

INTRODUCTORY NOTE TO THE INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT
DISPUTES: AES SUMMIT GENERATION LTD. V. REPUBLIC OF HUNGARY
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AES Summit Generation Ltd. (“AES Summit”), a UK company, and AES-Tisza Eromo Kft (“AES Tisza”), a Hungarian company, ninety-nine percent of which is owned by AES Summit, submitted a request for arbitration against the Republic of Hungary, invoking the ICSID arbitration provision in Article 26 of the 1994 Energy Charter Treaty (“ECT”).¹ After concluding that the ECT is the applicable law, the tribunal rejected the claimants’ contentions that Hungary’s actions concerning electricity pricing violated its treaty obligations.

Background

In 1995, Hungary initiated privatization of the energy sector, including the sale of state-owned power facilities. Subsequently, AES Summit purchased majority shares in state-owned AES Tisza for \$130 million. The assets of AES Tisza included the Tisza II power station and two older stations, Borsod and Tiszapalkonya. AES Summit agreed to retrofit Tisza II and to construct a new Borsod plant. For its part, Hungary was obligated to extend the term of an existing power purchase agreement (“PPA”) with Tisza II and to enter into a new PPA for the Borsod station.

In October 2000, AES Summit requested arbitration alleging Hungary’s failure to comply with the sale agreement. A second arbitration was commenced under the ECT and the bilateral investment treaty between the United Kingdom and Hungary. Both arbitrations were resolved by a 2001 settlement agreement, which superseded all prior agreements. The agreement included a waiver of the sovereign immunity clause, which the International Centre for Settlement of Investment Disputes (“ICSID”) tribunal concluded “mean[t] that Hungary was acting in its private character rather than in a public or governmental character.”² A revised PPA attached as an annex to the settlement agreement included a clause providing that “as long as the public utility generator prices are subject to administrative pricing, the prices published by [Price Decree] shall be . . . acknowledged and applied.”³ The agreement also included a pricing formula to be applied “following the termination of price administration of public utility generator prices.”⁴

In 2004, after Hungary acceded to the EU, the administrative pricing regime was terminated, and the formula established in the 2001 Tisza PPA was used to calculate the prices paid to AES Tisza II. After a political controversy broke out over the high profits of the private power generators, including AES, the Hungarian Parliament amended the 2001 Electricity Act by reintroducing regulated pricing for generator prices. In 2007, the Ministry of Energy and Transport issued decrees to fix the prices for each generator based on a target return.

Claimants contended that these actions were introduced for political reasons, that the decrees violated the terms of the 2001 PPA, as amended, and that they suffered price cuts of forty-three percent (under the 2006 Decree) and thirty-five percent (under the 2007 Decree). In addition to direct revenue losses, claimants contended that as a result of the decrees, their lenders declared the AES Tisza in default of a loan given for the retrofit.

Applicable Law

In its defense, respondent emphasized the negative consequences of an adverse ruling under the ECT which could require Hungary to act inconsistently with mandatory laws of the EU. It further argued that “when a state has obligations under two different treaties involving overlapping subject matter, those obligations should—to the extent possible—be read in harmony to minimize conflict.”⁵ Finally, Hungary argued that Community law could function as a defense to breaches of the ECT.

As a result of these claims, a key issue before the tribunal was the “applicable law.” The tribunal first pointed out that Article 41(2) of the ICSID Convention provides that the tribunal shall decide the dispute “in accordance with such rules of law as may be agreed by the parties.” On the other hand, Article 24(6) of the ECT provides that a “Tribunal established under paragraph (4) [which was the case here] shall decide the issue in dispute in accordance with this Treaty and applicable rules and principles of international law.”

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While the parties debated the applicable law issue extensively, they eventually agreed that the ECT would be the applicable law, together with rules and principles of international law. The tribunal accepted this agreement and held that if interpretation is required, general rules of interpretation in Articles 31 and 32 of the Vienna Convention should apply. Although Article 32 provides for the use of historical interpretation, such use would function “only as a complementary method of interpretation.”⁶

This then led to consideration of the role of EC competition law, which, the tribunal observed, “has a dual nature: on the one hand it is an international law regime, on the other hand once introduced in the national legal orders, it is part of these legal orders.”⁷ This is an important point because, according to the tribunal, it “is common ground that in an international arbitration, national laws are to be considered as facts.” Thus, EC competition law was held to be considered as a fact, taking into “account that a state may not invoke domestic law as an excuse for alleged breaches of its international obligations.”⁸ This determination precluded Hungary’s defense that the decrees were required by EU competition law.

