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Subject **Call for public comments on the proposed carbon tax launched by the Davis Tax committee of the Republic of South Africa on 07 April 2015**

Dear Representatives of the Davis Tax Committee

The Project Developer Forum (PD Forum) commends the government of South Africa for its ambitious climate change policy and the consistent evolution and constant stakeholder engagement. We believe that the ambition and the broad consultation that is being shown will give South Africa the leverage to play an active role in promoting the progress of the international climate change negotiations to achieve the international cooperation that is required to ensure its sustainable economic development.

With this submission we respond to your invitation for comments on the *Carbon Offset Paper* as launched in April 2014, under consideration of the *National Climate Change White Paper*, as published in 2011. Before entering into details, we would like to commend the documents for i) giving consideration to the importance of market mechanisms, ii) mentioning the opportunities for combining different policy instruments and tools to achieve the desired outcome, iii) recognizing the need for sound Monitoring, Reporting and Verification procedures; and iv) emphasizing the importance of private sector engagement. Furthermore we appreciate that the documents outline important elements for further evolution, such as a) the possibility for the definition of sectorial carbon budgets, b) the establishment of a national offsetting scheme and c) the possibility to progress towards Emission Trading.

In this context, the Project Developer Forum is glad to provide comments which we believe are suited to support South Africa in implementing a sound and efficient carbon pricing scheme which will promote quantifiable and reportable early and increasing action, attract private sector investment, innovation and jobs, and prepare the country for opportunities from enhanced international cooperation.

In the following section, we provide our response to some of the specific topics for comments as outlined in the mentioned Documents. We will also make specific reference on recent developments of the ADP negotiations as well as elements of Intended Nationally Appropriate Contributions that have been submitted by other UNFCCC parties as they offer new perspectives on the opportunities for South Africa.

a) General comments

The PD Forum welcomes the developments in the South African tax and associated carbon offset scheme. Though the initial level of tax is relatively low when considering that only 40% of the applicable GHG emissions are covered, the offset component will translate this into a very effective incentive for investments with Measurable, Reportable and Verifiable GHG emission reductions. This element, together with the announced increases in tax level and coverage, provide a very clear signal not only to existing installations, but also for new investments that are of importance for South Africa's economic growth. This is the kind of leadership which the fight against climate change needs and we believe that

the proposals that we are offering can contribute to the development of a transparent and efficient offsetting scheme that can mitigate some negative economic impacts of the tax and lead to new investments and innovation in renewable energy and low carbon technologies.

With this background in mind we would like to cite some important elements from a recent study that has been developed by Alton et al (2014)¹ and which allows to extract some important elements that are important for our comments:

- 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 would imply 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 and the opportunities of South Africa taking a leading role in climate change mitigation it also raises concerns that a pure carbon tax with adequate revenue recycling would harm economic growth and the country's competitiveness.

With these three elements in mind we would like to present our comments which will focus i) 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 ii) 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. In fact the draft negotiation text for the Paris accords now offer multiple references for the continuing use of flexible mechanisms and the CDM. Moreover, parties such as Switzerland and Norway as well as Mexico have illustrated in their INDC submissions that they build on the creation of an international carbon market in the post 2020 agreement. Moreover many countries such as China, South Korea and Mexico are following South Africa's example to use project or sector based carbon credits to facilitate domestic mitigation and we believe that the ample use of a reformed CDM could be an ideal opportunity to link domestic policies to the emerging international market.

b) General design features of the carbon offset scheme

The *Carbon Offset Paper* is intended to provide clarification as to "how firms" can reduce their carbon tax liability using carbon credits as offsets (para 7). However, the paper is structured so that the clarification regarding "how" to develop eligible offsets for the South African carbon offsets scheme is somewhat lost amongst the discussion of why certain decisions relating to the design of the offset scheme have been made. Whilst clarification regarding the rationale behind the offset design is welcome and important for the public consultation process, it might be useful for the next steps of the development, implementation or consultation to prepare two separate documents so that one document outlines the proposed procedures and requirements for firms who are considering using offsets and the other clarifies the rationale for the design.

