

Experimental introduction of an integrated domestic market for emissions trading (Global Warming Prevention Headquarters' Decision on October 21, 2008)

1. Objectives

Based on the Action Plan for Achieving a Low-carbon Society (Cabinet decision on July 29, 2008), an experimental introduction of an integrated domestic market for emissions trading is to be commenced in October 2008, from the standpoint that, in order to reduce CO₂ emissions, it is necessary to utilize the methods to encourage technology development and efforts to reduce CO₂ emissions by pricing CO₂ and using market mechanisms.

The experimental introduction will aim to establish effective rules that actually lead to technology development and reduction efforts and to develop a healthy market which is based on real demand and does not lend itself to money games.

Furthermore, it is essential to use the experience thus gained through the experimental introduction to clarify the conditions which need to be met, the issues of design that must be dealt with, and other relevant matters in the event an emissions trading scheme is to be fully introduced. In addition, the experimental introduction must pursue a system that is appropriate for Japanese industries, which are focused on technology and manufacturing to provide leadership in establishing international rules.

2. Summary of the scheme

Japanese experimental scheme consists of the following two schemes;

- I. Participant firms set their reduction targets, and can achieve the targets by trading emission allowances issued by emission reductions exceeding their targets and credits shown in (II) (the experimental emissions trading scheme); and
- II. Creation and trade of credits to use in the trading scheme:
 - Domestic CDM credits (created as additional reduction by small and medium-sized enterprises and through emissions reduction activities

including forestry biomass according to the *Kyoto Protocol Target Achievement Plan(KPTAP)*)

- Kyoto Mechanism credits.

To make the “integrated domestic market”, allowances (I) and credits (II) must be dealt with as follows:

- Allowances and credits can be equally used to achieve the reduction target stipulated in (I).
- Price indexes for trading are provided

I. Experimental emissions trading scheme

(refer to Annex I for its details)

- Participant firms set their own emission reduction targets and reduce emissions to achieve their goals.
- Participant firms are allowed to use the following allowances and credits to achieve the targets;
 - Other entities’ allowances issued by emission reductions exceeding their targets;
 - Domestic CDM credits; and
 - Kyoto Mechanism credits.

II. Creation and trade of credits

- Domestic CDM credits (refer to Annex II for its details)
 - Domestic CDM credits are certified through necessary procedures for emissions reduction projects conducted by small and medium-sized enterprises who do not participate in the Voluntary Action Plan on the Environment according to KPTAP.
 - Credits are created as a collaborative project between large enterprises and small and medium-sized enterprises.
- Kyoto Mechanism credits
 - Issuance and trading rules of Kyoto Mechanism credits stipulated in the Kyoto Protocol

3. Follow-up activities

Follow-up of the experimental introduction must be ensured in terms of the

following items and schedule.

I. Key points for examination

- Has the experimental introduction produced effects that lead to technology development and reduction efforts as a system that is appropriate for Japanese industries, which are focused on technology and manufacturing?
- Has the market mechanism functioned properly for smooth trading and price discovery? Was there any adverse effect due to money games?
- Has the system for issuing/controlling allowances and credits and checking achievement of targets functioned securely and smoothly?
- How much was participants' implementation cost (including trading, monitoring, and verification costs)?
- What findings that contribute to international rule-making has the experimental introduction brought about?

II. Schedule

- Interim review
 - A follow-up review of issues generated through the experimental introduction will be made in January to March 2009 after procedures (including establishment of emissions targets) for 2008 participants have been completed. The results of the review will be reflected in the scheme in FY2009.
- First follow-up activities
 - The first follow-up activities will be held after confirming target achievement of FY2008 participants, together with the evaluation/review of the KPTAP's follow-ups in autumn 2009.

4. Secretariat

To facilitate the experimental introduction, the Government must establish a management secretariat consisting of staff from the Cabinet Secretariat (CAS), Ministry of Economy, Trade and Industry (METI), and Ministry of the Environment (MOE).

