

# Sustainable Investment, Deep Decarbonization, and Investor-State Dispute Settlement: The Failure to Align The Investment Treaty System With Climate Change Law & Policy?

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To meet the Paris Agreement aspirational goal to limit post-industrial global warming to 1.5 degrees Celsius, and thereby hopefully avoid the worst effects of climate change, global emissions must reach net zero by around mid-century.<sup>1</sup> This unprecedented transformation of the global economy and societies will require investment in the clean energy transition to more than double to over US\$4 trillion annually.<sup>2</sup> Given limited public resources, private investment (backed by government policy support) must provide the lion's share of funding, particularly in emerging economies.<sup>3</sup> By helping to de-risk climate-friendly projects, well-designed regulation of foreign investment could therefore potentially play an important role in mobilizing the private capital necessary to close this enormous investment gap.

Yet international investment law – the legal system governing the promotion and protection of foreign investment that is built on a global network of over 3,200 investment treaties and trade agreement investment chapters (together, international investment agreements (“IIAs”)) – remains essentially silent on the subject of climate change and greenhouse gas emissions. Moreover, IIAs are “climate-blind”, in that they do not distinguish between investments that are low carbon or high carbon. Meanwhile, other investment-focused regulatory regimes, most prominently the European Union (“EU”)’s new Taxonomy Regulation, are intended to encourage the redirecting of capital flows into environmentally sustainable activities such as clean energy.<sup>4</sup> On the face of it, the political economy of the investment treaty system appears to be an outlier in a world rapidly embracing sustainability as a guiding principle of finance, investment, and trade.<sup>5</sup>

But this does not mean the investment treaty system exists only to serve fossil fuel investors, or that international investment law is inherently incompatible with deep decarbonization, as some critics suggest.<sup>6</sup> International investment law is primarily derived from: (i) the

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<sup>1</sup> IPCC, *Summary for Policymakers of IPCC Special Report on Global Warming of 1.5°C approved by governments* (8 Oct. 2018),

[https://www.ipcc.ch/site/assets/uploads/sites/2/2019/06/SR15\\_Full\\_Report\\_Low\\_Res.pdf](https://www.ipcc.ch/site/assets/uploads/sites/2/2019/06/SR15_Full_Report_Low_Res.pdf)

<sup>2</sup> IRENA, *World Energy Transitions Outlook: 1.5 °C Pathway* (March 2021), [https://irena.org/-/media/Files/IRENA/Agency/Publication/2021/March/IRENA\\_World\\_Energy\\_Transitions\\_Outlook\\_2021](https://irena.org/-/media/Files/IRENA/Agency/Publication/2021/March/IRENA_World_Energy_Transitions_Outlook_2021)

<sup>3</sup> IRENA, *Unlocking Renewable Energy Investment: The role of risk mitigation and structured finance*, 12 (2016), <https://www.irena.org/publications/2016/Jun/Unlocking-Renewable-Energy-Investment-The-role-of-risk-mitigation-and-structured-finance>

<sup>4</sup> European Commission, *EU taxonomy for sustainable activities: what the EU is doing to create an EU-wide classification system for sustainable activities*, [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en)

<sup>5</sup> See, e.g., Principles for Responsible Investment, *About the PRI*, <https://www.unpri.org/pri/about-the-pri>; [https://ec.europa.eu/commission/presscorner/detail/en/qanda\\_21\\_645](https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_645)

<sup>6</sup> See, e.g., Dietrich Brauch, “Should the European Union Fix, Leave or Kill the Energy Charter Treaty?”, CCSI (9 Feb. 2021), <http://ccsi.columbia.edu/2021/02/09/should-the-european-union-fix-leave-or-kill-the-energy-charter-treaty/>; Nicolás Perrone, “Oil companies don’t deserve reparations for fossil fuel bans. They’ll still want them”, *Guardian* (19 Apr. 2021), <https://www.theguardian.com/commentisfree/2021/apr/19/oil-companies-dont-deserve-reparations-for-fossil-fuel-bans-theyll-still-want-them>

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provisions of IIAs that are agreed by contracting States and are governed by international law; and (ii) the decisions of international arbitration tribunals that interpret and apply these IIAs to disputes between foreign investors and host States, a procedure known as investor-State dispute settlement (“ISDS”). The system is generally focused on establishing a predictable and stable domestic legal and regulatory framework in host States. Nevertheless, it is an adaptable system and is in principle open to progressive development, including through well-established principles of treaty interpretation and international law.

Accordingly, the following discussion shall briefly consider some of the proposals to better align the investment treaty system with climate change law and policy. The climate alignment issue has recently gained particular significance in the context of the ongoing negotiations to modernise the Energy Charter Treaty, with the EU proposing to exclude high carbon investments from protection – a significant departure from the status quo of climate-blind IIAs. Critics contend, however, that such proposals are insufficient and still fail to align the ECT with the Paris Agreement and the necessity of carbon neutrality.

The discussion is structured as follows: (1) The Paris Agreement, Policy Support, and Market Trends; (2) Climate-Related ISDS Arbitrations; and (3) The Alignment of the Investment Treaty System with Climate Change Law and Policy.

## **(1) The Paris Agreement, Policy Support, and Market Trends**

The Paris Agreement 2015, which aims to further the goals of the United Nations Framework Convention for Climate Change 1992 (UNFCCC), has been described as “the indispensable multilateral framework governing global climate action”.<sup>7</sup> Moreover, it has been instrumental in forging today’s international political and business consensus that rapid, deep decarbonization of all sectors of the global economy is necessary to combat climate change.<sup>8</sup>

Each State party to the Paris Agreement undertakes to pursue “domestic mitigation measures” with the aim of achieving certain “nationally determined contributions” (NDCs), in order to “reach global peaking of greenhouse gas emissions as soon as possible” and limit global warming to well below 2 degrees Celsius, and ideally to 1.5 degrees Celsius.<sup>9</sup> The Paris Agreement also emphasises the need to make “finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development”.<sup>10</sup> Importantly, like the UN Sustainable Development Goals 2015, the Paris Agreement further recognizes the imperative of a “just transition” to carbon neutrality in which workers and communities are supported.<sup>11</sup>

