What is Fueling the Future of the ECT?

Recent years have seen a political re-evaluation of the Energy Charter Treaty (ECT). The ECT is a multi-national legal instrument originally designed to liberalize energy trade after the fall of the Soviet Union in the 1990s. Investors with qualified investments can enforce the ECT's protections through international arbitration. To date, over 150 such cases have been launched. Many led to historically consequential compensation decisions.

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Whether the ECT's utility has become outmoded is a matter of perspective. Undoubtedly, the existence of safeguards against expropriation, unfair treatment, and discrimination (amongst others), along with the provision for international arbitration instead of domestic court systems, serves as an incentive for foreign investments of any nature. In this respect, the ECT substantively protects existing and new energy projects. Given recent geopolitical events, including the war in Ukraine and its effect on the global fuel market, and greater awareness about the repercussions of climate change, energy investments have attracted greater scrutiny. In particular, the ECT's historic protection of fossil fuel investments has been criticized as incongruent with rigorous decarbonization regulation and the promotion of alternative energy sources. Various economic and political factors at national and EU levels, have added further pressures for reforms, with some contracting parties advocating for reforms or the complete withdrawal from the ECT.

ECT Modernization

The Intergovernmental Panel on Climate Change (IPCC) reflects scientific consensus on global carbon dioxide (CO_2) emissions caused by human activity. It estimates that the energy sector contributes to approximately three-quarters of global greenhouse gas emissions. Although the ECT's reach does not cover all projects – only those of the contracting parties – this necessarily implicates the role of the ECT.

In 2022, after nearly five years of consultations by the ECT contracting parties, a proposed framework for modernization was announced. It includes a carve-out for new fossil fuel projects and a ten-year sunset of protections for existing projects. It specifically extends protection for decarbonization technologies. The framework expressly reserves environmentally-related public policy aims within the scope of the sovereign right to regulate.

However, efforts to implement the framework were stifled when certain EU parties decided to explore withdrawal from the ECT. Although no legal withdrawal from the ECT has occurred to date, the EU and Euratom are currently pursuing a coordinated departure by its membership, from which specific Member States of the ECT's 66 signatories are likely to take cues (in addition to the 66 State signatories, the EU and Euratom are also signatories).

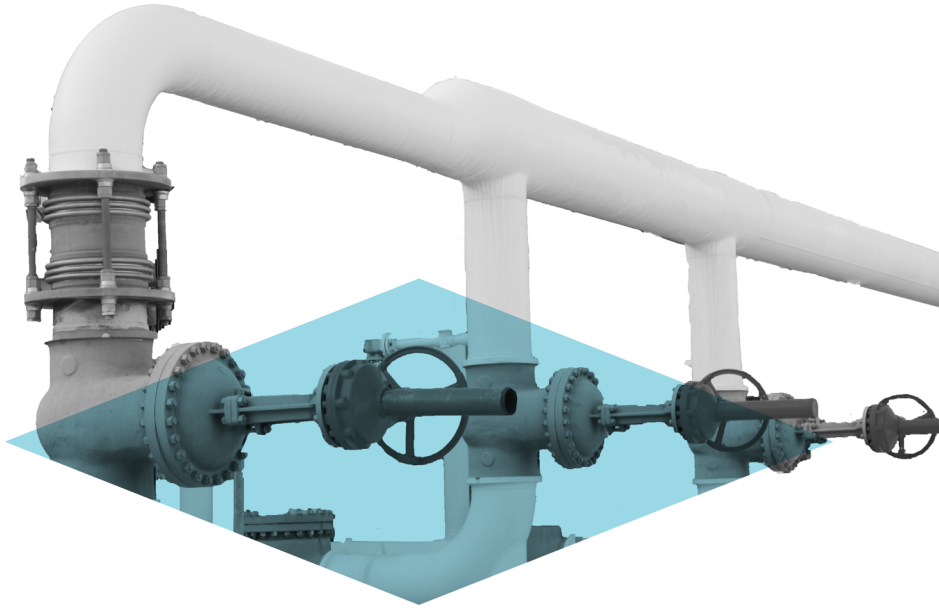
Certain contracting parties also proposed excluding the application of the sunset clause as part of the reforms. This would suggest any updated ECT text would depart from its current stance of energy-source neutrality. In essence, the modernized version of the treaty would distinguish between investments in carbon-intensive energy sources, which ought to receive less favorable treatment and eventually be phased out, and investments in low-carbon energy sources, which would be promoted and better protected.

