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International Arbitration Case Law

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AES SUMMIT GENERATION LIMITED & AES-TISZA ERŐMŰ KFT.
v.
REPUBLIC OF HUNGARY

ICSID CASE NO. ARB/07/22

Case Report by Brooks Hickman**
Edited by Ignacio Torterola***

Annulment decision dispatched to the parties on June 29, 2012, concerning the Award dated September 23, 2010 issued to the parties under the ICSID Convention.

***Ad Hoc* Committee on the Application for Annulment:**
Professor Bernard Hanotiau (President); Professor Dr. Rolf Knieper; Judge Abdulqawi Ahmed Yusuf

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Digest

1. Facts of the Case

AES Summit Generation Limited and AES-Tisza Erőmű Kft. ("AES" or "Applicants") initiated arbitration against the Republic of Hungary ("Hungary" or "Respondent") in a dispute arising under the Energy Charter Treaty ("ECT").[1] In July 2007, the Applicants filed their Request for Arbitration with the International Centre for Settlement of Investment Disputes ("ICSID Centre") in accordance with the ECT.[2] Hungary did not contest jurisdiction.[3]

AES's dispute with Hungary arose from pricing regulations adopted after the enactment of the 2006 Electricity Energy Act Amendment, which permitted the reintroduction of regulated prices after their abolition in 2004.[4] Under this law, Hungary adopted two price decrees in December 2006 and February 2007 to cap electric generators' return on assets in order to combat what it deemed to be "luxury profits" in the public utility sector and to minimize the cost to consumers.[5] The Applicants asserted that these regulatory changes breached Hungary's obligations under the ECT to (i) provide fair and equitable treatment; (ii) avoid unreasonable or discriminatory measures harming protected investments; (iii) provide national treatment; (iv) provide most-favored nation treatment; (v) provide constant protection and security; and (vi) observe the ECT's requirements for expropriation.[6] The Tribunal that was constituted to hear these claims issued an Award on September 23, 2010 (the "Award"), holding that Hungary had not breached the ECT.[7]

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1 *See AES Summit Generation Limited v. Hungary*, ICSID Case No. ARB/07/22, Decision of the *Ad Hoc* Committee on the Application for Annulment, ¶ 2 (June 29, 2012) [hereinafter the "Annulment Decision"].

2 *See AES Summit Generation Limited v. Hungary*, ICSID Case No. ARB/07/22, Award, ¶ 3.1 (Sept. 23, 2010) [hereinafter the "Award"].

3 Annulment Decision at ¶ 3.

4 *See id.* at ¶ 2.

5 *Id.* at ¶¶ 2, 69, 73.

6 *See id.* at ¶ 2.

7 *Id.* at ¶¶ 1, 3. The Tribunal was composed of Mr. Claus Werner von Wobeser (President), Professor Brigitte Stern, and J. William Rowley QC. *See* Award at p. 98.

Subsequently, the Applicants filed an application to annul the Award pursuant to Article 52 of the Convention on the Settlement of Investment Disputes Between States and the Nationals of Other States ("ICSID Convention"). The Applicants relied on two grounds in support of their request to annul the Award, claiming that the Tribunal: manifestly exceeded its powers (Article 52(1)(b)) and failed to state the reasons on which its decision was based (Article 52(1)(e)).[8] The ICSID Centre constituted an *ad hoc* Committee (the "Committee") to hear the parties' arguments concerning AES's annulment application. The Committee was composed of Professor Bernard Hanotiau (President), Professor Dr. Rolf Knieper, and Judge Abdulqawi Ahmed Yusuf.[9]

2. Legal issues discussed in the Annulment Award

2.1 Scope of Review

The Committee began its consideration of the annulment application by emphasizing the limited scope of its review. It observed that, under the ICSID Convention, "annulment is an exhaustive, exceptional and narrowly circumscribed remedy and not an appeal."[10] For this reason, the Committee could not "substitute its own judgment on the merits for that of [the Tribunal]" or "express any view on the substantive correctness of the Tribunal's reasoning."[11]

2.2 Manifest Excess of Powers

Applying the rules of interpretation contained in the Vienna Convention on the Law of Treaties of 1969, the Committee found that the ordinary meaning of "manifest excess of power" is "an obvious transgression of a tribunal's mandate or its obvious non-execution."[12] The Committee elaborated that "manifest" pertains to "the ease with which an excess of powers is perceived, rather than its gravity."[13] The Committee stressed that "such an excess must be … 'discern[able]

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8 *See* Annulment Decision at ¶ 4.

