DRAFT TAXATION LAWS AMENDMENT BILL 2025

COMMENT BY MERIDIAN ECONOMICS

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1 INTRODUCTION

In August 2025 National Treasury released the Draft Taxation Laws Amendment Bill (TLAB) 2025 for public comment, which included, amongst others, amendments to the Carbon Tax of 2019. The TLAB implements the Phase Two design of the tax, as outlined in both the Phase Two design discussion document and the subsequent Budget Review 2025.

This comment, prepared by Meridian Economics, responds to the proposed design, focusing on its implications for the electricity sector. Meridian Economics is a specialised South African energy and climate economics consultancy and think tank. The comment builds on the December comment provided on the Phase Two design document, with analysis elaborated in a recently published Briefing Note: Exploring the impact of Phase Two of the carbon tax in a transforming power sector.

The comments are structured as follows:

- Section 2 explores the functioning and impact of the proposed Phase Two design for the electricity sector, both in the context of the current electricity system structure and looking ahead towards a reforming power sector.
- Section 3 considers the interactions between the tax and the ongoing power sector reform process.
- Section 4 presents two other considerations to be taken into account.
- Section 5 presents a set of conclusions and recommendations.

To aid clarity in the discussion, we create two terms with very specific meanings in the context of this document. They are defined below and their use is highlighted in bold throughout to draw attention to these definitions:

Calculated Carbon Tax (CCT): tCO_2e emissions multiplied by the carbon tax headline rate less all applicable allowances.

Environmental Levy Equivalent (ELE): A carbon tax amount equal to what a taxpayer would have paid had the Environmental Levy still been in force. This is the mechanism Treasury has used to ensure price neutrality in the Phase Two of the tax – the Environmental Levy is swapped out for a carbon tax up to the Environmental Levy level.

Treasury sets out three objectives for the carbon tax in the electricity sector: price neutrality, revenue neutrality, and behavioural change (mitigation). Carbon pricing theory suggests that it is not possible for all three to be perfectly met simultaneously. By implication, Treasury can only achieve a balance between them.

Treasury does not clarify what 'revenue neutrality' means in the context of the carbon tax, apart from a 2015 media statement stating that 'while the impact should be revenue neutral from a macroeconomic

perspective, it will not necessarily be neutral for individual large emitters ("companies with significant emissions")[1].

2 THE IMPACT OF THE PROPOSED PHASE TWO DESIGN

There are three primary points where mitigation could be achieved in the South African power sector in the context of a carbon tax, demonstrated graphically in Figure 1. The first is the tax payer, the company owning the emitting assets. Unless the company is able to fully recover the carbon tax that they have to pay in the selling price of their electricity, the company could be incentivised to reduce their overall emissions, by increasing emissions efficiency and switching to lower emissions activities.

The second is at the electricity system level. If a carbon tax were to materially impact the price at which individual emitting power plants bid into the system, it could potentially affect the order in which generators are dispatched, reducing the competitiveness of the most carbon intensive power plants.

The final place where mitigation could be achieved is on the consumer demand side. If a carbon tax on emissions increases the cost of greenhouse gas intensive power, it could decrease the demand for that power. Consumers could then switch to suppliers of non-emitting power, generate their own non-emitting power behind the meter, or increase the efficiency of their power use, all of which drive mitigation.