Experimental emissions trading scheme

1. Objectives

This scheme encourages participant firms to set emission reduction targets and achieve them and, if necessary, allows them to trade emission allowances. It offers participant firms good opportunities with various options, such as accepting both absolute targets and intensity targets, and that may attract many firms enough to evaluate these options. It is also expected to investigate a Japanese original emissions trading model appropriate for Japanese industries which focuses on manufacturing and technology and lead to technology development and effective reduction of CO₂ emissions by utilizing voluntary activities and ingenuity at private firms and other entities.

2. Setting emission reduction targetsI. Entity to set an emission target

Installation, individual firm or plural firms (e.g., group of firms)

(*) In principle, a group of all member firms in a certain business sector is not allowed to participate in the experimental market.

II. Covered gases

CO₂ generated from energy use

III. Ways to set an emission target

i. Participating entities voluntarily set their emission reduction target.

- Member firms of the *Voluntary Action Plan (VAP)* set their emission targets consistent with the VAP.
- In order to prevent an entry of an easygoing seller (a seller who has “hot air”), the level of the target must be more stringent than (1) each participant's actual emission amount in a previous year, and (2) the level of the VAP's sectoral target or the actual sector-specific emission records. Specific concern of each participant in terms of target setting may be considered by the government.

ii. Non-members of the VAP set their own targets based on target

setting methods which will be established by the government taking into account the target setting methods of the Japanese Voluntary Emissions Trading Scheme (JVETS).

- Either an absolute target or intensity target can be employed.
- Participating entities can use other participants' allowances, domestic CDM credits and Kyoto Mechanism credits.

IV. Target setting period

- i. The participants can select the period for their target setting, which ranges entirely from FY2008 to FY2012 or part of the five years, considering the 2010 target in the VAP as a standard.
- ii. They should set their targets every year in the selected period and the government checks the achievement of the targets.

V. Registration of targets

- i. The participating entity should notify its emission target to the secretariat through the presiding ministry.
- ii. After the government's assessment and confirmation of the validity of the targets notified by the participant firms, the evaluation and verification of the targets are conducted by the relevant Policy Councils in the same way of VAP's evaluation and verification.

3. Transaction rules

I. Participating in transactions

i. Transaction entitles

- Not only participants with their own targets but also traders can transact emissions allowances.

ii. Opening accounts

- Participants with own targets who are willing to transact their allowances and traders are required to open their own accounts under the systems operated by the Japanese government
- Participants with their own targets who are unwilling to transact their allowances don't have to open accounts.

II. Trade of emission allowances

i. Timing of issuing allowances

- In case the participants set their absolute reduction targets, they have the following options;
 - Emission allowances equivalent to their own targets are determined and delivered in advance, and participants can trade a part of their emission allowances before the termination of the year for which the targets are set; or
 - The difference between their reduction goals and their actual emissions is cleared off at the end of their target setting periods. (This option enables participants who own an account to trade emission allowances equal to the differences after their target setting periods.)
 - In case the participants set intensity targets, the difference between their reduction goals and their actual emissions cleared off at the end of their target setting periods. (Issuance and trade of allowances are the same as participants with absolute reduction targets who clear off the difference between their reduction goals and their actual emissions at the end of their target setting periods.)
 - ii. Transaction of allowances
 - Allowances can be freely traded by the participants in the market.
 - Allowances should be transferred among trading parties' accounts.
- III. Other matters
- i. Commitment reserve
 - To prevent easy overselling, participant firms which received allowances in advance are not permitted to trade 90% of the initially-allocated allowances before their retirement.
 - ii. Avoidance of "money game"

The following measures must be taken to prevent money game problems.

- Banking and borrowing of emission allowances are permitted.
- The government will consider the possibility to provide participants with price indicators and other trade information.
- The government will consider and implement measures to prevent a sudden rise of price caused by overspeculation.

