Industry Task Team
on Climate Change

National Treasury
Republic of South Africa
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Pretoria
0001
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12 September 2022

Dear Sir/Madam

RE: INDUSTRY TASK TEAM ON CLIMATE CHANGE (ITTCC) SUBMISSION ON THE CARBON TAX SECTION OF THE TAXATION LAWS AMENDMENT BILL (TLAB)

The Industry Task Team on Climate Change (ITTCC) appreciates the opportunity to comment on the TLAB and associated impacts of the carbon tax. The ITTCC remains committed to addressing the challenge of climate change and supports the South African government and other stakeholders in transitioning the economy to one that is lower in carbon and overall resilient to the potential associated impacts of climate change. We support the development of policy that is coherent and consistent to ensure that the aforementioned transition is facilitated in a just manner while avoiding unintended consequences.

1. General position on the carbon tax rate proposals

The ITTCC supports the imperative to decarbonise the economy and commends government in the adoption of an ambitious Nationally Determined Contribution (NDC) as a guiding beacon to achieve this imperative. We acknowledge the role an effective carbon price has as part of an ecosystem of penalties and incentives to achieve decarbonisation and stimulate the growth of new low-carbon sectors. We are therefore supportive of a carefully implemented carbon price and trajectory with complementary incentives to achieve decarbonisation that does not come at the expense of industry in transition and the realisation of a just transition. In this regard, the membership of the ITTCC would like to highlight areas of concern as well as propose recommendation for improvement in the TLAB proposal.

Our main recommendations are summarised below with additional detail provided in subsequent sections. The ITTCC recommends:

- that annual increases to carbon tax rates are based on the current Consumer Price Index (CPI) +2% structure, to allow for the review and alignment of different policies (Section 2.1);
- retention of allowances with clear direction as to when these will be phased out (Section 2.2);
- a review and implementation of complimentary measures to assist industry with the just transition (section 2.3);
- a detailed study to evaluate the financial impacts of a carbon tax pass-through from the electricity generators and other industries that are not able to pass-through carbon tax (section 2.4);
- Carbon tax rates be put forward in ZAR currency (section 2.5); and
- Extension of the sequestration deduction to all sectors (section 2.6).

2. Detailed comments

2.1. Rate increase: Impact on competitiveness and overarching impact on the economy of South Africa *(Amendment 38, paragraphs (a) to (e) of subsection (1))*

The next few years are critical for the South African economy as industry attempts to recover from the devastating economic impacts of Covid-19. The proposed increases to the carbon tax rate to reach US\$20/tCO_2e in 2026 and US\$30/tCO_2e in 2030, introduces a highly punitive tax with little relief measures during this crucial time period of growth for our country.

Some of the ITTCC's member companies have indicated that, based on internal modelling, the proposed carbon tax uplift is too soon and too high for industry to absorb. Therefore, if implemented in its proposed form, the carbon tax could have the unintended consequence of premature shut-down of some member company's operations. Such a shock would severely impact the ability of the country to transition in a just and equitable manner.

The critical services provided by this industry base would likely be replaced by imports, negatively impacting the country's balance of payments and allowing those import country's economies to benefit from this industrial growth. Furthermore, if these imports come from countries that do not have sufficiently ambitious climate change targets in place, this could lead to the unintended consequence of increasing global emissions.

The ITTCC also submits that a single national carbon price applied indiscriminately to all sectors may not be effective at incentivising the required behaviour change needed to meet South Africa's NDC. A carbon price provides the requisite signal to switch to a lower carbon process or product or substitute for a different product (or import the same product). Different sectors will have different technology switching prices. As the Report of the High-Level Commission on Carbon Prices notes "The carbon price that will make CCS competitive is different from the one that will make concentrated solar competitive or the one that will accelerate the move toward low carbon transportation modes." The dynamics of switching and substitution need to be understood in each sector, which may result in different carbon prices for different sectors to achieve the intended outcome of decarbonisation.

The ITTCC proposes that the carbon tax rates should be significantly lower or that the annual increase structure of the Consumer Price Index (CPI) rate plus 2% are maintained during the first phase. This will facilitate above inflation increases to the rates while allowing for sufficient opportunities for the review of current national strategies such as the Integrated Resource Plan (IRP) and alignment with the country's just transition pathways. The ITTCC further propose that a study be conducted to determine the feasibility and implications of a sector-based carbon tax design and how the current rates would impact such dynamics.

2.2. Lack of clarity on the changes to the allowances

The ITTCC is concerned that the draft TLAB does not refer to the retention of the current allowances that are included within the carbon tax design. These allowances have been a fundamental element to protect industry against rapid or detrimental financial impacts, while industry develops the strategies that are required for a just transition.

The Climate Change Bill proposes a change to the allowances; this includes the discontinuation of carbon budget allowance that can be claimed for the voluntary participation to the carbon budget programme. Creating a situation where the carbon tax rate will indirectly increase more drastically than the current proposed rates. Further to the removal of the carbon budget allowance, it remains unclear how a proposed penalty rate will be applied to the carbon tax of taxpayers that exceeds their allocated carbon budget.

The uncertainty created is thus two-fold i.e. the specific rate that will be applied, as well as the applicability of the allowances on the tax liability. This creates a variable reference point when evaluating or establishing the potential impact of new or amended policy.

The ITTCC requests that the retention of the current allowances should be specifically mentioned to allow a clear reference point for the developing policy.

