



ENVIRONMENTAL ALERT

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THE PARIS AGREEMENT AND DRAFT REGULATIONS ON CARBON OFFSETS. RELIEF FROM PLANNED CARBON TAXES AND INCREASED CARBON TRADING OPPORTUNITIES?

Treasury published the Draft Regulations on Carbon Offsets (Draft Regulations) on 20 June 2016 under the Carbon Tax Bill for comment (Carbon Bill). Carbon taxes are anticipated to come into operation by early 2017 and will have significant financial implications for companies that will be subject to carbon taxes. The Proposed Carbon Offsets will give effect to one of a number of tax allowances in the Carbon Tax Bill, to lower these companies' tax liability and establish a carbon-offset scheme for South Africa (Scheme).

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Overview of the Draft Regulations

Using the proposed Scheme, entities will be able to reduce their taxable emissions by 5 to 10 % of their total greenhouse gas (GHG) emissions, depending on the sector the entity falls within, by investing in carbon reduction offset projects (Offset Projects). The Scheme proposes to allow entities to reduce their carbon tax liability by investing in Offset Projects of other entities that reduce, avoid, or sequester GHG emissions, at a lesser cost than having to invest in mitigation options in their own operations.

The Proposed Carbon Offsets in the initial stage will apply to Offset Projects approved by existing international carbon offset standards and structures, being the:

- Clean Development Mechanism (CDM) contained in the Kyoto Protocol, an agreement under the United Nations Framework Convention on Climate Change (UNFCCC). The Kyoto Protocol is the predecessor to the Paris Agreement, which is also an agreement under the UNFCCC, and was recently opened for signature on 22 April 2016). CDMs may be used until 2020 in terms of the Kyoto Protocol.
 - Verified Carbon Standards; and
 - Gold Standard
- (“Existing Offset Schemes”).

Offset Projects will also have to meet South African specific requirements under the proposed Scheme, in particular they must:

- a) be located in South Africa;
- b) not be subject to carbon tax under the Carbon Bill; and
- c) satisfy local eligibility criteria, including contributing to meeting South Africa's development priorities.

The proposed Scheme will therefore primarily centre on sectors and technologies not directly subject to carbon tax, for example projects in energy efficiency (excluding projects claiming an energy efficiency tax incentive), waste, public transport and transport energy efficiency, agriculture and forestry. It is envisaged that the list could expand as the proposed Scheme develops.

The proposed Scheme excludes projects and technologies benefitting from other government incentives. This includes all renewable energy projects under the Department of Energy's (DoE) Renewable Energy Independent Power Producer Programme and deductions allowed for energy efficiency savings under the Income Tax Act. The rationale for excluding renewable energy projects is that they receive benefits under Power Purchase Agreements and their qualification as an Offset Project would

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The Scheme will apply to all offsets generated after 1 January 2017 (which is the intended date for implementation of the Scheme).



amount to double benefits. Entities in the renewable energy sector have strongly opposed the exclusion and Legislature has indicated that it will reconsider it in relation to small and medium sized renewable energy projects.

The Designated National Authority within the DoE (initially tasked with administering CDM projects under the UNFCCC) will administer the proposed Scheme and manage registering Offset Projects on a South African registry. This will include assessing Projects to ensure they comply with local eligibility criteria prior to implementation or transfer of certified emission reduction (CERs) to the South African registry, registering projects and issuing offset certificates.

The Scheme will apply to all offsets generated after 1 January 2017 (which is the intended date for implementation of the Scheme). CERs generated by Existing Offset Schemes prior to 1 January 2017 can be used to offset carbon tax liability, if the CERs are transferred from an international registry to the South African registry within twelve months of implementation of carbon tax. For projects that are currently under development and will be registered under the Existing Offset Schemes on international registries before the commencement of carbon tax, the CERs must be transferred from an international registry to the South African registry within six months of the CERs being issued.

CERs generated by a company that will be liable for carbon taxes will need to be submitted to the South African Revenue

Services for the company to qualify for a reduction in carbon taxes.

The future market for CER Trading

Treasury has stated that it has not yet decided whether SA's CERs should be traded on international platforms or whether it would be more appropriate to develop a local trading platform. If trading on international platforms is pursued, the structure of the international market for CERs under the Paris Agreement is presently uncertain.

The Kyoto Protocol had a "cap and trade scheme" and under the CDM developed countries with emission targets could invest in Offset Projects in developing nations. Financiers of CDMs could acquire CERs and sell them to signatory countries with emission targets, which were tradable on the European Emissions Trading Scheme (EU- ETS).

