Paris Energy Series

The Paris Agreement on Climate Change: Beware the Shield? – Arbitral Implications for the Oil and Gas Sector

March 2016

On 12 December 2015, the Paris Agreement (or the "Agreement") on climate change was signed by 195 States and the EU, provoking scenes of euphoria among the delegates involved. The Agreement sets out how the great majority of the world's countries shall tackle climate change from 2021. While the parties agreed on the "urgent need" to reduce greenhouse gas (or "GHG") emissions and on making progressively greater reductions into the future, overall, the language of the Agreement is often vague and aspirational. But this does not mean it is toothless; the significance of the Agreement cannot and should not be reduced to the black letter. Given the current deference accorded by tribunals to State regulatory actions, the Agreement may serve as a springboard for further climate change-related regulatory measures by States and those States may well invoke (and be well advised to invoke) the Agreement in defence to claims of unfair treatment by international investors. Many of the measures likely to be taken have implications for the oil and gas industry and deserve attention.

A deferential approach to a State's right to regulate may be in the ascendancy

Bilateral and multilateral investment treaties are by definition geared to the protection of the rights of investors confronted with state action. But that being said, recent arbitration awards show that the pendulum may well have swung more towards States whose "inherent right" to regulate has in many decisions been expressly recognized.[1] Whereas in the past many investment case decisions were seen to accord investors substantive protections whatever the State's motivation for the measures complained of, this seems to have changed. It has been observed that tribunals now tend to accord States greater leeway in regulating their economies consistent with longer term goals.[2]

As will be seen, the essence of many recent decisions seems fixed upon the investor's expectations when entering into the investment in the first place and whether those expectations were reasonable.[3] This case-law suggests that an investor cannot close its eyes to the possibility that the host state may indeed regulate the sector in which it finds itself, at cost to the investor.

The roots of the current trend can be seen as early as a decade ago. In *Saluka v Czech Republic*, for example, it was held that a State is not liable to pay compensation to a dispossessed foreign investor when, in the normal exercise of its regulatory powers, it adopts in a non-discriminatory manner *bona fide* regulations that are aimed at the general welfare.[4]

More recently, in the pending *Perenco v Ecuador* arbitration, it was decided that where oilfield operators suspend operations due to State regulation, the State can validly intervene in the operations of the oil blocks to maintain their continuity of operation. The basis of that decision was the tribunal's finding that Ecuador had demonstrated the potential production losses and various technical problems that could have ensued had operations been suspended. The tribunal also held that the intervention in the operations could not be said to have interfered with the rights of management and control over the blocks – and could not amount to an expropriation - since the claimant had voluntarily surrendered such rights on a temporary basis.[5] The *Perenco* arbitration also stands for the notion that oilfield operators can be held to higher environmental standards after their initial investment where this is consistent with national and international law.[6] In another case concerning claims of expropriation and unfair treatment in relation to the operation of an oil refinery, the tribunal held that:

> "The stability of the legal framework has been identified as an emerging standard of fair and equitable treatment in international law. However, the State maintains its legitimate right to regulate, and this right should also be considered when assessing the compliance with the standard of fair and equitable treatment."[7]

This view echoes the *dicta* of the tribunal in *Parkerings v Lithuania* which held that:

> "It is each State's undeniable right and privilege to exercise its sovereign legislative power. A State has the right to enact, modify or cancel a law at its own discretion. Save for the existence of an agreement, in the form of a stabilization clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment. As a matter of fact, any businessman or investor knows that laws will evolve over time."[8]

EnCana Corporation v Ecuador is another example. That case concerned participation contracts for the exploration and exploitation of oil and gas reserves with an Ecuadorian State-owned entity. The company's claims involved VAT refunds to which the claimant's subsidiaries were allegedly entitled under Ecuadorian laws and regulations. In denying the Claimant's arguments concerning indirect expropriation, the tribunal held that issues of indirect expropriation would arise only if the impugned tax law was "extraordinary, punitive in amount or arbitrary in its incidence".[9] It decided that it was for Ecuador to determine for the future the regime of its tax law, taking into account its international obligations.[10] Similarly, in finding for the State in *Nations Energy v. Panama*, the tribunal held that the State had the right to regulate the conditions under which tax credits can be used.[11]

In light of the above, States anxious to ensure the Agreement achieves its aims – as they all profess to be – may well be encouraged by any apparent flexibility accorded to them in the arbitral arena. This is not a bad thing, but a tension may obviously exist where an investor finds itself subject to new measures not contemplated when undertaking the underlying investment.

