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# The Energy Charter Treaty and EU-Growth Policies

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## **Introduction**

The basic policy tool for increasing FDI is international investment agreements (IIAs), state-to-state treaties that protect FDI against host country policy measures. This note focuses on the IIA of most relevance from an EU growth perspective, the Energy Charter Treaty (ECT), which protects FDI in the energy sector. Since fossil energy use is a main source of CO<sub>2</sub> emissions, the EU should be highly sensitive to any restrictions that the ECT might impose on EU energy policies. The ECT should be thoroughly revised to not become an obstacle to the EU ambition to transform the EU economy toward carbon-neutrality.

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# The Energy Charter Treaty and EU-Growth Policies

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International economic integration can promote growth in various ways. For instance, trade liberalisation can increase competition and market size and thereby stimulate innovation and growth. Similarly, *foreign direct investment* (FDI) can foster growth by contributing to capital formation, by increasing productivity through spillovers of technology and other know-how, etc. Since trade and FDI interact in intricate ways, such as in international value chains, FDI might also unleash growth through increased trade.

The basic policy tool for increasing FDI is *international investment agreements* (IIAs), state-to-state treaties that protect FDI against host country policy measures. This note focuses on the IIA of most relevance from an EU growth perspective, the *Energy Charter Treaty* (ECT), which protects FDI in the energy sector. One obvious reason for its relevance is the importance of energy as an input into production. The ECT is also explicitly growth-oriented; its Preamble states that the Contracting Parties wish to "...catalyze economic growth by means of measures to liberalize investment and trade in energy...". Another reason for the importance of the ECT is the EU commitments to combine growth with reduced CO2 emissions. Since fossil energy use is a main source of CO2 emissions, the EU should be highly sensitive to any restrictions that the ECT might impose on EU energy policies. Furthermore, the ECT is by far the most invoked IIA in disputes against EU countries.

It is perhaps tempting to view IIAs as playing the same role for investment as trade agreements serve for trade. This note argues that the ECT, and traditional IIAs more generally, are of a very different nature from trade agreements. The ECT in particular should be thoroughly revised to not become an obstacle to the EU ambition to transform the EU economy toward carbon-neutrality.

## Investment treaties

The purpose of IIAs was initially to protect investment from developed to developing countries, during an era when expropriations were common in developing countries.<sup>1</sup> Today, IIAs also cover investment between developed countries; for instance, all major recent regional trade agreements have investment protection. Some 2300 bilateral investment treaties, and 300 other IIAs are in force globally. EU Member States have approximately 1100 bilateral IIAs with third countries in force. Additionally, the EU has close to 50 IIAs that bind EU Members.<sup>2</sup>

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1 See e.g. UNCTAD (2015) for a description of the evolution of the IIA regime.

2 See <https://investmentpolicy.unctad.org/international-investment-agreements>.

## Broad contents

IAs formed until the last five years or so – “traditional” agreements below – are remarkably similar. They are discriminatory in that they only protect investments between partner countries. They are typically very brief, comprising only five to ten pages, and include the following provisions.

IAs typically require *Most-Favoured Nation* treatment, i.e., that investments between contracting parties are not treated less favourably than investments from third countries. IAs also often request *National Treatment*, that investments from contracting parties are not treated less favourably than domestic investments.

IAs typically request *fair and equitable treatment* of foreign investment. This amorphous provision is the most common legal base for disputes.

IAs almost invariably specify compensation requirements in case of *expropriation*. These provisions apply both to *direct* expropriation, where a host country seizes an investor’s assets, and *indirect (or regulatory)* expropriation, where a host country’s measure is equivalent to direct expropriation without involving outright take-over of assets.

IAs include a range of other substantive commitments, such as *full protection and security* for investors, rights for investors to freely transfer funds out of the host country, and prohibition of performance requirements.

“Almost all IAs allow investors to *bring disputes*... in contrast to trade agreements, which do not give firms legal standing.”

Almost all IAs allow investors to *bring disputes* (Investor-State Dispute Settlement, ISDS), in contrast to trade agreements, which do not give firms legal standing. Disputes are normally arbitrated by ad hoc panels consisting of three persons. Decisions by panels can only be appealed on formal grounds.

