Institut Veblen pour les réformes économiques

CNCD 11.11.11

Aligning Investment Protection Policy with the Paris Agreement: What Are the Next Steps After the Current Wave of ECT Withdrawals?

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November 2024

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Introduction

Current International Investment Agreements (IIA) and the Investor-to-State Dispute Settlement (ISDS) mechanism represent a major obstacle to climate mitigation and adaptation as well as to the adoption of ambitious social and environmental policies.

There is a growing recognition of this incompatibility at the international level, as reflected by:

- the 2022 IPCC report on climate change mitigation which recognized the constraint represented by international investment treaties, in particular the Energy Charter Treaty (ECT), on the ability of States to adopt ambitious policies to combat climate change[1].
- the call from the UN Special Rapporteur on Human Rights and the Environment on States to unilaterally or jointly terminate international investment treaties that contain an ISDS, in his report[2] warning of "*an explosion of ISDS claims filed by fossil fuel investors alleging that climate measures breach their rights under the Energy Charter Treaty and other IIAs"*, and
- the OECD dialogue aimed at revising its investment protection policy in the light of the Paris Agreement, and in particular its article 2.1. c) requiring financial flows to be aligned with climate objectives.

In this regard, the EU's withdrawal from the Energy Charter Treaty (ECT), announced on 26 June 2024 and due to take effect on 26 June 2025, certainly represents a major step forward.

Putting an end to the ECT

Several EU Member States (France, Germany, Poland, Luxembourg, Slovenia, Portugal, Spain, the Netherlands) and the United Kingdom have also already officially notified their exit. All the remaining parties should follow this wave of withdrawal to put a definitive end to the treaty. But investments made before the effective exit will remain protected for 20 years, due

[1] A large number of bilateral and multilateral agreements, including the 1994 Energy Charter Treaty, include provisions for using a system of investor-state dispute settlement (ISDS) designed to protect the interests of investors in energy projects from national policies that could lead their assets to be stranded. Numerous scholars have pointed to ISDS being able to be used by fossil-fuel companies to block national legislation aimed at phasing out the use of their assets" (IPCC, 2022, Chapter 14 on international collaboration, Lines 9 to 14, page 81).

[2] Special Rapporteur on the issue of human rights obligations relating to the enjoyment of a safe, clean, healthy and sustainable environment, Paying polluters: the catastrophic consequences of investor-State dispute settlement for climate and environment action and human rights, A/78/168, 13 July 2023.

to a sunset clause[3]. This shows the importance for all the countries leaving the treaty to sign an agreement with each other to neutralize this provision and mitigate the risks of disputes that could still arise from it.

Revising the EU investment policy

Aligning investment protection agreements with the EU's international commitments regarding the environment, climate and human rights goes beyond the issue of the ECT. The EU must stop promoting investment treaties (or investment chapters in trade agreements) which have the same shortcomings as the ECT (i.e., protection of fossil investments and other investments harmful to the environment, climate and human rights, long sunset clauses) and contradicts its international environmental and human rights commitments. This is the case, for example, with agreements such as the CETA, or the recently modernized agreements with Chile and Mexico that include new chapters on investment protection. This is also the case with investment protection agreements concluded with Vietnam and Singapore, which are still awaiting ratification by Member States.

Our preference would be to put an end to International Investment Agreements. But in this note, we examine the compatibility of the Commission's position with that of the European Parliament. Indeed, the EU must at least align its investment policy with the European Parliament's resolution on the future of the EU international investment policy **adopted in June 2022** in which it urges *"the Commission and the Member States to ensure consistency between IIAs and the European Green Deal, environmental policies, labour rights and human rights*".

