Kluwer Arbitration Blog

Regime Interaction in Investment Arbitration: Climate Law, International Investment Law and Arbitration

Anja Ipp (Climate Change Counsel) · Wednesday, January 12th, 2022

Nearly 30 years have passed since world leaders signed the UN Framework Convention on Climate Change ("UNFCCC"), agreeing to combat "dangerous human interference with the climate system." For many of those years, nobody seemed to take that commitment very seriously. But things look different now: climate law has hit its stride.

At COP26 in November 2021, world leaders signed the Glasgow Climate Pact, which aims to reduce unabated coal usage and fossil subsidies, and finalized the "rulebook" that operationalizes the 2015 Paris Agreement. Also in Glasgow, private-sector finance pledged billions of dollars toward climate change mitigation and adaptation. Meanwhile, regulators worldwide work around the clock to translate lofty Net Zero goals into concrete policy at the national level, and the EU is legislating at breakneck speed to become the first climate-neutral continent.

It is a new reality out there. In the words of US climate envoy John Kerry, the world has embarked on the "biggest economic transformation since the industrial revolution."

International investment law, however, seems at odds with these developments. Not only are international investment agreements ("IIAs") still largely silent on climate issues, but the very regulations that are necessary to meet climate law obligations may trigger liability under investor-protection provisions. Various processes to update the investment law framework is underway, but progress is slow and hampered by politics. Therefore, as this short overview will explain, it will be necessary for arbitration practitioners to consider the interaction between the *current* IIA regime and the climate law regime, and to interpret states' obligations to protect investors in harmony with obligations to reduce carbon emissions.

Climate Law in a Nutshell

At the center of the international legal framework of climate change is the 2015 Paris?Agreement. It has been ratified by 191 states and the European Union, which signals a near-universal global consensus on its main goal: to limit global average temperature rise to well below 2°C (preferably 1.5°C) above pre-industrial levels. As the Paris Agreement requires, most state parties have set ambitious emissions-reduction targets – known as Nationally Determined Contributions ("NDCs") – typically aimed at cutting emissions significantly by 2030 and achieving Net Zero carbon emissions by mid-century.

Before Paris, there was the 1997 Kyoto Protocol – the first treaty to stipulate that big emitters should take the lead in slowing climate change by reducing greenhouse gas emissions. The 2012 Doha Amendment extended Kyoto, but ratification took so long that it rendered the treaty obsolete. The Paris Agreement has now largely superseded these previous commitments and mechanisms.

Around the world, governments have taken legislative action to implement their commitments under the Paris Agreement. In Europe,?climate action is at the heart of the European Green Deal – a package of policy measures that aim to?transform the European economy and decouple growth from resource use. The?European Climate Law was passed in June 2021 and enshrines into law the goal of Net Zero by 2050. Another recent development was the European Commission's adoption of "Fit for 55," a series of legislative proposals setting?out how the EU intends to cut carbon emissions by 55% by 2030.

Globally, there has been a veritable explosion of climate-related laws and policies, putting pressure on corporations and other actors to take concrete steps to reduce carbon emissions and invest in measures to adapt to the effects of climate change. A parallel development can be seen in the rise in climate litigation in national courts. Most such court cases have demanded *government* action on climate change. Recently, however, several cases have also been filed against *corporations*.

So, that is climate law in a nutshell. Let us juxtapose it with international investment law and investor-state arbitration.

The Clash between Climate Law and Investment Law

In simple terms, the clash is obvious: Legislative and regulatory measures necessary to meet obligations under *climate law* are likely to trigger liability claims under *international investment law*. States have two main tools – a carrot and a stick – to accomplish reductions in greenhouse gas emissions. Both are accompanied by risks under investment law.

- *The carrot* involves incentivizing investments in low-carbon technologies. This creates new regulatory frameworks upon which foreign investors may base legitimate expectations of stability and profit, which (as we know from the Spanish saga) may lead to investor claims in the event of future amendments.
- *The stick* involves regulating emissions and phasing out fossil fuels. This changes the existing legal framework and regulatory environment for foreign investors and affects the value of foreign investments, which may lead to claims of indirect expropriation or breach of the fair and equitable treatment ("FET") standard.

Nowhere is the fault line between climate law and investment protection clearer than in the energy sector, which accounts for two-thirds of all greenhouse gas emissions. To meet their emissions targets, most countries will need to significantly alter their energy mix and limit the extraction, transportation and combustion of fossil fuels. The Glasgow Climate Pact explicitly requires countries to reduce fossil subsidies and "phase down" unabated coal (changed from "phase out" as a last-minute semantic compromise forced by coal-reliant China and India). Such measures will turn many fossil investments into stranded assets, which may lead investors to seek compensation under applicable investment treaties.

The most important treaty in the energy sector is the multilateral Energy Charter Treaty ("ECT"), which, despite years of "modernization" negotiations, still protects *all* investments regardless of climate impact. As will be shown in a forthcoming report, none of the 70+ awards rendered under the ECT has considered the host state's climate law obligations, weighed the investor protections against the state's right to regulate for emissions reduction, or in any other way analyzed the interaction between these two legal regimes.