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<sup>7</sup> European Commission, *European Union text proposal for the modernisation of the Energy Charter Treaty*, [https://ec.europa.eu/energy/sites/default/files/eu\\_submission\\_-\\_revised\\_definition\\_of\\_economic\\_activity\\_in\\_the\\_energy\\_sector.pdf](https://ec.europa.eu/energy/sites/default/files/eu_submission_-_revised_definition_of_economic_activity_in_the_energy_sector.pdf)

<sup>8</sup> Financial Times, “Climate change: ‘the Paris goals are within reach’” (12 Dec. 2020), <https://www.ft.com/content/d6e23e40-2d6b-4e8c-b92b-6bf1b215798d>

<sup>9</sup> Paris Agreement (13 Dec. 2015), article 4; see IPCC, *Summary for Policymakers of IPCC Special Report on Global Warming of 1.5°C approved by governments* (8 Oct. 2018).

<sup>10</sup> *Id.*, articles 9(1) and 9(3); articles 6(2) (Emissions Trading) and 6(4) (Sustainable Development Mechanism).

<sup>11</sup> *Id.*, Preamble; see also The International Monetary Fund (IMF), the World Bank (IBRD) & the World Trade Organization (WTO), “Making Trade an Engine of Growth for All: The Case for Trade and for Policies to Facilitate Adjustment” 4–5 (2017), <https://www.imf.org/~media/Files/PP/041017/joint-wto-wb-imf-trade-paper.ashx>; UN Sustainable Development Goals (25 Sept. 2015), Goals 8-10, <https://sdgs.un.org/goals>

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Energy accounts for two thirds of all greenhouse gas emissions, which means that the scaling up of clean energy, combined with electrification, will be critical to achieving net zero.<sup>12</sup> To quote the head of the International Energy Agency, Fatih Birol, the energy transition entails a “worldwide undertaking of unprecedented speed and scale”.<sup>13</sup>

Effective public-private collaboration will be critical to de-risking low carbon technologies and systems, and thereby facilitating rapid pathways to their commercial viability at scale.<sup>14</sup> Historically, private investors were reluctant to invest in renewable energy projects, which were perceived as high risk due to new solar and wind technologies being comparatively expensive and the fact that such projects involve high upfront capital expenditures (sunk costs) that must be recouped from long term income streams. Around two decades ago, governments (particularly in Europe) therefore started introducing policy support (such as feed-in-tariffs or, more commonly in the U.S., tax credits) to incentivise private investment in renewable energy, and costs have since fallen radically as a result of massively scaled-up production and innovation.<sup>15</sup> Between 2010 and 2020, for example, the cost of electricity from utility scale solar photovoltaics fell by 82%.<sup>16</sup>

In competitive markets today, renewable energy prices have fallen below the threshold of cost-parity with fossil fuels.<sup>17</sup> President Biden has committed that the US grid will be 100% clean electricity by 2035.<sup>18</sup> Countries representing more than 60% of the world’s energy-related emissions have pledged to be carbon neutral by mid-century.<sup>19</sup> China plans for net zero by 2060.<sup>20</sup> Several oil majors have also pledged to hit net zero by 2050, and are investing heavily in renewable energy.<sup>21</sup>

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<sup>12</sup> IRENA, *Deep Electrification Powered by Renewables Key for a Climate-Safe Future* (9 Apr. 2019), <https://www.irena.org/newsroom/pressreleases/2019/Apr/Deep-Electrification-Powered-by-Renewables-Key-for-a-Climate-Safe-Future> ; IRENA, *Reaching Zero with Renewables*, Policy Report, 40 (Sep. 2020), <https://irena.org/publications/2020/Sep/Reaching-Zero-with-Renewables>

<sup>13</sup> Fatih Birol, “IEA chief: Net zero by 2050 plan for energy sector is coming”, *Financial Times* (11 Jan. 2021), <https://www.ft.com/content/6c5e29e1-283e-4df8-a402-ce09fcec3bda>

<sup>14</sup> Simon Sharpe & Timothy M. Lenton, “Upward-scaling tipping cascades to meet climate goals: plausible grounds for hope?”, *Climate Policy*, 1 (2021), <https://www.tandfonline.com/doi/abs/10.1080/14693062.2020.1870097?journalCode=tcpo20>.

<sup>15</sup> Mercure, Sharpe, Vinuales et al, “Risk-opportunity analysis for transformative policy design and appraisal”, *C-EENRG Working Papers 2020-4* (November 2020), p.9, <https://www.ceenrg.landecon.cam.ac.uk/system/files/documents/wp25.pdf>

<sup>16</sup> IRENA, *Renewable Power Generation Costs in 2019* (June 2020), p.12, <https://www.irena.org/publications/2020/Jun/Renewable-Power-Costs-in-2019>

<sup>17</sup> Id., p.13.

<sup>18</sup> White House, *Executive Order on Tackling the Climate Crisis at Home and Abroad* (27 Jan. 2021), <https://www.whitehouse.gov/briefing-room/presidential-actions/2021/01/27/executive-order-on-tackling-the-climate-crisis-at-home-and-abroad/>

<sup>19</sup> Fatih Birol, “IEA chief: Net zero by 2050 plan for energy sector is coming”, *Financial Times* (11 Jan. 2021), <https://www.ft.com/content/6c5e29e1-283e-4df8-a402-ce09fcec3bda>; International Energy Agency (IEA), *World Energy Outlook 2020* (2020) <https://www.iea.org/reports/world-energy-outlook-2020/achieving-net-zero-emissions-by-2050>.