In this regard, the "model clauses for the negotiation of BITs between EU Member states and third countries" published in September 2023 by the European Commission fall far short of the European Parliament's resolution[4]. The model clauses, aiming at guiding Member States in negotiating or renegotiating their BITs with third states, provides non-binding suggestions but nonetheless **must be seen as reflecting the EU's current position as to investment protection so that it can influence future BIT negotiations.** Based on EU "best practice", the model clauses reflect several features found in newer investment treaties aiming at guiding treaty interpretation to improve policy space for measures aimed at fighting climate change. **However, the model clauses are still underpinned by a strong investment protection rationale.** They do not include bold and innovative provisions and **align with now widespread "new generation" treaty practice which has already proven limitations in effectively preserving policy space,** especially for States wishing to advance the energy transition or otherwise pursue climate change mitigation and adaptation policies.

In particular, the absence of carve-outs effectively shielding climate policies or denying protection to fossil fuel investment, as well as the lack of any specifications on the

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[3] See Article 47 of the Energy Charter Treaty. For instance, the following recent fossil fuel cases are based on the ECT : *Azienda Elettrica Ticinese v Germany* (ARB/23/47) ; *Towra v Slovenia (ARB/22/33); Ascent Resources v Slovenia (ARB/22/21); Clara Petroleum Ltd v Romania (ARB/22/10) ; Lansdowne Oil & Gas v Ireland ; Klesch v Denmark, Germany, European Union (ARB/23/48, ARB/23/49, ARB(AF)/23/1)*.

[4] European Commission, Non-Paper: Annotation to the Model Clauses for BIT negotiations (21 September 2023).

calculation of damages, show that the model clauses fall short of current global best practice.

1. Foreign investments protected in all sectors

In October 2020, the European Parliament adopted an amendment[5] in the European climate law which states "*The Union shall end protection of investments in fossil fuels in the context of the modernization of the Energy Charter Treaty...*".

The European Parliament went further in its resolution of 23 June 2022[6] cited above by urging the EC and Member States to "*exclude from treaty protection investments in fossil fuels or any other activities that pose significant harm to the environment and human rights*".

But EC model clauses do not provide for any limitations as to the scope of investments covered by the treaty. The indiscriminate coverage of foreign investments, regardless of the type of activity, constitutes a harmful policy for the climate. This free taxpayer-funded insurance undermines public policy efforts aimed at gradually rendering fossil assets stranded, as highlighted by scientific experts[7].

EU-Chile Advanced Framework Agreement[8]

Chapter 10 on Investment
Article 10.1 Definitions
(...)
"Covered investment" means an investment which is owned, directly or indirectly, or controlled, directly or indirectly, by investors of one Party in the territory of the other Party, made in accordance with applicable laws, in existence as of the date of entry into force of this Agreement or established thereafter;
"investment" means every asset that an investor owns or controls, directly or indirectly, which has the characteristics of an investment, including a certain duration, the commitment of capital or other resources, the expectation of gain or profit, or the assumption of risk. Forms that an investment may take include:
(a) an enterprise;
(b) shares, stocks and other forms of equity participation in an enterprise;

[5] Amendment adopted by the European Parliament on 8 October 2020 on the proposal for a regulation of the European Parliament and of the Council establishing the framework for achieving climate neutrality and amending Regulation (EU) 2018/1999 (European Climate Law).

[6] European Parliament resolution of 23 June 2022 on the future of EU international investment policy (2021/2176(INI)

[7] Lea Salvatore, Investor–State Disputes in the Fossil Fuel Industry, IISD, Dec 2021

[8] Can be consulted here

(c) bonds, debentures, or other debt instruments of an enterprise;
(d) futures, options and other derivatives;
(e) concessions, licenses, authorisations, permits, and similar rights conferred pursuant to domestic law;
(f) turnkey, construction, management, production, concession, revenue-sharing contracts, or other similar contracts including those that involve the presence of the property of an investor in the territory of the Parties;
(g) intellectual property rights;
(h) any other moveable or immovable, tangible or intangible property, and related property rights, such as leases, mortgages, liens and pledges.
For greater certainty:
(i) returns that are invested shall be treated as investment. Any alteration of the form in which assets are invested or reinvested shall not affect their qualification as investments, provided that the form taken by any investment or reinvestment maintains its compliance with the definition of investment;
(ii) investment does not include an order or judgment entered in a judicial or administrative action.

