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Analysis of the EU proposal to change the Definition of Economic Activity in the Energy Sector as part of the modernisation of the Energy Charter Treaty

INTRODUCTION

The [Energy Charter Treaty](#) (ECT) is an investment agreement from 1994, which protects investments in the energy sector. It can be used by energy companies to challenge almost any state measures that harm their profits. Recently, it has also been used to target climate action and seek compensation. For instance, on 3 February, it emerged that German energy giant [RWE is suing the Netherlands](#) over its coal phase-out.

The ECT is currently undergoing a reform process. The Definition of Economic Activity in the Energy Sector is one of the most important topics under discussion as part of this reform. It defines which economic activities should benefit from the extensive investment protection provisions of the agreement and therefore provides ECT contracting parties with an opportunity to abandon the controversial investment protection for fossil fuel investments, which would be necessary to bring the ECT in line with climate commitments.

The EU has yet to announce its negotiation position for the Definition of Economic Activity but in October 2020, a draft position was leaked. This analysis is based on this initial draft position. The EU needs to submit a final version on Monday 15 February in order for this issue to be discussed at the upcoming modernisation round from 2-5 March. Few changes to the original draft are expected.

SUMMARY

With this proposal, the EU misses an opportunity to try and align the ECT with climate commitments. A large share of fossil fuel investments would continue to be protected under the ECT for a long period and most controversially, the EU intends to even expand the definition of economic activity to new technologies. The latter would further increase the risk of Investor-State Dispute Settlement (ISDS) challenges against ECT members as we set out in several examples in the analysis below.

Climate Action Network (CAN) Europe regrets a lack of ambition in the Commission's proposal for the following reasons:

1. Investment protection for future fossil investments should have been ended without the proposed exemptions for gas infrastructure.
2. Investment protection for existing fossil investments should be ended immediately but at the latest 1-2 years after the amendment takes effect, whereas the Commission had proposed 10 years in the draft from October.
3. The Definition should not expand investment protection to hydrogen, biomass, other technologies or the operation and maintenance of energy-related equipment.

Investment protection for future investments

In short: *The EU's position is to exclude future investments in fossil fuels from the definition. We welcome this suggestion. However, the proposal contains broad exemptions for certain gas power plants and pipelines, which should not have been granted.*

Reasons: Investment protection for gas is unnecessary and dangerous. [CAN Europe's Paris-compatible Energy Scenario](#) shows that gas is not needed as a bridge technology and must be gone from the EU's electricity mix by 2035 in order to limit temperature rise to 1.5°C.

Even if one believes that gas is required, this would only ever apply for a very limited time span. The ECT, however, would protect these gas investments for the lifetime that the investor could reasonably expect to run his gas plant or infrastructure. Investors would be due compensation not just for money they actually lost because of their assets becoming stranded, they could even claim compensation for future prospective losses. The gas exemption therefore creates a large financial risk for taxpayers without any need. According to an [OECD study](#), there is no conclusive evidence that the existence of an investment protection treaty leads to more investments.

Some more notes on the exact formulation of the gas exemption: The EU proposal foresees to continue investment protection until the end of 2030 for gas “power plants and infrastructure enabling the use of renewable and low-carbon gases, and emitting less than 550 g of CO₂ of fossil fuel origin per kWh of electricity.” 550g of CO₂ per kWh is a very high threshold compared to those intended for the EU's taxonomy. In its [Technical Report from March 2030](#), the EU Technical Expert Group on Sustainable Finance considers only “facilities operating at life cycle emissions lower than 100gCO₂e/kWh, declining to 0gCO₂e/kWh by

2050” sustainable. A [leaked draft Delegated Act](#) finds that gas power plants that emit more than 270gCO₂e/KWh do significant harm to climate mitigation.

An emission threshold of 550g of CO₂ per KWh could lead to ISDS claims from gas power plant investors in the future, if the EU or individual Member States were to introduce legislation requiring gas power plants to shut down or make additional investments if they were for instance above the “do no significant harm” threshold of 270g of CO₂ per KWh. Investors could bring an ISDS claim arguing they could reasonably expect to run a less efficient power plant as long as it emits less than 550g of CO₂ per KWh.

To summarise, **the gas exemption could become a major stumbling block for reaching the EU’s climate targets.**

Protection for existing investments

In short: *The EU wants to phase out investment protection for existing coal, gas and oil investments, which we welcome. However, the change would only take effect 10 years after the ECT is amended, which is much too late to avoid ISDS cases in particular of coal investors that could challenge governments legislating coal phase-outs.*

Our position: Investment protection for fossil fuels should be phased out once the amendment comes into effect. If at all, a transition period of no longer than 1 or 2 years instead of the proposed 10 years could be considered. Investment protection must end as soon as possible in order to allow states to fulfil their commitments under the Paris Agreement. Within the EU, coal must be phased out by 2030, gas by 2035 and oil by 2040 to have a chance to limit temperature rise to 1.5°C. The ECT even with this change would continue to hinder the phase-out of fossil fuels and create an unreasonable financial burden for taxpayers.

Expansion of the scope of investment protection to new technologies

In short: *The EU proposes to grant investment protection to economic activities that are currently not covered under the ECT, including hydrogen and biomass. Any expansion of the scope of the treaty should be rejected both because this expansion is unnecessary to attract investments and because it would significantly increase the risk of investor claims under the ECT’s outdated and dangerous ISDS system.*

Reasons:

- An expansion of the scope of the treaty is not needed to attract investments in renewable energy. There is no conclusive evidence that the existence of investment

treaty protection increases investment (see [OECD working paper](#)). Other factors are by far more important to increase the attractiveness of a location for renewable energy investors (see for instance [BNEF Market Outlook](#)).

