June 2022

Recent developments in Carbon Offset Markets in Japan

for achieving carbon net-zero

Kenji Miyagawa, Attorney-at-law

The Japanese Government has announced its nationally determined contribution to achieve carbon net-zero by 2050. Carbon pricing (including carbon offsets by using carbon credits) is considered to play a key role in order for the Japanese Government to achieve its NDC.
There have been active discussions on carbon pricing (including carbon credits) in 2021 and 2022 and a draft carbon credit report (the “Draft Carbon Credit Report”) was published Ministry of Economy, Trade and Industry in April 2022. Based on the Draft Carbon Credit Report, the amount of green investments and green financing is expected to dramatically increase.
In this newsletter, we will review major issues and opportunities in connection with carbon credits based on the Draft Carbon Credit Report.

1. Introduction

Following discussions around the Paris Agreement which was adopted in December 2015, the Japanese Government has announced its nationally determined contribution (“NDC”) to achieve 46% reduction of greenhouse gasses (“GHG”) by 2030 compared to 2013 and carbon net-zero by 2050. It is believed that carbon pricing (including carbon offsets by using carbon credits) will play a key role in order for the Japanese Government to achieve its NDC. In other words, carbon pricing is one of the drivers in achieving NDC of the Japanese Government since it will enable the Japanese Government and Japanese companies to reduce and/or remove GHG in ways which are cost-effective and by using various technologies.

2. Draft Carbon Credit Report

(1) Discussions around Draft Carbon Credit Report

In fact, there are different types of carbon credits available in international and Japanese domestic carbon offset markets and market players in Japan have been requesting for clarification on how to deal with such carbon credits. Ministry of Economy, Industry and Trade ("METI") has organized two committees to discuss such issues. Based on discussions at such committees, METI has published the Draft Carbon Credit Report[1] on April 13, 2022 and METI has also published public comments[2] received to the Draft Carbon Credit Report on June 15, 2022. Please note that our comments below may need to be updated subject to review of an updated version of the Draft Carbon Credit Report.

(2) Major issues under Draft Carbon Credit Report

We will review the major issues under the Draft Carbon Credit Report from the perspective of carbon credit transactions.

(A) Types of carbon credits

There are two types of carbon credits as listed below. The Draft Carbon Credit Report essentially deals with (a) Baseline & Credit:

(a) Baseline & Credit

A system that certifies units of emission reductions and carbon removal/sequestrations generated through projects such as renewal of boilers, introduction of solar power generation equipment and implementation of forest management based on the difference between baseline and actual emissions or removals established through MRV (monitoring, reporting, verification) process.

(b) Cap & Trade

A mechanism that establishes certain emission rules (allowance) for emissions of organizations and facilities, and if actual emissions exceed the allowance, excess emission limits are purchased from companies with emissions below the limit.

(B) Difference between carbon credits and certificates

In Japanese markets, certain types of certificates are issued which are similar to carbon credits. The Draft Carbon Credit Report explains the major difference between carbon credits and certificates as set out below:

(a) Carbon credits

Carbon credits are certified in t-CO2 units for the amount of GHG emission reductions based on the baseline, and buyers shall be entitled to claim carbon offsets by using certain types of carbon credits.

(b) Certificates (including non-fossil fuel certificates (*hikaseki-shousho*))

Certificates certify the amount of electricity and heat generated from energy sources, which are not related to fossil fuels. Certificates guarantee the nature of energy sources.

---

[1] English version of Draft Carbon Credit Report is available at the link below.
https://www.meti.go.jp/policy/energy_environment/kankyou_keizai/carbon_credit/carbon_credit_report_draft.pdf

[2] Public comments include comments from The Integrity Council for the Voluntary Carbon Market (IC-VCM), The International Emissions Trading Association (IETA) and AirCarbon Exchange (ACX) (please refer to the link below).
https://www.meti.go.jp/shingikai/energy_environment/carbon_credit/pdf/004_s03_00.pdf

(C) Examples of carbon credits

The Draft Carbon Credit Report explains the examples of carbon credits as set out in the table below:

Table: Examples of carbon credits in international and domestic markets

Issuer of Carbon Credits / Location of Projects	Domestic markets	International Markets
Governmental Bodies	J-Credit[3]	Joint Crediting Mechanism（JCM）[4]
Private Entities (such as NGO)	J Blue Credit[5]	Voluntary carbon credits[6]

(D) Rules related to Article 6 of the Paris Agreement

The Draft Carbon Credit Report discusses the issue related to "quality" of carbon credits. Among others, it is important to verify whether such carbon credits can be used by the Japanese Government to achieve its NDC (i.e., NDC eligible carbon credits). For that purpose, it is important to review whether or not "corresponding adjustment"[7] is made in connection with such carbon credits. On that basis, certain carbon credits could be regarded as "high quality" carbon credits if such carbon credits comply with the rules related to "corresponding adjustment".

(E) Actions to activate carbon credit trading in Japan

The Draft Carbon Credit Report refers to certain actions in order to activate carbon credit trading in Japan.

