The Reform That Isn’t

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As states are set to vote on the reform of the Energy Charter Treaty (ECT) at a Conference in Ulaanbaatar, Mongolia, on 22 November, concerns regarding the treaty’s impact on states‘ climate policies remain significant. In our assessment, the proposed reform fails to provide the treaty’s contracting parties with the necessary regulatory freedom to implement their climate commitments. Scheduled for the week after COP27, the vote comes at a crucial time, as scientists agree that this is the decisive decade to limit global warming to 1.5°C above pre-industrial levels. Meanwhile, several EU Member States, including Germany, France, Spain, Poland, the Netherlands, and Slovenia have announced unilateral withdrawals from the treaty, stating that the proposed reform fails to meet their expectations.

To curb emissions, states will need to adopt unprecedented measures that will inevitably impact foreign investments in the energy sector – which are protected under the ECT. In recent years, fossil fuel investors have increasingly used the ECT to challenge such measures by commencing so-called investor-state arbitration claims against them. The reform proposal that the treaty’s contracting parties now vote on fails to prevent such claims in the future. Contrary to what has been suggested in another recent article in this blog, the reform proposal neither reforms investor-state arbitration nor prohibits controversial third-party funding of these claims (see here, p. 35). In this article we take a close look at how states’ climate commitments and the ECT would interact, if the treaty were to be reformed, and reiterate why we think a coordinated withdrawal combined with an inter se modification of the treaty remains the viable option.

How would the reformed treaty interact with the unprecedented climate measures states must take?

Scientists and policymakers agree that unprecedented efforts are required at scale, if global warming is to be limited to 1.5 °C above pre-industrial levels. Governments have recently pledged to phase down unabated coal power and fossil fuel subsidies, while several governments also made individual commitments to phase out coal power. In addition, some states and subnational states announced the Beyond Oil and Gas Alliance (BOGA) and committed to not issuing any new licenses for gas and oil extraction and to phasing out these energy sources entirely in the coming years. A large group of states also pledged to drastically reduce methane emissions.

How will the reformed treaty affect state commitments to phase out coal?

Through the Power Past Coal Alliance, several states including the ECT Contracting Parties France, Germany, and the United Kingdom have committed to fully phase out coal power generation by 2030. In addition, twenty ECT contracting parties signed the COP26 statement committing to "transition away from unabated coal power generation", by 2030 for "major economies" and 2040 for others. In addition, four ECT contracting parties have also committed to phase out coal by joining the so-called „Powering Past Coal Alliance." If these commitments are to be effectively implemented, states will need to take measures affecting every step of the value chain of coal-based power generation. This includes „upstream exploration and extraction activities to the operation of coal-fired power plants."

However, the ECT, by allowing investor-state arbitration, could thwart such measures. For instance, following the passing of a Dutch law aiming to phase-out coal from its electricity mix, two investor-state arbitration claims were lodged against the Netherlands under the ECT by German energy giants Uniper and RWE. Uniper claimed violation of legitimate expectations and alleged a „lack of fair, adequate, and effective compensation" – an indicator of an indirect expropriation claim. While Uniper has agreed to withdraw its claim against the Netherlands as a condition for its bailout by the German government, this withdrawal is yet to take place. An official statement from September 2022 from Uniper explained that the withdrawal of the claim requires obtaining shareholder approval and that an Extraordinary General Meeting is to be held in Q4 2022 for this purpose. RWE has refused to drop its claims against Netherlands. Per the ICSID website, both Uniper's and RWE's cases are still pending.

The reform proposal to the ECT does not do enough to address this issue. *First*, fossil fuel investments, for the most part, would continue to enjoy protection under the reformed ECT. Pursuant to the reform proposal, only the EU and the United Kingdom will carve out some fossil fuels from investment protection. This means that for more than 20 other Contracting Parties to the ECT (including several countries that pledged to ‚transition away from unabated coal power generation,'), all fossil fuel investments including in coal would continue to be protected indefinitely.

Even for the EU and the United Kingdom, foreign investment in fossil fuels, including coal, made prior to 15 August 2023 will continue to be protected for a period of 10 years after entry into force of the relevant provision that contains this rule but no later than 31 December 2040. While this means that new investments in coal-fired power generation, made after the August 2023 deadline, would no longer be protected – a significant improvement – investments made prior to that date, which are often the most politically sensitive, will continue to receive protection.

