CAN EUROPE POLICY BRIEFING ON THE ENERGY CHARTER TREATY

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Climate Action Network (CAN) Europe is Europe's leading NGO coalition fighting dangerous climate change. With over 170 member organisations from 38 European countries, representing over 1.500 NGOs and more than 47 million citizens, CAN Europe promotes sustainable climate, energy and development policies throughout Europe.

The Energy Charter Treaty is an international agreement that protects foreign investors in the energy sector and allows them to challenge state measures in Investor-State Dispute Settlement (ISDS). The treaty is incompatible with the EU's climate commitments and the current modernisation process will not fix this, as the necessary reforms are either opposed by other contracting parties or not being discussed. We therefore urge the EU and its Member States to leave the treaty and to conclude an additional agreement that excludes the possibility of ISDS cases amongst the withdrawing parties. The EU and its Member States should also ensure that no further countries join the treaty.

1. WHAT IS THE ENERGY CHARTER TREATY (ECT)?

The Energy Charter Treaty (ECT) is an international agreement signed in 1994. There are currently 53 contracting parties, including the EU, nearly all European countries, Turkey, Central Asia and Japan. It grants foreign investors in the energy sector extensive protection that in practice goes far beyond the property protection that any company has under national law (see box 2). It also gives foreign investors access to a private arbitration mechanism known as Investor-State Dispute Settlement (ISDS). Rather than having to use national courts – like everybody else – investors can use these private arbitration panels that consist of only three investment lawyers, to claim millions, sometimes billions of Euros in compensation.

2. WHY IS THE ECT INCOMPATIBLE WITH THE EUROPEAN GREEN DEAL?

The ECT protects all investments in energy supply, from extraction to consumption, including mines, oil and gas fields, pipelines, other energy infrastructure, refineries and power stations. Energy companies have used it to challenge a range of state measures that harmed their profits. Compensation claims were for instance made against environmental rules, measures to alleviate fuel poverty and cuts in subsidies. Recently, we have also seen a number of cases where the ECT is being used against governments that are limiting the use of fossil fuels (see Box 1).

More cases targeting climate policies are expected to arise once Member States start to implement the commitments they have made as part of the Green Deal and the Paris Agreement. Coal mines and power plants will have to be shut down, oil and gas operations ceased and even new gas infrastructure being built now will have to be decommissioned well before their expected lifetime.

In many cases, investors will be able to use the ECT to claim compensation for such policies. A new report from the International Institute for Environment and Development (IIED) for the first time quantified the effects the ECT could have solely on the phase-out of coal and found that it protects at least 51 coal-fired power stations.

The energy system needs to be altered comprehensively and swiftly to achieve the EU's climate neutrality objective. This will not succeed if the ECT continues to protect fossil fuel investments, making the energy transition prohibitively expensive and slowing down necessary decisions. Even the threat of a case can be enough to persuade a government to water down or halt proposed regulations that would otherwise support the energy transition. The ECT is therefore a powerful tool in the hands of fossil fuel firms.

Box 1. *Some examples of how fossil fuel firms are using the ECT against climate action*

Rockhopper: In 2017, the British oil and gas company Rockhopper brought a claim against the Italian government under the Energy Charter Treaty, after the Italian Ministry of Economic Development had rejected the company's application for an oil production concession for the Ombrina Mare area. The Ministry's decision followed a ban introduced by the Italian Government on oil and gas exploration near the country's coastline, stemming from environmental concerns and opposition to such projects by local residents. Rockhopper's claim is funded by a third-party funder, i.e. an investment bank or other funder who is paying Rockhopper's legal fees in exchange for a part of the final award. This highly problematic practice is increasingly common in ISDS and, by lowering the financial risk to the investor, could increase the number of claims brought against states.

Uniper: In December 2019, the Dutch government enacted a law to phase out coal-powered electricity production by 2030. Following the decision, the German company Uniper started to challenge the measure under the ECT. The company owns a coal-fired plant near Rotterdam, which was opened in 2016 and would now be required to use another fuel type, such as biomass, or close. As the dispute is still in its early stages, not much is known about the content of the claim. However, Uniper is reportedly seeking 1 billion EUR in compensation, and the company's representatives have argued publicly that the law amounts to indirect expropriation. Moreover, Fortum (a majority shareholder in Uniper) has stated that the ECT "protects the rights of companies in the event of unilateral regulatory changes". It is therefore likely that Uniper will argue that the Dutch law violates the company's legitimate expectations to be allowed to run the power plant for its expected lifespan of up to 40 years.

