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CONTENTS

Spain

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The Spanish renewable sector after the regulatory changes of 2013/2014

Renewable energy has been one of the most controversial topics in the Spanish energy market during the last decade. Past policies regarding renewable energies were very successful in Spain, permitting a significant development of such technologies, making Spain one of the global leaders in this field.

However, times have changed. Spain's decision to be a world leader in clean energy led to the promulgation of an array of support schemes (feed-in tariffs, tax incentives, soft loans, loan guarantees...) which attracted foreign investors and foreign investment in droves. But the resulting large and growing electricity sector "tariff deficit" (i.e., the shortfall in tariff revenues vs. the cost of generating and delivering power) was deemed unsustainable.

The tariff deficit and the economic crisis that Spain is suffering since 2008 opened a period of regulatory and legal uncertainty characterised by continuous legislative changes. In recent years, the Spanish Government (actually, Spanish governments of all stripes) have promulgated a number of measures (three Laws, seven Royal Decree-Laws and seven Royal Decrees) with the intent and effect of modifying, reducing or removing some of the subsidies and other incentives in place when much of this investment in alternative energy was made or indirectly affecting the remuneration of renewable energy plants, such as creation of new taxes, limitation on the deductibility of interest, modifications in the rate revision regime, etc.). These changes have substantially reduced the remuneration received by renewable energy plants in operation in Spain.

New regulatory framework for renewable energy

From 2010 until mid-2013, Spain amended a number of regulatory provisions, reducing the incomes and the results from renewable projects but without changing the general legal framework.

Nevertheless, on 12 July 2013, the Spanish Government announced the legislative reform of the electricity sector and the main guidelines for a series of new pieces of legislation (the "**Electric Sector Reform**"). As with all other previous attempts to reform the electricity sector, the purpose of the Electric Sector Reform is to tackle once and for all the enormous electricity tariff deficit and lay the foundations for a new electricity system.

The core of the Electric Sector Reform is the total overhaul of the remuneration scheme for renewable energy facilities. Renewable energy facilities (we will refer to all of them as "**Renewable Projects**" for convenience) will be entitled to compensation until they are capable of competing in the market. The new approach is fundamentally different: Renewable Projects will be remunerated on the basis of a "*reasonable return*" calculated

according to their installed capacity investment cost and their O&M costs, rather than on their production (provided that a certain minimum number of operating hours is achieved).

The meaning of "*reasonable return*" on the investments made by renewable energy sponsors is defined. Regulation provides that a reasonable return, pre-tax, is a given margin over the average yield, for some period to be established by the Government before the start of a six-year regulatory period, of the Kingdom of Spain's 10-year bonds. The Spanish Government may change the margin and the average yield per each regulatory period.

Renewable Projects' remuneration is the sum of three different concepts: (i) the price obtained in the market by selling the electricity generated at market price just like any other power generator; (ii) an annual regulated remuneration for investments in capacity established by the Government; and (iii) an annual regulated remuneration for operation established by the Government.

An additional remuneration exists for projects located in the Spanish territories out of the Iberian Peninsula (Canary Islands, Balearic Islands and the African cities of Ceuta and Melilla).

Such remuneration is calculated for installations in accordance with their type and each project is included in a particular type. Therefore, each project receives the remuneration corresponding to the type of installation where it is allocated.

The regulated remuneration, which is paid during the entire regulatory useful life of the facilities, will afford the facilities a reasonable return.

The remuneration paid for investments is designed to compensate for investments in capacity that cannot be recovered through sales of electricity in the market, and is to be determined by reference to the net asset value of a standard generation facility of an efficient and well-run undertaking.

In order to fix the cost of the investments used for calculating the reasonable return, the Spanish Government has determined the exact values of standard generation facilities by an efficient and well-run undertaking, taking into account the different technologies, size, age, electricity system (mainland, islands, etc.) and any other factors deemed necessary.

