

ENGEN PETROLEUM LIMITED

Comments on the Discussion Document Entitled

“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”

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Comment on the Discussion Document entitled “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”

1 Introduction:

We thank you for affording Engen the opportunity to comment on the abovementioned draft document. It is apparent to Engen that a lot of thought and analysis has gone into the discussion document, particularly in light of the complex industry in which the company operates.

As a potentially affected party, Engen wishes to submit the commentary as set out in this response. Engen does not, however, wish to make an oral presentation at the public hearings planned for Tuesday 15th and Wednesday 16th August 2006.

Engen has formulated its response in the fashion as requested by the task team by commenting on the questions raised in section 9 of the discussion document. Engen has incorporated comments on any other issues it deemed appropriate in responding to the questions. Engen has mostly kept its responses relevant to the crude oil refining business where applicable.

2 Response to specific questions raised in section 9

2.1 p 89 Section 9.1 - Fiscal regime applied to the liquid fuel value chain

Bullet 1 – Royalty Bill: Coal – Engen does not have any comment in this regard.

Bullet 2 – Royalty Bill/OP 26 fiscal regime: Gas – Engen does not have any comment in this regard save to the extent that migrating a combustion process from coal to gas will reduce the carbon dioxide emissions per unit of heat generated and create a potentially tradable emissions credit, which may permit a higher price to be realised for the gas.

2.2 p 89 Section 9.2 - Relationship between fiscal, minerals, energy, industrial and environmental policies

Bullet 1 – Coherence of different policies – Engen does not have any comment in this regard.

Bullet 2 – Link with environmental taxes - Engen does not have any comment in this regard.

Bullet 3 –Investment to meet environmental requirements - Engen will have invested approximately R500 million in respect of the January 2006 fuel specification changes when all the relevant projects have been completed in 2008/9. As the future requirements are yet to be precisely defined, Engen is unable to currently assess what investment is still to be made. However, should Engen be required to meet Euro 4 equivalent fuel specifications, it is probable that Engen will have to spend in the order of R3 billion.

Bullet 4 – Possible future regulatory dispensation for investment in synfuel or bio fuels - It will be appropriate for government to consider a suitable fiscal dispensation to incentivise the introduction of biofuels if this is determined to be in the national interest. Engen is, however, of the opinion that any new synfuel projects based on coal or natural gas should proceed only if they can be justified on their economic merits without any special government support. Which options Engen deems appropriate (for biofuels) will be addressed when responding to section 9.7 later in the response document.

2.3 p 90 Section 9.3 – Methodology for defining windfall

Bullet 1 - Economic Rent\ Supernormal profits\Natural resource rent\Windfall profits – Engen agrees with the definition of economic rent. However we do not agree that economic rent and supernormal profits are necessarily synonymous and interchangeable terms. It is Engen’s view that the potential for windfall gains and supernormal profit exists only upstream and not in the RSA crude refining and liquid fuels marketing industry. Crude refining margins are earned against a realistic import parity benchmark, which represents the real alternate cost of supplying the country’s requirements in the absence of locally-manufactured supplies. These margins, against which investment in local refining must be justified, are determined by international market forces over which RSA refiners have no control, and are highly variable. At times they will yield a return more than sufficient to cover the cost of capital, and at other times they will be totally inadequate to do so, such is the cyclical nature of the international oil industry. Thus a return in excess of the cost of capital can be regarded as a “windfall” only when taking an inappropriately short-term view. RSA crude refiners are, in effect, price takers and their returns are in no way guaranteed. Thus more than adequate returns in the good times must offset less than adequate returns when margins are low.

The import parity benchmark used as a base for building up regulated fuel prices in RSA does, incidentally, send the correct signals to local refiners to guide their investment decisions. In Engen’s view, it is the only appropriate basis to use while government continues to regulate prices. Engen is opposed to alternatives such as a cost plus approach to setting ex-refinery prices which, apart from being inefficient and not market-related, would be impractical in RSA due to the existence of both synfuels producers and crude refiners with totally different cost structures.