Another issue involved the application of ECT Article 16, which applies when a conflict exists between an ECT provision and EC law. However, the tribunal held there was no such conflict because, “properly understood,” the dispute was about the conformity of Hungary’s acts (the reintroduction of price decrees) with the ECT. Whether Hungary believed it was obliged to take the actions in dispute under EC law was “only an element to be considered when determining the rationality of the reintroduction of administrative pricing.”⁹

Obligation to Provide Fair and Equitable Treatment

Claimants presented four reasons why the tribunal should find that Hungary violated its obligation to provide fair and equitable treatment pursuant to the ECT.

(a) Contractual Obligations: According to claimants, the reintroduction of administrative pricing in 2006 and 2007 breached their contractual rights and was contrary to the legitimate expectations that were relied on when they made their investment. The tribunal concluded, however, that it only had jurisdiction over treaty claims. While Article 26 of the ECT included a stability clause, Hungary opted out of this provision. Nevertheless, the tribunal found that it had “to determine whether Hungary’s conduct (including acts that could have breached contractual obligations) violated a specific Treaty obligation.”¹⁰

The tribunal first looked to the issue of claimants’ legitimate expectations at the moment of investment, which is the determinative time frame. Noting that the time of investment has been interpreted broadly,¹¹ the tribunal “as an initial question” considered whether claimants’ investment was made in 1996 (when AES Summit purchased AES Tisza) or in 2001 (when AES Tisza began to invest in the retrofit).¹²

With respect to the original PPA, which was adopted when AES Summit purchased the shares from Hungary in 1996, the tribunal measured expectations as of the date of the purchase. At that time, it was understood that Hungary would continue to set maximum administrative prices indefinitely, subject only to the principle that such pricing would provide a “reasonable return” on investment. However, the tribunal found nothing in the record to support the “heart of Claimants’ complaint - i.e., that following the termination of price administration in 31 December 2003, regulated pricing would not again be introduced.”¹³ Therefore, AES Summit had no legitimate expectation at the time of investment regarding Hungary’s alleged conduct.

AES Tisza made investments between 2001 and 2005, but the date selected by the tribunal for purposes of the expectations analysis was 2001. Claimants noted that in the 2001 Settlement Agreement, Hungary expressly promised “to do and perform all such acts and things as may be necessary . . . to carry out the provisions of this Agreement and/or to effect the purposes and intent of this agreement.”¹⁴ According to claimants, the purpose and intent of the agreement was frustrated by Hungary’s reintroduction of regulated pricing. The tribunal disagreed, finding that such clauses are commonplace in commercial agreements and did not constitute a specific promise not to frustrate the purpose or intent of the agreement by the reintroduction of administrative pricing.¹⁵

Reinforcing this conclusion in the view of the tribunal was the fact that the 2001 Settlement Agreement does not contain a “stabilization clause” (i.e., a covenant not to change the relevant law). To the contrary, the agreement has extensive provisions concerning the parties’ rights should there be a change in the law during the effectiveness of the PPA. This “change of law” provision reinforced the conclusion that claimants could not legitimately have

been led by Hungary to expect that administrative pricing would not be reintroduced under any circumstances during the term of the 2001 Tisza II PPA.

(b) Stable Legal and Business Framework: Claimants next argued that they were denied fair and equitable treatment due to Hungary's violation of ECT Article 10(1), which provides that "each Contracting Party shall encourage and create stable conditions for investors of other Contracting Parties." The tribunal disagreed, observing that Article 10(1) is not a stability clause and that "a legal framework is subject to change as it adapts to new circumstances day by day and a state has the sovereign right to exercise its powers which include legislative acts."¹⁶ The tribunal emphasized that any reasonably informed business person or investor knows that laws can evolve in accordance with the perceived political or policy dictates of the time. Thus, there was no breach of the fair and equitable treatment standard based on the "alleged failure to provide a stable legal and business framework."¹⁷

