Renewable Energy: Will Investors Strike Back?

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The year 2019 brought about new milestones for renewable energy in the world. Notably, the share of renewable energy in the EU's electricity mix hit a record high of 34.6%, with wind power grabbing 13.4%. Ukraine currently lags behind the EU, with a modest achievement of 5.5% in renewables, although the latest figures suggest that installed capacity doubled in 2019. In January 2020, the Ministry of Energy and Environmental Protection of Ukraine presented a draft concept of Green Energy Transition until 2050 aimed at increasing the share of renewables in the national energy mix to 70%.

Ukraine seems to be following in the footsteps of the EU states in many aspects, with one of them being the painful overhaul of the feed-in-tariff (FIT) for renewable energy. We can see the repercussions of similar reforms in Spain to this day, and their takeaways should be carefully considered by the Ukrainian government prior to taking action.

In 2009, Ukraine introduced the FIT at one of the highest rates in Europe. Despite the prescribed annual reductions, it's still a heavy burden for Ukrainian consumers. Last year the Ukrainian Parliament passed a law introducing a new system of green auctions; the very instrument which has proved its efficiency in Kazakhstan in a price reduction of up to 50%. Finding mutually acceptable changes to the FIT is now a key issue.

Investors already face prolonged delays in FIT payments. The mounting deficit adds to the rising concern that the government may introduce significant retroactive reductions to the FIT in the near future. Major regulatory amendments, coupled with their abrupt implementation, may then open the way for investors to pursue investment arbitration claims against Ukraine.

Implement, Invest, Scale Back – Repeat

Ukraine is a party to a large number of multilateral and bilateral treaties which have established a legal framework for the protection of foreign investments. Investors are typically offered such substantive protections as fair and equitable treatment, full protection and security, protection from unreasonable or discriminatory measures, expropriation and others. Pivotal regulatory changes by the host state often trigger fair and equitable treatment standard and an important component of it, namely the legitimate expectations of the investor.

Claims brought under such instruments are a tangible risk for Ukraine if the government proceeds with non-consensual changes. Similar experience of Spain, the Czech Republic and Italy, which have all been on the receiving end, is demonstrated below.

In Spain, basic incentive structure was implemented as early as 1998. Spain later introduced a FIT regime for the renewable sector. The effects of the 2008 economic crisis, together with excess generosity of the FIT, accumulated billions of euros in deficit. Solar power was particularly heavily subsidized: in 2009 alone, the solar-power industry received over EUR 2.6 billion though it supplied only 2% of Spain's electricity. In an attempt to deal with the deficit Spain had introduced dozens of regulatory changes by 2013 Spain, including major retroactive changes to renewable energy contracts and a moratorium on new projects.

Investors duly brought more than 40 arbitration claims against Spain, mostly under the Energy Charter Treaty. They claimed over 6.7 billion euros in damages. Around 700 million euros have already been awarded, with some cases still pending.

In November 2019 Spain was forced to approve new economic incentives aimed at encouraging investors to drop their claims in arbitration.

In the Czech Republic, the solar energy FIT introduced in 2005 resulted in a sizable increase in the electricity tariff for consumers. However, the Czech Republic adopted a different approach to that of Spain. In 2010, the government introduced a 3-year levy of 26% on revenues generated by photovoltaic power plants commissioned in 2009 and 2010. Later on, the government abolished the incentives for the power plants commissioned in 2014 onwards, while the earlier projects remained intact.

The Czech Republic faced 7 arbitration claims and successfully defeated them all, bar one. The approach of the Czech government proved to be reasonable since the changes did not have a retroactive effect and the solar levy was widely reported and discussed.

In Italy, the FIT for renewable energy was introduced in 2005. Subsequent regulations applied were based on the timing of the commissioning of the power plants. From 2011 the Italian government began to amend the renewables legal framework known as "Conto Energia". In 2014 investors had to choose either to accept a FIT cut under 20-year agreements, or to accept an extension of subsidies over a longer period, or to enter into a new agreement with a reduced FIT for the initial period and an increased one for an increased period.

Some 11 arbitration claims were subsequently brought against Italy, with 2 out of 4 awards being rendered in favour of investors whose legitimate expectations proved to be undermined.

Prospects in Arbitration

Although the same reforms sparked a large number of similar claims against states, the case law is far from consistent. The crucial issue is whether a government's incentive programs have created legitimate expectations on the part of investors and whether those have been frustrated either as self-standing protection or as part of fair and equitable treatment.

Importantly, there is no consistent interpretation as to what gives rise to an investor's legitimate expectations. Neither has a unified test been devised to draw a line between a state's right to regulate and respect of an investor's rights.

Host states can create legitimate expectations by making explicit representations to an investor. Whether a representation in the form of domestic legislation may amount to legitimate expectations is a subject of debate. Some arbitral tribunals have ruled that such an approach would equate the fair and equitable treatment standard to a stabilization clause. As a result, any changes in domestic laws would be elevated to a violation of international law.

There is seeming consensus that investors cannot expect that no regulatory change will occur if the government announces that updates or amendments may or will take place. The host state may further argue that before making an investment, investors should fulfil their due diligence obligations. Where an investor knew or should have known that certain changes to the incentive regime were expected, no legitimate expectations could be created. Therefore, the chance of success increases for those investors who invested at the outset of the incentive program. Last-minute investments may be qualified as opportunistic in nature.

This factor may be particularly important for Ukraine, as it attracted EUR 3.7 billion of investments into renewable energy in 2019 alone. These investments took place in the turmoil of FIT cuts in other countries, thus re-confirming the instability of the incentive. By the time of these investments, the FIT has proved to be unsustainable in the medium and long-term perspectives.

At the same time, it's important to bear in mind that multilateral and bilateral treaties tend to protect investors against total and unreasonable changes. Thus, retroactive radical changes that are profoundly unfair and inequitable, and which significantly affect or even eliminate the underlying investment, may result in an award being rendered against the host state.

Renewable energy investors in Ukraine are yet to see what changes the government has in mind. Depending on the approach chosen by the state, the investors' prospects in arbitration may vary significantly.

For Ukraine, however successful it may be in defeating claims (if any), the risk is to bear average legal costs to the tune of around EUR 3.2 million per case.

Final Remarks

There is a sense of déjà vu in Ukraine amidst the reforms of the expensive FIT regime for renewable energy. Taking into account the ambitious target set for 2050 and the need for ever larger investments in the sector, the state may not risk undermining its credibility. Extensive public discussion and negotiations with market players is a welcome initiative which may culminate in a win-win solution. In the event of major changes, and in the absence of a reasonable alternative regime, investors could be left with no other choice but resort to investor-state arbitration. At the current stage the prospects of such claims on the part of investors are difficult to gauge. However, for Ukraine, the risks are quite clear. Even if it successful in defeating any claims, it may face spending millions of euros in legal costs.