Many measures potentially taken in line with the Agreement will affect the oil and gas sector

As well as the above approach by tribunals, the scientific and political momentum which climate change action has attained – and the growing legal status of climate change principles e.g., the *Urgenda* case in the Netherlands – make a range of regulatory measures foreseeable.[12] First and foremost are emission reduction targets. For example, the US Clean Power Plan (currently being challenged by 29 States and State Agencies) sets State-specific CO2 emissions reduction targets mainly concerning existing coal-fired power plants.[13] The US also plans to adopt regulations to reduce methane emissions in the oil and gas sector, as stated in the US nationally determined contribution (a requirement for parties under the Agreement) published on 31 March 2015. Fiscal measures like carbon tax are also likely to feature. The awards in *EnCana* and *Nations Energy* are instructive in terms of how a tribunal may deal with claims relating to such tax or other fiscal measures that States may deploy under the umbrella of climate change regulation. Measures taken could also take the form of reductions to subsidies or export credits available to carbon-intensive industries such as the oil and gas industry.

It should be noted that even in the areas expected to benefit from the Paris Agreement, such as renewables, uncertainty lies. This has been amply demonstrated by the claims brought against Spain, Italy and the Czech Republic under the ECT, as a result of those States having offered economic incentives for electricity generation by renewable means only to then scale back the relevant benefits when the global financial crisis struck in 2008. This is noteworthy in the context of tax credit systems such as the renewable energy tax credits adopted in the US in December 2015.[14]

In the recent *Charanne* decision for example, and consistent with the trend outlined above, the tribunal held that Spain's modification of its feed-in tariff regime for solar energy producers did not violate its FET obligations towards the claimants and did not constitute an expropriation. The company was still in operation and turning a profit and the claimants' rights were in the company not in its returns.[15] As such, no expropriation had occurred.[16] Dismissing the FET claim, the tribunal found that Spain had not made specific commitments to the investors and their legitimate expectations could thus not be said to have been violated. Spanish law and court decisions indeed permitted Spain to modify its solar energy regulations and neither the government documents enticing the investment nor administrative registration of the project guaranteed any specific return.

An example of some of the design errors of renewable energy schemes in many European countries, including Spain, has been the development of an electricity tariff deficit. This deficit occurred because the amount in feed-in tariffs paid to energy producers increased out of proportion to the regulated tariffs paid by final consumers.[17] As the substantial incentives attracted more and more investors, the amount being paid in subsidies by Spain rose hugely, and the deficit increased. The need to scale back the subsidies in order to avoid unacceptable consumer energy price increases was one of the reasons for the scale back measures taken by Spain in the *Charanne* case.[18] Other States will doubtlessly learn from such miscalculations when conceiving their own renewable energy schemes

and the extent of such row backs will likely not therefore be as great in the future. But given the pace of technological development and the instability of many countries' economies, changes to such schemes cannot be ruled out, and investors could well be held to a standard by which they should have expected the same, and be estopped from seeking recourse.

Investors – in either carbon-intensive or carbon-friendly projects – would thus do well to undertake what may be called "climate change due diligence" before embarking on their investments. Oil and gas companies should take heed of legal developments in the host country and ideally obtain local legal advice as to the type of climate change regulation likely in that country. The recent *Charanne* award made clear that renewable energy investors' ignorance of indications that the investment régime in the host country may change is not necessarily an excuse. The investor should be aware of the regulatory and legal landscape before making its investment and cannot claim violation of legitimate expectations where this is not the case.

And if negotiating an investment contract, investors may thus wish to insert a stabilization clause which ensures greater protection in the event of regulatory change.[19] Care should be taken, however, not to aim too high. Full freezing clauses may never be agreed and in any event may not be enforced due to the above concern surrounding undue restriction of State sovereignty, of which national courts are also mindful. Including an economic equilibrium clause providing for negotiation and, ultimately, third party determination such as arbitration, may be a better option. This is in line with the evolution of stabilization clauses which have become less restrictive of State regulatory power and now typically aim to ensure no more than a measure of predictability and protection from arbitrary State action. It also demonstrates a collegiate approach which favours enforceability of the clause.

