ICELAND-UK INTERCONNECTOR: A BRIEF ANALYSIS OF POSSIBLE POLITICAL RISK MITIGATION AND DISPUTE SETTLEMENT

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Introduction

There is growing debate regarding the feasibility of an electricity interconnector between Iceland and the United Kingdom. Many different factors play a role when assessing the feasibility of this project, but this article will mainly focus on the political risks associated as well as ways to mitigate those risks. Furthermore, ways to seek arbitration and settle disputes will be reviewed. The article will attempt to answer the following research question: What are the political risks that Iceland could be confronted regarding the Iceland – UK interconnector project and how can they be mitigated?

Large scale energy projects, such as the proposed interconnector, take a long time to develop and to construct. Moreover, the operating lifetime of these investments can be of 20-30 years. Consequently, political risks need to be assessed with a few decades in mind. Numerous reports and research papers have been published evaluating the feasibility of the interconnector, but after conducting a literature review, the authors did not find any comprehensive critical assessment of the political risks associated with this project. Landsvirkjun, Iceland’s national power company has compiled a comprehensive list of news as well as reports and other material about the project on their website (Landsvirkjun, n.d.a; n.d.b) All of this information data was included in the review. An interconnector can be defined as “…a cable or overhead line connecting two separate market or pricing areas” (Turvey, 2006, p. 1457). This particular interconnector is somewhat special in terms of its scale. It is estimated to be over 1000km in length and have a transmission capacity of 800-1200MWh DC (Landsvirkjun, n.d.a). Furthermore, it needs a significant amount of investment in Iceland to become economically feasible. The total investment can be roughly divided into three sections as follows:

- the interconnector itself along with landing and launching stations in Iceland and the United Kingdom.
- strengthening of the national grid in Iceland, needed to cope with the increased flow of electricity due to the interconnector.
- the upgrade of current power stations in Iceland, in addition to the construction of new ones, needed to increase electricity supply.

The total cost of the project has yet to be determined, but numerous parties have come up with some estimates. For instance, according to a report made for the Ministry of Industry and Innovation (Iceland) the investment needed ranges from 288 to 553 billion ISK (Hagfræðistofnun Háskóla Íslands, 2013). Bloomberg New Energy Finance introduced a significantly higher sum of up to 813 billion ISK, or 4.327 billion GBP (as cited in Gíslason, 2014 [using current exchange rates]). It is clear that regardless of the final cost, investment into the project will be large, especially for a small economy
like in the case of Iceland. It would amount to a large portion of the country’s GDP, possibly about 30 percent (Sigurðsson, 2014). The United Kingdom, on the other hand, is one of the largest European economies in terms of GDP (World Bank, 2015). Therefore, it would likely find the investment’s risks more manageable.

**Methodology**
Numerous relevant cases were studied to provide some insight into the problem at hand. The methodology used in this article is the case study method. Compared to other research methods, a case study enables the researcher to examine the issues involved in greater depth. According to Yin (2009) six sources of evidence are most commonly used in case studies. These are: documentation, archival records, interviews, direct observations, participant-observation, and physical artefacts. Each of these sources has advantages and disadvantages, and, according to Yin, one should “…note that no single source has a complete advantage over all the others. In fact, the various sources are highly complementary, and a good case study will therefore want to rely on as many sources as possible” (2014). Information from international institutions, government institutions and companies as well as academic journals played a key role in this article. Furthermore, leading experts in the field at Harvard Business School, John F. Kennedy School of Government, Fletcher School of Law and Diplomacy and the University of Iceland were consulted. They provided valuable comments and ideas.

