

Kluwer Arbitration Blog

Dispute Resolution in Carbon Markets

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The shift from a carbon-intensive economic model to a net-zero economy by 2050 will result in an increasingly significant role for carbon markets. A proliferation of business activities in the carbon trading space will require seismic regulatory change across global jurisdictions. In this evolving landscape, common issues have begun to emerge including: the practical and conceptual challenges of carbon accounting, and the tensions between businesses' interests in purchasing carbon offsets and governments' efforts to regulate carbon markets. These new and untested issues come with a heightened risk of disputes. International arbitration has unique features that make it well-suited as a forum for the resolution of carbon market disputes.

Carbon Market Disputes

Challenges of Carbon Accounting

The integrity of carbon markets depends in large part on the reliability of carbon accounting and requires information about an entity's emissions and offsets to be genuine and accurate. However, there are several challenges that make carbon accounting a difficult and inherently ambiguous exercise, which contributes to increased risk of dispute, including:

- the lack of a credible and consistent method of calculating both emissions produced by a business, and emissions avoided or stored by an abatement project;
- the lack of a standardised emissions data collection procedure across entities and sectors, which is often done manually and is error-prone;
- inconsistencies in defining the scope of carbon accounting, e.g., whether and how much upstream and downstream supply chain emissions are included; and
- the complex and heterogenous taxonomy of carbon accounting where the terminology commonly used to describe emissions and offsets lacks a universally recognised set of definitions.

The practical challenges with maintaining consistency and transparency in carbon accounting processes are compounded by fundamental conceptual issues, such as the notion of 'additionality' in carbon trading agreements. Article 6 of the Paris Agreement allows States Parties to use internationally transferred mitigation outcomes towards meeting their nationally determined contributions. Following COP26, the concept of additionality was introduced into Article 6 of the Paris Agreement, as part of the adoption of a series of detailed rules and procedures to implement international carbon market mechanisms, colloquially known as the '[Paris Rulebook](#)'.

Additionality requires that the carbon reducing activity of an offset project *would not* have otherwise occurred ‘but for’ the incentive to generate offsets. Where a project is pursued purely for other financial motivations or to comply with regulatory requirements, it will not be considered ‘additional’. Determining what would have been done in the absence of a carbon market is a difficult task. Abatement that would have been undertaken in any event is considered to be a **low-quality offset**. Therefore, when entities who have purchased carbon credits claim to have offset a certain amount of their carbon footprint, that statement is only good insofar as that amount of carbon was in fact captured or removed from the atmosphere, *and* it would not otherwise have occurred.

The lack of clarity in carbon accounting practices is ripe for disputes. This lack of clarity may lead to exposure to claims of greenwashing, misleading or deceptive conduct and, contractual disputes regarding the proper value and/or veracity of carbon allowances and carbon offsets. Carbon credit standards bodies also face an **increased risk of contractual disputes**.

A number of entities have been accused of using fraudulent, exaggerated or methodologically unsound carbon credits and offsets. In July 2022, environmental groups brought **greenwashing proceedings** under the EU’s Unfair Consumer Practices Directive against Dutch airline KLM for its ‘Fly Responsibly’ campaign featuring the carbon offset product, ‘CO2Zero’, which involved reforestation projects that supposedly compensated for KLM’s flight emissions. A Dutch court recently made a **preliminary ruling on standing** in favour of the environmental groups. On 9 August 2023, the Australian activist group ‘Australian Parents for Climate Action’ commenced **an action for greenwashing** against EnergyAustralia, a retail electricity and gas company, in the Australian Federal Court, alleging that EnergyAustralia misled its consumers regarding the “carbon neutral” nature of its ‘GoNeutral’ product, which **claimed to have offset emissions by buying carbon credits**.

Recent **investigations** into Verra, the world’s leading certifier of forest carbon offsets, showed that more than 90% of rainforest carbon offsets do not represent genuine carbon reductions. Even jurisdictions like Australia, where a central regulatory body, the Clean Energy Regulator, is responsible for calculating abatement, are not immune from **whistle-blowers and claims** that the methods used by the regulator are flawed and accredit low-integrity projects with carbon credits.