<sup>20</sup> *Financial Times*, “China pledges to be ‘carbon-neutral’ by 2060” (22. Sept 2020), <https://www.ft.com/content/730e4f7d-3df0-45e4-91a5-db4b3571f353>

<sup>21</sup> See, e.g., BP, “BP sets ambition for net zero by 2050, fundamentally changing organisation to deliver” (12 Feb. 2020), <https://www.bp.com/en/global/corporate/news-and-insights/press-releases/bernard-looney-announces-new-ambition-for-bp.html>; TOTAL SE, “TOTAL adopts a new climate ambition to get to net

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Moreover, the rapid growth of sustainable finance, ESG investing, and regulations such as the EU's new Taxonomy Regulation, are all starting to encourage the market to more fully price long-term climate risks and to help redirect capital flows away from high carbon investments and into climate-friendly activities.<sup>22</sup> Larry Fink of BlackRock, the world's largest asset manager, has stated categorically that "climate risk is investment risk" and that "we are on the edge of a fundamental reshaping of finance".<sup>23</sup>

Contrary to some expectations, the Covid-19 pandemic appears to have shifted the Overton Window further in favour of deep decarbonization – manifest in the Biden Administration's pledge to half emissions by 2030,<sup>24</sup> proposed massive clean energy infrastructure stimulus,<sup>25</sup> and commitments to double public climate financing to developing countries and "to identify steps through which the United States can promote ending international financing of carbon-intensive fossil fuel-based energy while simultaneously advancing sustainable development and a green recovery".<sup>26</sup>

Environmental activist and investor Al Gore is optimistic that we are at the start of a "sustainability revolution".<sup>27</sup> Such optimism must, however, be tempered by the reality that the world is still not on track to hit net zero by mid-century. "[T]he data does not match the rhetoric".<sup>28</sup> Global energy demand will continue to increase;<sup>29</sup> in 2020, high-income countries together generated only a third of global emissions.<sup>30</sup> There is also the risk that net

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zero by 2050" (5 May 2020), <https://www.total.com/media/news/total-adopts-new-climate-ambition-get-net-zero-2050>

- <sup>22</sup> BlackRock, *Towards a Common Language for Sustainable Investment* (Jan. 2020), <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-towards-a-common-language-for-sustainable-investing-january-2020.pdf>
- <sup>23</sup> BlackRock, *Larry Fink's Dear CEO Letter: A Fundamental Reshaping of Finance* (Jan. 2020), <https://www.blackrock.com/hk/en/larry-fink-ceo-letter>
- <sup>24</sup> White House, *Fact Sheet: President Biden Sets 2030 Greenhouse Gas Pollution Reduction Target Aimed at Creating Good-Paying Union Jobs and Securing U.S. Leadership on Clean Energy Technologies* (22 Apr. 2021), <https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/22/fact-sheet-president-biden-sets-2030-greenhouse-gas-pollution-reduction-target-aimed-at-creating-good-paying-union-jobs-and-securing-u-s-leadership-on-clean-energy-technologies/>
- <sup>25</sup> White House, *Fact Sheet: The American Jobs Plan* (31 Mar. 2021), <https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/>
- <sup>26</sup> Financial Times, "Where Biden's climate summit succeeded and fell short" (23 Apr. 2021), <https://www.ft.com/content/2166779f-41b5-4cb1-a332-d813b596cc6d>; White House, *U.S. International Climate Finance Plan* (22 Apr. 2021), <https://www.whitehouse.gov/wp-content/uploads/2021/04/U.S.-International-Climate-Finance-Plan-4.22.21-Updated-Spacing.pdf>; White House, *Executive Order on Tackling the Climate Crisis at Home and Abroad* (27 Jan. 2021), <https://www.whitehouse.gov/briefing-room/presidential-actions/2021/01/27/executive-order-on-tackling-the-climate-crisis-at-home-and-abroad/>; see also Cameron Hepburn, Brian O'Callaghan, Nicholas Stern, Joseph Stiglitz & Dimitri Zenghelis, "Will COVID-19 fiscal recovery packages accelerate or retard progress on climate change?", 36 *Oxford Review of Economic Policy* 4 (2020).
- <sup>27</sup> Al Gore, David Blood, "We're in the early stages of a sustainability revolution" (25 Apr. 2018), <https://www.wired.co.uk/article/al-gore-sustainability-generation-investment-management-interview>
- <sup>28</sup> IEA, *Executive Director Speech at the Leaders Summit on Climate* (23 Apr. 2021), <https://www.iea.org/news/executive-director-speech-at-the-leaders-summit-on-climate>; BBC, "Climate change: Carbon emission promises 'put Earth on red alert'" (12 Feb. 2021), <https://www.bbc.com/news/science-environment-56208651>
- <sup>29</sup> IEA, *Global Energy Review 2021* (Apr. 2021), <https://www.iea.org/reports/global-energy-review-2021>
- <sup>30</sup> Martin Wolf, "Action must replace talk on climate change", *Financial Times* (4 May. 2021), <https://www.ft.com/content/3fa154f3-84e7-4964-9a21-d3dbd41e1470>

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zero policies “protect business as usual, not the climate.”<sup>31</sup> Despite governments’ net zero pledges, coal plants are still being commissioned throughout Asia and as recently as 2020 in Germany.<sup>32</sup> Institutional investors, including pension funds, remain heavily exposed to high carbon sectors.<sup>33</sup> Direct government subsidies of fossil fuels are several times greater than for renewables, with the International Renewable Energy Agency (IRENA) estimating that the costs of unpriced externalities plus direct fossil fuels subsidies exceed renewables subsidies by a factor of sixteen.<sup>34</sup>

The challenges are immense. IRENA predicts that investment in the clean energy transition will have to more than double to over US\$4 trillion annually.<sup>35</sup> Given constraints on public funding, private capital will have to provide the lion’s share of this investment.<sup>36</sup> Unsurprisingly, leading investors in the clean energy transition, such as the Spanish energy company Iberdrola, have placed lower risk countries with “high credit ratings, more-predictable regulation, and stabler legal frameworks” at the heart of their investment strategy.<sup>37</sup> But clean energy spending must be multiplied “within an annual global pool of investible capital that is mostly held in OECD nations, while much of it will have to be spent in the non-OECD developing world to deploy clean energy, with all the attendant risk.”<sup>38</sup>

Governments are being called on to signal their willingness to support clean technologies and to manage the orderly phase out of fossil fuels. As IRENA explains:

Government interventions will be critical in coming years both to react to the disruption caused by the pandemic and to set the energy transition on track to achieve internationally agreed goals. [...] Importantly, interventions must be persuasive enough to raise investor

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<sup>31</sup> The Conversation, “Climate scientists: concept of net zero is a dangerous trap” (22 Apr. 2021), <https://theconversation.com/climate-scientists-concept-of-net-zero-is-a-dangerous-trap-157368>

<sup>32</sup> Financial Times, “China is falling short on its climate pledge” (9 Mar. 2020), <https://www.ft.com/content/2cc58515-92ac-45fa-96bb-edb2050f21fb>; Financial Times, “Volkswagen boss condemns German coal plant” (14 Feb. 2020), <https://www.ft.com/content/257071f4-4f14-11ea-95a0-43d18ec715f5>; Financial Times, “Climate change: Australia wrestles with its coal mining dilemma” (2 May 2021), <https://www.ft.com/content/262db450-e619-4397-a46d-ccc6c8ec83a9>

<sup>33</sup> Financial Times, “Vanguard tops list of world’s largest coal investors” (14 Jan. 2020), <https://www.ft.com/content/c032f5a4-9801-47d3-abf7-d5d9826558cc>

<sup>34</sup> IRENA, *Energy subsidies: Evolution in the global energy transformation to 2050*, 45 (2020), [https://www.irena.org/-/media/Files/IRENA/Agency/Publication/2020/Apr/IRENA\\_Energy\\_subsidies\\_2020.pdf](https://www.irena.org/-/media/Files/IRENA/Agency/Publication/2020/Apr/IRENA_Energy_subsidies_2020.pdf)

<sup>35</sup> IRENA, *World Energy Transitions Outlook: 1.5 °C Pathway* (March 2021), [https://irena.org/-/media/Files/IRENA/Agency/Publication/2021/March/IRENA\\_World\\_Energy\\_Transitions\\_Outlook\\_2021](https://irena.org/-/media/Files/IRENA/Agency/Publication/2021/March/IRENA_World_Energy_Transitions_Outlook_2021)

<sup>36</sup> IRENA, *Unlocking Renewable Energy Investment: The role of risk mitigation and structured finance*, 12 (2016), <https://www.irena.org/publications/2016/Jun/Unlocking-Renewable-Energy-Investment-The-role-of-risk-mitigation-and-structured-finance>

<sup>37</sup> Ignacio Galán, “The CEO of Iberdrola on Committing to Clean Energy”, Harvard Business Review (Nov.-Dec. 2020), <https://hbr.org/2020/11/the-ceo-of-iberdrola-on-committing-to-clean-energy>

<sup>38</sup> Dan Reicher, Jeff Brown, & David Fedor, *Derisking Decarbonization: Making Green Energy Investments Blue Chip*, Stanford University 3 (2017), <https://www.ourenergypolicy.org/resources/derisking-decarbonization-making-green-energy-investments-blue-chip/>; see also World Economic Forum, *The Green Investment Report - The ways and means to unlock private finance for green growth* 9-19 (2013); Martijn Wilder & Lauren Drake, “Setting up the International Mitigation Regime: Contents and Consequences”, *The Oxford Handbook of International Climate Change* 359 (2016); Financial Times, “How the race for renewable energy is reshaping global politics” (4 Feb. 2021), <https://www.ft.com/content/a37d0ddf-8fb1-4b47-9fba-7ebde29fc510>

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confidence to the levels needed to mobilise the massive amounts of private sector funding required to achieve the 2030 targets of the Paris Agreement [...].<sup>39</sup>

Achieving net zero will require radical changes in “mindsets, regulation, and corporate behavior”.<sup>40</sup> In short, we require “first-class policy and policy implementation across the planet” involving a mix of incentives, disincentives, and assistance.<sup>41</sup>

It is in this broader context that climate-related ISDS claims concerning fossil fuel phase-outs, the stability of renewable energy policy support and the risk of sudden regulatory change come into focus.

## **(2) Climate-Related ISDS Arbitrations**

By far the largest number of climate-related ISDS cases to date have been commenced by renewable energy investors. There are at least seventy known claims concerning changes to renewable energy support schemes – in Canada, Europe, and most recently Japan – that *prima facie* implicate climate change law and policy.<sup>42</sup> In several of these cases, investors have argued *inter alia* that such changes were made in response to political pushback on renewable energy subsidies that were later perceived as having been initially set too high.<sup>43</sup>

The law in this field is developing, and there are important factual distinctions between decided cases. For example, in the approximately twenty awards published to date concerning Spain’s modification and ultimate cancellation of a feed-in-tariff renewable energy support scheme between 2010 and 2014, tribunals have taken differing views as to whether or not, and why, Spain’s measures constituted a breach of the fair and equitable treatment standard under the Energy Charter Treaty (“ECT”). A central issue has been the basis and extent of investors’ legitimate expectations of regulatory stability, and the corresponding limit on the host State’s freedom to modify policy support without incurring an obligation to pay compensation to protected investors.

A clear majority of tribunals have found in favour of the investors in respect of at least some of the contested measures, and have ordered Spain to pay in aggregate over EUR 1 billion in

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<sup>39</sup> IRENA, *The post-COVID recovery: An agenda for resilience, development and equality*, 117 (2020), [https://irena.org/-/media/Files/IRENA/Agency/Publication/2020/Jun/IRENA\\_Post-COVID\\_Recovery\\_2020.pdf](https://irena.org/-/media/Files/IRENA/Agency/Publication/2020/Jun/IRENA_Post-COVID_Recovery_2020.pdf); see also Yongping Zhai, *Investment in renewable energy is slowing down. Here's why* (3 Sept. 2019), <https://www.weforum.org/agenda/2019/09/global-renewable-energy-investment-slowing-down-worry/>

<sup>40</sup> Kenneth P. Pucker, “Overselling Sustainability Reporting”, *Harvard Business Review* (May-June 2021), <https://hbr.org/2021/05/overselling-sustainability-reporting>

<sup>41</sup> Martin Wolf, “Action must replace talk on climate change”, *Financial Times* (4 May. 2021), <https://www.ft.com/content/3fa154f3-84e7-4964-9a21-d3dbd41e1470>

