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Investor-state dispute settlement mechanisms: implications for the climate transition

In order to combat climate change, states must reduce their use of fossil fuels. This may push them to terminate certain contracts already agreed with fossil fuel sector companies. However, some foreign investors may benefit from legal protections, meaning that when a contract is terminated, they can claim compensation before an arbitration tribunal. A financial risk of this kind may hinder the implementation of policies to combat climate change: a phenomenon known as "regulatory chill". This poses an additional challenge for emerging economies that already need substantial amounts of financing to successfully achieve their energy transition.

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JEL Codes
F2, F23

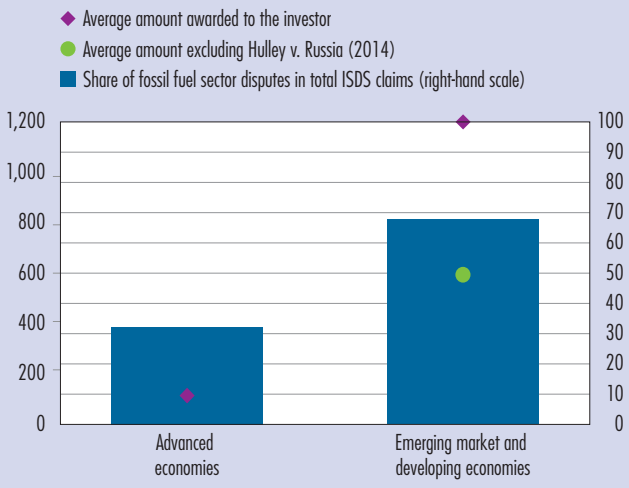
USD 593 million*
the average amount of compensation awarded under investor-state dispute settlement mechanisms against emerging and developing countries in fossil fuel sector arbitrations for the 1987-2023 period

68%
the share of fossil fuel sector disputes involving emerging and developing countries

USD 340 billion
maximum total compensation potentially payable by emerging and developing countries in the event that all disputes result in arbitration (estimate for 2022-50)

* This figure excludes the exceptional USD 40 billion award imposed in a single case (Hulley v. Russia, 2014, see below). Taking this dispute into account, the average amount comes to USD 1.2 billion.

The fossil fuel sector: average amount of compensation awarded and share of total ISDS claims for the 1987-2023 period
(amount in USD billion and share as a %)



Sources: United Nations Conference on Trade and Development (UNCTAD) data; authors' calculations.
Note: ISDS, investor-state dispute settlement.

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Since the 1990s, the number of international investment agreements covering foreign direct investment has increased significantly, with more than 2,600 agreements in force worldwide in 2025. Their purpose is to guarantee multinational corporations (MNCs) a stable economic and legal environment for their foreign direct investment (FDI) and therefore include FDI protection clauses[1] and – almost systematically – investor-state dispute settlement (ISDS) mechanisms. If the clauses set out in these agreements are breached, MNCs can claim compensation for financial damages suffered by triggering these ISDS mechanisms to bring the states before ad hoc arbitration tribunals. Over the 1987-2023 period, 1,325 claims were filed worldwide.[2]

Arbitration tribunals' interpretation of these clauses is complex as there is no international regulatory framework to underpin it. The line between state regulations implemented in good faith and the wilful violation of foreign investment protections can be difficult to discern (Moehlecke, 2020), while the absence, in the majority of cases, of appeal bodies and the heterogeneity of case law may contribute to a form of legal uncertainty for states (Berge and Berger, 2021). The risk of litigation is compounded by the higher financial risk faced by emerging market and developing economies (EMDEs),[3] which, on average, pay greater amounts of compensation than advanced economies.

Given the context, certain states – when exposed to, or risking exposure to, ISDS claims – may reconsider, delay or refrain from implementing some of the regulations that are or may be contested. This phenomenon is referred to as a "regulatory chill" (see definition in the appendix). Efforts currently underway to reform investor-state dispute settlement mechanisms and thereby offer greater protection to a state's "right to regulate" are supported by France and the European Union.

Applied to the challenges associated with the climate transition, the existence of ISDS clauses in agreements on fossil fuel exploration and exploitation may push EMDEs, whose financing needs are particularly severe, to hold back on the implementation of proactive climate policies.

