

## Update on the Japanese Government Study Group's Carbon Credit Report

### In brief

Several means exist to reduce greenhouse gas (GHG) emissions in order to achieve carbon neutrality by 2050, including development of new technologies, transitioning to renewable energy and voluntary energy conservation. In addition to these efforts, there is growing interest in offsetting residual emissions that are inevitably emitted despite reduction efforts through the use of carbon credits.

Although an increasing number of companies are interested in using carbon credits, the following issues have emerged:

- (a) The treatment of carbon credits under domestic and overseas legal systems is unclear, and their use cases and importance are not fully understood; and
- (b) Many types of carbon credits exist in Japan: J-Credits, Non-fossil Certificates, green electricity certificates, the Joint Crediting Mechanism (JCM) and voluntary carbon credits that are actively traded overseas. This makes it difficult for companies to determine which credits they should apply for and how to utilize them.

Against this backdrop, companies have been unable to fully estimate carbon credit demand, thus limiting their ability to increase the supply of carbon credits based on new carbon removal technologies and carbon sequestration using natural methods. In addition, carbon credits are mainly distributed via bilateral transactions, resulting in a lack of clarity on the status and pricing of these transactions.

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### Study on the use of carbon credits

In December 2021, the Ministry of Economy, Trade and Industry (METI) set up the Study Group on the Preparation of an Operational Environment to Ensure the Proper Use of Carbon Credits to Achieve Carbon Neutrality (the "Study Group") to help address to the above issues. The Study Group aims to:

- (a) Clarify the importance of the various types of carbon credits and their appropriate use in achieving a carbon neutral society and provide guidelines for carbon credit policy; and
- (b) Show the ideal direction for a "carbon credit market" that can leverage international ESG funds and become a hub for global decarbonization as the market for carbon credits expands globally as expected.

In addition, the Study Group has made it clear that market participants should prioritize emissions reduction efforts and that the use of carbon credits is recommended only where residual emissions exist despite these efforts.

The Study Group has conducted a series of consultations on these issues, and at its third meeting on March 24, 2022, it published a "Carbon Credit Report (Draft)" which provided guidance on the two points mentioned above and invited public comment. Subsequently, at the fourth meeting on June 15, 2022, a revised version of the Carbon Credit Report was published (the "Report") in response to the comments received. The Report contains some very helpful ideas about the future use of carbon credits.

- (1) Current status of each carbon credit scheme



According to the Study Group's discussions and interviews with industry participants (the "Interviews"), many industries are beginning to show interest in how various types of carbon credits can be used in domestic and international schemes and in carbon credit policy.

a) J-Credit Scheme

Under the J-Credit Scheme, the Japanese government certifies, as credits, the amount of CO<sub>2</sub> emission reductions achieved through the introduction of energy-saving equipment and the use of renewable energy, as well as the amount of CO<sub>2</sub> and other emissions absorbed through appropriate forest management.

The number of registered projects and the amount of certified carbon credits have been steadily rising. 885 registered projects totaling 8.04 million tons of CO<sub>2</sub> had been certified as of the 49th Certification Committee meeting held in March 2022. The Plan for Global Warming Countermeasures (the "Plan") approved by the Cabinet on October 22, 2021 sets an aggregate target for the issuance of 15 million tons of CO<sub>2</sub> in certified carbon credits by 2030. However, the amount of J-Credits certified is still small given the size of the global carbon credit trading market. Measures to encourage more widespread use of J-Credits are being considered and implemented, such as awarding J-Credits for unlimited amounts of time, developing assessment methodologies for new technologies and revitalizing forest credits.

The Guidelines for the Implementation of J-Credits state that projects that contribute to the reduction of GHG emissions and increase GHG absorption as reflected in Japan's GHG inventory are eligible.

