TERMS OF REFERENCE

TASK TEAM TO ASSESS THE FISCAL REGIME APPLICABLE TO WINDFALL PROFITS IN THE LIQUID FUEL SECTOR

Introduction

The purpose of this assignment is to advise the Minister of Finance on possible reforms to the fiscal regime applicable to windfall profits in South Africa's liquid fuel energy sector, with particular reference to the synthetic fuel industry.

The Minister of Finance seeks to be advised on options for securing the optimal contribution of the synthetic fuel industry to South Africa's long-term development, against the background of, *inter alia*, its significance for the economy and the balance of payments, its historic dependence on the state for capital funding and price support, the impact of movements in the oil price and exchange rates on synthetic fuel producers' profitability and the potential for further expansion of domestic synthetic fuel production.

A Task Team is accordingly proposed to assist the National Treasury to achieve these objectives, which are further identified below.

Background

The synthetic fuel industry meets about 30 per cent of South African demand for petroleum products, thereby reducing dependence on imported crude oil for local refining and imported fuel. The industry comprises two players – Sasol and PetroSA – both of which have their origins in government-backed initiatives to reduce dependence on imported oil. Sasol operates commercial scale facilities for conversion of low-grade coal to liquid fuel, is a major contributor to South Africa's petroleum production, is a world leader in the conversion of coal to fuels, chemical feedstock and gas, and is developing ventures internationally to convert gas into clean diesel fuel. PetroSA converts natural gas to liquid fuel.

Petroleum prices are administratively determined in South Africa, effectively reproducing an import parity price that takes into account international oil price movements, transport and refining margins and wholesale and retail distribution costs. The fuel tax elements apply to liquid fuel (petrol and diesel), both derived from imported crude oil and synthetically produced. Synthetic fuel manufacturers sell into this administered market at prices determined without reference to their production costs.

Concerns exist that the present dispensation benefits the synthetic fuel producers and their shareholders disproportionately, at the expense of the consumer and the taxpayer. South African taxpayers and motorists have historically supported the synthetic fuels industry through sizeable subsidies, when the administered fuel price has been too low to recover the costs of production. This had the effect of protecting the companies from the adverse impact of a below-cost price, with the associated benefit to the country's balance of payments of greater stability in domestic fuel production. This price support arrangement also provided for a recovery by the fiscus of a share of the windfall profits to the industry when high oil prices resulted in a high-administered fuel price. An agreement was in place that an offsetting reimbursement to the fiscus would be paid when oil prices exceeded $28.50 per barrel, but this fell away in 1995. A revised subsidy regime that provided for a subsidy in the case of low oil prices without the requirement of a payback during times of high oil prices was in place until1999, this revised regime was based on recommendations by the Arthur Andersen report. When this agreement expired in 1999 the Department of Minerals and Energy appointed consultants to recommend a more appropriate forward-looking fiscal regime. The issue has remained in abeyance since then, partly in recognition – until recently – that global oil prices were at moderate levels.

Internationally, oil and gas companies are often subject to fiscal regimes that effectively tax the windfall profits associated with high oil prices relative to resource extraction costs. These tax or profit-sharing regimes assist in mobilising surplus funds for public investment purposes, but arguably also inhibit exploration and hold back global oil supply, contributing to the persistence of high fuel prices already underpinned by strong growth in demand. It is recognised that South Africa's synthetic fuel production technology and capacity are considerable economic strengths in the context of high global oil prices. Careful consideration needs to be given to the long-term development of this industry, the design of appropriate fiscal measures and the evolution of the relevant environmental and industrial regulatory arrangements. Mindful of international practice and the complex balance of economic aspects to take into account, the Minister of Finance has requested that the fiscal regime applicable to South Africa's synthetic fuel producers should be reassessed.

Purpose of the Task Team

The National Treasury seeks through this Task Team to formulate a sound policy position on fiscal measures applicable to the synthetic fuel industry, underpinned by appropriate evidence and analysis.

The Task Team is requested to:

- Outline the international experience and approaches associated with a windfall tax;
- Comment on the contribution of the synthetic fuel industry to the South African economy;
- Where and if appropriate benchmark the synthetic fuel industry against the local and international petroleum (oil) refining industry;

- Review the role of fiscal support in the establishment and development of the synthetic fuel industry;

- Consider any distinguishing factors that are peculiar and specific to the South African liquid fuel and synthetic fuel production system that have relevance to windfall profits;

- Provide an economic and financial analysis of the synthetic fuel industry as a basis for assessment of these and other fiscal regime options;

- Take account of, and where relevant, comment on the various policy processes that are currently underway in respect to the fuel industry, including:

    - Energy policy and policy processes,
    - Other relevant tax dispensations and policy processes, including those associated with the proposed Mineral royalty regime and the taxation of intellectual property rights, e.g. Trade Marks,
    - Beneficiation dispensations and policy processes, and
    - Any other relevant dispensations and policy processes.

- Comment on the appropriateness of the current price regulations with respect to petroleum products in so far it impacts on windfall tax recommendations;

- Investigate the economic, financial and administrative implications of tax options identified and to draw where appropriate on international experience and practice;

- Identify key economic, technological, environmental and financial considerations relating to the future development of synthetic fuels and its future role in the South African economy; and

- Evaluate options for reform of the tax treatment of liquid fuel/synthetic fuel producers, possible fiscal support for future development of the industry and options for reform of the regulation of the pricing of synthetic fuel products.

Amongst the options to be considered are the following:

Revised subsidy regime: A price support and reimbursement arrangement could be reinstated. This might take the form, for example, of a floor price below which synthetic fuel producers would receive a subsidy, or pay a reduced fuel levy, and a ceiling above which a supplementary tax or revenue-sharing levy would be payable.

Cost-based administered price regime: Analogous to the price regime applicable to the refining industry, synthetic fuel producers could be reimbursed for their output on the basis of a cost-plus price structure. This would mean, in practice, a separate price for the synthetic product and an excess profit tax (or subsidy in the event of a negative differential) would fall on the gap between synthetic fuel production costs and standard refinery costs.

Progressive formula tax: Synthetic fuel production could be subject to a formula-based progressive profit tax, along similar lines to the South African gold mining tax formula. Such a formula has some advantages over a price or cost-based arrangement in that it avoids sharp tax thresholds and is linked directly to profitability. It can also provide for relief during periods of low commodity prices and low profitability.

Investment-linked tax and subsidy options: With due regard to economic and environmental considerations, account could be taken of investment by synthetic fuel producers in expanded or improved production capacity as part of an incentive-based targeted tax regime.

Proposed Process

In carrying out its task, the Task Team will need to consult with and gather facts and evidence from appropriate Government departments and other interested and affected parties including:

- The Department of Minerals & Energy;
- Synthetic fuel producers; SASOL & PetroSA;
- Oil companies operating in the South African market, SAPIA, the South African Petroleum Industry Association;
- Organised business;
- Organised labour;
- The accounting and legal professions;
- Consumer lobby groups; and
- The South African Revenue Service.

Mindful of the complexities associated with the liquid fuel sector, a public hearing and transparent evidence-led approach to gathering facts, evidence and information and views may be followed. If any additional powers are necessary to enable the Task Team to fulfil their committee functions, the Minister may following advice from the Task Team and National Treasury consider such authorisation of powers.

The Tax Policy Unit of the National Treasury will act as the secretariat to the Task Team.