Climate Change and Investment Arbitration

I The Complex Interplay between Climate Law and International Investment Law

I.I Climate Law: Overview

To tackle climate change and curtail its effects, States across the world have ratified and adopted several climate related international agreements and instruments.

The legal framework relating to climate change (so-called "Climate Law") comprises, among others, the following instruments:

- Kyoto Protocol (1997), entered into force in 2005. It is the first international instrument setting binding emissions reduction targets for industrialised countries, economies in transition and the European Union.

- Paris Agreement (2015), entered into force in 2016. It is a binding international treaty adopted by 196 Parties. Its main goal is to reduce greenhouse gas (GHG) emissions so as to limit global warming to 1.5 °C. According to the Paris Agreement, States must submit their national climate action plans, known as "nationally determined contributions" (NDCs), which need to be revised and updated every five years.

- European Green Deal and European Climate Law (2019/2021), entered into force in 2019. It is a strategic plan aimed at reaching net zero emissions and climate neutrality by 2050. It led to the adoption of the

European Climate Law (Regulation (EU) 2021/1119), which sets binding targets on EU countries with a view to implement and strengthen climate policies, in compliance with the European Green Deal.

• Glasgow Climate Pact – COP26 (2021), adopted during the UN Climate Conference in 2021. It reiterates the commitment to limit global warming to 1.5°C and urges States' action to reduce GHG emissions by 45% and reach net zero emissions by 2050.

Pursuant to this legal framework, States must adopt several legislative and regulatory measures necessary to meet their climate change related obligations.

I.II International Investment Agreements: Overview

Climate law does not exist in a vacuum but coexists with international investment law.

International investment law comprises over 2,300 International Investment Agreements (IIAs) currently in force. IIAs are international legal instruments entered into by two or more States as a means to promote and protect foreign direct investment (FDI).

The main categories of IIAs are:

Bilateral or multilateral Investment Treaties ("BITs" or "MITs")	Treaties with Investment Provisions ("TIP")
Agreements containing provisions for the development and protection of foreign investment between two (or more) States.	Economic agreements with a broader scope than BITs. Including: *Free Trade Agreements ("FTAs")*: e.g. the EU-Canada Comprehensive Economic Trade Agreement (CETA), containing provisions on the free-trade of goods and services. *Economic Partnership Agreements ("EPAs")*: e.g. trade and development agreements negotiated between the EU and African, Caribbean and Pacific (ACP) countries. EPAs go beyond conventional free-trade agreements, and include co-operation and assistance to help ACP countries benefit from the agreements.

Through the adoption of IIAs, a host State offers foreign investors several legal protections against adverse initiatives that may negatively impact the covered investment.

Standards of protection for foreign investments usually included in IIAs are:

Fair and equitable treatment: a rather broad and vague standard that includes the protection of foreign investors legitimate expectations; the right to due process; good faith, transparency, consistency, reasonableness, proportionality, non-discrimination and non-arbitrariness by the host State.

Guarantees against expropriation: protection against the acts of the State which can deprive, directly or indirectly, the investor of its investment.

Full protection and security: a standard that provides for an obligation for the host State not to harm foreign investors/investments through acts of State organs or acts otherwise attributable to the host State.

National treatment: according to this standard, the host State shall grant foreign investors no less favourable treatment than the one accorded to domestic investors.

Most-favoured-national treatment: this standard aims at granting to foreign investors/investments from one State treatment in another (the host State) that is not less favorable than the one accorded to investors/investments from third States.

In case of a breach of a standard of protection, IIAs permit foreign investors to bring a claim directly against the host State and, in most cases, they include the host State's consent to resolve disputes through international investment arbitration (for example, through an ICSID arbitration).

I.III The Conflict between Climate Law and International Investment Law and the Probable Increase of Phase-Out Disputes

Regulatory measures introduced by States to meet their environmental commitments may lead to disputes with foreign investors, whose investments pre-exist the regulatory changes. Indeed, it is possible that regulatory changes necessary under climate law are at odds with international investment law, translating into a breach of one or more standards of protections provided by IIAs.

Considering that most of IIAs currently in force do not contain any explicit provision preserving the States' right to regulate in the name of climate action, States may find themselves in the conflicting position of complying with environmental obligations and, at the same time, risking violating foreign investors' protections.

The very same standards of protection that were useful to stimulate coal investments at a time when they were needed, may now represent an obstacle to meet the targets set out in the Paris Agreement and other international instruments. This is even more so if one considers that, pursuant to the COP26, contracting States committed to keep global warming to 1.5 °C. In the words of the Intergovernmental Panel on Climate Change (IPCC), "*the shift towards a climate neutral economy will require the global phase-out of unabated fossil fuels*".

The energy transition from fossil fuels to renewables may have a material impact on fossil investments and result in foreign investors seeking compensation under applicable IIAs through investment arbitrations.

