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8 March 2018

Attention: Ms. Teboho Sepanya and Mr. Allen Wicomb
Committee Secretaries - Parliament

By email: tsepanya@parliament.gov.za and awicomb@parliament.gov.za

Dear Ms. Sepanya and Mr. Wicomb,

REQUEST FOR COMMENTS PERTAINING TO THE DRAFT CARBON TAX BILL

Deloitte welcomes the opportunity to provide comments on the Draft Carbon Tax Bill ("DCTB"), issued by the National Treasury on 14 December 2017.

We would like to re-emphasise that Deloitte recognises the importance of taking steps to mitigate anthropogenic climate change, and to keep global warming below the targeted 2°C. We agree in principle with utilising effective, efficient and least cost mechanisms to do so.

In this respect, we continue to believe that a Carbon Budget, as opposed to a Carbon Tax, is a more suitable approach. A Carbon Budget system is far simpler, resulting in less administrative burden and greater certainty to emitters. The opportunity for unintended consequences is also far lower due to the simpler design. The Department of Environmental Affairs ("DEA") is already testing a Carbon Budget system, and aims to introduce a Mandatory Carbon Budget by 2020.

We believe the Carbon Tax is not a suitable mechanism to realise its stated intention of reducing Greenhouse Gas ("GHG") emissions. National Treasury has indicated that the expected impact of the Carbon Tax would be a decrease in national GHG emissions by 13% to 14.5% by 2025 and 26% to 33% by 2035 compared to business as usual.

National Treasury has stated that the Carbon Tax will be revenue neutral for electricity producers during the first phase of the tax and will have no impact on the price of electricity. The Environmental Levy, effectively a carbon tax in its own right, will be offset against the Carbon Tax liability of electricity producers. A renewable energy premium will further reduce an electricity producer's Carbon Tax liability. Therefore, electricity producers will not be impacted by the Carbon Tax during the first phase or possibly thereafter if revenue neutrality is maintained and will not be encouraged by the tax Carbon Tax to reduce their emissions.

Based on the latest published GHG Inventory for South Africa (2000 – 2010), South Africa's national GHG emissions amounted to 544 $MtCO_2e$ of which 236 $MtCO_2e$ relates to electricity generation or 43% of total GHG emissions. Agriculture and waste are responsible for a further 10% and 4% respectively of total GHG emissions. Both of these sectors are exempt from the Carbon Tax. In reality, only 43% of the country's emissions will be subject to the Carbon Tax.

To achieve the estimated decrease in emissions of 13% to 14.5% by 2025 compared with business as usual, those who produce the 43% emissions subject to the Carbon Tax will need to reduce their emissions by 29% to 32%, if no interventions are made by others not subject the Carbon Tax.

More worrying is if the status quo remains that electricity producers will be revenue neutral for Carbon Tax purposes after 2025, emissions by others will need to decrease by 57% to 72%. To achieve the indented reductions the country will probably need to deindustrialise. The scale of the reduction is not feasible and places a too heavy burden on those who are subject to the Carbon Tax.

Ultimately, energy use is responsible for 80% of South Africa's GHG emissions. We therefore believe that the most effective tool for Government to reduce South Africa's GHG emissions is a Carbon Budget system with input from the Integrated Resource Plan for energy.

We set out below in Annexure A more detailed comments on the Draft Carbon Tax Bill. Please contact either Izak Swart (iswart@deloitte.co.za) or Gerhard Bolt (gbolt@deloitte.co.za) should you wish to discuss any aspect of our comments.

Yours faithfully,

Nazrien Kader
Managing Partner: Tax & Legal
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Annexure A

Please find below the detailed comments in respect of the Draft Carbon Tax Bill ("DCTB").

1. Scope

The scope of the Carbon Tax is significantly altered with specific reference to combustion emissions. The previous DCTB indicated that taxpayers would consist of entities that:

"if that person conducts an activity as set out in Annexure 1 to the Notice issued by the Minister responsible for environmental affairs in respect of the declaration of greenhouse gases as priority air pollutants under section 29(1) read with section 57(1) of the National Environmental Management: Air Quality Act, 2004 (Act No. 39 of 2004)".

When referring to Annexure 1, a limited number of heavy industries were listed.

In terms of section 3 of the DCTB, a person is subject to the Carbon Tax if that person conducts an activity above the threshold. The current DCTB has a far more extensive list of activities or sectors that would be subject to the Carbon Tax as can be seen in Schedule 2. The threshold for most combustion emissions are set at 10 MW thermal input capacity. Schedule 2 also includes a "catch all" category for combustion named "Non-Specified" (1A5). According to the response document released as Annexure 3 with the DCTB, the thresholds have been clarified to apply at entity level.