It is understood that the renewable projects obtain a reasonable return with the sum of the price collected in the market and the remuneration paid for investment in capacity.

The remuneration for operation is designed to compensate operation costs when the O&M costs for a given technology per unit of electricity generated exceed the estimated electricity sales proceeds (less any capacity payments) for that same unit. The O&M costs will again be determined by reference to a standard type of facility managed by an efficient and well-run undertaking.

An efficient and well-run undertaking is a concept developed by the European Commission as representative of an undertaking under satisfactory management, in the context of the analysis of public aid when granting compensation for the provision of services of general economic interest (see *"Communication from the Commission on the application of the European Union state aid rules to compensation granted for the provision of services of general economic interest"*, 2012/C 8/02). It is not the same as simply an undertaking generating profits. Consideration must also be given to compliance with accounting standards and productivity.

An important aspect of the new remuneration scheme for Renewable Projects is that the regulated remuneration is in principle determined for six-year periods (each, a regulatory period). At the end of each regulatory period, the new remuneration will be determined

by updating the sales proceeds forecast, O&M cost forecasts, price forecasts, variable generation costs, the financial remuneration rate and the reasonable return. The first regulatory period will end on 31 December 2019.

Every three years, the remuneration will be revised based on market sales forecasts for the next three years and the market deviation adjustment factors. The remuneration for operation will be updated (increased or decreased) by the Government on an annual basis for those projects whose costs are substantially linked to the price of fuel. The remuneration for investment may be adjusted annually depending on the number of operating hours of the project. Renewable Projects must operate a minimum number of equivalent hours annually, otherwise they lose the right to collect the remuneration for investment.

As a consequence of that, existing Renewable Projects have been seriously affected by the Electric Sector Reform and the new remuneration system described above. The new system applies retroactively to all renewable plants. The impact of the reform is different depending on the technology, years in operation and other parameters, for instance, some existing renewable projects will not receive any remuneration in the future (apart from the amounts collected for selling the electricity in the market), such as wind farms in operation before 2005, but most of them are suffering a substantial reduction in their incomes. The reason is that the Government considers that the amounts collected in the past have already provided such projects with a reasonable return for their investments.

Nevertheless, any amount already collected via the existing regulatory schemes will not have to be returned; even if the project remuneration under the existing regulatory scheme exceeds the reasonable return which the project is entitled to under the new regulation.

Claims brought by investors against the regulatory changes

Investors have challenged the measures in the Spanish courts. By and large, their claims have been or are considered very likely to be rejected following the argument that the Government may change the regulation at any moment as far as it provides a reasonable return to the investors, and such investors are not obliged to return the amounts already paid and received.

According to the judgments already issued by Supreme Court, in order to claim a compensable damage the whole lifetime of the installations must be taken into account, and it has been evidenced that the reduction on the incomes as a result of the limitation on the remuneration has been compensated with subsequent legislation. Therefore, the electricity production through this special regime still provides a reasonable return (8% annually) and so, no unlawful harm or damage may be claimed.

The Supreme Court points out that the holders of photovoltaic installations:

> "*did not purchase a correct and unlimited right to perceive a regulated tariff for all the net energy produced during the whole lifetime of the installation in the terms that in that time the regulatory provision laid down*". It also notes that "*[T]he form, the amount and the duration of the economic incentives recognised to the photovoltaic installations cannot remain unaltered with that initial regulation, but nonetheless have to adjust to the new circumstances, in particular, to the technology development and to the new economic situation that has affected the initial projected demand for electricity, without forgetting the so-called 'tariff deficit', which has exponentially increased in the latest years because the real costs of the regulatory activities and the own functioning of the electric system cannot be absorbed with the regulated tariffs imposed by the Administration and be finally assumed by customers.*"

The Supreme Court considers that public authorities must ensure that installations offer to their owners a "reasonable profit". Consequently, the damage caused for the limitation of energy that may have the right to receive a regulated tariff, may only be considered unlawful, and therefore, be entitled to compensation, if that amendment has determined that such installations are not reasonably profitable.

