

Emissions trading - what role will arbitration play?

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A webinar hosted by the British Institute of International and Comparative Law and chaired by **Kathryn Khamsi** of Three Crowns looked at the importance of emissions trading systems for meeting commitments under the Paris Agreement on climate change and the eventual role arbitration may play. **Nicola Peart** of Three Crowns reports.

The webinar on 18 November brought together climate change experts **William Acworth**, head of the secretariat of the International Carbon Action Partnership (ICAP); **Lisa DeMarco**, senior partner and CEO at Resilient (formerly DeMarco Allan) in Canada and vice chair of the International Emissions Trading Association (IETA); and **Jacob Werksman**, principal adviser to the Director General for Climate Action in the European Commission.

Underscoring the significance of the issues being discussed, the panel drew a large audience of arbitration practitioners as well as government lawyers and corporate executives.

A key theme was that international emissions trading and other forms of international carbon markets can play an important role in reducing global greenhouse gas emissions by providing governments and corporations lower compliance costs, encouraging investment, and putting a price on emissions.

However, as new markets and new participants emerge, governance structures and legal relationships are increasingly complex. Lawyers, including arbitration lawyers, play a valuable role in helping market

participants navigate regulatory and political risks, thereby enabling participants to realise the tremendous benefits and opportunities of emissions trading.

Khamsi set the scene by noting the important role carbon markets play in helping states and non-state actors achieve emissions reductions targets by creating economic incentives to reduce emissions. The context of the panel, she explained, was the Paris Agreement, which requires states to limit global average temperature increases this century to well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius.

Acworth provided some background on domestic and regional emissions trading systems. He explained they require a government-imposed limit on emissions. Regulated companies are then allocated “units” such as permits, or otherwise take part in an auction of units, each unit representing one tonne of greenhouse gas emissions. At the end of each compliance period, regulated companies surrender one unit for each tonne of emissions they have generated.

According to Acworth, emissions trading creates significant benefits because it imposes an emissions budget on covered entities, which through permit trade reveals a carbon price that can then be considered in production, consumption and investment choices.

Signalling their growing importance and prevalence, Acworth noted that to date 21 emissions trading schemes have been implemented around the world, including in the European Union, Switzerland, and New Zealand. Nine are under active development, including in China, and a further 15 are under consideration.

He also explained emissions trading systems can be linked across borders, such as the link between the EU and Switzerland or between California and Quebec, allowing market participants to trade across jurisdictions and encouraging co-operation among States.

Werksman, who represents the EU at the international climate change negotiations, explained that under the Paris Agreement, governments have made emissions reductions targets that are neither legally binding at the international level nor uniform in their design, which means that accounting rules applicable to international emissions trading under the Paris Agreement will be much more challenging than under the Kyoto Protocol.

He explained that the rules being developed under the Paris Agreement will, however, ensure no double-counting of units, by requiring parties to account for units traded across jurisdictions in a manner that ensures that only one party can use those units to meet its domestic emissions reduction target.

In addition, the rules under the Paris Agreement will include a mechanism for internationally certifying project-based offsets. This will, like the Kyoto Protocol's Clean Development Mechanism, create opportunities for private sector participation in international emissions trading.

Addressing new opportunities and challenges facing market participants, Khamsi noted the extraordinary complexity of overlapping regimes at the domestic, regional, and international levels. While the growth in markets and market participants generates opportunities for much needed emissions reductions, it also requires participants to navigate regulatory and political risks. For example, a participant seeking to take advantage of cross-border trading opportunities may be subject to regulatory action by multiple states as well as inter-state bodies.

Werksman added that the international carbon market now includes units designed for a variety of sources and purposes, ranging from "compliance" based units certified by governments and used to meet domestic legal commitments, to units certified by private sector actors for "voluntary" purposes, like meeting corporate emissions reduction goals or offsetting personal travel. Given the range of available units, buyers will need to be aware of the quality of the units they are purchasing, to ensure units correspond to real and additional emissions reduction.

DeMarco observed that, with the growth of markets in different jurisdictions, there has been a corresponding diversification of the form of tradable units. Some states treat units as licenses or permits, however investors will need to be cautious about jurisdictions that do not respect the property and/or financial rights associated with units. She observed this may have implications for foreign investors who make and seek to protect investments in emissions markets.

DeMarco added that some governments have decided to cancel emissions markets without notice following a change in administration, while others have limited the use of certain types of compliance units in their jurisdiction, or taken other measures that affect the value of compliance units, potentially with the aim of enhancing environmental integrity.

While certain measures may be beneficial for the environment over a period of time, they may also transform what was once a freely tradable commodity into a stranded asset. She gave the illustrative example of an investor's low-carbon project having been approved as generating 80 certified emissions reductions per unit of output, and then subsequent regulatory action reducing that outcome by an order of magnitude to 8 units per unit of output.

The project developer had contracted to forward sell millions of units to multiple state agencies and private entities in multiple jurisdictions based on the originally approved 80-unit factor. This resulted in disputes in multiple jurisdictions involving state owned and private corporations.

Turning to the role of dispute resolution, Khamsi asked the panellists to consider the relevance of investor-state arbitration. The panellists noted claims for expropriation or protection of legitimate expectations could arise if governing bodies take arbitrary or capricious decisions, fail to give market actors the right to be heard before making a particular decision, or fail to adhere to some semblance of policy consistency in their decisions.

DeMarco gave the example of foreign investors purchasing units auctioned by the government of Ontario after it linked with the Quebec-Canada emissions trading scheme in 2018. Following a change in government, there was an announcement that the Ontario cap-and-trade scheme would be shut down. The investors' accounts holding units that they had recently purchased were promptly frozen by authorities in Quebec and California.

That regulatory change in Ontario had a very negative effect on a number of secondary market investors who were left holding a potentially valueless asset. Arbitration in this context could provide an important opportunity to seek redress for harmed investors, but also to hold governments to account for improperly negating programmes and policies needed to incentivise the reduction of greenhouse gas emissions.

Concluding the event, the panellists predicted emissions trading will be increasingly important. Werksman noted rules on accounting of units and on the environmental integrity of international carbon markets will be a focus of discussions at the next climate change summit in Glasgow, in 2021, but this will not include the development of a dedicated mechanism for resolving disputes over international carbon markets. Acworth suggested that linkages between domestic and regional markets will be increasingly prominent in lieu of, or in addition to the international regime, linking high emitting sectors in certain jurisdictions with carbon reduction projects abroad, and promoting state cooperation on tackling climate change.

DeMarco said that, despite the potential risks, she was optimistic about investment in emissions trading, noting the conclusions of [a recent study](#) that the additional emissions reductions and ambition resulting from emissions trading under the Paris Agreement are worth nearly US\$250 billion per year. This is an “extraordinary value” that should not be avoided, she said.

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