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The Modernised Energy Charter Treaty: The New Text

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On 13 September 2022, the long-awaited text of the modernised Energy Charter Treaty (ECT) was published. Still subject to final agreement, this is the text that reflects the Agreement in Principle reached by the parties to the Treaty in June this year after more than three years and 15 rounds of negotiations.

Modernisation has several objectives: providing legal certainty on issues that have been the subject of inconsistent arbitral awards, clarifying the role of intra-EU investor-State dispute settlement (ISDS) in light of the CJEU's judgments in *Achmea* and *Komstroy*, and introducing greater transparency into ISDS procedures. In addition, a core purpose of modernisation is to ensure the ECT reflects climate change and clean energy transition goals and contributes to, rather than hampers, the objectives of the Paris Agreement. Recent claims from fossil fuel investors Uniper and RWE for compensation for harm resulting from the Netherlands' decision to phase out coal-fired electricity have focused minds.

The stakes are high. As the ECT Secretary General has said: "If the modernisation process fails, I don't see a future for the Treaty." Italy withdrew from the treaty in 2016. Poland has recently drafted a law to commence its withdrawal (see also here). The European Court of Human Rights is considering a claim that member state membership of the ECT would be a breach of the ECHR. Many public and private sector actors consider the treaty irredeemable and advocate the *en masse* withdrawal of all parties. The revised text may be a last chance saloon.

So, does it deliver? Well, sort of. Despite a crushing failure to exclude fossil fuel investments from scope within any sensible timeframe, the substantive changes in the modernised ECT represent progress. Whether they are sufficient to support an energy revolution remains to be seen. That will depend, in large part, on how arbitral tribunals apply the modernised text.

A Failure to Reflect the Urgency of the Climate Crisis

As has been trailed for some time, the modernised ECT does not exclude fossil fuel investments from its scope. Instead, it provides a flexibility mechanism that allows contracting parties to list in Annex NI investments that are not to be treated as an "economic activity in the energy sector" for the purposes of Part III of the treaty. Only the European Union, United Kingdom and (minimally) Switzerland have taken the opportunity to list any such investments. For the EU and UK, new fossil fuel investments are excluded from scope from August 2023 while pre-existing fossil fuel

investments (except coal fired electricity generation which is only protected until October 2024) continue to enjoy Part III protection for 10 years after entry into force or 2040, whichever is earlier. Other contracting parties continue to apply Part III investment protections to all fossil fuel investments *indefinitely*.

Indefinite protection for fossil fuel investments is climate madness. Even the UK and EU's 10-year timeframe is inconsistent with the science: the International Energy Agency's roadmap for reaching net-zero by 2050 permits almost no role for fossil fuels in developed economies beyond 2035. Unsurprisingly, this headline failure has prompted calls for withdrawal from the treaty. However, the ECT is like Hotel California: you can check out any time you like but you can never leave (per Art 47(3) existing investments in a contracting party are protected for 20 years post-withdrawal).

But It Is Not All Bad

Despite concerns related to the RWE and (now withdrawn) Uniper claims, no arbitral tribunal has yet awarded compensation to a fossil fuel investor under the ECT for harm caused by regulatory measures designed primarily to decarbonise an economy (the recent Rockhopper award appears to be in response to measures driven by ecological concerns more than decarbonisation objectives). That doesn't mean the threat of such a claim does not have a chilling effect, but it is significant. Moreover, a review by Climate Change Counsel suggests that substantially more than half of all awards made under the ECT relate to investments in renewable energy. That is, the ECT is used more often than not to protect investments in renewable energy. Given that the path to net-zero requires "immediate and massive deployment of all available clean and efficient energy technologies", the ECT has the potential to facilitate the rapid scaling-up of investment in renewables.

