Investors v. Climate Action

What recent case law and treaty reforms may mean for the future of investment arbitration in the energy sector

By Nikki Reisch, Director of Climate & Energy, Helionor de Anzizu, Staff Attorney

As governments step up action to end reliance on fossil fuels, oil, gas, and coal companies may wield investment law as a shield to insulate themselves from the cost of the energy transition or as a sword to thwart the transition altogether. Investor-State dispute settlement (ISDS) claims brought under the Energy Charter Treaty (ECT) or other multilateral and bilateral trade and investment agreements allow foreign investors to sue a State before a secretive arbitration panel for compensation when regulation or other State action adversely affects their returns. The possibility of ISDS claims looms as a deterrent to some of the most ambitious and urgently needed climate measures targeting fossil fuels. But recent case law in the European Union (EU) and proposed reforms to the ECT have made investor-State arbitration off limits for European investors operating in the EU and may fuel broader efforts to remove investment law impediments to effective climate action altogether.

Part I of this two-part blog explains some of the flaws in the investment arbitration system and the threat ISDS poses to climate action. Part II unpacks some of the recent case law in Europe that closes the door on the use of ISDS between European investors and States, and examines how proposed reforms of the ECT would cement those changes in Europe, but leave the ISDS system otherwise unchanged and lock in reliance on fossil fuels rather than help phase them out.

PART I

Investment Law: A Skewed System

The rise of international investment law since 1990 has led to the signing of thousands of bilateral and multilateral investment agreements designed to protect the interests of foreign investors from adverse host country action. Today, there are approximately 3,300 treaties with investment provisions globally. Most of those agreements contain arbitration clauses that permit aggrieved foreign investors to circumvent national courts and sue States directly before supranational, three-member panels of arbitrators appointed on a case-by-case basis. The arbitrators' decision is neither bound by any system of precedent nor subject to appeal. The result is fragmented rulings and a lack of accountability. Moreover, neither States nor affected members of the public (third parties) can initiate arbitration, only investors can. Investors have sought — and in some cases been awarded — compensation amounting to hundreds of millions and even billions of dollars from investment arbitration. The prospect of being slapped with such hefty awards and the sheer cost of defending against investment claims, even if successful, can chill state action to regulate investors or pursue public interest measures that may impose costs on a foreign investor or otherwise adversely affect their returns.

The system's skewed structure and the resulting dynamics have attracted widespread criticism, particularly from the human rights community. In a 2021 report, the United Nations Working Group on Business and Human Rights characterized the international investment regime as marked by imbalance, inconsistency, and irresponsibility. The report describes how the asymmetry between the rights and obligations of investors under international investment agreements can "[facilitate] irresponsible investor conduct or mak[e] it challenging for States to regulate such conduct." Simultaneously, investment agreements can "undermine affected communities' quest to hold investors accountable for human rights abuses and environmental pollution."

While investment disputes have long touched on a variety of environmental matters, claims concerning climate policy are mounting, feeding concerns that the system is fundamentally at odds with the type of rapid transformation needed to avoid catastrophic levels of global warming and the further irreversible harms that would ensue.

Investment Arbitration: An Industry Weapon in the Context of Climate Change

Tackling climate change requires urgent action to halt the expansion of fossil fuel supply and to rapidly end reliance on fossil fuels. That means not only no new oil, gas, and coal investments, but accelerated closure of existing fossil fuel projects and facilities. The latest Intergovernmental Panel on Climate Change (IPCC) report clearly states that "without early retirements, or reductions in utilization, the current fossil infrastructure will emit more [greenhouse gasses] GHGs than is compatible with limiting warming to 1.5°C."

But investors in the fossil fuel sector may weaponize existing investment treaties to challenge such measures and demand compensation when policies sunset their operations or foreclose future investments in oil, gas, and coal. In other words, unless States act to blunt the threat, bilateral and multilateral investment treaties like the ECT that may be invoked to protect foreign investments in the fossil fuel sector from the impacts of regulatory change or other State action could effectively force States to pay polluters to cease their planet-warming activities.

The fossil fuel industry is already the biggest user of the ISDS system, accounting for almost 20 percent of the total known ISDS cases across all sectors. The vast majority of fossil fuel arbitration cases are related to the oil and gas industry (92 percent), and almost half of those are related to upstream investment, from exploration to extraction.

What is the Energy Charter Treaty and How Might it Threaten Climate Action in Europe and Beyond?

The ECT, a multilateral agreement designed to protect foreign investment in the energy sector, is the most frequently invoked international treaty used for these investor-state claims. With over fifty State signatories, the ECT has been referenced in 17 percent of all fossil fuel ISDS cases.

