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The Climate Change and Fossil Fuels (CLIFF) project studies policy challenges surrounding the energy transition

BILATERAL INVESTMENT TREATIES HINDER THE FOSSIL FUEL PHASE OUT

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Key Messages

1. **Bilateral Investment Treaties (BITs) encourage investments in fossil fuels (FF) by protecting such investments.**
2. **BITs create a favourable investment climate for foreign investors and protects their rights while the state only has obligations (to protect the investment) and no rights.**
3. **Dispute settlement processes under BITs often involve international arbitration which side-lines national courts.**
4. **States may lose control over their resources included in the contracts because of the fear of high costs of arbitration and possible compensation awards.**
5. **BITs can be inconsistent with the host countries development and FF phase out policies that will become more stringent with future climate change goals.**
6. **Most BITs include survival clauses which enables investors to use a terminated BIT to launch international arbitration against a state.**

Introduction

Bilateral Investment Treaties (BITs)(Figure 1) are entered into by two contracting states with the aim to protect and promote protecting investments in all sectors, including energy and fossil fuels (FF), regardless of their carbon intensity (Di Salvatore, 2021). Under typical BITs, each state party grants substantive rights and procedural rights to investors from another state party and to the investments they make in the host state's territory. Investors in FF projects may invoke BITs expropriation provisions to seek compensation from governments implementing increasingly stringent regulatory measures to reduce greenhouse gas emissions – for example, through stricter environmental standards, a carbon tax, or bans on certain fossil fuels; — if the investors perceive these measures to substantially deprive them of their investment or affect their profitability.

The question is: do Bilateral Investment Treaties stand in the way of a fossil fuel phase out?

Fig. 1. Global network of BITs in force (around 3000)

Source: Bosch, 2022 based on UNCTAD, 'International Investment Agreements Navigator' (2022).

1. Bilateral Investment Treaties (BITs) encourage investments in FF by protecting such investments.

BITs are used to pressure states to postpone or withdraw the cancellation of licenses or permits for new projects. This leads to investment in assets that may lead to a carbon lock-in in the country, and if phased out, stranded assets and debt.

2. BITs create a favourable investment climate for foreign investors and protects their rights while the state only has obligations (to protect the investment) and no rights.

Contracts between foreign investors and states on FF under BITs are protected under these BITs. A state that wishes to prematurely end such a contract, is therefore obliged to pay compensation to the company for lost revenues during the period of the contract. Investors already resort to the Investor State Dispute Settlement (ISDS) mechanism to sue states over measures to phase out fossil fuels, and this trend is likely to increase (Tienhaara & Cotula 2020, p. 1). 75% of the foreign-owned coal power plants that need to be retired early in line with the Paris Agreement on Climate Change are covered by at least one treaty with ISDS (Tienhaara & Cotula, 2020, p.27). 60% of the fossil fuel arbitrations in ISDS cases are based on BITs (Di Salvatore, 2021). Certain BITs, mainly the more recent ones, impose concrete environmental obligations on state parties but not on investors as they are generally not bound by BITs (Leal-Arcas et al., 2020).

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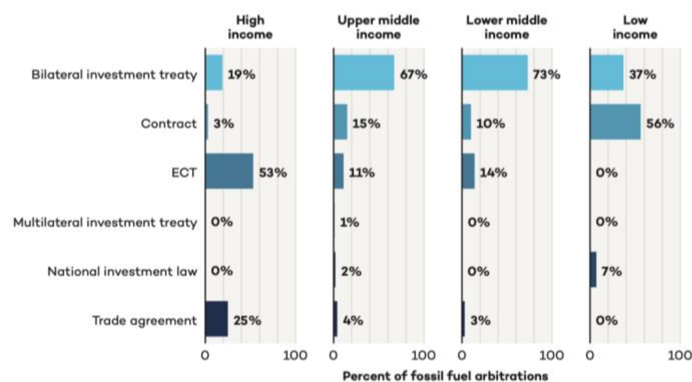
3. Dispute settlement processes under BITs often involve international arbitration which side-lines national courts.

In 2020, the EU Court of Justice ruled that intra-EU BITs conflicted with EU law after which 277 intra-EU BITs were terminated including their survival clauses (Moehlecke & Wellhausen, 2022). However, Austria, Finland, Ireland, and Sweden refused to terminate their intra-EU BITs. Additionally, the European Union has refrained from making a clear decision on the rights of individual member states to maintain BITs with non-EU states. New or renegotiated BITs should deny FF investors substantive rights and access to treaty-based dispute settlement since they can resort to domestic courts (Brauch, 2020).

4. States may lose control over their resources included in the contracts by the fear of high costs of arbitration and possible compensation awards.

In the FF context, states often face the dilemma between simultaneously meeting their obligations under the Paris Agreement and their obligations to protect fossil fuel investments (Sachs et al., 2020). Protections under investment law appear to be stronger than the requirements under the Paris Agreement on Climate Change and EU law. Even when host states succeed in fending off climate-related claims, the legal defence costs may be significant, affecting developing countries in particular (Brauch, 2020). Such cases could potentially deter governments from phasing out FF. A notable emerging trend is a rise in contract-based litigations in low-income countries. Lower-middle- and upper-middle-income countries see a predominance of claims based on BITs (Figure 2). In developing countries “assets such as coal power plants are often younger … so investors are more likely to suffer financial losses in the transition to cleaner forms of energy” (Tienhaara & Cotula, 2020, p. 32).

Fig. 2. Legal basis for arbitration claims according to the income level of the respondent state



Source: Di Salvatore, 2021.

5. BITs can be inconsistent with the host countries development and phase out policies that will become more stringent with future climate change goals.

Existing BITs fail to advance climate goals and can effectively hinder states’ climate action. As developing countries are encouraged to phase out fossil fuel, they may be deterred from doing so if they have just signed an investor state contract. While many companies would like to invest in FF abroad and ensure the protection of their investments through the use of BITs, developing countries need the flexibility to be able to stop a FF operation if needed without having to pay compensation to the company. Thus, climate friendly, new or renegotiated BITs must not hinder climate action (Brauch, 2020). They should also exclude controversial provisions such as fair and equitable treatment [FET], legitimate expectations, indirect expropriation, and most-favoured-nation [MFN]. MFN treatment, expropriation, FET and the protection of legitimate expectations are some of the substantive BIT provisions that put climate goals at risk. Climate-friendly measures adopted by states can be seen as violating non-discrimination obligations of BITs (e.g. cancelling subsidies or other investment incentives for high emission investment, i.e. fossil fuels (Brauch, 2020).

6. Most BITs include survival clauses which enables investors to use a terminated BIT to launch international arbitration against a state.

Countries increasingly seek to preserve greater public policy space and protect themselves from dispute settlement claims from foreign investors by terminating existing BITs or replacing them with renegotiated ones (Buzdugan, 2021; European Commission, 2020). Most terminations, at least 42 in 2020, resulted from the termination of intra-EU BITs and as a response to ISDS (UNCTAD, 2021). However, states terminating climate-unfriendly BITs still face survival clauses that protect existing investments in the host country for an additional period of between 10 and 20 years, keeping them liable for dispute settlement claims. Furthermore, none of the 13 BITs concluded in 2019 refers specifically to climate goals and therefore do not evidence climate-oriented reform (UNCTAD, 2020).

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