Cause for Cautious Optimism

Continued protection for fossil fuel investments under the ECT does not equal continued support for those investments. Investment protection under the ECT is not absolute. It guarantees fair and equitable treatment (FET) to investors and prohibits expropriation without compensation. Properly construed in light of a state's international climate change obligations and its sovereign right to regulate, those guarantees ought not be a barrier to rapid and ambitious climate action by contracting parties. The following key amendments in the modernised ECT support that outcome.

- ***The Right To Regulate***

The modernised ECT introduces a new standalone Article, preceding Article 10, which provides: *"The Contracting Parties reaffirm the right to regulate within their territories to achieve legitimate policy objectives, such as the protection of the environment, including climate change mitigation and adaptation, protection of public health, safety or public morals."*

This new Article may not do a lot of work on its own, but it is likely to provide support to states defending claims that their regulatory measures breach the FET standard or amount to indirect expropriation.

- ***Fair and Equitable Treatment***

As previously highlighted in this blog, the FET standard embodied in Article 10(1) of the ECT has been controversial and has given rise to inconsistent arbitral awards. Tribunals have variously found that it includes obligations to protect investors' legitimate expectations, to accord due process, and to act transparently. Of these, the protection of legitimate expectations has been perhaps the most controversial. Some tribunals have held that legitimate expectations may only arise from specific commitments from the host state; others that, irrespective of any explicit commitment, investors may have a legitimate expectation of stability in the host state's legal regime: see discussion here.

The modernised text deletes separate reference to unreasonable and discriminatory conduct and wraps it into the definition of FET. It takes a leaf from the Comprehensive Economic Trade Agreement (CETA) and provides, at Article 10(2), six elements that constitute a breach of the obligation to accord FET. Significantly, in relation to legitimate expectations, the measure or measures must amount to: *"the frustration of an Investor's legitimate expectations where these were central to its Investment, and arose from a clear and specific representation or commitment by that Contracting Party upon which the Investor reasonably relied in deciding to make or maintain the Investment."* A footnote clarifies that this does not include *"general expectations, such as an expectation (in the absence of clear and specific representations or commitments to that effect) that a Contracting Party's legal or regulatory framework will not change."*

- ***Expropriation***

As with FET, the modernised text gives greater clarity to the definition of expropriation and makes its less likely that regulatory measures are found to amount to indirect expropriation. Significantly, revised Article 10(4) provides: "*Except in rare circumstances when the impact of a measure or series of measures is so severe in light of its purpose that it is manifestly excessive, non-discriminatory measures by a Contracting Party that are designed and applied to protect legitimate policy objectives, such as public health, safety and the environment (including with respect to climate change mitigation and adaptation), do not constitute indirect expropriations."*

- ***Incorporation of Climate Change Obligations***

The reference to climate change mitigation as a legitimate policy objective in Article 10(4) is reinforced through new references to contracting parties' obligations under the UNFCCC and Paris Agreement in the preamble, in Article 19, and in a new self-standing article on climate change and the clean energy transition.

- ***ISDS***

The modernised text applies the *UNCITRAL Rules on Transparency in Treaty-based Investor-State arbitration* to all investor-state arbitrations under the treaty (Art 26(6)), enhancing the transparency of the process and encouraging greater consistency of decision making.

Collectively, these amendments (together with the deletion of the non-derogation clause in Article 16) strengthen the hand of contracting parties in exercising their sovereign right to regulate. Explicit references to international climate change obligations should encourage arbitral tribunals to address these obligations as applicable law, not merely as background facts. And that, in turn, should affect the assessment of reasonableness of regulatory measures to scale down fossil fuel use

or the legitimacy of expectations of a stable regulatory regime.

Conclusion

The modernised ECT is not, of course, a panacea. Much turns on how arbitral tribunals engage with the new text and grapple with the interplay of obligations under the ECT and the Paris Agreement. But if this is the text that is agreed in November, the modernised ECT is not likely to see a mass withdrawal. And the battleground will then move from the negotiating room to the arbitral tribunal, where there will still be much to fight for.

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