The ECT has an outsized impact in Europe. The fifty-three current signatories to the ECT include primarily States in Europe and Central Asia, but also the EU itself. To date, more than 135 investor-State arbitration cases have been lodged under the ECT. Nearly 60 percent of those disputes concern investments in the EU, and 81 percent of the investments protected by the ECT are intra-EU investments — which means recent restrictions on intra-EU arbitration, discussed below, have wide-reaching effects.

To reduce its greenhouse gas emissions and successfully meet its global climate change goals, the EU will have to transition to renewable energy rapidly and take immediate steps to end its reliance on fossil fuels. But the mere threat of arbitration under the ECT has already been used as a tool by the fossil fuel industry to weaken ambitious climate laws. And a growing wave of arbitration has been initiated to challenge specific climate measures, such as retiring fossil fuel infrastructure or halting new licensing rounds for oil and gas leases.

Examples include:

- In 2021, energy giants RWE and Uniper used the ECT to commence ISDS proceedings against the Netherlands, challenging the Dutch government's decision to phase out coal power plants by 2030. While Uniper recently announced the withdrawal of its claim against the Netherlands as a condition of the company's bailout by the German government, the RWE case is still pending.
- In 2017, Rockhopper, a UK company, and its Italian subsidiary filed an arbitration claim against Italy under the ECT, seeking compensation for the government's decision to ban certain offshore oil and gas exploration. After an initial jurisdictional ruling in favor of the investor, the proceeding was closed in April 2022.

In the European States and other countries where the ECT applies, the Treaty does nothing to benefit investment in renewables, but risks locking in dirty energy infrastructure. Despite what supporters claim, there is no evidence that the ECT attracts renewable energy investments needed for the energy transition. According to research published by IISD in December 2021, "so far, there is no evidence of a link between the existence of the ECT and an increase in Foreign Direct Investment among its contracting states. Furthermore, from 2013 to 2018, an average of 75% of global investment in renewable energy was domestic rather than foreign." Other studies, such as a paper published by the OECD in 2018, have likewise cast doubt on the assertion that international investment agreements spur investment.

The wide range of fossil fuel industry activities covered by the ECT means that investors in heavy-emitting industries including oil, gas, and coal extraction, production, and power generation may assert claims under the Treaty to deter public policy that accelerates the transition to renewable energy or to make governments pay up for protecting the climate and thereby safeguarding human rights. For example, according to research by the International Institute for Environment and Development (IIED), the ECT protects at least forty-seven coal plants operating in Europe that are at risk of becoming stranded assets.

As we discuss below, recent developments have all but eliminated the possibility of such claims between European investors and the European States, but the threat remains between investors from other countries and EU States, as well as outside of the EU.

PART II

The End of Intra-EU Investment Arbitration

As a result of recent judicial and political developments, the unreviewable and secretive investor-state arbitration system described in Part I is unavailable to European investors in disputes within the EU.

In a decision last year, Republic of Moldova v. Komstroy, the Court of Justice of the European Union (CJEU) barred European investors from suing EU Member States through investment arbitration. A briefing by ClientEarth and the Center for International Environmental Law (CIEL) published in late 2021 details the practical implications of the Komstroy ruling for future disputes under the ECT.

In short, rather than haul governments before opaque, unreviewable arbitral tribunals when they believe policy changes will cause them to lose money, European investors now will have to bring claims against European governments in local courts, as do other actors opposing State conduct. This change limits the ability of European fossil fuel companies to challenge State policies in Europe that aim to reduce reliance on oil, gas, and coal or accelerate the phaseout of existing fossil fuel infrastructure, in line with climate science and human rights obligations.

The Culmination of a Trend in Europe

The 2021 Komstroy decision is just the latest step in a continuing trend in the EU. For almost a decade, the EU has increasingly and more aggressively been pushing to replace ISDS with a multilateral investment court to hear investment disputes.

Since 2015, the EU's approach has been to institutionalize the system for the resolution of investment disputes by creating the Investment Court System (ICS), a project under discussion at the EU level. The goal is to have “one multilateral institution to rule on investment disputes covered by all the bilateral agreements in place,” rather than multiple bilateral investment tribunals in the form of ad hoc appointed panels.

In a 2018 ruling, Slovak Republic v. Achmea, the CJEU stated that the ISDS system sidelines and undermines the powers of Member States' national courts and EU law. This ruling expressly addressed only bilateral investment agreements between EU Member States. Komstroy extended that holding to all intra-EU disputes under multilateral treaties like the ECT.

In May 2020, a majority of EU Member States signed the Agreement for the Termination of Bilateral Investment Treaties between the Member States of the European Union. However, like the Achmea case, this agreement only concerned intra-EU bilateral investment agreements; it did not address intra-EU proceedings based on Article 26 of the ECT, which is a multilateral Treaty including non-EU Parties.