**Political Risk Mitigation**
Political risks can be defined as “Risks usually comprising currency inconvertibility, expropriation, war and insurrection, terrorism, non-government activists, and legal and administrative approvals” (Delmon, 2009, p. 598). Furthermore, Salacuse states that “(a) sudden, unexpected change in the rules (i.e. laws and regulations) is a principal form of political risk, perhaps its very essence “ (2010, p. 450). Risk associated with changes in policy, regulation and law is especially important for the interconnector given the probable importance of Contracts for Difference (CfD). These contracts are supposed to make investment in renewable energy more attractive by partly guaranteeing revenue. In practice this has been done in the UK by paying a variable top-up payment that amounts to the difference between the market price on a yearly basis and a fixed strike price (Department of Energy and Climate Change, 2013). The whole project could likely rely on such a scheme. Landsvirkjun has shown interest in studying those contracts further (Landsvirkjun, 2013). Although it is not the only supplier of electricity in Iceland Landsvirkjun, a state owned enterprise, is by far the largest (Orkustofnun, n.d.). Consequently, any decisions on this project in Iceland are likely to be influenced by Landsvirkjun in some way, not only because of its importance as an electricity supplier, but also due to its expertise and research in recent years.

Many other interconnectors rely on other methods to acquire revenue, sometimes without a long term revenue guarantee. One example is the NorNed interconnector between Norway and the Netherlands which relies on price variation between energy markets to secure a profit, rather than long term contracts. Interconnectors of this type are called merchant interconnectors (Parail, 2009). The scale of the project is huge for Iceland, as noted before, and it is crucial that the ownership and planning of the project minimise risk for the Icelandic nation and maintain Iceland’s sovereign power over its
clean energy sources. A possible scenario to mitigate risk can be seen in Figure 1.

Figure 1. Possible Interconnector Scenario

In this scenario the interconnector is operated, owned and financed by a project company, which would most likely be some sort of a public private partnership. It would not be owned by Landsvirkjun or the government of Iceland. A public private partnership can be defined as an “...arrangement between public and private entities for the delivery of infrastructure services and are seen as a way of raising additional funds for infrastructure investments but more importantly as a means to extend or leverage better budget funding through efficiency gains” (Delmon, 2009, p. 7). The PPP would serve as a project company for the interconnector and be guaranteed by the UK government which might also provide guarantees for the necessary infrastructure investments in Iceland.

In regard to the construction of new hydro and geothermal power stations in Iceland, needed to increase supply of electricity, a BOT (build-operate-transfer), financed by private investors, might be feasible. A BOT is a form of investment where “…the project is transferred back to the party granting the concession (in this case the Icelandic government or its SOEs)” (Delmon, 2009, p. 552). The BOT project would pay a fee to the Icelandic government for the use of resources during the investment’s lifetime. The project company would arrange a take-or-pay contract with energy suppliers in Iceland.

According to Holland and Ashley (2013, p. 205) “...take-or-pay clauses require a purchaser to pay for a minimum quantity of goods or services (i.e. electricity), whether or not those goods or services are taken”. The project company would thus assume the demand risk. A guaranteed minimum amount of electricity would in turn be transferred via the interconnector to consumers in the UK at an agreed price. This revenue guarantee could be provided with a CfD or other means. In addition, the project company would pay a fee to Landsnet, Iceland’s national grid. These fees need to cover the cost of investment and acceptable returns. Under the current law, it seems unlikely that the necessary upgrade of Iceland’s national grid could be financed with foreign investment (Raforkulög, 2003). However, foreign investors could take part in the upgrade of current power stations.

Two international institutions in particular seem likely to take part in infrastructure financing of this sort. The European Investment Bank has a wide range of financial instruments to offer and might provide loans and guarantees to support this project. The bank puts a special emphasis on infrastructure and climate friendly projects and has already lent close to 780 million EUR in Iceland, most of which went to renewable energy projects recently (European Investment Bank, n.d.a; n.d.b). EIB also provides guarantees which can in turn lower the cost of financing projects (European Investment
Another institution, of which Iceland is a founding member and part-owner, the Nordic Investment Bank might also play some role in this regard (Nordic Investment Bank, n.d.). National export credit agencies could provide guarantees for trade finance related to the project (Dinh and Hilmarsson, 2014; Goncharuk, 2015).