Sectoral exclusion - for fossil fuels or even energy and extractive industries - and a climate carve out are under discussion, for instance at the OECD.

- **A fossil fuel carve-out** would lead an arbitral tribunal to decline jurisdiction in the event of claims relating to such investments. A fossil fuel carve-out would safeguard policy space for measures to combat climate change and ensure that the investment treaty does not encourage finance flows that are inconsistent with net zero pathways in accordance with art. 2.1.c of the Paris agreement.
- **A climate change carve-out** would exclude from the tribunals' jurisdiction measures related to climate change mitigation or exclude liability for such measures.

Where a carve-out applies to exclude a specific range of measures from the scope of the treaty or from ISDS, there can be no duty to pay compensation. Under a "climate change carve-out", investments in fossil fuel and other emissions-intensive industries would continue to be protected by the treaty – as opposed to a sectoral carve-out. However, tribunals would deny jurisdiction or compensation if the challenged measures are related to, or aimed at, mitigating climate change.

Several examples of certain categories of government measures falling outside treaty scope already exist[9]. Several scholars advocate for the inclusion in BITs of similarly worded

[9] For example, most BITs standardly include a taxation exemption. BITs excluding government procurement measures or subsidies are also very common. And several BITs include carve-outs for e.g. tobacco control measures (See CPTPP, Art 29.5; Singapore-Australia FTA (as amended in 2016), ch 8, Art 22) or, more generally, any measure "that is designed and implemented to protect or promote public health" (See Indonesia-Australia CEPA, Art 14.21(1)(b); Peru-Australia FTA ch 8, sec B; Singapore-Turkey FTA, Art 12.14(2); Singapore-Sri Lanka FTA, Art 10.13(3); Singapore-Burkina Faso BIT, Art 10(2); Singapore-Rwanda BIT, Art 10(2)).

exceptions in relation to measures aiming to mitigate climate change[10]. This could be done in an extremely straightforward way[11]. It may also complement a sectoral carve-out. The European Parliament had already called for such a climate carve out in a resolution adopted in 2015[12].

But there is no trace of such approaches in the Commission's position on the foreign investment framework.

The EC retains a very limited approach in its model clauses:

First, the "investment protection and climate change" provision merely states that the parties "shall … promote investment of relevance for climate change mitigation and adaptation".

Second, the model clauses contain a GATT-like general exceptions provision for measures "necessary to" protect inter alia climate change but it only applies to non-discriminatory treatment and transfers[13]. This approach presents several limitations with respect to safeguarding policy space, in particular for States wishing to address climate change:

- For the **FET standard and expropriation**, the Commission refers to the "Investment and Regulatory Measures" provision under which States have the right to regulate and to change their domestic legal frameworks even where this negatively affects the investment operation or expected profits. However, **this merely codifies existing case-law, as investment tribunals regularly recall States'** "right to regulate" and the fact that the FET standard should not be interpreted as a "stabilization clause". Recalling those principles has not prevented tribunals from engaging in sweeping interpretations of investor protection standards and ultimately granting despite legitimate regulatory action.
- The model clauses only set out **interpretive tools** intended to guide and prevent far-reaching interpretation of investor protection standards. Yet, recent case-law shows that such an approach **still leaves significant discretion for investment tribunals to adopt unintended interpretations**. For instance, in Eco Oro v Colombia, the tribunal considered under a similarly worded expropriation provision that the measures at stake did not constitute indirect expropriation[14], but ultimately found a breach of the FET standard[15] based on highly questionable grounds[16].