Furthermore, while possible, a swift entry into force of the provision containing the 10-year period remains more than uncertain. For now, it is unclear exactly what would trigger an entry into force of the provision. It might be tied to the ratification threshold also required for amendments of the treaty (Article 42(4) ECT). This rule requires three quarters of all contracting parties to ratify, approve, or accept an amendment before it will enter into force among those having ratified, approved, or accepted. Experience with the EU-Canada Comprehensive Economic Trade Agreement (CETA), which has not met this threshold in the six years since being signed, shows that this could take several years moving the period closer to 15 or even 20 years.

However, formally, the 10-year period was introduced as a modification of an Annex of the treaty rather than an amendment, which could imply that it would enter into force upon provisional application. A proposed provisional application by default will be voted on as a separate Conference decision on November 22. However, since the ECT is a mixed agreement, provisional application is unlikely by the EU. While the text of this decision has not been made public, contracting parties will be able to opt out of provisional application prior to 22 February 2023. For various reasons, including constitutional constraints, several countries like France, the Netherlands, and Japan have already signaled an opt-out. These factors significantly delay the start of the 10-year period and might lead to different starting dates in different contracting parties – increasing legal uncertainty.

Second, the reform proposal expressly includes the breach of an investor's legitimate expectations as a standalone ground for breach of the so-called fair and equitable treatment (FET) standard – the most widely relied-on substantive protection in investment arbitration generally. This measure runs counter to the general practice in modern EU treaties, such as the EU–Singapore Investment Protection Agreement, CETA, and the EU–Viet Nam Investment Protection Agreement, which provide that the investor's legitimate expectations is *only one of several factors* that must be considered in determining whether there has been a breach of the FET standard.

Third, the reform proposal retains the provision on indirect expropriation – the second-most widely invoked substantive provision of the ECT. This provision has been construed broadly to encompass regulatory measures that have an effect that can be considered "equivalent to direct expropriation". While the reform proposal states that state measures „designed and applied to protect legitimate policy objectives" do not usually amount to indirect expropriation, it also requires such measures to be „non-discriminatory". This is cause for concern because tribunals confronted with indirect expropriation claims as a result of countries' fossil fuel phase-out plans may well find that measures aimed only at one group of energy investors, for example, coal investors, as opposed to all investors, are discriminatory.

How will the reformed treaty affect the BOGA Initiative — and other state efforts to limit oil and gas exploration and production?

"Core members" of the BOGA launched in 2021 committed to "end new concessions, licensing or leasing rounds for oil and gas production and exploration". Four of the core members to this alliance are presently ECT Contracting Parties. It is likely that if the ECT Contracting Parties that are "core members" of BOGA take any measures in line with their commitments under BOGA, they will be subject to investment arbitration claims. This same risk would also apply to other similar commitments made by states to curb oil and gas exploration and production.

Investors have already brought investment arbitration claims to target state measures aimed at phasing out oil and gas exploration activities. A prominent recent example is the case of *Rockhopper Exploration Plc, Rockhopper Italia S.p.A. and Rockhopper Mediterranean Ltd v. Italian Republic* (ICSID Case No. ARB/17/14), where a UK-based investor commenced ECT-based arbitration to challenge the decision of an Italian state agency to refuse to grant a production concession in respect of Ombrina Mare oil field off Italy's Adriatic coast. The agency had justified its decision by citing environmental concerns including the fact that the project would have produced substantial amounts of waste, drilling mud, and combustion fumes. Earlier this year, the arbitral tribunal awarded the investor 185 million EUR in lost profits, additional costs and interest.