Bullet 2 - Conditions to apply economic rent and windfall profits – Engen agrees that the stated conditions have been used in some countries as criteria for taxing economic rent/ windfall profits. This does not mean that Engen is in favour of such taxes. Engen accepts that windfall profits (and losses) can arise in the upstream (exploration and production) sector of the international oil industry and in the production of synfuels from coal and gas in RSA (due to the cost of synfuels production being unrelated to the prices received). Engen is, however, opposed in principle to the taxation of such “windfalls”. As crude oil becomes increasingly scarce and costly to find and produce, the forces of supply and demand should cause its average price to rise over time, but prices will inevitably continue to exhibit great volatility, this being the nature of the global oil markets. Investments in crude exploration and production, and in alternative technologies such as synfuels production, are generally very expensive, high risk ventures. Investors in these areas are entitled to whatever rewards the market will give them from time to time, and governments should not distort market signals, thereby inhibiting investment, by excessively taxing profits when these happen to be good

While the above is Engen’s firm view, our main concern here is to make the point that the concept of “windfall profits” cannot properly be applied to the RSA crude refining and marketing industry, wherever else it may be applied.

Bullet 3 – Distinction between backward looking windfall taxes and forward looking economic rent - Engen agrees that there should be a distinction between retrospective and prospective taxing. Engen believes that no circumstance warrants retrospective application of windfall taxes. Engen is not in agreement with retrospective taxing for the following reasons:

- a) Creates uncertain economic environment
- b) Inherently unfair towards shareholders\investors
- c) Where government has made certain agreements with stakeholders or put in place a certain regulatory environment, it is unreasonable to change these with retroactive effect

Bullet 4 - Windfall losses – As explained above, Engen agrees that these can arise, but not in the crude refining industry.

Bullet 5 – Concepts that may have been missed - An important point that may have been missed is the variable, cyclical nature of crude refining margins, which means that the concept of “windfall profits” is inapplicable to the business of crude refining.

Bullet 6 – Interpretation of examples and other cases for consideration – Engen does not have any further comment in this regard.

Bullet 7 – Role of the national resource stabilisation/savings fund – Engen does not have any comment in this regard.

2.4 p 90 Section 9.4 - History of the liquid fuel and synthetic fuel industry

Bullet 1 - Comments re History- Engen would like to take this opportunity to compliment the task team on the work done on the history of the fuel industry. Engen feels that this could serve as a reference work on the history of the liquid fuel industry in future. To improve the accuracy of the reference, Engen would like to make some comments on the history section for clarification or correction, even though these may not be directly relevant to the work of the Task Team. Please refer to **annexure A** for Engen's comments.

Bullet 2 –Logistics infrastructure - The way current pipeline (DJP) capacity is allocated is, Engen considers, prejudicial to it because its allocated share is unduly low in relation to those of our competitors. This is, however, not something which falls within the TOR of the Task Team, but should be rectified by the pipeline regulator.

P91 – Specific questions to OOC's

Bullet 1 – Quantification of historic benefits received by OOC's

- Engen has no knowledge of its predecessor Mobil having acquired any coal mining assets from government at any time.
- Compensation was only partial because the synlevy was fixed in rand cents per litre and not adjusted as the rand weakened against the dollar, whereas the margin foregone was a dollar margin. Thus over the 10 year life of the synlevy, the level of compensation as a percentage of margin lost became lower and lower. See also p43, response for para 6.
- Engen is not in a position to quantify the difference between support received by Natref and other oil companies.

Bullet 2 – Natref benefits from the purchase of crude oil stocks at “discount” prices- Engen is not in position to answer this question.

Bullet 3 –Total and Shell own crude procurement - Shell and Total still had some access to crude oil via the international systems of their parent companies, and were therefore allowed to continue procuring crude for their SA refining needs. The other oil companies were completely cut off from their international supply and trading systems, and were therefore required by government to procure their crude oil from CEF. No abnormal profits accrued to any local refiner. There were in fact abnormal costs involved in procuring crude oil for South Africa. These were absorbed by CEF, but CEF took care to ensure that the prices paid by the local refiners were those which would have applied in a “normal” situation

Bullet 4 –Other mothballing compensation other than synlevy – No other compensation was received by Engen.

