ENERGY TRANSITION AND THE IMPACT ON DISPUTES

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Legal Briefings – By **Craig Tevendale, Partner, Chris Parker, Partner and Charlie Morgan, Senior Associate**

A HINDRANCE OR A CATALYST? ARBITRATION AND THE ENERGY TRANSITION

There have been a number of 'energy transitions' throughout human history, but none more complex than the one currently underway. To give the world a chance of keeping global warming, measured against pre-industrialisation temperatures (ie pre-coal), below 2o C will require an energy transition far quicker and larger than ever before. This transition will involve: (i) a global move to reduce reliance on fossil fuels for energy production and consumption in favour of renewable sources of energy; and (ii) decarbonisation of (reduction in scope 1, 2 and 3 emissions arising from) continuing fossil fuel production, transportation and consumption.

Energy transition has been a tenet of global policy for over three decades already, and in particular since the United Nations Framework Convention on Climate Change was signed in 1992.

However, the past decade has seen a sharp increase in state co-operation on the international plane, most significantly in the form of the Paris Climate Agreement in 2015, driven by a significant shift in societal attitudes towards climate change and the emissions generated from hydrocarbon production and consumption.

The commercial drivers within the private sector are also shifting rapidly. Reflecting societal changes, investors are increasingly looking to deploy capital in accordance with Environmental, Social, and Governance principles (**ESG**). This has seen, for example, financial institutions take a more active role in monitoring and influencing the environmental impact of their investments. As discussed in the article authored by Antony Crockett, Patricia Nacimiento and Alessandro Covi, ihat trend will continue.

The growing appetite for renewable energy and decarbonisation of the current energy supply chain will continue to spawn exciting new infrastructure projects, many public-private partnerships and new collaborations between competitors in the fossil-fuel industry as well as between 'traditional' energy producers and new technology and renewables counterparts.

The challenges associated with the energy transition cannot be overstated, and it is inevitable that some projects and acquisitions will see significant friction between stakeholders. As such, dispute resolution will play a key role in keeping positive change 'on track' and ensuring that the investment climate exists to enable the colossal levels of public and private investment required to enable a successful 'transition' to be made.

Strakeholder friction will often manifest itself in "business as usual" disputes which are very familiar in the energy sector, but we will also see many disputes (both treaty and commercial) that are new to energy sector participants. This article will touch on some of those flashpoints for disputes. The energy transition will inevitably lead to a large number of complex construction and planning disputes, but those disputes are not considered here in any detail.

INVESTOR-STATE DISPUTES

Two 2019 reports on climate change and green technology disputes respectively by the International Chamber of Commerce (**ICC**)[1] and the Stockholm Chamber of Commerce (**SCC**)[2] suggest that energy and natural resources companies are increasingly relying on investment treaties (**BITs**) in respect of regulatory changes affecting fossil-fuel projects, including the outright phasing out of the relevant fossil fuel, as well regarding changes affecting the conditions of investment in renewable energy projects.

BITs are agreements between two or more states which commonly contain reciprocal undertakings for the protection of investments made by nationals of the respective states in each other's territories. Such investor protections usually guarantee a minimum level of protection, including a guarantee of fair and equitable treatment, and protection against discrimination and expropriation of the investment. Investment agreements generally recognise that private foreign investors should be adequately compensated when states wrongfully breach the legitimate expectations they created and in reliance upon which an investment was made.

Crucially, such treaties give investors a right to bring proceedings directly against a host state by way of international arbitration before an independent tribunal (rather than the host state's domestic courts) to seek compensation for breach of these protections. For example, over 136 cases have been brought since 1991 pursuant to the Energy Charter Treaty (**ECT**), which has 47 signatory states.[3] However, the ability of foreign investors to bring claims for damages against states under BITs has drawn criticism, including concerns that it may hamper states' ability to implement domestic regulation in response to legitimate social change, including in relation to the energy transition.

Disputes over the entitlement to and calculation of incentives for investments in 'green' segments of the energy market are becoming increasingly common in this context. For instance, a number of European states withdrew clean energy subsidies in the wake of the 2008 global financial crisis, and subsequently faced investment arbitration claims. Spain alone has seen more than 40 claims brought against it over its withdrawal of subsidies relating to the photovoltaic sector. One such case, *PV Investors v Spain* PCA Case No. 2012-14, involved a claim for compensation of over €2bn. Herbert Smith Freehills successfully represented Spain in those proceedings, which resulted in an award for compensation of only 5% of the quantum sought by the claimants. Many countries have also implemented significant new incentives and subsidies to boost investment in the green energy sector as the world rebuilds after the pandemic.