Contrary to what some suggest, reading this case as a mere consequence of the "procedural peculiarity of Italian law" might fail to consider systemic concerns arising with regard to the reform of the ECT. The award indeed hinges on the tribunal's finding that the investor had obtained the right to obtain a production permit (as opposed to the permit itself) under Italian law. In light of Article 1(6) of the ECT, such a right currently qualifies – and, under a reformed ECT would likely still qualify – as an investment, a fact that states may wish to consider when assessing the reform. Moreover, the amount of compensation awarded exceeds the amount actually invested by several orders of magnitude – a fact owed to the use of controversial forward-looking valuation techniques. In addition, the tribunal in *Rockhopper* openly states that „the material factual circumstances which have led to the final result of this arbitration are both specific and discrete from the environmental considerations which have been argued before the Tribunal." It is at least questionable whether decisions with a direct bearing on hydrocarbon exploration should be decided in a way that is disconnected from "environmental considerations." It is notable that Rockhopper is not an isolated case in this regard as investors have had recourse to investment arbitration to challenge the cancellation of gas fracking permits (*Lone Pine Resources Inc. v. The Government of Canada*, ICSID Case No. UNCT/15/2), and a moratorium for hydrocarbon exploration (*Westmoreland Mining Holdings LLC v. Government of Canada* (ICSID Case No. UNCT/20/3)).

Rockhopper also exemplifies the risk of the combination of a broad definition of 'investment' and the unrestricted use of so-called 'forward-looking valuation techniques' by arbitral tribunals. The reform proposal retains a broad definition of investment specifically including the 'exploration' of energy materials and products (Article 1(5)). Fossil fuel projects, like in *Rockhopper*, in respect of which a preliminary permit to explore or a comparable right has been granted but no license to produce was formally issued, would nevertheless count as existing investments pursuant to the EU fossil fuel carveout – a fact that considerably weakens the climate ambition of the proposal. Numerous studies have found that existing fossil fuel reserves – even prior to further exploration – massively exceed the amount that can be consumed globally while achieving the Paris goals. In addition, despite the inclusion of a new article on 'valuation', arbitral tribunals will still be able to use forward-looking valuation techniques like in *Rockhopper* and award compensation based on the hypothetical future profits had the project entered into production, even if was later cancelled at an early stage.

While the abovementioned cases do not allow for inferences to be drawn with certainty with regard to future developments, they nevertheless indicate a significant risk of future claims related to climate policy measures on the basis of the ECT. Further research is therefore required on the specific types of regulatory measure and the precise nature of assurances made by host states.

How will the reformed treaty affect efforts to limit methane pollution?

Pursuant to the Global Methane Pledge launched at COP26 last year, parties to the pledge, including the EU, committed to a collective goal of reducing global methane emissions by at least 30 percent from 2020 levels by 2030.

Per the International Energy Agency, fossil fuel operations account for more than one-third of human-caused methane emissions; emissions result from leaks in oil and gas infrastructure, decommissioned extraction sites, and the practices of „venting“ and „flaring“. This means that state efforts to cut methane emissions will likely permeate into the fossil fuel sector. For instance, like the American Orphaned Well Cleanup and Jobs Act 2021 requires, investors could be required to plug and remediate abandoned coal mines and orphaned wells to reduce methane emissions. Investors could also be asked to pay special taxes on methane emissions. For example, in Norway, where a venting and flaring ban requires operators to pay a special flaring tax and take measures to capture excess and associated gases. Effectively therefore, proper actioning of the Global Methane Pledge would mean that investors in fossil fuels will have to shoulder some part of the cost of methane emissions reduction.

This could lead to investor claims against host states under the ECT. As explained above, under the reform proposal, investments made within the EU and the United Kingdom prior to 15 August 2022 will continue to receive protection likely for significantly more than a decade. For all other Contracting Parties to the ECT, fossil fuels will continue to remain protected indefinitely.

Signatory states to the Global Methane Pledge must therefore be wary of, and pro-actively address, the risks of ECT-based investor-state arbitration arising from any national efforts to curb methane emissions. Investors could argue that the host state had breached the FET protection under the ECT by breaching their legitimate expectations. In particular, contrary to what is claimed here, under the reform proposal's fossil fuel carveout for the EU, certain gas-related investments, even if made after 15 August 2023 would continue to be protected for an extended period of time as long as the investment is below a carbon threshold of 380 g of CO_2 of fossil fuel origin per kWh of electricity. No separate threshold for methane has been included. This means that investors in gas-related infrastructure could argue that any unforeseen measures to curb methane emissions that lead to costs breach their legitimate expectations. This is not a theoretical risk. Investors have already raised claims under the ECT in response to efforts by states to protect the environment in gas-related arbitration cases. For example, in Ascent Resources Plc and Ascent Slovenia Ltd v. Republic of Slovenia, ICSID Case No. ARB/22/21 , the British investor Ascent argued that Slovenian Environmental Agency's insistence on an environmental impact assessment was "manifestly arbitrary and unreasonable." The case concerned a project to produce gas by hydraulic fracturing.