ECT tribunals have, of course, considered the host state's right to regulate in *other* contexts – confirming, for example, that states may exercise this right as long as it does not affect "the fundamental stability in the essential characteristics of the legal regime relied upon by the investors in making long-term investments" (*Antin v. Spain*). They have also analyzed the interaction between the ECT and *other* legal regimes – ruling, for example, that in the event of an inconsistency between the ECT and EU law, the ECT will prevail (based on Article 16 ECT). It remains to be seen how tribunals will apply these standards in cases challenging state regulations to phase out fossil fuels; the first so-called "phase-out cases" were filed by foreign investors against the Netherlands in 2021.

There are two principal ways to reconcile the apparent conflict between international investment law and climate law: (1) by reforming IIAs to integrate climate principles or hierarchy clauses stipulating which obligations take priority, and (2) by reinterpreting current treaty provisions through general conflict norms, such as the principle of systemic integration. The former option involves lengthy political negotiations, whereas the latter requires only invocation by arbitral tribunals.

Reforming IIAs to Resolve the Conflict with Climate Law

Reform of the framework of international investment law and treaty arbitration is underway – not least in UNCITRAL's Working Group III, the ECT modernization process, and the revision of the ICSID arbitration rules – but progress is limited and slow, and the integration of climate principles is not necessarily a main focus.

Some countries have developed model BITs that include climate and sustainable development provisions. These treaties typically alter the traditional IIA structure, in which states have obligations but no rights, and investors have rights but no obligations. The Dutch model BIT, for example, requires investors to comply with domestic laws and to conduct environmental impact assessments. And the Pan-African Investment Code, a template treaty developed by the African Union, omits the FET standard and allows states to submit counterclaims in arbitral proceedings.

Some observers may insist that amending IIAs to align with climate law will reduce investment protection and impede the flow of FDI; others may contend that IIAs never really served to incite FDI in the first place. Either way, the investment law regime is not inherently incompatible with climate law, and there are many good ideas on how to reconcile the two through treaty revision. But the process to renegotiate IIAs is slow – and there are 3000 of them. Moreover, in the case of multilateral treaties like the ECT, the unanimity needed for amendments may be entirely unattainable. Therefore, it is necessary to consider how to reconcile *current* IIAs with climate law through general treaty-conflict norms, such as the principle of systemic integration.

Working With What We've Got – Reinterpreting Current IIAs

The principle of systemic integration embodies a normative preference for a coherent international legal system. It is codified in Article 31(3)(c) of the Vienna Convention, which requires tribunals to take into account "any relevant rules of international law applicable in the relations between the parties" when interpreting treaties. Some IIAs include similar provisions. For instance, Article 26(6) of the ECT provides that tribunals "shall decide the issues in dispute in accordance with this Treaty and *applicable rules and principles of international law*." This now includes the Paris Agreement, the Glasgow Climate Pact, and EU climate law. It may also soon include environmental law *principles*: Just as past claims have been dismissed based on the principle of good faith, future claims might be dismissed based on the polluter-pays principle.

Although tribunals already have the mandate to do so, systemic integration has rarely been invoked in investment arbitration. More often, tribunals rely on the *lex specialis* doctrine to hold that the IIA, as a specialized legal instrument, prevails over more general rules and principles of international law. This could be because investment law, while part of public international law, belongs to international economic law and is implemented primarily by commercial lawyers who may be unaware of (or disinclined to consider) public interests or the broader public international law perspective.

Arbitral tribunals are not bound by precedent. This means that prior interpretations of investor protection provisions are not set in stone – even seemingly entrenched standards can be reinterpreted in alignment with climate law. For example, a 2019 ICC Report on resolving climate-related disputes through arbitration emphasized that arbitrators can consider climate law when interpreting the FET standard. Accordingly, a tribunal might reject the argument that an investor in a coal-fired power plant had legitimate expectations of regulatory stability, if at the time when the investment was made, the Paris Agreement made it foreseeable that the host state would soon regulate to phase out coal.

Ultimately, successfully integrating investment law and climate law will depend on the lawyers and arbitrators working the system. As John Kerry recently put it, all lawyers are climate lawyers now. This includes, of course, investment arbitration practitioners.

In Sum

With the signing of the Paris Agreement in 2015, climate law reached a tipping point. Since then, countries have been legislating and regulating to reduce emissions, and private actors have pledged to invest billions in climate change mitigation and adaptation. In its current iteration, international investment law is not fully aligned with this new reality. But if adequately renegotiated and revised, IIAs can support global climate goals and give effect to the Paris Agreement. That process, however, might take a while. In the meantime, arbitration practitioners can use the principle of systemic integration to reinterpret current IIAs in coherence with climate law.

To read our coverage of regime interaction in investment arbitration, click here.

To make sure you do not miss out on regular updates from the Kluwer Arbitration Blog, please subscribe here. To submit a proposal for a blog post, please consult our Editorial Guidelines.

This entry was posted on Wednesday, January 12th, 2022 at 8:00 am and is filed under Arbitration, BIT, Climate change, Environment, International arbitration, Investment Arbitration, Reform, Regime Interaction, Regime Interaction in Investment Arbitration
You can follow any responses to this entry through the Comments (RSS) feed. You can leave a response, or trackback from your own site.