Investor-State Dispute Settlement and Fossil Fuels: What role for a carveout?

By Lukas Schaugg, Suzy H. Nikièma, Nathalie Bernasconi-Osterwalder on March 8, 2024

On March 11, 2024, the Organization for Economic Co-operation and Development (OECD) hosted its 9th annual Investment Treaty Conference on "Supporting the Global Energy Transition: Methods to align investment treaties with the Paris Agreement." Delegates discussed a carveout of climate change measures in investor–state dispute settlement (ISDS) as a central reform proposal. In this blog, we assess the implications of this proposal for climate policy and for broader efforts to reform international investment governance.

With global temperatures soaring to new heights, surpassing 1.5°C above pre-industrial levels on average over the entire year in 2023, the window to meet the Paris Agreement temperature target and avert the catastrophic consequences of climate change is rapidly narrowing. Central to climate change mitigation is the move away from fossil fuels -the primary driver of climate change. The agreement at the 28th UN Climate Change Conference (COP 28) to transition "away from fossil fuels in energy systems" reminds decision-makers across all sectors of the urgency of climate mitigation efforts. For international investment policymakers, an important barrier to climate action is the powerful ISDS mechanism allowing fossil fuel companies to challenge such climate action on the basis of any of the over 2,500 investment treaties, including the Energy Charter Treaty (ECT).

What is ISDS, and why is it an obstacle to climate action?

ISDS allows investors to bring direct claims against the states in which they have invested for alleged breaches of an investment treaty (agreements between two or more states). The claims are typically adjudicated by three-member arbitral tribunals with the power to render a binding and final arbitral award that is globally enforceable and not usually subject to appeal. By bringing ISDS claims, investors can also circumvent the national courts of the host state that are the primary guardians of national law.

The fossil fuel industry has emerged as the most prolific user of this problematic system. ISDS has enabled fossil fuel investors to sue governments for actual and projected losses of profit to the tune of billions of USD, effectively challenging states' energy transition policies. The average award to fossil fuel investors amounts to USD 600 million. According to a conservative estimate, "global action on climate change could generate more than USD 340 billion in legal claims from oil and gas investors" in the upstream sector alone.

The ECT, an energy-sector investment treaty spanning Europe and parts of Asia, has generated more ISDS proceedings than any other. Investors have used the

treaty to challenge government measures to phase out coal-fired power generation or permitting decisions for offshore oil production and gas fracking. In response to these developments, a growing number of states have decided to leave the treaty, including Germany, France, Poland, Luxembourg, and Slovenia.

Last month, the United Kingdom also announced its withdrawal from the treaty, citing concerns that remaining a member could "penalize" it for its "world-leading efforts to deliver net zero."

In contrast to the salient ECT, a less visible global network of more than 2,500 bilateral investment treaties (treaties between two states, BITs in short), often granting the same access to ISDS to fossil fuel investors, has received far less attention from policy-makers. The wide range of BITs covers various sectors where investment should operate responsibly and is in urgent need of reform to advance sustainable development in all dimensions.

A new reform initiative at the OECD

At the OECD conference, policymakers considered, among other items, whether a "climate change carveout" from ISDS could be a viable means to harness reform and ensure the alignment of investment governance with the objectives of the Paris Agreement. Many OECD member states, including climate leaders, maintain dozens of BITs, extending "insurance" to outward fossil fuel investment worldwide by providing access to ISDS. In a recent OECD survey, most state respondents considered Paris-alignment of investment treaties "very important" but reported that almost none of their treaties excluded support for coal investments. Strikingly, 70% also reported that their governments had not analyzed their treaties' climate impacts.

At this stage, the OECD's work program mainly provides a platform for informal exchange. Yet, as in previous processes, such as the Global Minimum Tax, states could grant the OECD a formal mandate to negotiate a binding instrument. It is therefore important to assess the implications of a carveout developed under the auspices of the OECD for climate policy and investment governance reform.

What is a carveout, and how could it tackle the ISDS and climate change issue?