As a result, many additional sectors or activities who were arguably not going to be subject to the Carbon Tax will now be liable for Carbon Tax. An entity level threshold vastly broadens the scope of the Carbon Tax, meaning that the economic impact will be far more significant than initially anticipated. Consider a large entity with many different sites that individually fall below the threshold of 10 MW thermal capacity. Individually, the sites will not be subject to the Carbon Tax. When combined, as all the sites are in one legal entity, the legal entity will be subject to the Carbon Tax.

Another consequence of the above is that entities that operate across multiple sectors will be unfairly prejudiced. A specific activity within an entity may be subject to the Carbon Tax based on the threshold for a specific activity. In terms of section 4 of the DCTB the sum of all GHG emissions will be taxed. Therefore, activities that produce GHG emission elsewhere in the entity, that fall below the threshold, will be subject to the Carbon Tax.

The introduction of thresholds provides certainty on when an emitter will be subject to the Carbon Tax. However, the application of the thresholds still needs further clarification and consideration especially when it is aimed at an entity level as opposed to a site level as was initially thought.

2. Carbon Tax Threshold – Installed Capacity vs Consumption

The threshold to be subject to the Carbon Tax should be based on the level of emissions emitted as opposed to the capacity of the equipment. The use of thermal capacity to determine reporting requirements to the DEA may be acceptable to determine when a person must report its GHG emission but is an illogical fit for the Carbon Tax, which is based on actual emissions emitted.

Installed thermal capacity and utilisation are vastly different concepts. Although National Treasury has indicated that "emissions above a certain level will be taxed", the use of a capacity threshold voids the concept. For example, many entities have standby

boilers, for use when the main unit is offline for maintenance. Although smaller than the main unit, the combined capacity of the two boilers will be above the capacity threshold.

Furthermore, facilities may have downscaled, or have boilers installed that are far larger than necessary. Whilst the units may exceed the capacity threshold, its utilisation may be much lower. Entities operating in these situations will be subject to the Carbon Tax because of installed thermal capacity as opposed to actual emissions, which seems contrary to what is intended.

In other instances, some of the thresholds are not set in terms of thermal capacity, but rather on fuel quantity. Waterborne navigation has a threshold of 100 000 litres per year. There is uncertainty as to whether this threshold applies to usage or capacity. If it applies to usage, then the Carbon Tax thresholds are not uniformly applied. However, if it is capacity, it is again illogical and will likely be very difficult to determine. For example, most ocean going vessels utilise their engines only part time. In many cases, the utilisation can be estimated in the region of 30% to 50%. However, if the vessel is operated at full capacity, 365 days per year, it may be possible for the threshold to be exceeded.

Finally, setting 10 MW thermal capacity does not make sense considering the broad range of fuels being considered. 10 MW thermal capacity in terms of natural gas results in emissions of approximately 17 700 tonnes of Carbon Dioxide equivalent ("tCO_2e") per annum, while the same energy input in brown coal briquettes results in emissions closer to 31 000 tCO_2e. Some boilers in industry operate purely on renewable fuels, with fossil fuels only used for start-up. The emissions from this type of set up is likely to be less than 500 tCO_2e per annum, but whoever operates this type of equipment will still be subject to Carbon Tax.

We therefore recommend that the thresholds be set in terms of absolute total emissions, rather than installed capacity.

3. Exemption of Process Emissions

National Treasury has indicated that should the Carbon Tax at its current rate prove ineffective at changing behaviour, rate increases should be expected. As mentioned previously effectively only 43% of emissions will be subject to the Carbon Tax. A heavy burden is placed on those subject to the Carbon Tax to reduce its emissions.

Although electricity providers have been subject to a carbon tax in the form of an Environmental Levy, no real decreases in emissions have been observed. It is also understood that little of the revenue collected from this levy has been used for environmental purposes. The Carbon Tax is effectively an expansion of the Environmental Levy.

Under the circumstances, merely imposing the Carbon Tax to reduce emissions will be counterproductive. The Environmental Levy did not reduce emissions by electricity providers. More importantly, certain sectors of South Africa's economy, specifically those with process emissions, cannot be changed to reduce emissions. Process emissions are part of the chemistry of the products being produced. Examples are cement and steel that cannot be produced without process emissions. Imposing a Carbon Tax on these sectors will not result in reduced emissions, similar to what is being seen with the Environmental Levy. Furthermore, increasing the Carbon Tax rate will not change these sectors, it will simply close them down.

Process emissions account for less than 9% of national GHG emissions. Consideration should be given to exempt process emissions from the Carbon Tax, as is done in most international Carbon Taxes.