States, for their part, may choose to insert environmental regulation exceptions when revising investment agreements such as Model BITs.[20] By way of example, the US Model BIT 2012 has a reservation of rights clause for environmental regulation and enforcement. Article 12(3) refers to the two State parties' discretion in relation to regulatory and compliance matters and "the allocation of resources to enforcement with respect to other environmental matters determined to have higher priorities." Similarly, the national treatment provision of the Indian Model BIT 2015 permits India to distinguish between investments on environmental grounds.[21] Such provisions may not be necessary in order that measures can validly be taken but they can provide greater certainty. States will also doubtless aim to make clear that COP21 obligations shall be taken seriously and that effect shall be given to them. Proposed regulations would thus be made publicly know as soon as possible. This may help to qualify the legitimate expectations of investors and thus to reduce the scope for investor claims based on alleged violations of such expectations. In terms of stabilization clauses, should a State or state entity be prepared to agree to the same, it will no doubt resist full freezing clauses. An obligation to achieve equilibrium through negotiation and, failing that, third party determination is therefore also preferable for States as for investors.

By Michael Polkinghorne and Risteard de Paor

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Michael Polkinghorne
Partner, Paris

Michael Polkinghorne is a partner at White & Case, based in Paris. He specialises in oil and gas matters, and advises on both international arbitration and transactional issues in the sector.

Risteard de Paor
Associate, Paris

Risteard de Paor is an associate in the International Arbitration Group in Paris.

Endnotes

1. *See*, for example, *ADC v Hungary*, ICSID Case No. ARB/03/16, Award, 2 October 2006, at para. 423; *AWG Group Ltd. v. Argentine Republic*, UNCITRAL, Decision on Liability, 30 July 2010, at para. 139; and *Daimler Financial Services AG v. Argentine Republic*, ICSID Case No. ARB/05/1, Award, 22 August 2012 at para. 100.
2. *See* Catherine M. Amirfar, 'Treaty Arbitration: Is the Playing Field Level and Who Decides Whether It Is Anyway?' in Albert Jan van den Berg (ed), L*egitimacy: Myths, Realities, Challenges*, ICCA Congress Series, Volume 18 (© Kluwer Law International; Kluwer Law International 2015) at pp. 755 – 775; Jorge E. Viñuales, 'Chapter VII, Investment Law and Sustainable Development: The Environment breaks into Investment Disputes', 1714, in Bungenberg, Griebel, Hobe, Reinisch, *International Investment Law*; and Heikki Marjosola, Chapter 32: Police Powers or the State's Right to Regulate in Meg N. Kinnear , Geraldine R. Fischer , et al. (eds), Building International Investment Law: The First 50 Years of ICSID, (© Kluwer Law International; Kluwer Law International 2015) pp. 447 – 462.
3. The obligation which has been most successfully relied upon by claimants in investment treaty claims is the State's obligation to accord fair and equitable treatment (or "FET") to the investor (see, for example, Rudolf Dolzer & Christopher Schreuer, *Principles of International Investment Law* (2nd ed, 2012) at p. 130). Such FET provisions are typically considered to encompass respect for investors' legitimate expectations, even if such wording is not present in the clause. Legitimate expectations can derive from both specific commitments and from the host State's legal system (as confirmed recently in the *Charanne* award, at para. 494). However, as discussed, there appears to be an increasing emphasis by tribunals on striking a balance between the expectations of the investor and the State's right to regulate.
4. *Saluka v Czech Republic*, UNCITRAL, Partial Award, 17 March 2006, at paras. 253-265.
5. *Perenco Ecuador Limited v. Republic of Ecuador*, ICSID Case No. ARB/08/6, Decision on the Remaining Issues of Jurisdiction and on Liability, 12 September 2014 (or "*Perenco* Jurisdiction and Liability Decision"), at para. 705.
6. *Perenco Ecuador Limited v. Republic of Ecuador*, ICSID Case No. ARB/08/6, Interim Decision on the Environmental Counterclaim, 11 August 2015, (or "*Perenco* Interim Decision") at para. 347. In general, however, such changes may only be prospective and not retrospective (para. 357).
7. *Plama Consortium Limited v. Republic of Bulgaria*, ICSID Case No. ARB/03/24, Award, 27 August 2008, at para. 177.
8. *Parkerings-Compagniet AS v. Republic of Lithuania*, ICSID Case No. ARB/05/8, Award, 11 September 2007, at para. 332. These dicta place significant emphasis on stabilization clauses and were subsequently cited in *Yuri Bogdanov and Yulia Bogdanov v. Republic of Moldova*, SCC Case No. V091/2012, Final Award, 16 April 2013 and a similar approach was followed recently in the award in *Charanne B.V and Construction Investments S.A.R.L v The Kingdom of Spain*, SCC Case No. 062/2012.
9. *EnCana Corporation v Ecuador*, LCIA Case No. UN 3481, Award, 3 February 2006, at para. 177.

