JFT 4/2019 s. 254–265

PRAXIS OCH KORTARE BIDRAG

Kristiina Rebane, LL.M., Lawyer, Senior Associate at Klauberg BALTICS, Tallinn, Estonia

Free and Equitable Treatment and the State's Right to Regulate

A professional investor must consider all the circumstances before making an investment, including the possibility that the legal environment may change as shows the recent World Bank arbitral award in ICSID case ARB/14/24 in favour of the Estonian State.

1 Facts of the Case

On June 21, 2019, the World Bank Arbitration tribunal (hereinafter the Tribunal) ruled that the Republic of Estonia did not violate the principles of fair and equitable treatment, of due process and did not discriminate the investor under the Bilateral Investment Treaty signed between Estonia and the Netherlands and international law (hereinafter the Award). The Tribunal clearly stated that the investor and the Tallinn water company (ASTV) had no legitimate expectation that the law would not change.

Tallinn City Water Company AS Tallinna Vesi (ASTV) was privatised in 2001 by the British foreign investor United Utilities. The City of Tallinn retained its shareholding in the company and was at the same time also the regulator of water prices until 2010. Until the fall of 2010, the company and the city regulated the price of water by a service agreement. In November 2010, an amendment to the water and sewage act was passed by the Parliament to transfer the regulator's powers from the city to an independent regulator, the Estonian Competition Authority (hereinafter the ECA). The amendment to several other laws as well as to the water and sewage act was called the Antimonopoly Bill. The explanatory note to the bill mentioned specifically ASTV as an example of very high tariffs.

In 2011, the ECA did not approve the ASTV application for a price increase and issued an administrative decision to lower the price of water. ASTV challenged the decisions in the Estonian national court system and in 2014 filed an application with the World Bank Arbitration to initiate arbitration proceedings against the Republic of Estonia under the Bilateral Investment Treaty between Estonia and the Netherlands (hereinafter the Treaty). ASTV was of the opinion that the state and the ECA

should regulate the price of water on the basis of the service agreement concluded between the city of Tallinn and the ASTV. The State and the ECA were of the opinion that the service agreement concluded between the City of Tallinn and the ASTV is not binding on the state and that the ECA has the right to apply its own methodology and to regulate the price of water according to its own methodology. The service agreement used a different methodology for regulating the water price, a methodology close to the one used by the British water regulator Ofwat.

2 Jurisdiction of the Tribunal

Estonia challenged the jurisdiction of the ICSID tribunal mainly for three reasons: Firstly, because a shell company established by United Utilities in the Netherlands (the UUTBV) brought the claim and not United Utilities established in the United Kingdom that initially privatised the water company. However, since there was no bilateral investment treaty signed between Estonia and the United Kingdom, but there was a bilateral investment treaty signed between Estonia and the Netherlands, that was the only way that United Utilities was able to submit a claim against Estonia to ICSID.

Secondly, the other main reason why Estonia did not want to admit the jurisdiction of the tribunal was due to the on-going court proceedings in Estonia. Estonia claimed that these claims had the same subject-matter and that the parties to the dispute were also the same.

Thirdly, Estonia joined in with other EU Member States in the so-called Achmea case before the European Court of Justice and submitted a similar line of argumentation to the ICSID tribunal stating that after the accession of Estonia into the EU in 2004, the Treaty signed between Estonia and the Netherlands became invalid as the EU law provides the same protection for investors as the Treaty and an earlier international treaty becomes inoperable after the entry into force of a new international treaty signed between the same parties having the same subject-matter.

The Tribunal rejected all of the aforementioned arguments. The Tribunal found that the Dutch company established by United Utilities was part of the chain of control over the Estonian water company ASTV. The Tribunal cited other tribunals who had found that the notion of control should be assessed broadly. Control does not have to be direct; it can be indirect and since the UUTBV had been entrusted by the parent company, United Utilities to appoint the members of Supervisory Council of ASTV, the Tribunal found that there was control by UUTBV over the Estonian water company.

As for the national court proceedings, the Tribunal found that they did not have the same subject matter as the claims brought before the tribunal. In the Estonian national court proceedings, the parties to the dispute were the Competition Authority and the water company, ASTV. The claims brought by the water company against the ECA concerned the administrative decisions that the ECA had taken regarding the ASTV. The ECA had rejected a subsequent water price augmentation and had ordered the lowering of the water price. The ASTV had challenged the lawfulness of those administrative decisions. In the arbitration the UUTBV was demanding damages caused by the change in legislation that was passed by the Parliament in 2010 and enforced by the ECA in 2011. Up to 2010 the ASTV had been able to define the water price based on an agreement signed by the City of Tallinn, a shareholder of the water company, and the water company. Although there was to some extent an overlap in the parties to the dispute, the basis for the claims and the claims were different and the Tribunal thus rejected Estonia's arguments against the tribunal's jurisdiction on this issue.

