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Carbon Tax – a surprise extension to Phase 1

Environmental protection and climate change are at the forefront of many discussions globally, and the 2022 Budget Speech is no exception. As the first African country to introduce a carbon tax, the implementation thereof was designed to ensure electricity tariff neutrality (via the environmental levy offset to electricity tariffs), and incorporates a number of tax-free allowances, to reduce the initial impact on businesses, whilst encouraging the transition to a low carbon economy and meeting international climate action commitments.

The Carbon Tax Act No. 15 of 2019 (**the Act**) was assented to by the President on 23 May 2019 and became effective from 1 June 2019. While the Act sets out how the tax will be managed for Phase 1 (initially due to end on 31 December 2022), it is silent on the specifics of Phase 2, which was intended to run from 1 January 2023 to 31 December 2030, leaving many companies with unanswered questions regarding the future financial impact of the tax. The announcement of the extension of the first phase of the carbon tax by three years to 31 December 2025, therefore, provides some short-term certainty.

Carbon tax rate increase

The Act specifies that the initial rate of carbon tax of R120 per tonne will be increased by consumer price inflation ("CPI") +2% per year until 31 December 2022, whereafter the rate of tax will be increased only by CPI. It is, therefore, no surprise that the carbon tax rate will increase from R134 per tonne of carbon dioxide equivalent (**CO_2e**) to R144 per tonne of CO_2e for the 2022 calendar year.

Impact of the first phase extension

While the current support measures, such as significant tax-free allowances and revenue-recycling measures will remain in place until December 2025, the following changes are proposed:

— The section 12L energy efficiency savings tax incentive, which encourages businesses to contribute to South Africa's environmental goals through reducing energy costs, has been extended from 1 January 2023 to 31 December 2025.

— The electricity price neutrality commitment will remain in place until 31 December 2025 (the electricity-related deduction will be limited to the carbon tax liability of fuel combustion emissions of electricity generators, and will not be offset against the total carbon tax liability).

— The maximum trade exposure allowance available to entities that are trade exposed and sensitive to international competitiveness has been increased from 30% to 50% from 1 January 2023. (Updated sectors and allowances will be published for public consultation.)

Carbon budget allowance

In 2021, the Department of Forestry, Fisheries and the Environment (**DFFE**) proposed to regulate GHG emissions under the voluntary carbon budgeting system by imposing caps on companies for a five-year period and phase out the carbon budget allowance of 5%.

This proposal has now been realised, with the mandatory carbon budgeting system coming into effect on 1 January 2023, with the 5% carbon budget allowance falling away at the same time. To address concerns in respect of double penalties for companies under the carbon tax and mandatory carbon budgets, it is proposed that a higher carbon tax rate of R640 per tonne of carbon dioxide equivalent will apply to greenhouse gas emissions exceeding the mandatory carbon budget. These amendments will be legislated once the Climate Change Bill is enacted.

It should be noted that the following provision is contained within the Climate Change Bill:

"In respect of the carbon budgets issued… the Minister [Cabinet Minister responsible for environmental affairs] must follow a fair procedure prior to the issue of the carbon budget including consultation with the person to whom a carbon budget is allocated."

Clarification of the electricity generation levy and renewables deduction

In Phase 1 of the carbon tax, taxpayers generating electricity may claim a tax deduction for electricity generation levy payments and additional renewable electricity purchases. It is proposed that changes be made to the Act to clarify that taxpayers would qualify for a deduction if they generate electricity from fossil fuel and conduct fuel combustion activities under the Intergovernmental Panel on Climate Change (**IPCC**) code 1A1, Energy Industries and IPCC code 1A2, Manufacturing Industries and Construction.

Limitation to the carbon sequestration deduction

To address concerns regarding the permanence of sequestered emissions in harvested wood products, amendments were proposed in the draft Taxation Laws Amendment Bill (**the Bill**) in 2021 to limit the carbon sequestration deduction to forestry plantations. After reviewing public comments, the bill was amended to expand the scope of the carbon sequestration deduction to include emissions sequestered in harvested wood products for the paper and pulp activities under IPCC code 1A2D.

Amidst concerns regarding the certification and verification of sequestered emissions where forestry management and harvested wood products are owned by third parties and to curb potential abuse , it is further proposed that a limitation on the deduction for forestry management and harvested wood product sequestration activities be introduced to only those activities within the operational control of the taxpayer conducting paper and pulp activities.

In consultation with the DFFE, the National Treasury will gazette rules for the sequestration deduction for public comment. Once gazetted, these amendments will take effect retrospectively from 1 January 2022.

Carbon tax price path

The World Bank's High Level Commission on Carbon Prices estimated that, in order to drive transformational change, carbon tax should be US$40-80 per tonne of CO_2e by 2020, and between US$50-100 per CO2e tonne by 2030. Most prices internationally are below this range, and at the current levy of R144/ CO2e tonne (notwithstanding the various allowances which are in place), South Africa's carbon tax, as it stands, is significantly below this level.

With global carbon pricing on the rise, and the recent introduction of the European Union (**EU**) Carbon Border Adjustment Mechanism (**CBAM**), which aims to regulate GHG emissions embedded in certain goods upon their importation into the EU customs territory (by essentially charging a carbon price on imports which come from a country that has a lower carbon price than the importing country), it is imperative that South Africa transitions to a climate-resilient economy. Aside from the obvious climate goals, South Africa also needs to ensure that it maintains its competitiveness on a global scale.

To protect exports of carbon intensive goods such as iron and steel from additional carbon pricing, Government proposes to progressively increase the carbon tax price every year by at least US$1 to reach US$20 per tonne of CO_2e by 2026. Thereafter, Government intends to increase the carbon price more rapidly every year, to at least US$30 by 2030, accelerating to higher levels by 2040, and up to US$120 beyond 2050.

The basic tax-free allowances will also be gradually reduced to strengthen the price signals under the carbon tax from 1 January 2026 to 31 December 2030, and to encourage investments in carbon offset projects, Government intends to increase the carbon offset allowance by 5% from 1 January 2026.

As carbon prices spread globally and more countries introduce initiatives to decrease their emissions, we should see growth in the investment in, and the uptake of, more energy efficient and low carbon technologies. Merely passing the price of the carbon tax down the supply chain is an outcome that should be avoided by corporates, as this poses increased vulnerability to trade and investment. In order to remain competitive, relevant, and avoid potentially greater increases in the cost of carbon tax in the future, industry should also already be identifying ways in which its carbon footprint can be reduced.

Contact us

For additional information, queries on the impact of carbon tax on your business, or further assistance, please contact a member of our Carbon Tax Team.

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