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08 August 2006

Kiyasha Thambi
Secretariat
Task Team re Windfall Profits in Liquid Fuel Energy Sector
National Treasury

E-mail: kiyasha.thambi@treasury.gov.za

Dear Kiyasha

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: Business Unity South Africa (BUSA) comment on the discussion document

BUSA appreciates the opportunity to comment on the Discussion Document before the Task Team compiles its report and recommendation to the Minister of Finance.

BUSA's comment is attached as a separate word document (D327/06). Please note that BUSA would be willing to elaborate on any of the issues covered in the submission.

Yours faithfully

Jerry Vilakazi
Chief Executive Officer

F274/jd/06

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ANNEXURE

Business Unity South Africa (BUSA) Members

1. African Minerals and Energy Forum (AMEF)
2. Agri SA
3. AHI
4. Association for the Advancement of Black Accountants of Southern Africa (ABASA)
5. Association of Black Securities and Investment Professionals (ABSIP)
6. Automotive Sector
   - Automobile Manufacturers Employers' Organisation (AMEO)
   - National Association of Automotive Component and Allied Manufacturers (NAACAM)
   - National Association of Automobile Manufacturers of South Africa (NAAMSA)
   - Retail Motor Industry Organisation (RMI)
7. Banking Association
8. Black Business Executive Circle (BBEC)
9. Black Information Technology Forum (BITF)
10. Black Lawyers Association (BLA)
11. Black Management Forum (BMF)
12. Business Leadership South Africa
13. Casino Association of South Africa (CASA)
14. Chambers of Commerce and Industry South Africa (CHAMSA)
15. Chamber of Mines of South Africa (COM)
16. Chemical and Allied Industries' Association (CAIA)
17. Confederation of Associations in the Private Employment Sector (CAPES)
18. Congress of Business and Economics (CBE)
19. Construction Sector
   - Master Builders South Africa (MBSA)
   - South African Federation of Civil Engineering Contractors (SAFCEC)
20. Insurance Sector
   - Insurance Institute of South Africa (IISA)
   - South African Insurance Association (SAIA)
21. Life Offices Association (LOA)
22. National African Federated Chamber of Commerce and Industry (NAFCOC)
23. National African Farmers Union of South Africa (NAFU)
24 National Black Business Caucus (NBBC)
25. National Federation of Building Industries (NAFBI)
26. National Industrial Chamber (NIC)
27. Private Healthcare Forum (PHF)
28. Retailers' Association (RA)
29. Road Freight Employers Association (RFEA)
30. South African Black Technical and Allied Careers Organisation (SABTACO)
31. South African Chamber of Business (SACOB)
32. South African Communications Forum (SACF)
33. South African Institute of Black Property Practitioners (SAIBPP)

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34. South African Leisure & Tourism Association (SALTA)
35. South African Petroleum Industry Association (SAPIA)
36. Steel and Engineering Industries Federation of South Africa (SEIFSA)

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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

SUBMISSION BY BUSINESS UNITY SOUTH AFRICA (BUSA)

AUGUST 2006

1. INTRODUCTION

Reference is made to a discussion document (DD) prepared by a Task Team appointed by the Minister of Finance to consider possible reforms to the fiscal regime applicable to windfall profits in South Africa's liquid fuel energy sector. In response to a request for comment on the DD, Business Unity South Africa (BUSA) wishes to submit the commentary set out below.

BUSA is a confederation of chambers of commerce and industry, professional associations, corporate associations and unisectoral organisations. In that role it represents South African business on macro-economic issues that affect it at the national and international levels (Annexure 1 sets out the member organizations affiliated to BUSA). BUSA's function is to ensure that business plays a constructive role in the country's economic growth, development and transformation and thereby create an environment in which businesses of all sizes and in all sectors can thrive, expand and be competitive.

The commentary set out below has been confined to a general review of the approach adopted in the DD within the context of current developments in the country. No attempt has been made to discuss the issues, which relate to specific sectors of the economy or companies.

This submission is structured as follows:

- General
- Approach to fiscal instruments
- Concept of windfall tax and economic rent
- Responses to questions posed

2. GENERAL

2.1 Introduction

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BUSA is not in a position to comment on the issues relating to specific companies and has therefore elected to comment on this important DD within the context of the challenges facing the economy and tax policy as a whole.

