Standing Committee on Finance
Parliament of the Republic of South Africa
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Chair, Members,

Comments on draft carbon tax bill

We present herewith our written submissions on the draft carbon tax bill. Identical comments were made to National Treasury

We have deliberately tried to keep the discussion of our submissions as concise as possible, which does mean that you might require further clarification. In this respect, you are more than welcome to contact us.

Yours sincerely,

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PART A – CARBON TAX POLICY

1. Petrol and diesel

1.1 It is proposed that the carbon tax relating to the use of petrol and diesel be added to the current fuel tax regime. While we are not opposed to this proposal as a matter of principle, it raises a number of questions that require to be addressed.

Interaction with vehicle emissions tax

1.2 The vehicle emissions tax is levied at a rate of R110.00 per g/km CO^2 emissions exceeding 120g/km for motor cars and at a rate of R150.00 per g/km CO^2 emissions exceeding 175g/km for double cabs. This tax is therefore a tax on potential carbon emissions emanating from the use of petrol and diesel for transport purposes in such vehicles. Levying a carbon tax on actual emissions on the use of fuel in such vehicles would therefore amount to double taxation.

1.3 By way of a simple example, a Toyota Corolla 1.6 has CO^2 emissions of 157g/km. As such, this vehicle would attract vehicle emissions tax of R4 070. If that vehicle were to travel 200 000 km over its lifetime, it would emit 31.4 tons of CO^2 and the tax paid would therefore effectively amount to R129.62 per ton of actual CO^2 emissions. The result is that the effective rate of taxation on emissions from such a vehicle is already far higher than the effective rate of tax proposed in relation to actual carbon emissions and levying a carbon tax on top of the vehicle emissions tax will amount to double taxation of carbon emissions for vehicles covered by the vehicle emissions tax.

1.4 Should it therefore be proposed to include the carbon tax in the fuel tax regime, the vehicle emissions tax should be repealed in order to eliminate the double taxation that would otherwise result. Alternatively, the fuel tax should not include any carbon tax element relating to the burning of petrol and diesel.

Tax-free thresholds

1.5 It is not clear as to how the tax-free thresholds would operate in the context of petrol and diesel. No indication is given as to whether even the 60% basic tax-free threshold would apply.

1.6 However, it seems clear that any person that is subject to the carbon tax would not be able to benefit from the trade exposure, performance, carbon budget and offset allowances insofar as their emissions from the combustion of petrol and diesel are concerned. The result is that such persons would be indirectly exposed to a far higher effective carbon price through the fuel tax regime relating to the use of such fuels than they would face were the carbon tax from the use of the fuels to be levied directly on them. This would undermine the very purpose of the allowances.

1.7 The carbon tax should therefore be designed to incorporate an ability to claw back allowances in relation to the carbon tax imbedded in the price of such fuels.

International aviation and maritime transport

1.8 It is not clear how these sectors are to be exempted from the use of petrol and diesel or whether the carbon tax will not be included in the fuel tax regime applicable to fuels used in these sectors. This should be clarified.

PART B – CARBON TAX BILL

3. Persons subject to tax

3.1 This section provides that a person is liable for the carbon tax if that person conducts an activity resulting in greenhouse gas emissions above the threshold set out in schedule 2. There are a few problems that arise in this regard.

3.2 The section refers to a person conducting an activity. It provides no geographical limitation to the activities conducted. A person should only be liable for the tax if they conduct an activity in South Africa.

3.3 A person is also only liable if an activity results in emissions above the threshold. Frequently, companies will conduct more than one activity contemplated in schedule 2. It is unclear if the activities listed in schedule 2 are to be aggregated in determining liability for the tax or if each is to be considered separately. This should be clarified in the legislation.