(c) Due Process: Claimants also argued that their due process rights were violated because the manner in which the price decrees were issued and the lack of process constituted a failure to provide fair and equitable treatment. The tribunal disagreed, concluding that not every process imperfection amounts to a failure to provide fair and equitable treatment. "It is only when a state's acts or procedural omissions are, on the facts and in the context before the adjudicator, manifestly unfair or unreasonable (such as would shock, or at least surprise a sense of juridical propriety) that the standard can be said to have been infringed."¹⁸

The tribunal examined in detail the process by which the decrees were announced, noting that AES had an opportunity to comment in response to the drafts of the price decrees. While the time allowed for comment was short, the agency accepted late filings and adopted some of the AES's comments. Accordingly, the process of implementing the decrees, while "suboptimal," was not so flawed as to amount to a breach of the ECT's fair and equitable treatment standard."¹⁹

(d) Unreasonable and Discriminatory Measures: Claimants requested the tribunal to find that Hungary's actions violated ECT Article 10(1), which provides that "no Contracting Party shall impair by unreasonable or discriminatory measure their [investment's] management, maintenance, use, enjoyment or disposal." The tribunal accepted that AES's receipt of lower payments had a detrimental effect on the investment. However, for such impairment to amount to a breach of the fair and equitable treatment obligation, it must be the result of "an unreasonable or discriminatory measure."²⁰

The tribunal was careful to point out that there would be no violation where a "rational policy is taken by a state following a logical (good sense) explanation and with the aim of addressing a public interest matter,"²¹ and where there was a correlation between the state's policy objective and the reasonable measures adopted to achieve the objective.

Hungary first argued that the decrees were justified because the generators refused to renegotiate the PPAs. In response to this argument, the tribunal concluded that it is not reasonable for a state to use government powers to force a private party to change or give up its contractual rights. If the state decides that its contractual obligations need to be changed, "the state would have to end such contracts and assume the contractual consequences of such early termination."²²

A state can exercise its powers, however, in a way that affects private interests, such as investor's contractual rights, if the measure is based on public policy factors independent of those rights. Hungary argued that the price decrees were in response to EC Commission investigations regarding state aid to the generators. The tribunal agreed that addressing EC state aid concerns would constitute a rational policy measure, but the majority concluded that "Hungary's decision to reintroduce administrative pricing was not motivated by pressure from the EC Commission."²³

Arbitrator Professor Brigitte Stern added that while Hungary was not exclusively motivated by pressure from the EC Commission, the Commission's investigation was certainly a factor in the decision to reintroduce regulated pricing even though there was no final EC decision on the state aid issue involving Hungary. This factor, together with the claimants' refusal to renegotiate their agreements and the public concern about excessive returns, convinced Arbitrator Stern that "the evidence is overwhelming that the decision to reintroduce maximum administrative prices was a rational, non-arbitrary response to a complex set of legitimate policy concerns."²⁴

Finally, Hungary argued that it acted out of concern that the profits of the generators exceeded reasonable return rates. In response, claimants argued that the decision to reintroduce administrative pricing was arbitrary because it was motivated by political reasons. Based on evidence concerning debates inside and outside the Hungarian Parliament, the tribunal decided that the legislation was motivated principally by widespread concerns about the excessive profits earned by generators. While accepting that Hungary was principally motivated by political considerations, “the Tribunal is nevertheless of the view that it is a perfectly valid and rational policy objective for a government to address luxury profits.”²⁵

Finally, having determined that the decrees were not arbitrary or unreasonable, the tribunal carefully examined the record of the process of selecting the rates of return which took into account their consistency with rates of returns at the time of privation, and the fact that the price established for each of the generators was reached using the same methodology. Based on this analysis, the tribunal concluded that the prices fixed pursuant to the decrees were reasonable.²⁶

Constant Protection and Security

Claimants also argued that the reintroduction of administered pricing violated ECT Article 10(1), which provides that “investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal.” According to claimants, this obligation extended to “legal security and protection.”²⁷

The tribunal acknowledged that a state has the obligation to take reasonable steps to protect its investors against harassment. But the standard is not one of strict liability.