2.2 Achievement of shared growth

Government is committed to maintaining the tax burden at a fixed ratio to GDP and in fact to reduce the ratio under appropriate circumstances. BUSA supports this as part of the requirement for raising the growth rate. Indeed, BUSA has consistently argued that the corporate tax rate should be reduced to encourage increased private investment. Based on the 2006 KPMG International Tax Survey South Africa's nominal corporate tax rate of 29% (excluding STC) is higher than the 25% average for the European Union's 25 member countries and is higher than the average 26.8% level for the 46 countries in the KPMG survey. It is widely accepted that countries striving to promote investment require lower corporate tax rates.

Although some commentators argue that targeted tax incentives (such as the Strategic Investment Programme - SIP) should be used as an instrument to promote growth in specific sectors of the economy, the South African government has generally chosen not to follow this route, focusing instead on providing a uniformly attractive investment environment.

The Accelerated Shared Growth Initiative – SA (ASGISA) reflects this focus and identifies six binding constraints to achieving reductions in unemployment, alleviating poverty and achieving the economic growth rate required to meet the first two objectives.

Business has consistently argued that a lower corporate tax rate will indeed lead to a desired increase in private sector investment over and above the significant increases of recent years. Some commentators surmise that the positive impact of cuts in corporate tax rates and economic growth rates is at least partly due to an inverse relationship between corporate taxes and the rate of entrepreneurial activity and risk taking propagated by new endogenous growth theories.

Business believes that this conclusion would hold in the South African case. A key component in the drive to achieve growth rates in excess of 6% per annum under the ASGISA is pushing investment levels to above 25% of GDP. Significant funds have been set aside in the Medium Term Budget estimates for raising government's investment

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and the parastatals have outlined their plans for significantly higher levels of investment in the coming years.

Achieving such an ambitious outcome will require a coordinated approach between the state and the private sector to ensure complementary capacity building, including public-private partnerships. But the major share of the desired increase in investment levels will have to emanate from the private sector. Although private sector investment has increased significantly over the last two years, it will need a further "step-change" increase if the desired levels of total fixed investment are to be reached. Although it is recognised that increased public sector investment should unlock increased levels of private sector investment, it has been argued that a reduction in the corporate tax rate will provide an encouraging tailwind for private firms in achieving the goal of even higher levels of private sector investment growth.

The concept of shared growth is understood by BUSA to reflect two national imperatives, namely for the private and public sector to share the challenge of meeting the growth rates required to alleviate poverty and unemployment and to ensure that the increased resultant prosperity is shared by all South Africans.

It is recognised that the roles that the state and business through its corporations should play are different.

The state needs to promote an environment where private sector investment is encouraged, and in the South African case, where many new entrepreneurs enter the economy. The state has a role to play in nurturing these businesses in order to encourage growth. As the business matures, the relationship between the company and the state may change as the business no longer requires the same level of nurturing.

Corporations should act as good corporate citizens, which means, operating businesses within a sound framework of corporate governance, paying taxes and operating successful businesses that contribute positively to the GDP. The state on the other hand creates the environment within which good corporate citizenship is promoted.

3. APPROACH TO FISCAL INSTRUMENTS

3.1 Imposition of new taxes

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Although the Task Team has not yet made specific policy recommendations for a new tax, BUSA believes that the imposition of any new tax needs to be considered within the context of overall economic and social national objectives and that the nature and design of the tax needs to be evaluated against a range of criteria.

In the first instance, any new tax must comply with the traditional canons or principles of tax policy, namely:

- fairness and equity;
- certainty and transparency - for example, the design of the proposed tax must be structurally sound and be compatible with the existing tax structure and the structure of the economy;
- efficiency - for example, the cost of administration of the proposed tax in terms of collection and capacity to collect, and cost of compliance need to be considered;
- ease of administration; and
- neutrality - for example, a tax should not be motivated by external issues such as short-term fluctuations in one particular commodity price.

These key principles are supplemented by the private sector's need for tax stability, certainty and international competitiveness, in order to promote a clear taxation environment which promotes investment and economic growth. Ad hoc changes to taxation policy can materially undermine investment, especially for capital intensive long term industries that are subject to large shifts in business cycles.