9 *See id.* at ¶ 7.

10 *Id.* at ¶ 17.

11 *Id.* at ¶ 15.

12 *Id.* at ¶ 17.

13 *Id.* at ¶ 31.

with little effort and without deeper analysis.'"[14] The Committee considered that this understanding of "manifest" was "consistent with" the "textually obvious and substantively serious" standard articulated in the *Soufraki* annulment decision.[15] Following its analysis of Article 52(1)(b), the Committee agreed with AES that a tribunal could "exceed its power by failing to exercise the jurisdiction which it possesses."[16] In line with the parties' submissions and *Soufraki* annulment decision, the Committee specified that such failures to exercise jurisdiction must be significant or consequential and "result-determinative."[17]

While the Committee also recognized that a tribunal's failure to apply the proper law can constitute a manifest excess of power, it emphasized the distinction between the "*non-application* and mere *misapplication* of the applicable law."[18] The Committee asserted that the failure to observe this distinction could transform the annulment process into an appeal on the merits.[19] Accordingly, the Committee concluded that a party seeking annulment based on the failure to apply the applicable law must show "at the very least something more than a 'serious error'" in order to establish a manifest excess of power.[20] Rather, that party must show that the tribunal "fail[ed] to apply the proper law *in toto*."[21]

2.3 Failure to State Reasons

As a general construction of Article 52(1)(e), the Committee observed that the "failure to state the reasons on which the decision is based" ordinarily means an "absence of reasons or a presentation which is unintelligible in relation to the

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14 Annulment Decision at 31 (citing CHRISTOPH H. SCHREUER, LORETTA MALINTOPPI, AUGUST REINISCH & ANTHONY SINCLAIR, THE ICSID CONVENTION: A COMMENTARY 938 at ¶ 135 (2nd ed. 2009)).

15 *Id.* (citing *Soufraki v. The United Arab Emirates*, ICSID Case No. ARB/02/7, Decision of the *Ad Hoc* Committee on the Application for Annulment of Mr. Soufraki, ¶ 40 (June 5, 2007)).

16 *Id.* at ¶ 30.

17 *Id.* (referencing *Soufraki v. The United Arab Emirates*, ICSID Case No. ARB/02/7, Decision of the *Ad Hoc* Committee on the Application for Annulment of Mr. Soufraki (June 5, 2007)).

18 *Id.* at ¶ 33.

19 *See id.*

20 *Id.* at ¶¶ 33-34 (citing *Soufraki v. The United Arab Emirates*, ICSID Case No. ARB/02/7, Decision of the *Ad Hoc* Committee on the Application for Annulment of Mr. Soufraki, ¶ 86 (June 5, 2007)).

21 *Id.* at ¶ 35.

decision."[22] It cautioned, however, that this ground for annulment presents the greatest risk of inducing *ad hoc* committees to review, impermissibly, the merits of tribunals' reasoning, as if deciding an appeal.[23] Consequently, the Committee approved Professor Schreuer's commentary that the "duty to state reasons refers only to a minimum requirement" that does not obligate the tribunal to "attempt to convince the losing party that the decision was the right one."[24]

With these words of caution in mind, the Committee listed several situations where Article 52(1)(e) may be successfully invoked. First, an award can be annulled in the rare instance where there is "a total absence of reasons."[25] Second, annulment may be warranted where the award "in no way" permits one to follow the reasoning leading to the ultimate conclusion.[26] However, the Committee, recognizing the criticism of this approach, stressed the need to avoid any "assessment of the merits of the dispute" or the quality of the reasons provided.[27] Third, annulment may be necessary in the "exceptional circumstance" where the award's "reasons are so contradictory that they effectively amount to no reasons at all."[28] Finally, the Committee concluded that an award will "almost never" be annulled because it contains "frivolous reasons" unless they are "sufficiently frivolous or absurd" that they "would in effect amount to no reasons at all."[29]

3. Application to Arguments and Decision

The Committee applied the above legal standards to assess five aspects of the Award that, in the Applicants' submission, required its annulment: (i) the Tribunal's failure to address AES's historic profitability; (ii) the Tribunal's analysis of AES's legitimate expectations; (iii) the Tribunal's analysis of AES's

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22 Annulment Decision at ¶ 17.