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>

Considering the proposal as presented, we note a number of potential benefits, as outlined below:

- A hybrid of tax and trading 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 offers an effective hedging strategy which will induce investors to promote clean expansion to balance their portfolios.
- Early action from investors that developed and registered or validated projects is recognized.
- 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.
- Cost / revenue recycling in the power sector would allow minimizing the increase of power costs and thus support family budgets. Increased competition for REIPPP auctions can drive down power prices.
- The model will attract investment, competition & innovation.
- It will also give political prestige for international negotiations and position in Paris 2015.
- The scheme will prepare the ground for a possible future ETS development and allows immediate indirect linking with other schemes under development internationally.

However, there are some issues around the general design of the offset scheme which would need to be adjusted to ensure the full potential as outlined above. The PD Forum would also like to highlight that Certified Emission Reductions were created under the CDM for transfer *between* jurisdictions, and specifically between Non-Annex 1 and Annex 1 Parties. An additionality test was introduced to prove that the project activity was not business as usual. The advantage of using the CDM for internal offsetting is that it offers an existing infrastructure and high credibility, and most importantly the opportunity to sell part of the offsets to international buyers. Such indirect linking of domestic and international demand can support some of the domestic mitigation costs and it can pave the way towards direct linking in the future. To increase the efficiency of this concept we believe that the new Paris accord and the reform of the CDM can ensure that the transaction costs of the CDM are reduced for its domestic use and that any international transfer is adequately tracked by crediting and debiting transferred units to the respective jurisdictions.

A first element of reform already mentioned by the *Carbon Offset Paper* is to pursue the development of sectorial mechanisms and given the strong domestic policy support for some mitigation measures, such as the REIPPP offer an interesting opportunity to promote such concepts. With such an initiative, we believe that South Africa could be a key driver for the reform of the CDM towards a more cost efficient and effective offset and MRV mechanism as needed by developing countries to support the development of their domestic carbon market infrastructure.

Beyond the reform of the CDM and considering the objective to develop Carbon Budgets for specific sectors as defined by the *National Climate Change White Paper*, Section 6.1.3., as published in 2011, as well as the possibility to move towards a national Emission Trading Scheme, we suggest that consideration is given to the Joint Implementation (JI) mechanism, as a means of developing projects with lower transaction costs than the CDM. JI was designed for transfer of units within entities who held a cap and has similar levels of rigour to the CDM in terms of calculating emission reductions and MRV. Under JI however, additionality is less critical as units are usually transferred within a jurisdiction or between jurisdictions with a cap and as such these units are backed by the national inventory. For this reason JI can offer a high degree of transparency, efficiency and solid MRV and environmental integrity without being subject to the complexities of the CDM.

Given that high transaction costs under the CDM are mainly due to the demonstration of additionality, its evolution to a JI like mechanism in the context of a robust national inventory and full tracking of all internationally transferred units are adequately tracked.

c) Carbon-offset potential under the proposed carbon tax in South Africa.

The actual supply of carbon offsets is not clearly defined (para 16, 73, 79) since the potential will only be fully realized if the price signal provides sufficient incentive and there is also considerable uncertainty about the level of demand. This uncertainty of demand is not only related to the level of offsetting that will be used by entities covered by the domestic carbon tax, but also to a possible revival of international demand, which might be attracted by the fact that South Africa has established an ambitious domestic system. With full consideration of these uncertainties and given the importance of the offset mechanism to foster cost effective GHG mitigation and investments in clean infrastructure we recommend that eligibility criteria are clear, but not too restrictive in order to avoid that important and structural mitigation opportunities are lost. Furthermore we understand that the South African Treasury has effective measures to adjust its policies to the effective outcome. For example, in case 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 to ensure that this positive evolution is sustained. On the other hand, if international demand takes up a large share of the units and leading to a high demand and price, the coverage of the tax might be maintained at 40% for a longer time, to contain cost for the domestic economy.

In conclusion we believe that a sound monitoring of the progress of the offsetting policy is important to allow adequate adjustments over time, while it seems important to ensure that the option to develop GHG mitigation projects is accessible to a broad range of sectors and actors as this will reduce the cost of GHG mitigation and ensure innovation and growth in all sectors of the economy.