Where a host state has made environmental commitments enshrined in domestic or international law, its non-compliance with those commitments may be detrimental to investments made in reliance on them. In such circumstances, the investor may have legal recourse against the state. In *Peter A. Allard v Barbados* (2016) PCA Case No. 2012-06, the tribunal held that investors could bring claims where a host state failed to comply with environmental obligations imposed by its own domestic law and such failure caused damage to a protected investment, although this claim failed on the facts. A further illustration of this is *Zelena N.V. and Energo-Zelena d.o.o Inđija v. Republic of Serbia*, ICSID Case No. ARB/14/27, where Belgian investors in a waste management company complained that Serbia's non-enforcement of its environmental and veterinary laws allowed its competitors to dispose of animal waste more cheaply, thus giving them a competitive edge. The tribunal held that Serbia had denied fair and equitable treatment to the investors. Moreover, the tribunal in the *Allard* case also suggested that a State’s international environmental obligations *“may well be relevant”* in the application of investment treaty protections to particular circumstances. When considering the relevant regulatory framework and protections afforded to their investments, investors should be mindful of the international environmental obligations a host state has committed to, as well as its domestic regulatory regime.

Investor-state cases are also being seen as States withdraw from fossil-fuel projects in favour of cleaner energy sources. For instance, the Netherlands recently implemented legislation providing for the phase-out of coal by 2030, which did not contain provisions for the compensation of coal plant operators. German energy company RWE, which had built a coal plant in 2015, subsequently brought a claim against the Netherlands under the ECT seeking compensation of €2bn. Several companies including Vattenfall, the Swedish state-owned power company, brought similar claims over Germany's 2011 decision to phase out nuclear energy by 2022, with the parties agreeing to a settlement in excess of €2.4bn earlier this year. Disputes are also likely to arise as states review their contract portfolios seeking to amend or terminate longer-term fossil-fuel contracts, or in relation to the decommissioning of assets and the costs of the associated continuing environmental liability.

Tribunals have also recently appeared increasingly willing to hear counterclaims by states against investors for breach of domestic environmental regulations and international human rights law. Various arbitral tribunals, including in the case of *David Aven v. Costa Rica* (2018) ICSID Case No. UNCT/15/3, have accepted that they had jurisdiction to determine such counterclaims. Further, in twin arbitrations arising out of the same investment, *Burlington Resources Inc v. Republic of Ecuador* (2017) ICSID Case No. ARB/08/5 and Perenco Ecuador Ltd. v. Republic of Ecuador (2019) ICSID Case No. ARB/08/6, Ecuador successfully argued its counterclaim based on a breach of a statutory environmental regulation regime (albeit, in these cases, the investors expressly agreed to arbitrate the counterclaims in an international forum).

The interventionist stance taken by some national courts towards the enforcement of states' compliance with international environmental obligations adds further complexity. For example, in its 2019 decision in *Urgenda Foundation v. State of the Netherlands*, the Dutch Supreme Court upheld a decision of the District Court in the Hague ordering a 25% reduction in CO2 emissions relative to 1990 levels. Earlier this year, the German Constitutional Court similarly ruled that Germany must bring forward its climate change legislative agenda to reduce CO2 emissions more quickly than the Government had planned. Most recently, in May 2021, the District Court in the Hague also ruled that Royal Dutch Shell must cut its net carbon emissions by 45% by 2030 compared with 2019 levels. These decisions highlight the fact that the executive branch of a State is not always the sole and final arbiter of the scope and content of regulatory change, and therefore add to the uncertainty as to the stability of existing regulatory frameworks.

The accelerating pace of regulatory change intended to promote the energy transition will continue to generate investor-state disputes, both under BITs and host-state agreements, as a delicate balance is sought between the legitimate expectations of investors in the stability of the investment framework, and the increasing urgency with which states are responding to climate change.

COMMERCIAL DISPUTES

The SCC and ICC reports mentioned above forecast an exponential increase in climate-related commercial disputes. There are three key factors driving this trend: (i) the prospect of regulatory change, (ii) the increased significance of background factors not linked to a particular project, such as shareholder commitments and ESG concerns, and (iii) the evolution of market norms, such as partnerships between different kinds of market players.