Vermilion: In 2017, the French Environment Minister drafted a law intended to phase out fossil fuels by 2040. Soon thereafter, the Canadian company Vermilion - one of the largest oil producers in France - informed the French government that it would bring a claim under investor-state dispute settlement if the proposed law was passed. Vermilion reportedly argued that the proposed law violated six different standards of protection provided to investors under the ECT, including the fair and equitable treatment provision and expropriation. Vermilion's threat of a costly and unpredictable arbitration seems to have had the intended effect, as the French government eventually passed a revised version of the law, which included a possibility for companies to renew their oil exploration permits until 2040 and, in some cases, even afterwards.

3. WHY IS THE ECT A THREAT TO PUBLIC BUDGETS?

Arbitration panels can award huge amounts of money to investors. Up to 2018, governments have been ordered to pay at least $US51.2 billion in damages to investors in ECT disputes. This only includes figures from disputes where this information has been made public. At least $35 billion is still at stake in ongoing disputes that are publicly known. For example, the sum that investors in ongoing cases are claiming from Spain is over €3.3 billion.

In several cases, the sums awarded by far exceeded the companies' investment because under the ECT they are entitled to compensation for future hypothetical profits that they could have made without a change in regulation. The UK firm Rockhopper, for instance, is demanding up to $350 million in compensation from Italy according to Rockhopper's CEO Sam Moody, which is seven times the sum they initially invested (for details on this case, see Box 1).

Even the costs of defending an ISDS claim under the ECT can be very expensive for states. The German government recently stated that they had already spent €21.7 million in legal costs in an ongoing dispute with Swedish Vattenfall over the German nuclear phase-out. There is no rule that the losing party has to cover the costs of arbitration, so quite often, states have to bear the legal costs even if they win a case.

The huge and unpredictable amounts arbitration panels can award create high uncertainty for states trying to make their energy system fit for climate mitigation. By threatening to put a high price tag on climate policies, the ECT could dissuade governments from swiftly phasing out fossil fuels.

4. WHY IS THE ECT OUT OF CONTROL?

Investor claims under the ECT are not decided by independent courts but by private arbitration panels, consisting of three investment lawyers. These arbitrators are paid on a case-by-case basis, which gives them a financial incentive to inflate the number of cases. It is therefore unsurprising that the provisions in investment agreements have often been interpreted in an investor-friendly way (see Box 2).

Since the ECT foresees no institution that could correct the interpretation of arbitration panels, the system is effectively out of any democratic or even legal control. Governments have set it up but can do little to take back control since any change to the treaty would require unanimous support from all ECT parties. There is also no appeal mechanism, so once a ruling has been made, it is final. If the state does not pay out, awards can be enforced in any country worldwide by asking a local court to confiscate state assets.

5. THE ONGOING REFORM PROCESS: CAN IT SOLVE THESE PROBLEMS?

The ECT would need very substantial reforms to allow countries to transform their energy systems in line with the Paris Agreement and the Green Deal without risking compensation claims. Firstly, the ISDS system would have to be removed and, secondly, the protection for fossil fuels would have to be ended. Neither of these objectives will be achieved in the ongoing reform process, nor will the reform solve the ECT's incompatibility with EU law.

Even the EU recognises that the investment protection system under the ECT is "outdated" and would like to bring the ECT in line with the investment standards used in more recent EU investment agreements, such as the one in the Comprehensive Economic and Trade Agreement (CETA) with Canada. This would be required to ensure the ECT fulfills the requirements for compatibility with EU law as set out in *Opinion 1/17* of the Court of Justice of the European Union. However, changes to the ECT's ISDS system will not even be discussed. The EU has tried to add ISDS reform to the 25 negotiation topics but Japan has already decisively rejected this attempt. This means that one of the EU's top objectives for reform is unattainable.

The European Parliament included in the European Climate Law an amendment that calls for the exclusion of fossil fuels from protection under the Energy Charter Treaty. We warmly welcome this position and call on the European Commission and the Member States to make this the official EU position. However, even if the EU adopts this view, it is highly unlikely to achieve such a significant change in the negotiations. All changes to the ECT have to be taken unanimously by all 53 Contracting Parties and some of them have little appetite for reform. In fact, Japan has stated on all 25 negotiation topics that they don't want any changes.