While it is recognised in the DD, that the National Treasury has not yet made input to the document, the recently released document on Environmentally related taxes, provides some insight into the thinking of the National Treasury in respect of new taxes. Issues to be addressed include:

- Rationale for the proposed tax;
- Objectives to be achieved by its imposition - is the intention for example to alter taxpayer behaviour or to raise revenue?
- Clear link between objectives and tax imposed;
- Purpose to which net proceeds of the tax will be put;
- Which activities will fall within the net?
- Which taxpayers will fall within the net - for example, in this case, will it only apply to the synthetic fuel industry or to the entire liquid fuel energy sector; and will the nascent biofuels industry fall within its ambit?

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3.2 Potential impact

As suggested in the National Treasury DD on Environmentally related taxes, all new taxes should be subjected to an impact assessment prior to imposition. BUSA supports this approach and believes that issues to be addressed in an impact assessment should include the following:

- Total tax burden of the economy, including ratio of total tax burden to GDP;
- Incidence of the proposed tax;
- Ultimate burden, including distributional effects;
- Employment; and
- Economic growth, particularly economically optimal production levels and future investment.

Foreign precedent and experience may provide useful guidance provided always that care is taken to apply such foreign experience to the scenario of the South African economy. Internationally, it does not appear that windfall taxes have ever been levied on producers of alternative fuels. The trend appears to be to incentivise such producers in countries such as the US, China, India and Russia.

4. RESPONSES TO QUESTIONS POSED

4.1 Relationship between fiscal, minerals, energy, industrial and environmental policies (9.2)

BUSA welcomes the recognition in the DD of the interwoven nature of fiscal, mining, energy, industrial and environmental policies that apply across the liquid fuel value chain.

It is precisely this interwoven situation that does not allow windfall taxes to be seen in isolation from other fiscal instruments faced by the mining, energy and industrial value chain. All these sectors face increasingly stringent environmental requirements that include potential environmentally related taxes. The environmental policies and legislation in the mining and industrial sectors (including liquid fuels) are not aligned and increase the cost of compliance.

4.2 Methodology for defining windfall (9.3)

Comment is invited on the methodology used by the Task Team to define windfall, as outlined in Section 4.

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Do you agree with our definitions and use of the concepts of "economic rent", "supernormal profit", "natural resource rent" and "windfall profits"? If not please give reasons and alternative suggestions.

Broadly speaking BUSA agrees with these definitions as a way of classifying these concepts. However, equating the economic concept of rent to "super-normal profit", does introduce the complication of definition that all profits above rewarding the cost of capital is a form of super-normal profit.

Given the absence of a definition of the cost of capital and the fact that economic growth to a large part depends on companies achieving returns above their cost of capital, these definitions complicate dealing with this matter. This lack of clarity is further illustrated by stating that normal profits are those "necessary to attract and keep an entrepreneur invested in the business".

An alternative suggestion would be to distinguish, within economic rent, those profits that are predictable and achieved with low risk, and can be described as a steady stream of income. Supernormal profits are then that part of economic rent which are exceptionally high, leading to unusually high returns on capital. In addition, such a concept needs to take account of countervailing cyclical forces that produce periods of subnormal profits.

Do you agree with the conditions set out above which normally apply to the circumstances when economic rent (including windfall profits) is subject to taxation? In other words, when does economic rent qualify for taxation?

BUSA does not agree with the conditions set out in Section 4.5 of the DD.

Rents arising from natural resources are best addressed by a form of royalty tax to ensure that a country receives sufficient compensation for the extraction of a non-renewable resource (but royalties must be internationally competitive and take cognicance of the entire tax burden of the resources sector). Essential infrastructure service of goods sectors should best be priced to reward the investment appropriately. These industries are normally of low risk and don't face a wide fluctuation in income so that supernormal profits are unlikely to occur here. Furthermore, true utility companies are by and large not run for profit in South Africa. This makes this provision superfluous from their perspective.

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Excluding only profits that arise from efficiency improvements or the creation of valuable intellectual property excludes a wide range of possibilities to achieve profits, such as profits achieved through business acumen. This definition is too narrow, stemming from a set of definitions that are not appropriate to address this subject (as noted above).

Including the economic rent from infrastructure and essential services, which may be as a result of market power, possibly combined with regulatory failure" is similarly broad. Infrastructure and essential services are typically utilities operating in a low risk environment as noted already above.

Do you agree that the distinction between backward looking retrospective windfall profits and forward-looking expectations of economic rent, and thus a distinction between formulating respective policy responses has value as argued above?