Finally, the Tribunal found that the ICSID convention and the founding treaties of the EU 'belong to two distinct subsystems of international law. The Achmea Judgment cannot, as of consequence, bind an international entity asserting its jurisdiction based on the BIT.'[1]

3 Liability

The Claimants' claims were three-fold:

1. An alleged breach of the FET (fair and equitable treatment) standard by Estonia that consisted in the Claimants view in the violation of the Claimant's legitimate expectations arising out of the privatisation agreements.
2. Other breaches of the FET standard and breach of the standard of due process as well as discriminatory measures against the Claimants.
3. Breaches of Umbrella Clause in the BIT.

[1] Section 498 of the Award.

3.1 Fair and Equitable Treatment

The Claimants (ASTV and UUTBV) main concern was that after the change in law and in the regulator in 2010 the company was no longer able to define the water price based on the 2001 privatisation agreements and its subsequent amendments agreed upon with the City of Tallinn.

In 2001 the regulator of the water and sewage prices was the owner of the water company, the City of Tallinn. While working with this case we[2] had to go back in time of 15 years. We talked to the advisors of the city before and during the privatisation as well as to civil servants and politicians who were decision makers and policy definers at that time. It was clear that the new law, the Water and Sewage Act of 2001 lacked jurisprudence or any practice at all. It was evident from interviews and documents that nobody had a longer vision than the next 5 years following the privatisation. At the same time, it was also evident given the nature of water and sewage infrastructure that the investments made by the new investor would be for a much longer time horizon than 5 years.

The privatisation agreements concluded in 2001 clearly state that the company must always comply with the applicable law in addition to the provisions of the agreement. In addition, the privatisation agreements provided for the possibility of a change of the water regulator in the future. It is important to note in this connection that the part of the privatisation services agreement concerning the pricing of the water (the water price formula) is not an ordinary private law contract, but an administrative contract concluded instead of issuing an administrative act. The issue of the nature of this contract was debated before the Estonian national courts and it was the finding of the Supreme Court of Estonia that the agreement regulating the water price formula and eventually the water price was an administrative agreement. The interesting thing to note here is that this administrative agreement is still in force up to today, but it is impossible to enforce the agreement due to a change in law and in the regulator. Under the Estonian administrative law, an administrative act or agreement even if unlawful is in force until it is repealed. Therefore, the Claimants argued that the new regulator, the Competition Authority was bound by the privatisation agreements, namely by the administrative agreement fixing the formula for calculating the water price.

[2] The author of this article was at the time working at the Estonian Ministry of Justice responsible for representing the Estonian State in the arbitration and working together with outside counsel from law-offices Squire Patton Boggs and Primus.

The Tribunal analysed the FET standard in depth in its decision based on arbitral jurisprudence and international law including the Treaty. The Tribunal starts its analysis from the Treaty and gives substance to the relevant provisions of the Treaty based on the existing arbitral jurisprudence.

3.1.1 Breach of the FET Standard Arising from Privatisation Agreement

Article 3(1) of the Treaty states that:

> Each Contracting Party shall ensure fair and equitable treatment of the investments of nationals of the other Contracting Party and shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those nationals. The preamble of the Treaty states: 'fair and equitable treatment is desirable'. The Treaty does not give a definition of the FET standard nor does it specify the conditions or boundaries of its application.

The Tribunal analyses the substance of the Treaty's FET standard based on multiple ICSID and Uncitral international investment arbitral awards, including but not limited to: PSGE v Turkey[3], Waste Management[4], El Paso Energy v Argentina[5], MTD v Chile[6], Electrabel v Hungary[7], EDF v Romania[8], Parkerings v Lithuania[9], Saluka v Czech Republic[10], etc.

The Tribunal uses Waste Management award as a starting point in the analysis of the substance of the FET standard. In section 573 the Tribunal quotes the Waste Management as follows:

> [T]he minimum standard of treatment of fair and equitable treatment is infringed by conduct attributable to the State and harmful to the claimant if the conduct is arbitrary, grossly unfair, unjust or idiosyncratic, is discriminatory and exposes the

[3] PSEG Global Inc. and Konya Ilgin Elektrik Üretim ve Ticaret Limited Sirketi v. Republic of Turkey ICSID Case No. ARB/02/5.

