PROJECT DEVELOPER FORUM

National Treasury
of the Republic of South Africa

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Subject	**Call for public comments on the Draft Regulations: Carbon Offsets, published by National Treasury 20 June 2016**

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

The Project Developer Forum (PD Forum) once again commends the government of South Africa for its ambitious climate change policy and commitment to stakeholder engagement. Following our submissions to previous consultations from 30 June 2014[1], 8 May 2015[2], and 15 December 2015[3] we are happy to offer our comments on the *Draft Regulations: Carbon Offsets* published by the National Treasury on 20 June 2016.

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 the constructive implementation of the Paris Agreement. Particularly the Carbon Offset provision 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 Agreement. Considering the challenges that South Africa faces to align the need for equitable economic development with the objectives of limiting climate change, we believe that attracting investments and financial flows from international carbon markets is a policy objective that should guide the design of domestic flexibility mechanisms.

With this objective in mind, our general comments will address the a) Design of the Carbon Offset provision and its synergy with other policies to promote clean economic expansion; and b) Opportunities to position for a future international carbon market. Furthermore, we will offer specific comments on the text of the *Draft Regulations: Carbon Offsets.*

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

[1] Available from https://www.pd-forum.net/sites/default/files/pdf_uploads/0e829301243faa2e9e6024d3dc50744e.pdf
[2] Available from https://www.pd-forum.net/sites/default/files/pdf_uploads/a093d7a3f0443425b16a9406feda6f2e.pdf
[3] Available from https://www.pd-forum.net/sites/default/files/pdf_uploads/342_comments-on-sa-tax-offset-proposal_151215_final_signed.pdf

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, especially in capital intensive energy and industrial sectors. Nevertheless, we wish to remind that this tax level will not materially change the emission profile of existing infrastructure and that adequate policies need to ensure clean economic expansion as a more cost effective mitigation. To promote such clean expansion, the proposed Carbon Offset provision, especially if designed in synergy with other policy instruments such as South Africa's REIPPP, is an ideal instrument as it allows investors to anticipate investments and mitigate cost for industries and South African power consumers, which should be a priority of South Africa's energy policy.

Consequently, we welcome the *Draft Regulations: Carbon Offsets* as we believe that Project Based Mechanisms are ideal to engage the private sector in recycling the carbon tax price signal into new clean investments. Such investments assure sustainable economic growth and if developed with the CDM or future UNFCCC mechanisms they will yield globally recognized Measurable, Reportable and Verifiable (MRV) GHG emission reductions.

The importance of such a flexibility mechanism is defined by the material difference between the cost and logic of GHG mitigation from existing and new infrastructure. This concept is well explained by *Alton et al* (2014)[4] 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 successful policies 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 both the importance and opportunities of South Africa taking 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 favourably for connecting 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

[4] 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

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 the outcome. 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.

To facilitate such global fungibility the CDM is a preferable mechanism also for use as a domestic offset mechanism, until it is substituted by a new or reformed mechanism that will be developed on the basis of Article 6.4 of 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 developments in international carbon market instruments which may evolve from indirect linking with offsets to direct linking of Emission Trading Schemes.

With these elements in mind we would like to present our comments which will focus the a) Design of the Carbon Offset provision and its synergy with other policies to promote clean economic expansion; and b) Opportunities 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 disadvantages.

a) Design of the Carbon Offset provision and its synergy with other policies to promote clean economic expansion:

As mentioned, a well designed and implemented Tax and Offset mechanism 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 existing and new, even low emitting fossil fuel based power plants, but no incentive to clean investments 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 power generation 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 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), that wish to acquire international flexibility instruments to meet their domestic obligations. In line with this approach, we believe that robust use of the CDM and its successor mechanism as soon as available, is an opportunity to link domestic policies to the emerging international market.

b) Opportunities 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) As mentioned, the environmental effect of a pure carbon tax at the proposed level is limited and 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 CDM, 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, which will also influence the creation of a new mechanism as defined by Article 6.4 of the Paris Agreement. Of special interest would be to catalyse the development of sectorial baselines and crediting approaches that build on other domestic policies such as REIPPP.

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.

Specific Comments

On the background of the general comments provided above we would like to provide specific comments in relation to the different sections of the Draft Regulations. To facilitate your evaluation, we structure our contribution into editorial comments which simply address the clarity of the language used, as well as conceptual comments which address the rationale and purpose of the specific paragraphs in general.

Editorial comments on Part I - Definitions:

To increase clarity, we recommend the following changes:

- Spell out CDM and VCS and capitalize gold standard.

- Revise definition of “offset” to state that an offset equals the certified emission reduction of 1 metric tonne of CO_2e rather than “a measurable avoidance, reduction or sequestration of CO_2e emissions…”
- The definition of “VCS project” currently states that VCS project means a greenhouse gas reduction program…” Change the word “program” to “project”.
- Verified Carbon Unit (VCU) is defined but CER is not defined even though it is referred to in Section 2 of Part I. A definition should be added.

Conceptual comments on Part I - Definitions:

While we believe that it is adequate to allow different standards, including VCS and the Gold Standard for domestic offsetting we believe that it is recommendable to promote the use of the CDM or its successor mechanism as being developed under Article 6.4 of the Paris agreement as this will allow international fungibility and indirect linking to other international markets.

