Subject: IETA Response to South Africa's Carbon Offset Paper for Public Comment

June 30th, 2014

Mr. Peter Janoska
Senior Economist
Environmental & Fuel Taxes
National Treasury of South Africa

Dear Peter Janoska,

South Africa's Carbon Tax - Carbon Offset Scheme: Input from the International Emissions Trading Association

The International Emissions Trading Association (IETA) welcomes the opportunity to comment on the proposal by the National Treasury to establish a low-carbon economy by introducing a carbon tax complemented by a carbon offset scheme to reduce South Africa's emissions and address the challenges of climate change.

Introduction

IETA is a non-profit business organization created in June 1999 to develop a functional international framework for emissions trading that result in real and verifiable greenhouse gas emission reductions, while balancing economic efficiency with environmental integrity and social equity. Its membership includes more than 145 international companies from OECD and non-OECD countries, across the carbon trading cycle.

Our member companies include some of the world's, largest industrial and financial corporations—including global leaders in oil, electricity, cement, aluminum, chemicals, paper, and banking; as well as leading firms in the data verification and certification, brokering and trading, offset project development, legal, and consulting industries. Several of our members hail from South African industry, and are active in providing inputs to climate change policy of South Africa.

IETA is dedicated to the objectives of the United Nations Framework Convention on Climate Change and ultimately climate protection; the establishment of effective market-based trading systems for greenhouse gas emissions by businesses that are demonstrably fair, open, efficient, accountable and consistent across national boundaries; and maintaining societal equity and environmental integrity while establishing these systems.

IETA works for the development of an active, global greenhouse gas market, consistent across national boundaries and involving all flexibility mechanisms: the Clean Development Mechanism, Joint Implementation and emissions trading; the creation of systems and instruments that will ensure effective business participation.

In order to meet these goals, our objective with this letter is to promote views of experienced market participants on the design of the carbon-offset mechanism as a complementary solution to Climate Change.

Comments on South Africa's proposed carbon policy package

IETA provided its initial inputs to South Africa's rules on a carbon tax through a letter addressed to Dr. Memory Machingambi on August 2, 2013.

More specifically, IETA stated its position on **"A carbon tax versus an emissions trading system" (Page 34, Points 125-129)**. IETA expressed its viewpoint that an Emissions Trading Scheme provides a number of benefits including greater flexibility for the company or installation, reducing the concerns of business without compromising the overall objective of the policy. The political stigma of "another tax" - which is not always simpler than having a carbon price - also significantly stacks the argument in favor of a trading approach. We are encouraged that South Africa will move towards an emissions trading scheme in due course and again caution against the use of both a carbon tax and an ETS simultaneously, which can confuse businesses through multiple and overlapping price signals, and also raise the cost of compliance without necessarily impacting overall emissions. IETA welcomes South Africa's commitment to examine a transition from a carbon tax towards an emissions trading scheme at the earliest possibility.

Regarding the National Treasury's public consultation on the carbon offset mechanism:

A) General design features of the carbon-offset scheme as outlined in this paper.

We firstly commend the National Treasury's overall approach to the design and proposed operation of the offset scheme. It is important to establish rules and procedures for the offset market early so that market participants can go about developing projects to meet expected demand.

B) Recognition of third-party carbon offset programs.

We are supportive of the National Treasury's proposed approach of utilizing internationally-recognized carbon offset programs (i.e. CDM, Gold Standard Verified

Carbon Standard) as a means for providing clear and transparent rules to market participants wanting to develop projects and issue credits that will be recognized under the tax system. The use of established third-party programs is an excellent means of using existing requirements and infrastructure to facilitate the development of a robust offset market that can ensure a sufficient amount of offsets are available to the market to meet total potential industry demand as early as possible. Building a robust and sustainable offset pipeline to meet ongoing industry demand is critical. It is important to note however that ensuring that the necessary pipeline of supply is available will require business investment and often lengthy lead times.

To ensure that the Government of South Africa captures the full benefits of recognizing these third-party offset programs, it is critical that the rules for the offset mechanism be established early to provide necessary business certainty. In doing so, we recommend that it clearly indicates it is recognizing the full suite of requirements and procedures within the programs, including the development of new methodologies, ensuring proper accreditation and training of auditors, and the use of registries to track offset credits in a transparent manner. This will provide important clarity to market participants wanting to develop offset projects, indicating a clear pathway to develop both methodologies and projects.

C) Carbon-offset potential under the proposed carbon tax in South Africa.

