Right to Regulate vs Acquired Rights

How to Ensure the Success of Energy Projects by Making Outcome of Arbitral Disputes More Predictable

by Guy Block, Christophe Rolain and Elvira Saitova

Energy law contains numerous examples of tensions between a State's right to regulate and the investors' acquired rights. In every energy contract, public and private interests must be protected. The difficulty lies in the balance between the protected interests, predictability and regulatory risk.

1. From right to regulate to existence of 'regulatory risks'

In TTIP[1] or CETA,[2] "rights to regulate" are expressly included and some international treaties set certain limits. The imposed "limits" on the right to regulate are often in relation to expropriations or quasi-expropriations.[3]

Arbitral case law recognises States' right to regulate. It is expected that a State hosting investments will act in a "logical, unambiguous and transparent manner" so that the investor can identify the appropriate direction in the State's policy regarding its own investments.[4] [5]

In *Enron v Argentina*,[6] the arbitral tribunal adequately recalls the principle that stability does not mean "freezing" of the legislative system or "loss" of a State's regulatory

1 "Proposal for a Transatlantic Trade and Investment Partnership (TTIP), Trade in services, investment and e-commerce" (2014) chap. 2 Investment, art. 2(1). The article holds that "The provisions of this section shall not affect the right of the Parties to regulate within their territories through measures necessary to achieve legitimate policy objectives, such as the protection of public health, safety, environment or public morals, social or consumer protection or promotion and protection of cultural diversity."

2 "Comprehensive Economic and Trade Agreement (CETA)" (2014), chap. 8 Investment, section D, art. 8.9(1). The article holds that "For the purpose of this Chapter, the Parties reaffirm their right to regulate within their territories to achieve legitimate policy objectives, such as the protection of public health, safety, the environment or public morals, social or consumer protection or the promotion and protection of cultural diversity."

3 ECT (n2) art. 13. The article doesn't provide for a definition of the term "expropriation", but for the framework and situations under which it would be legal. It holds that:

> (1) Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalised, expropriated or subjected to a measure or measures having effect equivalent to nationalisation or expropriation (hereinafter referred to as "Expropriation") except where such Expropriation is:
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> (a) for a purpose which is in the public interest;
> (b) not discriminatory;
> (c) carried out under due process of law; and
> (d) accompanied by the payment of prompt, adequate and effective compensation.
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> Such compensation shall amount to the fair market value of the Investment expropriated at the time immediately before the Expropriation or impending Expropriation became known in such a way as to affect the value of the Investment (hereinafter referred to as the "Valuation Date"). Such fair market value shall at the request of the Investor be expressed in a Freely Convertible Currency on the basis of the market rate of exchange existing for that currency on the Valuation Date. Compensation shall also include interest at a commercial rate established on a market basis from the date of Expropriation until the date of payment.
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> (2) The Investor affected shall have a right to prompt review, under the law of the Contracting Party making the Expropriation, by a judicial or other competent and independent authority of that Contracting Party, of its case, of the valuation of its Investment, and of the payment of compensation, in accordance with the principles set out in paragraph (1).
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> (3) For the avoidance of doubt, Expropriation shall include situations where a Contracting Party expropriates the assets of a company or enterprise in its Area in which an Investor of any other Contracting Party has an Investment, including through the ownership of shares.

For the definition of quasi or indirect expropriation, see also: OECD, "'Indirect Expropriation" and the 'Right to Regulate' in International Investment Law", (2004) Working No 2004/4, 21, available at https://www.oecd.org/daf/inv/investment-policy/WP-2004_4.pdf (accessed 18 March 2019).

4 *Técnicas Medioambienrales Tecmed SA v Mexico*, ICSID Case No ARB(AF)/00/2, Award, 29 May 2003, para 154. The Arbitral Tribunal considers that *"this provision of the Agreement, in light of the good faith principle established by international law, requires the Contracting Parties to provide to international investments treatment that does not affect the basic expectations that were taken into account by the foreign investor to make the investment. The foreign investor expects the host State to act in a consistent manner, free from ambiguity and totally transparently in its relations with the foreign investor, so that it may know beforehand any and all rules and regulations that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives, to be able to plan its investment and comply with such regulations."*

5 *Enron Corporation Ponderosa Assets LP v The Argentine Republic*, ICSISD Case No. ARB/01/3, Award, 22 May 2007, para 266. It points out to the ambiguity and therefore a violation of the right to fair and equitable treatment: "*A decade later, however, the guarantees of the tariff regime that had seduced so many foreign investors, were dismantled. Where there was certainty and stability for investors, doubt and ambiguity are the order of the day*"; *Waste Management Inc v United Mexican States*, ICSID Case No ARB(AF)/00/3,30 April 2004, para 98:

> "… the minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct [...]or involves a lack of due process leading to an outcome which offends judicial propriety—as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process. In applying this standard, it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant."