The scenario in Figure 1 could allow the private sector to take part in the project and thus shift risks from the Icelandic government, its SOEs and the Icelandic nation to the UK government and the consumers in the UK. Efficient allocation of risks is key to the success of the project and the UK government is in the best position to prevent risk events, such as energy policy changes in the UK that could negatively affect the feasibility of the interconnector, from occurring. Therefore it should be willing to assume most of the risks involved. This might seem far-fetched but renewable energy projects seem to have a momentum and strong political backing in the UK. This can be seen in a recent case, where the UK government partly insured a large nuclear energy project (EDF Energy, 2015). Whether or not they would be willing to do the same for foreign investment remains unclear. It must be noted that the abovementioned scenario is only one of numerous possibilities. The project is still in the feasibility stage so many factors remain unclear. However, it is certain that Iceland’s comparative advantage lies in its resources – not economic power and ability to take on risks or provide funding.

The State of Play

Political and commercial relations between the two countries, Iceland and the UK, have normally been good. However, there have been some major exceptions. Perhaps the most prominent ones are the Icesave dispute and the Cod Wars. The more recent one revolved around Icesave during and following the 2008 crisis. One of the measures undertaken by the UK was activating the Anti-terrorism, Crime and Security Act of 2001 (Méndez-Pinedo, 2011) against Iceland. During the dispute Iceland was largely isolated and without friends. Major central banks such as the European Central Bank, the Bank of England and the Federal Reserve refused to assist. The limited support provided by Nordic Central Banks proved inadequate. This shows that Iceland cannot rely on “friendly” nations during times of crisis and political disputes with a larger nation such as the UK (Hilmarsson, 2015). The former conflict, known as the Cod Wars, occurred between 1952 and 1976 when Iceland expanded its fishery territories. This led to the intervention of the British Royal Navy (Hellmann and Herborth, 2008) and an unprecedented act given that both nations are NATO member states.

Disputes in the energy sector in Europe have occurred in recent years due to shifts in government policies, for instance in Spain and Germany. These cases show that energy policies can change fast and have a detrimental effect on the feasibility of investments in the energy sector. Spain used a support system of feed-in tariffs and other subsidies to promote renewable energy generation. The first steps were taken around 1980 and subsequent steps led to a highly subsidised renewable energy sector (Gonzáles, 2008). What followed was a huge increase in renewable energy generation (Bridle and Beaton, 2012). Consequently, the cost of the system increased and eventually the Spanish government introduced policy changes to counter the problem. This included cutting subsidies and increasing taxation on renewable energy suppliers, thereby removing one of the main incentives that attracted investors to the sector in
Spain. Consequently, a large number of investor claims versus the Spanish government were filed for arbitration. Many of these claims used provisions provided by the Energy Charter Treaty which will be discussed later in the article (Baltag, 2015; White, 2013; Rucinski and Rodríguez, 2013).

A similar scenario occurred in Germany following the 2011 Fukushima nuclear disaster. A shift in policy by the German government resulted in the phase out of nuclear energy, earlier than had been announced before, and included the immediate shut down of some old reactors. Vattenfall, owned by the Swedish government, owned two of these reactors and filed for arbitration before the International Centre for Settlement of Investment Disputes (ICSID) because of the losses associated. The arbitration is listed under the Energy Charter Treaty, but further details are mostly confidential (Vattenfall AB and others v. Federal Republic of Germany (ICSID Case No. ARB/12/12)) (Bernasconi-Osterwalder and Brauch, 2014) (ICSID, n.d.a). This case is known as ‘Vattenfall v Germany II’ because an earlier case, now known as ‘Vattenfall v Germany I’ had already been settled with the ICSID. That case, much like the latter, came to because of a policy change. However, the origin of the dispute lay in conditions set forth by the EU rather than the German government (ICSID, n.d.b; Bernasconi, 2009; Vattenfall AB and others v. Federal Republic of Germany (ICSID Case No. ARB/09/6)).

These cases are relevant to the proposed interconnector in many ways. They show how political risks, in these cases policy changes or even expropriation, can change the environment which investors entered into and negatively affect the feasibility of the project. Something similar might very well occur during a long term project such as the Iceland-UK interconnector. They also show what possibilities are available for arbitration, although the outcome is somewhat unclear as many cases are still pending and arbitration awards in concluded cases are often confidential.