The idea of a climate change carveout was introduced as an academic contribution by Joshua Paine and Elizabeth Sheargold to the conference. The contribution includes proposed language for treaties that would exempt "climate change measures" defined as "related to reducing or stabilizing greenhouse gas emissions" from the scope of ISDS. The authors suggest that a list of concrete examples of measures could complement this definition. The carveout would be accompanied by a two-tiered mechanism, allowing states facing an ISDS claim to request a joint

decision by the environmental authorities of the home and the host state before an investor could proceed to ISDS. The proposal also suggests that the carveout could either be retroactively fitted (retrofitted) into existing investment treaties through a multilateral agreement or be used in the renegotiations of investment treaties.
If widely adopted, effectively implemented, and combined with other reform measures, such a carveout could be a viable tool to protect governments' climate policy space against the looming threat of ISDS. To be effective, it would, however, have to overcome certain obstacles.

First, its effectiveness would depend on a broad subject-matter scope—that is to say, the definition of what climate measures ("measure-specific carveout") or sectors ("sector-specific carveout") are exempt. Second, the carveout would have to effectively prevent arbitral tribunals from assuming jurisdiction -a task that has proven difficult with similar carveouts related to tax policy in the past. The proposed mechanism could address this issue if it fully prevents the constitution of arbitral tribunals in cases in which the carveout applies. Third, the practical effect of the carveout would depend on the breadth of its implementation—that is to say, whether the carveout would be *retrofitted* into the plethora of existing BITs or implemented in a piecemeal, treaty-by-treaty manner. While the climate urgency demands the former, competition among capital-exporting states to protect outward investments may disincentivize such a broad implementation. A possible means to address this issue could include a ratification threshold in the multilateral agreement implementing the carveout. Fourth, to be aligned with climate science and the related urgency to reduce greenhouse gas emissions, the carveout would have to be implemented immediately.

A carveout should not detract from broader reform of the investment regime.

The proposal of a carveout emerges as a targeted damage control measure to address the recognized and urgent problem that ISDS poses to climate action. This approach is pragmatic and focused, potentially allowing for the quick resolution of a major climate-related problem while leaving a range of important policy concerns related to ISDS and the investment treaty regime unresolved.

While this would be a huge step forward from a climate perspective, it remains paramount that the negotiation and implementation of a carveout, as discussed at the OECD, does not detract policy-makers from broader reforms that are crucial from other environmental, social, and human rights perspectives, including efforts undertaken at the United Nations Conference on Trade and Development and at the United Nations Commission on International Trade Law Working Group III.

A climate change carveout, yes, but don't stop there!
States can use a carveout as a narrow and rapid way to mitigate the chilling effect of the investment treaty regime on climate action while safeguarding momentum for other much-needed reforms.

Developing an efficient carveout within its limited scope would notably require ensuring that it is:

- sufficiently broad in subject-matter scope to be aligned with climate science.
- designed in a way that ensures that ISDS claims adversely affecting climate mitigation and adaptation are dismissed prior to the constitution of the arbitral tribunal.
- retrofitted into the entire treaty regime without geographic discrimination through an inclusive multilateral agreement.
- implemented immediately; and
- accompanied by a commitment to review its effectiveness after an initial period that is short enough that it can avert catastrophic climate change.

More importantly, and to preserve much-needed momentum for holistic reform, if an OECD process on a carveout does materialize, its member states should:

- clearly declare this carveout to be a partial solution that does not preclude more holistic reform involving treaty termination, both at the OECD and United Nations levels.
- explicitly recognize other pressing issues, such as the calculation of damages and third-party funding in ISDS; and
- in contrast to adding new layers of exceptions to an outdated regime that protects all investments, consider a paradigm shift to only protect investments that are selected based on sustainable development. This approach was suggested in The Creative Disrupters' 2018 Treaty on Sustainable Investment for Climate Change Mitigation and Adaptation (Annex I).

Lastly, it is important to agree on a concrete timeline to ensure that energy and resources are channeled swiftly to implement a broad reform.