According to the recently published "Queen Mary – Pinsent Masons Future of International Energy Arbitration Survey Report 2022", over 900 respondents that took part to the survey identified certain regulatory changes (including States' implementation of treaties, notably the Paris Agreement) as the single most probable change able to give rise to disputes (so-called "phase-out disputes")[1].

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[1] *See* Queen Mary University of London, Pinsent Masons, "Future of International Energy Arbitration Survey Report", January 2023, available at https://arbitration.qmul.ac.uk/media/arbitration/docs/Future-of-International-Energy-Arbitration-Survey-Report.pdf.

Also, according to UNCTAD "*The risk of investor–State dispute settlement (ISDS) being used to challenge climate policies is a major concern*"[2]. Moreover, ISDS has been targeted as a "risk" to climate change mitigation efforts[3].

The probability of an increase in phase-out disputes is exacerbated if one considers that the Energy Charter Treaty (ECT), the most relevant international investment treaty in the energy sector, includes the protection of fossil fuel investments, regardless of whether the regulatory change is justified by climate law obligations.

Examples of "phase-out disputes"

Parties	Issue
RWE AG and RWE Eemshaven Holding II BV v. Kingdom of the Netherlands (ICSID Case No. ARB/21/4)	In the very first investment case against the Netherlands, RWE sought protection against a measure aimed at implementing a coal ban law by 2030. RWE argues that the measure – adopted in compliance with the Paris Agreement commitments – results in an expropriation of its investments in the Netherlands.
Rockhopper Exploration Plc, Rockhopper Italia S.p.A. and Rockhopper Mediterranean Ltd v. Italian Republic (ICSID Case No. ARB/17/14)	An ICSID tribunal found that Italy's ban on oil and gas exploration and production activities within 12 miles of the country's coastline, aimed at protecting the environment, amounted to indirect expropriation of Rockhopper's investment.

[2] *See* UNCTAD, "Treaty-Based Investor-State Dispute Settlement Cases and Climate Action", IIA Issues Note No. 4, September 2022, available at https://investmentpolicy.unctad.org/publications/1270/treaty-based-investor-state-dispute-settlement-cases-and-climate-action.

[3] *See* IPCC, "Climate Change 2022: Mitigation of Climate Change", Working group III Contribution to the IPCC Sixth Assessment Report, 2022, available at https://www.ipcc.ch/report/sixth-assessment-report-working-group-3/.

Considering the above, investors assessing a potential "phase-out disputes" should consider, among others, the following elements:

- **Carve-out clauses:** at times included in IIAs, these clauses exclude investor's protection in case the regulatory change is justified by an environmental obligation[4]. The exclusion usually covers the national treatment and indirect expropriation standards, but not fair and equitable treatment.

- **Whether the investment pre-existed the host State climate related commitments:** it may be relevant to assess whether the investment was made prior to or after the adoption of climate related commitments by the host State. An arbitral tribunal may deny protection to a foreign investor if, at the time of the investment, the host State had already undertaken commitments that justify climate related regulatory changes.

- **Application of Article 30 and 31(3) of the Vienna Convention on the Law of Treaties (VCLT) and of Article 26(6) ECT:** under the principles enshrined in Articles 30, 31(3) of the VCLT and 26(6) of ECT, which regulate the relationship between two international treaties concerning the same matter adopted at different points in time and the issue of interpretation of treaties[5], arbitral tribunals might tend to apply IIAs standard of protections in a restrictive way when they are not compatible with climate law obligations.

To cope with the complex interplay between climate law and international investment law, and to mitigate the risk of disputes arising out of climate related regulatory changes, several States are reforming their model BITs and multilateral efforts are undertaken to modernise the ECT.

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[4] *See* Article 8(9) of the Comprehensive Economic and Trade Agreement between the EU and Canada (CETA): "*For the purpose of this Chapter, the Parties reaffirm their right to regulate within their territories to achieve legitimate policy objectives, such as the protection of (…) the environment (…). For greater certainty, the mere fact that a Party regulates, (…), in a manner which negatively affects an investment or interferes with an investor's expectations, including its expectations of profits, does not amount to a breach of an obligation under this Section*".

[5] *See* Article 30 VCLT: "[…] *when the parties to an earlier treaty are parties also to the later treaty […] the earlier treaty applies only to the extent that its provisions are compatible with those of the later treaty*";
Article 31(3) VCLT: in the interpretation of a treaty "*there shall be taken into account […] any relevant rules of international law applicable in the relations between the parties*";
Article 26(6) ECT: a tribunal shall decide the issues in accordance with "*applicable rules and principles of international law*".

II The Ongoing Reform of IIAs

II.I The New Generation of "Green" IIAs

Against this backdrop, a new paradigm of IIAs is put forward by many States, and by the European Union through its EU Policies on Foreign Direct Investments. In particular, differently from the old-model IIAs, the new-generation of IIAs attempt to rebalance foreign investors' protections with the States' right to regulate, in particular when new regulation is justified by the protection of human rights, health and the environment.

While generally more generous towards States, new-generation IIAs also include obligations upon the contracting States, ranging from obligations of the host State to protect the environment to commitments to promote climate-friendly investments.