The aim of this bulletin is to (i) explore the regulatory chill phenomenon, (ii) identify the weaknesses specific to EMDEs, particularly in the fossil fuel sector, and (iii) analyse the impact of ISDS mechanisms on financing for the climate transition.

1 The spread of investor-state dispute settlement mechanisms carries a risk of "regulatory chill"

ISDS claims are multiplying due to the increase in international investment agreements

Recourse to ISDS mechanisms has risen sharply since the beginning of the 2000s, in direct correlation with an increase in the number of international investment agreements. While ISDS claims had previously almost exclusively targeted emerging market and developing economies, their reach has now spread to advanced economies (see Chart 1 below). Although most countries are now subject to ISDS claims (133 different countries over the 1987-2023 period), significant heterogeneity persists: six countries accounted for around 25% of the total number of claims in 2023, with each subject to more than 40 disputes (see Chart 2). Argentina and Venezuela alone account for more than 10% of all ISDS cases.

The increase in ISDS cases can be attributed to the proliferation of international investment agreements containing FDI protection clauses, including investor-state dispute settlement mechanisms. Several reasons for states

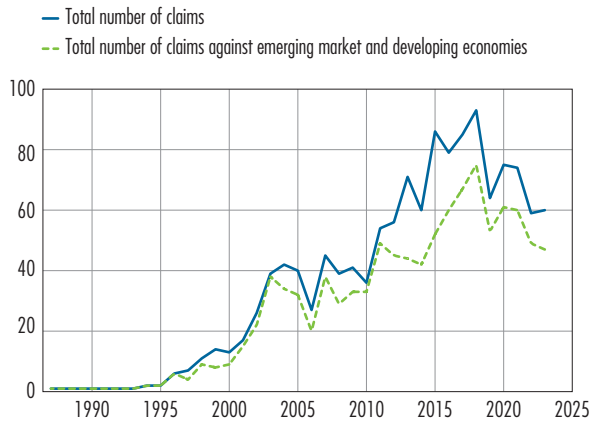
1 Most agreements include five main clauses: (i) non-discrimination protections (based on the national treatment and most-favoured-nation clauses); (ii) protection against direct or indirect expropriation; (iii) guarantees of fair and equitable treatment; (iv) the free transfer of initial invested capital, of the returns from it and, in the event of liquidation, of the proceeds from such liquidation; and (v) so-called "sunset clauses", which guarantee that investments are protected for a period beyond the expiry of the agreement.

2 This figure is very likely to be an underestimate, given that there is no public register of claims.

3 The classification used is based on the IMF's *World Economic Outlook Database – Groups and Aggregates Information*, which divides the world into two major groups: advanced economies and emerging market and developing economies (EMDEs).

C1 The evolution of ISDS claims over the 1987-2023 period

(x-axis: year of claim; y-axis: number of claims)



Sources: United Nations Conference on Trade and Development (UNCTAD) data; authors' calculations.
Note: ISDS, investor-state dispute settlement.