[10] Van Harten, Gus, An ISDS Carve-Out to Support Action on Climate Change (September 20, 2015). Osgoode Legal Studies Research Paper No. 38/2015, Available at SSRN: https://ssrn.com/abstract=2663504 or http://dx.doi.org/10.2139/ssrn.2663504 ; Joshua Paine, Elizabeth Sheargold, A Climate Change Carve-Out for Investment Treaties, Journal of International Economic Law, Volume 26, Issue 2, June 2023, Pages 285–304, https://doi.org/10.1093/jiel/jgad011

[11] For instance, Article 22 of the Singapore-Australia FTA (ch 8) reads: "No claim may be brought under this Section in respect of a tobacco control measure of a Party".

[12] European Parliament, Resolution on Towards a New International Climate Agreement in Paris, 2015/2112(INI), 14 October 2015, at para 80.

[13] The commentary to this provision explains that: "*The remaining standards of protection, notably FET and expropriation, which should be read together with the Article on the right to regulate, are not subject to this clause on general exceptions, as they are drafted in such way to ensure that a state's policy space to enact measures on public policy grounds is not reduced. In this regard, general exceptions are 'in-built' in those standards of protection*".

[14] Eco Oro v Colombia, paras 643-99

[15] Ibid, para. 821

[16] Ibid, Partial Dissent of Professor Philippe Sands QC, paras 12-19

- In any event, **general exceptions mirroring Article XX GATT appear ill-suited**. First, these risks importing restrictive WTO jurisprudence into investment arbitration[17] . Second, such exceptions come into play at the end of the tribunals' assessment as a final "safety net" rather than as preliminary objections to the tribunals' jurisdiction. Finally, recent awards show that some arbitrators consider that the operation of general exceptions does not preclude liability and the payment of a compensation to the investor[18] .

It follows that, should the model clauses be reflected in upcoming treaty practice (both at Member States and EU level), investments in emissions-intensive industries, including fossil fuels, will continue to benefit from extensive treaty protection. This seems at odds with the Commission's position in the ECT modernization process.

2. Investment protection provisions

The European Parliament in its resolution of 23 June 2022 cited above "*considers that protection standards should focus specifically on creating a level playing field between foreign and domestic investors, preventing and offering redress in cases where EU investors in non-EU countries are discriminated against, are denied access to justice, or fully lose the enjoyment of their investment to the benefit of the host state*".

Regarding **most-favoured treatment**, the model clauses contain welcome improvements. The model clauses suggest to explicitly limit the scope of most-favoured nation "treatment" to actual measures (i.e. law, regulation, decision), to prevent more favourable substantive provisions and dispute settlement procedures contained in other BITs from being imported in replacement of the provisions of the BIT on which the dispute is grounded. Such restrictions are welcome in view of existing case-law.

But as for the rest, the model clauses contain specifications for the main investment protection standards modelled on recent EU investment treaties.

- **The FET standard**[19] is expressly limited to the protection against denial of justice, fundamental breach of due process, manifest arbitrariness, targeted discrimination on manifestly wrongful grounds, and abusive treatment (e.g. harassment). Legitimate expectations (that can only be created if specific representations were made to individual investors) cannot give rise to a standalone treaty breach and should be treated as a relevant consideration in the assessment of one of those elements. **But those specifications may not be sufficient to adequately prevent investment tribunals from**

[17] Necessity tests usually are highly demanding tests and would not be appropriate for a climate carve-out (see Joshua Paine and Elizabeth Sheargold, "A climate Change Carve-Out for Investment Treaties" (2023) 26 Journal of International Economic Law, p. 299).

[18] Eco Oro v Colombia, para. 821. That understanding appears to clash with basic international law principles, as the application of the exception would normally lead the interpreter to find there is no internationally wrongful act.

[19] See the "Treatment of Investors and of Covered Investments" provision

engaging in far-reaching unintended interpretations[20] as illustrated by the Eco Oro award[21].