A few weeks after the Komstroy decision, the CJEU made another significant ruling in Republic of Poland v. PL Holdings, confirming not just that intra-EU arbitration is impermissible, but that EU Member States must take action to stop such cases from proceeding or prevent enforcement of their awards. The ruling clarified that based on EU law, Member States are obliged to challenge (i) the validity of arbitration agreements in intra-EU investment disputes; (ii) the jurisdiction of the tribunals that would have decided to move forward with those decisions; and (iii) the enforcement of any decision that would have been adopted nonetheless. Some States have begun to act accordingly. As a recent example, on April 19, 2022, the Court of Appeal of Paris set aside two intra-EU BIT awards against Poland on the basis of the Achmea and PL Holding decisions, finding that the tribunals lacked jurisdiction over the claims.

Additionally, for the last several years, the European Commission has been particularly active as an amicus in different fora, challenging the validity of intra-EU awards and the jurisdiction of arbitral tribunals in intra-EU ISDS cases. The Komstroy and PL Holdings decisions confirm that the European Commission will continue to challenge ongoing intra-EU cases.

For the first time ever, an arbitral panel recently upheld an intra-EU objection to jurisdiction in the case of Green Power K/S and Obton A/S v. Kingdom of Spain (SCC Case No. 2016/135), brought by Danish investors against Spain. This landmark decision may open the way for subsequent arbitral tribunals to similarly dismiss intra-EU claims on the grounds that hearing them would be contrary to regional and national law.

Implications of Recent Case Law in the EU and Beyond

Despite the clarity and convergence of these recent judicial decisions, they do not guarantee the end of investment arbitration against EU Member States. Some investors may engage in BIT-shopping, virtually moving their headquarters to States outside the EU to change the "nationality" of their investments and thereby access the protection provided by other investment agreements. And it remains to be seen whether arbitral tribunals will consistently decline to exercise jurisdiction if European investors bring claims against European States or whether extra-EU courts will decline to enforce such judgments should investors seek to recover awards against EU Member States from assets held in other States, despite the bars on doing so in the EU.

While the CJEU's Komstroy judgment is specific to the EU, its rationale — that ISDS undermines the rule of law and judicial precedent in the host State — is also relevant in other jurisdictions, as ISDS circumvents national judicial and legal systems by design. The decision sends a strong political message against ISDS, adding to growing critiques of investment arbitration, particularly its impacts on climate action. Moreover, the decision helps increase the scrutiny of ISDS beyond the EU, at a time when the threat that it poses to climate action is becoming ever more apparent.

Recently proposed reforms to the ECT discussed below, would put a definitive end to intra-EU investment arbitration under the Treaty, cementing the effect of the Komstroy ruling. However, they otherwise leave the ECT's ISDS provision untouched and the system's many flaws unresolved, only bolstering calls for withdrawal.

Proposed ECT Reforms Would Cement the Bar on Intra-EU ISDS, but Delay Needed Climate Action

In late June 2022, the Parties to the ECT announced a package of amendments meant to modernize the Treaty's investment provisions and purportedly bring it in line with the Paris Agreement. But as described below, the changes would entrench fossil fuel interests and prolong the protection of dirty energy sources for years into the future, well past when they need to be phased out. These proposed changes, agreed upon in principle, follow two years of negotiations and will become final only if they are formally adopted by the Contracting Parties to the ECT at the Energy Charter Conference in November 2022.

If adopted, the agreed revisions to the ECT would, among other things:

- Make the ECT's ISDS provision inapplicable among States that are members of the same Regional Economic Integration Organization (REIO), such as the EU, but leave States outside the EU, and European States facing claims by non-EU investors, vulnerable to ISDS suits;
- Grant existing fossil fuel investments in the EU and the UK ten years of investment protection after the amendments enter into force (which could itself take years);
- Maintain, for now, indefinite protection for fossil fuel investments in other Contracting Parties;
- Extend investment protections to new energy materials, products, and technologies, including carbon capture, hydrogen, and ammonia, which could function as a backdoor extension of protection to fossil fuels.

As CIEL explained in an analysis coauthored with ClientEarth and the International Institute for Sustainable Development (IISD) in July 2022, the agreed reforms to the ECT do not eliminate the threat that energy investment protections pose to climate action, particularly in the next decade — the most critical period for preventing climate catastrophe and further irreversible harm to people and nature. The reforms do not remove protections for all fossil fuel investments, as would be consistent with the rapid phaseout required to avoid catastrophic warming. Instead, they allow countries "flexibility" to "carve out" certain energy investments from ECT coverage. But so far, only the EU, the UK, and Switzerland have announced such carve-outs, and they contain significant loopholes.

The EU and UK have agreed to extend ECT protection for existing fossil fuels for a ten-year period from the effective date of the amendments. This timeline not only leaves climate action vulnerable to attack in the next decade — when fossil fuel emissions need to be slashed the fastest. It also allows investors to continue demanding compensation now for fossil fuel phaseout measures that would not come into effect until years later, effectively extending investment protections out beyond this decade.

