Kluwer Arbitration Blog

# 2023 in Review: Climate Change and ISDS – Reshaping Investment Arbitration to Achieve Climate Goals

Maria José Alarcon (Assistant Editor for Investment Arbitration) · Wednesday, January 31st, 2024

In 2023, investor-State dispute settlement (ISDS) reform has been influenced by growing concerns over climate change and state responsibility. This global shift is reflected in numerous requests for advisory opinions from international courts, aiming to clarify states' obligations regarding climate change (see here, here, and here). These developments suggest a move towards a more balanced approach between investor rights and states' environmental duties, potentially leading to significant reforms in investment arbitration, enhancing awareness of its current limitations, especially in addressing climate challenges. This post summarizes key ISDS and climate change developments that took place in 2023.

### 1. Addressing Climate Change in ISDS Reform: The ECT Modernization Process

The Energy Charter Treaty (ECT) is perhaps one of the "most controversial" International Investment Agreements (IIAs) (*see* here). Originally aimed at promoting energy cooperation (Art. 2), it has faced criticism from various quarters, including the Special Rapporteur on human rights and the environment, and the Intergovernmental Panel on Climate Change (*see further*, IPCC). Notably, the Special Rapporteur, criticized the ECT for arguably constraining the "ability of states to adopt the ambitious policies needed to combat climate change", particularly due to its lengthy sunset clause upon withdrawal. Critics further argue that the modest changes in the ECT's revised text are inefficient, continuing to make climate action costly.

While the modernized text of the ECT has received mixed reactions, some scholars recognize its innovations in supporting renewable energy investments and promoting green fuels, along with acknowledging states' regulatory rights for legitimate policy objectives. Following several EU member states' decision to exit the ECT, the European Commission proposed a coordinated withdrawal on July 7, 2023, which was eventually deemed moot. This led more EU member states to notify their withdrawal.

Several authors (here and here) suggest that if the ECT undergoes a meltdown, as it appears to be happening, it would create a legal vacuum. This gap would need to be filled by a combination of international, regional, and domestic legal frameworks that are layered to balance risk management and investment protection. Notably, as Eichberger argues, despite states withdrawing from the ECT, the sunset clause in Article 47(3) continues to extend investment protection for fossil fuels

for twenty years post-withdrawal. Therefore, commentators generally agree that reforming the ECT would be more beneficial than withdrawing from it.

Ultimately, even if the European Commission prompts an agreement to terminate the sunset clause and establish its non-applicability, this regime will likely create uncertainty within the ISDS community, as it is unlikely that investment tribunals will accept these types of agreements.

## 2. Reshaping State Responsibility in Investor-State Dispute Resolution to Adapt to Climate Change

The outcomes of the pending advisory opinions on climate change will have a significant impact on investment arbitration and public international law, as the International Tribunal for the Law of the Sea (ITLOS), the International Court of Justice (ICJ, Court) and the Inter-American Court of Human Rights (ACtHR) (hereinafter ITLOS, ICJ and ACtHR: "ICTs") will have to (i) clarify state obligations regarding climate change and (ii) establish guidelines and principles of state responsibility concerning climate change, where issues of causation are not as simple as in other cases.

### a. Upholding Climate Change Obligations in the Context of ISDS

The referred ICTs are responsible for clarifying states' climate change obligations, which are governed largely by soft law and customary international law, and to a lesser extent, treaty law. They are expected to establish that certain obligations, previously seen as merely declaratory or non-binding, are actually binding international responsibilities. This clarification will have two main implications for ISDS: firstly, states will be legally required to adhere to their climate change commitments; secondly, compliance with these climate change commitments could be used as a defense against state liability in ISDS cases.

Firstly, the recognition of climate change obligations as legally binding could lead to increased state responsibility and prompt foreign investors to require states to enhance environmental protection efforts. This is exemplified in the case of *Peter A. Allard v Barbados*, where the claimant sued Barbados for not adhering to environmental and climate obligations, allegedly damaging ecotourism business. Although unsuccessful, the case highlighted that a state's international obligations could be pertinent in applying environmental standards in specific situations.

Secondly, investment tribunals should uphold international legal obligations related to climate change as at least a partial defense against state responsibility in ISDS cases, especially when these obligations are rooted in customary international law or *jus cogens* norms, which do not allow for derogation. This approach aligns with legal precedents like the *North Sea Continental Shelf Case* (para. 63) and the principles outlined in Article 53 of the VCLT (see further here)

In this context, states must not disregard their international climate change obligations for the sake of foreign investors, nor should they be penalized for implementing regulatory changes to meet these obligations. Their responsibility includes ensuring domestic compliance with climate change directives, using their regulatory authority accordingly. However, investment tribunals have shown

hesitation in fully supporting this stance. As noted by one author in this blog, investors still continue to challenge state actions in ISDS cases that are taken to further climate goals, such as phasing out carbon-intensive energies (see, e.g. *Zeph Investments v Australia*, *Uniper*, *RWE v Netherlands*, *Westmoreland v Canada*). There have also been instances where tribunals upheld expropriation claims against states for denying or withdrawing project approvals for climate-related reasons (*see e.g.*, *TransCanada v USA*, *Rockhopper v Italy*, *Lone Pine v Canada*).