[4] Waste Management, Inc. v. United Mexican States (ICSID Case No. ARB(AF)/00/3).

[5] El Paso Energy International Company v. Argentine Republic (ICSID Case No. ARB/03/15).

[6] MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile (ICSID Case No. ARB/01/7).

[7] Electrabel S.A. v. Hungary (ICSID Case No. ARB/07/19).

[8] EDF (Services) Limited v. Romania (ICSID Case No. ARB/05/13).

[9] Parkerings-Compagniet AS v. Republic of Lithuania (ICSID Case No. ARB/05/8).

[10] Saluka Investments B.V. v The Czech Republic, UNICITRAL, Partial Award 17 March 2006.

> claimant to sectional or racial prejudice, or involves a lack of due process leading to an outcome which offends judicial propriety—as might be the case with a manifest failure of natural justice in judicial proceedings or a complete lack of transparency and candour in an administrative process. In applying this standard, it is relevant that the treatment is in breach of representations made by the host State which were reasonably relied on by the claimant.

The Tribunal goes on to assess of its own motion in point 574 and 575 of the Award that:

> This is not to stay, however, that the protection afforded to investors under this standard finds its source in investors' expectations. The protection derives from the terms of the applicable treaty; the expectations of an investor do not constitute a standalone source of obligations for the host State. Although the investor's expectations will be at the heart of the analysis, they are not to be assessed on a purely subjective basis, nor without due consideration of the State's sovereign right to regulate /---/

> Absent an express commitment to that effect by the host State, it is not reasonable for an investor to expect that its investment will enjoy a static legislative and regulatory regime; foreign investors must anticipate changes and adapt accordingly

After giving context to the FET standard the Tribunal continues to show that investors legitimate expectations protected under international law cannot rise out of contractual agreements. The Tribunal makes reference to Parkerings v Lithuania where the tribunal found that: */---/ contracts involve intrinsic expectations from each party that do not amount to expectations as understood in international law.*[11]

This leaves the Tribunal with the Claimants secondary claims: other breaches of the FET standard and breach of the standard of due process as well as discriminatory measures against the Claimants.

3.1.2 Other Breaches of the FET Standard

Although an agreement alone cannot form basis for legitimate expectations, it can *inform the existence of legitimate expectations, depending on the circumstances,*

[11] Section 585 of the Award.

including most notably the assurances contained in the contract, the other terms of the relevant agreement and the context in which the contract is executed.[12]

The context is meant to be the regulatory framework applicable to the case. The Claimants admitted in their submissions that they did not benefit from a stabilisation clause or any other explicit promise from the State that the regulatory framework would not change. They however claimed that they expected that 'the key principles of the regulatory framework applicable to ASTV, as set out in the Services Agreement, would not be radically overturned during its term.'[13]

Authors McLachlan, Shore and Weiniger explain that: 'tribunals have found a breach of the standard on the ground that the cumulative effect of the State's regulatory changes has been to alter completely the regulatory framework in a manner that virtually eliminates the investor's reasonably expected benefits.'[14] The Tribunal analysed several international investment cases that evolved around the breach of the FET standard in the context where a state had changed the regulatory regime. The Tribunal found that: 'in the absence of a stabilisation clause, regulatory changes *may* breach the FET standard where such changes are either made in bad faith or with the intent of depriving the investor of the benefit of its investment.'[15]

In order to apply this type of FET standard breach the State would have had to be involved directly or indirectly in assuring the investor that the regulatory regime would not change. The Claimants had admitted that there was no stabilisation clause in the privatisation agreements. They were relying on indirect assurances allegedly made by the State during the privatisation process. The City of Tallinn had asked before the opening of the public tender the Minister of Finance to grant the future investor an exclusive right of 20 years to operate in Tallinn. The city itself was only able to grant an exclusive right for a period of 5 years under the relevant law. An extended time period was needed to ensure economic interest of possible investors.

The Tribunal rejected this indirect link between the central government and the investor:

> This being said, there is no question that the relevant license could only be held by the water undertaking, *i.e.* ASTV, not the investor in the undertaking. And although the Ministry of Finance took into consideration the capital-intensive

[12] Section 588 of the Award.

[13] Section 592 of the Award.

