

PV, THE INCENTIVES AFTER THE CONSTITUTIONAL COURT DECISION

Damages quantification in any international arbitration can be based on the discount rate calculation but it is also necessary assess the impact of the regulatory risk

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Italy, with about 19,000 MW installed, is one of the European countries with the largest capacity of photovoltaic (PV) plants. This is largely due to the tariff incentives plans or subsidies (Conti Energia) that have been put in place between the 2005 and mid-2013, by which point subsidies reached a total annual cost of 6.7 billion euro. The investment trend in renewables has however gradually decreased for two main reasons. First, the new measures introduced over time by the Government and the Regulator have increased the costs for the operators of PV plants. For example the reduction of the recognized losses to the operators, the introduction of property tax (IMU) on plants and the increase of the transport costs on the network have all increased operators' costs.

Second, the measure *spalma-incentivi*, proposed by the Ministry for Economic Development, through a unilateral change of the existing contracts between the government and the operators, has reduced the incentives granted to PV plants with a capacity higher than 200 kW. Many owners of PV plants appealed these changes in the Italian courts, arguing that they were unconstitutional. Some foreign investors have started or are considering initiating international arbitration against Italy on the basis of the Energy Charter Treaty (ECT). While Italy is no longer a member of the ECT t joining it anymore but for investments made until December 2016 the terms of the ECT can be applied up to 2036.

In December the Italian Constitutional Court confirmed the constitutionality of the *spalma-incentivi* measure and has now published the decree. Hence Italian domestic investors, like domestic Spanish investors, are unable to escape the financial consequences of the ruling. The situation for foreign investors in Italy is similar, with exceptions, to the situation in Spain, where foreign producers of renewable energy, including investors in PV, have initiated about 32 international arbitration against Spain. Investors have started international arbitration for the recognition of the damages caused by the Government, arguing that the investments had been made on the promise of a certain revenue stream for the entire useful life of the plants. The claim is that the reduction in profits determined by cutting the incentives, in particular due to the change of the number of years in which to get benefits depending on the technology, between 20 and 30, violated the commitment made by the Government towards investors.

Our experience as economic experts in Italy and in other states is that the quantification of damages requires complex analysis for the comparison of current situation with the expected scenario at the time of investment (the 'but for' scenario). The investors claim damages calculated on the cash flows initially expected compared to lower cash flows following the introduction of the argued measures.

Claims for damages may be disputed by the Italian Government on the basis of various arguments, such as: (i) the reduction of incentives to existing plants is justified by the need to

eliminate unjustified profits with respect to profits initially expected; or (ii) the incentives should be adjusted downwards to reflect changes occurred in economic, financial and technical conditions of the electric system resulting from improved technological and operational efficiency.

In Spain the government has also said that changing the incentives was justified (iii) by the need to reduce the tariff deficit, a debt against the electrical system accrued over the years for not having rates adequate to the charges; and (iv) by the fact that the tariff deficit was determined by overly generous incentives recognized to renewable sources. Similarly, the Italian government could try to justify the reductions to incentives on the basis of the social unsustainability of the planned increases to cost of the incentives borne by the final consumers.

As part of the international arbitration proceedings, an arbitral tribunal evaluates the arguments in support of damage quantification and the economic analysis presented by investors and counter-arguments presented by Government. The decision of the arbitral tribunal, once made, obliges the Government to pay an indemnification for the damage that has been recognized.

The use of a discount rate in the calculation is crucial to estimate the extent the damage. The changes introduced in Italy, and in particular the *spalma-incentivi* decree, reduced future revenues of the PV systems. The Government has a strong incentive to say that investors overestimate the damage because the discount lower future revenues with a discount rate that is too low. The suggested approach is to use objective techniques to calculate a reasonable discount rate. The quantification of the damage has a further difficulty because the claimant has to calculate the impact of the regulatory risk, in part caused by the uncertainty created by the introduction of new significant changes to regulation. The damage should not be estimated only by comparing the investment cash flows before and after the introduction of the argued measures. The damage is larger than suggested by a simple comparison of the cash flows of investments in the actual and 'but for' scenarios, because before the changes to the incentives the PV plants had a reasonably certain cash flow, and after the changes the cash flows are more risky because of higher operational leverage and the risk of further changes in the regulation – in other words, increased regulatory risk. The Government may argue that the measures introduced determine a greater stability because they ensure the economic and financial sustainability of the electrical system to the investors in renewable sources, including PV. Based on our experience, a correct quantification of damages in Italy must also assess the regulatory risk that the disputed measures may have introduced. Recent arbitrations in Spain and in other countries show that those measures result in lower total value of the investments. If the shareholders are international investors they are entitled to be compensated for this increase in risk. On the contrary, local investors have no right to be compensated, for example, Italian banks. The government will likely try to show that the reduction of the value of investments resulted in a damage to creditors and not to the shareholders. It is therefore necessary to determine the amount of the damage that has been respectively caused both to shareholders and creditors. The calculation must be carried out using verifiable methodologies and can benefit from the experience gained on the large number of international arbitrations. The decisions of the arbitral tribunals on the quantum

of damages have elements of uncertainty, but the chances of getting a positive opinion increases if the analysis provided is objective, well-structured and free of errors, and consistent with the legal arguments.

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