4. Allowances

Large parts of the DCTB require additional regulations still to be published. It is difficult to provide meaningful comment while these regulations are outstanding. However, it is

of particular concern that most of the outstanding regulations surround taxpayers' ability to reduce their Carbon Tax liability. These regulations must be finalised quickly so as to allow taxpayers to understand what behavioural changes will be necessary.

Further, with the changes to the scope and threshold of the DCTB, many additional sectors will now be impacted by the Carbon Tax. These sectors, having not previously been covered, have not been actively pursuing the development of these allowances.

For example, the Performance Allowance requires that individual sectors engage with Treasury and submit benchmarks for their sectors. These sectors are only now beginning to evaluate the possibility of submitting a benchmark, but have a deadline of March 2018 to do so. Even, generously, assuming that these sectors started working on these benchmarks with the release of the DCTB, less than four months would be available. It is unfair when compared to other sectors who have had since 2015 to begin making submissions. Another problem in this regard is that many of the additional sectors that are now included make a large variety of products that cannot be covered by a single benchmark (for example pasta, bread, milk, cheese, sweets, motor vehicle manufacturing).

In respect of voluntary participation in the Carbon Budget, a similar problem occurs. Initially, only sectors where at least one participant emitted more than 100 000 tCO_2e were approached to participate. This is a process that has been running for several years. Even so, some of the submitted budgets have not yet been approved. There is significant uncertainty as to whether any entities that are now covered by the Carbon Tax will still be able to successfully submit voluntary Carbon Budgets to receive the allowance.

We are further concerned with the large quantities of additional work around the Carbon Tax that has been assigned to the DEA. It is our understanding that the DEA has already been slow to respond to comments on the GHG reporting regulations and technical guidelines, as well as in approving Carbon Budgets. Many additional submissions in terms of voluntary Carbon Budgets and emissions factors are expected to follow the implementation of the Carbon Tax. If the DEA cannot manage this workload in a timeous manner, this could delay taxpayers from receiving allowances or appropriate emission factors.

5. Revenue Recycling

National Treasury has indicated that the intention is for the Carbon Tax to be revenue neutral, and that the revenue generated will be used in "green" applications. However, to date, no commitments or plans have been given regarding the use of this revenue, except for the following in the Explanatory Memorandum:

> *"Measures are also taken to protect vulnerable households. The carbon tax will be revenue-neutral during the first phase and revenues will be recycled by way of reducing the current electricity generation levy, credit rebate for the renewable energy premium, and a tax incentive for energy efficiency savings. Efforts will also be made to prioritise and enhance allocations for free basic electricity (or alternative energy) and funding for public transport and initiatives to move some freight from road to rail."*

This paragraph raises several questions. Firstly, how will vulnerable households be protected, especially as both food and transport prices are set to increase with the implementation of the Carbon Tax due to its wider scope?

Secondly, it is understood that National Treasury believes that it is foregoing revenue by allowing the Environmental Levy to be subtracted from the Carbon Tax liability of fossil fuel electricity producers in terms of section 6(2) of the DCTB. However, this is a

mechanism to prevent double taxation and to maintain revenue neutrally for electricity providers.

The section 12L energy efficiency income tax deduction has been active since 2013, and has a sunset clause which means it will no longer be claimable after 2020. National Treasury indicated that 5.9 GWh of energy savings had been claimed at the end of 2016, and that this had resulted in foregone revenue of R2.7 billion. However, this is not correct, as the allowance values were R2.7 billion (5.9 GWh multiplied by the incentive rate at the time of 45 c/kWh). The foregone revenue would be the tax that would have resulted had this allowance not been claimed, which at the corporate tax rate of 28% would be R750 million. Our estimates show that the total foregone tax revenue due to Section 12L should be between R1 and R3 billion depending on energy efficiency savings achieved. Based on National Treasury's estimate of R13 billion annual revenue from Carbon Tax, this means that foregone revenue due to section 12L income tax deduction will be recouped in less than three months.

As such, the only references to new activities that will be subsidised by this revenue is that of allocating free basic electricity, as well as moving some freight from road to rail.

National Treasury have indicated that some of the revenue collected from the electricity generation levy was used to fund Solar Water Heater programmes. From 2009 to 2012, this funding amounted to a mere R332 175. In 2010 and 2011 respectively, R3 342 million and R4 996 million was collected from the electricity levy according to the 2012 National budget statistics document. This means that less than 0.5% of the revenue was actually recycled for environmental purposes. To transition South Africa to a low carbon economy, this cannot be repeated.