Bullet 5 – Explanation of low ROA – The SAPIA figures reflect the reality that in many past years the ROA's of the crude refining and marketing industry have indeed been very low. There is a popular misconception that regulated margin mechanisms have typically been overly generous to the industry. This perception is not supported by the facts. Furthermore, the industry has frequently suffered in the past due to failure on the part of government to apply marketing margin mechanisms consistently and timeously.

Bullet 6 –Difference in OOC profitability compared to Sasol Oil - We are not in a position to comment definitively on this. However, the Task Team has itself pointed to many of the advantages enjoyed by Sasol which, coupled with a low asset base in marketing, would presumably account for much of the difference.

Bullet 7 – Incentives to encourage refinery investments – No special incentives of any nature were granted to encourage refinery upgrades to meet clean fuels specifications.

Bullet 8 – Chevron shared logistics with PetroSA – Engen is not in a position to comment.

2.5 p 92 Section 9.5 - Value Chain Approach to liquid fuel industry

Transfer pricing: The Task Team has no reason for concern regarding transfer pricing in any part of the value chain in which Engen participates. SARS have audited Engen's transfer pricing and have not raised any objections to the current transfer pricing mechanisms. As a matter of policy, Engen would not engage in any transfer pricing which is not strictly market-related. We are not in a position to comment on the potential for transfer pricing in the synfuels value chain.

2.6 p 92 Section 9.6 - Applying windfall methodology on the liquid fuel value chain to identify economic rent streams

Bullet 1 – Usefulness of the value chain approach – While it may be useful to consider the whole value chain in order to clarify what is and is not relevant to this task, Engen feels, with respect, that the Task Team goes beyond the scope of its TOR in considering and commenting on value chain elements downstream of synfuels production and crude oil refining. Engen does not see these elements, which are in any event subject to regulation by the DME, as being relevant to the current investigation. Nevertheless, since the Task Team has chosen to include these elements, we are obliged to comment on its analysis.

Bullet 2 – Analysis of the individual value chain elements

General:

As already indicated, Engen believes that economic rents/ windfall profits can only arise in the upstream production of crude oil or in the production of synfuels from coal or gas, and not in crude oil refining or any other part of the RSA liquid fuels value chain.

Engen points out that in RSA the various elements downstream of manufacturing are regulated by DME. The margin control mechanisms are reviewed periodically by the regulator (such a review is presently in progress), and their outcome is anticipated. Certainly it is not intended that they should deliver, nor have they delivered, more than a fair return to industry members.

Engen’s comments on the individual downstream value chain elements relevant to the crude refiners are as follows:

p 81 point 7.4.2 BFP mechanism - Engen does not agree with the view that the BFP is higher than a ‘true’ import parity price. The BFP is intended to represent the realistic cost of importing substantial volumes (say 30% of the national requirements), and in Engen’s view it continues to do this well. It is a fair and reasonable benchmark because it represents the country’s real alternative to local refined product manufacture. It is of course accepted that incremental volumes at the margin can frequently be imported at a cost below BFP, but the BFP was never intended to represent the cost of marginal imports. (As a matter of interest, in recent times imports of high octane petrol have typically landed at above BFP prices). The individual elements of the BFP formula must and will continue to be reviewed from time to time to ensure that they remain market-related. However, the basic methodology remains sound, and the contention that it can deliver economic rent/ windfall profits and should be reviewed is without foundation.

p 82 point 7.4.4 – Transport cost

Not applicable to Engen as per report. Engen comments only that it is the duty of the Pipeline Regulator to ensure that no unreasonable or discriminatory tariff practices are perpetuated.

