July 13, 2012

Low carbon energy policies: vested rights, legitimate expectations and differential treatment in domestic and international law

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Cases and matters commented on:

Secretary of State for Climate Change v Friends of the Earth and Others, [2012] EWCA Civ. 28, aff'g lower decision

Mesa Power Group LLC v Government of Canada, Notice of Intent to Submit a Claim to Arbitration under Chapter Eleven of NAFTA, July 6, 2011

Mercer International Inc v Government of Canada, Notice of Intent to Submit a Claim to Arbitration under Chapter Eleven of NAFTA, 26 January 2012, and request for arbitration (ICSID Additional Facility), April 30, 2012

Governments around the world are adopting a variety of low carbon and green energy policies designed to increase the share of renewable energy sources in the energy mix. In addition, some governments, including the government of Alberta, have also adopted policies to provide for the sequestration of carbon dioxide emissions where carbon fuels continue to make up a significant part of the energy mix. These policies often provide financial incentives to investors in order to persuade them to commit to the new technology. For example, many governments provide for feed-in-tariffs (FIT) to encourage the development of wind and solar energy. A FIT represents a commitment by the government directly or through the incumbent utility to purchase the output from the designated facility (e.g. wind generator, solar panels or biomass generation) at a specified price for a prescribed number of years (typically representing the amortization period of the asset). Such commitments are designed to be "bankable" in the sense that the proponent will be able to use the commitment to raise capital to fund the venture. Similarly, many governments have found it necessary to provide financial support (subsidies or "state aid" in the language of the European Union) for the first commercial scale carbon capture and storage projects. For example, the province of Alberta is currently providing support for three different sequestration related projects in the province (see here).

In addition to providing incentives for new forms of generation and new technologies to clean-up forms of conventional generation, governments may also introduce laws and polices aimed at causing conventional generators to withdraw from the market either by making it more expensive for those forms of generation or simply by prohibiting certain forms of generation and forcing plants to close down before the end of their useful lives. Examples of the former include carbon taxes and cap and trade systems (which increase the cost of carbon based fuels); examples of the latter include Canada's proposed *Reduction of Carbon Dioxide Emissions from*

Coal-Fired Generation of Electricity Regulations (see post by Astrid Kalkbrenner here) and Germany's decision to close down its nuclear facilities by 2022.

But governments are fickle and sometimes play favourites. For example, governments change and the new administration may seek to back out of commitments made by the previous government. We saw a potential example of this in the last election in Alberta. The climate skeptics in the Wildrose Party denounced the Stelmach government's commitment to CCS and promised to cut funding to CCS proponents (see here). Other governments may come to believe that FIT programs are too generous (because technological improvements have reduced costs) or simply conclude that the government (or rate payers) cannot afford to continue subsidizing non-competitive forms of energy. Alternatively, governments may unwittingly (or deliberately) end up favouring some players rather than others in the design (or withdrawal) of support programs thus leading to charges of discrimination (see for example one of the first cases under the Energy Charter Treaty, *Nykomb Synergetics Technology Holding AB v The Republic of Latvia*, SCC, 16 December 2003.

What does the law have to say about all of this? In some cases it is evident that the investor may simply have an action for breach of contract. That presumably would have been the cause and course of action available to the three Alberta CCS proponents had the Wildrose Party been elected and delivered on its election promise. I say "presumably" because despite promises that the contracts would be made publicly available once all four deals had been finalized – and now there are just three – the texts have yet to be posted by the Government of Alberta.

But other examples may be more complicated. This post comments on three examples. The first refers to some domestic administrative law litigation in the English courts earlier this year on a FIT program and the second and third examples covers two NAFTA filings, one filed last year and involving Ontario's FIT program and the second filed earlier this year and targeting alleged discrimination in the implementation of British Columbia's policies to encourage biomass based generation in the pulp and paper sector. In picking these examples I do not mean to suggest that these are the only examples. For example, Vattenfall, the Swedish company, has commenced an ICSID arbitration based on the Energy Charter Treaty against Germany alleging that Germany's decision to close down nuclear plants including Vattenfall's Krűmmel and Brunsbűttel plants by 2022 before the end of the useful lives of those facilities is denying it the benefit of its investment. Germany registered the arbitration with ICSID on May 31, 2012 (for discussion see Bernasconi-Osterwalder and Hoffman).

