Center on Inclusive Trade and Development
GEORGETOWN LAW

October 2024

HARNESSING ISDS REFORM: A TARGETED FOCUS ON COAL?

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INTRODUCTION

Addressing climate change will require comprehensive efforts to move away from fossil fuels—coal, oil and gas—as these fossil fuels account for over 75% of global greenhouse gas (GHG) emissions and nearly 90% of all carbon dioxide emissions1 However, investment treaties require states to protect foreign investments, including fossil fuel investments, within their territory and the Investor-State Dispute Settlement (ISDS) system associated with those treaties can make it more costly and more difficult for states to transition away from fossil fuels. The ISDS system, established under Bilateral Investment Treaties (BITs), under the ICSID Convention, and investment chapters of Free Trade Agreements (FTAs), allows investors to file claims against states when climate-related measures interfere in certain ways with their investments. Tribunals often uphold these claims, awarding compensations to the investors.[2] Fossil fuel corporations and their shareholders are among the most frequent users of ISDS, benefiting from some of the largest awards to date.[3] At least 349 investor–state disputes have been related to fossil fuel projects, accounting for 20.3 percent of ISDS cases, with fossil fuel corporations receiving upwards of $82.8 billion through ISDS awards.[4] Estimates suggest that global measures to combat climate change could generate more than $340 billion in ISDS claims from fossil fuel corporations.[5]

Investor-state disputes can also play a significant role in hindering the phase-out of coal-fired power plants.[6] As more countries commit to phasing out coal through, among others, the establishment of Just Energy Transition Partnerships (JETPs)[7] and pledges from COP26,[8] the fear of ISDS claims could impede or slow efforts to transition to cleaner energy sources. ISDS inefficiently redirects significant state funds to carbon emitters, funds that could otherwise be used for climate change mitigation and adaptation. Moreover, the system creates "regulatory chill," discouraging states from implementing climate-related regulations.[9] As recognized by the Intergovernmental Panel on Climate Change, ISDS can deter governments from taking the necessary measures to combat climate change.[10]

1 United Nations, Causes and Effects of Climate Change. www.un.org/en/climatechange/science/causes-effects-climatechange / 3 IPCC (2023) Climate Change 2023: Synthesis Report, Section 2, p 58.

2 Maria José Alarcon, 2023 *in Review: Climate Change and ISDS - Reshaping Investment Arbitration to Achieve Climate Goal*s, Kluwer Arbitration Blog (2024), https://arbitrationblog.kluwerarbitration.com/2024/01/31/2023-in-review-climate-change-and-isds-reshaping-investment-arbitration-to-achieve-climate-goals/ (last visited May 28, 2024).2024

3 Lea Di Salvatore, *Investor-State Disputes in the Fossil Fuel Industry*, (2021).

4 Lea Di Salvatore et al., *Investor–State Dispute Settlements: A Hidden Handbrake on Climate Action*, (2023).

5 Kyla Tienhaara et al., "Investor-State Disputes Threaten the Global Green Energy Transition," Science 376, (May 2022): 701, https://www. science.org/doi/10.1126/science.abo4637.

6 See Westmoreland Mining Holding, LLC v Canada (ICSID Case No. UNCT/20/3); RWE v. the Netherlands (ICSID Case No. ARB 21/4); Uniper v. the Netherlands (ICSID Case No. ARB/21/22).

7 German Council on Foreign Relations, *Just Energy Transition Partnerships*, https://dgap.org/en/research/glossary/climate-foreign-policy/just-energy-transition-partnerships (last visited Oct 6, 2024).

8 Glasgow Climate Pact, U.N. Doc. Decision -/CP.26 (Nov. 13, 2021).

9 Ayush Kumar, *ISDS in the Era of Mandatory ESG Guidelines: Reforming Existing BITs to Address Climate Change Concerns – American Review of International Arbitration*, (2023), https://aria.law.columbia.edu/isds-in-the-era-of-mandatory-esg-guidelines-reforming-existing-bits-to-address-climate-change-concerns/ (last visited May 28, 2024).