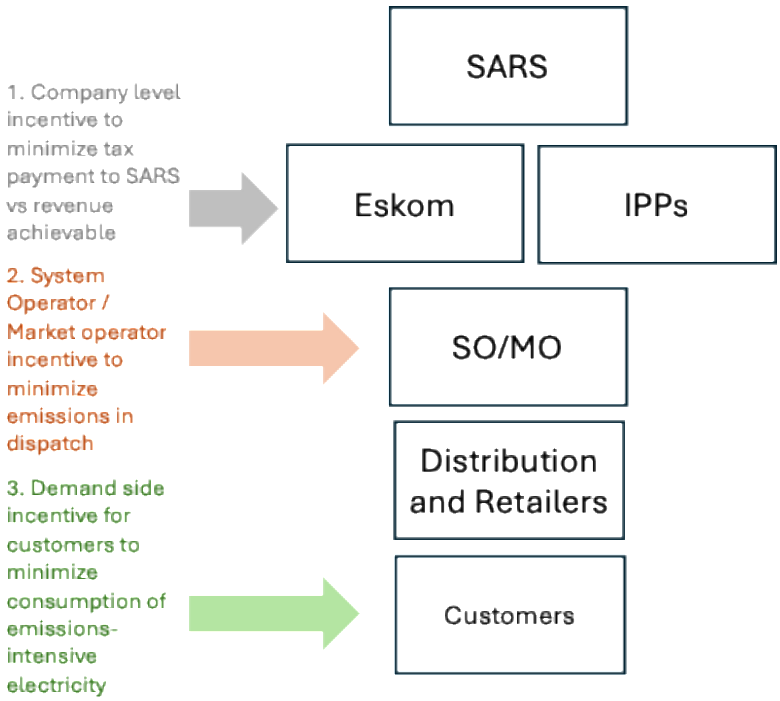

Figure 1: Primary places to incentivise mitigation in a power sector

[1] National Treasury. Media statement. Publication of the Draft Carbon Tax Bill for public comment.

2.1 MITIGATION UNDER THE CURRENT ELECTRICITY SECTOR STRUCTURE

Under the Phase Two design of the carbon tax, environmental costs to be paid by an emitter will be based on their GHG emissions. This is a change from Phase One of the tax, where environmental costs, expressed in terms of the Environmental Levy, were calculated based on the kWh of electricity generated using non-renewable sources (rather than associated emissions). Treasury suggests that this change will result in a better mitigation outcome. This suggestion is explored first from the power system perspective and then from the company consumer perspective.

2.1.1 Electricity system perspective

Eskom has been operating an internal electricity market since 2002, where generators submit complex day-ahead bids including generation costs, and technical, safety and local environmental constraints. Based on this, an hourly merit order of supply is established. The Environmental Levy is currently included as a variable cost in each bid. To drive mitigation, the costs associated with GHG emissions of each generator would need to be included in dispatch decision making.

From Phase Two, fossil plants – predominantly coal and diesel currently, but potentially also gas in future – will base their environmental cost calculations on tonnes of CO_2e emitted, rather than on the basis of MWh produced. Theoretically, this change should favour the dispatch of electricity generated using gas over coal and diesel, given the lower emissions intensity of gas per MWh[2], and prioritisation of more efficient coal plants over less efficient plants. To meet the requirement of price neutrality, however, the carbon tax pass-through is capped at their **Environmental Levy Equivalent (ELE)**. The only way there could be a distinction between coal and gas, or different coal plants, would be if their calculated carbon tax is below their ELE.

Meridian's Briefing Note on the impacts of the Phase Two design of the tax on the electricity sector demonstrates that it is highly unlikely that the calculated carbon tax of any of Eskom's generation plant would ever be less than its ELE: In 2026, the calculated carbon tax is projected to be between 3.2 and 5 times higher than the Environmental Levy for coal, 3 times higher for diesel-fired OCGTs, 2.8 times higher for gas-fired OCGTs and 1.8 times higher for gas-fired CCGTs[3]. With successive increases in the carbon tax's headline rate, this gap widens further: by 2030, the carbon tax is projected to be between 4.9-7.6 times greater for coal, 4.5 times greater for diesel-fired OCGTs, 4.2 times greater for gas-fired OCGTs and 2.7 times greater for gas-fired CCGTs.

All Eskom's fossil fuel plants will therefore include the Environment Levy Equivalent calculated in terms of MWh generated by fossil fuels in their market bids. Because of the ZAR totals of the **CCT** versus the **ELE** at the Generator and company level, all fossil fuel generation is taxed at equal ZAR/MWh rates. The outcome, therefore, is not that of a carbon price.

The only change between the environmental pricing signal on dispatch sent in Phase One and in Phase Two is that of nuclear no longer attracting an environmental charge. The Environmental Levy has historically applied to Koeberg (South Africa's only nuclear power station) on the grounds that it was classified as a non-renewable energy source. With the transition to the carbon tax in Phase Two, the Levy on nuclear falls away, as it produces no carbon emissions. This will make nuclear power marginally cheaper to dispatch than it was previously.

