

International Arbitration in the Energy Sector 2023

Colloquium

Facts:

The Republic of Laoc

The Republic of Laoc (“**Laoc**”) is a small developed state. It has a large coastal area and many rivers, reaching from the coastal part of the country into virtually all of its inland territories. While there are several large cities in Laoc, a considerable portion of the population lives in smaller towns.

Laoc is a parliamentary republic. The Laocan government is elected by the Parliament, which in turn, is established via direct elections.

Over the last two decades, the economy of Laoc has been steadily growing. Although it is now predominantly based around industrial and agricultural sectors, the mining industry has always played a significant role in the economy of Laoc. Several large deposits of precious and semi-precious metals, as well as smaller deposits of various base metals, have been found on its territory.

Because of extensive coal deposits, the coal-mining industry and coal-fired energy generation sectors have always played a considerable role in the economy of Laoc. In fact, many Laocans are employed by businesses directly and indirectly related to the mining of coal and its subsequent use for power generation.

Domestic electricity production in Laoc is dominated by coal-fired power plants, which are supplied by locally extracted coal from the more inland lying areas. Many of the Laocan coal-fired power plants were constructed at the end of the 1980s and are nearing the end of their life cycles. Foreign investors own some of Laocan coal-fired power plants.

Although there were some voices in Laoc saying that it should switch to cleaner energy sources the Laocan government never gave much attention to such views and kept stimulating coal-fired power generation. In particular, Laoc expected further growth of its domestic economy and, to remain independent from electricity imports and support its local coal industry, it was primarily interested in receiving

investments in new coal-fired power plants. Thus, contrary to its neighbouring states, wherein renewable energy sources gradually emerged, Laoc remained exclusively grounded in its traditionally coal-oriented electricity generation sector.

Laoc is a member of a regional economic integration organisation called the European Union (“**EU**”). Energy has become a core issue for the European Union. By virtue of Article 4(2)(i) of the Treaty on the Functioning of the European Union (TFEU) Member States and the European Union share competence in the field of energy. The details of this competence are set out in Article 194 TFEU, as detailed in Box 1.

Box 1:

Article 194

1. In the context of the establishment and functioning of the internal market and with regard to the need to preserve and improve the environment, Union policy on energy shall aim, in a spirit of solidarity between Member States, to:

- (a) ensure the functioning of the energy market;
- (b) ensure security of energy supply in the Union;
- (c) promote energy efficiency and energy saving and the development of new and renewable forms of energy; and
- (d) promote the interconnection of energy networks.

2. Without prejudice to the application of other provisions of the Treaties, the European Parliament and the Council, acting in accordance with the ordinary legislative procedure, shall establish the measures necessary to achieve the objectives in paragraph 1. Such measures shall be adopted after consultation of the Economic and Social Committee and the Committee of the Regions.

Such measures shall not affect a Member State's right to determine the conditions for exploiting its energy resources, its choice between different energy sources and the general structure of its energy supply, without prejudice to Article 192(2)(c).

The main actors of the European legislative process are the European Commission, the Parliament and the Council of the European Union. The Commission has the exclusive right to initiate a legislative process by proposing a draft legislation to the other institutions. The proposal is usually based on a consultation process with experts, main stakeholders and an impact assessment carried out by the Commission. The proposal is forwarded simultaneously to the European Parliament and to the Council. Energy related legislation needs to be approved by the Council of the European Union and European Parliament to become law. The proposal is adopted by the EU Council if a qualified majority is reached. A qualified majority is reached if two conditions are simultaneously met: 55% of member states vote in favour - in practice this means 15 out of 27 the proposal is supported by member states representing at least 65% of the total EU population.

Like most of the EU Member States, Laoc is a party to numerous bilateral and multilateral investment treaties and, in particular, the Energy Charter Treaty (“**ECT**”), which was ratified by the Republic of Laoc on 21 June 2012.

The Energy Charter Treaty contains, *inter alia*, several investment protection provisions. It also provides for an investor-state dispute settlement mechanism.

An Investor

Mountaintop Investments LLC (“**Mountaintop**”) is a company incorporated in the Republic of Mercuria, a country neighbouring Laoc. Like Laoc, Mercuria is a member of the EU and has ratified the ECT.

Mountaintop is a sophisticated investor that specialises in long-term investments into conventional power generation installations, such as nuclear, gas and coal-fired power plants. Over the past 15 years, Mountaintop invested in the construction of ten power plants around the globe, six of which are high-efficiency coal-fired power plants. Mountaintop has a good reputation in its sector and uses both its own financial resources and external financing for its projects.

In August 2009, Mountaintop engaged in protracted negotiations with several local authorities of Laoc and got an approval for the construction of a high-efficiency 850 MW coal-fired power plant from one of them. As the plant was to be built in the municipality of Ticadia, which had long been relying on the electricity produced by power plants in the neighbouring municipalities, it received the name “Ticadia-1” as the first power plant construed in this municipality. No environmental concerns were raised or discussed at this stage.