IAs often include *sunset clauses* that stipulate the time span, typically 10-20 years, during which protection continues to apply to existing investment for a party that terminates the agreement.

While not a formal part, a central feature of IAs is that they draw upon international conventions that request signatory countries to *automatically recognise and help enforce panel decisions*. IAs therefore have much more potent enforcement mechanisms than trade agreements.

Viewed at a more general level, some obligations in IAs provide for *increased market access*; for instance, some agreements stipulate National Treatment already before entry. Other provisions request *protection of invested assets*. Both types of commitments can promote investment, and they interact to this end in various ways. But importantly, *IAs are not limited to removing policy barriers intended to segment markets*, in contrast to most provisions in trade agreements.

## The critique

IAs were initially formed without much political opposition, but have recently become intensively criticised in the policy debate. Many internationally reputable academics in law, and to some extent in political science and economics, have also expressed serious concerns.<sup>3</sup>

A main claim in the debate is that IAs cause *regulatory chill* – they induce host countries to refrain from policy measures that are in some way desirable. Two broad features of traditional IAs contribute to this: the *lack of exceptions for legitimate public measures*, and the *vague drafting* of core substantive undertakings, which allows panels to make far-reaching interpretations of the agreements. To illustrate this ambiguity, the most frequent ground for complaints is the “fair and equitable treatment” obligation. It is typically not expressed more specifically than as a requirement, such as:

... accord at all times to Investments or Investors of other Contracting Parties fair and equitable treatment.

In the infamous dispute Tecmed vs. US, the panel interpreted this type of provision as follows:

...The foreign investor expects the host State to act in a *consistent manner, free from ambiguity and totally transparently* in its relations with the foreign investor, so that it may *know beforehand any and all rules and regulations* that will govern its investments, as well as the goals of the relevant policies and administrative practices or directives... Any and all State actions conforming to such criteria should relate not only to the guidelines, directives or requirements issued, or the resolutions approved thereunder, but also to the *goals underlying such regulations*.<sup>4</sup> [All italics are mine]

Several later panels adopted this extremely strict interpretation, but more recent panels have taken less extreme positions. The example demonstrates, however, the discretion panels have when interpreting traditional IAs.

Another type of critique is that the IAs *do not generate much investment*. This is in line with the empirical literature, which rarely finds significant positive effects, in particular for investment in developed economies.<sup>5</sup> Indeed, a common claim is that investors are not even aware of the existence of IAs until after they have encountered adverse government interventions, when lawyers alert them to their existence.

Intensive critique has also been directed at *the dispute settlement mechanisms*. For instance:

- two of three persons on a panel effectively represent the parties, and can have long-standing commercial relationships with law firms representing the clients, which *compromises the impartiality of panels*;

<sup>3</sup> For a critical view from an economic perspective, see Stiglitz (2008). See Horn and Norbäck (2019a) for additional references.

<sup>4</sup> Tecnicas Medioambientales TECMED S.A. vs. The United States, Case N. ARB (AF)/002, International Centre for Settlement of Investment Disputes, May 29, 2003, para. 154.

<sup>5</sup> See the literature review in Horn and Norbäck (2019a).

- there are very *limited possibilities to appeal* panel rulings;
- due to the rules concerning *confidentiality*, governments might be involved in legal processes, and might be obliged to make compensation payments hidden from the public;
- the *lack of consistency in case law* creates uncertainty as to what obligations the agreements actually impose; and
- investors can establish letter-box companies in countries with investor-friendly IIAs solely to use these agreements against third countries (“treaty shopping”).

During recent years there has been a trend among developed countries to revise their agreements. The EU has been a driving force in this process. The general trend is to reduce the scope of the substantive commitments, partly by adding exceptions for legitimate public measures. The dispute resolution mechanisms are also undergoing major changes, both in terms of procedures and limitations on the use of ISDS.