3.4 Schedule 2, insofar as the thresholds are concerned, is seemingly simply a replication of Annexure 1 of the National Greenhouse Gas Reporting Regulations. Rather than replicating this Annexure, the liability for carbon tax should be aligned with these regulations by cross-referencing them. As things stand, there is a lack of certainty on the alignment of the carbon tax and Regulations. For example, the Regulations allow for reporting at a group level and it is seemingly possible for different emissions to b reported for purposes of the tax and in terms of the Regulations. The two instruments should be fully aligned insofar as liability for the tax is concerned.

4. Tax base

4.1 Section 4 does not distinguish between emissions that take place within the borders of South Africa and those that take place outside the borders of South Africa. It should be made clear that the tax base comprises only of emissions that take place from activities conducted within South Africa.

4.2 The provisions of section 4(2) appear to be redundant as there should be no reporting methodology that is not approved by the DEA.

5. Carbon tax rate

5.1 The carbon tax rate increases should more appropriately be linked to the producer price index given that the companies liable will be producers.

5.2 In a number of places the legislation refers to a tax year as opposed to a tax period as defined in section 16. This should be rectified.

5.3 It should be clarified in the legislation that the increases in the rate commence in the tax period after that in which the tax becomes effective, i.e. in the second tax period.

6. Calculation of amount of tax payable

6.1 The formula incorrectly cross-reference sections 4(1)(a), (b) and (c). It should refer to section 4.

6.2 The formula reduces the emissions from combustion by those relating to petrol and diesel which then multiplies the reduced emissions by the allowances and the rate. The effect is that no allowances are given for emissions from petrol and diesel which will result in a higher effective tax rate for these, undermining the purpose of the allowances for trade exposure, performance, carbon budgeting and offsets. Rather than reduce emissions in the formula for petrol and diesel, the tax liability should be reduced for the carbon tax included in the fuel price. This will preserve the allowances for emissions from petrol and diesel.

7. Allowance for fossil fuel combustion

7.1 Section 7 is intended to also apply to fugitive emissions. However, it refers only to fuel combustion emissions.

8. Allowance for industrial process emissions

8.1 The allowance is expressed as a percentage of "the total percentage of greenhouse gas emissions". This is nonsensical. Greenhouse gas emissions are not a percentage but an absolute number.

9. Allowance for fugitive emissions

9.1 The allowance is expressed as a percentage of "the total percentage of greenhouse gas emissions". This is nonsensical. Greenhouse gas emissions are not a percentage but an absolute number.

10. Trade exposure allowance

10.1 We welcome the extension of trade exposure to cover both imports and exports as well as the determination thereof on a sectoral basis. However, some concerns remain.

10.2 The proposed relief for trade-exposed sectors applies only to direct emissions. The result is that such sectors that have significant scope 2 emissions will continue to be exposed to reduced competitiveness stemming from any increased electricity prices should all or a portion of the carbon tax be passed through to electricity consumers.

10.3 Many of South Africa's most trade-exposed sectors will be more exposed to the carbon tax as a result of scope 2 emissions rather than scope 1 emissions. For example, approximately 29% of

Arcelor Mittal South Africa's emissions are scope 2 emissions, approximately 91% of Anglo American Platinum's emissions are scope 2 emissions and 98% of Harmony Gold's emissions are scope 2 emissions. Manufacturers also face a predicament in that virtually all their emissions are in the form of scope 2 emissions. Such firms will therefore see their competitiveness being undermined through any further increases in the cost of electricity, but will receive no relief for trade exposure notwithstanding that they will indirectly bear the carbon tax levied on Eskom.

10.4 By contrast, Australia provided relief from both scope 1 and scope 2 emissions in the free allowances it granted to emissions-intensive sectors.

10.5 Concerns also remain as to whether the proposed approach will provide adequate protection to trade-exposed sectors. Some sectors may not see significant imports currently, but this could change with the introduction of the carbon tax. Reliance solely on quantitative trade data prior to the introduction of the carbon tax is misplaced. Even if this is updated after the introduction of the carbon tax, this may be too late to provide adequate protection to sectors exposed to import substitution.