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[2] In South Africa, coal has an average emission factor ranging from 0.92-1.44 tCO_2e/MWh (as disclosed by the National Environmental Consultative and Advisory Forum), whilst diesel and gas OCGTs, and gas CCGTs have emission factors of 0.86 tCO_2e/MWh, 0.80 tCO_2e/MWh and 0.51 tCO_2e/MWh, respectively (sourced from Meridian's Hot Air About Gas study - here).

[3] The calculated carbon tax rate for each year was calculated assuming the taxpayer only claims the basic tax free allowance. To the author's knowledge, Eskom has not yet claimed its offset allowance, and will not achieve NT's proposed performance allowance during Phase Two.

2.1.2 Company (Eskom) and consumer analysis

As a regulated entity, Eskom currently does not directly incur its environmental charges, as it is allowed to pass them through to consumers under regulated tariffs. In Phase One of the carbon tax, Eskom includes the Environmental Levy as a variable cost of production in its Multi-Year Price Determination (MYPD) tariff application, and pays the Levy to the South African Revenue Service (SARS). Similarly, under the Phase Two design the carbon tax, capped at the ELE, can be passed through in the tariff. Most consumers currently purchase their power through a regulated distributor (Eskom Distribution or a municipality), at the regulated tariff.

As such, the carbon tax under Phase Two provides no additional incentive for Eskom to mitigate at the corporate level. It also does not provide a strong further incentive for consumers to mitigate.

A similar observation is presented in terms of the potential for the R640/t rate on emissions exceeding a company's allocated carbon budget, introduced in the TLAB, to impact mitigation outcomes. As currently understood, while this higher rate increases the calculated carbon tax, the pass through remains capped by the Environmental Levy equivalent[4].

2.2 MITIGATION UNDER A REFORMING POWER SECTOR

The implementation of Phase Two coincides with the launch of the South African Wholesale Electricity Market (SAWEM), which will replace the Eskom internal market. SAWEM will be open to a broader and expanding range of market participants, providing a more open and transparent platform for electricity trading in South Africa that marks a significant departure from the traditional vertically integrated state-owned utility model. Treasury sees this transition as supporting the intended mitigation outcomes of Phase Two of the carbon tax, stating that "A partially liberalised electricity supply industry combined with the implementation of an effective carbon price will provide important incentives on the margin for behaviour change by electricity generators towards alternative lower carbon energy sources and energy efficiency improvements."[5]

However, market reform will take time. It was initially anticipated that the transition would be completed within five years, the timeframe of Phase Two of the carbon tax. But in reality this is looking like it will take longer. During the transition period, the power sector will fall into two broad market segments, regulated and unregulated, as shown schematically in Figure 2. The proportion of the market that is regulated will decline as reform proceeds.

[4] This outcome holds even when all Part II allowances (all except the free basic allowance) are removed as anticipated in section 14A of the draft TLAB.
[5] National Treasury, 2024, Carbon Tax Phase 2 Discussion paper, p8.

