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COP26 Created New Carbon Market Rules: How Will Arbitration Respond?

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As the climate crisis has intensified, much has been said about the roles that arbitration can play in the collective global response – including during the recent BVI Arbitration Week, which coincided with the Glasgow climate conference. Arbitration has been utilised as a tool for resolving disputes as market mechanisms have developed to deliver greenhouse gas emission reductions. At COP26, governments adopted long-awaited rules for carbon market cooperation under the Paris Agreement's Article 6.2 and Article 6.4. This post discusses the significance of these rules, what they mean for carbon disputes and how arbitration can contribute to the resolution of such disputes.

Carbon Markets Rising

Carbon markets exist to incentivise emission reductions at the least cost. By purchasing a carbon credit, a government or company can offset a proportion of its emissions, i.e., count the actual emission reductions underlying the credit against its own emission reduction commitments. Carbon markets can also create incentives for investment and technology transfer in climate-vulnerable countries.

By setting quantified emission targets for developed Parties, the Kyoto Protocol was a major spur for the development of carbon markets . This treaty sets out three 'flexibility' mechanisms:

- Joint Implementation (JI);
- the Clean Development Mechanism (CDM); and
- Emissions Trading.

Following Kyoto's adoption, domestic carbon pricing was introduced in various jurisdictions, with the EU's Emissions Trading System being the largest example.

Today, carbon markets have largely outgrown the Kyoto mechanisms. For instance, carbon pricing continued to expand during the past year, with the proportion of global emissions covered by carbon pricing up from 15% in 2020 to 25.1%.

Arbitrating Carbon Market Disputes

Carbon market transactions are effected through forward contracts for the production and delivery of credits (emission reduction purchase agreements) and spot and derivatives contracts for secondary trading. While some carbon contracts provide for court jurisdiction, many provide for arbitration. Examples include the International Emissions Trading Association's emissions trading master agreement for the EU ETS (providing for the PCA Secretary-General as the appointing authority, with the option to choose among the ICC Rules, UNCITRAL Rules or PCA environmental rules), the World Bank's Forest Carbon Partnership Facility general conditions for emissions reduction payment agreements (PCA Secretary-General as appointing authority; UNCITRAL rules; London as arbitral seat) and Norway's template agreement for purchase of CDM credits (LCIA rules; London as arbitral seat).

Arbitration is also provided for in the processes of carbon crediting standards bodies, such as Verra and the Gold Standard Foundation (which the World Bank reports were collectively responsible for half the credits issued through crediting mechanisms in 2020). Verra's template agreement provides for disputes with validation/verification bodies (which assess projects under Verra's standard) to be settled through arbitration in London under ICC rules. The Gold Standard has developed bespoke rules, based on the PCA environmental rules, for arbitrating disputes concerning project registration and credit issuance and labelling.

Carbon disputes often turn on issues common to other contractual disputes: commodity non-delivery, breach of covenants or warranties, failure to fulfil conditions precedent, disputes over title or security, etc. Distinctive elements include the nature of the commodity, the carbon crediting project cycle, and the application of international climate standards. The project cycle itself can also generate disputes, e.g., concerning project registration or credit issuance.

For instance, in an SCC arbitration a Danish firm successfully claimed damages from its Russian counterparty regarding a JI project. The Danish company had reduced emissions from the Russian state-owned entity's gas pipelines, but the Russian entity had failed to get the relevant projects registered in Russia, thereby blocking the issuance of the JI emission reduction units due under the contract.

Carbon disputes are not limited to carbon contracts themselves but extend to the full gamut of disputes concerning the underlying infrastructure projects undertaken to generate emission reductions, potentially resulting in commercial or investment arbitration proceedings. Interstate arbitration has also been chosen for dispute settlement concerning international emissions trading cooperation.

The Paris Agreement and COP26 Outcomes

Article 6 of the Paris Agreement introduced 'cooperative approaches' involving internationally transferred mitigation outcomes (ITMOs) (Article 6.2) and a 'mechanism' to contribute to emissions mitigation and sustainable development (Article 6.4), as well as non-market approaches (Article 6.8).

According to the rules agreed in Glasgow, the Article 6.2 and 6.4 modalities differ from their Kyoto predecessors. The guidance on Article 6.2 provides for the participation of *all* Paris

Agreement Parties in cooperative approaches, not just developed Parties as in Kyoto emissions trading (pilot projects are quite diverse).

