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National Treasury
of the Republic of South Africa

To	Memory.Machingambi@treasury.gov.za
From	sven.kolmetz@pd-forum.net
Date	15 December 2015
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Subject	**Call for public comments on the Draft Carbon Tax Bill launched by the National Treasury of the Republic of South Africa on 02 November 2015**

Dear Mr Memory Machingambi,
Dear Representatives of the National Treasury of the Republic of South Africa

The Project Developer Forum (PD Forum) commends the government of South Africa for its ambitious climate change policy and commitment to stakeholder engagement. We believe that the ambition and the broad consultation shown by your Government provides South Africa with the leverage to play an active role in constructive implementation of the Paris Accord. In particular, we believe that South Africa's Carbon Tax proposal has the potential to foster international cooperation and position South Africa favourably for integration into the international carbon market that we expect to emerge on the basis of the Paris Accord.

With this submission we respond to your invitation for comments on the *Draft Carbon Tax Bill* as launched on 02 November 2015. While we will not comment in detail on the mechanism or the structure of the proposed carbon tax, we offer some constructive comments that address the topics of i) revenue recycling and offsetting ii) the role of the carbon tax in an effective policy mix, and iii) opportunities for effective domestic and global flexible mechanisms and emissions trading.

With our comments, the Project Developer Forum hopes to support South Africa in implementing a sound and efficient carbon pricing scheme, that will promote quantifiable and reportable early action, attract private sector investment, stimulate innovation and jobs, and prepare the country for opportunities for enhanced international cooperation.

a) General comments

The PD Forum welcomes the development of the South African carbon tax with its associated carbon offset provision. In relation to the level and coverage of the tax, we understand that it is justified in the context of South Africa's development status and the significant challenges it faces in the energy sector. Nevertheless, we note that the tax level is too low to materially change the emission profile of existing infrastructure. In addition, we reiterate our view that investment and clean economic expansion should be the overriding priorities of South Africa's energy policy. As a consequence, the provision for revenue recycling will play a material role in the environmental and social effectiveness of the proposed law and related regulations. Consequently, we welcome that the Draft Carbon Tax Bill and its accompanying documents define that tax revenues will be fully reverted to promote energy efficiency and renewable energy, as well as sustainable transport and social objectives.

In addition, we applaud the significant potential and advantages that may be expected from the inclusion of an offset provision. This is, an effective mechanism to engage the private sector in recycling the carbon tax price signal into new clean investments. Such investments assure sustainable economic growth as well as globally recognized Measurable, Reportable and Verifiable (MRV) GHG emission reductions.

The importance of such a flexibility mechanism is its relation to the material economic difference between the cost of GHG mitigation from existing and new infrastructure. This concept is well explained by Alton et al (2014)[1] using the example of the power sector:

- Power generation is responsible for 53,1% of South Africa's GHG emissions and GHG mitigation in this sector is subject to the vintage problem, which implies that existing assets have to be substituted at the end of their economic lifetime. As a result, there is little room to impact the emissions of existing installations in the short term. A consequence of this fact is that any policy should focus on the development of new clean infrastructure to compensate for emissions of these existing assets.
- An ambitious GHG mitigation trajectory as defined by South Africa's NAMA announcement requires investments in renewable power generation of 171 billion USD, i.e. 63 billion above the business as usual trajectory. The incremental 63 billion corresponds to 19% of South Africa's GDP in 2010 and is necessary because of the lower load factor that renewable energies have when compared to thermal assets.

Though the study reiterates the importance of and the opportunities for South Africa to take a leading role in climate change mitigation, it also raises concerns that a pure carbon tax, without adequate revenue recycling, would harm economic growth and the country's competitiveness.