6 *Enron v The Argentine Republic* (n 12), para 261: "*Stabilisation requirement does not mean the freezing of the legal system or the disappearance of the regulatory power of the state*".

power that should be linked to the 'stabilisation" clauses examined below.

On the other side, any investor is deemed to have analysed the "regulatory risk"[7] before investing. In *Charanne*'s case, the tribunal rejected investors' claim on the ground that "in order to make a reasonable investment decision, the claimants should have performed an analysis of the regulatory environment. Such an analysis would have revealed that the introduction of changes to the subventions in later years was highly probable".[8]

This "regulatory risk" is also used to assess if the principle of reasonable and legitimate expectations have been violated,[9] especially in the case of quasi-expropriation.[10]

In *Starett Housing Corp v In Iran*,[11] for example, the court held that:

> "Those who invest in Iran, like those who invest in any other country, must bear the risk of seeing the country affected by strikes, lockouts, unrest, changes in the economic and political system and even a revolution. If any of these risks materialise, it does not necessarily mean that the property rights affected by this type of event can be considered as having been usurped."

Zero regulatory risk does not exist and the investor is expected to assess it case by case. However, such risk can be mitigated through "stabilisation" clauses.

2. Attempts to limit regulatory risk through 'stabilisation' clauses[12]

Stabilisation clauses are intended to maintain the famous "balance" of relations between the parties. Their primary purpose is to limit the regulatory[13] risk that weighs on any investor. By the insertion of such clauses, the State is allowed to make regulatory changes as long as the economic benefit for the investor is maintained ("*Economic Equilibrium clause*") or the State commits not to modify the legislation in place at the time of investment or that the effect of the new law will not apply to the investment made ("*Freezing clause*"). Such clauses can be very general or very specific (taxation, import or export duties, employment or environmental law).

Stabilisation clauses differ from intangibility clauses preventing the State from using any national rules allowing to unilaterally change the agreement's terms and from freezing clauses.

Some arbitral awards rely on the absence of stabilisation clauses in order to draw conclusions — often negative — at the expense of investors. In the *Charanne*[14] case, the arbitral tribunal relied in particular on the absence of

7 Regulatory risk is defined as *"threats to the profitability of a project that derive from some sort of governmental action or inaction rather than from changes in economic conditions in the marketplace."* Theodore H Moran, *"Political and Regulatory Risk in Infrastructure Investment in Developing Countries: Introduction and Overview"*, (1999) 5(6) Center for Energy, Petroleum and Mineral Law and Policy (CEPMLP) Journal, 3.

8 *Charanne BV and Construction Investment SARL v The Kingdom of Spain,* SCC Case No V 062/2012, Award, 21 January 2016, para 514:
"[...] an investor has a legitimate expectation that, when modifying the existing regulation based on which the investment was made, the State will not act unreasonably, disproportionately or contrary to the public interest."

9 *National Grid PLC v The Argentine Republic*, UNCITRAL Case No 1:09-cv-00248-RBW, Award, 3 November 2008, para 173:
"[...] fair and equitable treatment is considered an objective standard that does not require bad faith by the State. It also shows that this standard protects the reasonable expectations of the investor at the time it made the investment, and which were based on representations, commitments or specific conditions offered by the State concerned. Thus, treatment by the State should 'not affect the basic expectations that were taken into account by the foreign investor to make the investment'."

10 OECD, "'Indirect Expropriation" and the 'Right to Regulate' in International Investment Law" (n 10), 21.

11 *Starrett housing Corporation, Starrett Systems Inc, Starrett Housing International Inc v The Government of the Islamic Republic of Iran, Bank Markazi Iran, Bank Omran, Bank Mellat*, 16 Iran-United States Claims Tribunal (Iran-U.S. CTR) Case No. 314-24-1, Award, 14 August 1987, para 154; Also cited by Hassan Seddigh, "What level of host state interference amounts to a taking under contemporary international law?" (2001) 2(4) Journal of World Investment, 664-665.

