MANAGING SOVEREIGN RISK IN SOUTH-EAST ASIAN RENEWABLE ENERGY PROJECTS

Foreign investment in renewable energy projects is continuing to grow in South-east Asia. While the potential rewards are great, renewable energy investments are often associated with a relatively high degree of sovereign risk. We explore how that risk can be managed and the steps that investors should consider.

Key issues

- Foreign investment in renewable energy projects is continuing to grow in South-east Asia.
- Most renewable energy projects involve direct interface between investors and the host government by way of Feed-in Tariffs (FiTs).
- FiTs and other government incentives are, by their very nature, high sovereign risk.
- Investors and contractors should consider using the BIT, MIT and FTA system to secure investment protection (including international arbitration rights).

WHAT ARE THE RISKS?

According to one study of Investor State Dispute Settlement (**ISDS**) cases, energy disputes are the most common subject matter of dispute between States and foreign investors,[1] and an increasing portion of the overall energy dispute case-load is comprised of disputes in the renewable energy sector.

Most renewable energy projects involve direct interface between investors and the host government. In most cases, governments offer Feed-in Tariffs (**FiTs**) that are determined in regulations and then reflected in Power Purchase Agreements (**PPAs**) between producers and State-owned utilities. The existence of FiTs and other incentives will be material, and often determinative, in a foreign investor's decision to invest in the project. But FiTs and other government incentives are, by their very nature, high sovereign risk components of a renewables project and increasingly the cause of disputes between foreign investors and host governments.

THE USE OF PPAS AND FITS IN SOUTH-EAST ASIA

With a population of some 640 million people, South-east Asia's energy needs are steadily increasing and renewable energy is a key focus. The Association of Southeast Asian Nations (**ASEAN**) has agreed to pursue a 20% reduction in carbon emissions by 2025 and some States have gone further, including the Philippines, which has pledged a 70% reduction by 2030.

Both PPAs and FiTs are frequently used by South-east Asian States. PPAs are entered into between purchasers or "*offtakers*" – often a State-owned electricity utility – and privately owned power producers to secure the payment for an independent power plant. This is often achieved by securing a price that

[1] Known treaty based cases. See United Nations Conference on Trade and Development, *Mapping of PPP-related ISDS cases* (2016) (available online: https://investmentpolicy.unctad.org/pages/31/mapping-of-ppp-related-isds-cases).

the foreign investor will receive for the electricity it produces over an extended period of time (for example 20 years). This price is often the FiT.

In simple terms, a FiT is where the State or a State-owned-utility pays a long-term rate to independent power producers to develop renewable energies. These rates are typically provided for in legislation. The application of a FiT will ordinarily result in profit for the foreign investor, although FiTs often fall quickly after the first round. In South-east Asia, tariff regimes have been implemented in a number of jurisdictions including Vietnam, Indonesia and the Philippines.

SOVEREIGN RISK

Sovereign risk in the electricity sector is significant. A 2016 analysis by the United Nations Conference on Trade and Development (**UNCTAD**) found that electricity was the most common economic sector in terms of number of known treaty-based ISDS cases (154) and share of PPPs giving rise to ISDS claims (90%); followed by water and sanitation (36 known ISDS cases, 80% PPP-related); construction (69 ISDS cases, 30% PPP-related); and transportation (37 known ISDS cases, 60% PPP-related).

A large proportion of electricity-related ISDS cases relate to changes in laws and the revocation or reduction of FiTs and other government incentives. In Europe, for example, more than 40 investment treaty claims have been brought against Spain relating to its decision to change regulatory policies encouraging investment in renewable energy projects in the late 2000s. In 2017, Eiser Infrastructure Limited became the first investor to be awarded damages against Spain (€128 million) by a Tribunal. In that case, the claim was brought under the Energy Charter Treaty (**ECT**) (discussed below). The Tribunal found that the Fair and Equitable Treatment (**FET**) standard under the ECT protected investors from "*a fundamental change to the regulatory regime in a manner that does not take into account of the circumstances of existing investments made in reliance on the prior regime*". The Tribunal further found that Spain eliminated a favourable regulatory regime that had been extended to encourage investment, and replaced it with an "*unprecedented and wholly different regulatory approach*" which was profoundly unfair and stripped Eisner of "*virtually all of the value*" of its investment.

It remains to be seen whether similar issues will arise in South-east Asia. It seems reasonable to expect that, in some South-east Asian countries where renewable energy investment has been actively promoted by governments, investment disputes will arise. Over time, some of the countries concerned may become reluctant to honour mature PPAs that include high FiTs, if only because high FiT PPAs may appear uneconomical in comparison with newer projects (some of which may have prices based on reverse auctions).

There are a number of ways that a government may seek to avoid paying these prices, including by stopping payments and seeking to renegotiate (see for example the Indian State of Andhra Pradesh, which in 2019 tried to force renewable producers to lower the price included in their PPAs), implementing legislation that provides for an economic merit-order (i.e. lowest priced electricity is dispatched first), or by other measures that effectively preclude higher price producers from accessing the grid.

HOW TO MANAGE SOVEREIGN RISK

To reduce sovereign risk and to best protect their investment, investors should consider nationality planning to secure the coverage of Free Trade Agreements (**FTAs**), Bilateral Investment Treaties (**BITs**), or Multilateral Investment Treaties (**MITs**) that provide protections against unlawful expropriation and unfair treatment and clear access to ISDS in the event of a dispute with their host State. Nationality planning is the process of corporate structuring an investment with the aim of obtaining FTA, BIT or MIT protection.

This nationality planning exercise should be undertaken before the investment is made, although it is possible to restructure to obtain such treaty protection after an investment has been made (provided that, at the time of restructuring, a dispute between the investor and the host State does not exist or is not reasonably foreseeable).

If an investor covered by an FTA, BIT or MIT is subjected to measures by a State that affect its ability to sell electricity at the FiT included in the PPA, there are a number of possible claims that could be made (each dependent on the relevant facts of the investment). These include claims for breach of the FET standard and claims for indirect expropriation. The renewables cases against Spain illustrates this combination of claims.

In addition to nationality planning, investors should seek to obtain investment protections (including the right to refer disputes to international arbitration) through a direct agreement with their host State. Investors normally look to secure other terms commonly included in investment agreements for major natural resources projects, such as stabilisation provisions and waivers of sovereign immunity. However, relatively few governments, including in South-east Asia, are willing to enter into investment agreements with renewable energy investors – a reality that makes it even more important for investors to plan their investments so that they are covered by an appropriate FTA, BIT or MIT.

STEPS INVESTORS SHOULD CONSIDER

The experiences of renewable energy investors in other countries, such as Spain, show that sovereign risk is a major factor. Foreign investors and contractors entering into South-east Asian renewable energy markets should carefully consider the legal framework in which they are investing and take steps to protect their investment from the outset. Investors and contractors should consider using the BIT, MIT and FTA system to secure investment protection (including international arbitration rights) and, where possible, seek direct agreements with, or specific written assurances from, their host State.

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