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Painting the Grass Green: A Climate Change Carve-Out in Investment Agreements

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ABSTRACT

During the Twenty-Eighth Session of the Conference of the Parties (COP-28) of the United Nations Framework Convention on Climate Change (UNFCCC), States recognised the critical need to accelerate efforts to mitigate climate change and called on Parties to take action to transition away from fossil fuels in energy systems, to achieve net zero emissions by 2050. However, implementing such a transition finds obstacles in investor-State dispute settlement (ISDS) mechanisms, which can undermine regulatory actions necessary for climate policies, leading to a 'regulatory chill'. As a response to these challenges, the Organisation for Economic Co-operation and Development's (OECD) Future of Investment Treaties program has proposed a model carve-out provision to exclude fossil fuel sectors from ISDS protection with procedural safeguards, but its effectiveness may be limited. A holistic reform of investment agreements and additional measures, such as withdrawal from international investment agreements, are necessary to safeguard regulatory space and promote sustainable investment and a just transition.

KEYWORDS: *Climate Change, International Investment Agreements, Investor-State Dispute Settlement (ISDS) Mechanisms, Fossil Fuels, Sustainable Investment, Just Transition*

Lors de la vingt-huitième Conférence des parties (COP-28) de la Convention-cadre des Nations unies sur les changements climatiques (CCNUCC), les États ont reconnu la nécessité d'intensifier les efforts visant à atténuer les conséquences du changement climatique et ont appelé les parties à prendre des mesures en vue de réduire leur dépendance aux énergies fossiles en matière énergétique et atteindre l'objectif de zéro émission nette en 2050. Toutefois, la mise en œuvre d'une telle transition se heurte aux mécanismes de règlement des différends entre investisseurs et États, qui peuvent remettre en cause les mesures réglementaires nécessaires à la mise en œuvre des politiques climatiques et entraîner un « gel réglementaire ». En réponse, le programme de l'Organisation de coopération et de développement économiques (OCDE) sur l'avenir des traités d'investissement a proposé un modèle de disposition permettant d'exclure le secteur des énergies fossiles du champ des mécanismes de règlement des différends entre investisseurs et États et prévoyant des garanties procédurales, mais son efficacité pourrait être limitée. Une réforme globale des accords en matière d'investissement et des mesures supplémentaires, telles que le retrait des traités internationaux d'investissement, sont nécessaires pour préserver l'espace réglementaire et promouvoir des investissements durables et une transition juste.

KEY MESSAGES

- "The staggering number of treaty-based ISDS claims involving fossil fuels in the energy sector…underscores the potential for these mechanisms to limit climate action and exacerbate the climate crisis."
- "…investor-State dispute settlement (ISDS) mechanisms can pose significant risks to climate change mitigation. These mechanisms…could potentially curtail States' regulatory space for implementing climate action and energy transition, leading to a 'regulatory chill'"
- "Although the objective of these efforts signals an important step towards restricting fossil fuel investments…the effectiveness of carve-out provisions has proven to be limited"
- "Developing countries should explore alternative measures to guarantee their right to design, adopt and implement measures against climate change. These options may include interpretative statements or renegotiating agreements."
- "There is also a need to consider that structural and procedural reforms to ISDS are insufficient to address the dreadful challenges climate change poses. This requires undertaking a holistic reform of investment agreements"

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MOTS-CLÉS: *Changements climatiques, Traités internationaux d'investissement, Mécanismes de règlement des différends entre investisseurs et États, Énergies fossiles, Investissements durables, Transition juste*

Durante el vigésimo octavo período de sesiones de la Conferencia de las Partes (COP-28) de la Convención Marco de las Naciones Unidas sobre el Cambio Climático (CMNUCC), los Estados reconocieron la necesidad crítica de acelerar los esfuerzos para mitigar el cambio e hicieron un llamado a las Partes Contratantes para adoptar medidas dirigidas a abandonar los combustibles fósiles en los sistemas energéticos, con el fin de lograr cero emisiones netas para 2050. Sin embargo, la aplicación de dicha transición encuentra obstáculos en los mecanismos de solución de controversias entre inversores y Estados (SCIE), que pueden socavar las acciones reguladoras necesarias para adoptar dichas políticas climáticas, dando lugar a un "enfriamiento regulatorio". Como respuesta a estos retos, el programa Futuro de los Tratados de Inversión de la Organización para la Cooperación y el Desarrollo Económico (OCDE) ha propuesto una disposición modelo para excluir a los sectores de los combustibles fósiles de la protección de la ISDS con salvaguardias procesales, pero su eficacia puede ser limitada. Es necesaria una reforma integral de los acuerdos de inversión y medidas adicionales, como la retirada de los acuerdos internacionales de inversión, para salvaguardar el espacio normativo y promover la inversión sostenible y una transición justa.

