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Recent developments in Carbon Offset Markets in Japan

For achieving a green transformation (GX) and carbon net-zero (carbon-neutrality)

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1. Introduction

The Japanese Government has set targets to achieve carbon net-zero in 2050 and reduce greenhouse gas (“GHG”) emissions by 46% in 2030 as compared to 2013, but there are only 6 years left until 2030. It is believed that carbon pricing, which means putting a price on greenhouse gases, is effective for promoting the reduction of greenhouse gas emissions at the government level and the private level. As part of this, various measures have been taken such as launching a “GX League” and issuing GX Economy Transition Bonds. Offsetting by carbon credits is also beneficial when taking into consideration the reduction of emissions in the product supply chain (see below, “Scope 3”), and the use of carbon credits is expected to promote decarbonization investment broadly.

On the other hand, some people criticize the use of carbon credits as a greenwashing measure (that is, achieving environmental value without substance). Therefore, it is necessary to take into

consideration risks such as greenwashing risks before proceeding with carbon credit trading.

In this newsletter, we will canvass some recent developments in Japanese and overseas carbon credit markets and examine points to be noted when Japanese companies make use of a carbon credit trading mechanism.

2. Recent developments in carbon credit markets in Japan

2.1. Overview

Japanese carbon credit markets are mainly of two types, described below.

- Green Transformation (GX) League: This includes a voluntary emissions trading system in Japan (“J-ETS”). It imposes levies and onerous emission allowances as economic burdens and provides economic incentives for activities to reduce GHG emissions, such as allowing carbon credits to be purchased and sold upon the reduction of GHG emissions.
- Subsidies, etc., based on the Act on the Promotion of a Smooth Transition to a Decarbonized Growth-Oriented Economic Structure (the “GX Promotion Act”) backed by GX Economy Transition Bonds, etc.: Japanese companies need to promote decarbonization by their actions before relying on offsetting by carbon credits and are required to make an initial investment to promote the decarbonization of various industrial activities. This initial investment is promoted by the government through using subsidiaries, etc.

Based on the above, we will explain recent developments in each sector, below.

2.2. Recent developments in GX League

2.2.1. Schedule

Based on the “Carbon Credit Report” published by the Ministry of Economy, Trade and Industry in June 2022, the “Green Transformation (GX) League” was officially launched in April 2023. The schedule of GX League is as follows.

- Phase 1 (from FY 2023 to FY 2025): Experimental period (however, after the end of October 2024, the trading of allowances (*chouka-sakugenwaku*) will be launched)
- Phase 2 (from FY 2026 to around FY 2032): Official operation of the emissions trading markets
- Phase 3 (from around 2033): Further developments

2.2.2. Disclosure of GHG reduction targets via dashboard

On January 16, 2024, GX League opened a “GX Dashboard” on its official website displaying each participating company’s GHG reduction targets were announced. In the GX League, as

a premise of J-ETS, participating companies set their targets for reducing emissions and take measures to achieve them. The GX Dashboard serves as a platform for information disclosure for the participating companies to disclose their targets for reducing emissions or measures to reduce supply chain emissions. The total amount of direct emissions in FY 2021 of companies that have already submitted data accounted for more than 50% of GHG emissions in Japan. From next year onwards, each company's actual amount of emissions will be disclosed.

2.2.3. Eligible Carbon Credits

Primarily GX League participants shall reduce GHG emission by their own actions (e.g., use of renewable energies). However, if it is difficult or cost too much to achieve their GHG reduction targets by their own actions, GX League participants is entitled to reduce GHG emission by off-setting against "eligible credits". Currently "eligible carbon credits" include:

- J-credits¹ which are created in connection with GHG reduction/removal activities within the territory of Japan.
- JCM credits² which are created in connection with GHG reduction/removal activities within the territory of the host country with whom Japan has a bilateral arrangement.

2.2.4. Rule-making activities by GX League

In the GX League, various working groups are formed by the companies, etc. participating in the GX League to disseminate a variety of information, not only on carbon credits, but on measures to promote decarbonization. The following are typical examples:

- On October 2, 2023, three Working Groups, including the "Eligible Carbon Credits Working Group", were formed to discuss the definition of Eligible Carbon Credits that have been available since Phase 1 of J-ETS and the certification of these credits.
- On December 3, 2023, the GX Business Working Group announced the results of leveraging avoided emissions at COP28.
- On December 27, 2023, the final report of the "Working Group for Consideration of Voluntary Carbon Credit Disclosure" was released. In this report, favorable measures taken by Japanese companies to expand the voluntary carbon credit markets are highlighted, which will be helpful when dealing with voluntary carbon credits.