Furthermore, the Supreme Court considers that the constitutional principle of non-retrospective application of the laws is not violated for the reduction of the remunerations carried out by means of regulatory changes, as such limitation does not affect acquired rights or effects already produced.

Finally, the Supreme Court has also rejected the argument about the infringement of EU law in relation to legal certainty and protection of legitimate expectations, as it considers that the tariff system provided for in the 2007 regulations and ahead did not have an unalterable nature, and that it was very likely to be amended. In any event, the essential element in which all state liability claims must be grounded was not evidenced either; that is, the effective and unlawful harm or damage.

A number of claims are currently awaiting judgment. However, due to the case law that the Supreme Court and the Constitutional Court have elaborated during the last five years, nothing is expected from those judgments.

The last hope is the result of the international arbitrations brought by foreign investors (see following section). We understand that the Tribunal Supreme will be sensitive to the awards resulting from the arbitrations. A defeat of Spain in those international processes may change the mind of the Supreme Court, or even the mind of the Spanish Government, implying a new reform of the remuneration mechanism for projects in operation before 2013 as an implicit compensation for the regulatory changes by means of an increase of future remuneration.

International arbitrations

Foreign investors affected by the new provisions have the additional option to commence international arbitrations against the Kingdom of Spain. The options they have are determined by international treaties for the promotion and protection of investments ratified by Spain. There are two ways: (i) specific bilateral treaties for the protection of investors; or (ii) multilateral treaties such as, in particular, the Energy Charter Treaty ("**ECT**") signed in December 1994, in force since April 1998, ratified by Spain and many other countries.

Specifically, the ECT could be invoked to obtain compensation for damages caused by Spain to foreign investors (but not domestic investors) that are nationals of a state which has ratified the ECT. The ECT is a multilateral treaty for the protection of foreign investment and the promotion of international trade and competition in the energy sector, and has in recent years attracted a very significant amount of investment claims. Several factors explain this activity, including of course, geopolitical and economic considerations having a special impact on investors and investments in the energy sector. But the key factor in the recent prominence of the ECT in investment arbitration is its availability to serve as the substantive basis for investors in the renewable energy sector to challenge regulatory changes recently imposed in a number of ECT member states.

The ECT has proven to be the "go-to" option to challenge regulations having the intent and effect of reducing economic incentives that were accorded to investors in the sector before the financial crisis hit, in order to ensure an attractive return on their investment.

The cornerstones of the ECT are its investment protection regime and dispute settlement system.

Insofar as investment protection is concerned, the ECT's critical provisions are the Article 13 protection against undue and uncompensated expropriation, and the Article 10(1) guarantee of fair and equitable treatment ("FET"), particularly in the context of adverse regulatory measures.

During the last two years, a veritable barrage of ECT arbitral proceedings (more than two dozen as of this writing) has followed. Needless to say, each of these cases (as well as any that may follow) is unique. The measures challenged are manifold, and while they share common elements, no two are identical. They affect various renewable subsectors (photovoltaic, thermosolar, wind, etc.), each with its own distinguishing characteristics.

In any event, rarely if ever have so many cases of a generally similar nature, raising generally similar issues under international investment law, been cued up for decision over such a short time. It can be expected that in the coming two or three years, as these cases reach decision, the vexing issues of indirect expropriation and (especially) legitimate expectations under the rubric of FET will be amply developed, debated and (perhaps) clarified, with consequent effects going beyond renewables and beyond the ECT and impacting the future of investment arbitration generally.

Until recently, Spain had been on the receiving end of only two investment arbitrations, the historic Maffezini case involving an FET claim under the Spain-Argentina bilateral investment treaty, and a recent claim brought by the Venezuelan Inversión y Gestión de Bienes, I.G.B., S.L. and IGB18 Las Rozas, S.L., involving a failed real estate development in suburban Madrid.

