

Gov'ts Must Balance Green Energy, Investment Treaty Duties

By **Kenny Grant and Jamie Donovan** (June 30, 2021)

While there is a move toward investment treaty reform, tensions between states' actions regarding climate policy and fossil fuel-based foreign direct investment, or FDI, are arising much more quickly than any proposed treaty alterations.

For example, the German utility, RWE AG, which operates the Amer and Eemshaven coal-fired power stations in the Netherlands, recently commenced a €1.4 billion arbitration under the Energy Charter Treaty before the International Centre for Settlement of Investment Disputes, on the grounds that the Netherlands failed to offer it adequate compensation for losses it sustained in converting its plants to burn biomass instead of coal, in order to mitigate the impact of the Netherlands' decision to phase out coal-fired generation by 2030.[1]

And, in what has been described as a landmark decision, a Netherlands court ruled in May that by 2030, Royal Dutch Shell PLC must reduce its greenhouse gas emissions by 45% relative to 2019 levels — a much faster reduction than the company had planned for.[2]

While the Dutch ruling did not speak directly to Shell's foreign investments, the decision, if it stands, will undoubtedly have significant implications for Shell's global portfolio of fossil fuel investments. By one estimate, compliance with the ruling would force Shell to cut oil product sales by 30% from 2020 levels.[3]

More generally, a recent study by the Sabin Center for Climate Change Law and Arnold & Porter found that legal disputes centering on climate change have been increasing.[4] Such litigation includes increasing claims before international adjudicatory bodies.[5]

This is not surprising. The United Nations reports that the value of announced greenfield FDI projects in the power and gas sector exceeded \$1.4 trillion between 2003 and 2019, with an average project value of over \$266 million.[6]

We argue that these tensions — and the resulting challenges — are only likely to accelerate, given the changing economics of power generation, and the increasing international consensus around climate policy.

Regarding the economics, new utility-scale solar and onshore wind generation, which historically required state-sponsored incentives, is now competitive with existing conventional power generation.[7] The most recent data from a widely recognized analyst firm finds that the estimated revenue required to build and operate a utility-scale onshore wind or solar facility is now less than that of a coal-fired plant and competitive with a natural gas facility, while offshore wind is now competitive with coal facilities and approaching competitiveness with natural gas facilities.[8]

Increasingly favorable economics of renewable generation, however, alone are not sufficient to meet international carbon reduction timelines. Meeting these timelines will require state actions that accelerate the transition of the global energy system from "gray molecules" to



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"green electrons." [9]

The RWE and Shell matters are indicative of the actions being taken on that front by national and international authorities. And such actions are likely to heighten frictions between states' climate policies and fossil-fuel-based FDI.

The evidence demonstrates that the introduction of renewable generation at scale diminishes the value of conventional resources, by reducing average power prices and displacing conventional generation in the resource stack. [10] Lower prices and reduced output mean lower revenues and returns for fossil fuel generation.

Treaty reforms offer an important long-term approach to assist tribunals in reconsidering the balance between a state's right to regulate versus investor protections in the wake of growing awareness of the need to cut carbon emissions. However, meaningful changes will likely take years to materialize — a schedule very much at odds with the urgency of climate action.

Moreover, it is unclear whether such changes will apply to existing investments. Fortunately, economics can offer important guidance to tribunals as to how to weigh state and investor claims in this new environment in the meantime.

While the issue of an investor's legitimate expectations will continue to be fact-intensive, the underlying information shaping those expectations has been undergoing rapid changes in recent years. In particular, states' and multilateral organizations' growing political engagement on climate policy and decarbonization efforts signal the increasing likelihood of policies that limit carbon emissions.

All else being equal, this implies greater economic relevance of the policy environment of individual states and multilateral organizations in forming investor expectations.

Consider investments in a fossil fuel plant undertaken 20 years, 10 years and one year ago. States' increasing — and increasingly vocal — commitments to climate policy over that time period could reasonably be expected to have increased both the probability and scope of state action to reduce carbon emissions.