A coordinated withdrawal and *inter se* agreement are best suited to reduce post-withdrawal risks

It is clear from the above that even a reformed ECT would significantly impair states' ability to realize their climate commitments. For this reason, there is a growing chorus of calls for states to withdraw from the ECT rather than seeking to reform it.

Since Italy withdrew in 2016, *Rockhopper* was based on the sunset clause of the ECT. This fact has been argued to be a case in point why states should reform rather than withdraw from the treaty. As the argument goes, 10 years of additional protection would allow for a sooner end of fossil fuel protection than the 20-year withdrawal. However, this argument must be qualified in several important respects: (1) it only applies to the EU and the UK, but none of the more than 20 other contracting parties, which include major oil producers (e.g., Kazakhstan) and capital exporting states (e.g., Japan); (2) even inside the EU, it is likely that the 10-year period would only start to run years from now and possibly at different times in different ECT contracting parties (see above). Nor is the 20-year sunset period the only alternative to this 10-year period through the proposed reform: the sunset clause could be fully neutralized – without these two weaknesses – by an *inter se* agreement, an option that is often disregarded (see below). Several states that have announced withdrawals (e.g., France, Germany, Spain, Poland, the Netherlands, and Slovenia) or withdrawn from the treaty (Italy), appear to have recognized this fact and have taken a step in the right direction.

Going forward, a coordinated withdrawal of the EU – an ECT contracting party in its own right – its member states, and other interested states combined with an *inter se* agreement to eliminate, or at least significantly reduce the scope of the sunset clause within the ECT is the most viable option. The European Union would be in the best position to facilitate and implement these steps and EU member states should swiftly mandate it to do so via the decision-making process in the Council of the EU.

We have shown elsewhere, that an *inter se* agreement to modify the treaty among withdrawing states has a solid basis in Article 41 of the VCLT and *mutatis mutandis* the VCLT-IO. Such an agreement would not undermine the object and purpose of the ECT, as all rights of non-modifying states and their investors would be left intact. The viability of this option is further supported by the fact that the European Commission has itself suggested a draft inter se agreement. The proposal clarifies what is widely agreed even by critics of a withdrawal (see here), that the ECT and its arbitration mechanism do not apply, and never applied to the intra-EU context. Per the text of the *inter se* agreement, the EU appears firmly determined to address any residual risk of claims. In the agreement, EU member states undertake to file non-disputing party interventions in such arbitral proceedings (Article 5(1) of the draft), and "where they are a party to judicial proceedings" by asking competent courts, even outside the EU if necessary, to set aside or annul awards or refrain from enforcing it (Article 5(2) of the draft).

To accommodate a coordinated withdrawal that extends beyond the EU, this draft could be adapted to allow withdrawing non-EU ECT contracting parties to join and neutralize the sunset clause. Out of an abundance of caution, it could also expressly override the non-derogation clause in Article 16 of the ECT. Contrary to what is sometimes claimed (see here), this provision does not prohibit subsequent international agreements and only concerns agreements *on the the same subject matter,* i.e., the provisions in Part III and V of the ECT. The Article furthermore concerns the relationship of coexisting investment treaties within the meaning of Article 30 of the VCLT – and according to Article 30(5) of the VCLT, the rules on priority between coexisting treaties apply without prejudice to the right of modification. Another frequent argument according to which the possibility of an *inter se* modification would thwart the purpose of sunset clauses is general is moreover inaccurate. In the case of the ECT, an *inter se* modification would leave the sunset clause intact for investors from states that do not modify. Sunset clauses are means for home states to ensure post-withdrawal protection of their investors in the area of a withdrawing state – but they may not disqualify states from being the masters of their treaties.

Finally, it appears central not to assess the reform against the benchmark of the sunset clause alone. As we have shown here (p. 9ff), the reform also comes with a significant expansion of the scope of the treaty to include new energy materials and products, many of which are untested at scale. Besides the phase-out of fossil fuels, the sovereign right of states to flexibly regulate, incentivize or limit these new energy materials and products will be a decisive factor in the clean energy transition. As it stands, even if reformed, the ECT would continue to restrict this sovereign right through the threat of arbitration.

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