Submission to the Organization for Economic Co-operation and Development on investment agreements and climate change by PowerShift[1]

1. High risk of fossil fuel claims

Investment treaties pose a serious risk for much needed climate action. Three factors make the fossil fuel sector particularly prone to resorting to investment arbitration:

a) Fossil fuel companies are already the prolific users of investment treaty arbitration. Research has shown that the fossil fuel sector resorts to ISDS more than any other economic sector. All carbon majors have initiated ISDS claims, making companies and their legal departments well aware of the powers and possibilities of investment treaty arbitration. Furthermore, awards in the fossil fuel sector are on average five times larger than in other economic areas. [2]

b) The fossil fuel sector is characterized by particularly large capital investments, often coupled with an investment horizon of several decades. Especially oil and gas extraction, transportation and processing are very capital intensive. *New* investments in fossil fuel extraction and power generation fluctuated between USD700 billion and USD1 trillion annually in 2019-2021.[3] The existing investment stock in fossil fuel infrastructure is thus extremely large and it has been estimated that up to USD9 trillion of fossil fuel investments could be at risk of litigation.[4] Even if only a very small fraction ended up as the subject of investment treaty arbitration, it could seriously endanger a swift transition away from fossil fuels.

c) The home states of large fossil fuel companies have signed a large number of mostly old investment treaties. For example, the Netherlands, France, the UK, the United States, China and Canada, home to some of the largest private fossil fuel companies, have all more than 50 investment treaties or treaties with investment provisions in force. Coupled with the global presence of many fossil fuel companies and the prevalence of treaty shopping, it is likely that a high percentage of fossil fuel investments are protected through investment treaties with ISDS. One study found that 75% of foreign-owned coal power plants were protected by an investment treaty with ISDS.[5]

The three factors above make it highly attractive for law firms working in investment arbitration to advertise the possibility of investment treaty arbitration against energy transition measures. The law

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1 PowerShift is a non-governmental organisation based in Berlin, Germany. We critically analyse and intervene in EU trade and investment policy. We have worked on investment treaties and investor-state dispute settlement for the last decade. Over the last couple of years, we have focused on the intersection between climate policies and investment treaties, in particular the Energy Charter Treaty. This contribution has been written by Fabian Flues: fabian.flues@power-shift.de. More information about our work can be found on our website: https://power-shift.de/.

2 Lea di Salvatore (2021) Investor–State Disputes in the Fossil Fuel Industry, IISD, 31 December https://www.iisd.org/publications/investor-state-disputes-fossil-fuel-industry

3 See: IEA (2021) World Energy Investment 2021 and the corresponding dataset available at: https://www.iea.org/reports/world-energy-investment-2021.

4 AFP (2021) Governments risk 'trillions' in fossil fuel climate litigation, 11 December https://www.france24.com/en/live-news/20211112-governments-risk-trillions-in-fossil-fuel-climate-litigation

5 Kyla Tienhaara, Lorenzo Cotula (2020) Raising the cost of climate action? Investor-state dispute settlement and compensation for stranded fossil fuel assets, IEED, 20 October https://pubs.iied.org/17660iied

firm Jones Day, for examples, highlighted the opportunities for fossil fuel firms in pursuing climate related ISDS cases and counselled them to undergo corporate restructuring to enable the use of ISDS against climate change mitigation measures: "Climate change litigation is often viewed by companies as a risk. However, it is also an opportunity—if brought in the right forum—for companies exposed to certain climate-related government measures to vindicate their rights. [...] ISDS is therefore likely to be an increasingly important avenue for the resolution of climate change disputes. Companies in industries most affected by States' climate change obligations (e.g., fossil fuels, mining, etc.) should audit their corporate structure and change it, if needed, to ensure they are protected by an investment treaty. […] Notably, some treaties have superior investor protections than others. It is thus important to assess which treaty would best protect the company from any adverse climate-related government measures."[6]

2. Systemic concerns

Investment treaties and investment arbitration are a conservative force in policy making. I.e. they structurally favour stability of the regulatory environment or at best incremental changes rather than rapid and far-reaching policy shifts such as those needed for a swift transition away from fossil fuels. At the same time hardly any investment treaties or tribunal awards acknowledge the need for climate change mitigation, let alone give it precedence over the broad property rights enshrined in investment treaties.[7]

Climate change poses a unique challenge in this regard as for the first time in recent history a major, economically viable sector of the economy has to be phased-out through public policy measures. Experience has shown that pure demand side measures, probably less prone to cause investment arbitration cases, are not sufficient to curb greenhouse gases emissions to the level necessary for a 1.5°C path and regulatory action needs to be taken at all points of the fossil fuel life cycle, in particular when we see uneven ambition across jurisdictions.