Under Article 30(a) of the Articles on Responsibility of States for Internationally Wrongful Acts (ARSIWA), states must, *inter alia*, immediately cease any actions that violate international law and ensure such breaches do not recur. If an industry or energy program contradicts a country's climate change obligations, the state must end or modify it without incurring any liability or owing compensation. This is exemplified in legal precedents like the *Whaling in the Antarctic Case* (para. 247(7)) where Japan was instructed to refrain from issuing permits for its illegal whaling program.

Based on these considerations, arbitral tribunals should consider cases within the wider international legal context to avoid fragmenting international law, recognizing that investment law is part of the broader international legal system and not an isolated private justice scheme. This requires tribunals to adjudicate claims in line with existing international law obligations and not to ignore intersecting obligations from other international regimes.

### b. Issues of Causation in State Responsibility Concerning Climate Change in the Context of ISDS

The ARSIWA Articles provide a somewhat mathematical formula for determining state responsibility: (i) the existence of an international legal obligation, (ii) breach of such obligation, (iii) attribution of that wrongful conduct to a state, and (iv) a causal link between the internationally wrongful conduct and the production of loss and damage suffered. However, these principles do not fully capture the complex causation issues in climate change, such as concurrent causes, collective contribution, risk enhancement, and the evolving role of science in identifying breaches and new causes.

In this context, undoubtedly, the referred advisory opinions' outcomes will significantly influence investment arbitration and public international law, as international courts establish guidelines for state responsibility in climate change, where causation is more complex. The simple *"but for"* causation approach may be inadequate. Instead, concepts like collective contribution, similar to those outlined by the ICJ in the *Bosnia Genocide Case*, will likely be relevant. In that case, the ICJ emphasized collective causation and the efforts of multiple states, suggesting that joint compliance with international law could have prevented genocide, regardless of whether individual state actions alone could have stopped it (para. 431).

Similarly, the Court is likely to move beyond the *'but for'* causation test in the context of climate change. It will most likely rule that all states are legally required to fulfill their climate obligations, including using their regulatory powers to depart from fossil fuel production and use, control greenhouse gas emissions, and enforce climate change obligations within their borders. In the ISDS context, this implies that tribunals, when deciding cases, must consider the contribution of investors to the production and risk enhancement of climate change through their activities. Tribunals should employ the best available science to ascertain whether an investor's activities

within a country violate the state's international climate change obligations, thereby exempting a state from international responsibility and reaffirming the state's right to regulate in these matters.

### c. Counterclaims and Their Application to ISDS in the Context of Climate Change

Furthermore, it is necessary to consider counterclaims in the context of climate change. Although ICSID (Rule 48, 2022) and UNCITRAL (Article 21, 2013) Rules permit counterclaims under certain circumstances, the tribunal's jurisdiction is arguably limited to the consent of the parties. In this context, the Respondent State may bring counterclaims if the relevant consent instrument permits this (see, e.g. *Aven and others v Costa Rica*, paras. 742, 743, 747).

While some tribunals agree that consent to arbitration implies an automatic consent to counterclaims (see e.g., *BSG Resources v Guinea (I)*, para. 1095, and *Goetz v Burundi (II)*, paras. 277, 278, 279), others hold a differing opinion (*Iberdrola v Guatemala (II)*, paras. 389, 391, *Karkey Karadeniz v Pakistan*, para. 1012). The jurisdiction of a tribunal typically hinges on the specific wording of the investor-State arbitration clause. However, pursuant to Article 31(a) of the VCLT, interpreting treaties requires adherence to the legal text, along with an obligation to interpret in "Good Faith". As Professor Schwarzenberger points out, in this context, good faith is shaped by the rights stipulated in treaties, contrasting with rights in international customary law (p. 171). When customary international law is considered, it is important to recognize an emerging trend towards accepting counterclaims, reflecting concerns about procedural fairness for states and investors within ISDS. As several tribunals have consistently held that the right to regulate is part of a state's regulatory power and is presumptively used in a legitimate way, the ability to counterclaim when climate change issues are being debated should also be implied in treaties despite not being expressly mentioned.

## Conclusion

ISDS continues to undergo significant structural reforms (substantive and procedural). 2023 was marked by an increased focus on redefining state responsibility for climate change as seen in the numerous requests for advisory opinions from international courts clarifying states' climate obligations. Looking ahead, the pronouncements regarding state responsibility in the referred advisory opinions, coupled with evolving legal interpretations of climate change obligations in ISDS cases—particularly in relation to counterclaims and exceptions to state responsibility—are anticipated to align investment arbitration more closely with global climate change objectives.

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