23 *See id.* at ¶ 47.

24 *Id.* at ¶ 48 (citing CHRISTOPH H. SCHREUER, LORETTA MALINTOPPI, AUGUST REINISCH & ANTHONY SINCLAIR, THE ICSID CONVENTION: A COMMENTARY 997 at ¶ 342 (2nd ed. 2009)).

25 *Id.* at ¶ 49.

26 *Id.* at ¶ 50 (citing *Klöckner Industrie-Anlagen GmbH and others v. United Republic of Cameroon and Société Camerounaise des Engrais*, ICSID Case No. ARB/81/2, Decision on Annulment, ¶ 144 (May 3, 1985)).

27 *Id.* at ¶¶ 51-52.

28 *Id.* at ¶ 53.

29 *Id.* at ¶ 54.

claims that Hungary failed to observe due process; (iv) the Tribunal's analysis of Hungary's ECT obligation to create stable conditions for investors; and (v) the Tribunal's analysis of the applicability of Hungarian and EU law.

3.1 AES's historic profitability

The Applicants claimed that the Tribunal exceeded its mandate and failed to provide reasons by failing to address whether AES's historic profits justified the reintroduction of regulated pricing.[30] Specifically, they argued that under the two-prong test in *Saluka v. Czech Republic*, Hungary's measure could only be justified if there were (i) a "rational policy goal aimed at addressing a matter of public interest" and (ii) some "reasonable correlation" between that goal and the challenged measure.[31] According to AES, the Tribunal had to evaluate AES's historic profitability because "Hungary's only rational policy goal was to address historically excessive profits."[32] The Applicants also claimed that the Tribunal gave "contradictory" or "frivolous" reasons regarding the nature of Hungary's public policy objective.[33]

The Committee, however, found that the Tribunal concluded that Hungary's regulated pricing measures were aimed at "a perfectly valid and rational policy objective," namely preventing so-called "luxury profits" in order to avoid burdening consumers.[34] Accordingly, the Committee concluded that the Tribunal had no need to address historic profits. The Committee also observed that the Tribunal considered the reasonableness of the pricing regulations, thus satisfying the second *Saluka* prong.[35] Consequently, the Tribunal did not fail to address the crucial issues on these points and stated its reasons for its conclusions.[36]

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30 *See* Annulment Decision at ¶ 55.

31 *Id.* at ¶ 56.

32 *Id.* at ¶ 58.

33 *Id.* at ¶¶ 60-61.

34 *Id.* at ¶ 69.

35 *See id.* at ¶¶ 72-77.

36 *See id.* at ¶¶ 78-79.

3.2 AES's Legitimate Expectations

On this issue, the Applicants principally claimed that the Tribunal erred by "applying a non-existent 'absolute certainty' standard" to evaluate whether the new pricing regulations were so unforeseeable as to violate AES's legitimate expectations.[37] They also alleged that the Tribunal failed to state reasons by erroneously relying on irrelevant documents, by not addressing applicable authorities that AES had presented, and by not explaining why the absence of a "Stabilization Clause" or the presence of a "Change of Law" provision supported its ultimate conclusion.[38]

The Committee, however, found that the Tribunal had not adopted "absolute certainty" as a new legal test and that it had instead found that AES did not have any "express governmental assurances and representations" that the pricing regime would not be altered.[39] Moreover, even if the Tribunal had adopted a new legal test, the Committee refused to conclude that such innovation would constitute an "error of law … so egregious as to merit annulment."[40] The Committee also held that the Tribunal had provided reasons supporting its application of the legal standard to the facts when determining whether AES had legitimate expectations concerning the permanence of the previous regulatory regime.[41] Finally, the Committee rejected the contention that the Tribunal's reliance on the "Change of Law" provision contained in the Applicants' power purchase agreement ("PPA") with the Respondent constituted a reason so frivolous that it would compel annulment.[42]

3.3 AES's Due Process Claims against Hungary

The Applicants alleged that the Tribunal failed to state its reasons why the manner in which Hungary adopted the pricing measures did not violate due process in light of the "arbitrarily short timeframe" in which AES was permitted to provide input regarding the regulatory change, the role of the Ministry of the

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37 Annulment Decision at ¶ 82.