The particularities of the investment treaty regime make it especially dangerous for ambitious climate action. The vague wording of substantive rights, in particular in first generation treaties, leaves states (and investors) in continuous uncertainty as to whether certain climate mitigation measures infringe on those rights or not. This is compounded by (1) the lack of precedent and the fact that arbitration tribunals have taken different decisions in very similar situation in the past; (2) the lack of an appellate mechanism which leaves states (and investors) at the mercy of the particular tribunal ruling on the case.

3. Concrete risks

3.1 Reduction in ambition

Perhaps the most significant danger of investment treaties is a reduction in GHG mitigation ambition out of a fear of expensive and lengthy investment treaty claims. This can play out in two ways:

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6 Michelle Bradfield et al (2022) Climate Change and Investor-State Dispute Settlement, Lexology, 1 March https://www.lexology.com/library/detail.aspx?g=086370ea-bd96-4c3d-9446-24ca72136151

7 See, for example, the new analysis of available ECT awards: Anja Ipp et al (2022) The Energy Charter Treaty, Climate Change and Clean Energy Transition: A Study of the Jurisprudence, Climate Change Counsel, 15 March https://www.climatechangecounsel.com/_files/ugd/f1e6f3_d184e02bff3d49ee8144328e6c45215f.pdf

First, explicit threats from investors to initiate an investment treaty claim if a particular GHG mitigation measure is going ahead. Such threats are usually only made public as a consequence of freedom of information requests, meaning that their number is probably vastly underestimated. An example is the letter sent on behalf of Vermilion to the French government, which led to less ambitious phase-out plans for fossil fuels.[8] The Dutch government has also publicly stated that they're not pursuing further initiatives on coal fired power generation to avoid the risk of litigation.[9]

Secondly, there is a risk of a reduction of ambition without explicit threats of investment arbitration claims. Internal risk assessment conducted by government civil servants, especially in countries that have been respondents in ISDS proceedings before, could lead to an avoidance of measures that are seen as potentially leading to ISDS claims.[10] Such regulatory chill, where regulators factor possible liabilities into their decision making without any actual (threat of) claims, has already been observed in environmental policy making and it would be surprising if climate change mitigation was not affected by this.[11]

One challenge is that a reduction in ambition because of actual or hypothetical threats of ISDS claims happens in internal deliberations of ministerial bureaucracies which is usually not made public.[12] This makes it not only difficult to assess how widespread this phenomenon is. It also gives little opportunity for public interest groups to push back through legal assessments that come to a different conclusion or other forms of outside interventions.

There is evidence that the fossil fuel industry sees investment arbitration as a lever against unwanted policy changes. When Chevron lobbied the European Commission on the investment provisions of the planned free trade agreement with the United States, the TTIP, it argued that "the mere existence of ISDS is important as it acts as a deterrent."[13] Similarly an ExxonMobil lobbyist highlighted the continuation of investment protection for oil and gas companies in the USMCA, the revamped NAFTA, as a significant lobbying success.[14]

3.2 Increasing costs of the energy transition

Investment treaties can also increase the costs of the energy transition. The obvious way is for ISDS cases to lead to high compensation payments from states to fossil fuel investors. Several cases are currently ongoing, such as the ECT claims by Uniper and RWE against the Dutch coal phase-out,

8 Friends of the Earth Europe et al (2019) Blocking Climate Change Laws with ISDS Threats: Vermilion vs France, https://10isdsstories.org/wp-content/uploads/2019/06/Vermilion-vs-France.pdf

9 See this response by the Dutch government to parliamentary questions: https://www.tweedekamer.nl/kamerstukken/brieven_regering/detail?id=2021Z19314&did=2021D41482

10 A recent example might be the decision of New Zealand not to join the Beyond oil and gas alliance. In this case there is no publicly known threat by an oil or gas producing company (which does not at all preclude the possibility that those threats have been made in private) https://www.energymonitor.ai/policy/international-treaties/why-investor-lawsuits-could-slow-the-energy-transition

11 Van Harten, Scott (2016) Investment Treaties and the Internal Vetting of Regulatory Proposals: A Case Study from Canada, Osgoode Legal Studies Research Paper No. 26/2016, 19 April, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2700238.

