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Recent developments in Carbon Offset Markets in Japan

for achieving green transformation and carbon net-zero

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The Japanese Government has announced its nationally determined contribution (i.e., NDC) 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.
On February 10, 2023, the Cabinet of Japan has approved "GX Policies" which include introduction of Japanese emissions trading system (i.e., GX-ETS). Outside of Japan, there have been various developments in order to enhance better quality of voluntary carbon credits.
In this newsletter, we will explain recent developments in Japanese and overseas carbon credit markets and examine typical risks and solutions in connection with carbon credit trading.

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. The Japanese Government has determined to introduce wide range of policies to reduce GHG by itself (e.g., expansion of renewable energies in Japan) before it relies on off-setting entirely (such approach is called as "hierarchy approach"). However, it is expected to be very difficult or not cost effective for the Japanese Government to achieve its NDC by utilizing their GHG reduction actions (e.g., expansion of use of renewable energies in Japan). Carbon pricing (in particular use of carbon credits) will be useful tools to resolve such issues. Hierarchy approach also applies to each company in Japan, i.e., a company in Japan must take its actions to reduce GHG by itself (e.g., expansion of use of renewable energies,

expansion of use of hydrogen or ammonia). However, it is expected to be very difficult or not cost effective for a Japanese company to achieve its GHG reduction target by utilizing its GHG reduction actions (in particular, in connection with GHG emission in its supply chain (which is Scope 3). Carbon pricing (in particular use of carbon credits) will be useful tools to resolve such issues.
Having said that, use of carbon credits are frequently criticized as "greenwash" which means that carbon credits do not represent actual GHG emission reduction due to various reasons (e.g., poor management of underlying GHG reduction activities). Therefore, it is crucial for each company or financial institution to deal with carbon credit related transactions after analyzing risks related to such carbon credit related transactions.

2. Recent developments in Japan

(1) GX Policies and GX Laws

On February 10, 2023, the Cabinet of Japan has approved GX Policies and GX Laws which include policies listed below.

- Energy transition including expansion of renewable energy, nuclear power, and hydrogen/amonia;
- Issuance of GX Transition Bond of approximately JPY 20 trillion; and
- Introduction of carbon pricing (including GX ETS, allocation of allowances to energy sectors via auction and carbon levy applicable to energy sectors).

(2) Green Transformation League ("GX League")

GX League has been preliminary launched in September 2022 and is expected to be officially launched in April 2023 based on "Carbon Credit Report"[1] published by Ministry of Economy, Industry and Trade ("METI") in June 2022[2]. Compared to other emission trading schemes (e.g., EUETS), GX League has unique aspects as set out below:

（A）Relationship among GX League, GXETS and Carbon Credit Markets

- It is understood that GX League is a platform in which any company/financial institution in Japan can join and contribute to drafting rules in connection with carbon credit trading in Japan. It is expected that leading Japanese companies/financial institutions will participate in GX League and disclose their targets via GX League Dashboard so that GHG reduction actions by other companies/financial institutions will be enhanced.
- GX League participants shall participate in a voluntary emissions trading system in Japan ("GX-ETS"). At the end of January 2023, it is voluntary for each company to participate in

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1 https://www.meti.go.jp/shingikai/energy_environment/carbon_credit/pdf/20220627_2.pdf

2 Please refer to our newsletter published in June 2022 for further details in connection with Carbon Credit Report. https://www.amt-law.com/asset/pdf/bulletins12_pdf/220629_en.pdf

GX League/GXETS and/or to achieve its emission reduction target. However, according to materials published by GX League Committee, it is suggested that certain compliance obligations to achieve its emission reduction target might be imposed on each participant in GXETS/GX League in or around 2026. Although it is still subject to review of detailed rules, the basic concept of GX-ETS seems to be as follows:

  - Sell-side: Allowances will be allocated to certain GX League participants who will achieve GHG reduction/removal at a level which is higher than NDC equivalent (e.g., 46% GHG reduction by 2030). Such GX League participants will be able to sell such allowances to other GX League participants.
  - Buy-side: If certain GX League participants will not be able to achieve GHG reduction/removal at a level which is higher than NDC equivalent, such GX League participants will need to take certain actions (including off-setting their GHG emissions against "eligible carbon credits" (including J-credits, JCM credits).