4. Calculation, reporting and verification of emission amounts/ confirmation of target achievement

I. Calculation, reporting and verification of emissions

i. Calculation, reporting and verification of emissions

- Participants with their targets are required to calculate and report their emissions to the government after each target-setting period.
- Calculated emissions need to be verified.

ii. Detail procedures of calculation, reporting and verification of emissions

- For the member firms of the VAP:
 - In principle, calculation, reporting and verification of emission amounts are done in accordance with the procedures and methods stipulated in the VAP.
 - Calculated emission amounts of firms which are willing to sell allowances are required to be verified by the third-party verifiers approved by the government. Firms not willing to sell allowance can access the third-party verification anytime if they want.
- For the non-member firms of the VAP:
 - Calculation, reporting and verification of emissions are done in accordance with otherwise determined guidelines
 - The emissions must be verified by the third-party verifiers approved by the government

II. Confirmation of target achievement

i. Retirement of allowances and credits and confirmation of target achievement

- The government confirms the achievement of the participant firms' emission targets in the running system .
 - For participants with the initially-issued allowances, the government confirms whether the participants clear off their allowances and/or credits equal to their actual emissions
 - For participants with the lastly-issued allowances, the government records the surplus between targets and

actual emissions if the participants achieve their targets. (When the participants have their accounts, allowances equivalent to the surplus will be issued.) Otherwise, the government confirms whether the participants clear off their allowances and/or credits equal to their deficits

ii. Banking and borrowing

- When the actual emissions of participant firms exceed or miss their emissions target, banking or borrowing of allowances is allowed respectively.

5. Schedule

October 21, 2008 Opening of applications for the experimental emission trading scheme

(* due for participation in FY2008 is the mid of December

(* applications for participation in FY2009 will be also opened. The deadline for each financial year is to be announced.

August 31, 2009 Deadline of reporting emissions in FY2008

November 30- Mid of December, 2009

Deadline of retiring allowances and credits, and confirmation of the emission targets achievement

6. Concerns which require further discussions

I. Concerns required to be decided by the end of 2008

- Treatment of allowances and credits in terms of tax and accounting issues for participant firms
- Guidelines on calculation, reporting and verification of emissions for non-members of the VAP
- Procedures for approval of third-party verifiers in the scheme

II. Concerns required to be decided by the interim review

- For firms with intensity targets, potential for interim transaction of allowances and credits and for introduction of the initial allocation and those methods
- Potential for provisions of price indicators
- Intensity target setting methods for non-members of the VAP

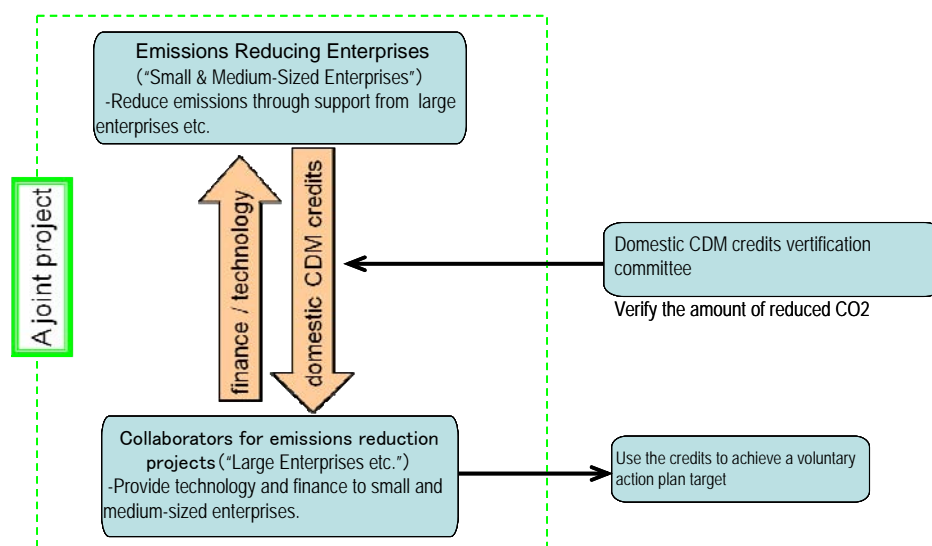
III. Concerns required to be decided according to the circumstances of the scheme

- Necessity and validity of accepting GHGs other than CO₂ from energy consumption
- Penalties for appropriate manners (such as excessive sales and reporting failure, especially in the case of non-achievement of targets)
- Potential for introducing exchange markets

Summary of Domestic CDM

I. Objectives

The Domestic CDM Scheme is stipulated by the *Kyoto Protocol Target Achievement Plan (KPTAP)* (Cabinet decision on March 28, 2008). Under the scheme, large firms provide their funds or technologies with small- and medium-scale firms and utilize emission credits certified as emission reductions in their joint project to achieve the Voluntary Action Plan (VAP) targets.