In addition to the carbon tax being capable of promoting clean economic expansion, we believe there is an important opportunity to position the country favourably in relation to the provisions of Article 6 of the Paris Accord. That provision states that Parties may:

> *"pursue voluntary cooperation in the implementation of their nationally determined contributions to allow for higher ambition",*
>
> but that any
>
> *"internationally transferred mitigation outcomes"* shall *"promote sustainable development and ensure environmental integrity and transparency, including in governance, and shall apply robust accounting to ensure, inter alia, the avoidance of double counting".*

In accordance with this provision, the domestic use of a *"mechanism to contribute to the mitigation of greenhouse gas emissions and support sustainable development",* would position South Africa to connect to an international carbon market that will gradually re-emerge over the coming years. Given the large investment requirements and clean growth opportunities we believe it is in South Africa's best interest to ensure that its domestic policies and regulations allow the use of flexible carbon market mechanisms that satisfy the basic principles of international comparability and fungibility in order to attract international investments and financial flows.

Moreover, it is difficult to project with confidence the emission reductions that will result from the carbon tax and even more difficult to measure and verify. This is all the more reason why such measures should be complemented by mechanisms capable to Measure, Report and Verify the emission reductions achieved by specific projects or whole sectors.

In our view, the CDM should be used as the basis for a domestic offset mechanism, until it is substituted by a new or reformed mechanism that will be developed under the Paris Accord. This will allow seamless engagement of the private sector in broad, but measurable early action. It will also position the economy favourably for future evolutions in international carbon market instruments.

[1] Alton et al; Introducing carbon taxes in South Africa; Applied Energy 03/2014; 116:344–354, available from http://www.sciencedirect.com/science/article/pii/S0306261913009288

With these elements in mind we would like to present our comments which will focus b) on the use of internal flexible mechanisms as an effective form of recycling carbon cost for the benefit of a clean economic expansion as well as c) the opportunity to position for a future international carbon market in the context of the post 2020 agreement as means to attract financing and to minimize competitive distortions.

b) Domestic flexible mechanisms for the benefit of clean economic expansion:

As mentioned, we welcome the Carbon Tax and Offset proposal, provided it is well designed and implemented, offers a series of tangible benefits and advantages:

- A hybrid of carbon tax and offsetting is easy to implement, but still offers a broad carbon price signal as the offsetting component provides a specific focus on the necessary clean economic expansion.
- Due to the cited vintage problem, a tax alone poses non manageable risk to fossil fuel investors, but no incentive to clean investors and thus hampers economic growth. Tax and offsetting together offer investors an effective hedging strategy that will stabilize GHG emissions and promote clean expansion to balance portfolios. This concept is equivalent to the envisaged "sectorial carbon budget approach" and therefore constitutes the first step towards that concept.
- As soon as the terms for offsetting are clear and defined, there will be an effect of anticipation, leading to enhanced investment even before the tax obligation is effective. This element is of special importance as an expansion in coverage and increase in the tax level is already foreseen, a fact that will induce investors to clean investments now, without generating anticipating costs for the economy.
- The mechanism is designed to ensure efficient MRV of mitigation results even for new capacity and is capable to generate tradeable Certified Emission Reductions.
- If the carbon offset mechanism is combined with polices such as REIPPP, South Africa would have a suitable opportunity to develop a sectoral mechanism and ensure sound MRV of the results of its renewable energy promotion mechanism.
- As the REIPPP incentives are being allocated under a tendering process, the anticipated revenues from selling carbon offsets effectively lower the bids offered by investors and thus contribute to lowering the resulting tariffs. This is a benefit for society and the economy.
- The potential to generate offsets will attract a wide range of existing and new national and international investors. This combination of policies will lead to a diversification of technologies and structures, as well as increased competition, one of the key drivers to lower the bidding outcome of the auctions.
- The scheme will prepare the ground for a possible future ETS development and allows immediate indirect linking with other schemes under development internationally.