- Separate from GX League and GX-ETS, an emission trading system in Japan[3] ("Carbon Trading Markets (TSE)") is preliminary launched at Tokyo Stock Exchange in September 2022. It can be said that Carbon Trading Markets (TSE) is a trading market in order to (a) activate carbon credit tradings in Japan and (b) provide price indications to various players in Japan/outside of Japan.

（B）Expected Timeline

It is expected that GXETS/GX League will be developed in a timeline set out below:

- From September 2022 to March 2023: Preliminary launch;
- From April 2023 to March 2026: Phase 1 (GX League/GXETS will be operated on a voluntary basis);
- From April 2026 to March 2030: Phase 2 (GX League/GXETS will be operated with certain compliance obligations); and
- After April 2030: Phase 3 (GX League/GXETS will be operated with further developments (e.g., auction of allowances in energy sector)).

（C）Carbon credits to be traded at GXETS

GXETS plays a key role in Japanese carbon markets and one of the key questions is what kind of carbon credits can be traded at GXETS. It is a choice of policy makers in Japan, but any of the carbon credits set out below (including any token issued in connection with such carbon credits) can be traded at GXETS.

Table：Examples of carbon credits in international and domestic markets

3 Please refer to JPX website below for further details.
https://www.jpx.co.jp/english/corporate/news/news-releases/0060/20220922-01.html

Issuer of Carbon Credits / Location of Projects	Domestic markets	International Markets
Governmental Bodies	Allowances J-Credit[4]	Joint Crediting Mechanism(JCM)[5]
Private Entities (such as NGO)	J Blue Credit[6]	Voluntary carbon credits[7]

- Allowances (*chouka-sakugenwaku*)
  - ✓ Definition

    According to materials published by GX League Committee, allowances (*chouka-sakugenwaku*) ("Allowances") means "allowances which will be granted by GX League Committee in connection with amount of GHG emission reductions which are achieved over a certain level (e.g., 46% reduction as compared to 2013 level (which is equivalent to NDC by Japanese Government). It can be said that Allowances may be similar to allowances under EUETS, subject to further developments.
  - ✓ Trading at GXETS

    There may be no critical issue which would prevent trading of Allowances at GXETS so long as: (a) it is verified/issued by a public sector (e.g., Japanese Government); and (b) it is verified/issued in accordance with clear/fair rules.

- J Credits
  - ✓ Definition

    J credits ("J Credits") mean "carbon credits issued by Japanese Government after Japanese Government verifies GHG reduction in accordance with the rules/methodologies made by the Japanese Government.
  - ✓ Trading at GXETS

    According to materials published by GX League Committee, J Credits are one of "Qualified Carbon-Offset Credits" which can be used for off-setting purpose under GX League. Also, J Credits are traded at GXETS which is preliminary launched in September 2022.

[4] 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/

[5] 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/

[6] 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/

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

- Joint Crediting Mechanism (JCM Credits)
  - ✓ Definition

    Credits issued under Joint Crediting Mechanism ("JCM Credits") mean "credits issued by [a joint committee] organized by the Japanese Government and a Counterparty Government after such committee verifies GHG emission reduction in accordance with the rules made by the Japanese Government and the Counterparty Government".
  - ✓ Trading at GXETS

    According to materials published by GX League Committee, JCM Credits are one of "Qualified Carbon-Offset Credits" which can be used for off-setting purpose under GX League. Although JCM Credits are not currently traded at GXETS, it is expected that JCM Credits will be traded at GXETS in order to scale up volume of traded credits at GXETS.

