Recent developments in Carbon Offset Markets in Japan
for achieving green transformation and carbon net-zero

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In April 2023, GX League Phase 1 (pilot phase), a Japanese emissions trading system was launched, and in October 2023, the Tokyo Stock Exchange started trading J Credits. The use of carbon credits, etc. is important for achieving decarbonization of Japan, but there are also some issues. In this newsletter, we will explain recent developments in Japanese and overseas carbon credit markets and examine how to deal with carbon credit trading.

1. Recent developments in Japan

(1) Green Transformation League (“GX League”)

GX League was preliminarily launched in September 2022 and was officially launched in April 2023 based on “Carbon Credit Report”1 published by Ministry of Economy, Industry and Trade (“METI”) in June 20222. Compared to other emission trading schemes (e.g., EUETS), GX League has unique aspects as set out below:

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

● It is understood that GX League is a platform in which any company/financial institution

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1 https://www.meti.go.jp/shingikai/energy_environment/carbon_credit/pdf/20220627_2.pdf
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. As of June 30, 2023, more than 600 companies from many industries, such as manufacturing, service, and financial institution, were participating in GX League.

- GX League participants must participate in a voluntary emissions trading system in Japan ("GX-ETS"). At the end of September 2023, it is voluntary for each company to participate in GX League/GX-ETS and/or to achieve its emission reduction targets. 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 GX-ETS/GX League in or around 2026. Although it is still subject to review of the detailed rules, the basic concept of GX-ETS seems to be as follows:
  - GX League participants will be required to set their own targets for direct/indirect emissions reductions in Japan and to calculate and report their actual amount of emissions.
  - Sell-side: From 2030 onward, 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). After the end of October 2024, the trading of allowances will be launched and 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 ("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. The differences between Carbon Trading Markets (TSE) and GX-ETS are as follows:
  - As of October 2023, only J Credits are traded in Carbon Trading Markets (TSE) on the Tokyo Stock Exchange.

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In order to become a participant of Carbon Trading Markets (TSE), it is necessary to apply to and be registered with the Tokyo Stock Exchange.

(B) Expected Timeline

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

- From April 2023 to March 2026: Phase 1 (GX League/GX-ETS will be operated on a voluntary basis);
- From April 2026 to March 2033: Phase 2 (GX League/GX-ETS will be operated with certain compliance obligations); and
- After April 2033: Phase 3 (GX League/GX-ETS will be operated with further developments (e.g., auction of allowances in energy sector)).

(C) Carbon credits to be traded at GX-ETS

GX-ETS plays a key role in Japanese carbon markets and one of the key questions is what kind of carbon credits can be traded at GX-ETS. 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 GX-ETS.

Table: Examples of carbon credits in international and domestic markets

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- Allowances (chouka-sakugenwaku)
  ✓ Definition

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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/](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/](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/](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).
According to materials published by GX League Committee, allowances (choukasakugenwaku) ("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 GX-ETS
There may be no critical issue which would prevent trading of Allowances at GX-ETS 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.

Expected Timeline
It is expected that the timeline set out below will be adhered to:
✧ By September 29, 2023: GX League participants will submit their targets.
✧ By the end of December 2023: Such targets will be announced on GX League Dashboard.
✧ At the end of October 2024: GX League participants will report on emissions reduction achieved in 2023.
✧ From October 2024 onward: Trading of allowances will be launched.

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 GX-ETS
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 allowed to be traded at Carbon Trading Markets (TSE).

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 GX-ETS
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 Carbon Trading Markets (TSE), it is expected that JCM Credits will be traded at Carbon Trading Markets (TSE)
in order to clarify the market price, etc. of JCM Credits and scale up volume of traded
JCM Credits at Carbon Trading Markets (TSE).

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

In addition to policies related to GX League/GX-ETS, 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) Financial institutions and Scope 3 emissions

When the so-called Scope 3 emissions (supply chain emissions) are calculated
mechanically for financial institutions, a challenge is posed by the hope that the provision
of finance to industries with high greenhouse gas emissions will be reduced. Therefore, in
October 2023, the JFSA, METI, and Ministry of Environment published a document entitled
“Addressing the Challenges of Financed Emissions” which discusses the basic concept of
financed emissions and the specific methods of calculation and disclosure. This is expected
to revitalize transition finance, etc. and accelerate emissions reductions in Japan.

(C) 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.

(D) Issues concerning Anti-Monopoly Regulations

On May 31, 2023, the Fair Trade Committee of Japan (“JFTC”) published a 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. According to the memorandum, the actions taken by companies to realize a green
society have the effect of promoting development, such as creating new technologies and superior products, and generally do not cause any issues under Anti-Monopoly Law. However, if such actions taken by companies restrict the price, quantity, technology, etc. of their products, resulting in the loss of innovation of new technologies or the increase in prices or decreases in the quality of goods and services, this may become an issue under Anti-Monopoly Law.

2. Recent developments outside of Japan

Major developments outside of Japan affecting decarbonization strategies of companies, such as carbon credit trading, are as follows:

(1) EUETS

EUETS (European Union Emissions Trading System) is an emissions trading system that came into effect in 2005, but the revised EUETS will be in operation from 2024. The main points of the revision are as follows:

(A) Reinforcement of reduction target
   The reduction rate, which was 2.2% before the revision, was increased to 4.3% from 2024 to 2027 and 4.4% from 2028 to 2030. This is expected to result in a 62% reduction in emissions ceiling for facilities covered by the system in 2030, compared to when EUETS was introduced in 2005. (It is planned to partially introduce CBAM at the same time as the phase-out of free allocation starts in 2026, and fully replace it with CBAM when free allocation is abolished in 2034.)