Such an evolution is not only compatible with the policy design that we are seeing from countries including China, South Korea and Mexico, it is also consistent with the positions of some parties (Switzerland, Norway, New Zealand and South Korea) as illustrated in their INDC submissions, that they wish to acquire international flexibility instruments to meet their domestic obligations. In line with this approach, we believe that robust use of a reformed CDM could be an ideal opportunity to link domestic policies to the emerging international market.

c) Opportunity to position for a future international carbon market:

In addition to the practical arguments above we would like to highlight some important opportunities to develop a regulation which can facilitate that the South African mitigation efforts are recognized by the international community, as well as to facilitate international cooperation and future linking of carbon pricing schemes:

a) The environmental effect of a pure carbon tax is difficult to quantify, especially because it focuses on existing infrastructure more than on new capacities. On the other hand, a developing country such as South Africa will need to focus on economic growth and creation of jobs and welfare and at the same time minimise the build-up of new GHG intensive infrastructure. Such a focus on a clean expansion and green growth can be achieved by allowing offsetting of existing GHG mitigations by emission reductions that stem from sustainable new production capacities.

While the Paris Accord has defined a new "mechanism to contribute to the mitigation of greenhouse gas emissions and support sustainable development, we believe that the CDM is the most effective and reliable mechanism currently available for baseline setting as well as for MRV. Moreover, its use by developing countries will ensure that it can continue to evolve gradually towards the global flexible mechanism that we need.

b) By using the Kyoto mechanisms as one of the key mechanisms, South Africa would ensure that the emission reductions generated are eligible according to the principles of the UNFCCC and thus are eligible in many other countries. In addition to promoting such indirect linking with the international community, which would facilitate sharing some of the domestic mitigation cost, we believe that South Africa has an important opportunity to catalyse the reform of the CDM towards an offsetting mechanism more suited to the demands of developing countries. Of special interest would be to catalyse the development of sectorial baselines and crediting approaches.

c) A further step would be to evolve towards sectorial and national carbon budgets and as soon as South Africa understands that it is feasible and adequate to convert its emission reduction objectives into firm national targets. Under such a scenario South Africa could develop a sound domestic offsetting mechanism which is aligned with UNFCCC principles and which generates tradable units with the highest level of environmental integrity.

d) Recommendations:

With our arguments, we hope to highlight the importance of the offset provision as part of South Africa's policy mix. To ensure maximum benefit and sound development of adequate regulations, it is important that the Carbon Tax Bill provide some clear signals:

- Emphasizing the important role of the offset provision in engaging the private sector in undertaking the investments in South Africa's clean expansion is paramount to attract investors.
- While it is important to develop international demand for emission reduction outcomes, it is also important that adequate domestic demand be created. We believe that an initial offset allowance of 10% of verified emissions, i.e. 25% of taxable emissions, is a good start. We suggest, however, that this number apply to all covered sectors.
- Once the system is up and running, the South African Treasury can adjust its policies to achieve the most effective outcome. For example, in the event the offsetting mechanism is very successful and offers abundant GHG mitigation at low cost, the coverage of the carbon tax or the share of offsetting allowed under the scheme could be expanded. On the other hand, if international demand takes up a large share of the offset units available and thus leads to high demand and a high price, the coverage of the tax might be maintained at 40% for a longer time period. This would contain cost for the domestic economy. Such measures would promote a stable price for domestic mitigation investments. This does not only mitigate the risk for investors, but also leads to the anticipation of investments.
- The earlier and more explicit this policy and applicable eligibility criteria is announced, the more anticipation and early action will be attracted, with positive effects for economic growth.
- Allowing offsetting to domestic aviation is also a positive signal to the International Civil Aviation Organisation (ICAO) and provides South Africa's domestic airlines with the advantage of having a domestic system that is compatible with the fundaments of ICAO's Market Based Mechanism.

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In conclusion, we would like to reiterate that we believe the carbon tax and offset proposal, which is being developed by South Africa, is a highly differentiated and promising solution which we believe does not only contribute to the country's international prestige, but may also be an inspiration for other countries.

As soon as the rules for such a mechanisms are announced in consistent and transparent manner this regulation will not only trigger domestic action, but also contribute to equivalent action by other jurisdictions.

Given the importance of a coordinated progress by the international community, we encourage South Africa to continue its constructive way under close consultation with all stakeholders and in cooperation with other countries in order to ensure that the solutions that are being developed are comparable and allow as much international cooperation as possible.

Kind regards,

Dr. Sven Kolmetz
Chair, Project Developer Forum

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