10.6 There are a number of industries in South Africa that are largely in this position, including cement, glass, steel and petroleum.

10.7 The result is that inadequate protection for domestic producers exposed to import substitution is likely to place significant strain on those industries, potentially placing jobs at risk and negatively impacting on the trade deficit.

10.8 It is therefore suggested that qualitative factors should also be taken into account in assessing trade exposure and not just reliance on historical data.

11. Performance allowance

11.1 The proposed adjustment to the basic tax-free threshold for carbon intensity against a benchmark creates unnecessary complexity and uncertainties. These uncertainties include the following:

- It is proposed that the adjustment to the tax-free threshold be made based on absolute emissions for the year. As such, the adjusted tax-free threshold can only be determined after the end of the year in question once the absolute emissions of the firm and its output are known. The result is that a taxpayer will not be in a position to accurately determine its exposure to carbon tax and plan accordingly.

- Any volatility in capacity utilisation will invariably impact on a firm's carbon intensity. Benchmarks are usually determined on the basis of the assumption that a facility is utilised to full capacity. The result is that when a facility is not used to full capacity,

carbon intensity will generally increase. The extent to which capacity is utilised is often beyond the control of a firm, being driven by external factors, such as customer demand, the general state of the economy, etc. Firms often have few options to mitigate increases in carbon intensity resulting from under-utilisation of capacity as these are generally chunky in nature, e.g. reducing the number of operating shifts.

- Including scope 2 emissions in the determination of carbon intensity introduces a significant aspect over which consumers of electricity have little control in the South African context. While consumers do have limited options to improve energy efficiency and, in some cases, to generate electricity for own consumption from combined heat and power or other sources of less carbon-intensive electricity, these options are not readily available to all firms.

- Benchmarks can vary dramatically depending on the basis on which these are selected and determined. This will introduce a significant amount of lobbying into the carbon tax, a practice which should be avoided insofar as possible.

11.2 Section 11(1)*(b)* refers to benchmarks prescribed by the Minister. Firstly, the provision does not prescribe the manner in which the Minister must prescribe the benchmark, e.g. by way of regulation or notice. Secondly the Minister is the Minister of Finance. We would question whether this should not be the Minister of Environmental Affairs as being the appropriate person to prescribe emissions intensity benchmarks.

12. Carbon budget allowance

12.1 Ostensibly, the purpose of this allowance is to align the carbon tax with the carbon budget programme. With all due respect, simply granting an additional allowance of 5% for those companies participating in the carbon budget pilot hardly constitutes alignment. The fact of the matter is that companies participating in the carbon budget pilot will still be faced with two instruments covering the same emissions and a resultant duplication of costs in the form of the carbon tax and costs incurred in order to bring emissions within the carbon budget.

12.2 A proper alignment would entail the exemption from the carbon tax of those companies participating in the carbon budget programme or, at the very least, a basic tax-free allowance equal to the carbon budget (with no further allowances for trade exposure or performance) such that the company would only have a carbon tax liability on those emissions in excess of the budget.

12.3 Furthermore, there is no indication of how alignment will take place after 2020. This is important for companies to understand so that they are able to plan for the long term effectively, bearing in mind that the type of investments affected by the carbon tax have a long investment horizon. Certainty is therefore required over the long term and not just the short to medium

term. As such, full alignment with carbon budgeting is required before the carbon tax is implemented.

12.4 Notwithstanding the above, we note that section 12 is poorly worded –

- There is no definition of the "carbon budget system" and the definition of "carbon budget" is vague. The definition should be linked to the appropriate instrument of the DEA.

- The provision refers to participating in the carbon budget system "during or before" the tax period. The implication is that if a company participates in the carbon budget system in year 1, but not in subsequent years, it will always qualify for the additional allowance. Surely this is not what is intended?