### The Energy Charter Treaty

The *Energy Charter Treaty* (ECT) is a combined trade and investment agreement for the energy sector. An important motive for the EU to lead in the creation of the ECT in the 1990s was to ease former socialist countries’ transition to market economies, and to become members of the *General Agreement on Tariffs and Trade* (GATT), and the *World Trade Organization* (WTO). The EU also had an interest in securing access to cheap, and geographically close, sources of energy. The ECT is currently applied by 52 members, comprising all EU member states except for Italy (which has withdrawn), the EU itself, and the countries listed in Table 1.

**Table 1: Non-EU members of the Energy Charter Treaty**

Soviet republics	Oth. former socialist	OECD+	Other
Azerbaijan	Albania	Iceland	Afghanistan
Armenia	Bosnia	Japan	Yemen
Belarus	Montenegro	Liechtenstein	Jordan
Georgia	Mongolia	UK	
Kazakhstan	N. Macedonia	Switzerland	
Kyrgyzstan		Turkey	
Moldova			
Tajikistan			
Turkmenistan			
Ukraine			
Uzbekistan			

The focus here is on the investment protection part of the ECT, which is of the above-described traditional type, although with some adaptation to energy. It is the IIA that is most often invoked in disputes, with around 140 pending or closed disputes to date, 80% of which was initiated during the last decade.

The ECT has very much become an EU concern. Around 80% of ECT disputes during the last decade have targeted an EU country, and 90% of these disputes have only EU investors as complainants. The ECT has thus undergone “mission creep” from an EU perspective. There is now pronounced public distrust in the ECT, in particular since it is seen as an obstacle to the transition to a green economy by protecting FDI in fossil industries.<sup>6</sup>

The applicability of the ECT between EU countries is contested. The Court of Justice of the European Union recently judged that the ECT is not applicable.<sup>7</sup> However, when disputes are adjudicated outside the EU, arbitration panels typically see themselves as unbound by EU law. They might therefore in future disputes still find the ECT to be applicable.

## Economic costs and benefits of the ECT

Like all IIAs, the ECT is reciprocal, applying both to investments by EU firms in non-EU countries, and investments by non-EU firms in EU countries. It is useful to discuss the economic effects in the two markets separately.

### Increased protection in non-EU ECT countries

The economic literature on the rationale and consequences of IIAs is meagre compared to the huge literature on trade agreements. But a literature is beginning to emerge. It sees IIAs as a means to counteract problems arising from the irreversibility of investments and host countries’ disregard of investor interests when addressing regulatory problems.<sup>8</sup> This approach seems readily applicable to ECT protection in many of the non-EU ECT countries. Energy investments are often highly irreversible. They are also often very long term, implying that the conditions existing at the time the investments are made may undergo significant changes. Furthermore, many of the partner countries in the ECT lack credible investment protection. The ECT protection in these markets therefore increases the expected profits for EU investors, and is in this sense beneficial to EU countries.

It seems plausible, however, that the investments in the non-EU partner countries will be concentrated to fossil fuels, given the economic profiles of these countries. For instance, only one of the 33 disputes against non-EU countries that EU investors have been involved in so far, have concerned renewable energy.<sup>9</sup> To

<sup>6</sup> Two recent cases brought by German energy investors against the Netherlands involving the phase-out of coal-based power plants are seen as examples of how the ECT is used against governments that pursue desirable climate policies. The plants in question were recently completed, at total investment costs of around €4.2 billion.

<sup>7</sup> Case C-741/19, Republic of Moldova v. Komstroy LLC.

<sup>8</sup> See Horn and Tangerås (2021) for a formal analysis, and Horn and Norbäck (2019b) for a less technical introduction.

<sup>9</sup> Based on dispute summaries provided by <https://www.energychartertreaty.org/cases/statistics/>, using



*the extent that these investments are harmful to the climate, they will be hard to reconcile with the EU's firm commitment to significantly reduce its climate impact.* This should reduce the value for EU countries of the protection that the ECT might give EU investments in these countries.<sup>10</sup>

### Increased investment inflow into the EU

While hard to establish in a systematic fashion, it seems clear that the ECT offers more protection in the EU than investors would otherwise have access to. For instance, it offers the choice between bringing disputes through regular national and EU legal systems as well as adjudication outside these systems.

