ESG funds, state energy policy and maximising shareholder value – what the future holds

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Earlier this year, Glenn Hegar, the Texas comptroller of public accounts, hit the headlines when he announced that hundreds of investment funds are "boycotting" fossil fuel companies. Texas Senate Bill 13, passed in September 2021, means that some Texas government funds will have to divest. Similar laws have also been introduced by state legislatures in West Virginia, Oklahoma and Indiana.

Proponents of the Texas law may argue that there is a continued need for investment in oil and gas pending the completion of the transition to clean energy, but critics are likely to counter that the funds accused of "boycotting" fossil fuels are simply following market forces which favour investment in the transition. The continued need for energy security makes it possible that these types of laws or aligned policies also could arise outside the United States.

Paris Agreement

The UK and EU are unlikely to take steps to ban environmental, social and governance (ESG) funds in the same way as the United States; any such action would likely be inconsistent with the terms of the Paris Agreement, as well as other legally binding instruments which governments must consider in their decision making.

States have already been challenged successfully in the courts for failure to demonstrate adequate consideration. The UK government was forced to revisit its Net Zero Strategy following a judicial review case. In the Urgenda claim, menawhile, a Dutch court found that the government of the Netherlands was taking insufficient steps to implement the Paris goals. Germany and the Czech Republic have also failed to defend themselves against similar claims, and there are pending claims in Brazil.

The United States, in contrast, withdrew from the Paris Agreement during the presidency of Donald Trump, taking effect on November 4, 2020.

Any action to deter funds from operating ESG-strategies would also fly in the face of the EU Green Deal and the regulations which have been put in place both to promote ESG goals and to try to guard against greenwashing, including under the EU taxonomy.

Energy Charter Treaty

There are also legal (as well as socio-economic) factors pushing states in the opposite direction, including historic commitments which could arguably dissuade governments from putting in place policies which could damage the profitability of fossil fuel companies.

The Energy Charter Treaty (ECT) is receiving particular attention. Signed in 1994 and in force since April 1998, the ECT has 53 signatories and contracting parties, including the UK and EU. The ECT allows investors from one signatory state to make claims for damages against other signatory states in certain situations, including where new policies discriminate against them.

The ECT has been used by some fossil fuel companies to make claims. In August 2022, the Italian state was ordered to pay 190 million euros plus interest to Rockhopper Exploration (including claims for loss of profits) following the Italian government's decision to ban new oil and gas projects within 12 nautical miles of the coast.

In 2021, RWE launched a substantial compensation claim against the Netherlands, following the Dutch government's agreement to phase out coal power by 2030, affecting two of RWE's coal plants. A study published this year by the Climate Change Counsel, however, concluded that the interpretation of climate-change related arguments and conflicting laws by tribunals in ECT claims remains unsettled.

In June 2022, five individuals launched a claim in the European Court of Human Rights against 12 states (Austria, Belgium, Cyprus, Denmark, France, Germany, Greece, Luxembourg, the Netherlands, Sweden, Switzerland and the UK) for their active membership of the ECT.

In addition to arguments about inconsistency with the Paris Agreement goals, the claimants submit that continued membership of the ECT violates art 2 (the right to life) and art 8 (the right to and respect for family life) of the European Convention of Human Rights.

The EU has been vocal in arguing that the ECT needs to be revised. After five years of negotiations, an agreement in principle for its modernisation was reached in June 2022, which could be adopted in November 2022 if no contracting party raises an objection.

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This does, however, maintain a minimum 10-year phase-out period for fossil fuel investments (which an individual member must trigger using an opt-out clause) and also continues to protect investments in energy sources and technologies where sustainability concerns have been raised (including biomass, hydrogen, ammonia and carbon capture storage). Critics maintain, therefore, that it is a barrier to necessary legislative support for, and investment in, clean energy.

Attracting foreign investment

Attracting investment into vital industries requires some level of legal and policy certainty. The ECT was put in place to give investors that comfort when the signatories needed to attract foreign direct investment in the 1990s, well before the adoption of the Paris Agreement in December 2015. It does specifically acknowledge climate goals, albeit that these references do not necessarily interact with the investor protection and compensation provisions.

Although the claims by fossil fuel companies have hit the headlines, the ECT is not designed to protect fossil fuel companies, but to give certainty to all types of energy investment, including renewables.

Many of the early claims made under the ECT related to protections for renewable energy generation. In 2018, Spain and Italy were ordered to pay substantial damages to 9REN, Greentech, Novenergia and CEF Energia respectively, arising out of changes to incentives regimes for renewable energies. Similar claims issued against Germany by Strabag and others in 2019 remain pending.

Withdrawing from the ECT could result in states finding it more difficult to attract foreign direct investment for all types of energy sources (although some other bilateral and multilateral investment treaties would remain in force). The timing is bad given that states need to step up investment in schemes designed to offset the effects of climate change which have already accrued, compounded by pressure from the increasing number of human rights-based cases alleging state responsibility to protect life, property and indigenous customs from the effect of climate change. One such example is the United Nations decision in favour of the Torres Strait Islanders, demanding that Australia take further action to protect their rights.

It may be too simplistic to assess the effectiveness of the U.S. legislation in protecting investment in fossil fuel companies by considering investment decisions in fossil fuels on a fund-specific basis. A number of the funds blacklisted by the Texas comptroller point to their continued investment in fossil fuels as part of a holistic investment strategy, and blacklisted firms, including BlackRock, have also been criticised by climate activists alleging they do too little to cut global emissions.

Maximising shareholder value

Ultimately, funds will continue to be driven by their need to comply with fiduciary duties which are generally focussed on maximising shareholder value. They may consider ESG factors in a longer-term view, but they are generally limited to addressing such factors to protect the company from the effect of those risks on the bottom line, unless they are given a specific purpose to do otherwise (set out in the trust documents or company articles of association).

The investment debate is many-faceted and will no doubt continue to be shaped by the politics and economics of energy security and the diverse needs and obligations of states and their citizens, as well as the funds and the fiduciaries managing them.

Complaints Procedure

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