(3) Other key policies to achieve net zero by 2050

In addition to policies related to GX League/GXETS, there are a wide range of other policies which enhance actions to tackle ESG related issues. It is necessary for each company and financial institution in Japan to take strategic actions since actions related to ESG are now treated as one of the key management issues rather than a CSR issue.

（A）Issues concerning disclosure

- Mandatory disclosure of non-financial information

  On January 31, an amendment ("Amendment") to the Cabinet Office Ordinance on the disclosure concerning sustainability related information has been finalized/enacted. Under the Amendment, a listed company, etc., shall disclose its strategy, etc. in a new section of "sustainability related information" in a form of an annual report, etc.
- Corporate Governance Code

  In April 2021, Financial Services Agency of Japan ("JFSA") published an updated version of Corporate Governance Code which requires a listed company (in particular, companies listed in the prime sector) to make a disclosure of non-financial information to be consistent with international rules (e.g., TCFD).

（B）Issues concerning ESG funds

In December 2022, the JFSA published a Code of Conduct concerning ESG evaluation which introduces detailed rules to prevent greenwash in connection with ESG funds.

（C）Issues concerning Anti-Monopoly Regulations

In January 2023, the Fair Trade Committee of Japan ("JFTC") published a draft memorandum concerning potential issues under Anti-Monopoly Law (e.g., issues related to actions taken by group of companies in the same sector). Companies/financial institutions need to analyze potential anti-monopoly law issues before implementing joint actions in the same sector.

3. Recent developments outside of Japan

(1) COP27

In November 2022, the 27th session of the Conference of the Parties to the United Nations Framework Convention on Climate Change (COP 27) was held in Egypt. It can be said that the result of COP27 will enhance carbon credit transactions since the detailed rules concerning Article 6 of Paris Agreement are being agreed among the Parties to the Paris Agreement.

(2) Developments to enhance carbon credit trading

（A）Article 6 Implementation Partnership

In November 2022, the Japanese Government and UNFCCC signed a Letter of Intent (LoI) aiming to collaborate in the Paris Agreement Article 6 Implementation Partnership[8].

It is expected that investment into Article 6 mechanisms (e.g., JCM initiated by Japanese Government) will be enhanced by this Article 6 Implementation Partnership.

（B）US new initiative (Energy Transition Accelerator)

In November 2022, the US Government, the Rockefeller Foundation, and the Bezos Earth Fund announced a partnership to work towards the creation of an Energy Transition Accelerator (ETA) intended to catalyze private capital to accelerate the clean energy transition in developing countries[9]. It is expected that investment into GHG reduction projects will be enhanced not only by US private sectors but also by US public sectors.

（C） Developments in standardization of transaction documents

Certain template documentation have been published by International Swaps and Derivatives Association(ISDA) or International Emissions Trading Association (IETA) in connection with carbon credit trading[10]. It is expected to enhance carbon credit trading due to lower transaction costs based on standardization of transaction documents.

(3) Developments to improve quality of voluntary carbon credits

In recent years, the volume of voluntary carbon credits (“VCCs”) has been increasing. However, VCCs are criticized because (a) the volume of VCCs are not sufficient to achieve carbon net-zero by 2050; and (b) the quality of VCCs are questionable (e.g., greenwash issue). There are multiple developments in order to deal with the issues set out in (a) and (b) above.

（A）ICVCM

[8] https://www.env.go.jp/en/press/press_00746.html

[9] https://eg.usembassy.gov/u-s-government-and-foundations-announce-new-public-private-effort-to-unlock-finance-to-accelerate-the-energy-transition/

[10] ISDA：https://www.isda.org/2022/12/13/isda-launches-standard-definitions-for-the-voluntary-carbon-market/
IETA：https://www.ieta.org/page-18192/13088342

The Integrity Council for the Voluntary Carbon Market ("ICVCM")[11] has published a draft on Core Carbon Principle. According to ICVCM, it is planned that a draft on Core Carbon Principle will be finalized in March 2023 and VCCs which are issued in accordance with Core Carbon Principle (i.e., CCP eligible) will become available in Q3 2023[12]. It is expected that the volume of VCCs will be increased and the quality of VCCs will be improved based on such ICVCM initiatives.