When a technical regulation is implemented which affects a particular project, this may have a direct or indirect adverse effect on the contractual relationships which underlie the development, financing and operation of the project. Strain may also be put on commercial relationships by background factors such as broader shareholder reporting obligations or voluntary shareholder commitments – for example, some international oil companies have adopted ambitious targets for emissions reductions, whereas others have made no public commitments. The contrast may be even more stark where ESG funds are involved as investors. This will lead in some projects to tensions between partners, for example as to the increased costs involved in reducing emissions. Similar issues may arise as a result of representations made in financing agreements with environment-conscious lenders. Examples may include regulations requiring the use of less carbon intensive fuels when shipping products from projects within the host state for sale on the global market, or the use of green steel in the construction of new energy projects. These increased tensions will likely to give rise to disputes between commercial parties.

In parallel, increased M&A activity in the energy sector is likely to continue, as established energy companies diversify their offering away from traditional upstream oil and gas assets to align their portfolio with mandatory and voluntary net-zero targets. Joint venture (**JV**) activity is also on the rise as new entrants to the renewables market look to partner with traditional fossil fuel producers. In both the M&A and JV context, disputes are likely to arise in relation to indemnities and breaches of representations and warranties relating to the environment, as well as as a result in clashes in approach between market participants who may come from divergent backgrounds.

We expect to see a growing number of disputes also arise from contractual requirements to report on and reduce the environmental impact of projects. For example, as companies start to monitor the environmental impacts across entire supply chains (as well as their own sope 1 emissions), disputes are likely to arise from breaches of obligations relating to the monitoring, reporting, and verification (**MRV**) of emissions. These disputes are likely to be exacerbated and their resolution made more complex by the lack of robust and globally accepted frameworks on emissions MRV. As a result, disputes may arise in relation to the effectiveness of monitoring processes, the reliability and veracity of emissions data, and the integrity of the verification and auditing mechanisms.

These reflect only a few examples of potential disputes. In short, greater scrutiny of environmental credentials by all stakeholders in a project will lead to a broad array of disputes, from operators' duties to financing obligations (we are seeing the more regular inclusion in financing agreements of representations regarding emissions and other environment-related targets), reporting and information rights, access to discussions with counterparties (particularly with state entities), budgeting, approvals and distributions.

We also expect to see an increasing number of disputes arising from activist shareholders. By way of example, in 2019, a shareholder class action was brought against ExxonMobil, wherein the claimants argued inter alia that the board of directors did not adequately evaluate the potential impact of climate change-related risks on the value of the company's assets and its long-term business prospects. In May 2021, activist shareholders succeeded in nominating two new members to ExxonMobil's board.

The proliferation of new technologies, relating for example to storage and grid connectivity to support renewables or carbon measurement and verification, also creates fertile ground for dispute. As the key asset of many renewable companies is their proprietary technology, technology-sharing agreements are likely to become more common. These contracts and arrangements will be bespoke and – given the technology is so new – involve significant risk and uncertainty as to the efficacy and development of the technology. This raises the prospect of disputes as to IP, the scope of obligations to develop or warrant technology and the allocation of risk and reward based on the success or failure of the technology and the collaboration.

THE ROLE OF ARBITRATION IN THE ENERGY TRANSITION

A ubiquitous feature of energy disputes is their international dimension. Existing energy projects often have a cross-border element. They may involve a number of parties incorporated and based in different jurisdictions. The jurisdiction of the host state may be foreign to some or all of them. This will hold true for many new projects arising out of the energy transition, for similar reasons and because some projects (such as the construction of subsea electricity cables to connect electricity grids) will cross borders. Arbitration in a neutral seat is the natural choice for international contracts, given the advantages of enforcement pursuant to the New York Convention. Further, the ability to ensure an arbitration is confidential and to choose arbitrators from with the requisite legal and technical expertise will remain important advantages of arbitration. International arbitration is therefore likely to remain the prime forum for resolving these disputes.

CONCLUSION

To meet globally agreed climate change targets, radical changes to energy markets are required in the coming 20-50 years. A large majority of the energy currently being produced from fossil fuels will need to be provided by renewable-energy sources, nuclear power or fossil-fuels that can be produced and consumed as carbon neutral, for example through carbon capture utilisation and storace. Governments and the private sector alike are committed to achieve the necessary changes. However, this will be a gargantuan task with many operational, financial, technical and cultural challenges.

Associated with each of those challenges is a risk of legal disputes. While some of those challenges will be exacerbations of 'business as usual' issues, others are entirely novel. This is an exciting time for incumbent energy produces and new market participants alike. Parties are well-advised to closely assess their dispute resolution mechanisms at the outset of new investments and in the light of ongoing market shifts. Given the nature of likely disputes in this area, international arbitration remains the primary dispute resolution mechanism to enable parties effectively and efficiently to enforce their legal rights, while ensuring that the energy transition maintains its positive course.

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