<sup>42</sup> See, e.g., International Energy Charter, “Even more renewable energy investors rely on treaty protection: updated statistics of investment arbitration cases under the Energy Charter Treaty” (12 Oct. 2020), <https://www.energycharter.org/media/news/article/even-more-renewable-energy-investors-rely-on-treaty-protection-updated-statistics-of-investment-arb/>

<sup>43</sup> See, e.g., *Greentech v. Italy*, SCC Case No. V 2015/095, Final Award (2018), ¶¶ 418, 420; *Watkins v. Spain*, ICSID Case No. ARB/15/44, Award (2020), ¶¶ 438-439; see also *Financial Times*, “Hong Kong energy fund sues Japan in groundbreaking case” (3 Mar. 2021), <https://www.ft.com/content/155da1d7-075e-4122-aded-1e4fec51f582>

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compensation.<sup>44</sup> A minority of tribunals have generally found in favour of Spain, however, holding that most of the support scheme changes were reasonable and proportionate.<sup>45</sup>

Notably, the awards do not appear to substantively engage with issues of climate change law or policy – including thorny questions such as whether the retroactive cancellation of renewable energy incentives is consistent with host States’ GHG emissions commitments under the Paris Agreement.<sup>46</sup>

On the flip side of renewable energy claims, several climate-related ISDS cases have been brought by fossil fuel investors,<sup>47</sup> including two recent EUR 1 billion claims under the ECT against the Netherlands concerning its policy to phase-out of coal power plants in order to meet Paris Agreement targets.<sup>48</sup> On this basis, critics contend that the investment treaty system – and the ECT in particular – wrongly protects high carbon investments and undermines the Paris Agreement goals. To date, however, no ISDS tribunals have ruled on the phase-out issue.

In this context, it is interesting to consider the growing number of cases against governments and corporations in domestic courts that give legal effect to the Paris Agreement. In a landmark 2019 test case, *Urgenda v. Netherlands*, the Dutch courts ordered the government to cut its greenhouse gas emissions in order to meet the Netherlands’ obligations under the Paris Agreement.<sup>49</sup> A similar argument is also currently being tested in the Dutch courts against Royal Dutch Shell, where Friends of the Earth Netherlands are seeking an order that Shell cut its emissions to zero by 2050, in line with Paris Agreement targets.<sup>50</sup>

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<sup>44</sup> See, e.g., (i) awards finding a specific commitment for life of projects: *Masdar v. Spain*, Award (2018); *9REN v. Spain*, Award (2019); *OperaFund v. Spain*, Award (2019); *InfraRed v. Spain*, Award (2019); *STEAG v. Spain*, Decision on Jurisdiction, Liability and Principles of Quantum (2020); (ii) awards finding legitimate expectation of a reasonable return: *RREEF v. Spain*, Award (2019); *NextEra v. Spain*, Final Award (2019); *RWE v. Spain*, Decision on Jurisdiction, Liability and Certain Issues of Quantum (2019); *Cavalum v. Spain*, Award (2020); *Hydro Energy v. Spain*, Decision on Jurisdiction, Liability and Directions on Quantum (2020); *PV Investors v. Spain*, Final Award (2020); (iii) awards finding legitimate expectation of no fundamental regulatory change: *Eiser v. Spain*, Award (2017); *Novenergia v. Spain*, Final Award (2018); *Foresight v. Spain*, Final Award (2018); *Antin v. Spain*, Award (2018); *Cube v. Spain*, Decision on Jurisdiction, Liability and Partial Decision on Quantum (2019); *SolEs Badajoz v. Spain*, Award (2019); *Watkins v. Spain*, Award (2020).

<sup>45</sup> See, e.g., *BayWa v. Spain*, Decision on Jurisdiction, Liability and Directions on Quantum (2019); *Stadtwerke München v. Spain*, Award (2019); *FREIF v. Spain*, Award (2021); *Eurus v. Spain*, Decision on Jurisdiction and Liability (2021).

<sup>46</sup> See Annette Magnusson, “New Arbitration Frontiers: Climate Change”, in Jean Kalicki and Mohamed Abdel Raouf (eds), *Evolution and Adaptation: The Future of International Arbitration*, ICCA Congress Series, Volume 20 (2019), pp. 1024 (“None of the awards in the solar energy arbitrations published to date contain any factual conclusions or arguments regarding CO2 emissions. GHG emissions appears not to have been argued, nor have any international obligations relating to climate change mitigation.”).

<sup>47</sup> *Vattenfall AB, Vattenfall Europe AG, Vattenfall Europe Generation AG v. Federal Republic of Germany* (ICSID Case No. ARB/09/6), <https://icsid.worldbank.org/cases/case-database/case-detail?CaseNo=ARB/09/6>

<sup>48</sup> *Uniper SE, Uniper Benelux Holding B.V. and Uniper Benelux N.V. v. Kingdom of the Netherlands* (ICSID Case No. ARB/21/22), <https://icsid.worldbank.org/cases/case-database/case-detail?CaseNo=ARB/21/22>; *RWE AG and RWE Eemshaven Holding II BV v. Kingdom of the Netherlands* (ICSID Case No. ARB/21/4), <https://icsid.worldbank.org/cases/case-database/case-detail?CaseNo=ARB/21/4>

<sup>49</sup> *Urgenda Foundation v. State of the Netherlands*, HAZA C/09/00456689 (2015), <http://climatecasechart.com/non-us-case/urgenda-foundation-v-kingdom-of-the-netherlands/>

<sup>50</sup> *Milieudefensie et al. v. Royal Dutch Shell plc.* (2019), pending, decision expected in May 2021, <http://climatecasechart.com/non-us-case/milieudefensie-et-al-v-royal-dutch-shell-plc/>

## **Sustainable Investment, Deep Decarbonization, and Investor-State Dispute Settlement: The Failure to Align The Investment Treaty System With Climate Change Law & Policy?**

Will the Paris Agreement be given legal effect in future ISDS cases? In the following section, we shall consider this issue and other ways in which alignment might be achieved.