While BUSA agrees that this distinction is useful in so far as it recognizes that a past occurrence can only be addressed by a backward looking perspective and thus a retrospective tax, as a general principle BUSA does not support any retrospective measures with regards to any policy changes, including tax policy. Any advantages of exacting retrospective tax are far outweighed by the disadvantages. More than anything, investors need certainty in order to conduct a proper assessment of their investment prospects. Introducing retrospective measures raises uncertainty levels for investors and hence could act as an inhibiting factor to future investment.

The disadvantages relate to the uncertainty that retrospectivity would introduce into the business community, and hence the market. In general, BUSA strongly supports the reluctance of the lawmaker to introduce retrospective elements into the South African tax system. BUSA believes this is a sound principle and would therefore be most reluctant to countenance any form of retrospective windfall tax on any sector of the economy.

The issue of retrospective measures is a sensitive area, and one which the Task Team would like to address openly at this early stage. Mindful of the basic stance of South African fiscal authorities - in support of fiscal certainty and against retrospectivity and its possible consequential adverse impact on investor confidence - outlined in Section 3.1 above, please comment on whether there are any

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circumstances applying to the liquid fuels value chain that could justify a retrospective approach.

BUSA does not support any retrospective taxation and does not believe that the DD presents compelling evidence justifying that the liquid fuels value chain should be an exception to this principle.

Do you agree with our arguments about "windfall losses" as made for both the infrastructure and essential services sectors, and the natural resource sectors?

Raising the point of windfall losses in this context may be relevant, but it does interfere with the symmetry of risk. Providing some industries effectively with a guarantee against bankruptcy, can lead to excessive risk taking. Cases where such businesses do face bankruptcy should best be dealt with on a case by case basis.

Are there other important considerations for the key concepts that we have missed?

One aspect that is not addressed and which is not clear from the definitions is how the variation in company profits will be dealt with. At times, these will be below and at times above the required return. This is particularly the case for cyclical commodity industries, where indeed supernormal profits are required at times to compensate for low returns during the trough of the cycle. As the long term cycle of these industries cannot be predicted, the period and extent of the next trough is unknown. Taxing industries at the peak of the cycle will make these industries even riskier investments, thus arguably increasing the volatility as potential investors stay out during times of low profitability.

It is vital that the policy makers take cognisance of the volatile cyclical nature of many resource industries and the need to take a long term perspective, as opposed to a once off short-term view at the top of the commodity cycle.

Do you agree with our interpretation of the examples and are there other cases that we should consider?

BUSA's interpretation of the international examples of windfall taxes suggests that the objectives for introducing windfall taxes differed from case to case. Three objectives can be identified.

- To ensure a country receives adequate compensation for the extraction of a non-renewable resource;

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- To facilitate price decontrol; and
- To raise taxes for the fiscus.

The international examples are open to interpretation. The task team has tried to distill two main criteria from the international examples: if economic rent is earned through resources extraction; and if economic rent is earned in industries that provide essential goods and services.

The point is that by making essential goods and services industries a condition under which economic rent qualifies for additional taxation measures opens the debate to determine which industries are deemed to be essential. The DD does not define essential goods and service industries explicitly. However, the thread in the argument suggests a wider application than the traditional utility. More specifically the suggestion is that the liquid fuels industry is an essential goods and services industry. This notion is not supported as utilities are typically provided through a wide infrastructure, the construction of which has high barriers to entry.

Do you agree with our interpretation of the role of natural resource stabilisation/savings funds, and or their limited applicability to the South African coal sector?

BUSA believes that the main consideration in this regard should be how important the revenue flow from a specific commodity is for the overall well being of the economy. If an economy has a high dependence on a certain commodity for government finances and or export receipts then resource stabilisation funds may well prove worthwhile. Witness the funds that have been mostly set up by petroleum exporting countries. In South Africa's case, however, arguably no single resource revenue flow fits this description and could interfere with true pricing signals reaching the market. Pursuing stabilisation funds could therefore lead to distortions in the use and investment of those commodities.

4.4 Potential fiscal measures (9.7)

At this stage, the Task Team has not concluded on which rent streams, if any, might exist or might qualify for policy recommendations. Should a policy recommendation ultimately be made, the Terms of Reference call for four distinct fiscal measures to be considered and investigated. Comments on the merits and demerits of these potential fiscal measures for addressing anticipated future economic rent are invited.

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/alternative 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.*

Although various forms of subsidy regimes were in operation in prior years. BUSA understands that all these schemes have terminated and no merit is seen in reintroducing the subsidy regime.

