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CLIMATE CHANGE LAW. CURRENT PERSPECTIVES.

Climate change, international investment law and arbitration

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A pressing question in the field of investment law and arbitration is how investment tribunals will decide claims arising out of measures taken to mitigate climate change, and whether (and, if so, how) the system of investment law needs to adapt in order to accommodate measures taken by States to deal with the climate crisis.

There are already many well-known examples of claims by investors relating to measures which the relevant State contends were necessary in order to pursue environmental objectives. The number of such claims can only be expected to increase. In an article published in the journal Science in 2022, the authors sought to estimate the potential levels of claim from oil and gas investors relating to climate action by States: the upper end of their estimate was USD 340 billion, on any view a very substantial sum.

Considering the effects of treaties more generally, the UN Intergovernmental Panel on Climate Change (IPCC) in its Sixth Assessment Report on the Mitigation of Climate Change noted the potential for international investment agreements actually to increase low-carbon investment. However, it also noted that the protection of existing investors under such agreements may lead to “regulatory chill”, impeding the adoption of climate mitigation policies.

In this post, we explore three areas: first, we consider the issue of treaty reform, including recent developments regarding the Energy Charter Treaty (ECT); second, we highlight certain aspects of existing treaty standards and case law; third, we consider the possibility for States to bring counterclaims for environmental harm.

Treaty developments

According to an estimate by UNCTAD, approximately 3,300 international investment agreements (**IIAs**) – bilateral investment treaties (**BITs**) or other international agreements which contain investment protection – have been concluded (albeit not all are in force).

Such treaties typically apply to investments regardless of the sector to which they relate (i.e. traditional fossil fuel investments are protected investments, just as are investments in the field of renewable energy). And such treaties typically provide investors with access to investor-State dispute settlement (**ISDS**).

It is common to distinguish between so-called 'first generation' and 'new generation' BITs. First generation BITs – those which were concluded over the past decades – are by far the more numerous, and are characterised by having broad and open-textured standards, including typically the obligation to afford "fair and equitable treatment" (**FET**) to investments, along with protection against expropriation. New generation treaties have often sought to provide more detail as to exactly what such standards require and some also contain specific provision regarding the environment in general or climate change in particular. This can take different forms. One approach is to include wording in the preamble regarding the importance of sustainable development or environmental protection, as, for example, in the Morocco Model BIT. Some go further and contain a substantive provision which seeks to provide a general exception for non-discriminatory measures designed to protect the environment, such as, for example, Article 5 of the Burkina-Faso–Turkey BIT. A useful overview of differing approaches to treaty drafting on climate issues can be found in the UNCTAD publication *The International Investment Treaty Regime and Climate Action.*

It remains to be seen how such provisions in new generation investment agreements will be applied when deciding claims relating to climate mitigation measures by a State. In the meantime, given that the vast majority of disputes continue to arise under first generation BITs, consideration of the approach to existing treaty wording will remain important: see the following section.

By far the most significant recent development on the treaty front concerns the ECT. With more than 50 contracting parties (including the EU/Euratom), it is the world's largest existing agreement providing investment protection and access to ISDS. As readers will be aware, it has been the subject of intense recent controversy. An agreement in principle was reached on a revised text in summer 2022. While the proposed revised text has not been published, it is said to include in particular (i) the option to phase out the protection of fossil fuel investments in respect of all new investments from August 2023 and regarding existing investments after 10 years from the entry into force of the new provisions; (ii) provisions emphasising the State's right to regulate and the need to combat climate change; (iii) more closely-defined standards of protection; and (iv) provisions to prevent recourse to ISDS in "intra-EU" disputes.

However, after this revised text was proposed and before it could be voted upon, a number of European states – Germany, Slovenia, France, the Netherlands, Spain, Poland and Luxembourg – announced their withdrawal from the ECT. In light of these announcements, a scheduled vote on the adoption of the modernised ECT was postponed. In November 2022 the EU Parliament passed a resolution calling for coordinated withdrawal from the ECT by the EU and all EU Member States. In early February 2023, the EU Commission reportedly told EU Member States that EU withdrawal is inevitable, given the lack of Member State support for the modernised text and the incompatibility of the current treaty with climate change goals. The ECT Secretariat responded in a letter of 13 February 2023, noting in particular that if States withdraw instead of amending the ECT, this would result in fossil fuel investments being protected for longer under the ECT's sunset clause than if the modernised treaty were adopted. For this reason, the ECT Secretariat has proposed that the potential withdrawal from the ECT be separated from the adoption of the modernised version of the treaty.