(B) Expansion of coverage: maritime transportation
   Maritime transportation will be newly added to the coverage, where all emissions for navigation in the EU and 50% of emissions for navigation outside of EU will be covered.

(C) Phase-out of free allocation
   Since cement, steel, aluminum, fertilizer, and hydrogen, which have been subject to free allocation, will be replaced with the introduction of CBAM as described below, it has been decided to phase out free allocation from 2026 and to abolish it entirely in 2034 in EUETS.

(D) Establishment of EUETS II
   EUETS II will be applied from 2027 to CO₂ emissions from building heating systems, road transportation, and other economic activities in the sectors not regulated by EUETS. Although EUETS II will come into effect in 2025, it will only require reporting of emissions until 2026.

Especially for (B) among these revisions, carbon pricing will be added to 50% of CO₂ emitted by shipping, when exporting from Japan to the EU or importing from the EU to Japan.
(2) CBAM

CBAM (Carbon Border Adjustment Mechanism) is a carbon border adjustment regime that imposes a carbon charge on imports from target sectors. The target products include iron, steel, cement, electricity, fertilizer, aluminum, and hydrogen. If these products are manufactured in the EU, a carbon charge is imposed based on the EU ETS. CBAM also requires payment equivalent to such charge if the target products are imported from outside the EU. CBAM applies to all countries except for exempted countries (which are countries that apply the EU ETS or are subject to a carbon pricing mechanism that is fully linked to the EU ETS).

The CBAM regulations provide that the full-scale application of CBAM will commence from 2026, and set the transition period from October 1, 2023 to December 31, 2025. Treatment during the transition period is provided in the CBAM Implementation Regulations adopted in August 2023, which require the submission of a CBAM report. During the transition period, only the reporting obligation will be imposed, and there will be no obligation to pay the equivalent of the carbon price as a result of import of target products.

While the current target products are as listed above, the CBAM regulations require the European Commission to identify and report on downstream value chain products that use the current target products and that should be considered for addition to CBAM. Thus, automobile parts that use steel materials may be included as a downstream value chain product. Similarly, under the CBAM regulations, the European Commission is required to consider and report, by December 31, 2025, which is the end of the transition period, (1) an extension of the application to indirect emissions from products for which only direct emissions are currently planned to be considered, (2) an extension of the application to emissions in transport and from transport services of the target products, and (3) an extension of the application to organic compounds and polymers including plastics. Therefore, CBAM target products may be expanded in the future.

Since exports of the target products from Japan to EU countries are very small, the impact on Japanese companies is limited at this point. However, as described above, the target products may be expanded, and if finished products of automobiles, for instance, are added to the target products, the impact on Japanese companies may increase.

(3) US Inflation Reduction Act

Inflation Reduction Act (IRA) was passed in August 2022 and provides for tax credits for investments in North America related to energy security and climate actions. Guidance on the tax relief for clean vehicles (the generic term for battery electric vehicles (BEV), plug-in hybrid electric vehicles (PHEV), and fuel cell vehicles (FCV)) will be released by the end of the fiscal year 2023 and is expected to grant tax relief to battery producers.
(4) Developments concerning 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

The Integrity Council for the Voluntary Carbon Market (“ICVCM”)\(^8\) has published a draft on Core Carbon Principle. In March 2023, the ICVCM released the CCP (Core Carbon Principles), the program-level evaluation framework and the evaluation process. In addition to the program-level evaluation framework, it released a category-level evaluation framework in July 2023 to enable to determine whether credits meet the CCP. On July 27, 2023, ICVCM released operating rules on the “Core Carbon Principles (CCP)” for quality labels of carbon credits. On September 15, 2023, the application for the acquisition of CCP commenced. 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.

(C) Discussion on the legal nature of VCCs

The legal nature of VCCs (from the viewpoint of public law and private law) currently depends on the discussions held in each jurisdiction. Meanwhile, the International Institute for the Unification of Private Law, for example, is making an attempt to unify the legal treatment of this issue. This is considered to be beneficial for enhancing the legal stability of VCC-related transactions.

(5) 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.

(6) Disclosure of sustainability related information

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\(^8\) [https://icvcm.org/](https://icvcm.org/)
On June 26, 2023, International Sustainability Standard Boards (ISSB) released “General Requirements for Disclosures (S1 Standard)” and “Climate-related Disclosures (S2 Standard).” S2 specifies that not only Scope 1 and Scope 2, but also Scope 3 shall be included in the calculation and reporting of GHG emissions, and makes it clear to, in principle, apply the GHG protocol to the measurement of emissions in Scope 3.

Based on the S1/S2 standards above, etc., the Sustainability Standards Board of Japan is developing standards equivalent to these (Japanese S1/S2 standards). In addition, it is required to apply the S2 standards from annual reporting periods beginning on or after January 1, 2024; hence, it is necessary to monitor developments in disclosure regulations in Japan such as contained in the Financial Instruments and Exchange Act.

3. Approach to carbon credit trading

While developments concerning carbon credit trading are complicated as explained above, carbon credit trading would be necessary to achieve net zero emissions at the government level and the company level in the medium- to long-term of 2030 and 2050. Therefore, it may be an option to take approaches to carbon credit trading that consider the following perspectives, for example:

- Carbon credits cannot only be purchased, but also be issued and sold. It is beneficial to be involved in their issuance while assessing the market demand.
- There are a wide variety of carbon credits. It is necessary to assess which kind of carbon credit is most suitable for each company’s purpose.
- When purchasing carbon credits, it is necessary to be familiar with issues concerning purchase agreements and carbon credits (legal, accounting, and tax aspects). It may be an option to purchase and reserve carbon credits for the future, however small the amount may be.
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