### **(3) Aligning the Investment Treaty System with Climate Change Law and Policy**

The two primary ways to accomplish alignment of the investment treaty system with climate change law and policy are through: (1) IIA (re)negotiation by States parties to include express language on the issue, such as we are seeing in the ongoing negotiations to modify the Energy Charter Treaty; and (2) integration of climate law norms by ISDS tribunals when interpreting an IIA, pursuant to Article 31(3)(c) of the Vienna Convention on the Law of Treaties, which provides that “any relevant rules of international law applicable in the relations between the parties” shall be taken into account when interpreting the terms of the treaty.<sup>51</sup>

As for the second process, ISDS tribunals are empowered to progressively interpret IIAs in accordance with general international law, including relevant climate or environmental treaties.<sup>52</sup> Moreover, tribunals may also have regard to international public policy, as Wendy Miles QC has emphasised in the context of climate-related cases.<sup>53</sup>

Arguably, ISDS tribunals therefore already have the tools to address many climate change issues. Indeed, in its November 2019 report, the ICC Task Force on the Arbitration of Climate Change Related Disputes concluded that, even when silent on climate change, existing treaties do not preclude alignment, and the Paris Agreement will likely be relevant *inter alia* to an investor’s legitimate expectations.<sup>54</sup>

Nevertheless, State practice in IIA negotiations will be important in framing the extent to which international investment law is likely to be aligned with climate change law and policy.<sup>55</sup>

Newer IIAs negotiated since the Global Financial Crisis have increasingly focused on the *quality* of investment, in order to promote sustainable development in the host State.<sup>56</sup>

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<sup>51</sup> Vienna Convention on the Law of Treaties between States and International Organizations or Between International Organizations, Mar. 21, 1986, 25 ILM 543 (1986), article 31.

<sup>52</sup> See, e.g., *Peter A Allard v The Government of Barbados*, PCA Case No 2012–06, Award (27 Jun. 2016), para 244; Joshua Paine, “Failure to Take Reasonable Environmental Measures as a Breach of Investment Treaty?”, *Journal of World Investment & Trade* 18 (2017) 745-754.

<sup>53</sup> See, e.g., Wendy Miles & Merryl Lawry-White, *Arbitral Institutions and the Enforcement of Climate Change Obligations for the Benefit of all Stakeholders: The Role of ICSID*, 34-1 *Foreign Investment Law Journal* 17 (2019); *Philip Morris Brands Sàrl, Philip Morris Products SA, Abal Hermanos SA v. Uruguay*, ICSID Case No. ARB/10/7, Award, (8 Jul. 2016), para 30.

<sup>54</sup> International Chamber of Commerce, *Resolving Climate Change Related Disputes Through Arbitration And ADR*, ICC commission report 39 (2019), <https://iccwbo.org/publication/icc-arbitration-and-adr-commission-report-on-resolving-climate-change-related-disputes-through-arbitration-and-adr/>

<sup>55</sup> See e.g., Freya Baetens, “Combating Climate Change Through the Promotion of Green Investment: From Kyoto to Paris Without Regime-Specific Dispute Settlement” (19 Nov. 2018) in K. Miles (Ed.), *Research Handbook on Environment and Investment Law* (2019) 107-130, <https://ssrn.com/abstract=3334925>

<sup>56</sup> UNCTAD, *UNCTAD's Reform Package for the International Investment Regime* 15 (2018), [https://investmentpolicy.unctad.org/uploaded-files/document/UNCTAD\\_Reform\\_Package\\_2018.pdf](https://investmentpolicy.unctad.org/uploaded-files/document/UNCTAD_Reform_Package_2018.pdf); Diane Desierto & Frédéric Gilles Sourgens, “Investment Law & Decarbonization”, in *Law, Policy and Regulation in Low-Carbon Energy Markets* (Tade Oyewunmi et al. eds) 164-169 (2020); Netherlands Draft Model



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However, even these newer IIAs remain in effect climate-blind, in that they do not distinguish between low and high carbon investments.

The investment treaty system is arguably behind the curve when it comes to reflecting structural changes to private investment flows. By contrast to climate-blind IIAs, for example, the EU's new Taxonomy Regulation establishes a systematic classification of what constitutes an environmentally sustainable economic activity, and requires financial institutions and corporations to disclose this information.<sup>57</sup> The EU believes the taxonomy will encourage capital flows into sustainable investments.<sup>58</sup> A somewhat similar concept distinguishing between “green” and “non-green” investments in IIAs was proposed by the Stockholm Treaty Lab project.<sup>59</sup> The merits of such binary classifications (rather than an approach recognising, in the words of UN climate envoy and former central banker Mark Carney, “fifty shades of green”) are debated, but taxonomies generally look set to proliferate around the world.<sup>60</sup> Will such developments be reflected in new IIAs?

The potential direction of travel of State practice can be gleaned from negotiations ongoing since late 2019 on the modernization of the ECT, an important multilateral investment treaty which has been the basis for the vast majority of climate-related ISDS claims.<sup>61</sup>

The issue of the ECT's compatibility with the Paris Agreement and climate goals has recently become increasingly contentious, particularly in the EU, with senior European government ministers and the European Commission itself raising the prospect of withdrawal.<sup>62</sup>

The EU's position is that “[t]he Modernised ECT should reflect climate change and clean energy transition goals, and contribute to the achievement of Paris Agreement objectives.”<sup>63</sup> To that end, the EU has proposed several material amendments to the ECT relating to climate change, including the:

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Bilateral Investment Treaty (Mar 22, 2019), <https://www.rijksoverheid.nl/ministeries/ministerie-van-buitenlandse-zaken/documenten/publicaties/2019/03/22/nieuwe-modeltekst-investeringsakkoorden>

<sup>57</sup> European Commission, EU taxonomy for sustainable activities: What the EU is doing to create an EU-wide classification system for sustainable activities, [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en)