Both locally and internationally, industry does not have capital to implement new or experimental technologies with lower carbon footprints. Internationally, many governments provide sponsorships or grant money to this effect. For example, in India, large portions of the Carbon Tax is allocated to a National Clean Energy and Environment Fund. We recommend that South Africa also consider such an approach if the Carbon Tax is introduced.

6. Units of Measure

In several locations in the bill, the term "ton" is used. It should be understood that tonne (equivalent to 1000 kg) and ton (1016 kg or 907 kg, depending on whether the US or UK imperial is used) are not the same unit of measure. We believe believed that the intended unit of measure is tonne. We suggest that the DCTB be changed to reflect "tonne".

7. SARS rules

As the Customs and Excise Act will be used to administer the Carbon Tax, SARS rules will be required. It is understood that, despite being less than two months from implementation, the rules regarding the payment of the Sugar Tax are still in draft form. Considering that the scope of the Carbon Tax will be far larger, and the impact far greater, such delays cannot be the norm.

To provide meaningful comments the SARS rules should also be published for comments.

8. Carbon Sequestration

In section 6 of the DCTB the formula to calculate a taxpayer's carbon tax liability is as follows:

$X = \{(E - D - S) \times$ ……

- "E" represents the number in respect of the total fossil fuel combustion related greenhouse gas emissions of the taxpayer in respect of that tax period expressed as a carbon dioxide equivalent determined in terms of section 4(1)(a);

- "D" represents the number in respect of the petrol and diesel related greenhouse gas emissions of that taxpayer in respect of that tax period expressed as a carbon dioxide equivalent, determined in terms of section 4(1)(a);

- "S" represents the number in respect of greenhouse gas emissions, expressed in terms of carbon dioxide equivalent that were sequestrated in respect of that tax period as verified and certified by the Department of Environmental Affairs;

Provided that where the number in respect of the determination of the expression "(E – D - S)" in the formula is less than zero, that number must be deemed to be zero.

Restricting the formula to be less than zero unfairly penalises entities whose main activity is carbon sequestration related. We suggest that consideration should be given to where the formula is less than zero that entities could sell the excess sequestrated carbon to other entities to use as offsets or could be used to reduce the entities fugitive and process emissions.

9. Socio-economic Impact

We find it concerning that the Socioeconomic Impact Assessment ("SEIA") released as Annexure 2 with the DCTB seems not to be evaluating the true impact of the Carbon Tax, and does not foresee any of the unintended consequences that will result.

With the introduction of the 10 MW thermal capacity threshold at an entity level, as well as the expanded list of activities that will be liable, the Carbon Tax reach has been significantly expanded as explain in point 1 above. For example a number of food and beverage producers will now be covered. Bakeries, wheat & maize mills, dairy producers, and confectionary producers are all industries that exceed the 10 MW thermal capacity threshold. Carbon Tax will inevitably result in food price increases, specifically for cheap, staple foods. We do not believe food price inflation was or should be an intended consequence of the Carbon Tax, and it is particularly worrying that no mention of food price increases is made in the SEIA. The effect of the Carbon Tax will be further magnified by its effect everywhere in the value chain, including material suppliers as well as on road transport.

The Explanatory Memorandum indicated that the Carbon Tax will be applied to Diesel and Petrol through the fuel levy, and will have an impact of between 11 and 13 cents per litre depending on the fuel type. However, these figures only include the direct charge for the Carbon Tax on combustions of the fuels and does not take into account the pass through of Carbon Tax from producers and transporters of fuel. The Carbon Tax incurred by the producers and transporters will need to be passed on consumers. The numbers are therefore understated.

Finally, insufficient attention has been given to the impact that the Carbon Tax will have on large industry. Unlike industries that sell locally, most of these industries sell into the international market. As such, a pass through of the Carbon Tax is not tenable. Instead, these industries must rely solely on mitigation to manage the price impact of the Carbon Tax. However, these industries, such as steel and cement, have emissions associated with their processes that simply cannot be mitigated with the technology available at this time as explained in point 3 above. The end result is that the sustainability and competitiveness of these industries will be impacted.

None of these impacts is adequately investigated in the SEIA. As such, the impact that the Carbon Tax will have once implemented is possible understated. It is also highly

likely that these strong, negative consequences will not be easily reversed. Impacts such as increased food prices and transport costs are also likely to be experienced by the most economically vulnerable in South Africa.

As such, we emphasise that a Carbon Budget approach, which can be targeted more precisely, will be a better mechanism. Furthermore, we suggest that the Carbon Tax be implemented with a universal 100% tax-free threshold initially as suggested by the Davis Tax Commission so that the potential consequences can be properly understood and evaluated.