One example of the use of J-Credits is the emissions accounting, reporting and disclosure system (the "SHK system") under the Act on Promotion of Global Warming Countermeasures (the "Act"). Under this system, Specified Business Operators (and Specified Emitters, both as defined under the Act) are required to report "unadjusted greenhouse gas emissions (actual emissions)" as well as "adjusted greenhouse gas emissions" after deducting "certified domestic emission reductions (credits for domestic emission reductions)." With the revision of the related ministerial ordinances and public notices effective April 1, 2014, J-Credits have been brought under the Japanese domestic certified emission reductions scheme and can be used to calculate adjusted greenhouse gas emissions under the SHK system.

Use of J-Credits under the Act, however, is not directly related to the achievement of Japan's NDC (Nationally Determined Contribution) under the Paris Agreement. In this regard, the Report sees J-Credits as a way to promote the involvement of more companies by converting emission reductions, carbon absorption and carbon removal activities in Japan into carbon credits which will ultimately contribute to the achievement of Japan's NDC.

b) JCM

The JCM is a means by which Japan contributes to global warming countermeasures on a global scale by providing developing countries with advanced decarbonization technologies. Accreditation institutions then evaluate the contributions of the projects implemented using the JCM to greenhouse gas emission reductions and absorption.

According to the "Latest JCM Trends" published by the Ministry of the Environment in March 2021, Japan had collaborated with 17 partner countries through the JCM as of June 29, 2021, and the number of projects has further increased to 197 since then. Furthermore, given growing interest in participating in the international emissions trading market through the JCM, the Japanese government is considering allowing JCM projects to be led mainly by private-sector funds in addition to the public sector and also increasing the scale of the projects.

When private companies are involved in the JCM, those holding credits are allowed to transfer them to a retirement account for carbon offsetting purposes. Upon being transferred to this account, the JCM credits can then be used to adjust greenhouse gas emissions under the SHK system described above. In addition, the Japanese government may utilize JCM credits to achieve Japan's NDC (c.f., Article 5 of the "Rules of Implementation for the Joint Crediting Mechanism" effective January 17, 2022 (the "Rules of Implementation for the JCM")). In other words, the government is to approve JCM credits issued for emission reductions, removal and absorption realized after January 1, 2021 to be used to achieve (i) Japan's NDC and (ii) international emission reduction programs through retired credits (Article 6 of the Rules of Implementation for the JCM) as a party to and in accordance with the Paris Agreement and related decision making documents.

The Report explains that double counting of carbon credits is not an issue when the amount of carbon credits retired by a company for carbon offsetting is simultaneously utilized by the government to achieve its NDC because the calculations are made at different emissions layers.



### c) Voluntary credits

Credits issued by private or non-governmental credit certification organizations, such as the Verified Carbon Standard (VCS) issued by Verra and the Verified GS issued by Gold Standard, are collectively called "voluntary credits."

Voluntary credits currently are not permitted under the domestic systems in Japan, and no consensus exists as to how they should be used. In this regard, various opinions were expressed during the Interviews. For example, some believe that voluntary credits before corresponding adjustments should be available for the calculation of "direct emissions" by private companies. This is based on the expectation that the supply of corresponding adjusted voluntary credits will likely be insufficient during the transition period before the use of carbon credits matures. Others believe that voluntary credits should be clearly distinguished from credits that contribute to NDCs because their contribution to domestic reductions is unclear. There is also the question of who will guarantee and certify the quality of voluntary credits. International initiatives (e.g., the GHG Protocol, ISO, TSVCN) are still discussing rules for calculating and reporting GHG emissions, international standards for promoting carbon neutrality, the quality of carbon credits and the like, but no concrete consensus has yet been reached.

Despite this situation, the Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) launched by the International Civil Aviation Organization (ICAO) in 2021 is an example of an initiative that allows the use of voluntary credits. CORSIA has a Technical Advisory Board (TAB) which is responsible for the implementation of the scheme. CORSIA allows voluntary credits that meet certain criteria set by its TAB (CORSIA Emissions Unit Criteria) and are approved by the ICAO Counsel on the recommendation of the TAB to be used as "CORSIA Eligible Emissions Units."