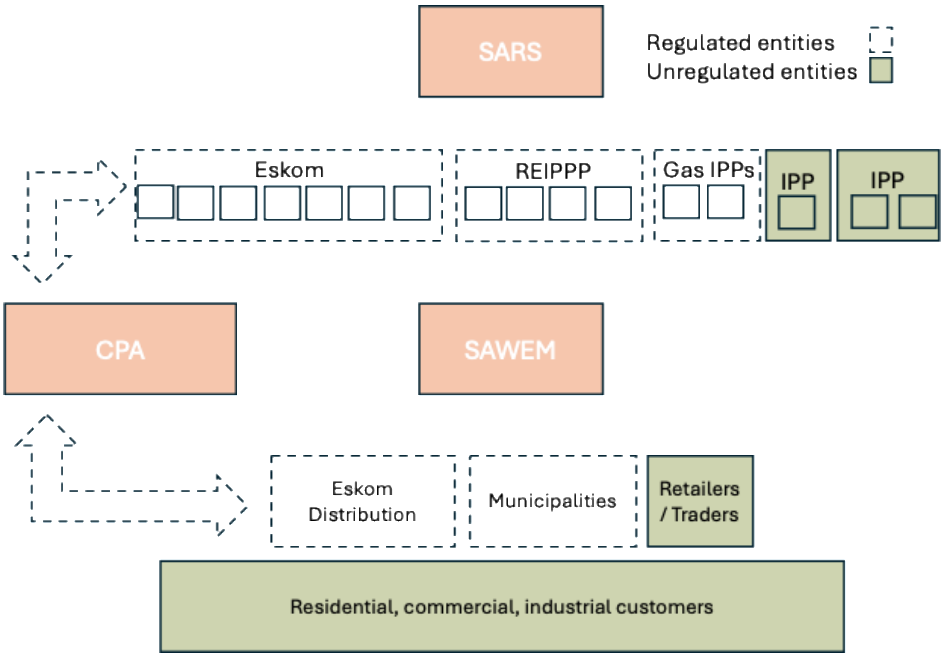

Figure 2: South Africa's transitioning power market

Regulated electricity generators include Eskom's power stations, the REIPPP projects and the two diesel IPPs contracted to Eskom. On the distribution side, regulated entities are Eskom Distribution and Municipalities. The primary mechanisms for ongoing regulation are the vesting contracts between the Central Purchasing Authority (CPA) and legacy generators, and between the CPA and the public distributors. These contracts will both determine the costs that the legacy generators can include in their market bids, and the tariffs that can be charged to consumers purchasing from these regulated entities.

Unregulated electricity generators include RE or future diesel / gas IPPs selling either via wheeled PPAs or into the spot market, and storage plants. On the retail side, both private retailers and traders are anticipated. Non-regulated generators are not restricted in terms of how they price their market bids, but they need to balance their bid prices with the volumes they wish to sell and need to cover their costs. Similarly, the price at which unregulated IPPs can sell to customers will be determined by the price at which they can expect to sell sufficient volumes to cover their costs.

As in Eskom's internal market, individual generators will submit bids to the SAWEM Market Operator and will be dispatched by the System Operator according to a merit order. In the regulated segment of the market it is anticipated that the National Energy Regulator of South Africa (NERSA) will only allow the pass through of the ELE as the carbon tax variable cost in vesting contracts, in order to fulfil Treasury's objective of price neutrality. As a result, in the regulated market, the price neutrality mechanism employed in Phase Two will not allow for the incentivisation of dispatch of lower emission regulated generators beyond the incentives contained in the Environmental Levy. Because Eskom can pass the ELE through to consumers, who experience no change in the tariff due to the carbon tax compared to Phase One, there is no mitigation incentive under Phase Two of the tax for the regulated segment of the electricity sector.

It is less clear what happens in the unregulated portion of the market, as there are many possible and complex impacts at the margin of price and volume that are difficult to determine definitely without modelling. Initially, given the low volumes in the unregulated market, the impact of the tax in driving mitigation in this market segment is less relevant than that on the regulated market. However, what is critically important is the long-term investment signals that the tax provides to the unregulated market,

in order to grow this over time. The establishment of a carbon price (as opposed to an environmental charge) in the electricity sector is central to this signal.

3 POWER SECTOR REFORM AND A CARBON TAX

As was discussed in Section 2, the transition to a fully competitive power market will take time, and in its final form the market is likely to still contain certain regulatory interventions. At least for Phase Two of the carbon tax however, significant regulatory interventions remain, primarily the vesting contracts between the CPA and both legacy generators and public distributors. The legacy generators and public distributors represent the majority of the market initially, and the majority of emissions (Eskom's coal fleet). Given the economics of power generation technologies, emissions will remain increasingly concentrated in the portion of the market that is regulated for the foreseeable future.

Whilst the impact of a carbon tax is relatively simple to determine for the regulated segment of the market, as described in Section 2, how this segment interacts with the unregulated segment in terms of the carbon tax is far more complex to anticipate, especially as aspects of the market architecture are not yet decided. For example, the ratio between fixed and variable charges will influence the impact of the carbon tax on consumer decisions to buy through regulated or unregulated suppliers. So too will the pace of battery price reduction as an alternative to purchasing firm power through the wholesale market which will include a carbon tax component.