2.3. GX Economy Transition Bonds

Pursuant to Article 7 of the Act on the Promotion of a Smooth Transition to a Decarbonized Growth-Oriented Economic Structure (the "GX Promotion Act") that came into effect on June 30, 2023, the government began to issue Decarbonized Growth-oriented Economic Structure Transition Bonds³ ("GX Economy Transition Bonds") in FY 2023 and will continue to issue these

1 <https://japancredit.go.jp/english/>

2 <http://carbon-markets.env.go.jp/eng/jcm/index.html>

3 <https://www.mof.go.jp/english/policy/jgbs/topics/JapanClimateTransitionBonds/index.html>

bonds for ten years until FY 2032 as a prior investment instrument to achieve GX. GX Economy Transition Bonds are designed to help promote private investment in projects that contribute to the reduction of GHG emissions and economic growth, a goal that is otherwise difficult to realize by initiatives taken by private companies alone.

According to some reports, the government will require companies that receive state support to participate in J-ETS as a precondition for subsequently receiving government support for the decarbonization measures funded by GX Economy Transition Bonds. For more information, we will need to wait for follow-up reporting by the government, but this mechanism should provide an incentive for non-participating companies to consider participating in GX League.

2.4. Utilization of green financing

Separate from the government's support for decarbonization as funded by GX Economy Transition Bonds, various types of green financing, such as green bonds, green loans, transition bonds and transition loans, are provided by each financial institution. These are expected to deal with greenwashing risks and promote decarbonization investment by individual companies by complying with and implementing such guidelines.

3. Recent developments outside of Japan

3.1. COP28

The 28th Conference of the Parties to the United Nations Framework Convention on Climate Change (COP28) was held in November and December 2023, and the final agreement, the "UAE Consensus", was unanimously adopted.

3.1.1. Global Stocktake (GST)

GST is a scheme used for evaluating the progress made in the global response to global warming. It is held every five years, as distinct from the purposes and more long-term goals of the Paris Agreement and is based on various sources of information including IPCC's latest report. As a result of the first GST a GST synthesis report was issued that articulated the actions and measures that are necessary to progress towards a 1.5°C goal, and describing how GHG emission are set to peak out by 2025 (including to triple renewable energies).

3.1.2. Establishment of a "loss and damage fund"

It was decided to establish a new fund under the World Bank for "loss and damage" associated with adverse impacts of the climate change. Japan pledged USD 10 million for the establishment of the fund.

3.2. Developments of regulations on carbon credits (major examples)

Various measures related to carbon pricing, such as carbon credits and carbon taxes, have also been developed outside Japan, as described below. When Japanese companies expand their operations internationally, they need to investigate the carbon-related regulations in each jurisdiction and carefully examine the carbon-related risks in each jurisdiction.

3.2.1. EUETS

The EU Council and the European Parliament agreed to gradually incorporate the maritime sector into the EU ETS starting from 2024. The kinds of ship emissions covered are:

- Emissions from ships of 5,000 gross tonnage and above;
- 100% of GHG emissions that occur between two European Economic Area (EEA) ports, and 50% of GHG emissions from voyages starting or ending outside of the EEA.

3.2.2. Singapore

In Singapore, the “International Carbon Credit (ICC)” Framework allows carbon tax-liable companies to offset up to 5% of their taxable emissions from 2024.

The ICC must (1) meet the specified criteria (eligibility criteria), and (2) be approved as an eligible ICC by the National Environment Agency (NEA) under the control of the Ministry of Sustainability and the Environment of Singapore, in accordance with the instructions of the competent minister.

In order to meet the ICC’s eligibility criteria, the following 7 basic principles must be observed: (a) no double-counting; (b) is additional to the amount of reductions or removals set by the legal standards; (c) amount of reductions or removals based on realistic, defensible, and most conservative estimate; (d) calculated in a transparent manner; (e) permanent, rather than temporary, reductions or removals; (f) reductions or removals in compliance with laws; and (g) reductions or removals not resulting in an increase in emissions elsewhere.

3.2.3. Indonesia

The Ministry of Environment and Forestry and Climate Change of Indonesia (MOEF) issued the MOEF Regulation No. 7 on Procedures for Carbon Trading in the Forestry Sector in June 2023. The purpose of the MOEF Regulation No. 7 is to control GHG emissions resulting from business activities in the forestry sector. The main features are:

- limiting participants in emissions trading in the forestry sector with forest business license holder
- considering imposing emission caps on peatland and mangrove management;
- establishing a formula to calculate the maximum allowable quota for a particular company to conduct international carbon trading; and

- issuing a GHG emission reduction certificate (SPE-GRK) for a company's extra GHG emission reduction amount under the emission trading scheme that can be allocated to an international carbon trading quota.

3.2.4. UAE

In March 2022, Abu Dhabi Global Market (ADGM) in the UAE announced the launch of a carbon credit exchange and clearing house. It is expected to be launched in partnership with Air Carbon Exchange (ACX), a Singapore-based digital exchange. The exchange will allow companies to trade and finance carbon credits in a manner similar to traditional financial assets.