The transferrable carbon units, ITMOs, can be measured either in tonnes of CO2 equivalent (as with the Kyoto units) or in other metrics consistent with participating Parties' Nationally Determined Contributions (NDCs). ITMOs can be transferred not just as credit against a receiving Party's NDC target but also for 'international mitigation purposes' (currently, the international aviation carbon mechanism) and 'other purposes' (voluntary carbon markets).

The Article 6.4 mechanism rules build on the CDM model with important differences. All Paris Agreement Parties can participate in the A6.4 mechanism both as host States or as investors/purchasers of credits, unlike JI (limited to developed Parties) and the CDM (limited to developing Party host states and developed Parties as purchasers of credits). As with A6.2 cooperation, A6.4 emission reductions can be credited to NDCs, international purposes and voluntary markets.

The Article 6 rules should reinforce the existing trend toward more widespread and credible carbon markets. Indeed, over 70% of Parties reportedly intend to use at least one Article 6 approach, with A6.2 cooperation the most popular.

What Does this Mean for Arbitration?

COP26 will also affect the nature of future carbon market disputes. For instance, significant growth in market activity through the creation and trade in ITMOs (including the subcategory of A6.4 emission reductions) can be expected to eventually result in more disputes. Institutions that provide for arbitration in agreements with counterparties (such as the Asian Development Bank) have already indicated plans to participate in this market. Also, the entry of new market participants and the unfamiliarity and complexity of new modalities compared to previous carbon credits – e.g., allowing for the diversity of NDCs (from which 'mitigation outcomes' are derived), mitigation metrics and activity methodologies – may generate disputes, at least during the early years of implementation.

Carbon contracts will need to be updated to reflect the new rules (e.g., concerning human rights and environmental and social safeguards), thereby affecting the respective obligations of parties. A new generation of carbon contracts (mitigation outcome purchase agreements, or MOPAs) are being developed for this purpose. Some market standards bodies have already indicated intent to update their frameworks for consistency with the COP26 outcomes.

Governments are likely to introduce or amend legislation to structure their interaction with the Article 6 processes (e.g., as A6.4 activity hosts). These changed legal frameworks, differing from country to country, will apply to relevant disputes alongside pertinent international rules.

It is also possible that arbitration will be directly incorporated into Article 6 governance. The A6.4 rules provide that *"[s]takeholders, activity participants and participating Parties may appeal decisions of the Supervisory Body or request that a grievance be addressed by an independent grievance process"*. This language indicates that two distinct processes – an appeal process and a grievance process – must be made available. For the appeal process, it is conceivable that arbitration would be utilised, perhaps if mediation is unsuccessful (as carbon contracts often

provide). One model might be the Gold Standard Rules mentioned above, which provide for appeals from the kinds of decisions that the Supervisory Body will also be taking (at least concerning registration of activities and issuance of units).

In the A6.4 decision, Parties tasked the Supervisory Body to develop provisions for matters including the appeals and grievance processes. There is no existing UN climate appellate process that could be readily applied to the A6.4 mechanism. It is also worth noting that Parties never agreed a process for appeals against CDM Executive Board decisions, despite the issue being on the agenda since 2010.

With the Paris rules adopted at last, arbitral institutions and associations now have opportunities to prepare for arbitration to play an effective role in their implementation. These opportunities include:

Observing and contributing to UN processes mandated in Glasgow for putting the new rules into practice, for instance for the A6.4 Supervisory Body to develop provisions for appeals and grievance processes. The Supervisory Body begins meeting in 2022. Since the pandemic started, most meetings of UN climate bodies have been held virtually and open to observers. Arbitral institutions and practitioners have been present at several recent COPs. Their advocacy has not resulted – and, in my view, will not result – in adoption by Parties of an arbitration Annex for the Climate Convention (mandated in 1992 to be adopted *"as soon as practicable"*). However, Article 6 is a more discrete matter, and the timely adoption of dispute settlement arrangements might reasonably be expected.

Engaging with carbon market standards bodies, as well as sovereigns and institutions nominated by them to participate in the ITMO marketplace, regarding further development of template and bespoke contract provisions and the potential utility of arbitration.

Building capacity and awareness among arbitration practitioners regarding dispute settlement in this specialised but growing market. This includes developing familiarity with the unique regulatory context for carbon credits that includes the Paris Agreement, Article 6 rules, CDM rules, etc, plus the project cycle, actors involved and common structure of carbon agreements.

Institutions exploring a larger role in carbon market disputes might also consider measures such as the adoption of specialised rules tailored to this market, the establishment of a panel of arbitrators with relevant expertise and the creation of a list of technical experts.

This post is written in a personal capacity.

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