- **Indirect expropriation** is defined and complemented with several specifications[22]. **But the scope of assets from those listed in the treaty's definition of "investment" that can possibly be expropriated is not further specified.** Here it applies broadly to all "covered investments". Certain treaties contain even stricter language and limit the indirect expropriation qualification to measures "eliminat[ing] all or nearly all of [the investments'] value"[23].

- The model clauses include a so-called **"umbrella" provision under which any breach of specific written commitments with investors through the exercise of sovereign authority (e.g. passing legislation) amounts to a treaty breach.** Although a common feature of BITs, umbrella clauses are not systematic and further increase investor protection.

Modernization of the Trade part of the EU-Mexico Global Agreement [24]

Annex on Expropriation

(…)

4. The determination of whether a measure or series of measures by a Party, in a specific situation, constitutes an indirect expropriation requires a case-by-case, fact-based inquiry that considers, among other factors:

(i) the economic impact of the measure or series of measures, although the fact that a measure or series of measures by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred;

(ii) the duration of the measure or series of measures by a Party;

(iii) the extent to which the government measure interferes with the distinct and reasonable expectations of the investor arising out of the investment; and

(iv) the character of the measure or series of measures, notably their object and context.

3. For greater certainty, non-discriminatory measures by a Party that are designed and applied to protect legitimate policy objectives, such as the protection of public health, social services, public education, safety, and the environment, or public morals, social or consumer protection, privacy and data protection, or the promotion and protection of cultural diversity

[20] See e.g. Günes Ünüvar, "A tale of policy carve-outs and general exceptions: Eco Oro v Colombia as a case study" (2023) 14 Journal of International Dispute Setllement, pp. 517-533

[21] Eco Oro v Colombia, ICSID Case No ARB/16/41, Decision on Jurisdiction, Liability and Directions on Quantum (9 September 2021

[22] *For greater certainty, except in the rare circumstance when the impact of a measure or series of measures is so severe in light of its purpose that it appears manifestly excessive, non-discriminatory measures by a Party that are designed and applied to protect legitimate policy objectives, such as the protection of public health, social services, public education, safety, environment including climate change, public morals, social or consumer protection, privacy and data protection, or the promotion and protection of cultural diversity do not constitute indirect expropriations*

[23] Canada-Korea FTA (2014), Annex 8-B.

[24] Can be consulted here

do not constitute indirect expropriations, except in the rare circumstance when the impact of a measure or series of measures is manifestly excessive in light of its purpose.

3. The absence of "CSR" provisions

The model clauses include specific provisions on climate change, environment, and labour, but do not contain any provisions specifically directed at addressing investor conduct (e.g. investor obligations or specifications that investor misconduct must be taken into account when deciding the merits of the claim or calculating damages).

4. The lack of specifications on damages valuation

The European Parliament in its resolution of 23 June 2022 cited above "*points out that the use of valuation methods generally used by adjudicators is highly controversial owing to their very wide margin of discretion and reliance on highly complex and inherently speculative assumptions; invites the Commission to assess in depth and provide for corrective and transparency oriented rules and safeguards in relation to the provisions governing compensation in EU IIAs, including the use of stronger clauses preventing the use of punitive damages; calls for compensation to be capped at the level of sunk costs, reflecting the amount of eligible expenditure actually incurred by the investors; underlines that balancing approaches should, as appropriate, determine compensation awards below this cap, taking into consideration contextual elements such as non-compliance by undertakings with their legal or contractual obligations or commitments*".

The model clauses do not contain any specifications to guide the investment tribunals' assessment of the amount of compensation in the event of a treaty breach. They only refer to the classic "fair market value" standard for expropriation.

Yet, the amounts awarded in compensation to investors in investment arbitration disputes have been considerably higher than in similar disputes before domestic courts or other international courts. Researchers highlighted the significant discrepancies between the amounts awarded in compensation and those actually invested, as well as with host States' benefits from the investments. In particular, consideration of lost profits and the calculation of interests leads to considerable amounts being awarded, while other contextual factors (e.g. investor conduct, public interest) are usually not taken into account by tribunals in determining compensation.