PALABRAS CLAVES: *Cambio climático, Acuerdos internacionales de inversión, Mecanismos de solución de controversias entre inversores y Estados (SCIE), Combustibles fósiles, Inversión sostenible, Transición justa*

Introduction

During the Twenty-Eight Session of the Conference of the Parties (COP-28) of the United Nations Framework Convention on Climate Change (UNFCCC), States recognised the need to increase global efforts to mitigate climate change, including by "transitioning away from fossil fuels in energy systems, in a just, orderly and equitable manner, accelerating action in this critical decade, to achieve net zero by 2050".[1]

However, the path to these goals necessitates reforming and adopting legislation and public policies to phase out fossil fuels and promote renewable energies. Yet, as the Intergovernmental Panel on Climate Change (IPCC) Working Group III (WG-III) has pointed out, investor-State dispute settlement (ISDS) mechanisms can pose significant risks to climate change mitigation. These mechanisms, if misused, could potentially curtail States' regulatory space for implementing climate action and energy transition, leading to a 'regulatory chill'. This is a situation where States are compelled to hesitate or delay the adoption of climate change policies crucial for achieving energy transition[2].

This situation is evidenced by the staggering number of treaty-based ISDS claims involving fossil fuels in the energy sector. Since 1977, fossil fuel companies have initiated 349 ISDS claims, with 89 resulting in damage awards for investors and 67 cases settled, amounting to a staggering $82.8 billion in damage awards. The United Nations Special Rapporteur on the issue of human rights obligations relating to the enjoyment of a safe, clean, healthy and sustainable environment has also acknowledged this situation, emphasising that "the growing number and magnitude of ISDS claims is impeding the clean energy transition and escalating the costs, often to the advantage of the very corporations responsible for causing the climate crisis"[3].

In light of the pressing imperative to combat climate change, States have undertaken efforts to limit the effects of ISDS in the energy transition and to achieve their commitments under the UNFCCC and the Paris Agreement. As part of these efforts, some States have considered the relevance of including carve-out provisions in investment agreements to exclude the fossil fuel sector from the purview of investment protection and reduce the risk of costly investor-State disputes. Although the objective of these efforts signals an important step towards restricting fossil fuel investments to fall under the protection of investment agreements, the effectiveness of carve-out provisions has proven to be limited[4]. Therefore, besides carve-out provisions, States could also consider other measures intended to safeguard their regulatory space towards adopting climate change policies.

The Carve-out on Climate Change Model Provision

In 2021, the Organisation for Economic Co-operation and Development (OECD) established the Future of Investment Treaties work programme[5]. The work programme recognised the crucial role of investment treaties in regulating foreign investment. Still, it highlights the need to update these treaties to address pressing issues like climate change. Under Track 1 of this programme, the OECD focuses on the interaction between investment treaties and climate change. This track encompasses various aspects, including determining which types of investment should be promoted and protected, the role of investment treaties in fostering market openness and supporting climate-friendly investments, and assessing how investment treaties might affect government policy flexibility for climate action.

During the OECD 9th Annual Conference on Investment Treaties, a paper was submitted as an academic contribution, incorporating a proposal for a carve-out provision from ISDS mechanisms for measures to reduce greenhouse gas emissions[6]. This carve-out aims to expedite the resolution of investor challenges

1 See: Report of the Conference of the Parties serving as the meeting of the Parties to the Paris Agreement on its fifth session, held in the United Arab Emirates from 30 November to 13 December 2023.
2 Ibid.

3 David R. Boyd, Paying polluters: the catastrophic consequences of investor-State dispute settlement for climate and environment action and human rights, Report of the Special Rapporteur on the issue of human rights obligations relating to the enjoyment of a safe, clean, healthy and sustainable environment, UN Doc. A/78/168.
4 Daniel Uribe and Manuel Montes, "Building a Mirage: The Effectiveness of Tax Carve-out Provisions in International Investment Agreements", Investment Policy Brief, No. 14 (Geneva, South Centre, 2019). Available from https://www.southcentre.int/investment-policy-brief-14-march-2019/ (accessed 04.05.2024).
5 See Organisation for Economic Co-operation and Development, The Future of Investment Treaties in https://www.oecd.org/investment/investment-policy/investment-treaties.htm (accessed 06.05.2024).
6 See: Joshua Paine and Elizabeth Sheargold, Future of Investment Treaties Track 1 -- Investment Treaties and Climate Change, Organisation for Economic Co-operation and Development, Document DAF/INV/TR1/RD(2024)1 (2024) in https://one.oecd.org/document/DAF/INV/TR1/RD(2024)1/en/pdf (accessed 07.05.2024).