2.3. Lack of alternative incentives to support decarbonisation projects

Carbon pricing remains a key mechanism to enable a just transition strategy and the reduction of greenhouse gas (GHG) emissions by triggering a behavioural change. However, there is currently a lack of incentives available to industry that will promote, enable, and assist with an accelerated transition towards decarbonisation.

The ITTCC appreciates and support the extension of the 12L Energy Efficiency Incentive (Amendment 9) to the end of 2025. Although this provides a clear incentive for industries to improve energy efficiency, the viability of the incentive could start to diminish if the rate is not adjusted to ensure that it remains attractive. Furthermore, the extended end date for the energy efficiency incentive provides an indication that it would ultimately fall away.

Aside from the 12L incentive however there is limited support to assist industry with decarbonisation and a just transition, creating the undesirable situation where industry actions are only punished while positive progress is not promoted.

Carbon pricing should be enacted in conjunction with other complementary measures to realise a transition and sustainable industry environment. These measures can include the imposing of standards or regulations on material efficiency and the use of low carbon products, improving the investment landscape with specific de-risking instruments such as guarantees, revenue recycling of the carbon tax to provide incentives for low carbon manufacturing and support of Research and Development pilot projects on low-carbon technologies through innovation policies and potentially subsidies.

The ITTCC therefore recommends that the section 12L energy efficiency incentive should be reviewed to ensure that it remains an attractive option for industry. Further recommendations include the expansion of measures that support industry with decarbonisation transition. This could be realised by ring-fencing funds generated from carbon pricing and focussing it towards the promotion of a just transition.

2.4. Implications for inclusion of the electricity sector *(Amendment 39, paragraph (c) of subsection (1))*

The ITTCC appreciates and supports the extension for electricity generators to continue including the environmental levy as part of their carbon tax determinations. However, this poses a significant financial risk from 1 January 2026 for energy intensive industries as well as the general public.

The ITTCC membership represent intensive energy users within various industry sectors, with most being reliant on electricity. The proposed end date causes a concern that the electricity prices could significantly increase and cause financial strain on electricity consumers. This will impact the members of the ITTCC as well as the general public if these costs are passed through to the consumers.

It has been noted in Eskom's Integrated Annual Report, 2021 that their carbon tax exposure will add an additional 4-5% to the year-on-year price increases since it will be passed through in terms of regulatory rules. This additional increases on top of the current requested and approved tariff increases will place strain on all citizens in South Africa. The pass-through of carbon tax to the consumers essentially leads to an effective double taxation for industry that is liable for their own carbon tax as well as that of the electricity supplier. Modelling carried out by one of the ITTCC member companies operating in the mining sector indicated that the carbon tax that would be passed through could be 30 times greater than their own direct carbon tax liability.

Creating additional financial strain since many industries are not able to pass the carbon tax through or are potentially limited to a low pass-through to their customers due to customer affordability (e.g. for electricity generators), regulations (e.g. in the liquid fuels sector) or external price determination (e.g. in the mining and mineral sectors).

The ITTCC therefore proposes that an in-depth study should be conducted to determine the impact and consequences of a carbon tax pass-through from the electricity sector specifically. Such a study should also analyse the impact on different industries and sectors that are not able to pass-through carbon tax to customers.

2.5. Representation of tax in USD *(Amendment 38, paragraphs (a) to (e) of subsection (1))*

The ITTCC is concerned that the reflection of the carbon tax rate in USD creates an additional layer of uncertainty for future planning. Currency correlations are notoriously unpredictable, with the USD/ZAR pairing considered as 'exotic' and also one of the most volatile currency pairings globally. Factors that will impact the value of the Rand relative to the USA include interest rate differentials, geopolitics, the perceived economic strength of each currency's issuing country, and the value of these nations' imports and exports. As the Covid-19 pandemic and recent Russia/Ukraine war bears testament, these factors are extremely volatile, contributing to the significant uncertainty in currency forecasting models. Furthermore, it introduces additional process complexity through the need to adopt hedging strategies to counteract the effects of a dramatic change in currency's value

Therefore, for industry to bare an annual tax liability to at least 2030 in USD creates a large amount of uncertainty and associate risk that will impact project planning and investments in mitigation and low-carbon growth projects.

We are therefore of the opinion that legislating the carbon tax rate in a foreign currency is counter to National Treasury's ambition of providing a carbon price that predictably and credibly increases over time and request that the carbon tax rate be put forward in ZAR currency.

2.6. Sequestration (Amendment 39, paragraph (d) of subsection (1))

The ITTCC supports the inclusion of the deduction of sequestration activities in the carbon tax formula, but requests that this be expanded to all sectors (not just the paper and pulp industry as is currently indicated).

We propose the extension of this to all companies that have land assets within their control to increase biodiversity and in doing so improve sequestration potential and claim the GHG removal benefits against their carbon tax.

3. Conclusion

An effective and well implemented carbon price is a key mechanism towards realising South Africa's commitments towards combatting climate change. The ITTCC reviewed the draft TLAB and aimed to highlight concerns that could have an impact on the different industries represented by the membership. Six main recommendations are made to clarify uncertainties, propose changes in wording or the approach being taken, and establishment of additional studies to inform decisions.

The ITTCC would appreciate the opportunity to further clarify our enclosed submission via a bilateral engagement or wider consultation. We will make our membership available at the convenience of National Treasury should any further clarification be required.

Yours sincerely,
Dr Storm Potts
ITTCC Chairman
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