The Paris Agreement however does not include a general cap on developed countries GHG emission levels and a different approach will be followed. Strictly speaking, signatory Parties are no longer legally bound at an international level to achieve their targets. Each Party is only legally bound to pursue domestic mitigation measures and submit an Intended Nationally Determined Contribution (INDC) to "serve as an outline of a country's ambitions for responding to climate change in the context of their national priorities, circumstances and capabilities". The Paris Agreement provides for the implementation of a new mitigation crediting mechanism (Paris Mitigation

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Some commentators have forecasted that there will be a significant decline in international CER trading, as there is no longer a set cap on all developed countries and not all signatory Parties have included caps on GHG emission levels in their INDCs.



Crediting Mechanism) to replace CDMs. International CER trading will therefore still be possible under the Paris Agreement. However, not all countries have included in their INDCs market measures, such a trading of CERs.

Some commentators have forecasted that there will be a significant decline in international CER trading, as there is no longer a set cap on all developed countries and not all signatory Parties have included caps on GHG emission levels in their INDCs. However, as at May 2016, several signatory Parties stated in their INDCs that the level of commitment they are putting forward in their INDCs is conditional upon having access to international carbon markets under the Paris Agreement. Overall, of the 119 INDCs received at May 2016, 91 INDCs mention the use of carbon markets. The potential for an international carbon market is improved by the fact that under the Kyoto Protocol only developing countries could host CDMs. In terms of the Paris Agreement, all signatory Parties, both developing and developed, can now host Offset Projects under the Paris Mitigation Crediting Mechanism. Developed countries that had caps under the Kyoto Protocol accounted for no more than 14 percent of global emissions (and zero percent of global emissions growth). INDCs submitted for the Paris Agreement now cover 186 countries, representing 96 percent of global emissions.

The extent of the international carbon market is unclear however, given the number of countries that have now included in their INDCs market

mechanisms and the fact that many of these countries are responsible for a high percentage of global emissions, it appears there will still be an international market for CERs. Allowing South African CERs to be traded on international platforms would thus seem viable.

A domestic trading platform would however also be viable, as there will be a demand for CERs by companies subject to carbon taxes wanting to reduce their liability.

Will South Africa benefit from Offset Projects implemented by international entities?

The CDM and future international Offset Projects provide South African companies with the advantage of receiving potential economic and environmental benefits through the implementation of "clean facilities" at no costs to the South African company.

However, under the international CDM market, developed countries were slow in taking advantage of implementing CDMs in South Africa, despite its ranking as one of the highest per capita carbon emitters in the world and thus being an attractive host country for implementing CDM Projects. Only 12 CDM projects were issued with CERs in South Africa as at January 2016, in comparison to Asia, which has approximately 600 registered CDMs. It remains to be seen whether this will change under the Paris Agreement and if there will be an increased interest in companies developing Offset Projects in South Africa.

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Written comments must be submitted to Treasury before 29 July 2016.



Obstacles for immediate benefits for tax relief and from CER trading

The immediate potential for Offset Projects to provide tax relief by the time the Carbon Bill is anticipated to be enacted into law in 2017 and to provide the opportunity for either domestic or international trading is however limited by the following factors:

- the Scheme provides in the initial stages that Offset Projects must still be verified according to the very costly, technical and lengthy processes under the Existing Offset Schemes;
- for CERS generated through Existing Offset Schemes to be used in the initial stages to offset a carbon tax liability under the Carbon Bill, they will:
 - need to be issued in terms of an international standard registry and then cancelled from such registry and transferred to the South African registry;
 - have to meet the local eligibility criteria before being registered on the South African registry and being capable of being surrendered to Treasury to reduce carbon liability;
- creating a carbon registry in South African will require the DoE to implement significant institutional capacity and data management systems. It appears unlikely that this will be in place by early 2017;
- the procedure involved in developing and validating offset projects through independent specialists and registering them on international registries under Existing Offset Schemes and methodologies is costly and time consuming. The Scheme proposes that a South African specific methodology is developed. This may streamline the lengthy procedure and reduce the costs of Offset Projects. The methodology will however still need to be developed under the onerous requirements of the Paris Agreement and it is unlikely that the procedure and costs will be reduced;
- given the costs of implementing an Offset Project, there may not be a significant reduction in carbon tax liability. This is particularly for companies whose carbon tax liabilities will not be relatively high;
- it must still be assessed whether South African CERs can best be traded on existing international trading platforms or if developing a South African trading platform would be more appropriate; and
- new Offset Projects will take several years before they are generating sufficient carbon offset volumes to meet demand, thus making the allowance mechanism initially less effective.

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