The first award: a victory for Spain

On 21 January 2016, the first final award in a Spanish renewable case was handed down in Charanne. The case involved a challenge to a set of legislation enacted in 2010, brought by Dutch and Luxembourg indirect shareholders of a Spanish entity which (via separate vehicles) owns and operates a number of photovoltaic plants producing and selling electric energy in Spain. The challenged legislation (Royal Decree 1565/2010 of 19 November 2010 and Royal Decree Law 14/2010 of 23 December 2010) modified a special regime for solar energy producers that were set up in 2007 and 2008. The changes, *inter alia*, eliminated the feed-in tariff contemplated by the special regime after 25 years and for the remainder of the useful life of the plants in question, and capped the amount of operating hours that could be subject to the regime (and its regulated tariff) during a three-year period (2011–2013) but extending from 25 to 30 years the time the plants were entitled to be paid under the feed-in-tariff.

Various jurisdictional objections were raised by Spain and rejected by the Arbitral Tribunal:

- Spain's fork-in-the-road objection (Article 26(3)(b)(i) of the ECT), which was based on the facts that: (a) the entity in which the claimants were indirect shareholders and the SPVs had brought suit in Spain's Supreme Court challenging the norms; and (b) affiliates of the entity had brought a claim before the European Court of Human Rights, was rejected, the Tribunal concluding that the "triple identity" test necessary to trigger the fork-in-the-road was not satisfied where the entities involved in the various proceedings were different (mere membership in a common group being insufficient to establish sufficient identity).

- Spain's assertion that the Tribunal should conclude that the claimants should not be recognised as investors under article 1.7 of the ECT, since they were owned and controlled by nationals of Spain, was rejected, the Tribunal stating that absent evidence of fraud which might permit a lifting of the corporate veil, the language of the ECT was clear to the effect that due establishment under the laws of a contracting party is sufficient to merit treatment as an investor.
- Spain's assertion that permitting the Tribunal to resolve the dispute would be contrary to Spanish public policy and the principle of equality established in article 14 of the Spanish Constitution was rather summarily rejected by the Tribunal, on grounds that the provision in question did not relate to non-Spanish tribunals, and that Spanish public policy could not limit the jurisdiction of a tribunal established pursuant to a treaty to which Spain was party.
- Finally, Spain's assertion that the dispute was an intra-EU dispute, with no diversity of territory, was rejected, the Tribunal considering that individual states should not be deemed to have lost their character as EU member states merely by virtue of being part of the EU's economic integration regime.

The focus of the merits portion of the case and the award was on the claims that the 2010 roll-back of the incentives initially created in 2007/2008 constituted a violation of the ECT's protections against undue expropriation and its guarantee of FET (legitimate expectations).

The Tribunal dismissed the indirect expropriation claim rather readily, noting that to constitute an indirect expropriation meriting protection under the ECT, the effect of the challenged host state measure must be tantamount to an effective taking of all, or such part of the investment of such magnitude as to destroy its value and be the equivalent of the deprivation of title of the investment. Since what claimants actually complained of was simply a reduction in profitability of their indirect holding and thus in the value of their shares in the company owning the assets in question, the Tribunal rejected the indirect expropriation claim. While the version of the award (published by the Spanish *Ministerio de Economía, Turismo y Fomento* on its webpage) redacts the percentage reduction of profitability of the photovoltaic plants in question, the drafting suggests that the reduction was relatively modest in percentage terms and in any event did not leave the plants operating at a loss. In any case, given the Tribunal's emphasis that inherent in the concept of expropriation is the loss of property, even a severe reduction in profitability would not be sufficient to constitute indirect expropriation.

The Tribunal acted by a majority over a partial written dissent on the FET issue. The majority took a fairly strict view as to the source of legitimate expectations meritorious of protection under the ECT. The majority concluded that claimants had not received specific commitments as to the stability of the regulatory regime, that regulations aimed at a limited number of investors are general in nature and thus cannot be understood as specific commitments sufficient to generate legitimate expectations, that investors cannot expect an existing regulatory framework to remain unchanged in the absence of a specific commitment to this effect and that objectively-viewed, the likelihood of regulatory change of the special regime's initial contours was reasonably foreseeable at the time of the investment.