It remains to be seen how this situation will play out. The issue regarding the period during which fossil fuel investments will continue to be protected arises because of the ECT's "sunset clause". Although there is provision for withdrawal from the ECT, Article 47(3) provides that:

> "The provisions of this Treaty shall continue to apply to Investments made in the Area of a Contracting Party by Investors of other Contracting Parties or in the Area of other Contracting Parties by Investors of that Contracting Party as of the date when that Contracting Party's withdrawal from the Treaty takes effect for a period of 20 years from such date."

The European Commission has reportedly proposed a draft agreement between EU Member States by which they would agree that the ECT and its sunset clause do not, and never have, applied in an intra-EU context (a proposal which the EU Parliament has welcomed). One can plainly see that being subject to vigorous challenge by investors.

Claims regarding climate change measures

As noted above, the potential for claims under existing treaties is going to be a reality for some time to come.

According to a September 2022 study by UNCTAD, 175 IIA-based claims have already been brought against States in relation to measures taken for the protection of the environment (including a significant number of cases relating to renewable energy investment).

There are already various prominent examples of such treaty claims relating to fossil fuel investments affected by decisions taken by States on the basis of acting against climate change. These include: (i) claims by Uniper and RWE against the Netherlands, claiming that the Dutch decision to phase out coal by 2030 violates investors' rights under the ECT and (ii) the "Keystone XL Pipeline" arbitration against the USA, in which the claim is that revocation of a permit by the Biden administration regarding a pipeline which was to export crude oil from oil sands in Alberta to US refineries was a breach of the US-Mexico-Canada Agreement.

It is not possible in a post of this length to summarise all of the legal issues to which such claims give rise, and those reading this post will in any event be familiar with debates about what in general is required by the treaty standards in play, such as the requirement to afford fair and equitable treatment and the prohibition of indirect expropriation. We highlight the following points:

Fair and equitable treatment: there are now various awards which refuse to treat the FET obligation as comprising a strict obligation of regulatory stability. It seems likely that the scope of the protection of "legitimate expectations" will be a key focus in cases challenging climate change cases. Of course, there is the debate about the circumstances in which an expectation arises (e.g. how specific does a representation need to have been and what level of due diligence does the investor need to have undertaken). In that respect, one can foresee debates about the reasonableness of an alleged expectation that a particular regulatory regime would not change, given the state of knowledge of climate change and the development of obligations in international law in that regard over recent years.

A separate question, which may assume particular importance in cases where a State decides to change policy in order to tackle climate change, is the extent to which a State will be liable *even if it does act contrary to an investor's legitimate expectations*. Put another way: if a State acts contrary to a "legitimate expectation", does that automatically amount to a breach of an FET obligation, or is there a further stage to the analysis? In *Saluka v Czech Republic*, the Tribunal (chaired by Sir Arthur Watts) distinguished between the question whether a legitimate expectation had arisen and the question whether frustration of such expectations was justified. In the recent run of cases against Spain and other countries in relation to the removal of subsidies in the field of renewable energy, one can see a division between at least two views: (i) that once an investor has established the existence of a legitimate expectation, it is a treaty breach for a State to act contrary to that expectation; and alternatively (ii) that action contrary to a legitimate expectation can in some circumstances be justified. (Cases on either side of the line are collated in a recent dissenting opinion in *Kruck v Spain* at paras 49 – 50; see also the further discussion of the topic by Professor Ortino.)

Expropriation: in cases where the investor claims that there has been an expropriation – most commonly relying on the doctrine of indirect expropriation – an important question will be whether a State acting to protect the environment can rely on the police powers doctrine (which, broadly, recognises that a State has an inherent right to regulate in protection of the public interest and

does not act wrongfully when, pursuant to this power, it enacts *bona fide*, non-discriminatory and proportionate regulations in accordance with due process). Some treaties expressly address whether this doctrine extends to protection of the environment. That was the case in the treaty considered in *Eco Oro v Columbia*, concerning a mining project in Columbia, where the majority of the Tribunal held that State action regarding a mine did not amount to indirect expropriation, despite its impact on the investment, because of the police powers doctrine. It was, however, nevertheless held (again, by majority) that there had been a violation of the minimum standard of treatment.