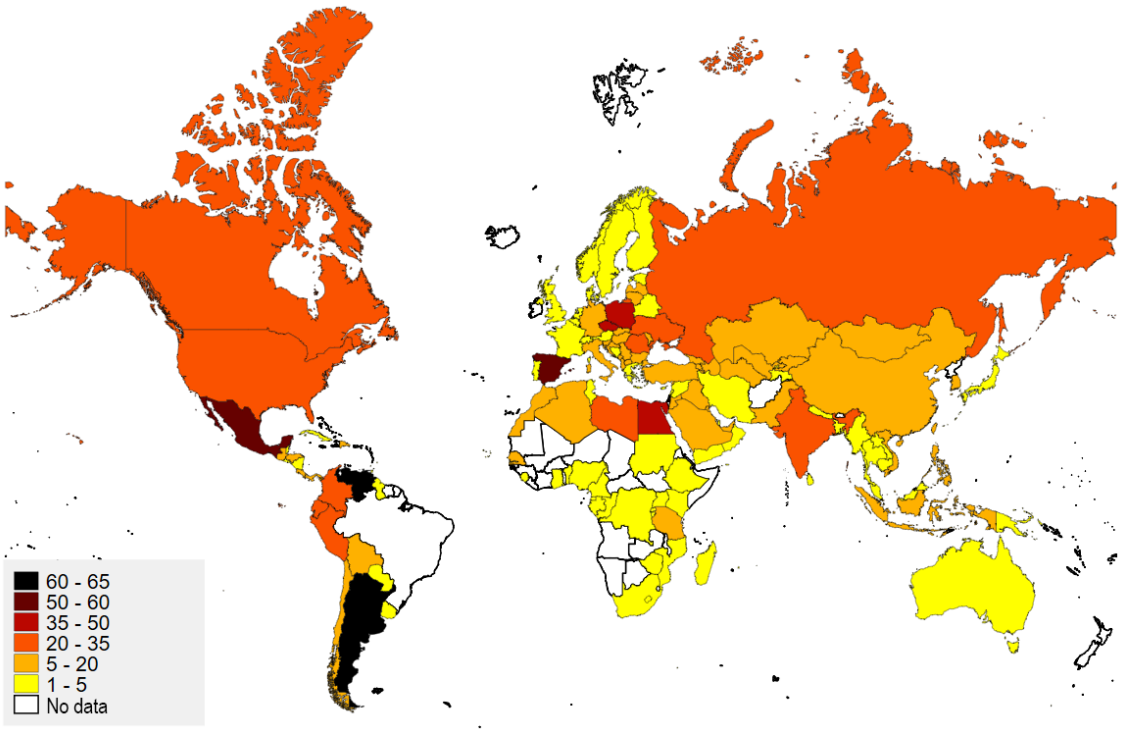
entering into these types of agreements are identified in the literature:

- Signatory states seek to reassure multinational corporations (MNCs) by providing protection against political risk in order to attract FDI (Tienhaara et al., 2022a). Through these clauses, states ensure that MNCs receive fair treatment for their investments, at the very least on a par with the treatment accorded to domestic companies.

- For EMDEs in particular, ISDS mechanisms provide a framework that contractualises and depoliticises investor-state disputes, thus shielding them from any diplomatic pressures likely to be exerted by the country of domicile of the MNC party to the dispute (Gertz et al., 2018; Moehlecke and Wellhausen, 2022).

C2 Total number of ISDS claims in 2023

(in units)



Sources: United Nations Conference on Trade and Development (UNCTAD) data; authors' calculations.
Note: ISDS, investor-state dispute settlement.

- ISDS mechanisms – like innovation – experience a diffusion effect: once a network of agreements containing ISDS clauses reaches critical mass, other states are incentivised to adopt comparable agreements in order to attract FDI (Jandhyala et al., 2011).

- Certain states with insufficiently developed national judicial institutions may be tempted to substitute domestic law with international law to gain credibility with MNCs at minimal cost (Malesky and Milner, 2021).

While several econometric studies demonstrate the positive impacts of (primarily bilateral) international investment agreements on FDI flows, most of them focus on the existence or absence of an agreement and neglect to analyse the specific clauses they contain (Hallward-Driemeier, 2003; Tobin and Rose-Ackerman, 2003; Gallagher and Birch, 2006). However, the effectiveness of these agreements depends on numerous factors, including their specific content and how they interact with the host country's political and economic situation (Pirotte and Titi, 2020).

Other studies also point out that trade and investment treaties that include ISDS mechanisms can act as an extra plus when trying to attract FDI. However, they also specify that their existence can turn out to be less decisive in foreign investors' choices than other key criteria, such as market size, the quality of domestic infrastructure or cooperation and investment facilitation agreements. Brazil is an interesting case in point: it has refused to sign international investment agreements containing ISDS clauses but net FDI flows into the country amounted to 3% of its GDP in 2023, a median level compared with other EMDEs in South America (World Bank data).[4]

ISDS mechanisms carry a risk of regulatory chill for states' public policy implementation

The concept of regulatory chill[5] was first analysed in political science through case studies (Tienhaara, 2011; Moehlecke, 2020). Econometric studies have since complemented this qualitative approach – when the existence of a legal challenge allowed – by taking a data analysis approach to the regulatory chill phenomenon. Moehlecke (2020) and Delpeuch (2023) thus demonstrated the existence of the phenomenon with regard to tobacco legislation. MNC-initiated legal proceedings to contest public policies targeting tobacco use in one country effectively results in regulatory paralysis or slowdown in other countries.[6]

The scale of the compensation claims to which states are exposed, combined with the broad interpretative powers of arbitration tribunals and the absence of an appeal body, heighten the legal uncertainty of the states concerned. One method applied by arbitration tribunals to calculate the compensation claimed from states is based on the net present value (NPV) of the profits the MNC hoped to make, even if no final investment decision had been made, while another is based on estimated discounted cash flows. These methods can lead to financial compensation calculations that are more favourable to investors, prompting some MNCs to refuse to negotiate with the state concerned and to resort directly to ISDS mechanisms.