Secretary of State for Climate Change v Friends of the Earth and Others involved a preferential FIT offered to small-scale low carbon generators including generators in the biomass, wind, and solar photovoltaic (solar PV) sectors. The scheme was put in place under the terms of s.41 of the UK's Energy Act. At some point the Minister became concerned that larger small scale solar PV projects were taking up a disproportionate share of the funding available, principally, it would appear, because the costs of installing a 4kW had fallen by over 25% resulting in higher real rates of return. The Minister engaged in a fast track consultation on this issue commencing in November 2011 and closing on 23 December 2011 after which the Minister made two decisions. The first was to reduce the FIT for facilities which became eligible after 1 April 2012 and the second was to reduce the tariff for facilities which became eligible after 12 December 2011, effective 1 April 2012.

The applicants, the ENGO Friends of the Earth but also a number of solar PV installers, immediately sought judicial review of the second branch of the decision but not the first. Both

the first instance judgement and the Court of Appeal ruled that section 41 of the Energy Act did not authorize the Minister to change the tariff for a generator that had already qualified as eligible. Even though such a change might appear to be prospective (i.e. there would be no claw-back of monies already paid) the reality is that such a change would interfere with an existing entitlement i.e. to the tariff which was prescribed in the year when the generator became eligible for a 25 year term. The Minister could not thereafter change the rate except as contemplated to take account of inflation. The Minister could change the rate for generators who had yet to qualify as eligible but that was a different matter (at para 50). The Court of Appeal was clearly of the view that this distinction conformed to the commercial realities of investments in energy generation (at para 51):

> It is not impossible but it would be curious to contemplate a statutory provision which envisages a scheme for financial incentives to capital investment to encourage small-scale electricity generation in which the return could be varied once the capital expenditure had been incurred. It is in that context that the presumption against retrospective operation is so important. Were there to be a power to introduce, by modification, such a scheme one would expect it to be clearly shown. On the contrary, there is no reference to that possibility. The references in the section specifying how a payment is to be calculated, to the decrease by a formula and to circumstances in which no payment or a reduced payment is to be made, would be positively misleading if there exists a wide, general power to vary rates after expenditure on installation has occurred….

The Mesa Power Group's Notice of Intent to Submit a Claim to Arbitration under Chapter Eleven of NAFTA also involves a FIT program. In this set of proceedings, Mesa Power, a US based group of investors, argues that the Government of Ontario and its associated entity the Ontario Power Authority (OPA) has breached various provisions of Chapter Eleven of NAFTA in the way in which it has administered Ontario's FIT program under its Green Energy Act. As part of its program the Ontario Power Authority developed a set of criteria for determining both the eligibility and ranking of renewable energy projects. In order to be eligible, a windpower project must achieve a 25% domestic content (later changed to 50% for projects becoming operational after January 1, 2012). Projects were to be ranked according to a number of different factors (expertise, financial capacity, access to wind turbine supply and permitting) and within specific defined geographic electricity transmission zones. Successful applicants obtain power purchase agreements with the OPA with a set purchase price for a 20 year term. At some point, Ontario changed the rules for awarding FIT contracts and in particular changed the rules with respect to transmission zones and interconnection capacity and thus projects came to be ranked on a province-wide basis rather than within particular transmission zones.

Mesa alleges that Canada (Ontario) has breached its NAFTA obligations in a number of ways. First, Mesa alleges that the changes to the ranking system breached the minimum standard of treatment of Article 1105. Second, the minimum domestic requirements constitute a performance requirement in breach of Article 1106, and third, Ontario had breached both the national treatment standard and the most favoured nation standard in the manner in which it changed and applied the ranking system (Articles 1102 & 1103).

The most complex of these cases is likely that described in the Notice of Intent to Submit a Claim to Arbitration under Chapter Eleven of NAFTA filed by Mercer International Inc in relation to its investment in the Celgar pulp mill in Castlegar, British Columbia (January 26, 2012). Mercer, like other operators in the wood processing business, had invested heavily in

clean energy production as a co-product at this facility (installing close to 50MW of capacity after it acquired the facility in 2005) and Mercer argues that the Province of British Columbia and its entities, BC Hydro (the Crown owned utility and major generator in the province) and the BC Utilities Commission (BCUC), the province's regulatory authority have discriminated against it by comparison with the way in which its competitors in the pulp and paper industry are treated. Mercer alleges, inter alia, breach of NAFTA's national treatment standard, the most favoured nation obligation and the fair and equitable treatment standard (minimum standard of treatment).