How, and to what extent Eskom, municipalities and other legacy entities continue to be regulated over time will affect the effectiveness of the carbon tax, and can also impact how the carbon tax supports or undermines the power market reform process. For example, if the regulated distributors remain unable to pass the CCT through to their customers, this artificially suppresses the carbon signal in the regulated market, potentially incentivising customers to purchase from these distributors above the unregulated generators, traders and retailers. A second example of how the carbon tax could undermine power market reform is how the proposed Phase Two design favours new OCGT and CCGT generation plant built by Eskom over those built by IPPs. This is because Eskom will be able to access the RE Premium Offset given that the NTCSA is the counterpart to the REIPPP PPAs, thereby reducing its CCT to the ELE. This makes Eskom's gas generation more competitive when bidding into the market. This mechanism will not be available to new gas IPPs unless they too purchase and trade in renewable electricity – which in turn requires them to have a trading license. The tax will thus work against market reform whilst the RE Offset Premium remains only available to purchasers of renewable electricity.

4 DISTORTIONS IN THE CARBON PRICE SIGNAL BETWEEN LIQUID FUELS AND COAL/GAS

A further concern is that the TLAB does not seem to have engaged with the implications of the carbon tax on diesel being incorporated into the sale price of the liquid fuels. This as opposed to being calculated and charged at the point of combustion as is the case with coal and gas. There are two important considerations to be taken into account here. The carbon tax on liquid fuels is calculated based on a basic tax-free allowance of 75%. This makes diesel exposed to a lower tax rate than coal and gas per tonne of CO_2 emissions, given that the latter are only allocated a 60% basic tax-free allowance. At the same time, while the CCT is lower, when diesel is used for electricity generation by Eskom in their CCGTs, the carbon tax cannot be offset against the RE Premium Offset as would the tax on emissions from coal and gas. This introduces some distortion between the different energy sources. It also means

that there is no distinction in terms of the carbon tax between Eskom and an IPP's OCGT, given they both pay the same tax as included in the fuel price.

5 CONCLUSIONS AND RECOMMENDATIONS

The currently proposed Phase Two design codified in the draft TLAB achieves Treasury's stated carbon tax objectives of revenue and consumer price neutrality but does not affect behaviour change (mitigation). Capping the tax payable at the Environmental Levy Equivalent results in the tax acting as an environmental charge on MWh from fossil fuels in the electricity sector, and not a carbon price. This outcome undermines Treasury's claim to a broad based carbon tax. It also means that Treasury has implicitly traded off, rather than balanced, mitigation versus price neutrality in the tax design. Given the rapidly escalating electricity tariffs and early-stage market reform in the sector, the difficulty involved in implementing an effective carbon tax in the electricity sector is acknowledged. However, to a large extent these challenges are overcome by the low effective rate of the carbon tax. In the timeframe of Phase Two, the sector is also characterised by significant investment potential, and high levels of technology and policy driven disruption and uncertainty. We therefore suggest that clarifying the long-term investment signal of the tax needs to be prioritised, as well as getting the fundamentals of the price signal right to allow the tax to work at the margins given the complexity.

> Recommendation: Given the significance of the electricity sector for both economic growth and decarbonisation, it is suggested that alternatives to improve on the balance of the three carbon tax objectives are further considered. These alternatives should also be considered for their impact on the market reform process.

> Recommendation: Consider alternatives that at minimum reflect the full effective carbon tax in dispatch, prioritising the establishment of a true carbon price signal in the sector. Full removal of the RE Premium Offset mechanism should be undertaken as soon as possible, but latest by Phase Three.

Regulatory interventions provide options for optimising between carbon tax objectives, which should be considered as they are developed as part of the market reform process. At the very least, these interventions (and the vesting contracts in particular) must not lock out the possibility of imposing the full effective carbon tax on electricity from 2030.

> Recommendation: Treasury should engage with the NTCSA and NERSA to consider the carbon tax implications of the regulations as they are developed for the SAWEM

The R640/t rate on emissions exceeding a company's carbon budget cannot work for Eskom as the amount Eskom pays SARS is capped by the Environmental Levy Equivalent[6].

> Recommendation: Treasury could remedy this by clarifying that the escalated rate for emissions exceeding a carbon budget in the electricity sector must be paid regardless of the Environmental Levy Equivalent cap. Further, any escalated payments should not be passed through to the consumer under the vesting contracts.

The intention to align the tax rate with science was last stated in the 2022 Budget Review, and the effective tax rate has only been weakened subsequently.

[6] *This outcome holds even when all Part II allowances (all except the free basic allowance) are removed as anticipated in section 14A of the draft TLAB.*

Recommendation: Re-iterate the longer-term objective of aligning the carbon tax rate with science in the next Budget or Medium Term Budget Review.