2 Emerging and developing economies and the fossil fuel sector account for a significant proportion of claims

Emerging and developing economies are particularly vulnerable to ISDS mechanisms

Emerging and developing economies are relatively more exposed to ISDS mechanisms, both in terms of amounts and frequency, with USD 107 billion in total compensation imposed between 1987 and 2023 (compared with only USD 5.8 billion against advanced economies, see appendix). This amount includes the exceptional USD 40 billion compensation awarded against Russia in the case of Hulley v. Russia (2014) following the nationalisation of Yukos Oil

4 In 2023, according to World Bank data, net FDI flows (as a percentage of GDP) stood at –7.1% in Uruguay, +1.7% in Mexico, +3.7% in Argentina, +4.7% in Colombia and +6.5% in Chile.

5 The appendix provides further details on the regulatory chill typologies developed by Berge and Berger (2021) and Tienhaara (2018).

6 Moehlecke (2020) demonstrates that the ISDS claims brought by Phillip Morris International (PMI) in the cases of PMI v. Uruguay (2010) and PMI v. Australia (2011) had a significant impact on states' propensity to regulate in the areas targeted by the claims.

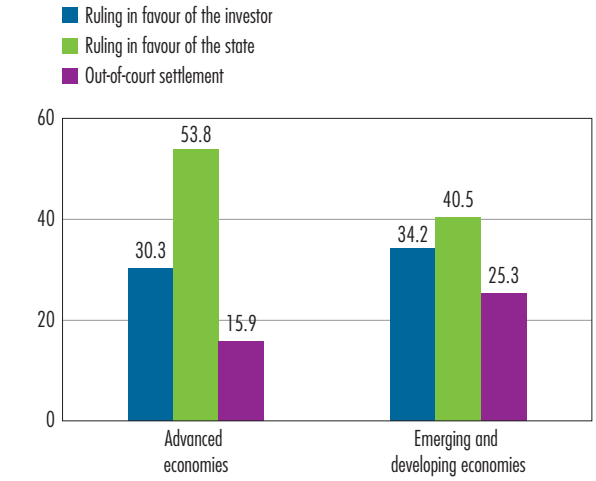
Company. Excluding this case, the total amount awarded against EMDEs for the period stands at USD 67 billion, or 92% of total compensation.[7]

Several factors contribute to this disparity. First, since 1987, EMDEs have accounted for around 80% of ISDS cases (compared with only 20% for advanced economies). Second, the verdicts on disputes that went to arbitration appear to be less favourable to EMDEs, with 40.5% of rulings going in their favour, compared with 53.8% for advanced economies (see Chart 3). EMDEs are also more likely to accept out-of-court settlements (25%, compared with 16% for advanced economies), which in most cases involves the states concerned paying compensation. Third, in rulings in favour of MNCs, the average compensation awarded against EMDEs amounts to USD 285 million, compared with USD 113 million for advanced economies[8] (see Chart 4).

In addition to bearing higher financial costs, EMDEs are also more affected by regulatory chill. This is demonstrated by Moehlecke (2020), who, in reference to the tobacco industry, shows that while the regulatory chill affects both EMDEs and advanced economies, its long-term effects are more pronounced in EMDEs. EMDEs tend to delay the implementation of a regulation that leads to disputes for longer, whereas advanced economies are better equipped to respond. Applied to the environmental sector, Berge and Berger (2021) insist on the role played by the relative maturity of administrative institutions in countries facing an ISDS case.[9]