10 Priyadarshi R. Shukla et al., "Climate Change 2022: Mitigation of Climate Change. Working Group III Contribution to the Sixth Assessment Report of the Intergovernmental Panel on Climate Change," *Intergovernmental Panel on Climate Change,* April 2022, https://www.ipcc.ch/report/sixth-assessment-report-working-group-3/.

BACKGROUND

There is momentum in the global system for tailored reforms or adjustment to the ISDS system and the question presented in this paper is how to harness that momentum to support climate change action.

Costly ISDS awards affecting states' environmental and climate change policies have led European countries to withdraw from the Energy Charter Treaty (ECT), as the ISDS provisions contained in that treaty have been used to challenge fossil fuel phase-out efforts.[11] For years, pressure from civil society had been mounting against the ECT, with accusations that is provisions, most of which are also contained in other BITs and FTAs, were in conflict with European Union (EU) law, the EU's 2050 carbon neutrality objective, and commitments under the 2015 Paris Agreement. Italy was the first country to denounce the ECT in 2014. More recently, many other European countries have decided to withdraw from the ECT, prompting a vote within the European Parliament on April 24, 2024 resulting in the Union's formal retreat.[12]

Other bodies have also been exploring options to forestall ISDS's impact on climate action. For instance, the Organization for Economic Cooperation and Development (OECD) has been discussing a proposal to exclude climate-related measures from ISDS.[13] The aim is to quickly resolve investor challenges without full litigation, ensuring states retain control over their climate measures while minimizing potential abuse. This approach can be combined with sector-specific exclusions, such as with respect to fossil fuel investments, and implemented through a plurilateral treaty that modifies existing BITs and FTAs. Meanwhile, Working Group III of the United Nations Commission on International Trade Law (UNCITRAL) has been reviewing certain problematic features of the ISDS regime. However, thus far those efforts have been directed mainly at reforming procedural aspects of ISDS, but not its substantive or systemic issues.[14]

ROLE OF ISDS IN COAL PLANT PHASE-OUT

In 2022, coal accounted for 36% of global electricity generation.[15] Global coal demand also surged to an all-time high, increasing by 4% compared to the previous year, reaching 8.42 billion tonnes (Bt). This rising demand, driven both by power and non-power sectors, primarily resulted from the growth in Asia, particularly in China, India and Indonesia.[16] Despite its environmental impacts, coal remains significantly underpriced. An IMF study from 2021 on efficient fossil fuel pricing outlines that 99% of coal is priced at below half of its efficient level in 2020 due to the lack of accounting for high carbon and local air

11 Lukas Schaugg, Suzy H. Nikièma, & Nathalie Bernasconi-Osterwalder, *Investor–State Dispute Settlement and Fossil Fuels: What Role for a Carveout?*, International Institute for Sustainable Development (2024), https://www.iisd.org/articles/policy-analysis/investor-state-dispute-settlement-fossil-fuels-carveout (last visited May 28, 2024).
12 The Energy Charter Treaty, International Institute for Sustainable Development, https://www.iisd.org/projects/energy-charter-treaty (last visited Jun 3, 2024).
13 David Gaukrodger, *Future of Investment Treaties Track 1 — Investment Treaties and Climate Change Academic Contribution to the 9th Investment Treaty Conference*, OECD 9th Annual Conference on Investment Treaties (2024).
14 Lise Johnson et al., *Crucial Ingredients for Meaningful Reform at UNCITRAL: Withdrawal of Consent to Arbitrate and Termination of Existing Treaties | Columbia Center on Sustainable Investment,* https://ccsi.columbia.edu/news/crucial-ingredients-meaningful-reform-uncitral-withdrawal-consent-arbitrate-and-termination (last visited Jun 4, 2024).
15 Joel Jaeger, *These 10 Countries Are Phasing Out Coal the Fastest*, (2023), https://www.wri.org/insights/countries-phasing-out-coal-power fastest?apcid=0065a83d6ad8c2c5be925800&utm_campaign=wridigest&utm_medium=email&utm_source=wridigest-2024-10-03 (last visited Oct 6, 2024).
16 International Energy Agency, Coal 2023: *Analysis and Forecast to 2026*, (2023).