The European Commission has consistently argued that the intra-EU application of the ISDS system is incompatible with EU law and it has intervened in ISDS proceedings to challenge the jurisdiction of tribunals. In its *Achmea* judgement in 2018, the Court of Justice of the European Union considered that the use of ISDS in disputes between EU member states could hinder the efficacy of EU law and undermine fundamental values of the EU, such as the principles of sincere cooperation and mutual trust. So far, the ECT tribunals have been able to reject such arguments against intra-EU application because they are not bound by EU law. The lack of compatibility between the two legal regimes will not be solved by the modernisation process either.

6. WHAT HAS TO HAPPEN INSTEAD TO STOP THE ECT FROM OBSTRUCTING CLIMATE ACTION?

For the above reasons, we don't believe that the ECT reform process will succeed in making the ECT harmless from a climate perspective. We therefore urge the EU and its Member States to take alternative measures to remove the ECT as an obstacle to the clean energy transition:

First, the EU and EU Member States need to jointly withdraw from the ECT, ideally together with our neighbouring EFTA countries, the UK and Balkan accession states. This should happen as soon as possible because investments taken after withdrawal are no longer protected under the ECT. Given that even today, a majority of new investments in the energy sector are in fossil fuels, not renewable energy, the sooner we withdraw, the fewer fossil fuel investments will fall under the protection of the treaty. This is particularly important to avoid a lock-in in natural gas technologies and infrastructure.

Our Paris-compatible energy scenario shows that gas is not required as a bridge technology but even if one believes that gas is needed, 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. The ECT could be used to pass costs for stranded assets on to taxpayers. The sooner we withdraw from the ECT, the lower our liabilities to investors.

Secondly, withdrawing from the ECT alone is not enough, as the treaty contains a so-called "sunset clause", which allows existing investors to sue governments for 20 years after they have withdrawn from the ECT. To mitigate this problem, the withdrawing countries should adopt an agreement that excludes investor claims within this group of countries.

Lastly, the EU should stop any attempts to expand the ECT internationally. As things stand, dozens of low and middle income countries, in Africa, Asia and Latin America, are being encouraged to join the ECT. The European Union and Member States should ensure no funds are going towards this expansion process and most importantly, they should oppose the admission of any new members.

Box 2. *Dangerous investors' rights under the ECT - what makes this treaty so dangerous*

The ECT protects a range of foreign investors' rights, including a guarantee for so-called 'fair and equitable treatment' (FET), which past arbitral tribunals have interpreted broadly. In investment arbitration, the FET standard is sometimes referred to as a "super standard" due to the high number of successful claims invoking it. This stems partly from the open-ended formulation of the clause, which leaves tribunals significant leeway in interpreting investors' rights. Perhaps most controversially, arbitral tribunals have found the FET standard to mean that the host state must, in implementing new regulations, respect the investor's "legitimate expectations".

While it is generally agreed that the investor's expectations must be reasonable in order to be protected, some tribunals have in practice adopted a very broad definition of how such expectations may reasonably arise, therefore limiting the regulatory space of the state. For example, in *Eiser v Spain*, the tribunal stated that the investor could legitimately expect the state not to fundamentally change its legal framework and considered that the measures introduced by the Spanish government to roll back the incentives given to renewable energy constituted such a fundamental change.

Other decisions, such as *Greentech v Spain* and *Novenergia v Spain*, have also recognised that the ECT protects investors from radical and fundamental changes to the legal framework. In *Novenergia*, the tribunal concluded that the Spanish measures in relation to the incentives for renewable energy constituted a violation of the investor's legitimate expectation that the legal framework would not be fundamentally or abruptly changed in a way that would "deprive them of a significant part of their projected revenues".

Beyond the general expectation of regulatory stability, tribunals have also stated that investors can base their expectations on specific commitments made by the state in relation to their investment. In such cases, tribunals have given the state's freedom to regulate even less weight. While the term "specific commitments" is generally regarded to refer to promises made by state representatives directly to the investors, for example for the purposes of attracting their investment, some tribunals have gone beyond this. Indeed, the tribunal in *Antin v Spain* considered the government to have made a specific commitment to the investor by adopting a Royal Decree, due to the detailed language used in the regulation.

Overall, for a finding of a breach of legitimate expectations, even a relatively modest negative impact on the investment is sufficient, as long as the investor can show that their expectations towards the state were 'reasonable'. There has been a lack of consistency even among the different cases arising out of the measures implemented by Spain, for example, which further contributes to the lack of predictability when it comes to the regulatory space of the state.

For questions and comments regarding this CAN Europe policy briefing, please contact Cornelia Maarfield, Trade and Climate Project Manager at cornelia@caneurope.org.