(a) Actions to be taken by companies on the demand side[8]

Companies on the demand side are subject to reporting requirements under the Act on Promotion of Global Warming Countermeasures (the "Global Warming Act"). Such companies will be able to use NDC eligible carbon credits (e.g., J-credits or JCM credits) to offset their GHG reduction targets. Moreover, other types of carbon credits can be used for other purposes (e.g.,

---

[3] The J-Credit Scheme is designed to certify the amount of greenhouse gas emissions reduced and removed by sinks within Japan.
https://japancredit.go.jp/english/

[4] JCM is a mechanism under which: (i) Japanese Government and companies provide low carbon technologies to a partner country and a company located in such partner country that operate certain GHG reduction projects; and (ii) certain carbon credits are granted to such GHG reduction projects.
https://gec.jp/jcm/about/

[5] J Blue Credit is a mechanism which is operated by Japan Blue Economy Association which focuses on blue carbon (please refer to the link below) (Japanese language only).
https://www.blueeconomy.jp/credit/

[6] Voluntary carbon credits include Verified Carbon Standard(VCS), Gold Standard（GS）, American Carbon Registry（ACR）and Climate Action Reserve (CAR).

[7] For example, Article 7 of the updated version of the implementation rules of Joint Crediting Mechanism deals with "corresponding adjustment" (please refer to the link below (Japanese only)).
https://www.env.go.jp/content/900517302.pdf

[8] Companies on demand side include companies, which: (a) are currently emitting GHGs on a large scale; and (b) may need to purchase carbon credits in order to achieve its GHG reduction target.

to offset GHG emissions in supply chain companies). Therefore, investments into various types of GHG reduction projects will be activated by using various types of carbon credits.

(b) Actions to be taken by companies on the supply side[9]
Volume of available carbon credits will need to be substantially increased in order to activate carbon offset markets in Japan. For such purposes, there are various initiatives which enhance the availability of carbon credits in Japan (in particular, NDC eligible carbon credits such as J-credits or JCM credits).

(c) Actions to develop markets in Japan
On February 1, 2022, METI has announced that Green Transformation League (the "GX League") will be launched in April 2023. 440 companies/financial institutions have joined the GX League as of April 1, 2022.
Tokyo Stock Exchange has announced that it will start an experiment of "Japanese carbon credit markets" from September 2022.

3. Major points to be considered by companies / financial institutions

(1) Major points to be considered by companies on the demand side

(a) Reduction of GHG emissions by their actions: Before relying on offset, companies will have to initiate actions to reduce its GHG emissions by themselves. Such actions include: (i) introducing more energy efficient machines; or (ii) replacing its electricity generated by fire power plants with electricity generated by renewable energies (e.g., solar, wind).

(b) After initiating actions in item (a) above, companies will be able to achieve its GHG emission reduction targets by using offset mechanisms. Depending on its purpose and scope, such companies will be able to procure various types of carbon credits.

(c) Disclosure: Companies will need to make proper disclosure to their stakeholders in accordance with applicable disclosure requirements which include the ones listed below:

- Disclosure requirements in accordance with Japan's Corporate Governance Code[10].
- Disclosure requirements in accordance with the relevant finance regulations (which are currently subject to discussions)
- Disclosure requirements in accordance with the Global Warming Act

(2) Major points to be considered by companies on the supply side

(a) Choice of Carbon Credit Scheme: Companies which have expertise/technology in GHG reduction projects will be able to originate carbon credits by utilizing their expertise/technology.

---

[9] Companies on the supply side include companies which: (a) have expertise/technology in GHG reduction projects; and (b) can originate carbon credits by utilizing such expertise / technology.

[10] Among others, Section 3.1.3 of Japan's Corporate Governance Code states that "*In particular, companies listed on the Prime Market should collect and analyze the necessary data on the impact of climate change-related risks and earning opportunities on their business activities and profits, and enhance the quality and quantity of disclosure based on the TCFD recommendations, which are an internationally well-established disclosure framework, or an equivalent framework.*"
https://www.jpx.co.jp/english/news/1020/b5b4pj0000046kxj-att/b5b4pj0000046l07.pdf

Such companies will need to choose an appropriate carbon credit scheme (e.g., J-credit scheme or JCM credit scheme) under which such companies will be able to generate carbon credits.

(b) Choice of GHG reduction projects: Such companies will need to choose an appropriate jurisdiction of GHG reduction projects.

(c) Procurement of carbon credits: Once such GHG reduction projects have been verified, such companies (as the initial holder of the relevant carbon credits) will need to make sure that such carbon credits will be recorded in their name in the relevant registry. Such companies will be able to use such credits for themselves or their supply-chain companies or sell them to companies on the demand side.