While new fossil fuel investments in the EU would no longer be protected after August 2023, that prohibition contains significant exceptions for fossil gas and for energy materials, like hydrogen, that are derived from fossil fuels — chiefly fossil gas. For example, the EU exempts from the carveout fossil gas plants and pipelines that are capable of using or transporting hydrogen or that meet emissions-intensity caps, which analysts say are well above the current average emissions intensity of power generation in the EU, let alone future targets that aim to green electricity generation. The UK's carveout, in turn, does not apply to new fossil gas-fired power plants that use carbon capture and storage (CCS) and hydrogen-ready gas pipelines–in effect extending protections to new fossil gas investments indefinitely. Moreover, questions remain as to what will qualify as "existing investments" by the time the carveout comes into effect, potentially giving a free pass to fossil fuel projects commenced in the next year, incentivizing a rush to commit resources and thereby lock in dirty investments for years to come.

The reforms are, therefore, clearly not aligned with the rapid phaseout of fossil fuels that science shows is required to avoid climate catastrophe. Nor are they consistent with the International Energy Agency scenario limiting global warming to 1.5°C above pre-industrial levels, under which all new investment in oil, gas, and coal must halt immediately — not a year from now, let alone in a decade. These developments only reinforce growing concerns that a system designed to insulate investors from regulatory change is incompatible with the urgent need to adapt laws and policies to the accelerating climate crisis.

National and International Response to ECT Reforms

Given unresolved tensions between the ECT and needed climate ambition, exiting the Treaty remains an attractive and justified option. In the wake of the recent negotiations, some States, such as Poland, Spain, and the Netherlands, announced their wish to withdraw from the Treaty altogether, as Italy has already done. Article 47 of the ECT provides that a Contracting Party may withdraw from the ECT at any time through written notice. Pursuant to this rule, withdrawal could occur unilaterally or be coordinated, such as in the case of a withdrawal of all EU Member States – for which many civil society organizations have long been pressing through campaigns like the ECT's Dirty Secrets and Exit ECT.

Demands for withdrawal got a recent boost from the UN Special Rapporteur on the promotion and protection of human rights in the context of climate change, who recommended "repeal of the Energy Charter Treaty" in his latest report.

Withdrawal from the ECT is not necessarily without consequences. Under the current text of the ECT, withdrawal triggers the survival clause contained in Article 47(3), which states that the Treaty's investment protection provisions continue to apply to all previously protected investments for twenty years after the withdrawal takes effect. The twenty-year survival clause could significantly impede the urgent action needed to achieve Paris commitments if applicable and enforced. To avoid this, Contracting States could agree to "neutralize" — extinguish — the legal effects of the survival clause in the ECT or develop and advance other legal arguments to justify the non-application of the clause.

Conclusion

The recent judicial and political developments detailed above make clear that the window is closing on the use of investor-State arbitration, at least in Europe. In practice, intra-EU ISDS is no longer available to delay or deter climate action or otherwise deflect the costs of such action back onto the State and, thereby, the public. Even before the new ECT comes into effect, expressly prohibiting intra-EU ISDS claims under the Treaty, the CJEU's rulings continue to apply, barring arbitration between European investors and States. However, more work remains to be done to definitively close off investors' recourse to the "secret weapon" of opaque investor-State arbitration proceedings outside of the EU.

The incompatibility of ISDS with necessary climate action on fossil fuels is by no means limited to Europe. Illustrations of the tensions abound, from a $15 billion investment arbitration claim lodged against the United States over the cancellation of the Keystone XL Pipeline Project to claims against Canada following the Quebec Government's revocation of all permits for oil and gas exploration in the St. Lawrence River Basin, pursuant to a moratorium on fracking, and a claim pending against Nigeria for denial of offshore oil production licenses.

States have ample tools to break free from the handcuffs of investment arbitration. States created the ISDS system and States can dismantle it. They can terminate treaties, withdraw their consent to ISDS, or put a moratorium on the use of ISDS in the context of climate action. These measures would render investors' claims impossible, forcing investors to pursue legal challenges through domestic courts and regional tribunals, just as other actors must. Short of the political will or consensus to undertake such structural changes, or until such reforms take hold, States can take other steps to diminish the risk of claims arising from climate action, by designing policy measures to insulate them from challenge or defend against those claims that are filed. The tools for responding to ISDS need to be strengthened, but they are available and there is no time to lose in testing them out. Ultimately, the threat that ISDS poses to States' ability to rapidly end reliance on oil, gas, and coal must be blunted worldwide, as States everywhere have an interest and imperative to accelerate the transition to a fossil-free future.

Published on September 2022