12 PowerShift is currently involved in litigation with the German government for the release of documents relating to investment treaty arbitration and the German coal phase-out: https://power-shift.de/pm-zu-viel-kohle-fuer-den-kohleausstieg-klage-will-licht-ins-dunkel-bringen/

13 Arthur Neslen (2016) TTIP: Chevron lobbied for controversial legal right as 'environmental deterrent', The Guardian, 26 April https://www.theguardian.com/environment/2016/apr/26/ttip-chevron-lobbied-for-controversial-legal-right-as-environmental-deterrent

14 See fourth in this investigation by Greenpeace: https://unearthed.greenpeace.org/2021/06/30/exxon-climate-change-undercover/

reportedly suing for €2.4 billion in compensation, and the USD16.3 billion claims by TC Energy and the Province of Alberta against the United States for the cancellation of the Keystone XL pipeline permits. The calculation of compensation payments in ISDS cases, often done on the basis of the hypothetical income the asset could have generated, could lead to extraordinarily large liabilities for states, in particular for economically viable oil, gas and coal reserves.[15]

More indirectly, investment treaties can raise the costs is by increasing the bargaining power of fossil fuel companies in the energy transition. In cases where an early phase-out of fossil fuel infrastructure requires the payment of some kind of compensation to the owner, the existence of an investment treaty (and even more so the implicit or explicit threat of a treaty arbitration case) can be used to increase the compensation states are willing to pay if it allows them to avoid a costly and lengthy arbitration.

4. The example of the German coal phase out

The case of the German coal phase-out brings together a few of the elements described above. They will be briefly summarised here and are laid out in more detail in a recently published briefing.[16]

In 2020 Germany decided to phase-out power generation from coal by 2038. Environmental organisations had strongly advocated for mandating the closure of coal powerplants through a regulation, which would have brought environmental benefits. Instead, the German government chose to phase-out the burning of (imported) hard coal through an auctioning system for powerplants and end the burning of domestically mined lignite through a contract with the two main operators. An internal document obtained via a freedom of information request shows that the economics ministry had warned the chancellery of potential "costly and lengthy" investment treaty claims if the government pursued a phase-out through regulation only.[17]

In the contract, the companies and their main shareholders waive their right to pursue investment treaty claims against the German government in relation to the phase out. But this waiver came at a steep price. The negotiations gave the coal companies significant bargaining power, helping them to negotiate a contract in which the public shoulders the risks and uncertainties of the phase-out and that makes it harder for the government to bring the phase-out forward.[18]

In return for the waiver, the companies also demanded higher compensation payments from the German government for the phase-out. While the German government has publicly admitted that the

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15 See for example: Jonathan Bonnitcha and Sarah Brewin (2021) Compensation Under Investment Treaties, IISD Best Practice Series, November https://www.iisd.org/system/files/publications/compensation-treaties-best-practicies-en.pdf

16 Fabian Flues (2022) Coal ransom: How the Energy Charter Treaty drove up the costs of the German coal phase-out, PowerShift and others, March https://power-shift.de/wp-content/uploads/2022/03/How-the-Energy-Charter-Treaty-drove-up-the-costs-of-the-German-coal-phase-out-web-22022022.pdf

17 See extract from the document "Bewertung Kohleausstieg durch Ordnungsrecht" sent by the Federal Ministry of Economics to the Chancellery on 31 October 2019. Available at the following link on p. 81, https://fragdenstaat.de/anfrage/dokumente-zum-energiecharta-vertrag-und-kohleausstieg/639279/anhang/211025-UIGBescheid-NAMEIIIFinal_geschwaerzt.pdf

18 See: Ida Westphal (2020), Stellungnahme zum Thema „Öffentlich-rechtliche Verträge der Bundesregierung mit den Braunkohlebetreibern", Öffentliche Anhörung im Ausschuss für Wirtschaft und Energie des Deutschen Bundestages, 7 September https://www.bundestag.de/resource/blob/711246/c8642c292aec135747bb2d312e0114c0/stgn-sv-westphal-data.pdf

waiver played a role in determining the level of compensation,[19] it is difficult to exactly quantify the level of additional compensation the coal companies received. In total, the two lignite companies are paid €4.35 billion in compensation. This amount is seen by independent experts as too high. The climate think tank Ember concludes in an analysis for Greenpeace Germany that a total compensation of €343 million for the two companies would have been adequate.[20] The European Commission has opened a state aid investigation into the payment, because it "doubts that the compensation is kept to the minimum required and that the amounts are proportionate."[21]

In short, in order to avoid investment treaty arbitration over its coal phase-out, the German government chose to negotiate a contract with the two leading coal companies. The conclusion of the contract led to a coal phase-out that is more favourable to the companies and costlier to the taxpayer than it would have been had a purely regulatory exit been pursued.