Options for reform include *inter alia*[25]:

- introduce **balancing rules for compensation** to be determined according to a range of contextual factors, rather than solely based on the fair market value of the investment (e.g. the use of the investment, history of its acquisition, and purpose of government measure, foreseeability of the measure, the investor's conduct). Several treaties in Africa take this approach, notably requiring compensation to be based on "*an equitable balance between the public interest and interest of those affected*" [26]. The Dutch Model BIT also provides that in determining compensation tribunals should consider **whether the investor has complied with the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for Multinational Enterprises**[27]. Additional rules may be needed to ensure tribunals are not given excessive discretion.
- **capping damages at the amount actually invested by the investor.** This would reduce complexity and facilitate the presentation of reliable evidence. Some treaties - in particular those concluded by the EU[28] - specify that damages should not exceed the loss suffered by the investor. However, scholars stressed that this amounts to codifying existing case-law[29].
- requiring tribunals to **determine the amount of compensation in accordance with domestic law** or in a way that is consistent with other international courts or tribunals (e.g. the ECHR).
- Some countries also seek to address the issue of exaggerated claims by making the investor liable for a fraction of the difference between the amount of compensation sought and the amount of compensation awarded in certain circumstances, or to prevent the inappropriate use of the certain calculation methods to value early-stage investments[30].

In all cases, specifications on damages valuation should be as clearly drafted as possible, and address the amount of compensation required for all breaches of investment treaties (not only expropriation).

Failing to provide for such specifications would result in favouring the status quo and further demonstrates that the Commission's approach suggests far-reaching protection for investments.

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[25] See Jonathan Bonnitcha and Sarah Brewin (IISD), "Compensation Under Investment Treaties" (November 2020), pp. 32-37.

[26] South African Development Community (SADC) Model BIT, the Common Market for Eastern and Southern Africa (COMESA) Common Investment Area Agreement (the CCIA) and the PanAfrican Investment Code (PAIC). India's model BIT, published in 2015 Art 23.3.

[27] Dutch Model BIT (2019), Art 23.

[28] E.g. CETA; EU-Vietnam Investment Protection Agreement; EU-Singapore Investment Protection Agreement.

[29] Bonnitcha and Brewin, p. 25.

[30] Colombia Model BIT (2017), p. 21.

5. The inclusion of a sunset clause

The European Parliament in its resolution of 23 June 2022 cited above "*calls on Member States and the other contracting parties to neutralize sunset clauses in current agreements, and to significantly shorten sunset clauses in new investment agreements*".

The model clauses suggest the inclusion of a sunset provision without any specification as to the recommended length of the sunset period.

Sunset clauses generally provide that investments will continue to be protected for a given duration after a State withdraws from the treaty. Such clauses have been subject to criticisms due to significant limitations placed on regulatory flexibility in the host State (e.g. the 20-year ECT or CETA sunset clauses).

At the very least, the model clauses could have suggested that a short period is best in comparison to treaties freezing investor protection for 10, 15, 20, or even 25 years after withdrawal.

Modernization of the Trade part of the EU-Mexico Global Agreement
Article 21 Termination

1. In the event that this Agreement is terminated pursuant to Article XX (Duration and Termination), this Section and Section C (Resolution of Investment Disputes…) shall continue to apply for a further period of 5 years from the date of termination, with respect to investments made before the date of termination of the present Agreement.
2. The period referred to in paragraph 1 shall be extended for a single additional period of 5 years, provided that no other investment protection agreement between the Parties is in force.
3. This Article shall not apply in the case where the provisional application of this Agreement is terminated, and this Agreement does not enter into force.
A similar clause can be found in Article 10.21 of the EU-Chile Advanced Framework Agreement

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