C3 Arbitration tribunal rulings in ISDS cases over the 1987-2023 period

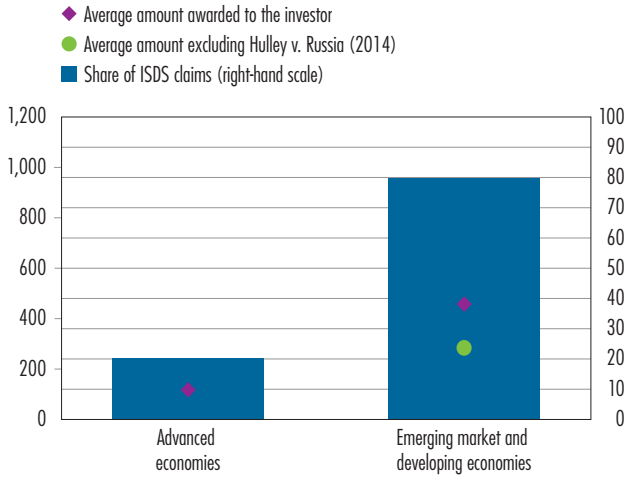
(%)



Sources: United Nations Conference on Trade and Development (UNCTAD) data; authors' calculations.
Note: ISDS, investor-state dispute settlement.

C4 Average amount of compensation awarded and share of total ISDS claims for the 1987-2023 period

(amount in USD billion and share as a %)



Sources: United Nations Conference on Trade and Development (UNCTAD) data; authors' calculations.
Key: EMDEs account for around 80% of ISDS claims (right-hand scale) and average compensation (left-hand scale) imposed on EMDEs amounts to USD 285 million (USD 453 million if Hulley v. Russia, 2014, is included).
Note: EMDE, emerging market and developing economy; ISDS, investor-state dispute settlement.

7 These amounts correspond to the compensation awarded and not to the sums actually paid by states to investors. For example, in the Yukos case – where Hulley v. Russia (2014) resulted in the highest award of a series of disputes that involved cumulative compensation of USD 50 billion – Russia has not yet paid the amounts imposed.

8 This figure rises to USD 453 million if the USD 40 billion awarded against Russia is taken into account.

9 The phenomenon of regulatory chill is thought to be more pronounced in states with robust inter-ministerial coordination capabilities, as the departments responsible for drafting regulations are better able to internalise the legal risk posed by ISDS mechanisms, thanks to more efficient information-sharing between administrations.

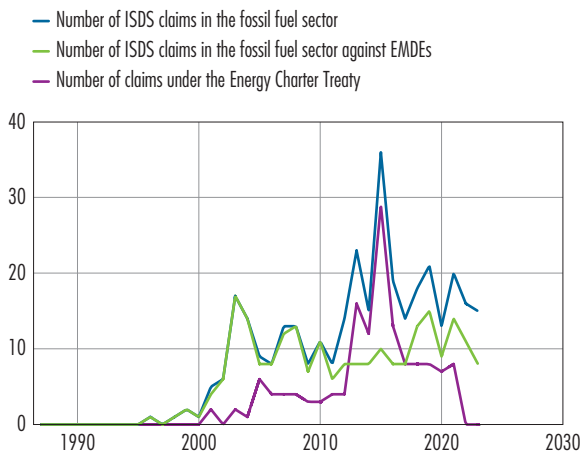
The fossil fuel sector brings additional risk factors

ISDS claims in the fossil fuel sector have risen sharply since the 2000s, particularly those within the framework of the Energy Charter Treaty (ECT), which exerts a disproportionate influence on this trend (see box below). In the 2000s, there was an average of 12 ISDS cases in the fossil fuel sector per year, almost exclusively targeting EMDEs. Between 2010 and 2017, the number of ISDS claims in the sector rose sharply, peaking in 2015 with 36 filed claims. This rapid rise was mainly due to 70 claims brought within the framework of the ECT from 2013 to 2016, which also contributed to the increase in cases brought against advanced economies (see Chart 5). Consequently, the gap in terms of dispute numbers between EMDEs and advanced economies in the fossil fuel sector is smaller than for all sectors combined (see Chart 6). However, the gap in terms of average compensation between EMDEs and advanced economies in the fossil fuel sector is wider (at USD 593 million compared with USD 114 million) than for all sectors combined (USD 285 million for EMDEs, compared with USD 113 million for advanced economies).[10] The ECT is the instrument most widely used by MNCs to bring ISDS proceedings against states, particularly because it has been empirically shown to work in their favour: tribunals have ruled in favour of investors in 61% of cases (Bos and Gupta, 2019). The ECT accounts for 11% of all ISDS claims filed between 1987 and 2023, and 41% of all fossil fuel sector claims.[11]

