Energy Charter Treaty (ECT) reform: Why it has failed to deliver on the EU's own objectives

CAN Europe · SOMO · TROCA Plataforma por um Comércio Internacional Justo · Friends of the Earth Europe · NO! Tratados de Comercio e Inversión · ecologistas en acción · Both ENDS Connecting people for change · FNV · Veblen Institute for Economic Reforms · HANDEL ANDERS! · Power Shift

Summary of key issues

What is the ECT? A trade and investment treaty which protects investments in the energy sector. Its provisions, effectively unchanged since conception in 1994, include the ability for fossil fuel investors to sue governments through private tribunals for multiple-billions of dollars if action on climate change and the environment damage their future profits.

- EU and Member States recognise the ECT is out of date.
- Reform process started in 2018. In 2019, the European Commission received a negotiation mandate with a threefold objective. Analysis of progress reveals that the Commission mostly failed to achieve those ambitions.

EU objective	On track?	Why?
Ensure the ECT is not an obstacle to fulfilment of the Paris Agreement or energy transition	✗	At best, existing coal, gas and oil investments would continue to be protected well into the mid-2030s. Some new gas investments in pipelines and power stations could even be protected until 2040. And worst, other members of the ECT are reportedly able to protect fossil fuels indefinitely.
Reform the ECT's Investor-State Dispute Settlement system	✗	The outdated system of ISDS in the ECT, declared 'dead' by Trade Commissioner Malmstrom in 2018, has not been reformed in the modernisation process. It hasn't even been one of the items tabled for discussion throughout the process. It is therefore politically unacceptable but also legally in contradiction with EU law, as it doesn't fulfil the conditions for arbitration set by the CJEU in the CETA ruling (Opinion 1/17).
Align investment protection with EU standards	?	Key elements of the EU's reform agenda are opposed by other ECT members. The EU's proposals are very likely to be watered down. As a result, investment protections will remain broad and retain supremacy over the legitimate right of states to regulate in the public interest. Crucially, it remains uncertain whether the reforms will ensure compatibility with EU law, as the ECT currently lacks sufficient safeguards to preserve the autonomy of EU courts.

- The European Commission intends to politically sign off the reform in June 2022.
- Honest evaluation of progress must balance against the possibility of joint EU withdrawal.
- Solutions can and must include action to neutralise the 20-year sunset clause and measures to ensure a socially just energy transition.

Analysis: Can ECT reform deliver on the EU's objectives?

The European Union and its Member States have long considered the ECT outdated and in conflict with some of the basic principles of EU law and hence started a process to reform the ECT in 2018. The EU received a mandate from the Council to achieve three objectives for this reform. We discuss each of these in turn and their likelihood to be achieved in ECT reform.

Objective 1: Making the ECT climate-compatible

The ECT can be used and **is being used by fossil fuel firms to attack policies aimed at their regulation and eventual phase-out**. For example, RWE and Uniper are suing the Netherlands for banning the use of coal in energy generation from 2030. The EU wants to prevent such claims in the future to ensure that the ECT is no obstacle to the fulfilment of the Paris Agreement and facilitates the required transition of energy systems.

One of the EU's core ambitions and the most contentious issues in ECT reform so far has been the 'definition of economic activity in the energy sector', which defines the **energy sources that benefit from the ECT's investment protection**. The EU has submitted a proposal in the negotiations that would gradually reduce and eventually end investment protection for fossil fuels.

Unfortunately, this **proposal falls far short of what would be required to make the ECT compatible with the Paris Agreement and the European Green Deal**. For existing investments, it foresees a 10-year transition period in which fossil investments would continue to be protected. The transition period would start after Contracting Parties have ratified the reformed agreement, i.e. not before the mid 2020s - but the last ECT reform in the 1990s took no less than 12 years to enter into force. This means that **existing coal, gas and oil investments would continue to be protected well into the 2030s. The proposal even extends the protection of some new investments in gas infrastructure, such as pipelines and power stations, until 2040**.

Paris-compatible energy scenarios show that in order to limit global warming to 1.5°C, we must stop burning coal by at least 2030, gas by 2035 and oil by 2040. Phase-out decisions for all of these energy carriers would have to be taken many years before investment protection for these fuels ends, which poses a great risk of litigation under the ECT.

Hence, **even under the EU's proposal, states could not pursue a climate-compatible energy transition without having the risk of being sued**. It was the most ambitious proposal on the table at ECT reform but as reported in the media in July 2021, **not a single contracting party supported the EU's move**. Ever since its rejection, the EU has tried to work on compromises.

The compromise that has reportedly won now is the so-called **flexibility approach**. It allows the EU to put its insufficient proposal into practice to slowly end investment protection for fossil fuels at home while all other Contracting Parties can continue business as usual and not implement any changes. This means that countries such as the UK, Switzerland, Japan or Turkey will **keep fossil investment protection indefinitely**, while in the EU existing investments in coal, oil and gas will continue to be protected until the mid-2030s and some gas investments even until 2040.