38 *See id.* at ¶¶ 85-87.

39 *Id.* at ¶ 95.

40 *Id.* at ¶¶ 98-99.

41 *See id.* at ¶¶ 101-111.

42 *See id.* at ¶ 112-117. The Committee recalled its view that "frivolous" reasons could only justify annulment "in the exceptional event that they amount to no reasons at all." *Id.* at ¶ 113.

Economy in the process, and Hungary's failure to conduct a full review of AES's costs and assets before setting prices.[43]

The Committee rejected these arguments, finding that the Tribunal explained its assessments of both the amount of time provided to the Applicants to submit comments on the proposed regulatory changes and the role of the Ministry of the Economy in the process.[44] Likewise, the Committee determined that the Tribunal did not have to make any additional findings concerning the need for a full cost and asset review because it relied on uncontradicted testimony concerning the reasons why Hungary did not do so.[45] In the Committee's view, the Tribunal's reasoning was neither contradictory nor frivolous in this regard because the Tribunal also found that the Applicants could have—but did not—request an individualized price review if they thought their costs were not properly reflected.[46]

3.4 Stable Conditions for Investment

AES alleged that the Tribunal failed to define the actual content of the applicable legal standard for "stable, equitable, favourable and transparent conditions for Investors" under the ECT and proceeded instead by analyzing what does not constitute stable conditions.[47] Furthermore, AES claimed that the Tribunal's failure to make affirmative findings effectively disregarded the applicable law. According to the Applicants, the Tribunal also manifestly exceeded its powers by not making findings on AES's profitability record.[48]

The Committee, however, rejected these claims, finding that the Tribunal both provided a standard and evaluated the circumstances to determine whether Hungary's new pricing regulations breached the ECT protections concerning stable investment conditions. Accordingly, the Tribunal did not manifestly exceed its powers. [49]

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43 Annulment Decision at ¶¶ 121-124.

44 *See id.* at ¶¶ 132-133.

45 *See id.* at ¶¶ 137-139.

46 *See id.* at ¶¶ 144-145.

47 *Id.* at ¶¶ 146-147.

48 *See id.* at ¶¶ 147-149.

49 *See id.* at ¶¶ 154-159.

3.5 Legality of the Pricing Regulations under Hungarian and EU Law

Finally, the Applicants alleged that the Tribunal exceeded its powers and failed to state its reasons when it applied international law to the dispute without addressing AES's claims that the new regulations violated Hungarian and EU law.[50] The Applicants argued that this failure was significant because the legality of the measures was a factor relevant to ascertaining their "rationality."[51]

The Committee rejected this argument because the Tribunal reached its conclusion after evaluating the parties' arguments concerning the applicability of international law versus EU and Hungarian law, including AES's own contention that "the ECT and the applicable rules and principles of international law" constituted the only applicable law.[52] Furthermore, the Committee noted that the Tribunal assessed the rationality of the policy underlying the new regulations by seeking a "logical (good sense) explanation"; therefore, the Committee concluded that the Tribunal did not need to evaluate the legality of re-introducing pricing regulations under Hungarian or EU law to reach its conclusion.[53]

3.6 Result and Costs

For the foregoing reasons, the Committee rejected the Applicants' grounds for seeking annulment of the Award. As Hungary "prevailed in totality," the Committee found no reason to deviate from the approach that "costs follow the event."[54] The Committee, therefore, ordered the Applicants to pay ICSID's full costs and expenses, including those of the *ad hoc* Committee's members, and to pay the legal expenses and costs of the Respondent.[55]

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50 *See* Annulment Decision at ¶ 161.

51 *Id.* at ¶ 162.

52 *Id.* at ¶¶ 168-170; *see also* Award at ¶ 7.3.1.

53 Annulment Decision at ¶¶ 171-174.

54 *Id.* at 181.

55 *Id.* at 182.