In order to understand Mercer's claim it is necessary to describe the structure of British Columbia's electricity market. BC Hydro is the dominant player in the electricity sector in British Columbia. It generates most of the province's energy and is responsible for meeting the needs of industrial and residential consumers throughout most of the province. Most of BC Hydro's energy is generated by the so-called heritage assets including the major dams on the Columbia and Peace Rivers. Power from those facilities is provided on the basis of their low embedded costs effectively guaranteeing low electricity prices for those served by BC Hydro. By contrast, newer forms of generation including renewable energy sources are much more expensive. However, there is one area of the province in the West Kootenays which is anomalous in that it falls within the franchise of another utility, formerly West Kootenay Power and Light (WKPL) now owned by Fortis. WKPL developed a number of hydro facilities on the Kootenay River in the first part of the 20th Century principally to supply local metallurgical projects. Mercer's plant at Celgar happens to fall within Fortis' franchise area. Both BC Hydro and Fortis are regulated by the BC Utilities Commission. Fortis has some access to heritage power through a power purchase agreement with BC Hydro but Celgar has no access to that power so long as it is selling any self-generated electricity.

Consistent with its mandate to diversify energy supply and to encourage generation by a variety of different players, BC Hydro with the approval of the BCUC, entered into a variety of commercial arrangements with pulp and paper mills to assist them in developing biomass generation capacity associated with their facilities. According to Mercer "These deals have included direct subsidies or low interest rates to finance construction of new or additional turbines". In addition, BC Hydro purchases energy from these entities at market rates while continuing to sell some energy to these same entities at cost-based rates. Mercer alleges that, by contrast, and by a combination of government policy and BCUC decisions, it has been denied access to both of these benefits (subsidies and access to heritage power) in the development of its own biomass generation facilities. Celgar does have a power purchase agreement with BC Hydro that allows it to sell surplus power to Hydro at market-based rates but no right to purchase heritage power. In sum, Celgar alleges (at para 26, Notice of Arbitration)

> The measures have placed the Celgar mill in a uniquely disadvantaged position vis-à-vis its competitors. Indeed, notwithstanding the fact that the Celgar mill is the most energy efficient, lowest carbon footprint pulp mill in British Columbia, and generates more electricity than any other BC pulp mill, it is able to capture far less of the economic benefit of its power generation than any other comparable pulp mill in the Province. The inconsistent treatment of similar investors within the same industry within the Province is arbitrary, discriminatory, unfair and inequitable. It interferes with the legitimate expectations upon which Mercer reasonably relied in investing in the Province, particularly in the expansion of the Mill's generation capabilities. The measures also divert much of the economic benefit of Mercer's investment to BC Hydro, a State-owned enterprise within the

> Province, and/or to its customers, without any compensation to Mercer. These measures violate Canada's obligations to U.S. investors under relevant provisions of NAFTA.

Mercer expressly concedes in its filings that NAFTA does not dictate the adoption of any particular energy policy and concedes that a treaty party may, for example, deny all self-generators access to heritage power entirely, or may only allow a generator to sell energy to BC Hydro at market rates above a certain base-line load. But the substance of Mercer's argument is that in developing and applying an energy policy, including one that provides for an enhanced share for renewables, a government must be careful not to discriminate, (see Notice of Arbitration, at para 41). The practical effect of discrimination in this sort of case is that the Celgar mill will be less profitable than its competitors and will be more vulnerable in a market downturn. Celgar suggests in its Notice of Arbitration that the costs and foregone opportunities associated with its discriminatory treatment at the hands of BC Hydro and the BCUC justifies a damages award accruing at the rate of $19 million per year.

Conclusions

The challenges associated with global warming and climate change as well as concerns over energy security will continue to push countries to develop energy policies which seek to manage the use of carbon based fuels and encourage the adoption of renewables. In doing so, governments may interfere with the expectations of incumbents and may also need to incent investors to participate in newer ventures - whether different forms of renewables or carbon sequestration efforts. This comment suggests that in designing the relevant policies governments will need to pay heed to their legal obligations both to existing investors (the incumbents) and the investors they hope to attract. The relevant obligations include obligations in domestic law (contract and administrative law) but also in international law (including, in particular, international investment law. This does not mean that governments should avoid taking the necessary steps to adopt and develop cleaner forms of energy but it does mean that governments should take advice in designing and implementing such policies. More positively perhaps, it also means that law should serve to protect those who make new investments in renewable energy. In this way law, and in particular international investment law, should help mobilize the huge investments required to transform the energy sector to cleaner forms of generation and to meet the needs of those many countries which suffer from energy poverty. In this way, investment law may work harmoniously with climate change law to achieve mitigation targets.

Bankes' research on carbon management issues is supported by a grant from Carbon Management Canada.