwerke* found that Spain's regulations from 2010 did not radically change the legal and business environment in which investments were initially made, and that many initial

incentives for foreign investors in the renewable energy sector were still maintained. Thus, the Tribunal determined that the Spanish regulatory measures were not “unreasonable” and were the only available at the time.

IV. Final Remarks

In renewable energy sector, due to the lack of adequate information, FiT prices may be initially set too high, creating an excess supply that will need to be adjusted sooner or later. In this regard, it is reasonable for investors to expect that they will benefit from high FiT prices only for a short-term, subject to a high probability of regulatory changes. If understood in a narrow sense, a “radical change” – such as to sustain an FET claim – would only occur when it results in severe damages to investors due to unreasonable measures taken by a host state.

The tribunals in the cited cases determined that the Spanish regulatory changes were last-resort measures; that finding, added to the reasonableness of these measures, subject to their non-retroactive application would derive in a non-breach of the FET standard. Such a comprehensive analysis in *Stadtwerke v. Spain* is well suited to balance competing interests in renewable energy sector.

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