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Stepping out of the modernized Energy Charter Treaty – the best way forward?

By Christina Eckes

On 24 August 2022, Italy was ordered by an international arbitral tribunal established under the Energy Charter Treaty (ECT) to pay EUR 240 million to the English gas and oil company, Rockhopper. The reason for awarding damages to Rockhopper was Italy's decision to prohibit further drilling for oil and gas within the range of 12 nautical miles of its coast. The ECT to which 53 parties are signatories – including the EU and its Member States, except Italy - has become a weapon in the hands of fossil companies that seriously hampers fighting the climate crisis. The EU and its Member States should withdraw from this toxic treaty as soon as possible.

The ECT was signed in 1994 and entered into force in 1998. It aimed to incentivise and protect Foreign Direct Investments (FDIs) in the energy sector, in particular from Western European countries into fossil rich countries in the East. In many respects, the ECT is an unusual and anachronistic investment treaty that would not meet current standards of protecting the right to regulate, in particular in order to meet other legal obligations, including obligations to reduce emissions.

For long, the ECT has been strongly criticized. Different from the protection of property rights, *e.g.*, under EU law and the European Convention of Human Rights, the ECT protects not only lost investments but also (uncertain) future profits. The stark contrast in protection becomes apparent when comparing the 2018 case of *O'Sullivan McCarthy Mussel Development Ltd v. Ireland*, in which the European Court of Human Rights (ECtHR) held that a company's loss of profit from a temporary ban to fish mussel seeds imposed in order to comply with EU law did not call for compensation. The ECtHR argued, first, that the protection of the environment and compliance with EU law were both legitimate

objectives and, second, that the company should have been aware that the need for the State to comply with EU regulation was likely to affect its future business. On a broader scheme of climate mitigation measures, one could conclude from this case that the mitigation of climate change, as well as compliance with a state's obligations under the 2015 Paris Agreement and EU law regulating emission reduction would qualify as a legitimate objective. Furthermore, the fossil fuel industries have and should have been aware for a long time that states will need to adopt mitigation measures that impact their business model.

However, under the ECT the situation is evaluated differently. Rockhopper for example had invested slightly less than EUR 30 million in the drilling project off the Italian coast, *Ombrina Mare*, at the time of Italy's oil and gas ban. This is less than an eighth of the compensation awarded by the arbitral tribunal. The German energy company RWE has a similar claim pending against the Dutch government for the ban on burning coal in its power plants after 2030. Only this claim amounts to EUR 1,4 billion. Furthermore, in 2021, the German energy company Uniper had started similar proceedings against the Netherlands but suspended them in 2022 in line with the conditions imposed on it for receiving state subsidies from the German government.

The climate crisis requires an energy transition of unprecedented proportions and pace, including an accelerated departure from the existing fossil infrastructure. It is precisely this context in which the Energy Charter has become an attractive business model for fossil companies. Large international law firms now advertise the "opportunities" offered by the investment treaty (see European Law Blog of 4 Oct 2021). Litigation can be conducted without significant cost or risk, further encouraging its proliferation. For example, Rockhopper's litigation costs were paid for by an arbitration funder on a no-win–no-fee basis, which now receives 20% of awarded damages in return.

The next two months are crucial. The EU and the EU Member States will decide on the future of the ECT. On the agenda is whether the EU and its Member States will withdraw from the ECT, or participate in the adoption of the modernization package as it was agreed in June 2022 by the signatory parties.

Unilateral withdrawal of any (group of) signatory parties is legally possible under the ECT (see Article 47 ECT). In response to the criticism of the ECT and the pending claims for compensation against the Dutch state, the Dutch Parliament earlier this year asked the Dutch government to withdraw from the ECT. Italy already stepped out of the ECT in 2015. However, withdrawal does not immediately end the effects of the ECT for the withdrawing parties. The ECT contains a so-called "survival" or "sunset clause" that protects investments for 20 years after withdrawal. This long transition period is cited by the European

Commission as the main reason for taking the modernization route rather than withdrawing.

The agreement in principle on the text of the modernized ECT largely reflects what the EU wanted at the outset of the negotiations. Once provisionally applicable, it would offer improvements over the current situation. For example, intra-EU arbitration proceedings - which currently account for about two-thirds of all disputes - would be excluded the so-called REIO (Regional Economic Integration Organisation) clause in new-Art 24(3). This addresses the incompatibility with EU law as identified by the Court of Justice (Komstroy, 2021). In addition, a "flexibility mechanism" would allow contracting parties to terminate investment protection for fossil fuels in their territories. The protection of fossil fuel investments made before 15 August 2023 would – as the text also states – end ten years after entry into force. The protection of many fossil fuels investments made after 15 August 2023 can be excluded.

At the same time, at least four fundamental objections speak against the modernized ECT:

First, the modernized ECT also retains an undesirable legal framework that prioritizes economic goals over necessary climate policies, protects the future earnings of investors beyond and above the property protection of ordinary citizens, and removes disputes about fundamental socio-economic changes in the context of the energy transition from the embedded domestic judiciary.

Second, the 10-year protection period for fossil fuel investments made before 15 August 2023 would begin to run at the moment the ECT enters into force, not provisional application. Entry into force, however, will take in the most optimistic scenario several additional years. In other words, the modernized ECT still offers protection for existing and future (made within the next 11 months) fossil fuel investments for at least the next 12 or 13 years. Yet, as repeatedly stated by the Intergovernmental Panel on Climate Change (IPCC), these years are determinative in the fight against climate change.

Third, the modernized ECT continues to protect fossil fuel investments made by EU investors abroad (unless the other signatory party has terminated the protection of fossil fuel investments). This is relevant, e.g., in relation to investments in Azerbaijan, which have recently drawn attention as investments in a relationship with a 'reliable and trusted' energy partner.

Fourth, protection under the modernized ECT is extended to investments into renewable energy sources, including biomass, biofuels and synthetic fuels. This cements future energy policy and is at odds with what we need in the energy transition: flexibility for a search for the best energy solutions. In particular the great speed with which the energy transition must take place in light of the urgency of the climate emergency requires choices to be made that may have to be adjusted later. The discussion on the use of

biomass for electricity generation is a good example of this. This need for flexibility makes the modernised ECT a curse, not a blessing, for the energy transition.

For all those reasons, the by far better option is to unilaterally withdraw from the treaty. The EU and as many like-minded countries as possible would then have the chance to conclude an inter se modification treaty pursuant to Article 41 of the Vienna Convention on the Law of Treaties (VCLT) that excludes arbitration proceedings by an investor of one of the parties against another party to the inter se modification. The EU and all EU member states would ideally need to participate but also non-EU states. It must include the EU to avoid all doubts that Member States could be asked to foot the bill for ambitious national or local climate policy under the EU Financial Responsibility Regulation. France, Germany, the Netherlands, Poland and Spain have previously indicated that they are considering to withdraw. If an inter se modification agreement between EU member states is reached in the coming months, nothing stands in the way of giving that agreement immediate legal effects. Withdrawal from the ECT enters in force one-year after notification.

Such coordinated withdrawal from the ECT is preferable to modernization. It would also send an important signal that we have understood the urgency of the climate emergency and no longer want to continue with treaties that place investor rights above all other considerations in the energy transition.