12 On stabilisation clauses, see Deloitte, "Stabilisation Clauses in International Petroleum Contracts: Illusion or safeguard?" (2014) available at https://www2.deloitte.com/content/dam/Deloitte/ug/Documents/tax/tax_StabilisationClauses_2014.pdf.

13 Katja Gehne and Romulo Brill, *Stabilisation clauses in international investment law: Beyond balancing and fair and equitable treatment* (Institute of Economic Law, Transnational Economic Law Research Center (TECL), School of Law, Martin Luther University Halle-Wittenberg, 2017), 5.

14 *Charanne v Spain* (n 17), para 503:
" [...] the Claimants could not have the legitimate expectation that the regulatory framework established by RD 661/2007 and RD 1578/2008 would remain unchanged for the lifetime of their plants. Admitting the existence of such an expectation would, in effect, be equivalent to freeze the regulatory framework applicable to eligible plants, although circumstances may change. Any modification in the amount of the tariff or any limitation of the number of eligible hours would then constitute a violation of international law. In practice, the situation would be the same that if the State had signed a stabilisation clause or adopted a commitment to not modify the regulatory framework. The Arbitral Tribunal cannot support such a conclusion."

a stabilisation clause to base its reasoning on regulatory risk-taking in Spain, in this case the change in the support regime for renewables. Similarly, in *Enron v Argentina*[15] and *Parkenings v Lithuania*,[16] the arbitral tribunals had firmly recalled States' right to regulate — i.e. the non-legislative freeze — arguing that it would have been otherwise in the presence of a stabilisation clause: "The Rule (or right to regulate) is valid unless the state and the investor enter into an agreement including a so-called stabilisation clause which freezes the legal regulation as at the day of allowing investment".

It should be noted that such stabilisation clauses are not applicable when a state is not a party to the agreement with the investor[17] and are sometimes considered unconstitutional as a government cannot alienate a legislative power it does not have.

A stabilisation clause cannot also prevent a state from a lawful indirect expropriation,[18] nor a direct expropriation unless the clause expressly considers that situation.[19] Even in this situation, the remedy is still a financial compensation.

Finally, such clauses can be found contrary to international environmental or human rights treaties thus not enforced by the courts or arbitration panels.

Since such clauses are part of States' sovereignty, they should be written as specific as possible with regards to the particular act of the state party being precluded or restrained in the clause, linked to an international arbitration clause and if possible, the applicable law is not the one from the State party to the agreement.

To alleviate concerns regarding the enforceability of a stabilisation clause, a State may unilaterally provide similar guarantees by means of a global Investment Code or a legislation specifically designed for a particular sector such as electricity, or gas. However, it should be noted that a State will still have the right to change such laws and regulations. Therefore, the question of a potential breach of the investor's legitimate expectations arises.

3. Limits of a host State's right to regulate and investor's legitimate expectations

Over the years, arbitral jurisprudence has established certain criteria to determine how far the State can go in its right to regulate and therefore how far the reasonable and legitimate expectations of[20] investors can go.

Several tests can be drawn from this case law, namely:

(a) The existence or name of promises, guarantees or assurances (representation and insurance) from the host State (Saluka Test);[21]

15 *Enron versus The Argentine Republic* (n 12), para 261:
"This Tribunal notes, however, that the stabilisation requirement does not mean the freezing of the legal system or the disappearance of the regulatory power of the State. As noted by the tribunal in CMS: It is not a question of whether the legal framework might need to be frozen as it can always evolve and be adapted to changing circumstances, but neither is it a question of whether the framework can be dispensed with altogether when specific commitments to the contrary have been made. The law of foreign investment and its protection has been developed with the specific objective of avoiding such adverse legal effects."

16 *Parkerings Companiet AS v Republic of Lithuania*, ICSID Case No. ARB/05/8, 11 September 2007, Award, para 332:
"It is each State's undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion. Save for the existence of an agreement, in the form of a stabilisation clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment. As a matter of fact, any businessman or investor knows that laws will evolve over time. What is prohibited however is for a State to act unfairly, unreasonably or inequitably in the exercise of its legislative power."

17 *Amoco International Finance Corp v Iran* (1987-II) 15 Iran – U.S.C.T.R. 240-241.