to climate measures, ensuring States maintain control over its application. The model provision includes a procedural mechanism delegating environmental authorities of the treaty parties to decide on the nature of the measures under revision and the possibility of establishing a State-State panel to consider the nature and extent of the measure under review. The paper prepared by the OECD also includes safeguards to prevent abuse, such as requiring consensus among environmental authorities on the nature of the measures and allowing recourse to State-State dispute settlement to challenge protectionist or unfair measures.

The Effectiveness of Carve-out Provisions

Investment treaties' practices have shown that most carve-out provisions use the model of a "*Matryoshka* type clause."[7] The extent to which a carve-out provision achieves its objectives depends on the exceptions linked to its implementation. For example, the Energy Charter Treaty (ECT) contains a general carve-out on tax measures. Still, it also enumerates the provisions that apply with respect to tax measures, including prohibitions against discrimination, uncompensated expropriation, and measures that "arbitrarily restrict benefits accorded under the Investment provisions of this Treaty"[8].

Although the carve-out provision proposed by the OECD excludes the application of ISDS to measures taken to address climate change, the procedural mechanisms and language included in the model provision might limit its effectiveness as a general exception. For example, the use of a joint committee procedure between the authorities of the Parties to the investment agreement has been recognised as a pre-procedural requisite[9] and not a complete carve-out. Similarly, tribunals have recognised that such a mechanism is not compulsory as it is time-barred and does not prevent these measures from being considered under a tribunal's jurisdiction, particularly if the measure under review is presumed discriminatory or amounting to expropriation[10].

Including a State-State panel to review the measure's nature and scope is a significant step towards safeguarding the State's regulatory space and promoting the Party's ownership of the agreement. Nonetheless, this panel has been considered a means to avoid the abuse of the carve-out[11] rather than a mechanism to strengthen the role of States. The State-State Panel could be considered the mandatory and only mechanism for resolving this kind of dispute, particularly considering that measures falling under the climate change carve-out provisions should be taken *bona fide* in line with clear objectives towards climate change mitigation.

7 William W. Park, "Arbitrability and Tax", in *Arbitrability: International and Comparative Perspectives*, Loukas A. Mistelis and Stavros L. Brekoulakis, eds. (The Netherlands, Kluwer Law International, 2009).
8 The Energy Charter Treaty (1994), Article 21.3 (b).
9 *Marvin Roy Feldman Karpa v. United Mexican States*, ICSID Case No. ARB(AF)/99/1 (2002)
10 *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, UNCITRAL, PCA Case No. AA 227 (2014).
11 See: Paine and Sheargold (2024), p. 7.

In addition, the OECD proposal requires a nexus between the measure under review and the objective pursued, particularly that such a measure is "capable of contributing to climate change mitigation, but without imposing the more demanding requirements of necessity tests.[12]" Although the proposed carve-out seems to have moved away from the high threshold of the necessity test, this language might not be sufficient to limit ISDS tribunals' intervention in cases involving climate change measures. ISDS tribunals have interpreted carve-out provisions as not preventing them from hearing a claim to the extent of determining that carve-out provisions do not prevent the payment of compensation for measures that affect the investor's legitimate expectations.[13]

Carve-out Provisions are not the 'Only' Option

The OECD proposal mentions that the carve-out provision could be developed in conjunction with other measures to reduce greenhouse gas emissions, such as excluding fossil fuel investments from the investment agreement's coverage.[14] Nevertheless, other options can be more effective than introducing carve-out provisions or sectoral exceptions.