**Dispute Settlement**

If disputes do occur, numerous different options are available for arbitration between a PPP/investor and a state. The Energy Charter Treaty, which has been mentioned before, could possibly be a player in that regard, due to the fact that both Iceland and the UK have signed the treaty. Although the genesis of the charter lies in cooperation between Eastern and Western Europe it spans a much wider range today.

Hobér states that the ECT is “…the only binding multilateral instrument dealing with inter-governmental cooperation in the energy sector, and contains far-reaching undertakings for the contracting parties. The ECT includes provisions regarding investment protection, provision on trade, transit of energy, energy efficiency and environmental protection and dispute resolution.” (2010, p. 155). Therefore it seems clear that in the case of disputes, the ECT could prove beneficial. This is emphasised further by the fact that there is currently no bilateral investment treaty between Iceland and the UK (Kluwer Law International, 2016). Surely, many of the factors mentioned above, in addition to financing, ownership and general operation of the interconnector, will be addressed in a bilateral contract made especially for the project. The contract could be made between the energy suppliers and a PPP or other contracting parties including the two states involved. It might also state where and how disputes should be settled. If provisions from the ECT are used, a few forms of international arbitration are available (Hobér, 2010).
Perhaps the most prominent one, the International Centre for Settlement of Investment Disputes (one of the five institutions of the World Bank), has already shown its merit in the cases above. Iceland and the UK are both members (ICSID, n.d.d). It uses a number of instruments for arbitration in disputes between member states and nationals of other member states, i.e. investors. It does however, not make procedural rulings. The ICSID website states that “Independent conciliation commissions and arbitral tribunals constituted in each case are vested with the power to rule on procedural issues and resolve the parties’ dispute (ICSID, n.d.e). ICSID keeps a regularly updated list of cases on their website. A large number of cases are listed with the ECT as an invoked instrument, many of which are between two developed parties from Western Europe (ICSID, n.d.c). In addition to ICSID, the ECT can use UNCITRAL and the Arbitration Institute of the Stockholm Chamber of Commerce to settle disputes (Hobér, 2010). The New York Arbitration Convention could also prove useful as Iceland and the UK are both members (The New York Arbitration Convention, n.d.). Further research is needed to analyse other options available.

**Conclusion and Further Research**

Given the state of the energy sector in Europe, in addition to historical relations between Iceland and the United Kingdom, it certainly seems important to study political risks that may affect the feasibility of the proposed interconnector. Ownership and financing of the interconnector along with related infrastructure may become predominant risk factors. Contracts for difference, possibly offered by the UK government, might help improve the project’s feasibility in addition to mitigating some risk. These contracts might also increase the project’s vulnerability in the case of regulatory changes in the UK. The terms of the project have yet to be determined as it is still in the feasibility stage. A bilateral contract could consider many of the associated political risks. If disputes occur, a few well recognised organisations offer international arbitration between PPPs and states, notably the Energy Charter and ICSID. However, there are numerous other institutions that also offer arbitration, though they have not been as prominent in recent cases.

This brief analysis has covered some of the ways available to mitigate political risks related to the proposed interconnector between Iceland and the UK. There are, of course, many other risk factors associated with the project, including environmental and technical risks. In addition, legal issues are not covered in detail. These factors are all subjects that need to be researched further and in greater detail.

**References**


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Abstract

The proposed interconnector between Iceland and the United Kingdom carries numerous and different types of risks for Iceland. This article focuses on political risk. Ownership of the interconnector and related infrastructure needs to be settled in a way that minimizes political risk for the Icelandic nation without sacrificing national sovereignty over its clean energy sources. A public-private partnership could use various methods to mitigate risk. International institutions, such as the Energy Charter Organization and the International Centre for Settlement of Investment Disputes (part of the World Bank Group) could provide a basis for international arbitration in the event of dispute. Other solutions, such as bilateral legal agreements and contracts for difference, are also assessed with regard to the interconnector in addition to some financing options.

Keywords: political risk, risk mitigation, cross-border investments, cross-border financing, international business
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International Humanitarian University, Odessa, Ukraine
September 29–30, 2016