- Any expansion would increase the risk of new ISDS cases. Given the many flaws of this old ISDS system – which are recognised by the European Commission and Member States themselves – it is inconsistent to consider expanding access to ISDS. Any reform of the ISDS provisions as part of the ECT modernisation are unlikely to happen despite the repeated attempts by the EU to put ISDS reform onto the agenda, which has been opposed by Japan from the beginning.
- Governments could be dissuaded from establishing support schemes to renewable energies if changes to these subsidies can be targeted with ECT-based claims. This is particularly true given the limited chances to reform the extensive privileges that the ECT grants to investors.

Specific concerns in relation to the EU's position to extend investment protection to certain economic activities:

Hydrogen:

Hydrogen is not per se clean. Its environmental impact is determined by its production method. At the moment, about 95% of hydrogen is produced from fossil fuels - fossil gas and coal without carbon capture and storage. Renewable hydrogen has the best climate balance and is produced via electrolysis of water using renewable energy.

The EU's position does not distinguish between fossil and renewable hydrogen. This could lead to ISDS claims from investors in fossil fuel-derived hydrogen if future regulations would for instance make carbon capture and storage mandatory or set maximum emissions levels, so that some production facilities would have to cease operating.

Investment protection should therefore not be granted to hydrogen. Non-renewable hydrogen must be disqualified because of their doubtful environmental merits. But even investment protection for hydrogen produced with renewable electricity could become highly problematic.

The EU's Hydrogen Strategy foresees [investments of between 320 billion and 458 billion euros](#) until 2030 - to increase electrolyser capacity, additional capacities in renewable energy to feed the electrolysers and for hydrogen transport, distribution, storage and refueling stations.

Given the extensive investment protection standards of the ECT, a range of situations could occur, in which governments could be impaired in regulating the renewable hydrogen expansion or be taken to arbitration for seemingly unrelated measures. For instance, the

profitability of hydrogen plants is largely determined by the cost of renewable energy, electrolyzers and the cost of capital. Many state actions that would increase the price of either of these factors could be challenged in arbitration tribunals, who may find that the 'legitimate expectations' of an investor were violated and compensation could be awarded.

Other possible challenges from renewable hydrogen investors could concern changes in support schemes. Spain has been sued over 50 times by investors in solar energy after the country had made changes to its subsidy regime. This should give states reason to caution.

Biomass:

Power plants that produce electricity by burning biomass, with timber being the main source, are considered 'renewable energy' in the EU, even though the technology's social and environmental impact can often be negative.

In particular, biomass is often linked to deforestation. Sustainable supply of timber is very limited and potentially insufficient to fulfill future demand if biomass is further encouraged as a way to meet renewable energy targets.

It is likely that states will want to raise social and environmental standards for biomass plants, for instance by introducing stronger emission standards to prevent a negative impact on local resident's health or by mandating that the feedstock needs to come from sustainable sources. The Commission has already committed to assess the sustainability of biomass use for energy (Biodiversity Strategy) and has included the option to review the sustainability criteria for forest biomass in the Inception Impact Assessment for the review of the Renewable Energy Directive. It may also be necessary to ensure emissions from biomass are adequately priced in through the EU's CO₂ accounting framework or through taxation measures.

Such measures could be challenged under the ECT instead of local courts. For example, the German company RWE's permit to burn biomass in its two power plants in the Netherlands is currently being challenged in Dutch courts, based on the local environmental legislation. Any such decisions that could make an investment inoperable or lower its expected profit could in the future allow the investor to claim massive amounts of compensation under the ECT.

EU member states and the UK are [paying out over €6.5 billion in subsidies](#) per year to biomass burning facilities. Changes to these subsidy schemes could also potentially trigger ISDS claims.

Other energy products:

The EU also proposes to expand the treaty to undenatured ethyl alcohol of an alcoholic strength by volume of 80 % or higher, methanol and formic acid, all of which can be used to generate electricity, but the processes to do so are still being refined.

Methanol and ethanol are so far mainly used to fuel vehicles. However, recent innovations have given them some applications in the energy system. Methanol is for instance used as a

hydrogen carrier and to fuel generators. Ethanol can also be used to generate electricity. Both Methanol and Ethanol can be derived from fossil and renewable sources. Formic acid is used in fuel cells and tested as an alternative to hydrogen for some applications.

The viability of these technologies is at best unproven and more R&D will be needed over the coming years to assess their use for the clean energy transition. It is therefore surprising that the EU proposes to include them under the investment protection of the ECT and we strongly advise against such a step, in particular in the absence of a thorough impact assessment.

Operation and maintenance of Energy-Related Equipment:

“Energy-Related Equipment” is defined in the ECT’s Annex [EQ I](#) and [EQ II](#). It lists dozens of different types of equipment, for instance tubes and pipes used in oil or gas pipelines, drilling equipment, fuel tanks, containers for liquefied gas, nuclear reactors, central heating boilers, turbines, industrial furnaces and ovens and all kinds of machinery used in the extraction and processing of fossil fuels.

We strongly oppose the suggested expansion of investment protection to the operation and maintenance of all these items. First of all, a lot of equipment used in fossil fuel production would suddenly enjoy investment protection under the ECT, thereby seriously undermining the intention to phase out the protection for fossil fuel investments. Secondly, the risks associated with such a vast expansion of the scope of the treaty has not been analysed, which gives reason to believe that the full implications of this proposal have been understood by those making the suggestion.

It also seems that there is an attempt to greenwash this proposed change to the ECT in the EU’s proposal, which suggests adding “energy efficient goods used for energy purposes” to the list of Energy-Related Equipment.

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