For example, the European Union Member States have recently consented to a unilateral withdrawal from the ECT because the treaty does not consider the need for adopting strong climate change policies, including the need to "immediately prohibit fossil fuel investors from suing contracting parties for pursuing policies to phase out fossil fuels in line with their commitments under the Paris Agreement"[15]. Similarly, the European Commission has engaged with Canada to prepare an interpretative statement aimed at clarifying the Comprehensive Economic and Trade Agreement Between Canada and the European Union (CETA) aimed at avoiding the misuse of ISDS mechanisms in the framework of legitimate public objectives adopted in climate, energy and health policies.[16]

There is also a need to consider that structural and procedural reforms to ISDS are insufficient to address the dreadful challenges climate change poses. This requires undertaking a holistic reform of investment agreements, including reconsidering the usefulness of ad-hoc tribunals, which are characterised by their lack of legitimacy, transparency, and consistency, becoming the monster that were supposed to fight: an unstable and opaque regulatory investment framework. The experience of developing and developed countries alike has showcased that termination or withdrawal of investment agreements is a viable option[17], in particular given the unbalanced approach that exists

12 Ibid.
13 *Eco Oro Minerals Corp. v. Republic of Colombia*, ICSID Case No. ARB/16/41, Decision on Jurisdiction, Liability and Direction on Quantum (2019), para. 380 and para. 805. See also: *Bear Creek Mining Corporation v. Republic of Peru*, ICSID Case No. ARB/14/2 and *Infinito Gold Ltd. v. Costa Rica*, ICSID Case No. ARB/14/5.
14 See: Paine and Sheargold (2024), p. 2.
15 See: Energy Charter Treaty: withdrawal of the Union, 2023/0273(NLE) in https://oeil.secure.europarl.europa.eu/oeil/popups/ficheprocedure.do?lang=en&reference=2023/0273(NLE).
16 Statement from the Commission on clarifications discussed with Germany regarding investment protection in the context of the CETA agreement (2022)
17 Agreement for the termination of Bilateral Investment Treaties between the Member States of the European Union, Document SN/4656/2019/INIT and Ank Santens and Estefania San Juan, "Latin American Arbitration in Transition",

between investment protection and investor obligations, as well as safeguarding the regulatory space of States.

The African Continental Free Trade Agreement Protocol on Investment[18] also has recognised the need to promote and facilitate investments linked to mitigating greenhouse gas emissions and the negative impacts of climate change (Article 26), including by applying "the precautionary principle to their environmental impact assessment and to decisions taken in relation to a proposed investment, including any necessary mitigating or alternative approaches to the investment, or precluding the investment if necessary" (Article 34).

These innovative measures are accompanied by exceptions to particular provisions. For example, the Protocol establishes that measures adopted by a State Party applied to enhance climate action shall not be construed as a breach of the Most-Favoured-Nation Treatment and National Treatment clause. Likewise, Article 20.2 recognises that regulatory measures adopted by a State Party designed to protect legitimate public policy objectives, including the protection of the environment, will not constitute indirect expropriation. Although the Annex on Rules and Procedures governing Dispute Prevention, Management and Resolution of Disputes is yet to be developed, the Protocol requires investors and States to resolve their disputes through amicable resolution mechanisms, and it is intended to balance the protection of investors with the right of States to regulate sustainable investment and pursue climate action.

Conclusions and Recommendations

The need to fight climate change and transition away from fossil fuels is clear and urgent. However, ISDS mechanisms pose a significant risk to States' efforts. The large amount of damages granted in ISDS claims involving fossil fuels in the energy sector underscores the potential for these mechanisms to limit climate action and exacerbate the climate crisis.

While carve-out provisions represent a step towards safeguarding the State's regulatory space for climate action, they alone may not be sufficient. Developing countries should explore alternative measures to guarantee their right to design, adopt and implement measures against climate change. These options may include interpretative statements or renegotiating agreements to clarify the relationship between ISDS mechanisms and legitimate public objectives, such as energy transition and risk mitigation. Other options include unilateral withdrawal from investment agreements that do not align with climate objectives, as seen in the European Union's decision regarding the Energy Charter Treaty.

Furthermore, a holistic reform of investment agreements is necessary. This reform process should not be limited to structural and procedural reform of ISDS. It could include moving away from ad-hoc tribunals towards more transparent and legitimate dispute resolution mechanisms. The African Continental Free Trade Agreement Protocol on Investment provides a good option for recognising the importance of climate action and incorporating provisions to balance investor protection with the right of States to regulate in the public interest.

Finally, it is important to consider that carve-out provisions on climate change are important for addressing the risks posed by ISDS mechanisms to climate action, but State efforts should not be limited to implementing them. On the contrary, they should be part of a broader strategy that includes structural reforms to investment agreements and proactive measures to promote sustainable investment and climate resilience.

Latin America Focus (Fall 2021, White & Case) in https://www.whitecase.com/insight-our-thinking/latin-american-arbitration-transition (accessed 07.05.2024).

18 See: Protocol to the Agreement Establishing the African Continental Free Trade Area on Investment (2023).

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