We also encourage South Africa to consider that offset mechanisms are designed to direct investment wherever in the world can significantly reduce GHG emissions most cost effectively. The international carbon market, which transcends national boundaries, is a crucial tool to achieve global GHG reductions. Whilst we understand South Africa's intentions to develop and support localized projects, it is worth considering that a local carbon market industry may not be sustained without significant demand created in South Africa's tax policy at the right price to invest in projects.

We would like to caution, in particular, the optimism presented in the paper with respect to current and future potential CDM supply. According to the UNEP Risoe data as of June 2014, South Africa's expected annual average CERs from total registered CDM projects, adjusted to exclude those projects listed on the proposed negative list (based on our best estimation), is forecast to be just ~3.7mt generated. This forecast is based on PPD documents estimates. In reality, when the issuance is discounted to account for the risk-adjusted success rate of issuance, we predict, this number could fall to ~2.6mt per year.

We therefore reiterate that it is a positive step for South Africa to utilize pre-existing internationally recognized offset mechanisms and methodologies in the offset programme that will allow for international offset sourcing, should there is be supply shortage or development prove to be unfeasible at least cost.

D) Eligibility criteria of carbon-offset projects under the carbon tax &
E) Interim arrangements to operationalize issuance of carbon-offset credits by using existing international carbon-offset standards.

In general we are supportive of the standardized 'eligibility list' approach proposed by the South African government to determine offsets eligible for compliance.

However to ensure simplicity and remove ambiguity, we urge the Government to consider implementing only a 'negative' list. In having both a positive and negative list, complications and ambiguity can exist for projects sitting between both categories, with their eligibility being unclear.

Such ambiguity is highlighted in the fact that as currently proposed, it is unclear whether this list reflects a broad set of activities that may be eligible or if the GSA has envisioned the development of more detailed positive lists for these project types or areas.

Having only a negative list will remove such ambiguity, ensure environmental integrity across the mechanism and significantly reduce political pressure and the potential for perceived preferential treatment and inconsistencies in adding project types to the positive list. Such an approach is modelled on that adopted by the EU ETS and NZ ETS where, similar to the South African mechanism, the development and infrastructure for their offsetting mechanism was outsourced through the Kyoto Protocol's Clean Development Mechanism (CDM) and Joint Implementation (JI). Under both schemes the use of credits is subject to a simple negative list banning certain types of projects (large hydro, industrial gas, nuclear etc.) and has proved successful.

For further reference on the importance of developing standardized approaches we would like to draw your attention to an article that Verified Carbon Standard (VCS) prepared for IETA's 2012 Greenhouse Gas Market report[1]. The article well clarifies the importance of setting out an overarching framework of common requirements and procedures for the development of standardized approaches and can be found on page 61 of the aforementioned report.

In considering the existing proposed negative list, we support the Government's commitment to avoid double counting but we request that the Government better clarify the boundary conditions for energy efficiency and fuel switching projects that are excluded based on the activities that are owned or controlled by companies covered by the carbon tax. There is no doubt that facilities covered by the carbon tax should be excluded from generating offsets in order to avoid double counting, however as currently reads this requirement would discourage direct investment in additional offset projects, e.g. energy efficiency/fuel switching, by compliance entities. For instance, as currently reads, a fuel switching project implemented outside of a refinery and developed by a refiner would not

[1] http://www.ieta.org/assets/Reports/ieta%20greenhouse%20gas%20market%202012.pdf

be eligible. We do not believe based on paragraph 51 that this is the government's intention.

Regarding eligibility, our expert body, the International Carbon Reduction and Offset Alliance, does not recognize transaction of credits verified to the Climate, Community and Biodiversity Standard (CCBS) in isolation. This is deemed as an additional standard for the qualification of social and sustainability approaches and is generally used for a "tagging" with VCS credits for carbon credit transactions.

We also advocate for addition of AFOLU projects developed under clear standards with defined monitoring and verification protocols to ensure there is effective supply of credits and delivery of sustainable land management to sustain a localized market in South Africa. Indeed, the offset programs recognized in the paper all have the ability to develop methodologies and projects in the Agriculture, Forestry and Other Land Use (AFOLU) sector, albeit to varying degrees, reinforcing the idea that recognition of all of the elements of these offset programs will be sufficient to enable the development of projects in this sector. It would help expedite development of this asset class if clearer guidelines on the desired sustainability benefits were provided.

Regarding section 3.4, which describes how existing projects may transfer into the South African offset system, we noticed a lack of clarity on whether future projects developed under recognized programs would be eligible for recognition by the GVA. We think it is important to ensure full recognition into the future, or at least until a domestic offset program is able to meet the demand for credits, to entire GHG programs, and not just to existing projects developed under those programs. The lack of an explicit longer-term recognition hinders the efforts to meet the demand from covered entities.

