



Addressing the Systemic Risks of Investor-State Dispute Settlement (ISDS) to Climate Action

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Abstract

The current international investment agreement (IIA) framework, featuring over 2,200 treaties with Investor-State Dispute Settlement (ISDS) mechanisms, acts as a structural barrier to the implementation of key aspects of the Paris Agreement. By protecting fossil fuel investments, those treaties create significant financial risks that may induce "regulatory chill," deterring states from implementing necessary climate mitigation measures. Recent rulings from the International Court of Justice, the Inter-American Court of Human Rights, and the European Court of Human Rights have affirmed states' sovereign rights to regulate for climate action, providing new legal tools to challenge the ISDS status quo. However, these judicial developments do not eliminate litigation risks or guarantee favourable outcomes. Consequently, states must pursue systemic reform, including treaty modernisation, the termination of outdated IIAs, the implementation of comprehensive climate carve-outs, and restrictions on forward-looking damages. Addressing these legal barriers at upcoming forums like the 64th sessions of the United Nations Framework Convention on Climate Change (UNFCCC) Subsidiary Bodies (SB 64) is essential to align international investment law with the existential imperative of a low-emission transition.

Introduction

The current framework of international investment agreements (IIAs), comprising over 2,200 active treaties,¹ could act as a profound structural barrier to the operationalisation of UNFCCC Article 2.1(c).² These treaties, the majority of which feature Investor-State Dispute Settlement (ISDS) mechanisms, include investment protection standards that extend to the fossil fuel sector, effectively chilling the regulatory autonomy of host States by imposing exorbitant financial risks that may deter the adoption of requisite climate

¹ UNCTAD, 'International Investment Agreements Navigator' (Investment Policy Hub) <https://investmentpolicy.unctad.org/international-investment-agreements> accessed 27 May 2026.

change mitigation measures.²

The significant financial burdens of ISDS proceedings, which have amounted to tens of billions of dollars, have drained national budgets and created a powerful deterrent, discouraging States from implementing policies necessary to meet their Paris Agreement obligations.³ For example, there are currently at least 231 known treaty-based ISDS claims specifically involving fossil fuel investments.⁴ The prospect of losing similar cases and facing multi-billion dollar compensation awards in many instances leads to a ‘regulatory chill,’ deterring governments from enacting ambitious climate policies. Furthermore, these awards directly divert critical public funds away from climate mitigation and adaptation.⁵

Consequently, the prevailing architecture of international investment law sends the wrong signals to the global market by de facto insulating carbon-intensive investments from regulatory risk, actively undermining the systemic transition to a low-emission economy and requiring urgent, structural treaty reform.

The Need for Action

Several governments have recognised the critical importance of aligning investment treaties with the climate finance goals set out in UNFCCC Article 2.1(c), and that the current interpretive frameworks in the context of ISDS litigation do not offer sufficient legal certainty regarding the preservation of sovereign policy space for climate-mitigation measures.⁶ Despite this growing consensus among States, reforms to date have been fragmented, largely procedural, and insufficient, failing to address the foundational imbalances that continue to subject climate-responsive State action to the chilling effect of investment arbitration.

The detrimental effects of ISDS on climate action have increasingly been discussed in environmental and climate negotiations. For example, during the 62nd sessions of the UNFCCC Subsidiary Bodies (SB62) in Bonn, an official side event held on June 16, 2025, focused explicitly on addressing investment treaties to achieve Article 2.1(c).⁷ The event emphasised that mobilising climate finance requires removing these systemic legal barriers that distort investment decisions and exacerbate the debt burdens of developing nations.

² Kyla Tienhaara, ‘Regulatory Chill in a Warming World: The Threat to Climate Policy Posed by Investor-State Dispute Settlement’ (2017) 7(2) *Transnational Environmental Law* 229

³ See: Daniel Uribe, ‘Painting the Grass Green: A Climate Change Carve-Out in Investment Agreements,’ *Investment Policy Brief No 25*, The South Centre 2024 https://www.southcentre.int/wp-content/uploads/2024/07/IPB25_Painting-the-Grass-Green-A-Climate-Change-Carve-Out-in-Investment-Agreements_EN.pdf accessed 27 May 2026

⁴ Hélionor De Anzizu, ‘International Investment Law and ISDS: Overcoming Legal Barriers to Effective Climate Action under the UNFCCC and the Paris Agreement’ (Center for International Environmental Law, 2024)

⁵ Uribe, n.3.

⁶ OECD, ‘Methods to Align Investment Treaty Benefits for Energy Investment with the Paris Agreement and Net Zero: Note by the Secretariat’ (OECD, 2024)

⁷ E3G, CIEL, IIED, SEATINI and South Centre, ‘Addressing Investment Treaties to Achieve Article 2.1(c) of the Paris Agreement’, E3G, 9 June 2025.

Similarly, the First Conference on Transitioning Away from Fossil Fuels, convened in Santa Marta, Colombia, in April 2026 (see Box 1), considered the legal and economic barriers generated by the ISDS regime to the financing and adoption of State climate action.⁸ Participants in the Conference consider how ISDS proceedings create legal risks that systematically induce regulatory chill and limit the adoption of legitimate environmental regulations necessary to achieve the objectives in the Paris Agreement.

For SB 64, developing states should consider whether strengthened efforts are required to prioritise collaborative legal strategies against the ISDS threat, explore pathways to avoid ISDS obstructing climate action and decarbonisation, and advocate for a legal architecture that unequivocally subordinates corporate profit expectations to the existential imperative of climate mitigation and sovereign regulatory autonomy.