<sup>58</sup> *Id.*

<sup>59</sup> Stockholm Treaty Lab, <http://stockholmtreatylab.org>

<sup>60</sup> Gillian Tett, *Olive is the new green in fighting climate change*, Financial Times (29 Jan. 2021), <https://www.ft.com/content/e37bb0b5-3362-497a-8df7-7c28b95d0cb4>; Financial Times, “EU green finance rules must be politically sustainable” (20 Apr. 2021), <https://www.ft.com/content/a608ead1-790d-4587-8e77-9211066a0a03>

<sup>61</sup> Energy Charter Secretariat, *Report of the Modernisation Group on Progress Made in Fulfilling the Negotiations Mandate*, CC 699 (16 Dec. 2020), <https://www.energycharter.org/fileadmin/DocumentsMedia/CCDECS/2020/CCDEC202016.pdf>

<sup>62</sup> *The Economist*, “Stranded but costly: How some international treaties threaten the environment” (5 Oct. 2020), <https://www.economist.com/finance-and-economics/2020/10/05/how-some-international-treaties-threaten-the-environment>; *Euroactiv*, “France puts EU withdrawal from Energy Charter Treaty on the table” (3 Feb 2021), <https://www.euractiv.com/section/energy/news/france-puts-eu-withdrawal-from-energy-charter-treaty-on-the-table/>; Investment Arbitration Reporter, “EC puts EU withdrawal from ECT on the table, in case its reform objectives are not met” (3 Dec. 2020), <https://www.iareporter.com.ezproxy.law.stanford.edu/articles/ec-puts-eu-withdrawal-from-ect-on-the-table-while-belgium-asks-eu-court-for-opinion-on-modernization-proposal/>

<sup>63</sup> Energy Charter Secretariat, Discussion of the Energy Charter Conference 2 (6 Oct. 2019), <https://www.energycharter.org/fileadmin/DocumentsMedia/CCDECS/2019/CCDEC201908.pdf>

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- Graduated phase-out of investment protection for fossil fuels, pursuant to which existing fossil fuel investments would be protected for a further ten years while future fossil fuel investments would generally be excluded, subject to exceptions for certain gas power plants and pipelines, which could be protected until 2040.<sup>64</sup>
- Expansion of investment protection to include new types of lower carbon energy investments, including hydrogen and biomass.<sup>65</sup>
- Reaffirming of Contracting Parties’ right to regulate to achieve legitimate policy objectives, “such as the protection of the environment, including combatting climate change”,<sup>66</sup>
- Addition of new language on regulatory stability and subsidies, purportedly “[f]or greater certainty”, that the ECT “shall not be interpreted as a commitment from a Contracting Party that it will not change the legal and regulatory framework”, and a Contracting Party’s decision not to issue, renew or maintain a subsidy in accordance with its terms shall not constitute a breach of the ECT unless a specific commitment has been made to the investor;<sup>67</sup>
- Carving out of non-discriminatory measures designed to combat climate change from the indirect expropriation standard, provided such measures are not manifestly excessive;<sup>68</sup>
- Addition of a non-regression clause, which provides that Contracting Parties shall “strive to ensure...and improve” high levels of environmental and labour protection, and shall not seek to encourage investment by weakening such standards;<sup>69</sup> and the
- Addition of a new provision on “Sustainable development – Climate change and clean energy transition”, including obligations on Contracting Parties to: “effectively implement the UNFCCC and the Paris Agreement”; “promote and enhance the mutual supportiveness of investment and climate policies and measures, thereby accelerating to the transition towards a low emission, clean energy and resource efficient economy, as well as to climate- resilient development”; and “promote and facilitate trade and investment of relevance for climate change mitigation and adaptation”.

Most of these proposals focus on preserving host States’ policy space, which has been a major trend in investment treaty-making over the past decade. The EU’s proposed distinction between higher and lower carbon investments for the purposes of qualifying for investment protection is, however, a fundamental departure from the status quo of climate-blind IIAs, and is reminiscent of the Taxonomy Regulation’s aim to redirect capital flows into sustainable investments. In a note accompanying its proposal to phase-out protections for fossil fuels, the EU states:

In line with the Paris Agreement and its long term decarbonisation and energy transition policies, the EU is bound to discourage all further investments into fossil fuel based energy infrastructure projects, unless they are fully consistent with an ambitious, clearly defined pathway towards climate neutrality in line with the long-term objectives of the Paris

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<sup>64</sup> European Commission, European Union text proposal for the modernisation of the Energy Charter Treaty: additional submission (March 2021), <https://trade.ec.europa.eu/doclib/press/index.cfm?id=2248>

<sup>65</sup> *Id.*

<sup>66</sup> European Commission, European Union text proposal for the modernisation of the Energy Charter Treaty (2020), [https://trade.ec.europa.eu/doclib/docs/2020/may/tradoc\\_158754.pdf](https://trade.ec.europa.eu/doclib/docs/2020/may/tradoc_158754.pdf)

<sup>67</sup> *Id.* at 5; see also Singapore-Australia Free Trade Agreement (SAFTA), amended text (2020), article 6(5); The Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) (2003), article 4(5); Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) (2016), article 9.6(5); EU–Canada Comprehensive Economic and Trade Agreement (2016), article 8.9(3).

<sup>68</sup> *Id.* at 8.

<sup>69</sup> *Id.* at 8.

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Agreement and best available science. The EU will support international efforts to reduce the environmental and GHG impact of existing fossil fuel infrastructure.<sup>70</sup>

In this context, it is interesting that the EU's proposed permissive language on the removal of subsidies does not distinguish between fossil fuel and clean energy subsidies. This raises the question of whether the investment treaty system could do more to incentivize low carbon investments, in addition to discouraging high carbon investments.<sup>71</sup>

In theory, IIAs should promote foreign investment in the host State by reducing political and regulatory risk, which in turn reduces an investor's cost of capital.<sup>72</sup> (That said, a clear causal link between IIAs and international investment flows, or investment decisions, or cost of capital, has not been empirically established.<sup>73</sup>) Viewed from a renewable energy investor's perspective, host States may be more likely to incentivize foreign investment in sustainable activities – and thereby meet their decarbonization targets – if IIAs help to promote well-designed policies and regulatory stability in the renewables sector, and discourage host States from radically altering the policy support originally offered. Indeed, climate change lawyer-turned-investor Martijn Wilder contends that the 36% decrease in renewable energy investment in Europe between 2011 and 2012 stemmed from uncertainty in the market following the regulatory changes that precipitated the ISDS claims discussed in section (2) above.<sup>74</sup> And as discussed in section (1), stable policy support will remain vital to the clean energy transition, particularly in emerging markets, even as new technologies become competitive.