Issues for consideration include whether the synthetic fuels industry can itself withstand the risks of adverse market conditions caused by fluctuating commodity prices and whether such government support is warranted in the free market to adjust the risk/reward profile of companies that have invested significantly in cutting edge technology.

There may be merit in distinguishing between a start up and mature business in respect of government support. In many instances some form of incubation support may be advisable. But beyond this, it is clear that any introduction of such regimes has a market distorting effect that should be avoided.

Cost-based administered price regime: *Analogous to the price regime applicable to the refining industry, synthetic fuel/alternative 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/alternative product and an excess profit tax (or subsidy in the event of a negative differential) would fall on the gap between synthetic/alternative fuel production costs and standard refinery costs.*

BUSA would argue very strongly against the introduction of a cost plus price structure. The removal of price control at the time of the transition to democracy was a correct measure. Price control is inimical to economic growth and investment and cannot be reconciled with market principles.

Progressive formula tax: *Synthetic/alternative 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.*

While BUSA does not see fundamental weaknesses in the current South African gold mining tax formula, Business is not convinced that it is appropriate for the liquid fuels industry.

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

Although BUSA's preference is for a low tax regime and clear and relatively unchanging rules of the game, it is interesting to note that where any form of "windfall tax" has been introduced globally, this is usually accompanied by "investment credits" for new investment which has the effect of reducing the taxable "base" on which such tax is imposed.

Alternative fiscal measures

A possible candidate - which BUSA would strongly oppose - would be a measure similar to the United Kingdom system. At present, the North Sea petroleum companies pay a 50% Petroleum Resource Tax (PRT) on their profits relating to the sale of oil, or the transfer of oil to their own refineries. This 50% tax is deductible for corporation tax purposes. The PRT regime applies only to oil fields founded before 1993. Post 1993 oil fields pay no PRT.

However, all North Sea oilfield operations and refiners pay a second leg, namely a Supplementary Tax, which was recently increased from 10% to 20%. This tax, which is not tax deductible, is imposed on the normal corporation tax base, with the exception that interest expense is not allowable.

The third leg is the normal corporation tax rate, currently 30% in the UK. It is all these taxes together which, according to BUSA's understanding, generate an effective rate of about 70% for the old (pre-1993) oil fields, and somewhat over 50% for the new fields.

BUSA does not believe that South Africa should move in this direction. It is submitted that the serious weakness of the UK regime is that it is rigid, and does not take cognisance of the eventuality of a reduction in oil prices. This could well have the effect of deterring future investments in a scenario where a falling oil rate is projected by the relevant company. In addition, it should be noted that the UK imposes no royalties on its petroleum industry.

5. CONCLUDING REMARKS

BUSA welcomes the opportunity for open discussion on an issue, which is both important in the context of South Africa's economic growth trajectory and consequent sustainable prosperity for all South Africans and an issue of intense public interest.

BUSA believes that it is important to consider the issues raised in the DD in a holistic manner that takes into account the long term interest of the country as a whole.

In this regard the following key considerations need to be borne in mind:

- In today's globalised world with countries competing for investment and investors faced with a wide range of choices, the impact of any policy change on future investment needs to be carefully considered.

- Energy policy is increasingly becoming a highly contested area globally, with increasing emphasis being placed on diversification of approach to energy sources, as was reflected at the recent G8 Summit. Any policy intervention in this area needs to be measured against the need for domestic long term energy security.

- Although other countries have indeed introduced windfall taxes they generally did not enjoy business (investor) support, even where generous capital write off provisions were introduced simultaneously. The countries had or have budget deficit problems which the windfall tax could usefully address. South Africa has virtually no budget deficit problem and thus has no need to make up a shortfall. Both the US and the EU have recently rejected the (re) imposition of windfall taxes on oil and gas producers within their respective jurisdictions, calling instead for further reinvestment, especially in alternate and renewable energy sources.

- The fuel price is currently determined by the BFP pricing formula and is linked to international prices. The high current fuel price is thus market related and therefore producers are not responsible for the high price, which is a result of current global market fundamentals.

In conclusion, BUSA acknowledges the work of the Task Team and thanks them for the opportunity to comment and to engage further on this important debate, which could affect the way prospective investors view South Africa. At a time when the country is vigorously pursuing economic growth any interventions that could affect investor confidence need to be very carefully considered.

D327/06