10 *Ibid*, at para. 187.
11 *Nations Energy, Inc. and others v. Republic of Panama*, ICSID Case No. ARB/06/19, Award, 24 November 2010 [Spanish] at para. 690.
12 *Urgenda Foundation v The State of the Netherlands (Ministry of Infrastructure and the Environment)* [2015] Case C/09/456689/ HA ZA 13-1396. The Hague District Court ruled that States' legal obligations on climate change extend beyond international treaties and comprise an independent duty of care toward their citizens.
13 The Plan was challenged by 24 US States and State agencies before the D.C. Circuit Court and then by 29 parties in the US Supreme Court which stayed the Plan on 9 February 2016. Peabody Energy Corporation, one of the largest coal companies in the world, is reported to have already sought to prevent the coming into force of the Plan in the D.C. courts and other US coal companies are expected to follow suit. See Jessica Wentz, 'October 2015 Update to the Climate Change Litigation Chart' (Climate Change Blog, Columbia Law School, 9 October 2015) http://blogs.law.columbia.edu/climatechange/2015/10/09/october-2015-update-to-the-climate-litigation-chart/
14 This is also relevant to oil and gas companies like Repsol and Statoil who have begun to diversify their assets and invest in offshore windfarms.
15 *Charanne*, at paras. 459-462.
16 Note that only one of many series of reforms was challenged in this case and the Tribunal indicated that its findings should not influence other tribunals who may come to different conclusions on claims for FET breaches based on other State measures (at para. 542).
17 European Commission, 'Electricity Tariff Deficit: Temporary or Permanent Problem in the EU?', Economic Papers 534 (October 2014), Section 3.1.
18 *Charanne*, at para. 535.
19 In referring to stabilization clauses, the tribunal in *Perenco* stated that it was "well recognized" in investment treaty arbitration that States retain the flexibility to react to changing circumstances unless their relationship with an investor has been stabilized. See *Perenco*, Jurisdiction and Liability Decision, at para. 586.
20 Ecuador is an example of a State having gone further and has inserted provisions in its Constitution which grant rights to Nature itself and includes State obligations to take precautionary measures for the protection of the environment (see Chapter 7 of the Ecuadorian Constitution).
21 Indian Model BIT 2015, arts 4(1) and 4(5).

Contact us

Americas

Los Angeles
T +1 213 620 7700

Mexico City
T +52 55 5540 9600

Miami
T +1 305 371 2700

New York
T +1 212 819 8200

São Paulo
T +55 11 3147 5600

Silicon Valley
T +1 650 213 0300

Washington, DC
T +1 202 626 3600

Europe, Middle East and Africa

Abu Dhabi
T +971 2 611 3400

Almaty
T +7 727 258 26 50

Ankara
T +90 312 442 5680

Astana
T +7 717 258 26 50

Berlin
T +49 30 880 911 0

Bratislava
T +421 2 5441 5100

Brussels
T +32 2 219 16 20

Doha
T +974 440 64300

Dubai
T +971 4 381 6200

Düsseldorf
T +49 211 49195 0

Frankfurt
T +49 69 29994 0

Geneva
T +41 22 906 9800

Hamburg
T +49 40 35005 0

Helsinki
T +358 9 228 641

Istanbul
T +90 212 275 7533

Johannesburg
T +27 11 341 4000

London
T +44 20 7532 1000

Madrid
T +34 91 787 6300

Milan
T +39 02 00688 300

Moscow
T +7 495 787 3000

Paris
T +33 1 55 04 15 15

Prague
T +420 255 771 111

Stockholm
T +46 8 506 32 300

Warsaw
T +48 22 50 50 100

Asia

Beijing
T +86 10 5912 9600

Hong Kong
T +852 2822 8700

Seoul
T +82 2 6138 8800

Shanghai
T +86 21 6132 5900

Singapore
T +65 6225 6000

Tokyo
T +81 3 6384 3300

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