In this environment, the more recent investments should generally bear greater risk of state policies that could negatively impact their going-forward value. Interestingly, in spite of this increasing risk, FDI investments in conventional generation projects have continued apace, resulting in a large amount of relatively new fossil-fuel-based generation that may well end up as stranded assets as decarbonization efforts gain momentum.

For example, the World Bank's data on public-private Infrastructure investments indicate that commitments of nearly \$130 billion in coal generation FDI have been made in the decade preceding 2020. [11] To meet emissions targets, many of these coal generation plants will have to be retired long before their decades-long economic life is up.

Juxtaposed against investors' legitimate expectations are states' right to regulate within their borders. Here there are two salient, but related, economic questions: Does the policy serve a public interest? And to what extent does the policy discriminate against particular investments or investment classes? We consider these questions in the context of the economics of renewable energy.

As noted, onshore wind and utility scale solar are now competitive with fossil fuel

generation, no longer requiring state-sponsored incentives to overcome higher costs. As a matter of economics, the integration of utility-scale renewable energy now promotes the public's welfare, not only by reducing carbon emissions, but by lowering energy costs as well.

Among the immediate consequences of this shift for states is that it provides them with more flexibility to craft policies that encourage the development of renewables and accelerate the decarbonization of the energy sector, but that cannot be assumed a priori to discriminate against incumbent generators.[12] For tribunals, these economic shifts highlight the continued — if not increasing — importance of case-specific, fact-intensive determinations of the consequences of state actions related to the energy sector.

We encourage the efforts of states to formally address the increasing tensions between FDI and climate change through treaty changes as a longer-term solution. In the meantime, however, it is critical for states, investors and tribunals to understand the changing economics of power generation, and their potential to provide states with more flexibility in climate policy.

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[1] <https://www.politico.eu/article/eu-government-climate-and-coal-lawsuits/> <https://globalarbitrationreview.com/climate-change/netherlands-faces-first-icsid-claim-over-coal-plant-ban>.

[2] <https://www.bloomberg.com/news/articles/2021-06-04/what-a-dutch-court-ruling-means-for-shell-and-big-oil-quicktake>.

[3] <https://stockxpo.com/climate-ruling-could-force-big-change-at-shell/>.

[4] The study found that filed cases increased by 10% to over 1,800 between the fall of 2020 and the spring of 2021. See <https://stockxpo.com/climate-ruling-could-force-big-change-at-shell/>.

[5] Global Climate Litigation Report: 2020 Status Review, United Nations Environment Programme and the Sabin Center for Climate Change Law at Columbia University (<https://wedocs.unep.org/bitstream/handle/20.500.11822/34818/GCLR.pdf?sequence=1&isAllowed=y>).

[6] UNCTAD World Investment Report 2020, Annexes 15 and 18 (<https://unctad.org/topic/investment/world-investment-report>).

[7] See, e.g., Lazard Levelized Cost of Energy, v.14.

[8] Lazard Levelized Cost of Energy Vol. 14.

[9] See, e.g., Michael Waldron and Yoko Nobuoka, *IEA Commentary: A Capital Allocation Dilemma in Energy Transitions*, IEA, Sept. 18, 2019 (<https://www.iea.org/commentaries/a-capital-allocation-dilemma-in-energy-transitions>).

[10] Joachim Seek, Andrew Mills and Ryan Wiser, *Impacts of High Variable Renewable Energy Futures on Wholesale Electricity Prices and Electric-Sector Decision Making*, Lawrence Berkeley National Laboratory, May 2018 (<https://emp.lbl.gov/publications/impacts-high-variable-renewable>); see also, James Bushnell and Kevin Nova, *Setting with the Sun: The Impacts of Renewable Energy on Wholesale Power Markets*, Energy Institute at HAAS (WP 292), August 2018.

[11] World Bank PPI data, 202.

[12] We note that Spain, for example, has removed financial incentives for renewable resources in light of the changing economics of solar generation. This has, in turn, resulted in a series of investment treaty arbitration claims.