18 A lawful direct expropriation is done for a public purpose; in a non-discriminatory manner, in accordance with due process of law and provides for a payment as compensation. A indirect expropriation through a change of law or regulation is valid if non-arbitrary, non-discriminatory, proportionate and In good faith serving legitimate public welfare interests. See notably on the latter: *Methanex corporation and United States of America*, 3 August 2005.

19 *Aminoil v Kuwait*, 24 mars 1972; *Liberian Eastern Timber Corporation (LETCO) v Liberia*, 31 mars 1986.

20 *AES Summit v Hungary* (n 5). Full analysis of the court can be found in paras 9.3.6 – 9.3.26.

21 *Saluka Investments BV v The Czech Republic*, UNCITRAL, 17 March 2006, Partial Award, point 304:
"This Tribunal would observe, however, that while it subscribes to the general thrust of these and similar statements, it may be that, if their terms were to be taken too literally, they would impose upon host States' obligations which would be inappropriate and unrealistic. Moreover, the scope of the Treaty's protection of foreign investment against unfair and inequitable treatment cannot exclusively be determined by foreign investors' subjective motivations and considerations. Their expectations, in order for them to be protected, must rise to the level of legitimacy and reasonableness in light of the circumstances."

(b) The "drastic change" test in relation to the ordinary regulatory risk at the time of the investment;[22]

(c) The test of excessive profits (luxury profits).[23]

Behind each of these criteria or tests is the economic calculation — the famous balance — that justified the decision to invest.

4. Legal recognition of acquired rights: 'Grandfathering Clauses'

The State can also take the initiative to include in its legislation certain provisions designed to maintain a balance with investors, whether national or international, in the event of a fundamental change or disruption in the system through the "Grandfathering Clauses and other provisions for the maintenance of effects".

Typically, grandfathering clauses are used to maintain acquired rights prior to the adoption of a new law or the opening of a market. It repeats the "previous or historical agreements" that are valid, notwithstanding the new regulations. Only new constructions are subject to the new law.

A good example can be found in the recent opening of the West African electricity market (WAPP) where a resolution of the ERERA authority expressly provided for the continuation of the effects of bilateral (electricity) power purchase agreements notwithstanding the entry into force of the opening of the electricity market.[24]

However, exceptions are provided for to this prior art, in particular with regard to unused capacities.[25]

Such a rule was also applied in Europe in the aftermath of the liberalisation of the gas market[26] for long-term supply contracts. **LH-AG**

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22 *Técnicas Medioambienrales Tecmed SA v Mexico.*

23 *AES Summit v Hungary* (n 5), paras 10.3.31 – 10.3.32:

> "[...] the majority has concluded that Hungary's reintroduction of administrative pricing in 2006 was motivated principally by widespread concerns relating to (and it was aimed directly at reducing) excessive profits earned by generators and the burden on consumers. This is because virtually all of the debate in parliament at the relevant time was about "profits." Indeed, government minister Mr. Tibor Kovács specifically asked the opposition parties if they were prepared to support the proposal, which he said, 'gives tools for the government to limit the alleged and so-called luxury profits."

24 ECOWAS Regional Electricity Regulatory Authority (ERERA), "Approval of the Regional Market Rules for the West African Power Pool, Regulation No. 5/ERERA/15, 8 August 2015. Article 29.4 states:

> "Existing contracts: Existing contracts approved before the official launch of the 1st phase of the contract will be fully respected. However, the contracting parties are invited to make the necessary readjustments in order to adapt them as far as possible to the contract and the approved standard contract form".

25 Art. 29.5: Power Purchase Agreements (PPAs)

> a. The Terms and Conditions of a PPA are not mandated by these RMR except for the following:
> *(i)* Unused capacity on cross border interconnectors and transit capacity within national borders must not be withheld from any other Participants of the WAPP and must be declared to the SMO using the procedure for physical notifications specified in Article 30 Access to transmission capacity.
> *(ii)* If there is any clause or condition within an existing PPA or contract that specifically prevents the use of physically available capacity under normal operating conditions, it must be struck from the contract by mutual consent. If the PPA is silent on the use of unused capacity, then these market rules shall prevail.
> *(iii)* Any PPA agreed after the RMR approval shall be in the formal of the model contract and shall use the Transmission Pricing Methodology valid for that Market Phase.

26 Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005 [2009] OJ L 211/36, Annex I