Furthermore, the exposure of emerging market and developing economies to ISDS claims within the framework of the ECT could increase as the number of signatory countries grows, with 32 countries wishing to accede to the treaty in 2023 according to Tienhaara et al. (2022a). According to Tienhaara et al. (2022b), ECT expansion could increase the net present value of assets that countries could be liable for by USD 38 billion, of which USD 17 billion would be in Iraq and USD 8 billion in Mauritania. It would also expose other countries, such as Tanzania, Kazakhstan, Niger, Jordan and Senegal, to increased risks of USD 1 billion or more.

C5 Number of ISDS claims in the fossil fuel sector over the 1987-2023 period

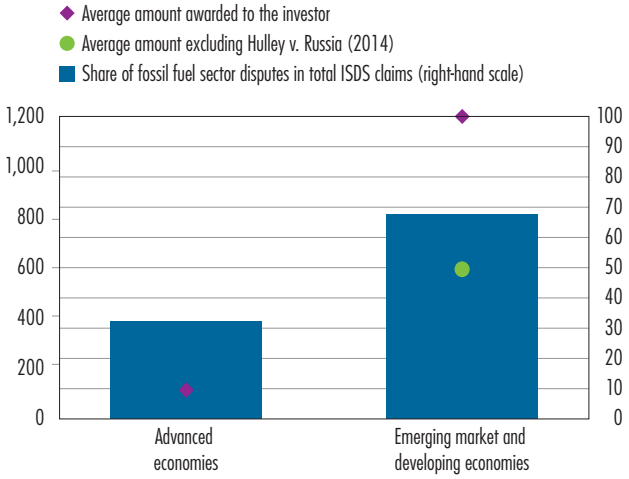
(x-axis: year of claim; y-axis: number of claims)



Sources: United Nations Conference on Trade and Development (UNCTAD) data; authors' calculations.
Note: EMDE, emerging market and developing economy; ISDS, investor-state dispute settlement.

C6 The fossil fuel sector: average amount of compensation awarded and share of total ISDS claims for the 1987-2023 period

(amount in USD billion and share as a %)



Sources: United Nations Conference on Trade and Development (UNCTAD) data; authors' calculations.
Note: ISDS, investor-state dispute settlement.

10 This calculation does not include the case of Hulley v. Russia in 2014, which involved investments in fossil fuels and resulted in an award of USD 40 billion. Taking this exceptionally high compensation into account, the average amount awarded in the fossil fuel sector would rise to USD 1.2 billion.

11 The fossil fuel sectors (NACE Rev. 2) are defined as follows: 05 Mining of coal and lignite; 06 Extraction of crude petroleum and natural gas; 19 Manufacture of coke and refined petroleum products; and 35 Electricity, gas, steam and air conditioning supply.

BOX

The Energy Charter Treaty (ECT)

The ECT is an agreement signed in 1994 that entered into force in 1998. Its original aim was to integrate the emerging energy markets of Eastern Europe into the broader European and world markets following the collapse of the Soviet Union. The treaty includes very wide-ranging provisions for the protection of foreign investment, as well as a mechanism for investor-state dispute settlement – ISDS (Article 26 of the ECT). When it entered into force, the treaty counted 55 signatory states,[1] most of which were advanced economies, which explains their preponderance in ECT-related disputes (see Chart 5 above).

The ECT is regularly criticised for holding back the energy transition of signatory states due to a regime deemed overly protective of private investors' interests (Bos and Gupta, 2019). The Intergovernmental Panel on Climate Change (IPCC), in its Sixth Assessment Report (AR6), mentions the ECT explicitly as an agreement that favours investors' interests at the expense of public policy, through the massive recourse to ISDS.[2]

The stakes are particularly high given that the ECT protects more than 2,000 oil and gas assets in 31 countries, which constitutes a total production volume of 18 million barrels per day (Tienhaara et al., 2022b).

In May 2024, the European Union (EU) decided to withdraw from the ECT, citing its incompatibility with the EU's climate goals under the European Green Deal and the Paris Agreement. This decision illustrates, more broadly, the shift in public policymakers' perception with regard to the clauses presented in these agreements, and in particular ISDS mechanisms. Furthermore, the effects of the revisions to the ECT that entered into force in September 2025 continue to be disputed.