From a climate perspective, the expected reform outcome is a failure. No Contracting Party will end investment protection for fossil fuels in a timeline that is necessary to align with the Paris Agreement.

Expansion of investment protection to new technologies

While there is no support from Contracting Parties other than the EU to limit investment protection for fossil fuels, there is **widespread support to even expand the list of technologies that are protected**. The EU for instance is proposing to add 'low-carbon' hydrogen, renewable hydrogen, biomass and biogas to the energy carriers that are protected. According to media reports, Switzerland supports this and in addition suggests to protect energy storage as well as CCS. The latter is also supported by the UK.

It was already evident in the leaked ECT reform's progress report from December 2020 that **several contracting parties supported the expansion of the ECT to new technologies and not a single contracting party had raised objections** to this approach. It is yet unclear which technologies will finally be included. However, what is clear already is that this would significantly increase the risk of future ISDS cases for no gain. A comprehensive OECD study found no conclusive evidence that investment protection agreements stimulate investments. Moreover, **it seems particularly incoherent that the EU is willing to expand the coverage of the ECT's outdated ISDS** (see below Objective 2).

Objective 2:
To reform the ECT's Investor-State Dispute Settlement (ISDS) system

The European Commission considers Investor-State Dispute Settlement (ISDS) "not acceptable" and "inadequate". The EU no longer concludes international agreements with ISDS and has replaced it in recent agreements with an **Investment Court System (ICS)**, first used in the EU-Canada Comprehensive Economic and Trade Agreement (CETA). In parallel, the EU is trying to establish a Multilateral Investment Court at UN level. These reforms aim to address some controversial procedural aspects of ISDS by **improving transparency**, replacing party-appointed arbitrators that are often subject to conflicts of interest with **a roster of state-selected adjudicators** and introducing an **appeal system**.

The EU is bound to this new system politically and legally. In its Opinion 1/17 on CETA, the **Court of Justice of the EU (CJEU) set some minimum requirements for international treaties providing for investment arbitration**. It ruled that the system must 1) guarantee the impartiality of judges; 2) provide for an appeal mechanism; 3) guarantee that arbitration panels only interpret the agreement itself, not EU or national law.

The ISDS mechanism in the ECT doesn't fulfil any of these requirements, nor will the modernisation process address this. The reason is simple: The issue is not even being discussed. In particular Japan opposed the topic to be added to the reform agenda. For this reason, the **reform will fail to align the ECT with EU law and contradicts the EU's stance against ISDS**.

The question of intra-EU lawsuits – Are EU investors worse off than non-EU investors?

In September 2021, the CJEU clarified in its Komstroy ruling that the intra-EU investment arbitration on the basis of Article 26 ECT is not compatible with EU law and thus cannot **apply in conflicts between an EU investor and an EU Member State**. The ruling is legally binding but still needs to be implemented by the EU and its Member States. Indeed, they will have to find a way to effectively prevent intra-EU cases from going ahead. So far, arbitration panels continue to hear intra-EU disputes, ignoring the CJEU's ruling – as they have frequently done in the past.

In the Komstroy ruling, the CJEU only dealt with the legality of intra-EU disputes. Non-EU investors will continue to benefit from the extensive protection and compensation system that the ECT provides. This further reinforces the discriminatory character of investment arbitration where foreign investors (in this case, **non-EU investors) enjoy an extra layer of protection and thus have more substantial and procedural rights than national (EU) investors. This situation may also encourage European investors to structure their activities within the EU via the UK or Switzerland, for example, in order to continue to benefit from a maximum level of protection**.

Objective 3:
To align the ECT's investment protection provisions with the latest standards in EU investment agreements

International investment agreements grant broad protection standards to foreign investors. In its recent agreements, the EU has started to **tighten the wording of these extensive investors' rights**, for instance by refining the so-called **Fair and Equitable Treatment (FET) standard**. The purpose of these changes is to ensure that **states' right to regulate** is not limited by investment protection rules.

The EU has submitted a proposal for ECT reform in May 2020. No information is publicly available so far to what extent the EU will succeed in putting this proposal into practice. However, even if the EU proposal would be fully implemented, investors could continue to misuse the ECT to target legitimate policy objectives, failing to give governments the policy space they require to successfully regulate the transition to climate neutral energy systems:

Modernisation topic	What are the problems to be solved?	Is the reform likely to change this?
Definition of 'investor'	The current ECT allows investors without substantial business activities (so-called mailbox companies) to use the ECT's ISDS mechanism.	Partially. The EU is aiming to end this practice by tightening the definition of investor.
Fair and Equitable Treatment (FET) standard	In investment arbitration, the FET standard is sometimes referred to as a "super standard" due to the high number of successful claims invoking it. The open-ended formulation of the clause in the ECT leaves tribunals with significant leeway in interpreting investors' rights. Perhaps most controversially, arbitral tribunals have found the FET standard to mean that the host state must, in implementing new regulations, respect the investor's "legitimate expectations" and that this meant the investor could legitimately expect the state not to fundamentally change its legal framework. The ECT's FET standard is therefore a major obstacle for a state's right to regulate.	No. Even the EU's proposal - which is likely to be the most ambitious - for FET falls short of real improvement. The article codifies that 'frustration' of an investor's 'legitimate expectations' will breach the FET standard. This interpretation is not a limitation of the standard, but an expansion of it. Moreover, the provision does not require a written promise or commitment in order for a legitimate expectation to be established. This leaves room for wide interpretation and will most likely lead to a chilling effect on necessary and important domestic regulation. The public communications from the ECT negotiation rounds make it clear that the FET standard remains one of the most contested issues in ECT reform. It is therefore likely that the insufficient EU proposal will be watered down further.
Definition of 'indirect expropriation'	Investors can argue that they have been indirectly expropriated when a state activity lowers their expected returns on investment. For instance, Uniper is arguing that the Dutch decision to phase-out coal for electricity production constitutes indirect expropriation. This significantly limits states' right to regulate.	No. The EU's proposed changes for indirect expropriation are unsatisfactory. It merely limits the definition to 'non-discriminatory measures' that protect 'legitimate' public welfare objectives and to measures that do not 'appear manifestly excessive'. This invites additional scrutiny of domestic policies by private investment lawyers. It also creates a significant legal loophole, as it would be very easy for investors and arbitrators to present disruptive – albeit entirely necessary – emission reduction measures taken to achieve climate objectives as 'manifestly excessive'.

Inclusion of a new article to protect states regulatory space	This new article is intended to 'reaffirm' states' right to regulate and to clarify that investors' treaty-based privileges do not constitute a commitment from the Contracting Parties not to change their regulatory or legal framework.	No. The formulation proposed by the EU is merely a guideline for investors and arbitrators and does not constitute a proper carve-out for decision-making in the public interest. Investors could continue to challenge public interest regulations with success as demonstrated in a recent arbitration decision in the so-called Eco Oro case, in which Colombia unsuccessfully tried to invoke an environmental exception clause for measures aimed to protect a natural ecosystem that impacted on a mining company's operation.
Inclusion of a new article referring to the UNFCCC and the Paris Agreement	The ECT currently makes no mention of the climate emergency, whereas the treaty is more and more often used by fossil investors to sue against climate measures.	No. This new article proposed by the EU, even when read in conjunction with the new article on the right to regulate, is not sufficient to ensure the ECT cannot be used to challenge climate response measures. More effective would have been the inclusion of a supremacy clause clarifying to investment arbitrators that investment protections do not outweigh Contracting Parties' obligations arising out of international environmental, social and human rights agreements. Instead, the current Article 16 which provides for the supremacy of the ECT over other international agreements will remain unchanged.
Valuation of damages	Arbitration panels often award staggering sums in compensation to foreign investors. The reason is that they compensate for future expected profits and the methods to calculate the compensation are often overstating the actual damage caused.	No. The EU proposal would neither exclude expected profits from being compensated, nor would it rule out the most controversial forms of damage valuation. Moreover, arbitration panels wouldn't be forced to base compensation amounts on a fair balance between the public interest and the interests of the injured parties.

While the EU may succeed to some extent in aligning the ECT to most of its proposals on the substantive standards, there remains concerns about whether the ECT, even if **reformed according to the EU proposal, will in practice preserve states' regulatory space needed for a swift and just clean energy transition**.

Conclusion

Negotiations of the ECT have so far suffered from a lack of transparency. However, **all available information points to the conclusion that ECT reform will not deliver on most of the EU's stipulated objectives and therefore the EU fails to fulfil its mandate**. Moreover, even if reformed accordingly to the EU's proposals, the ECT would continue to pose a **threat to urgently needed climate action**, it would continue to be **in conflict with EU law** and it would **undermine the EU's reformed approach to investment protection**, which needs to go further and not fall back into old patterns.

Policy makers should assess the outcomes of the ECT modernisation process **against the following benchmarks**:

- Does it make the agreement coherent with the Paris Agreement targets and the European Green Deal by immediately ending protection for all fossil fuel investment, for all parties?
- Does it guarantee states' right to regulate by introducing effective limits to investors' rights and clarifying the supremacy of international social and environmental obligations over investors' rights?
- Does it end the use of the old ISDS system, so that the minimum requirements set by the CJEU's Opinion 1/17 are met?
- Does it end the risk of ISDS claims in particular against climate and energy transition policies or does it increase that risk even further due to an expansion of the scope of investment protection to new technologies?

The EU and its Institutions need to **carefully evaluate whether ECT reform can be deemed a success**. If not, the EU and its Member States could **jointly withdraw from the ECT**. In order to neutralise the sunset clause, which allows investors to sue for another 20 years after a state has withdrawn, states should conclude an additional agreement to not apply this clause amongst one another. Ideally, the EU should try to convince other countries to withdraw jointly to maximise the neutralisation effect of the sunset clause.

For further information, please contact:

Cornelia Maarfield, Senior Trade and Investment Coordinator, CAN Europe
cornelia.maarfield@caneurope.org