Power Sector Reforms in Africa: Balancing States' Regulatory Powers with their International Legal Commitments

By:

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As observed by the International Energy Agency's most recent World Energy Outlook, the Covid-19 crisis has underlined the importance of a reliable, affordable and secure electricity supply that is able to accommodate sudden changes in behaviour and economic activity, while continuing to support vital services. The electricity sector will play a key role in supporting economic recovery, and an increasingly important long-term role in providing the energy that the world needs, as it evolves into a system with lower CO2 emissions and enhanced flexibility.

This is particularly crucial for African countries, which, while experiencing relatively lower fatality rates than in other parts of the world, have suffered a significant economic downturn that has impacted local demand for power. The

situation has compounded financial difficulties for (largely State-owned and vertically- integrated) utilities working to improve electrification, reversing some of the progress made across the continent. As African economies emerge from the Covid-19 pandemic, there will be a significant drive both to reduce the cost of power and to attract the foreign investment necessary to increase access to it. However, in pursuing cost savings, governments and offtakers should be wary of adopting policies and measures that could generate protracted international disputes and the flight of investment.

The Public Debate on Power Sector Reforms in Africa

Several African governments and offtakers have been scrutinizing the cost of their electricity supply from independent power producers, focusing on the terms of power purchase agreements (PPAs) and feed-in tariffs for renewable energy projects. Such instruments have previously been seen as key to attracting private sector investment.

As the World Bank explains, PPAs are designed to provide a reliable supply of power to the offtaker, in return for a revenue stream that effectively underwrites the financing for the construction and operation of the power plant. Tariff provisions typically include: a capacity charge, payable in consideration of the power plant operator making generation capacity available to the offtaker (irrespective of whether it takes electricity from the power plant) and designed to cover the project's fixed costs; and an energy charge, payable on energy delivered and compensating the project's variable costs. Such tariff provisions, combined with other provisions allocating payment and political risks to the offtaker, ensure that the PPA is 'bankable' in the eyes of private sector lenders and sponsors.

Feed-in tariffs seek to promote generation of electricity from renewable energy sources by offering cost-based compensation to producers. They guarantee a pre-determined, above market tariff to small-to-medium-scale producers for a fixed and (generally) long-term period. In principle, the tariff must be high enough to cover the generation cost of a given technology, including a sufficient rate of return and supplements for technology and country risks. Several African countries operate feed-in tariffs for renewable energy projects (e.g., Algeria, Egypt, Kenya, Ghana, South Africa or Tanzania).

In a context of reduced demand, particularly from industrial consumers, offtakers are finding themselves with excess generation capacity. Moreover, some of that capacity has been contracted at tariffs that are said to be uncompetitive relative to comparable projects (as, for example, in Ghana) and/or above what can be passed through to consumers. Hard hit State-owned utilities (such as Eskom in South Africa and KPLC in Kenya) sought last year to reduce their offtake from suppliers and independent power producers and associated payments, on grounds that lower demand constituted a force majeure event. Some African governments and utilities (e.g. in Ghana and Kenya) have been challenging the requirement to pay for power they are not using, via the capacity charge, and seek to transition to a model where the offtaker only pays for the electricity that is dispatched. There are public calls to renegotiate tariffs in existing PPAs and/or to review feed-in-tariff policies for renewable energy, either to remove them altogether or to restrict eligibility criteria (see, e.g. the 2021 Feed-in-Tariff Policy and Renewable Energy Auctions Policy recently published by the Kenyan Ministry of Energy, which limit feed-in tariffs to smaller-scale projects and certain renewable energy technologies, while other renewable energy projects are to be procured through auctions).

Legal and Strategic Considerations

The public concern around the cost of power generation is legitimate, particularly in a time of economic and social crisis. However, as they seek to address this concern, African policy makers and public stakeholders should be mindful of the following legal and strategic considerations.

First, PPAs contain robust contractual protections. Long-term PPAs may run for around 20 to 25 years, with no possibility of early termination other than for (serious) breaches of contract or other specified events of default, or prolonged force majeure events. They cannot be modified other than by mutual agreement, and parties are excused from contractual performance only on the occurrence of limited events (e.g., force majeure). Any unilateral attempt by an offtaker to terminate an existing PPA for convenience, or modify its terms or performance, may constitute a breach of contract exposing the offtaker to damages (or, if provided, an early termination payment). In addition, the offtaker typically confirms the validity and enforceability of PPA terms through contractual representations and warranties. Thus, any termination on grounds

of invalidity and unenforceability of an existing PPA may place the offtaker in breach of warranty and be perceived as a wrongful attempt to engineer an early termination, as illustrated by a 2021 arbitral award against the Government of Ghana.

Secondly, measures threatening the performance of PPAs in the context of foreign-owned or foreign-financed projects may also violate the State's international obligations under international investment treaties. Such treaties protect qualifying foreign investments through provisions that, e.g., prohibit expropriation with no compensation, mandate fair and equitable treatment and/or require States to observe specific commitments with respect to such investments. For instance, breaches of contracts and other undertakings may violate the fair and equitable treatment standard, in that they frustrate investors' legitimate expectations that specific commitments upon which they relied when investing would be upheld. While States are not usually party to PPAs, they may have provided separate assurances and commitments that such agreements would be upheld and performed by the offtaker, for instance through legal opinions, letters of comfort/support or even guarantees. The failure to uphold such commitments may render States liable for breach of the fair and equitable treatment standard, as illustrated by a 2014 award against Hungary upholding a claim by the French multinational energy company EDF arising out of the State's termination of PPAs, or a 2008 award against Ecuador concerning the State's failure to satisfy a guarantee for the offtaker's payment obligations. In contrast, in another investment arbitration against Hungary, a claim arising out of the termination of the investor's PPA (due to its incompatibility with EU law) was dismissed, as the State had made no specific representation and the PPA allocated the risk of change in the law (and any resulting termination) to the operator. In the African context, however, bankable projects typically require robust protections against such risks, both in the PPA and external instruments, which increases African States' exposure to successful investment treaty claims.