Based on these considerations it might be of interest to define and signal that such flexibility in the design parameters of the carbon tax and the offset eligibility are being considered.

d) Comments on the Eligibility criteria of carbon-offset projects under the carbon tax.

We offer the following comments on the eligibility criteria:

The discussion of eligibility criteria touches on 1) the topic of positive lists as well as the justification for excluding all activities covered by the tax is due to 2) the argument that the offset mechanism should not support mitigation activities that can be achieved at negative costs (Para 56) and 3) due to concerns about double counting.

- 1) It is understood that the registering organization or accrediting organization will develop positive lists for specific project types in the following sectors - Energy and Energy efficiency, transport, agriculture, forestry and other land uses and waste. Project types that are included on the positive lists will be deemed automatically additional. The methodology or criteria for defining how projects will be included on this list however remains vague. More information on the approach for defining the positive list would be useful for both project developers and would help clarify understanding regarding the supply potential of eligible projects.
- 2) In relation to the topic of negative mitigation cost we wish to remember that this argument comes short of the economic reality. The fact that the existence of such opportunities is referenced illustrates that there are other barriers that prevent their implementation and the carbon crediting mechanism might be a tool to promote their implementation. This is also justified as such measures like energy efficiency have a positive impact for the economy as a whole.
- 3) With regards to the issue of double counting, there are alternative design approaches which could address the issue of double counting which have not been explored in the paper. Our main concern

in this respect is the fact that renewable energy projects, developed under the REIPPP scheme or implemented by entities covered by the carbon tax are not eligible under the current proposal and we believe that this is not in line with several of the premises and concepts which the paper has clearly defined. In order to clarify our views we would like to provide the following clarifications:

- a) For the power sector we have to highlight that GHG emissions of existing plants are generally of structural nature (the vintage problem according to Alton et al., 2014) and that there are no significant opportunities for mitigation. In such situations, paragraph 27, chapter 2.1. of the Carbon Offset paper suggests that offsetting is a justified approach. In line with this concept we believe that it is in South Africa's best interest that investors in the power sector promote investments in new renewable power generation capacity to compensate for GHG emission of their existing power plants which cannot be mitigated. This will also help to avoid further lock in and thus avoid high costs in the future.
- b) In relation to the suggestion above, section 3.1.2 of the Carbon Offset Paper discusses concerns with double counting. In order to elucidate this discussion we would wish to clarify that there is a difference between an emission reduction project in an existing facility (e.g. energy efficiency or fuel switch at cement factory or thermal power plant) and in a new facility, such as a renewable energy generation plant, which could be made by an existing or new actor. Differences are:
 - i) Emission reduction project initiatives in an existing facility are not aimed at increasing its capacity. They simply show that such mitigation is feasible and cheaper than paying the carbon tax. Here it is justified that no offsets are awarded.
 - ii) Emission reduction project initiatives associated to the installation of a new facility is aimed at creating new capacity associated with a GHG mitigation action. Such investments are usually very capital intensive and important for economic growth. The opportunity to obtain offsets to improve the financial performance of the new facility or to compensate for GHG emissions from existing facilities will attract both new, as well as existing investors and lead to green growth and innovation.

Based on this understanding, we argue that the concept of double counting as described in the paper is misleading for the power sector, since in the case of new facilities, there would be clearly no double counting of the mitigation effort, if the corresponding offsets were included as valid compliance instruments under the new tax scheme.

A possible way to address this concept is to clarify that *crediting of GHG mitigation would not be allowed within taxable installations, but that new installations would be entitled to generate offsets for existing installations.*

- c) Moreover, we believe that awarding CERs to new renewable energy investments has many additional important benefits:
 - i) It acknowledges early action from proactive players, thus leveraging a favourable business environment.
 - ii) It encourages new investment in the power industry, leading to a cleaner and more sustainable economic expansion, competition and innovation. As soon as clarity on this aspect is available, investors will anticipate investments to ensure generation of offsets in time for 2016.
 - iii) A tax for GHG emissions from existing power plants without the option of compensation with new clean generation projects will introduce a non-manageable risk to power sector investors. As investors will expect that both coverage and tax will increase over time, they will shy away from new fossil fuel investments. On the other hand, if offsetting from renewable energy is allowed they will seek to develop such assets to hedge against that risk. This will have the effect of stabilizing the GHG emissions as investors will 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.