pollution damages.[17] While some countries are rapidly phasing out coal from their power generation[18], treaty-based ISDS cases related to environmental measures can and have challenged the phase-out of coal-fired power plants as outlined above.[19]

Globally, foreign investors have made substantial investments in the development of coal-fired power plants. For instance, in Indonesia the Korea Electric Power Corporation (KEPCO) has won the bid of the Jawa 9&10 coal-fired project in 2019.[20] In Vietnam, KEPCO also owns with the Japanese Marubeni Corporation and Tohoku Electric Power Co., Inc at a stake of 50%, 40% and 10% respectively the Nghi Son 2 Power Plant.[21] Furthermore, Posco Energy, South Korea's largest private energy producer, also owns the Mong Duong II Thermal Power Plant[22]; the Van Phong Power Company, a wholly owned subsidiary of the Japan-based Sumitomo Corporation owns the Van Phong 1 Coal Fired Power Project.[23] Mozambique is expanding its coal sector, the Benga Power Station is currently developed by the UK-based firm Kibo Energy.[24] All these investments can be protected under BITs of the respective countries and puts countries at the risk of exposure to arbitration if governments decide to implement rapid coal phase-out targets.[25] Indeed, a 2020 study noted that at least 75% of the foreign-owned coal power plants that need to be retired early are covered by at least one treaty with ISDS provisions.[26] Without implementing trade tools, ISDS cases could delay the pressing need to transition away from coal and/or make it more costly.

TRADE TOOL

To prevent the ISDS system from hindering states' climate measures, particularly their efforts to phase-out reliance on coal, while providing a legal pathway for resolving differences arising from the investor rights recognized in BITs and FTAs, several non-mutually exclusive options can be explored.

One option is to **establish an international claims process** for administering disputes from investors while recovering damages related to climate change impacts caused by these investors. The idea would be somewhat analogous to the Paris Club process for debt restructuring in which an informal group of investors and finance officials from the developing countries, potentially joined by any official creditors to relevant JETPs would work to find a coordinated approach to the phase out of coal. Such a central body would set benchmarks and criteria for compensation, stranded costs, and liability damages, ensuring fairness and consistency. Environmental and social costs would be included

17 Ian Parry, Simon Black & Nate Vernon, *Still Not Getting Energy Prices Right: A Global and Country Update of Fossil Fuel* Subsidies, (2021).
18 Joel Jaeger, *supra* note 12.investor-State dispute settlement (ISDS
19 See *supra* note 5.
20 KEPCO, *Business*, https://home.kepco.co.kr/kepco/EN/B/htmlView/ENBJHP00201.do?menuCd=EN02080101 (last visited Oct 6, 2024).
21 Nghi Son 2 Power Limited Liability Company (NS2PC), *About Us*, https://ns2pc.com/pages/about-us (last visited Oct 6, 2024).
22 Posco Energy, Global Business, https://eng.poscoenergy.com/_service/business/generator/global.asp (last visited Oct 6, 2024).
23 NS Energy, Van Phong 1 *Coal Fired Power Project*, 05/11/2020, https://www.nsenergybusiness.com/projects/van-phong-1-coal-fired-power-project/?cf-view.
24 Global Energy Monitor, *Global Coal Plant Tracker*, (2024).
25 Investment Policy Hub, *UN Trade & Development (UNCTAD)*, https://investmentpolicy.unctad.org (last visited Oct 6, 2024) (The Indonesia – Republic of Korea BIT is in force since 1991, the Vietnam – Republic of Korea BIT is in force since 1993 and both coexist with the ASEAN – Republic of Korea Investment Agreement (2009); The Japan – Vietnam BIT is in force since 2003 and coexists with the TIPP (2016). The Mozambique – United Kingdom BIT is in force since 2004).
26 Tienhaara, K., & Cotula, L. (2020). Raising the cost of climate action? International Institute for Environment and Development