[14] Section 593 of the Award and Campbell McLachlan – Laurence Shore – Matthew Weiniger, International Investment Arbitration – Substantive Principles. 2nd ed. Oxford University Press 2017.

[15] Section 605 of the Award.

> nature of the sector in extending ASTV's license term, there is no evidence that it also took into consideration the specific interests of ASTV's future investor. Nor is there any evidence that the Central Government was provided with a copy of the Services Agreement or that it considered either the particular return expected by the investor or the share price.[16]

The principle of fair and equitable treatment would have been violated if the investor had been able to demonstrate convincingly that the central government was involved in the privatisation and that changes to the regulatory environment were arbitrary, grossly unfair, and one-sided in harming the company and contrary to the principle of due process. None of these circumstances were established. Back in 2001 the legal framework, namely the Public Water Supply and Sewerage Act was new and there was no implementation practice, so both the investor and the City of Tallinn lacked a clear idea of how to precisely define the terms 'justified profitability'. It was clear that the law required that the water price should be cost-based, i.e. to take into account production costs, ensure safety, hygiene and environmental compliance, and allow the company to earn 'justified profitability'. The parties to the privatisation, the City of Tallinn and the investor tried to define those criteria during the negotiations leading up to the signing of the privatisation agreements. The Tribunal found that the privatisation agreements are interconnected and formed integral parts of a single transaction.[17] The Tribunal did not find any evidence that the privatisation agreements would have set a specific justified profitability rate for the whole investment time period. The only thing that was established in the privatisation agreements was the method or formula for calculating the water price.

The main reasoning of the Tribunal can be found in sections 708 to 710 of the Award:

> 708. The Tribunal agrees with the interpretation offered by Respondent. The Services Agreement terms plainly disclosed to Claimants that the regulatory framework was not static and, what is more, that change was indeed likely. There is no stabilisation clause here; the relevant provisions could even be said to comprise anti-stabilisation clauses.
>
> 709. These elements must also be considered against the legal environment prevailing in 2001. At that time, the PWSSA was a newly enacted law within a newly independent State and the evidence establishes that this yielded uncertainty

[16] Section 625 of the Award.

[17] Section 653 of the Award.

> (which, as commented in the previous section, provoked discussion among other things on the meaning of justified profitability). Moreover, the City of Tallinn, the sole State entity involved in the privatisation and which made any representations whatsoever to the bidders, did not have authority under Estonian law to guarantee the maintenance of the 1999 PWSSA or the stability of any element of the Estonian legal order. In the light as well of Mr Sellner's evidence, it simply cannot be sustained that an investor as sophisticated as UUTBV could have formed the expectation that the regulatory regime prevailing at the time of the investment would apply throughout the Mandate Period.
>
> 710. This is so irrespective of the specificity of the tariff regime that the parties to the privatisation agreements may have set out to craft. The City of Tallinn and the investors may have negotiated an interpretation of "justified profitability" and a mechanism for setting tariffs under the 1999 PWSSA. They could not, however, and it could not have been reasonably understood, that in doing so they would bind the Central Government and the Estonian Parliament to a legislative or regulatory freeze or to a commitment to respect that mechanism notwithstanding legislative change. The current matter is not analogous to Perenco v Ecuador, commented above at paragraphs 598–600, insofar that, here, the privatisation agreements were not "anchored in a legislative framework duly considered and enacted by the Estonian Parliament".[18]

3.2 Due Process and Discriminatory Measures

Amendments to the law passed by the Parliament in 2010 (the so-called anti-monopoly bill) added the phrase 'from invested capital' to justified profitability. The purpose of the amendment was to exclude the privatisation price from being included in the assets of the company, as it would have significantly changed the permissible water price. The Tribunal acknowledged that the public discussion prior to the amendment of the Act, including the political discussion, focused to a significant extent on the water price in the service area of ASTV. The arbitral tribunal also accepted, in the light of the evidence, that the additional phrase 'invested capital' was included in the Act mainly because of ASTV, as it would not have been relevant to any other water company operating in Estonia at that time.

The Tribunal found that while such public and political debate may be questionable, it was not a violation of the principle of fair and equitable treatment because the investor had no legitimate expectation of a particular formula for calculating the water price. When creating and modifying a regulation, a state may choose

[18] Sections 708–710 of the Award.

between different solutions as long as the chosen solution is non-discriminatory and uniformly implemented. The arbitral tribunal added that an unreasonably high rate of return could be one of the legitimate motives for changing the legal framework. This is understandable, since the object of regulation is not only the interest of the investor to make a profit, but also the interest of the consumers to obtain a quality service at the lowest possible price.