- iv) The possibility of using offsets from new renewable energy projects will ensure that the cost / revenues are recycled within the power industry and thus will help to avoid rising prices for the final consumer. Furthermore, if a share of the offsets can be exported to other buyers as described below, a part of the higher cost for the mitigation can be financed on the basis of international cooperation.
 - v) The use of some of the cost / revenues in the power sector will attract new diverse investors which will promote competition and innovation, as well as attract equipment manufacturing and related services and thus generate jobs and income and help to overcome non-financial barriers to further investment.
- d) Specifically in relation to the renewable energy projects developed under the REIPPP we would like to highlight the important opportunity to establish an effective combination of policies with interesting benefits for the South African Society, Economy and the country's integration into the international carbon market. Following a brief outline of the key aspects:
- i) As the REIPPP is a domestic support policy to promote the development of renewable energies, the projects developed under this scheme are intrinsically additional according to the E- concept as established by the CDM Executive Board in Annex 3 to EB meeting 22.
 - ii) Based on the consideration above, the REIPPP is very much suitable to develop a sectorial mechanism and this would allow South Africa to ensure a sound MRV of the results of its renewable energy promotion mechanism. The ability to demonstrate the results of the domestic policy based on a sound and internationally recognized baseline setting and MRV mechanisms as offered by the CDM is important to demonstrate the effectiveness of South Africa's domestic policies.
 - iii) As the REIPPP incentives are being allocated under a tendering process, the revenues from selling carbon offsets will effectively lower the bids offered by investors and thus contribute to lowering the resulting tariffs, which is a benefit for society and the economy, especially if part of these offsets can be exported. I
 - iv) By offering a revenue stream related to the GHG mitigation effectiveness of a project, such a combination of policies will effectively promote projects with the highest benefit for GHG mitigation, thus contributing to the objective to curb GHG emissions at least cost to the economy.
 - v) As the possibility of generating 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, which is one of the key drivers to lower the bidding outcome of the auctions. Such competition will also ensure that there are no excessive rents as any consideration of carbon revenues will lead to more aggressive bids.

e) Interim arrangements to operationalize issuance of carbon-offset credits by using existing international carbon-offset standards.

It is understood that in order to "kick start" the offset scheme, project developers may refer to methodologies for the eligible project types under the international offset standards defined by the CDM, Verified Carbon Standard (VCS), GS, Climate Community and biodiversity standard (CBS). It would be useful if the South African DNA defined in advance of the scheme which methodologies under these international standards are eligible. This would then remove the need for the DNA to "validate" projects for eligibility as indicated in para 91.

It is understood that ISO 14064 (1-3) a, ISO 14065 and ISO 14066 will be used as the standard for accrediting bodies/third party verifiers. It is however not clear if the CDM Validation and Verification standard will be applicable in the interim period. It is recommended that the South African government consider allowing the use of the CDM VVS in order to maximize the availability of auditing companies which will in turn ensure that transaction costs for their services are kept to a minimum as a result of competition.

Clarification regarding the timing and inclusion of stakeholder consultations would be useful, especially during the development of the positive list of project types deemed automatically additional, the approval of new methodologies and at the pre-screening of a project and/or at validation.

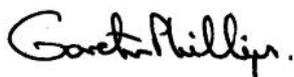
i) Other issues that might be of relevance.

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. For such avoided GHG emissions, we believe that the Kyoto mechanisms (CDM and JI) are the most effective and reliable mechanisms for baseline setting as well as for MRV.
- 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 could be to migrate from using the CDM towards using the Joint Implementation mechanism, an option which could be envisaged as the country develops its sectorial and national carbon budget approach 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.

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. 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,



Gareth Phillips
Chair, Project Developer Forum