Conceptual comments on Part II - Eligibility:

As explained in our general comments, the national and international recognition and fungibility of carbon market instruments is a fundamental element to reduce risks and transaction costs and thus to ensure the economic and environmental efficiency of the instrument. We therefore draw some fundamental conclusions and recommendations that should guide the definition of eligibility:

1) With regards to clause 2(1) *(a)* it might be advisable to relate the date to the effective date of enforcement of the Carbon Tax Bill in order to emphasize the link between both provisions.

   In relation to the limitations to projects that are wholly undertaken in the Republic (of South Africa) we note that this approach is adequate and in line with the strategy adopted by other countries such as China, South Korea and Mexico, but we would also like to mention that it could be of interest to envisage a future cooperation with the countries that participate in South African Power Pool.

2) With regards to clause 2(1) *(a)* we would like to confirm our understanding that the term *“activity”* refers to a specific installation that is covered by the tax and does not hinder a company to invest into GHG mitigation activities at a different place, even if situated next to the concerned *“activity”.* It is essential for the effectiveness of a flexible mechanism that investors and operators that are subject to a carbon tax at certain industrial or power generation facilities with GHG emissions that cannot be abated at reasonable cost, have the opportunity to invest into GHG mitigation and compensation measures outside of the perimeter of this facility. Such flexibility will not only reduce the cost of GHG mitigation, but also promote investment and economic growth.

3) It is important that South Africa recognizes the GHG mitigation results that have been achieved by early action and investments undertaken by the private sector. Many investors have and are anticipating the need and the regulations to mitigate climate change and limiting the validity and usability of their achievements does not contribute to the building of a favorable investment environment. We therefore urge you to define generous and practicable provisions for the use of such mitigation results. With respect to this objective, the rules as drafted under section 2.(2) and (3) (a) and (b) are not clear as the term *“existence”* is not defined. Now even if we assume that “existence” is equivalent to “registered” by the UNFCCC, the clause seems excessively restrictive. We therefore recommend:
   a. That all projects with a registration date before the effective start of the carbon tax are eligible to generate offsets under the Draft Carbon Tax Bill.
   b. That Investors are free to use credits that were issued under the CDM without any limiting timeframes as any constraint will generate risks and decrease the value of mitigation investments in South Africa.

In complement to these comments we wish to reiterate our believe that an absence of efficient and workable regulations will stymie investments and thus lead to a shortage of eligible offsets and to lower sustainable development contributions. Furthermore, GHG mitigation will have to be achieved at higher cost and without adequate and internationally recognized MRV. Now if adequate regulations are in place, the Offset Provision is an opportunity to build a link between domestic and international demands is a fundamental strategy to pave the way to international linking and thus to attract international investment and financial flows. We therefore urge to establish a market infrastructure that allows units to flow freely between the international and national registries.

Conceptual comments on Part III – Non-Eligibility:

Clauses 4(1) and (2) effectively prevent that emission reductions that are achieved with projects that obtain other incentives such as power tariffs that were defined under the IPP bid program are used to substitute the tax payment. The argument provided by the explanatory note is that this would represent some kind of undue double counting, which is a concept that we would like to address with the following arguments:

- The drawback of policies such as preferred power tariffs or tax rebates is that they alone actually do not allow to measure, report and verify the emission reductions that are achieved. For this reason, we believe that a combination with a project based mechanism such as the CDM would be of advantage because it will add appropriate accounting. Once such accounting is in place, any domestic use or international transfer will have to be accounted for. If this is warranted, we do not see a risk of double counting as only one set of Certified GHG Emission Reduction is generated as a result of a combination of policies.
- Such policy combination is a common feature in the design of GHG mitigation frameworks and should be judged from the perspective of resource efficiency. This means that the question is if a combination of policies is likely to increase or decrease the cost of GHG mitigation for the domestic economy.

  In the case of the REIPPP and as explained above we believe that a combination of project base mechanisms that allow the investors to take ownership of the emission reductions both for use as domestic and international offsets will reduce the cost for the South African Society because:

  - As the REIPPP tariffs are defined under a tendering process, the anticipated revenues from selling carbon offsets increase competition and result in lower bids and resulting tariffs. This is a benefit for society and the economy.
  - The reduction in the cost of new renewable energy capacity compensates for the increase in cost of fossil fuel based electricity that results from the carbon tax. Consequently, the offset provision largely neutralizes the negative economic impacts of the carbon tax, but it amplifies its environmental benefits.
  - As investors will anticipate future increases of the carbon tax the cost reduction will be larger than the current tax level, i.e. the offset regulation allows the private sector to anticipate GHG mitigation and hedge against future constraints.
  - Once international demand for GHG mitigation offsets arises, investors will be able to export as long as higher prices are paid. This will lead to a net capital flow to South Africa and further reduce the burden for the economy.

We therefore believe that it is economically rational to allow the combination of these complementary mechanisms because it will not only reduce the cost for South Africa's society, but also ensure appropriate MRV and the fundaments for future international linking.

Final Remarks

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, especially in capital intensive sectors such as power generation and industry.
- 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.

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.

About the PD Forum

Project Developer Forum (PD Forum) is a collective voice of companies and practitioners that are developing and financing greenhouse gas emission reduction projects in all regions of our globe.
Our knowledge and experience with global carbon market, climate finance instruments, country specific policies and NAMAs, make PD Forum a unique platform and stakeholder for discussions around the reform and creation of policies and mechanisms to mitigate climate change.

Kind regards,

Philipp Hauser

Philipp Hauser
Co-Chair, Project Developer Forum