Among other matters, developing a reasonable approach to damages and quantum in climate-related cases will also be important to alignment efforts. To date, however, the issue has received relatively little attention and indeed is not specifically addressed in the EU's proposals for the modernised ECT.

Certainly, climate change adds additional layers of financial and scientific complexity to damages issues. ISDS parties, experts and tribunals will have to grapple with the impact on valuation of the physical and transition risks of climate change, including the issue of

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<sup>70</sup> European Union text proposal for the modernisation of the Energy Charter Treaty: additional submission (March 2021), <https://trade.ec.europa.eu/doclib/press/index.cfm?id=2248>

<sup>71</sup> See OECD, 6<sup>th</sup> Annual Conference on Investment Treaties: The future of investment treaties – potential avenues (29 Mar. 2021), <https://www.oecd.org/daf/inv/investment-policy/Note-on-possible-directions-for-the-future-of-investment-treaties.pdf>, para 61. For an opposing view questioning *inter alia* the need for policy support for renewable energy, see e.g. Kyla Tienhaara, “Does the Green Economy Need Investor-State Dispute Settlement?”, IISD (28 Nov. 2015), <https://www.iisd.org/itn/en/2015/11/28/does-the-green-economy-need-investor-state-dispute-settlement/>

<sup>72</sup> Joachim Pohl, *Societal benefits and costs of International Investment Agreements: A critical review of aspects and available empirical evidence*, 1 OECD Working Papers on International Investment 36 (2018), <https://www.sipotra.it/wp-content/uploads/2019/03/Societal-benefits-and-costs-of-International-Investment-Agreements.-A-CRITICAL-REVIEW-OF-ASPECTS-AND-AVAILABLE-EMPIRICAL-EVIDENCE.pdf>.

<sup>73</sup> Jonathan Bonnitcha, Lauge N. Skovgaard Poulsen & Michael Waibel, *Political Economy of the Investment Treaty Regime* 9 (2017); Joachim Pohl, “Societal benefits and costs of International Investment Agreements: A critical review of aspects and available empirical evidence”, 1 OECD Working Papers on International Investment 36 (2018), <https://www.sipotra.it/wp-content/uploads/2019/03/Societal-benefits-and-costs-of-International-Investment-Agreements.-A-CRITICAL-REVIEW-OF-ASPECTS-AND-AVAILABLE-EMPIRICAL-EVIDENCE.pdf>

<sup>74</sup> Martijn Wilder & Lauren Drake, “Setting up the International Mitigation Regime: Contents and Consequences”, *The Oxford Handbook of International Climate Change* 359 (2016).

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stranded assets. Climate-related cases may also implicate new factors in financial modelling, such as a social cost of carbon or border adjustment carbon taxes.<sup>75</sup>

The granting of compensation to investors impacted by climate policies is, of course, not the exclusive preserve of ISDS tribunals.<sup>76</sup> In July 2020, for example, Germany's parliament adopted a coal exit law that will pay EUR 4.35 billion to compensate coal plant owners for forced shutdowns.<sup>77</sup> Older workers who will be among the 6,000 resulting job losses will also receive financial support under the German legislation, which seeks to reflect the imperative of a just transition.<sup>78</sup> There is as yet no sign, however, of agreement on an international standard of compensation in fossil fuel phaseouts.

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Negotiating rounds on the ECT's modernization are set to continue through at least November 2021.<sup>79</sup> Meanwhile, climate change policy and law continues to develop apace. An immediate challenge for the investment treaty system is to keep up with the energy transition and sustainability revolution. For their part, international investment lawyers should look outside of their professional silos, seeking insights from a broad range of experts, investment policymakers and stakeholders, and critically consider what the system needs to deliver in order to maintain its relevance and legitimacy in the net zero era.

May 2021

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<sup>75</sup> Tienhaara, Johnson & Burger, "Valuing Fossil Fuel Assets in an Era of Climate Disruption", IISD (20 Jun. 2020), <https://www.iisd.org/itn/en/2020/06/20/valuing-fossil-fuel-assets-in-an-era-of-climate-disruption/>; Tienhaara and Cotula, "Raising the cost of climate action? Investor-state dispute settlement and compensation for stranded fossil fuel assets", IIED (2020), <https://pubs.iied.org/sites/default/files/pdfs/migrate/17660IIED.pdf>

<sup>76</sup> Financial Times, "Germany strikes €44bn deal to phase out coal use in energy supply" (16 Jan. 2020), <https://www.ft.com/content/0e26b798-3848-11ea-a6d3-9a26f8c3cba4>

<sup>77</sup> Clean Energy Wire, "Spelling out the coal exit – Germany's phase-out plan" (3 Jul. 2020), <https://www.cleanenergywire.org/factsheets/spelling-out-coal-phase-out-germanys-exit-law-draft>; see also Clean Energy Wire, "RWE sues Netherlands for two billion euros compensation over the state's 2030 coal exit" (5 Feb. 2021), <https://www.cleanenergywire.org/news/rwe-sues-netherlands-two-billion-euros-compensation-over-states-2030-coal-exit>; Client Earth, "Briefing: The German lignite phase-out contract and investment arbitration" (Sept. 2020), <https://www.documents.clientearth.org/wp-content/uploads/library/2020-09-04-the-german-lignite-phase-out-contract-and-investment-arbitration-isds-ce-en.pdf>

<sup>78</sup> *Id.*; Michael Jacok et al, "The future of coal in a carbon-constrained climate", Nature Climate Change 10, 704-707 (Jul. 2020), <https://www.nature.com/articles/s41558-020-0866-1>

<sup>79</sup> International Energy Charter, *Modernisation of the treaty*, <https://www.energychartertreaty.org/modernisation-of-the-treaty/>