In this regard, the majority noted that Spanish law and jurisprudence predating the investment specifically permitted Spain to modify its solar regulations, that the Spanish promotional documents inducing foreign investment were not sufficiently specific to create legitimate expectations, and that registration of the plants on an administrative register was merely an administrative requirement and not a guarantee of a specific return.

The partial dissent, while agreeing as a general legal matter that legitimate expectations as to regulatory stability are not created by general legislation, would have found that the Spanish state's actions in connection with the special regime (including the direction of the special regime to a select and limited group of potential recipients) created objectively legitimate expectations as to the maintenance of its initial contours sufficient to merit protection under the ECT against changes of the sort implemented in 2010.

Thus, for the dissent, legitimate expectations need not necessarily be derived only from specific commitments or conditions, but can also be grounded in appropriate circumstances on the host state's legal regime at the time of the investment.

The Tribunal finally (without dissent) rejected the claim that the modified regime created by the 2010 regulations applied retroactively.

On initial analysis, the Charanne award triggers two observations.

First, it would seem to indicate that for the critical issue of FET/legitimate expectations, the battle is served: the existence of a terse, respectful but forceful dissenting opinion on the point highlights the centrality and difficulty of the issue of what degree of specificity is required to constitute a commitment sufficient to generate legitimate expectations deserving of treaty protection.

Second, the award's repeated mention of its being limited to the case at hand and the 2010 regulations that it challenged, makes clear the fact-specific and measure-specific nature of the legitimate expectations exercise. Since the vast majority of the Spanish renewable cases involve challenges of post-2010 regulatory measures, the impact of the split decision in this first battle remains very much to be seen.

One can perhaps anticipate a variety of results, difficult to reconcile, in the upcoming awards.

Consolidation process

The Electric Sector Reform looks to have had economic motives behind it. According to the news from the Government, the electric system is not generating additional tariff deficit, the legal regulatory framework has not been amended during the last two years, and the Spanish economy is improving, thus investors are coming back to Spain looking for opportunities in the renewable market.

As a consequence of that, Spain is suffering a period of consolidation, reducing substantially the number of players in the market. There are a number of opportunities for acquiring not only renewable facilities but also big companies active in the sector for years, with an international presence and a large number of MW in their portfolios.

Future projects

For future renewable projects, regulation established competitive bid processes called by the Government in order to obtain the right to the remuneration mechanism described below. However, there is no commitment by the Government on the number of MW or when these bid processes will be called.

A special regime has been enacted for new projects located in the Spanish territories out of the Iberian Peninsula (Canary Islands, Balearic Islands and the African cities of Ceuta and Melilla). The Canary Islands has already promoted the construction of a new project. At the end of year 2015, the Government called for the first bid for wind and biomass technologies. Although the number of MW was reduced, we understand that the process was

successful for the Government. Thus, probably, a new contest will be called in the future. At the end of the day, as a consequence of the regulatory uncertainty established in Spain since 2010, the number of new projects has been reduced dramatically and Spain may not be able to comply with European requirements and the EU's 20-20-20 goals (20% increase in energy efficiency, 20% reduction of CO_2 emissions, and 20% renewables by 2020).

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Francisco is specialised in energy; advising on numerous projects relating to the promotion, acquisition, construction and financing of energy projects in all contractual and regulatory related matters.

Over the last 10 years, he has focused on the renewable energy sector, having a deep knowledge of the regulation affecting this sector, especially of that approved in the last few years greatly affecting the regulatory and benefits frame of renewable plants. He advises all kind of players involved such as project promoters, contractors, financing banks, project purchasers and/or sellers, managers of the installations, etc.

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