13. Offset allowance

13.1 It is not clear what the rationale is for the proposal to limit offsets for those firms which obtain relief for process emissions to 5%. It would seem that the policy has as a point of departure that an offset mechanism constitutes the grant of further free emission allowances or exemption from the carbon tax. While this may be true to the extent that the State will not obtain tax revenues to the extent that an offset applies, it hardly amounts to free emissions or an exemption. This is because any offset comes at a cost to the company offsetting its emissions, whether through the acquisition of carbon credits or investment directly in offset projects.

13.2 Furthermore, we concur with the views expressed by the Davis Tax Committee to the effect that, given that the rationale behind the carbon tax is environmental and not revenue generation, there is no clear reason why the maximum offset should not be 100%.

13.3 Based on the studies undertaken, it would seem that demand for offset credits is likely to be between 20 million and 30 million tonnes per year (although projections as low as 5 million tonnes are included in the studies, this seems unrealistic as it seemingly excludes the energy sector). Demand for carbon offsets from Eskom alone could exceed 22 million tonnes per year were it to make maximum use of its offset allowance. On the other hand, although potential supply of offsets may exceed 50 million tonnes according to the paper, a realistic estimate would appear to be a maximum of 20 million tonnes in the first phase of the carbon tax.

13.4 The result is that demand is seemingly likely to exceed supply. This will mean that the price of a carbon offset will tend towards the rate at which the carbon tax is levied, thereby undermining a primary purpose of the offset scheme, being to enable emitters to invest in emission reduction projects with a lower cost of mitigation than the carbon tax and thereby undermining the efficacy of the carbon offset scheme.

13.5 Serious consideration will need to be given to expanding the pool of eligible projects in order to increase supply, particularly in the first phase of the carbon tax. At the very least, this would

mean reducing the extent of ineligible projects such as those receiving government incentives, but may also necessitate the extension of allowable projects to those outside South Africa.

13.6 We note that the Davis Tax Committee has also raised concerns with the likely availability of offsets.

13.7 It is noted that the offsets are to be prescribed by the Minister. Firstly, the section does not specify the manner in which the offsets are to be prescribed. Secondly, it is questioned whether the Minister of Finance is the appropriate person to prescribe the offsets. It is suggested that this should be the Minister of Environmental Affairs.

14. Limitation of allowances

14.1 This section appears superfluous given that it is not possible for the sum of the allowances to exceed the amount stipulated in Schedule 2.

14.2 Section 14 refers to a limitation of 95% as referred to in Schedule 2. However Schedule 2 in some cases contains a limitation of 90% or 100%. The legislation is therefore ambiguous in this regard.

14.3 Notwithstanding the above, we repeat the view that there should be no maximum tax-free allowance given the environmental objective of the tax.

15. Administration

15.1 We don't believe that the Customs and Excise Act is the appropriate legislation under which to administer the carbon tax as it is not designed to deal with a tax of this nature. It is designed to deal with easily measurable goods that can be easily identified. The result is that this will lead to significant uncertainties in the application of the Customs and Excise Act in the context of the carbon tax.

15.2 It would be preferable for a separate Carbon Tax Administration Act to be promulgated to address administrative issues specific to this tax and for the tax to be administered in terms of the Tax Administration Act insofar as general matters are concerned, as is the case for other taxes such as the Mineral Royalties.

16. Tax period

16.1 No comments.

17. Payment of tax

17.1 It is proposed that accounts and payments of the tax must be submitted six-monthly.

17.2 This is problematic for a number of reasons. Firstly, it is not aligned with the Greenhouse Gas Emissions Reporting Regulations which require reporting for the calendar year to be done by 31 March of the following year. It would therefore impose a further burden on companies.

17.3 Secondly, it is not possible to measure certain of the allowances (e.g. the performance allowance) over this shorter period and it would not be possible to determine emissions for the 6 months, calculate the tax liability and pay it all on the last day of the 6 month period.

17.4 It is suggested that a 6 monthly provisional tax payment system should be introduced for the carbon tax, similar to that applying to Mining Royalties, and for a final tax return and payment to be made within 6 months of the end of the tax period.