This increase in protection could in principle foster growth in the EU by inducing *more inward* FDI from non-EU ECT countries. It does not seem likely that the ECT will induce much investment from non-EU ECT countries, however, considering their limited capacity to invest in the EU. Therefore, one should not expect any significant effects for EU from increased inward investment by non-EU ECT countries. Also, the benefit of any increase in investments would be diminished if it squeezed out other investments. For instance, if these new investments just replace other identical investments, there is no net increase in investment and no benefit to EU countries. Even worse, if the investments induced by the ECT replace other FDI with stronger positive externalities for the EU, the ECT-induced increase in investment could even be harmful.<sup>11</sup>

### Costs of providing increased protection in the EU market

Since the investor protection that exists at national and EU levels reflects a careful balancing of various societal interests, protection beyond this level *must be costly* for EU countries. For instance:

- EU countries might have to *compensate investors* when undertaking certain policy interventions in situations where they would otherwise not be required to compensate;
- EU countries might be induced to *deviate from their preferred policies* to avoid such payments; and
- whenever host countries become involved in disputes, they incur *legal costs*, both for the arbitration itself and for their own legal costs. The costs are normally split in some fashion regardless of the outcome of disputes. For instance, the parties cover their own legal costs in almost half of the ECT disputes for which information is available.

Some EU countries have already incurred considerable costs due to the ECT. Such costs are likely to increase substantially if the EU's expressed ambition to pursue much more ambitious climate policies is implemented.

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text searches for "renewable", "wind", "solar" and "photovoltaic".

<sup>10</sup> These matters have become more complex with the current political turmoil due to the energy price hikes.

<sup>11</sup> Lawyers sometimes claim that IIAs also benefit host countries by fostering "good governance." This might possibly be relevant for some developing countries. But arbitration lawyers clearly have no expertise in how EU countries should be governed, so this argument is not applicable to the present context.

First, the transition to a carbon-neutral economy will require *significant phasing out of stranded production units*. To the extent that the ECT protects such investments – either since they are owned by investors from non-EU ECT countries, or more likely since they come under the protection of the ECT through some form of treaty shopping – the ECT protection will make the phasing out of these assets more costly. Owners of such assets are likely to pursue disputes against EU countries, or the EU itself, in order to obtain compensation.

Second, it will be necessary to achieve significant new investments in the energy sector. As always with drastic policy changes, mistakes will be made in the design of incentive schemes. And the prevailing conditions might change: New information regarding the climate problem might arise, countries might experience financial difficulties, etc. Climate-ambitious EU countries might

“Climate-ambitious EU countries might... have to *change their policies*, which will create scope for more costly ECT disputes.”

therefore have to *change their policies*, which will create scope for more costly ECT disputes. The same applies to EU climate policies, since the EU is also a member of the ECT. Recent experience shows the relevance of this concern. Some 75% of investment disputes against EU countries have entailed *withdrawal* of support schemes for renewable energy. For instance, Spain has faced some 50 disputes of this kind, and Italy more than ten.

The fact that these disputes concern renewable energy is often said to prove the climate friendliness of the ECT. However, losing countries have not reinstated support schemes in *any* of these disputes, to the best of the author’s knowledge. They have instead opted for compensation to investors (but not always paid out). These disputes might have induced some countries to not revoke other such schemes. However, it seems more plausible that these disputes have *made governments more cautious not to introduce schemes* unless they are certain that they will not be revoked.

### The net effect

The reasoning above suggests that the ECT in its current form:

- gives some benefit from protection of EU outward FDI, but adverse climate effects probably reduce the value of this to the EU;
- only generates small inflow of FDI into the EU, and then possibly distorts investment patterns; and
- imposes costs on EU countries in the form of compensation payments, etc.

It would be very hard to credibly quantify the net effect, and there are no such studies to the best of the author’s knowledge. Hence one must instead resort to intuition, as often with economic policymaking. The author’s view is that on net, the current ECT is probably *harmful* to EU countries, and will be *more harmful* in the future. In a nutshell, the current ECT:



- provides discriminatory legal protection of investment in the EU as a means to obtain protection of EU investments in fossil energy in the countries listed in Table 1 above; and
- is mainly used by EU firms in costly disputes against EU countries, through which they circumvent national and EU legal procedures, and secure more protection than available to investors in other sectors.