The projected lifetime of Ticadia-1 is 40 years. The investment into the construction of the power plant is expected to break even after circa 20 years of successful operation, depending on coal prices and operational expenses. Ticadia-1 LLC is expected to pay off the entire amount of funds loaned for the construction by the time the investment breaks even.

15 On 15 December 2010, Ticadia-1 LLC bought a plot of land, obtained a construction permit, and began building the power plant. To secure the fuel for the plant, Ticadia-1 LLC entered into a long-term agreement with a local coal mining company.

Ticadia-1 was commissioned and became fully operational on 25 September 2014.

The decision of the EU to phase out all coal-fired power plants and its implementation by Laoc

Historically, many natural disasters, such as floods, occurred in most of the EU Member States. However, between 2000 and 2015, the number of floods in the EU countries and their magnitude was unusually high, with the EU countries experiencing in total 14 major floods, 6 of which occurred in Laoc. Over these 15 years, those floods led to the death of 85 thousand people, destroyed more than 50,000 houses in various regions of Laoc and caused significant damage to the local infrastructure.

Against that background, the influence of environmental, political movements has been steadily growing in the EU Member States, including Laoc, and pro-environment political parties won a considerable number of elections in virtually all of the EU Member States. Laoc, however, was a notable exception as most of its Parliament delegates came from the Laocan Workers Movement (“LWM”), a centrist party, which traditionally advocates for the interests of major industrial businesses, including the coal industry. The LWM held the parliamentary majority in Laoc between 2000 and 2014.

By 2015, however, the Laocan Environmental Union (“**LEU**”) became the most supported environmental political party in Laoc. In 2015 Laocan elections, environmental parties received 30% of the seats in the Laocan Parliament for the first time in Laocan history. The LEU, together with other parliamentary minorities sharing its environmental agenda, was able to form an environmentalist coalition, which has since then held a majority in the Laocan Parliament. Although it still held at that time around 40% of seats in the Laocan Parliament, for the first time, LWM lost its majority in 15 years.

In December 2015, Laoc — against the background of growing internal pressure and under the impression of natural catastrophes occurring in Laoc and surrounding countries — signed, together with other Member States and the EU itself, the Paris Agreement (“**Paris Agreement**”). The Paris Agreement was ratified by Laoc on 11 January 2016.

Moved by this treaty, on 17 February 2016, after a short deliberation, the EU adopted, by majority, Directive 2016/87 on the renewable sources of energy (“**Coal Directive**”). Under the Coal Directive, all coal-fired power plants in the EU Member States shall be phased out by 31 December 2028, *i.e.* in the following 12 years. The Laocan delegate in the EU Council voted against the adoption of the Coal Directive but was outvoted. Although the Coal Directive regulates the phase-out in detail and provides explicitly in Article 7(3) that the EU Member States shall pay no compensation to owners and/or operators of the coal-fired power plants subject to phase-out, it, nevertheless, leaves the Member States of the EU with discretion to introduce support schemes to provide incentives for the integration of electricity from renewable sources in the electricity market. According to EU law, the Coal Directive is binding upon any of its members States, including Laoc, which would have no other option but to implement it.

After some parliamentary debates and despite a wave of country-wide protests from workers in the coal industry and LWM members, on 6 July 2016, the Laocan Parliament implements the Coal Directive by enacting Law 66/2016 “*on the Phase-out of Coal Energy on the Territory of the Republic of Laoc*” (“**Law 66/2016**”) prohibiting coal-fired power plants by 31 December 2028. Laoc decided to set the maximum possible (*i.e.*, 12 years) deadline for phase-out.

Adoption of the Law 72/2016 “on Energy Transition”

After the introduction of the Coal Directive, Laoc finds itself in a difficult situation as its domestic electricity generation is dominated by coal-fired power plants. Following the adoption of Law 66/2016, LEU also finds itself in a difficult position as many of its voters actually think that fast phase-out will hurt Laocan economy and may even result in an electricity shortage. Against that background, LEU devises the so-called “*Energy Transition Plan*”, which envisages massive investments into renewables sector from the Laocan budget. Using its parliamentary majority, on 5 December 2016, LEU adopts Law 72/2016 “*on Energy Transition*” (“**Law 72/2016**”).

Law 72/2016 establishes a feed-in tariff scheme designed to bolster private investments into the renewables sector. It also envisages the creation of Laocan Renewables Company (“**LRC**”). In light of the concerns for possible energy shortage, LRC is tasked with headlining the development of the Laocan renewables sector and building a number of large-scale renewable facilities in all regions of Laoc. LRC is to be owned and funded entirely by Laoc. It is to be privatised by 31 December 2028.

Law 72/2016 also offers the investors that would be affected by the coal phase-out but decide to invest further into the renewable energy sector an option of entering into a 20-year energy supply contract at prices substantially above market value.