## (2) Proposal made in the Report

Based on the current status of carbon credits as outlined above, the Report discusses supply, demand and revitalization of distribution.

### a) Demand stimulation

It is important to promote emission reductions and achieve the goal of carbon neutrality through the use of domestic carbon credits. The report summarizes the characteristics of carbon credits in terms of whether they contribute to emissions reduction in Japan as follows:

- i) Carbon credits that contribute to the achievement of NDCs in Japan;
- ii) Domestic voluntary carbon sequestration / removal credits outside the scope of the J-Credit Scheme;
- iii) Domestic and international voluntary credits that contribute to a positive cycle of economic growth and environmental protection;
- iv) Carbon credits instrumental in contributing to emissions reductions at the global level and incentivizing local and individual behavioral change;

The Report then analyzes and evaluates (i) to (iv) above under the following hypothetical domestic systems:

- i. A system aimed at accurately ascertaining the emissions of companies in Japan

Under this objective, the use of carbon credits in category (i) above should be allowed, but those in categories (ii) to (iv) should not be allowed to be used in the same way because they do not necessarily accurately indicate the amount of domestic emissions reductions compared to those in category (i).

- ii. A system that can evaluate both present and future efforts (e.g., a Green Transformation (GX) League and a voluntary emission trading market established by a GX League, environmental impact reduction assessments in public and private procurement by national and local governments)

Carbon credits categorized under (i) above, those categorized under (ii) that are expected to contribute to the expansion of CO<sub>2</sub> removal and absorption in the future and carbon credits categorized under (iii) that contribute to a sustainable cycle of domestic economic growth and protection of the environment should be utilized. On the other hand, carbon credits categorized under (iv) should not be allowed to be used in the same way even in light of the broader evaluation criteria described above.



- iii. A system that evaluates voluntary corporate efforts separate from numerical reporting, such as voluntary reporting (e.g., voluntary reporting separate from numerical reporting under the Act's SHK system)

Under such a system, carbon credits in every category should be allowed to be utilized.

In addition, the private sector should be allowed to voluntarily use all of the carbon credits described above (e.g., in disclosures to financial institutions and in the provision of offset products and services to the market) not only under national or local government systems, provided that information is properly disclosed.

## b) Supply stimulation

Increasing the number of types of carbon credits that can be utilized domestically and enabling companies to forecast demand are expected to stimulate the creation and procurement of carbon credits. For this purpose, it is necessary not only to increase the scale of domestic carbon credits (J-Credits) and the JCM issued under the current inventory-based methodology, but also to establish schemes to encourage carbon removal from new technologies such as Direct Air Carbon Capture and Storage (DACCS), Bio-Energy with Carbon Capture and Storage (BECCS), carbon sequestration in agricultural land and carbon capture and removal using natural resources such as blue carbon (i.e., carbon captured and stored in coastal and marine ecosystems).

## c) Revitalization of distribution

The distribution of carbon credits in Japan is mainly based on bilateral transactions, and the volume and prices of such transactions are not publicly disclosed. In order to resolve this situation, it will be necessary to establish a market where the prices of various types of carbon credits are publicly announced and widely traded, and to clarify the legal, accounting and tax treatment of carbon credit trading.

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## Conclusion

Given the ever-changing circumstances surrounding carbon credit transactions, the Report does not intend to provide a definitive conclusion on the status of carbon credits. However, the classification and organizing of carbon credits in the Report is important when considering the direction of policies to increase supply and demand, and therefore the size of the carbon credit market, including J-Credits, the JCM and voluntary credits.

Furthermore, the fact that the Report has clearly organized the utilization of existing crediting schemes such as J-Credits and the JCM and their relationship with Japan's carbon neutrality policy (i.e., achievement of Japan's NDC) should, in conjunction with the various efforts being made through international initiatives to facilitate carbon credit transactions, expand supply and demand in the future in response to the urgent need to scale up supply.



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