The main findings of the Tribunal are summed up in sections 801 and 802 of the Award as follows:

> 801. In the light of this evidence, the Tribunal is persuaded that the phrase "capital invested by the water undertaking" sought to exclude privatisation value from the calculation of tariffs. Although this might not have been the sole purpose of this amendment to the draft AMB (anti-monopoly bill), the evidence nonetheless indicates that this was an important reason for the amendment and was directed specifically at ASTV. As to Respondent's argument that such modification did not alter the state of Estonian law, the Tribunal rejects that proposition and agrees in this respect with the Estonian Supreme Court.
>
> 802. That being said, the Tribunal does not find that this legislative change is indicative of a breach of the FET standard. This modification to the PWSSA falls within the scope of the changes that an investor should have foreseen, especially when considering the clauses of the Services Agreement disclosing potential change in the law. It cannot either be sustained that the fact that some aspects of the AMB (anti-monopoly bill) were directed to ASTV means that its adoption necessarily amounts to a breach to international law. In this respect, even if not directly pertinent to the FET standard, the Tribunal is mindful that at least one international tribunal has concluded that the curtailing of perceived luxury profits constitutes a proper policy motivation. What is more, it is fair to understand, upon review of the evidence, a concern with ASTV in particular was legitimate considering its especially significant position among water utilities in Estonia.[19]

As for the other claims the Claimants had made, the Tribunal rejected those, as they did not fundamentally differ from their main claim of legitimate expectations and had thus already been addressed previously.

The Arbitral Tribunal used in questions of interpretation of the Estonian law the rulings of the Supreme Court of Estonia in the national dispute between ASTV and the ECA. The arbitral award is noteworthy in the international context, as arbitration as a tool to dispute resolution is criticized for concerns of transparency and high costs.

[19] Sections 801 and 802 of the Award.

The UUTBV v Estonia case is one of the most transparent examples with all materials available on the ICSID website. The two weeks of arbitration hearings were live broadcasted online for everyone to see and hear. Within the European Union, the direction has been taken to terminate bilateral investment treaties between Member States, and one of the main arguments against arbitration is the fact that arbitral tribunals are not bound by jurisprudence of the national courts of the Member States nor by the jurisprudence of the European Court of Justice. In the case of UUTBV v Estonia, the Tribunal has very well demonstrated that this is not the case and that national jurisprudence can elegantly and harmoniously work together with international law. Furthermore, one can see that international investment arbitration and the relevant international law influences national regulation and the way a national legislator or regulator works.

3.3 The Award and Costs

The Tribunal found that the Claimants claims were not founded and ordered the Claimants to pay Estonia's costs. Estonia's costs were downsized by the Tribunal because Estonia lost their quite extensive argument regarding jurisdiction and because of the increased costs due to the intervention of the European Commission. The Tribunal ordered the Claimants to pay 25% of Estonia's costs.

4 Conclusion

The main issue in the dispute was what formula should be used to regulate the water price and whether the law or the privatisation agreement should be the primary basis for determining the formula. The arbitral Tribunal's ruling consistently focused its analysis on the principle of fair and equitable treatment of investors (the so-called FET test). The sovereign right of the State to establish and change the rules must be balanced by the legitimate expectation of the investor to earn a reasonable return on the investment made. Finding the right balance can be difficult and can lead to long and costly disputes. Just as public procurement law does not allow for arbitrary requirements, the change in laws must be handled in a balanced and fair way. The right of a State to amend an existing law should be consistent with a wider public interest. Transparency of the whole procedure as well as substantive stakeholder involvement and consultation is also very important.

At the same time, it is important to note that the legitimate expectation of an investor is not a subjective category but an objective category based on the circum-

stances and taking into account the rights of the consumers.[20] A professional investor must consider all the circumstances before making an investment, including the possibility that the legal environment may change. If an investor seeks a total regulatory freeze over the full lifetime of its investment it would do best to receive a clear and irrevocable promise from the host state clearly attributable to that state.

The Tribunal showed how national and international laws as well as national and international courts and arbitral tribunals can work together and supplement each other. This example paws way for greater transparency and trust for arbitration as a professional dispute resolution tool.

[20] World Bank Arbitration in El Paso Energy International Company v. Argentine Republic, ICSID Case No. ARB/03/15.