Before moving on to consider treaty reform, one particular recent case should be noted: the decision in the case of *Rockhopper v Italy*. This is a controversial recent decision under the ECT, in which the claimant succeeded in its expropriation claim after the Italian authorities denied a production permit for an offshore oilfield. The decision turned on a detailed analysis of the applicable Italian law; it is of more general note, however, because the majority sought to portray the decision with which the Tribunal was faced as neutral in the environmental debate. The majority stated that their decision did not restrict Italy's sovereign power to regulate, but was simply a ruling on the consequences under a particular regime of international law to which Italy had consented (i.e. the ECT) and which might require payment of compensation if the power to regulate was exercised in a particular way. Readers will no doubt have their own views about whether that is realistic. It is noteworthy that the decision awarded damages calculated on a discounted cash flow basis, as opposed to sunk costs, even though it was an early-stage project where production had not started.

State counterclaims for environmental damage

The ISDS system is sometimes criticised as being 'asymmetrical', providing protections only for investors, without providing sufficient protection for States. However, the potential exists for States to bring counterclaims against investors in appropriate circumstances.

Both the ICSID Convention (Article 46) and ICSID Arbitration Rules (Rule 48 in the 2022 Rules; Rule 40 in the 2006 Rules), and the UNCITRAL Arbitration Rules (Article 21(3) in the 2021 and 2010 Rules; Article 19(3) in the 1976 Rules) allow Respondents to pursue counterclaims, provided that there is jurisdiction to consider such claims. In that regard, attention must be paid to the wording of the relevant treaty pursuant to which the investor has brought its claim. On the wording of a number of treaties, counterclaims may arguably be able to be brought in appropriate circumstances.

Despite this, counterclaims in investor-State disputes have remained rare. As stated in a Note drafted by the Secretariat of the UNCITRAL Working Group III in 2020: "such claims have rarely been framed as counterclaims in treaty-based ISDS; rather States have resorted to domestic courts to seek affirmative relief". This may be due in part to the jurisdictional difficulties of bringing a counterclaim.

In *Saluka v Czech Republic*, the Tribunal decided that previous caselaw reflected a requirement that the counterclaim must arise directly out of an investment and out of the dispute which was before the Tribunal, and a counterclaim needed a "*close connexion*" with the primary claim. The Tribunal found that the Czech Republic's counterclaims (which were largely concerned with general non-compliance with domestic law) did not constitute an "*indivisible whole*" with the claim and therefore there was no jurisdiction over them (see paras. [78]-[79]).

Such a requirement is also present in Article 46 of the ICSID Convention, which gives tribunals jurisdiction to determine "*counterclaims arising directly out of the subject-matter of the dispute*".

In the environmental and energy sphere, States have attempted to bring counterclaims against investors for breaches of environmental rules. However, such claims have faced jurisdictional challenges. This was the case in *Paushok v Mongolia*, where counterclaims for, amongst other things, an alleged breach of the claimants' "*environmental obligations towards Mongolia*" was dismissed, including because, in the Tribunal's view, the counterclaims did not have a sufficiently close connection with the investor's claim.

The related cases of *Burlington v Ecuador* and *Perenco v Ecuador* are interesting examples where the

counterclaims were successful. Both cases concerned production sharing contracts for oil exploration in two areas known as Blocks 7 and 21. By their counterclaims, Ecuador alleged that the claimants abandoned the Blocks, causing environmental damage. The Tribunal found that Ecuador was entitled to compensation of almost US$40m (in *Burlington*) and UD$54m (in *Perenco*), relating to the costs of addressing the environmental damage. However, there was no dispute as to the Tribunal's jurisdiction to determine the counterclaims in *Burlington* pursuant to an agreement between the parties, and the point does not appear to have been taken in *Perenco*.

While environmental counterclaims by States remain rare, in part due to the requirement of a close connection with the principal dispute, such counterclaims may well be expected to increase, in particular under the wording of new generation BITs. As noted above, a number of such BITs specifically address environmental concerns: one example is Article 18 of the Morocco-Nigeria BIT, which requires investors to maintain a post-establishment environmental management system and obliges them not to operate investments in a manner which circumvents the international environmental, labour or human rights obligations of either the home or the host State. Whether these developments in treaty practice will result in a development of the jurisprudence on counterclaims remains to be seen, but it seems likely that such counterclaims by States will increase under new generation BITs, and potentially also under first generation IIAs, as environmental issues become more pressing as part of States' legal frameworks and policy agendas.

This note is written by the authors in their individual capacities as independent practitioners.

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