in calculations, recognizing the broader impacts of fossil fuel use. The biggest hurdle may be creating sufficient incentives for foreign investors in coal mines or coal-fired power plants to be willing to forego full compensation for expropriation or to forego current ISDS rights. One potential form of leverage could be a cap on potential liability arising from litigation over the damages caused by coal-fired power (air pollution emissions like sulfur dioxide and particulate matter, toxic coal ash waste disposal, water contamination from cooling processes, contribution to carbon emissions, etc.) or coal mining (including methane releases). While limited in number, a growing set of cases around the world are finding that the operation of coal-fired plants violates various domestic regulations or broader constitutional rights to live in a healthy environment.[27] The idea would be to pair the threat of significant liability from such lawsuits with the desire for foreign investors to accept lesser compensation for their coal-related investments. Such a scheme could set up various tracks for phasing out coal-fired power or coal mining, with higher compensation amounts and/or lower caps of potential liability for those that agree to faster phasing out of coal and greater participation in JETP or other forms of transition financing. The program could require companies to cover costs related to dismantling, recycling, site clean-up, and employee transition, and to reinvest compensation into renewable energy, forest preservation, or climate projects. Liability payments could be capped and directed into a climate mitigation and adaptation fund, ensuring that awards from climate litigation are effectively utilized for addressing climate change.[28]

Another option, inspired by an OECD paper, is to **exclude certain investments** (e.g., fossil fuel investments) **from protection** under investment treaties **or exempt climate-related measures from ISDS**. This would allow states to adopt climate regulations without fear of ISDS claims. The carveout would need to be structured to prevent arbitral jurisdiction, applying not only to new treaties but also retroactively to existing BITs and FTAs through amendments[29] (such as the withdrawal of consent to arbitrate)[30] or a multilateral agreement. The OECD academic paper[31] suggests that states favoring climate carve-outs could conclude a subsequent plurilateral treaty that modifies their existing International Investment Agreements (IIAs) where both parties to an IIA are parties to the plurilateral opt-in agreement, similar to the approach that has been suggested for adopting ISDS reforms stemming from the UNCITRAL Working Group III process and was used to modify tax treaties to accommodate the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. The OECD academic paper presents an overview of how such a carve-out might work:

27 See Environmental Law Alliance, Coal Litigation Strategies https://elaw.org/coal; NB: Supreme Court of Chile finding operation of caol-fired power plants violated right to live in environment free from contamination, Rol No. 9852-2013, Supreme Court of Chile, decided on 9 January 2014 (as revised 6 November 2014)

28 Ingrid Palmquist, An Alternative to Climate Change Litigation: An International Claims Process, April 8, 2024

29 Maria José Alarcon, *supra* note 1.investor-State dispute settlement (ISDS

30 Draft Treaty Language: Withdrawal of Consent to Arbitrate and Termination of International Investment Agreements1 Submission to UNCITRAL Working Group III on ISDS Reform, contributed by Columbia Center on Sustainable Investment (CCSI), International Institute for Environment and Development (IIED), and International Institute for Sustainable Development (IISD) 15 July 2019

31 Joshua Paine and Elizabeth Sheargold, "Carving-out climate action from investor–State dispute settlement (ISDS): Suggested treaty language and commentary," OECD Future of Investment Treaties Track 1 -- Investment Treaties and Climate Change Academic Contribution to the 9th Investment Treaty Conference, March 11, 2024, https://one.oecd.org/document/DAF/INV/TR1/RD(2024)1/en/pdf

Figure 1: Diagram of procedural mechanism