1 Signatory countries in 1994: Albania, Armenia, Austria, Azerbaijan, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Finland, Georgia, Germany, Greece, Italy, Kazakhstan, Kyrgyzstan, Latvia, Liechtenstein, Luxembourg, Moldova, the Netherlands, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, Switzerland, Tajikistan, Turkmenistan, the United Kingdom and Uzbekistan. The EU ratified the treaty in 1997.

2 "A large number of bilateral and multilateral agreements, including the 1994 Energy Charter Treaty, include provisions for using a system of investor-state dispute settlement (ISDS) designed to protect the interests of investors in energy projects from national policies that could lead their assets to be stranded" (p. 2442).

3 Do investor-state dispute settlement mechanisms hinder the transition away from fossil fuels?

Phasing out fossil fuels carries a significant risk of litigation

States' implementation of climate commitments raises the risk that a very large number of fossil fuel sector investments currently protected by ISDS mechanisms would be stranded. Meanwhile, the global stocktake that came out of COP28 confirmed that strong additional measures to phase out fossil fuels were essential, and against that backdrop, the "transition away from fossil fuels" was enshrined for the first time in a multilateral decision.

However, according to Tienhaara et al. (2022a), over the 2022-50 period, 10% of oil and gas production from projects awaiting a final investment decision are currently protected by ISDS mechanisms. The authors estimate that the net present value of these investments could range from USD 60 billion (minimum scenario) to USD 234 billion (maximum scenario),[12] of which 6% to 7% are only covered by the ECT. Some countries are particularly exposed to losses, including Guyana and Venezuela

12 Net present values vary depending on future oil price assumptions, in this case ranging from USD 50 per barrel (minimum) to USD 100 (maximum).

(USD 11 billion and USD 10 billion, respectively, in the central scenario). The total potential claim amount could vary from USD 92 billion to USD 340 billion (under the minimum and maximum scenarios) if projects already under development are included.

Potential compensation must be considered in relation to the cost of the climate transition in EMDEs

According to the International Energy Agency (IEA, 2023), annual investment in clean energy in EMDEs will need to rise from USD 770 billion in 2022 to between USD 2,200 billion and USD 2,800 billion per year over the 2030-35 period, and remain at similar levels thereafter until 2050. Bhattacharya et al. (2024) estimate that the financing needed by EMDEs (excluding China) to achieve the Paris Agreement goals amounts to USD 2,440 billion per year by 2030. By way of comparison, the maximum cumulative amount of compensation according to Tienhaara (USD 340 billion) is triple that of the climate finance mobilised for developing countries by developed countries in 2022 (USD 115.9 billion according to the Organisation for Economic Co-operation and Development). The juxtaposition of financing needs and the rising costs associated with ISDS claims to which they may be exposed presents an extra obstacle to achieving this transition.

Faced with ISDS mechanisms, certain EMDEs may be forced to delay their transition away from fossil fuels. For the first time, the IPCC (2023) also referred to regulatory chill in its Sixth Assessment Report as a potential barrier to the adoption of mitigation policies given the costs associated with potential litigation. Although this phenomenon is documented in the literature for the tobacco sector, Tienhaara (2018) draws a parallel with the fossil fuel industry given the two sectors' similar characteristics.[13]

The dual challenge facing emerging market and developing economies of (i) managing the risk of litigation linked to ISDS mechanisms while (ii) seeking to mobilise unprecedented amounts of financing to ensure their climate transition warrants closer attention to the effects of ISDS mechanisms. Further reforms to ISDS functioning will need to ensure that the protection accorded to foreign private investment is balanced with the right of states to introduce legislation within their borders to carry out climate policies to phase out fossil fuels. Bhattacharya et al. (2024) estimate that USD 1,000 billion per year in external investment is needed in developing economies, excluding China, to ensure their transition.

13 These characteristics include a market concentrated around a small number of players with significant financial resources who face an existential threat from internationally coordinated public initiatives.