International Decisions and Climate Change

Recent rulings and advisory opinions from international and regional courts could provide states with new legal tools to defend climate policies against ISDS claims:

- a. **International Court of Justice (ICJ)⁹:** In its July 2025 Advisory Opinion, the ICJ confirmed that taking action against climate change is a binding *erga omnes* legal duty, not a policy discretion. A state's failure to protect the climate system, such as through ongoing fossil fuel licensing and subsidies, can constitute an internationally wrongful act. This effectively dismantles the "legitimate expectations" defence often used by investors, as no investor can reasonably expect regulatory frameworks to remain frozen in violation of international law.¹⁰
- b. **Inter-American Court of Human Rights (IACtHR)¹¹:** In Advisory Opinion OC-32/25, the IACtHR urged states to review their existing investment agreements and ISDS mechanisms to ensure they do not restrict climate efforts,¹² as the practice of awarding high amounts on damages discourages states from implementing necessary public policies.¹³

European Court of Human Rights (ECtHR): The ISDS regime is also facing direct challenges from citizens. On June 21, 2022, five young people filed a landmark lawsuit against 12 European states at the ECtHR, arguing that the Energy Charter Treaty (ECT) delayed climate action and breached human rights. Following a wave of state withdrawals from the ECT, the plaintiffs withdrew their complaint but

⁸ Lorenzo Cotula and Kyla Tienhaara, 'Santa Marta Conference Highlights Legal Barriers to the Energy Transition' (International Institute for Environment and Development, 18 May 2026) <https://www.iied.org/santa-marta-conference-highlights-legal-barriers-energy-transition> accessed 28 May 2026.

⁹ *Obligations of States in respect of Climate Change* (Advisory Opinion) [2025] ICJ Rep 101.

¹⁰ See: Daniel Uribe Teran, 'Leveraging the ICJ Opinion to Secure a Just Climate Future for the South during COP30,' Climate Policy Brief 29, South Centre, 2025, https://www.southcentre.int/wp-content/uploads/2025/11/CPB29_Leveraging-the-ICJ-Opinion-to-Secure-a-Just-Climate-Future-for-the-South-during-COP30_EN.pdf accessed 28 May 2026.

¹¹ *The Climate Emergency and Human Rights* (Advisory Opinion OC-32/25) IACtHR Series A No 32 (18 May 2025).

¹² *Ibid.*, para. 351

¹³ *Ibid.* para. 164.

reserved the right to initiate new legal action if states fail to withdraw from climate-damaging treaties.¹⁴

- c. Although these developments represent meaningful progress, they do not eliminate the risk of litigation, and they cannot guarantee that arbitral tribunals will adopt such interpretations in particular cases. Therefore, the need for comprehensive and holistic reform of IIAs remains essential.

Strategic Steps Forward

To align the international investment regime with the Paris Agreement and unlock climate finance, states must pursue coordinated actions:

- a. **Treaty Modernisation:** States should increase efforts to renegotiate and modernise their existing investment agreement to incorporate investor obligations with regard to human rights, climate change and environmental protection, and incorporate other means of dispute resolution, particularly those that strengthen domestic justice systems.
- b. **Termination and Sunset Clauses:** If renegotiation and modernisation of existing IIAs are not possible, States should consider the withdrawal from or termination of outdated investment treaties and actively neutralise their survival ("sunset") clauses through mutual agreement.
- c. **Implementation of Climate Carve-Outs:** For remaining treaties, as exemplified by the case of New Zealand and Australia,¹⁵ through the exchange of diplomatic letters, States can introduce clear and all-encompassing climate action exemptions ("carve-outs") that explicitly exclude climate measures from the scope of ISDS compensation claims. This kind of exchange would constitute a subsequent agreement between the parties that investment arbitration tribunals should be bound to give effect to. New treaties should consider completely excluding ISDS provisions, or including specific provisions related to climate change carve-outs.
- d. **Restriction of Forward-Looking Damages:** States must implement rules that restrict ISDS tribunals from awarding forward-looking damages (most notably based on the Discounted Cash Flow method) in response to claims of speculative future revenues for fossil fuel assets, which overlook the declining value of these stranded assets.

Some of these issues could be fully discussed at the upcoming SB 64 sessions in Bonn, as they present a strategic juncture for institutionalising them within the Just Transition Work Programme and the Forum on the Impacts of the Implementation of Response

¹⁴ Kate Abnett, 'Plaintiffs Drop 5 Climate Cases at Europe's Human Rights Court' (23 July 2024) <https://www.reuters.com/world/europe/plaintiffs-drop-5-climate-cases-europes-human-rights-court-2024-07-23/> accessed 28 May 2026.

¹⁵ See: *Exchange of Letters between the Government of Australia and the Government of New Zealand concerning Investor-State Dispute Settlement* (signed 8 March 2018) <https://www.dfat.gov.au/sites/default/files/sl15-australia-new-zealand-isds.pdf> accessed 4 June 2026.

Measures.

South Centre Member States could consider whether introducing ISDS discussions within these fora would allow them to identify how the financial risks arising from ISDS litigation could limit the allocation of transition finance and exacerbate the cross-border socioeconomic consequences of mitigation policies. Consequently, advancing a coherent approach within the subsidiary bodies could rely on and confirm the legal principles affirmed by recent judicial opinions by International Courts that seek to guarantee States' sovereign right to regulate matters relating to climate change and to limit the detrimental effects of ISDS on climate action and environmental protection.

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