Thirdly, changes in policy and regulations affecting power projects may trigger States' international liability. In recent years, there has been a wave of investment claims arising out of changes to feed-in tariffs and other incentives for renewable energy projects, against States such as Italy, Romania, Ukraine, the Czech Republic or, most notably, Spain. The Spanish Government's

decision, from 2010 onwards, to retract incentives for renewable energy projects and ultimately abrogate the feed-in tariff regime, has alone led to the initiation of around fifty international arbitrations by foreign investors. In some cases, tribunals have held that the removal of the incentives was unfair and inequitable because it violated specific commitments to investors, provided in the regulations governing renewable energy projects, that the incentive regime would remain stable (see, e.g., a 2019 award against Spain). In other cases, tribunals have recognized the right of States to modify the regulatory framework governing power projects but subjected this to requirements of proportionality and transparency. As one arbitral tribunal observed, in a 2016 award against Italy arising out of modifications to its feed-in-tariff regime: *"In the absence of a specific commitment, the state has no obligation to grant subsidies such as feed-in tariffs, or to maintain them unchanged once granted. But if they are lawfully granted, and if it becomes necessary to modify them, this should be done in a manner which is not disproportionate to the aim of the legislative amendment, and should have due regard to the reasonable reliance interests of recipients who may have committed substantial resources on the basis of the earlier regime."* Although the proportionality analysis is necessarily fact-specific, key considerations are whether the policy changes respond to a genuine public need and are not so drastic as to fundamentally alter the legal and financial framework for the investment, crippling or destroying the value of the power project. While changes to tariffs and other economic incentives may be driven by legitimate fiscal concerns, States must take account of, and address their practical consequences for existing power sector projects and investments. To illustrate, a 2016 award against Canada held that, although a moratorium on the development of offshore wind energy projects was not in itself wrongful, the State's failure to address the resulting regulatory and contractual limbo affecting the claimant's project was unfair and inequitable. In addition, as African States seek to move away from feed-in tariffs to renewable energy auctions, they may be inclined to introduce local content requirements to be met by prospective bidders, as is already the case in South Africa. In so doing, they should take care to ensure that local content requirements are not in violation of the prohibition on domestic performance requirements in certain investment treaties (such US, Canadian or Japanese treaties) or the WTO TRIMs Agreement (as illustrated by the WTO disputes that arose in 2011 in connection with domestic performance requirements in Canada's feed-in tariff

programme).

Fourthly, claims for damages in power sector disputes may be substantial. Compensation for the wrongful termination or other breach of a PPA would, subject to any specific contractual provision (such as an early termination fee), normally be based on the profits that the IPP expected to make, *but for* the termination or other breach, over the remaining term, discounted to their present value. Similarly, compensation for an investment treaty breach would seek to put the claimant investor in the economic position it would have enjoyed had the wrongful acts never occurred, covering any financially assessable damage, including loss of profits. The fact that a power project may be in the initial stages does not necessarily preclude an award for lost profits (as opposed to compensation for sunk costs). This will turn on whether the claimant can demonstrate with reasonable certainty that, *but for* PPA termination, the project would have reached financial close and could have proceeded through its various milestones to reach commercial operation and generate the lost profits.

Fifthly, international power sector disputes are typically resolved through international arbitration in a foreign forum, as provided in many PPAs and investment treaties. Arbitral awards are final and binding, with possibilities of challenge on only limited grounds. Any resulting award of damages may, subject to rules on State immunity, be enforced against the commercial assets of States and offtakers held abroad in accordance with the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. While many arbitration proceedings are (to varying degrees) confidential, some, such as arbitrations under the auspices of ICSID, are a matter of public record, attracting publicity that may be detrimental to the investment climate of the host State.

Sixthly, international power sector disputes involve stakeholders other than the international power producer. Many African power projects are financed through a combination of shareholder equity, commercial debt and development finance on a non-recourse basis, relying on the project's revenues for repayment of the loans. Any changes impacting such revenues (such as to tariffs or other critical PPA terms) may have an impact on the financing and operation of the project, triggering events of default. Additionally, while only

the IPP, as contracting party, would have a claim under the PPA, equity sponsors and lenders may have claims under investment treaties, many of which protect direct or indirect interests in a broadly defined set of local assets. Indeed, a 2020 award against Spain has held that loans and related financing instruments issued by lenders to investors in renewable power projects may also constitute protected investments under the applicable investment treaty.

Conclusion

African power projects are typically underpinned by robust contractual and other protections designed to insulate the project from political and regulatory risk over time. They involve a range of stakeholders whose rights may be affected if the State or offtaker challenges such protections. The consequences may be costly, both in terms of legal and financial exposure and disruption to existing and future investments (in turn potentially prejudicing developmental and environmental goals).

Moreover, the debate around the cost of power generation should not obfuscate other fundamental problems affecting demand, such as poor transmission and distribution infrastructure, limited interconnection and system adequacy issues. These issues, causing a supply and demand imbalance, contribute to driving up the cost of power generation. Failing to address them while targeting existing independent power projects will only add fuel to claims by private sector developers and their financiers.

In the short term, striking the right balance between reform and protecting accrued legal rights requires considerable engagement with all stakeholders in the power sector. In the longer term, African States are likely to seek increased regulatory flexibility in the sector (in line with the States and organizations engaged in discussions over the modernization of the Energy Charter Treaty). Whether they can achieve this while continuing to attract vital investment remains to be seen.

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