[W]hile it can, in appropriate circumstances, extend beyond a protection of physical security, it does not protect against a state’s right . . . to legislate or regulate in a manner which may negatively affect a claimant’s investment, provided that the state acts reasonably in the circumstances and with a view to achieving objectively rational public policy goals.²⁸

Given the findings about the rationality and reasonableness of Hungary’s actions, there was no violation of the constant protection and security requirement. Indeed, the tribunal observed, “[t]o conclude that the right to constant protection and security implies that no change in law that affects the investor’s rights could take place would be practically the same as recognizing the existence of a non-existent stability agreement”²⁹

Significance of the Decision

The tribunal’s findings concerning the applicable law are important, but interestingly, played little role in the final decision. Instead, the tribunal focused on the investigation by the EC authorities of Hungary’s practices, admittedly pursuant to EU law, as a basis for determining the rationality of the actions taken to reintroduce administrative pricing.

The decision is also an important analysis of the ECT’s obligations in a contractual setting. While finding that it had no jurisdiction over contract claims as such, the tribunal examined whether Hungary’s actions violated the ECT’s fair and equitable treatment obligation, a determination that hinged on claimants’ legitimate expectations at the time the investments were made.

The tribunal also concluded that the ECT obligation to provide a stable legal and business framework was not the equivalent of a stability clause. Instead, claimants must recognize that the state has the sovereign right to adapt its laws to new circumstances.

Another important point made by the tribunal was that the ECT impairment clause is not violated when a state adopts a rational policy that has a public interest objective, and that there is a rational correlation between the policy objective and the measure taken. On this issue, the tribunal concluded that it was appropriate for Hungary to consider both the EU investigation of its agreements with power generators as well as public opinion before taking actions that concededly impair the claimants’ contract rights.

 ENDNOTES

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|----|--|----|---------------------------|
| 1 | Energy Charter Treaty, Dec. 17, 1994, 2080 U.N.T.S. 100 | 12 | <i>Id.</i> ¶ 9.6.13. |
| 2 | AES Summit Generation Ltd. v. Republic of Hungary, ICSID Case No. ARB/07/22, ¶ 4.9 (Sept. 23, 2010), <i>available at</i> http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC1730_En&caseId=C114 . | 13 | <i>Id.</i> ¶ 9.3.18. |
| | | 14 | <i>Id.</i> ¶ 9.2.23. |
| | | 15 | <i>Id.</i> ¶ 9.2.24. |
| 3 | <i>Id.</i> ¶ 4.11. | 16 | <i>Id.</i> ¶ 9.3.29. |
| 4 | <i>Id.</i> | 17 | <i>Id.</i> ¶ 9.3.35. |
| 5 | <i>Id.</i> ¶ 7.2.3. The Treaties refer to the European Community and the Energy Charter Treaty. | 18 | <i>Id.</i> ¶ 9.3.40. |
| | | 19 | <i>Id.</i> ¶ 9.3.73. |
| 6 | <i>Id.</i> ¶ 7.6.5. | 20 | <i>Id.</i> ¶ 10.3.6. |
| 7 | <i>Id.</i> ¶ 7.6.6. | 21 | <i>Id.</i> ¶ 10.3.8. |
| 8 | <i>Id.</i> | 22 | <i>Id.</i> ¶ 10.3.12. |
| 9 | <i>Id.</i> ¶ 7.6.9. | 23 | <i>Id.</i> ¶ 10.3.18. |
| 10 | <i>Id.</i> ¶ 9.3.5. | 24 | <i>Id.</i> |
| | | 25 | <i>Id.</i> ¶ 10.3.34 |
| 11 | <i>Id.</i> ¶ 9.3.8 (citing Duke Energy Electroquil Partners v. Republic of Ecuador, ICSID Case No. ARB/04/19, Award, ¶ 340 (Aug. 18, 2008); Técnicas Medioambientales Tecmed S.A v. United Mexican States, ICSID Case No. ARB(AF)/00/2, Award, ¶ 154 (May 29, 2003); CMS Gas Transmission Co. v. Argentine Republic, ICSID Case No. ABB/01/8, Award, ¶ 275 (May 12, 2005)). | 26 | <i>Id.</i> ¶¶ 10.3.45-53. |
| | | 27 | <i>Id.</i> ¶ 13.1.1. |
| | | 28 | <i>Id.</i> ¶ 13.3.2. |
| | | 29 | <i>Id.</i> ¶ 13.3.5. |