II. Reduction Projects subject to the scheme

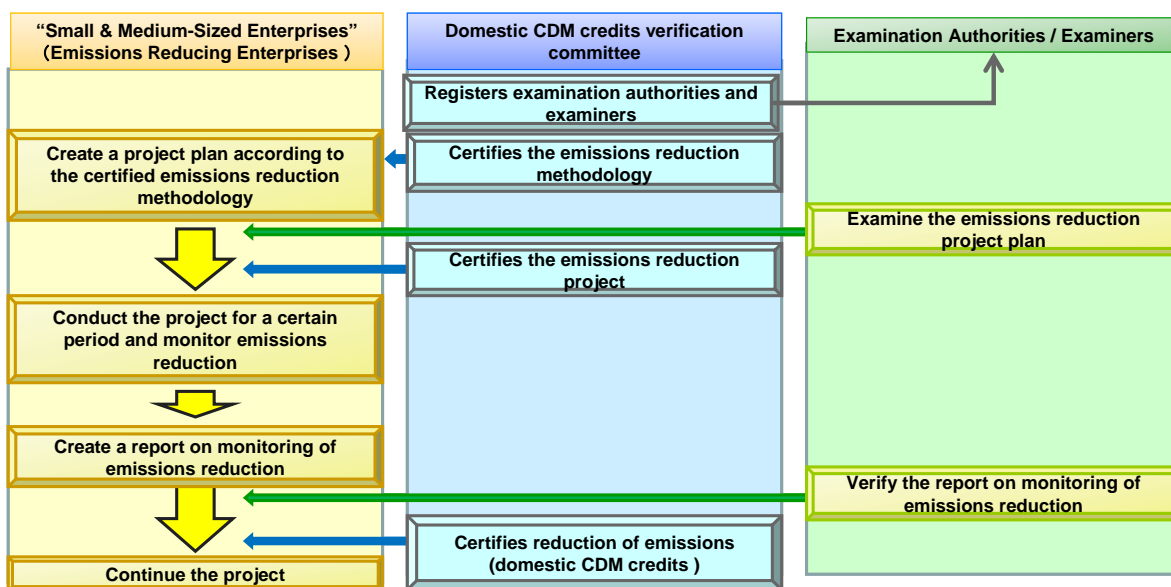
- Reduction projects by non-member firms of the VAP (generally small- and medium-scale firms)
 - In principle, these firms need to collaborate with member firms of the VAP (generally large firms).
- Reduction projects by agriculture, forestry and other services in commercial and household sector are also accepted

III. Domestic CDM Scheme project cycle

- Each applicant has to draft a project design document in accordance with each technology's form (emission reduction methodology)
- Each applicant needs to put its scheme into practice for a certain period

and make a report on monitoring of emission reduction amount. The Domestic CDM credits Certification Committee certifies the achievements in accordance with the standards which emulate the simplified certification methods applied to Kyoto Mechanism credits. That ensures rigorousness and additionality of this scheme. The designated third-party organization or individual for examination monitor implementation of the projects and confirm the emission reduction achievement.

- These procedures are simplified to ensure the convenience for small- and medium-scale firms.



*1 The Japanese government establishes the Domestic CDM credits Certification Committee for smooth administration of the Domestic CDM Scheme and its secretariat is administrated by Ministry of Economy, Trade and Industry, Ministry of the Environment and Ministry of Agriculture, Forestry and Fisheries based on administration rules for the scheme.

*2 With regard to management of Domestic CDM credits, it would be as simple as possible; for example, small- and medium-scale firms and large firms jointly draft and submit their application of the project design.