（B）Nationalization risk

In recent years, there are some countries which require an approval, etc. in order to transfer VCCs issued in connection with GHG reduction/removal projects implemented in such countries. Therefore, it is necessary to review such potential approval requirements in countries where GHG reduction/removal projects are implemented.

(4) Developments concerning tokenization

There have been multiple projects outside of Japan where VCCs are traded in a form of token. It is worth keeping an eye on developments concerning tokenization of carbon credits in Japan (including J Credits, JCM Credits and VCCs), subject to review of: (i) the legal nature of such token under Japanese law; (ii) rules to avoid money laundering; and (iii) rules to make sure consumer projections are conducted.

(5) Disclosure of sustainability related information

International Sustainability Standard Boards (ISSB) have been reviewing the framework of disclosure of the total amount of GHG emissions emitted in a company's supply chain (i.e., Scope 3). Therefore, it is necessary for Japanese companies to prepare disclosure of Scope 3 GHG emissions.

4. Major risks concerning carbon credit trading and risk mitigations

As a matter of Japanese law, major risks concerning carbon credit trading (e.g., sale and purchase, derivatives, financing) can be summarized as set out below. It is important that each company understands the risks and takes reasonable and realistic risk mitigating actions.

(1) 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[13].
- 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

[11] https://icvcm.org/

[12] https://icvcm.org/integrity-council-unveils-timetable-to-introduce-high-integrity-label-to-voluntary-carbon-market-in-q3/

[13] Please refer to our newsletter below for further details.
https://www.amt-law.com/asset/pdf/bulletins12_pdf/220629_en.pdf

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.

(2) Major risks in connection with carbon credit trading

- Greenwash risk
  Purchaser of carbon credits cannot achieve its objective (e.g., off-setting) if the carbon credits do not represent GHG reduction/removal which is necessary. For example, the amount of GHG emission is reduced by 5,000t only although certain carbon credit represents the reduction of GHG emission of 10,000t.
- Risk of Seller's entitlement
  Seller of carbon credits does not hold clean ownership of certain carbon credits (e.g., Seller does not hold any right, carbon credits are subject to security interest held by others, carbon credits have already been invalidated).
- Risk of Seller's insolvency
  Seller becomes insolvent after entering into a carbon credit trading with purchaser. Therefore, such carbon credit trading will be subject to insolvency procedure of Seller.

(3) Potential risk mitigating actions

There are various ways to mitigate risks as set out in (2) above. Please note, however, that actions below are 上記 examples of risk mitigating actions and the parties will need to review whether or not each of such actions is feasible in terms of market practice and negotiation with the relevant parties.

- Review of documents in connection with underlying GHG reduction/removal projects (i.e., due diligence)
- Review of risks related to underlying GHG reduction/removal projects (e.g., nationalization risk)
- Review of the holder of carbon credits in the relevant registry
- Review of legal issues applicable to underlying GHG reduction/removal projects and carbon credits
- Negotiation of provisions in transaction documents (e.g., representations and warranties of Seller)

5. Prospects in 2023

GX League and GXETS will be officially launched in 2023. It is expected that carbon markets inside and outside of Japan will further develop, but such development will need to be reviewed taking into account the points listed below.

- Expansion of scope of carbon credits which can be traded at GX League/GXETS.
- Increase of supply of J-Credits and JCM Credits which can be traded at GX League/GXETS.
- Increase of volume of VCCs and improvement of quality of VCCs.

6. Final remarks

It is not realistic for each company in Japan to achieve GHG reduction target including Scope 3 by its own actions and it is necessary to utilize off-setting by using carbon credits with good quality. For such off-setting purpose, it is necessary to analyze risks related to carbon credit trading and take realistic risk mitigating actions.

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