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Appendix
Further information

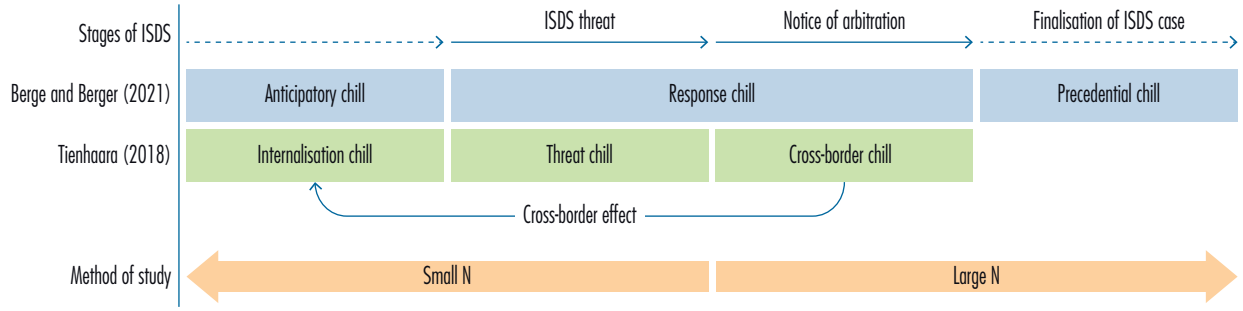
1 Types of regulatory chill

Berge and Berger (2021) distinguish between three types of regulatory chill: (i) an anticipatory response, before there is even a real threat of an investor-state dispute settlement (ISDS) claim; (ii) a direct response, following notification of a risk of an ISDS claim; and (iii) a precedential response, once the ISDS ruling has been finalised.

Tienhaara (2018) also outlines three varieties of regulatory chill, which partly overlap with Berge and Berger's typology: (i) internalisation chill, whereby regulatory progress is hindered across all areas due to a state's fears of an ISDS dispute (a logic similar to the anticipatory response); (ii) threat chill, where a specific regulatory measure is prevented due to a particular industry's threats of ISDS arbitration; and (iii) cross-border chill, where an ISDS dispute concerns legislation in a given state but is easily transferable to similar legislation in other jurisdictions.

The diagram below compares two methods. The analytical method used in the literature to substantiate the existence of a regulatory chill varies according to its type. In the absence of litigation and therefore of data, the authors prioritise qualitative studies in the form of case studies. However, where legal action has been taken, a specific point in time can be identified and a database developed, allowing econometric studies to be applied in the analysis of the phenomenon of regulatory chill.

Types of regulatory chill

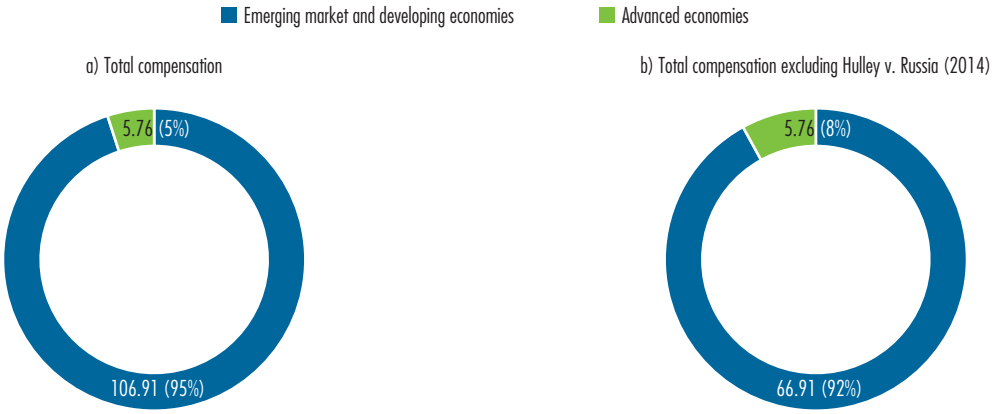


Sources: Berge and Berger (2021), Tienhaara (2018); authors.
Note: ISDS, investor-state dispute settlement.

2 Total compensation awarded under ISDS claims

Total compensation awarded under ISDS claims over the 1987-2023 period

(amount in USD billion and share as a %)



Sources: United Nations Conference on Trade and Development (UNCTAD) data; authors' calculations.
Note: These figures include (Chart a) and exclude (Chart b) the largest award in the history of investor-state dispute settlement (ISDS) mechanisms: the exceptional case (Hulley v. Russia), in which Russia was ordered to pay USD 40 billion in 2014.

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