In another development, the United Kingdom has utilized the ECT's denial of benefits provision, attempting to revoke protection for specific Russian investors, including those commonly referred to as "mailbox" investors and those who are subject to the UK sanctions regime.

Government Policies and Energy Investment

The primary political call for ECT reform addresses members' desire to achieve fossil fuel project phase-out without incurring liability and significant compensation for failure to comply with the ECT's obligations. Several high-profile cases that concern environmental and carbon emission reduction schemes demonstrate this tension. Critics frequently express reservations about the ECT's investment protections, arguing they are not tailored to specific energy sources and undermine climate targets. This concern was illustrated in Rockhopper v Italy, which concerned Italy's decision to reintroduce a ban on oil and gas exploration and production activities within a 12-mile zone along the Italian coastline. The tribunal ultimately ruled that Italy had committed an unlawful expropriation of Rockhopper's investment under the ECT's protections as a result of this regulation.

On the other hand, investors have worries regarding the abrupt enforcement of policies and regulations of fossil fuel projects, which can lead to devaluation or total loss of value of their investments. Coal phase-out deadlines often result in the premature closure of fossil fuel facilities before they have reached their intended economic lifespan achieved equilibrium with investedcosts. The State's failure to provide adequate time and resources for a smooth transition gave rise to the recent case of RWE AG and RWE Eemshaven Holding II BV v. Kingdom of the Netherlands. The German utility company RWE initiated arbitration against the Netherlands, arguing a breach of the ECT in response to a 2019 law prohibiting coal for electricity generation. RWE committed a substantial EUR 3.2 billion investment in the construction of its latest plant, a decision which was claimed to be in response to a specific request from the Netherlands. According to RWE, it would be economically impractical to achieve profitability for these plants by switching to an alternative fuel source in the contemplated five-year timespan. While the decision is as yet unissued,, the case demonstrates the complexity of balancing the fossil fuel phase-out ambition and the protection of investor's legitimate expectations.



The Renewables Conundrum

Governments have defended quick and rigorous regulation for phasing out fossil fuel projects by invoking their responsibilities under the Paris Agreement. Specifically, they argue that the ECT is incompatible with EU law.

Since 2012, almost 70% of ECT arbitrations concerned reforms impacting the renewable energy sector. A careful analysis suggests that the disputes did not concern fossil fuel projects but rather the regulatory measures that target renewables. In particular, after the 2008 global economic crisis, many States reduced renewable energy sector subsidies. Several instances of tax levies in the Spanish industry spurred numerous investors to commence arbitration proceedings under the ECT. Furthermore, the removal of incentives for photovoltaic generators had a similar impact in Italy, while a State-imposed levy on solar energy led to investor claims in the Czech Republic.

The arbitral award issued in Charanne v. Spain was the first decision in a series of arbitrations commenced under ECT against Spain regarding amendments to its renewable energy regulations. In this arbitration, the Tribunal held that Spain's legislative changes were reasonable, proportionate, and in the public interest.

The *Charanne* case demonstrates the political parameters informing the intersection of renewable energy policies, investment protection, and regulatory sovereignty. The interaction of these issues is expected to remain a hot topic.For instance, the IEA Government Energy Spending Tracker reported that USD 1.34 trillion was allocated by governments for clean energy investment support since 2020. Government spending has played a central role in the rapid growth of clean energy investment since 2020, which rose nearly 25% from 2021 to 2023, outpacing growth in fossil fuels in the same period. Governments need to explore mechanisms that provide fair compensation to investors in cases where regulatory changes impact their investments, while also ensuring that the overarching goals of climate action and environmental protection are fulfilled.

Looking Ahead

The modernization of ECT poses complex challenges involving commercial, legal, and geopolitical dimensions. Yet, climate goals and investment protection are not mutually exclusive. A potential outcome can be achieved if investors have confidence that their rights and investments remain protected re and States can retain the ability to enact and enforce environmental protection laws to drive their policy objectives.

States can manage any apparent tension by engaging in constructive consultation with stakeholders on investment treaties, taking proactive mediation and alternative dispute resolution before a dispute manifests, and devising fair compensation structures that consider the broader context of climate action. Enhancement of policy certainty by providing clear, long-term roadmaps for climate action, and the featured role of private investment is also key in assisting investors to make informed – if qualified –decisions and reduce the uncertainty often associated with rapid policy changes. After all, the impact of investment has many reverberating benefits for the development of human capital and research, the advancement of technology and the establishment of a competitive market – the very features which make climate change goals actualizable.

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The authors thank **Dr. Abayomi Okubote** *for his valuable research assistance in the preparation of this article.*