5. Options for reform

It is important to note that any reform option that addresses only climate-related aspects of investment treaties is partial, because issues similar to the ones described above arise in other areas of environmental and social concern such as mining, public health or infrastructure and construction all of which have seen high numbers of investment arbitration cases. It is therefore preferable that reform options tackle the underlying problems of the investment treaty regime rather than focusing solely on climate change.

The decentralised structure of the investment treaty regime makes it hard for any single approach to work. A case in point is the very slow and marginal progress of multilateral reforms, such as the negotiations at UNCITRAL. Therefore, a mix of different measures is likely to be needed to urgently address the issues identified. In our view, the following options should be considered, in descending order of desirability, and combined where possible.

a) Withdrawal of Consent to Arbitrate and Termination Treaty
   An international treaty by which states would withdraw their consent to arbitrate and would terminate investment treaties has been developed by leading investment law experts.[22] It would be the most comprehensive solution to problems identified and allow states to join over time. While some states are unlikely to join such an initiative at the moment, there is a successful precedent to such a treaty: The one developed by the European Union to end the application of intra-EU BITs, including the cancellation of sunset clauses.[23]

19 Nico Schmidt (2021) Wie Schiedsgerichte Europas Klimaziele bedrohen, BuzzFeed News, 23. February, https://www.buzzfeed.de/recherchen/energiecharta-vertrag-schiedsgerichte-europa-klimaziele-90214917.html

20 Greenpeace (2021) Strich durch die Rechnung, 4 June https://www.greenpeace.de/themen/energiewende-fossile-energien/kohle/strich-durch-die-rechnung

21 European Commission (2021) State Aid SA.53625 (2020/N) – Germany – Lignite phase-out, 2 March, https://ec.europa.eu/competition/state_aid/cases1/202117/292944_2268207_78_2.pdf

22 See CCSI, IEED, IISD (2019) Draft Treaty Language: Withdrawal of Consent to Arbitrate and Termination of International Investment Agreements, 15 June https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/wgiii_withdrawalconsent_0.pdf

23 Agreement for the termination of Bilateral Investment Treaties between the Member States of the European Union (2020) https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:22020A0529(01)&from=EN

b) Termination

In case where a joint termination of agreements is not possible, countries should consider terminating their investment agreements unilaterally. A number of countries have taken such action in the past, without negative impacts on their FDI inflows. Such termination would shield them from potentially enormous liabilities for new fossil fuel investments, which over the past years reached between USD1 trillion and USD700 billion globally.

c) Unilateral withdrawal of consent to fossil fuel investors

A third element in the toolbox should be for countries to unilaterally withdraw consent to arbitration for investors in fossil fuels, ideally as part of multi-country coalition to reduce the possibilities for treaty shopping. Such an approach would be similar to some of the measures suggested in a) but specifically targeted at fossil fuel investors only. It might help to overcome hesitation of countries that are unwilling or unable at this moment to exit the investment treaty regime in its entirety.

d) Replacement of existing investment treaties

Where countries are unable to terminate their investment treaties, another option might be to replace existing treaties with entirely new investment treaties that should categorically exclude fossil fuel investments and other carbon intensive sectors from their coverage, while providing protection only to investments that are sustainable and benefit the host state. In addition, such agreements would need to depart from the investor-state dispute settlement system, for example by replacing it with state-to-state dispute settlement or more conciliatory approaches such as mediation. Substantive investor rights should be limited to direct expropriation. Some elements have been already been developed in model or existing treaties.[24]

e) No contract-based arbitration in the fossil fuel sector

A serious challenge is the use of contract-based arbitration in the fossil fuel sector, especially against low-income countries.[25] There should be global guidance to all states to avoid including arbitration clauses in contracts with fossil fuel companies, especially in the upstream oil & gas sector. Such guidance should be issued and supported by all relevant multilateral development institutions, regional integration bodies and bilateral development agencies. Countries should be supported in re-negotiating existing contracts.

24 Southern African Development Community (2012) SADC Model Bilateral Investment Treaty Template https://www.iisd.org/itn/wp-content/uploads/2012/10/sadc-model-bit-template-final.pdf, Creative Disrupters (2018) Treaty on Sustainable Investment for Climate Change Mitigation and Adaptation https://www.iisd.org/publications/treaty-sustainable-investment-climate-change-mitigation-adaptation

25 Lea di Salvatore (2021) Investor–State Disputes in the Fossil Fuel Industry, IISD, 31 December https://www.iisd.org/publications/investor-state-disputes-fossil-fuel-industry