(3) Major points to be considered by intermediaries

(a) Choice of Carbon Credits: Intermediaries will need to choose carbon credits which are suitable for their customers (e.g., companies on the demand side) taking into consideration the points listed below:

- Which type of carbon credits (e.g., J-credits, JCM credits or voluntary carbon credits) would be suitable to satisfy the requirements of their customers.
- Whether such carbon credits should be procured from primary markets or secondary markets.
- Whether such carbon credits should be procured via carbon trading platform (e.g., GX League) or via OTC transactions (after carbon-trading platform is officially launched in Japan).

(b) Review of carbon credits: Intermediaries will need to review whether or not such carbon credits are suitable for achieving the objectives of their customers (which includes review of “quality” of such carbon credits via due diligence).

(4) Major points to be considered by financiers

(a) Choice of Financing Scheme: Subject to various guidelines/initiatives, financiers will need to choose an appropriate financing scheme (e.g., issuance of green bonds, arrangement of green loan) which is suitable for their clients.

(b) Review of GHG reduction projects: If financiers are to provide finance to GHG reduction projects, financiers will need to review the quality of such GHG reduction projects (e.g., how much GHG will be reduced, what kind of carbon credits will be generated, etc.).

(c) Review of Carbon Credits: Financiers will need to evaluate carbon credits taking into account specific features of carbon credits which are listed below:

- Carbon credits themselves will not generate cash-flow however, carbon credits will represent value of GHG reduction.
- In addition to other cash-flow (if any) to be generated from GHG reduction projects, sale proceeds of carbon credits can be considered as a source of profits of the project operator of the GHG reduction project since carbon credits have certain economic value, provided

that insolvency risk of the project operator would need to be analyzed from legal perspective.

- Creation of security interests (e.g., pledge) over carbon credits will be subject to discussions on the nature of the relevant carbon credits (please see items (5) and (6) below).

(5) Major legal issues applicable to carbon credits in general

So long as Japanese law is applicable, major legal issues (listed below) will need to be analyzed from Japanese law perspective based on discussions related to carbon allowances in the past.

- To confirm the legal nature of carbon credits under Japanese law[11].
- To confirm the requirements for valid issuance, transfer and perfection of carbon credits.
- To confirm the requirements for creation and perfection of security interests over carbon credits.
- To confirm any licensing requirements applicable to carbon credit transactions.
- To confirm appropriate terms of agreements (e.g., sale and purchase agreements) from perspective of seller / purchaser.

(6) Major legal issues applicable to international voluntary carbon credits

In addition to the issues listed in item (5) above, major legal issues (listed below) will need to be analyzed subject to on-going discussions on international voluntary carbon credits ("VCCs")[12].

- To verify the quality of VCCs[13].
- To confirm the governing law of transfer and perfection of VCCs taking into account the governing law of issuance of VCCs or their registry.
- To confirm the requirements for valid issuance, transfer and perfection of VCCs taking into account the governing law of VCCs.
- To confirm the permitted use of VCCs by Japanese companies, subject to detailed rules in connection with GX League.

4. Expected Development in the second half of 2022

On June 17, 2022, the Prime Minister and his cabinet have approved the Basic Policy on Economic and

[11] For your information, the report issued by the Ministry of Environment in 2012 mentioned that "allowances would be considered as a special form of intangible assets".
[12] For example, according to the ISDA report (please see the link below), there are various discussions on legal nature of voluntary credits.
https://www.isda.org/a/38ngE/Legal-Implications-of-Voluntary-Carbon-Credits.pdf
[13] Methods to verify the quality of VCCs would include checks on whether VCCs would satisfy the requirements under "Core Carbon Principles" which are being drafted by The Integrity Council for the Voluntary Carbon Market (ICVCM). It is stated at the ICVCM website below that "*the public consultation on the Core Carbon Principles and Assessment Framework will launch in July 2022 and run for 60 days*".
https://icvcm.org/revised-timeline-for-public-consultation/

Fiscal Management and Reform 2022 (the "Basic Policy 2022"). Investment related to green transformation (GX) is stated as one of top priorities in the Basic Policy 2022. The Basic Policy 2022 also refers to the detailed plans, which include the items listed below:

- To draft detailed rules on carbon pricing mechanisms in order to achieve investments into green transformation over JPY 150 trillion in the coming 10 years.
- To launch GX Transition Bonds in order to activate investments into green transformation.
- To publish a road map on development of GX League, etc. in order to avoid any uncertainty.

Based on the above, discussions in Japan around GX League and carbon offset markets will advance to a higher level in the second half of 2022.

5. Final remarks

Despite uncertainties in the short term, actions to achieve carbon net-zero seem to be mid-term and long-term trends globally which will lead to energy transition from fossil fuels to energy sources which emit much less GHGs. It is important to keep a close eye on the development in GX League and other carbon offset markets in order not to miss new opportunities arising in Japan.

- This newsletter is publsihed as a general service to clients and friends and does not consitute legal advice. Should you wish to receive further information or advice, please contact the authors below.

- Authors:
  Kenji Miyagawa (kenji.miyagawa@amt-law.com)

- If you wish to unsubscribe from future publications, kindly contact us at General Inquiry.

- The back issues of the newsletter are available here.