In a nutshell, through a series of new provisions, new-generation IIAs are not simply aimed at enhancing and protecting foreign direct investments but see foreign investors as key players to enhance sustainability, promoting gender and regional diversity and strengthen corporate social responsibility.

How new-generation IIAs may affect foreign investors:

Substantive provisions directly related to environmental protection	The new provisions on environmental protection and sustainable development will compel foreign investors to comply with environmental standards. In the event foreign investors do not meet these standards, protection under Green IIAs is likely to be reduced[6].
Provisions directly related to climate action	Green IIAs provide for a set of rules that deal with climate mitigation and adaptation measures. The majority of these provisions include the right to regulate on climate change[7].
Environmental protection as a carve-out from	Green IIAs provide for carve-out clauses that would cover measures that have a reasonable causal nexus with reducing and stabilising greenhouse gas emissions. Carve-out clauses make new regulatory measures adopted by host States more difficult to challenge, and give host States more room to regulate. Carve-out clauses are often found in indirect expropriation and national treatment clauses, though not in fair and equitable treatment provisions.[8]
Environmental protection as a general exception	Green IIAs may include general exceptions or public policy exceptions. Exception clauses are intended to relieve host States from treaty liability for good faith measures taken to pursue public welfare objectives (including health, animal or plant life)[9].
Damages quantification	*E.g.*, the new Dutch Model BIT (2019) provides that the arbitral tribunal, in deciding on the amount of compensation in favour of the foreign investor, is expected to consider non-compliance by the investor with its commitments under the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises[10].

[6] *See* Article 24 of Morocco-Nigeria BIT (2016): *"In addition to comply with all applicable laws and regulations of the Host State and the obligations in this Agreement, (…) investors and their investments should strive to make the maximum feasible contributions to the sustainable development of the Host State and local community through high levels of socially responsible practices".*

[7] *See* Article 6 of the Model BIT Italy (August 2022) available at https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/6438/download.

[8] For instance, under Article 5(5) of the India-Kyrgyzstan BIT (2019), should the host State apply non-discriminatory measures to protect the environment that entail expropriating a foreign investment, such regulatory measures would not constitute expropriation under the very same BIT.

[9] *See* Article 15(1)(b) of the Model BIT Italy (August 2022) available at https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/6438/download.

[10] *See* Article 23 of the Dutch Model BIT (March 2019) available at https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/5832/download. Similarly, *see* Article 19 of the Model BIT Italy (August 2022) available at https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/6438/download.

How new-generation IIAs may affect host States:

Substantive provisions directly related to environmental protection	Green IIAs purport to promote sustainable development and to take urgent action to combat climate change. To this end, the host State investment laws and policies should provide for and encourage high levels of environmental protection[11].
Prohibitions to lower environmental standards	Prohibition of investment enhancement by lowering or relaxing domestic environmental or labor legislation and standards, or by failing to effectively enforce such legislation and standards[12].
Procedures for cooperation and implementation of environmental protection	Green IIAs can also require contracting States to effectively enforce their environmental laws and establish institutional mechanisms for cooperation. As a consequence, host States shall implement their system establishing joint-committee mechanisms, public participation, consultations, panel of experts[13].

[11] *See* Article 6(1)(2) of the Dutch Model BIT (March 2019) available at https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/5832/download. *See* also Article 21 of the Model BIT Italy (August 2022) available at https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/6438/download.

[12] *See* Article 20(2)(3) of the Model BIT Italy (August 2022) available at https://investmentpolicy.unctad.org/international-investment-agreements/treaty-files/6438/download.

[13] As a matter of fact, the European Commission and the government of Germany have recently released a draft decision, containing interpretations and clarifications to certain previsions in Chapter 8 (the Investment Chapter) of the CETA, that shall be "(...) *interpreted and applied by the Tribunal by taking due consideration of the commitments of the parties under the Paris Agreement and their respective climate neutrality objectives in a way that allows the Parties to pursue their respective climate change mitigation and adaptation policies*" (*See* Draft Decision of the CETA Joint Committee, "Decision No X/2022 of the CETA Joint Committee on the Interpretation of Certain Terms in Article 8.10, Annex 8-A and Article 8.39").

II.II Elements to Consider When a "Green" IIA is Applicable

In light of the above description, investors, whose investments are protected by a new-generation IIA, should conduct a proper due diligence of both the scope of protection provided by the applicable IIA and the climate related obligations imposed by the host State domestic legislation. Among others, important elements to be considered are:

- Whether an investment that is not made in accordance with the host State's environmental legislation could be denied treaty protection or receive a lower amount of damages compensation.

- Whether the applicable IIA provides for the host State's right to regulate on climate related issues (including regulatory measure that might negatively impact foreign investors) and whether these regulatory changes are covered by carve-out clauses or general exceptions.

- Whether the failure by the host State to promote sustainable development and to take action to combat climate change may have contributed to reduce or destroy the value of the investment, translating into a breach of a standard of protection and a potential treaty claim.

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