Carbon Investment and Regulatory Change

Another emerging trend in carbon markets is the full or partial regulatory withdrawal from carbon credit schemes, with high concomitant risks of disputes arising from entities whose investments into the scheme have suffered alleged harm. This phenomenon has already been witnessed across the world, most notably in the Canadian province of Ontario.

In July 2018, following a change in government, Ontario abruptly ended the cap-and-trade scheme that had operated briefly in the province and introduced legislation to prohibit former registered participants from trading or otherwise dealing with emission allowances and credits. This decision was supposedly motivated by the proposition that the scheme was a ‘carbon tax’ and its abolition would save taxpayer money.

While the legislation recommended compensating some participants, it did not compensate general market participants. As a result, two separate proceedings were filed in response to this decision – the first, by Koch Industries and the second, a class action by aggrieved businesses led by investor

Sharolyn Mathieu Vettese, the president of SMV Energy Solutions. Koch Industries brought [ICSID arbitration proceedings](#) under NAFTA against Canada, claiming that the carbon allowances it purchased under this program were rendered worthless by the cancellation. Koch also claimed that Ontario wrongfully failed to compensate Koch for its loss, allegedly amounting to over US\$30 million. The outcome of the arbitration remains pending. Similar claims were made by the [class action in the Canadian courts](#) for the value of their lost investments against the Ministry of the Environment and then-environment minister Rod Phillips.

Arbitration as a Dispute Resolution Mechanism

With a dramatic increase in the size and complexity of carbon markets, disputes arising from such carbon trading agreements are also likely to become more multifaceted. Selecting an appropriate and sophisticated dispute resolution framework will be crucial for commercial enterprises and accrediting organisations alike when negotiating carbon trading agreements.

Arbitration remains a viable and suitable dispute resolution mechanism for such disputes for the following reasons:

- The technicality of carbon reduction technologies, carbon accounting and associated regulatory frameworks means that carbon disputes are particularly complex, often requiring market-specific expertise. The ability of parties to select arbitrators and experts with relevant scientific, environmental and regulatory knowledge is a significant advantage of arbitration over other dispute resolution forums.
- Locality and jurisdiction are often particularly important in carbon disputes. For example, the locality of the laws and regulations governing the market and the locality of the carbon offset project. These factors all contribute to arbitration being a suitable dispute resolution mechanism, especially where the local courts of the jurisdiction may be perceived to lack independence.
- Many carbon disputes involve cross-border contracts and multinational entities with a global presence, who often seek to utilise the emissions reduction projects in one jurisdiction to offset certain carbon-intensive activities in another jurisdiction. Sometimes, this may involve utilising commercially beneficial carbon market schemes. The almost-universal enforceability of arbitral awards and procedural flexibility to accommodate for the legal traditions of culturally diverse counsel, parties and arbitrators is an important consideration in selecting arbitration as the dispute resolution mechanism for such contracts.
- Carbon disputes often deal with commercially sensitive information or matters concerning national security. The ability for arbitration to maintain confidentiality by restricting public access to certain documents while opening proceedings or taking other measures to improve transparency makes it well-placed as the dispute resolution forum for carbon disputes.

On the other hand, the settlement of disputes concerning carbon markets has occurred to date primarily by way of domestic litigation or investment treaty arbitration, as opposed to commercial arbitration. This trend can be explained by the fact that governments are often defending these disputes. While the settlement of carbon market disputes through arbitration has many advantages, it may not be a panacea. Claimants may seek declarative or civil penalty relief under domestic consumer protection or corporations law, which may be non-arbitrable in some jurisdictions. The confidential nature of arbitral proceedings may also be of limited assistance to claimants seeking a more public forum for the ventilation and resolution of their dispute.

While carbon markets as well as associated dispute resolution frameworks are still developing, there is [growing appreciation](#) of the suitability of arbitration for resolving carbon market disputes, including in the field of investment arbitration. Carbon credit standard bodies have incorporated arbitration into their standard templates for disputes with validation and verification bodies. Many institutions that publish standard form contracts for the production and delivery of carbon credits are also beginning to include arbitration as a method of dispute resolution. It is likely that international arbitration will continue to be considered as an appropriate dispute resolution mechanism to meet the challenges of uncertainty in carbon market disputes.


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The graphic features a black background with white text and a circular icon. The icon depicts a group of stylized human figures, with one figure in the center being magnified by a magnifying glass. The background is accented with horizontal lines in blue and green.

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