In the view of the author, the burden of proof falls heavily on anyone who claims that this is a desirable regime.

The ECT could become significantly more beneficial however, if appropriately revised.

## How should the ECT be renegotiated?

The core problem with the ECT is not that it requests EU countries to provide more protection of inward investment to obtain better protection for its outgoing investment. Trade agreements implement exchanges of tariff concessions for domestic and foreign products, without this causing any concern. However, trade agreements *levy* the playing field between domestic and foreign products, whereas the ECT introduces *discriminatory* legal protection of investments in the EU. This is a central problem with the ECT (and EU IIAs more generally).<sup>12</sup>

A key to neutralize the adverse effects of the ECT would thus be to renegotiate the agreement such that it does *not provide more protection for inward investment than is offered to investors in general in the EU*, regardless of nationality or industrial sector. This would remove most of the costs for EU countries for the protection of inward investment. Since the ECT most likely will continue to be reciprocal, EU investors will then have the same protection level in non-EU ECT countries as they have at home. This is more protection than what they would have without the ECT. In theory at least, this would ensure that the ECT is beneficial to EU countries, since it would neutralize the negative effect of protection in the EU market, while retaining some gains from the protection in non-EU ECT countries.

It would be easier said than done to redraft the ECT to target this particular level, however. But some desirable changes can readily be identified.

### Restrict the effective scope of substantive obligations

The ECT should follow the recent trend to reduce the scope of substantive obligations by defining core terms, such as “fair and equitable treatment” and “indirect expropriation”, and by specifying closed lists of government behavior that might possibly fall under the treaty prohibitions. It will also be important to *strengthen exception clauses for reasonable public policies*, in particular for climate policies.

<sup>12</sup> An additional severe drawback of IIAs in general is that they are poorly targeted, in that they provide costly protection to all investments from partner countries in the ECT, regardless of whether they result from the ECT. See Horn och Norbäck (2019a).

## Reduce compensation amounts

Compensation under current rules is normally based on foregone operating profits. This stems from the well-established principle in International Law that investors should be fully compensated for their losses. The principle has an economic logic in that it indirectly induces a regulating host country to face the full cost of its intervention for foreign investors. However, when a host country pursues climate policy, it creates benefits also to the source country, to the extent it is harmed by the climate problem. It is then undesirable that the host country must pay the full foregone profits as compensation.

One possibility could be to base compensation on *incurred investment costs* rather than foregone profits, as arbitration panels sometimes already do. Since the investment costs normally will be smaller than the foregone profits (for investments to be profitable), this compensation rule should increase the incentives for host countries to pursue climate policies relative to compensation based on foregone operating profits. This would probably also make compensation payments seem more acceptable to the public.

## Prevent the ECT from being used for treaty shopping

Treaty shopping is a pervasive problem with the ECT. For instance, according to the website "ECT's dirty secrets", 24 out of 25 firms that have pursued ECT disputes under the guise of being Dutch investors are foreign mailbox companies. Another example is the litigation by Gazprom-owned Nord Stream 2 against the EU. The company is incorporated in the ECT member Switzerland. Hence, a fully Russian-owned company can use the ECT without Russia having taken on any corresponding commitments. This possibility should be removed to lessen future pressure on EU countries.

## Limit sunset clauses

If the EU and EU member states were to withdraw unilaterally from the ECT, existing investments in the EU by non-EU firms, including in fossil fuels, would be protected by the treaty for another 20 years. It is less clear, partly due to a lack of case law, what applies in case both EU and non-EU states agree to terminate the ECT or to renegotiate the sunset clauses. According to one view, the parties can jointly decide whatever they want, including to remove sunset clauses with immediate effects. This seems to have been the view of most EU states when they terminated their intra-EU bilateral investment treaties. This also seems reasonable from an economic perspective. But there is a legal view that the treaty has created rights for investors that investors cannot be deprived of. *The EU should seek to get acceptance among its Member States of the former principle and to drastically shorten the sunset clause.*

## Revise the dispute settlement system

The dispute settlement system in the ECT suffers from the same severe problems as do the corresponding mechanisms in most other IIAs (some of which are listed above), and they need to be addressed.

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