From a non-discriminatory perspective, we also believe that Renewable Energy Independent Power Producer Procurement (REIPPP) projects should be included in the list of eligible offsets, since they are procured under a competitive tender and they do not receive benefits from the Government. REIPPP plants provide a number of benefits to the Country in terms of power supply, financial savings and sustainable development. For example, REIPPP projects that qualify to produce CERs would already meet UNFCCC requirements for monitoring, reporting and verification procedures as well as "additionality", providing certainty of the achieved emission reductions.

F) General institutional arrangements to implement a domestic carbon-offset scheme.

Any offset programme should ensure it has an independent registry, which allows the carbon credits generated to be tracked, using their serial numbers, from origination to retirement.

We support South Africa's intent to ultimately establish a new South African Registry. Providing such infrastructure which will facilitate the issuance of a single South African eligible offset type which will reduce administrative complexity for compliance entities by requiring them to have just one registry account as opposed to the potential to hold 3 or more, and will promote a single price signal for South African offsets that will better aid the establishment of a deep and liquid market.

Such an approach may indeed prove too demanding, and as such adopting established and credible international carbon-offset registries as an interim measure can be justified in order to avoid costly set up processes. In future international policy scenarios such an approach may also support potential international linkages in the future. Such registries already have expertise, experience, "Know Your Customer" protections and infrastructure that South Africa can adopt to set up systems quickly and effectively.

However, in adopting multiple international carbon-offset registries, the Government should clarify how it will address the resulting complexity in dealing with multiple registry requirements.

Under the CDM this will be particularly onerous requiring entities wishing to transact in offsets will be required to receive a Letter of Approval (LOA) for their projects as well as opening a registry account in an Annex I country under the Kyoto Protocol (e.g. EU, New Zealand). For this reason, in absence of being able to establish a domestic registry, adopting multiple independent standards is beneficial as other registry opening procedures are likely to be less onerous and provide a shorter set time and as such will provide greater flexibility to compliance entities.

With respect to Box 2: Registration and enforcement system features, we support the key features identified for the registry design and enforcement systems and would like to highlight the following requirements in addition:

- Contractual or legal standards that clearly identify the original "owner" of the emission reductions as well as further owners of this offset.
- Contractual or legal standards that identify who bears the risk in case of project failure or partial project failure (e.g. who is responsible for replacing the offsets that should have been produced by the failed project).

G) The role, functions, capacity and location of the administrating entity of the scheme.

We are encouraged by South African policy maker's commitments to turn to the practices and readily available infrastructure that are already established in global markets.

In utilizing independent offset standards, it will be important for the government to adopt oversight procedures to ensure that standards function in accordance with defined quality criteria.

Moreover, we think that there is a need for regulatory oversight from the GSA in order to couple the recognition of international standards with the strengthening of local auditing capacity. This is crucial to ensure that validation and verification of projects are carried out by local auditors in full compliance with the rules of the recognized programs. To this end it is important for the GSA to commit itself to the development of a formalized accreditation program that would enable South African companies to participate in the auditing that will inevitably need to happen.

H) Other issues that might be of relevance.

Co-benefits:

Another very important consideration is the co-benefit delivery of offset projects. There is increasing evidence on the type of projects that deliver different co-benefits and recommend review and consideration of incentivizing different project types for additional co-benefit outcomes to support South Africa. A recent publication by Gold Standard Foundation reports on co-benefit delivery per project type.[2] There will be other academic reports released 2014 to support further decision-making and thought leadership in this topic area.

We outline further considerations below regarding South Africa's offset mechanism.

Point 49 (South Africa to be the only allowed geographical location of projects):

While domestic offsets can offer great socio-economic and environmental advantages whilst supporting areas of the economy to significantly reduce GHG emissions, this relies on an appropriate domestic level of supply and demand for carbon offsets. Restricting carbon offsets domestically might create a 'price bubble' which would overprice offsets and make it uneconomical for installations under the carbon tax to invest in carbon offset programs. Hence, IETA encourages South Africa to consider that the offset design mechanism also includes a percentage provision for wider sourcing of offsets beyond South African borders, where direct investment could significantly reduce GHG emissions at least cost most effectively. The utilization of international standards will allow for this approach. Considerations on the use of offsets beyond South African borders are also related to our concerns on the limited supply potential within South Africa, as already articulated under point C.

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[2] http://www.goldstandard.org/report-the-real-value-of-robust-climate-action

Conclusion

Thank you very much for taking the time to review IETA's and recommendations with respect to these issues. Please do not hesitate to contact us should you have comments or questions on the views expressed above.

Sincerely,

Dirk Forrister

President and CEO, IETA