3.2.5. Australia

In Australia, the government-led Australian Carbon Credit Units (ACCU) are used, which use the CO₂ absorption capacity of agricultural land, etc. as carbon credits. ACCU is also classified as a "financial product" under the Corporations Act, 2001. ACCU is transferable between registry accounts only within Australia.

3.3. CORSIA

Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA), an initiative of the International Civil Aviation Organization (ICAO) to achieve decarbonization in the international aviation sector, consists of two phases: the first phase from 2024 to 2026 and the second phase from 2027 to 2035. It is currently in the first phase where participating countries need to achieve a certain mandatory amount of offsets. Carbon credits must meet 19 requirements to be qualified as eligible credits (CORSIA Eligible Emissions Units), and the 19 requirements consist of 11 requirements for program design, including "Clear Methodologies and Protocols, and their Development Process" and 8 requirements for credit integrity. J-credit, a carbon credit in Japan, is also under application for qualification as CORSIA Eligible Emissions Units.

3.4. Discussion on legal nature, etc. of voluntary carbon credits

Overseas voluntary carbon credits ("Overseas VCC") certified and issued by foreign NGOs, such as Verra and Gold Standard, are expected to contribute to the development of a carbon credit market because of their large volume of issuance. On the other hand, they have been criticized as greenwashing (i.e. deceptive environmental actions), and there have been moves to promote "high-quality Overseas VCC transactions", as below:

- Attempts have been made to clarify unresolved legal issues concerning Overseas VCCs such as their legal nature and the requirements for perfection in the case of transfer;
- ICVCM (the Integrity Council for the Voluntary Carbon Market Core Carbon Principle) has announced the Core Carbon Principle as criterion to ensure "high-quality Overseas VCCs" for example, and it is expected that the Overseas VCCs that satisfy the CCP criteria will be announced around March 2024.

3.5. Developments concerning climate change litigation

In recent years, climate change litigation has become more active overseas. In some examples, environment conservation groups having standing as plaintiffs have had some success facing industries with high GHG. The term climate change litigation includes various types of cases. The following are two representative overseas cases whose impact on Japan is still unknown.

3.5.1. Shell plc (Netherlands and UK)

In 2019, several environment groups filed a litigation against Royal Dutch Shell as the defendant before the Hague District Court (Netherlands) seeking a reduction in the amount of GHG emissions generated by its entire group. The court accepted the plaintiffs' claim and ordered the company to reduce the amount of its group-wide GHG emissions by 45% by 2030 compared to 2019 levels.

This case is categorized as litigation in which an environment group requires a company to reduce the amount of GHG emissions, proactively promoting climate change countermeasures.

In addition, in 2023, an environment group filed a litigation against the board of Shell (UK) for failing to take sufficient climate change countermeasures. This case is categorized as litigation in which the management of a company such as directors is held accountable. The court's decision in this case has not yet been handed down.

3.5.2. Delta Air Lines Inc (US)

In 2023, consumers filed a class action against Delta Air Lines as the defendant before the California District Court (US) alleging that in its advertising since 2020 it has used exaggerated descriptions of itself as "the world's first carbon-neutral airline". The complaint alleges that these advertisements mislead consumers to understand that the company does not harm the environment, while the actions taken by Delta Air Lines include the use of unreliable carbon offsets. The court's decision in this case has not yet been handed down.

As seen in this case, greenwashing litigation to criticize a company's actions feigning environmental friendliness has been increasing in recent years as well.

4. Points for Japanese companies to remember

Based on the above, we will examine some points that Japanese companies should pay attention to concerning carbon credit trading and relevant matters.

- First, it is necessary to understand the respective amount of Scope 1, Scope 2, and Scope 3 GHG emissions generated by each company and each company group. Although in particular the calculation and disclosure of the amount of Scope 3 emissions is difficult, the percentage of Scope 3 emissions in a company's total amount of

emissions is often large, and it can also be a key indicator for ESG investment.

- After understanding the amount of GHG emissions of each company and group, it is required, especially with regard to Scope 1 and Scope 2, to reduce GHG emissions through its own actions (such as by energy conservation and transformation to decarbonized energy) (the so-called hierarchical approach). For decarbonization measures resulting from its own actions, it may be an option to receive the government's support for decarbonization financed by GX Economy Transition Bonds, as mentioned in in the context of our discussion of Phase 1, above, and to receive support from private financial institutions through green financing.
- However, the reduction of GHG emissions, including Scope 3 type reductions, cannot realistically be achieved or may be relatively expensive by the proactive steps taken by the company alone. Therefore, it is necessary to carry out offsetting through the acquisition or procurement of appropriate carbon credits. As the acquisition or procurement of appropriate carbon credits may involve legal risks, it is necessary to chart in advance an approach that also takes into consideration such legal risks.

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