p 82/83 points 7.4.5 & 7.4.8 - Zone and Service differentials

Zone differential and service differential are cost recovery elements for transport and depot/ delivery costs respectively. Engen does not accept that they can or do yield undue benefits to industry members. In any event, both mechanisms are currently being reviewed by DME as regulator.

p 82 point 7.4.6 - Volume uplift agreements

The various supply agreements which existed in the past and those which continue to exist were entered into voluntarily by the parties to them. There is no basis for concluding that economic rents/ windfalls have arisen or might arise from any of them, including the current agreement with PetroSA.

p 83 point 7.4.7 - Volume infrastructure constraints

Engen agrees that there are presently logistics constraints which could be exploited by inland suppliers. Engen does not, however, agree that “windfall taxation” would be an appropriate way to deal with any abuses. The machinery exists to deal with any anti-competitive behaviour.

p 83 point 7.4.9 - Wholesale margins

Economic rents have not occurred in the past, nor are they likely to occur in the future as a result of the application of wholesale margin mechanisms. The MPAR mechanism is presently the subject of another review by the regulator (DME).

p 84 point 7.4.10 - Dealers margin

Once again, the retail margin mechanism has done what the regulator apparently intended it to do (cover the costs of an average service station), and cannot be said to have delivered “economic rent”. This element is also presently under review by DME.

Incidentally, the statement that the MPAR methodology has rewarded oil companies with a “guaranteed” return on service station investments is untrue.

Bullet 3 - Conclusions on the value chain

In summary, Engen is firmly of the view that economic rents/ windfall profits do not arise in the RSA crude refining and marketing industry, and that these parts of the value chain fall outside the TOR of the Task Team. In any event, the margin elements concerned are already subject to regulatory review.

2.7 p 93 Section 9.7 –Request for comment on the fiscal measures identified in the TOR that the Task Team has been requested to consider.

With reference to the questions raised on page 86 and 87 of the discussion document, some of which are not summarised elsewhere in section 9, Engen has the following comments:

p87, bullet 1 – SAPIA forecasts - SAPIA forecasts are merely indicative – for which reason SAPIA gives both a high and low forecast number.

p87, bullet 2 - Meeting expected growth in domestic market -

Engen will balance its supply and demand in the regional fuels market through a combination of actual production from imported crude oil, from purchases of locally manufactured synfuels and bio-fuels, and imports/exports of finished products and blending components, and the combination of these will depend on the relative economics of these various options.

p87, bullet 3 – Advantages in meeting growth by domestically produced fuel instead of imported fuel - Engen will invest in expanding its local production when that investment is expected to yield a return covering our shareholders' cost of capital, when compared to the alternative of importing shortfalls. Investments which do not yield a return covering the cost of capital destroy shareholder value and will be avoided if possible. Engen notes in passing that investments in additional refining capacity normally only become economically justifiable once there are significant shortfalls in supply.

p87 bullet 4 – Consider the four fiscal mechanisms to address windfall profits - Parties are requested to consider the four fiscal mechanisms to address:

- windfall profits
- incentivising future investments

(which we see as two distinctly different issues)

- **Windfall Profits**

As stated earlier, Engen is in principle opposed to the application of windfall profit taxes. Retroactive taxes of any kind are unacceptable. There could theoretically be a case for forward-looking taxes under exceptional circumstances, but Engen is not persuaded that such circumstances presently exist in RSA.

As far as the proposed mechanisms are concerned, Engen is opposed to the re-introduction of any subsidy scheme of any kind for synfuels producers, be it to protect existing operations or to incentivise further investment in synfuels capacity. The RSA synfuels producers no longer need protection, nor are they likely to again in the future. And neither synfuels producers nor crude refiners should be subsidised to increase production capacity. It should be left to normal market forces to determine what capacity additions get made when and by whom. Subsidies distort market signals and lead to misallocation of capital resources.

Engen is also strongly opposed to any kind of cost plus administered price regime. Such systems promote inefficiency and are not market-related.

Should the authorities decide to impose windfall profit taxes, in spite of the strong economic arguments against such taxes, the least objectionable way of doing so might be through some form of progressive formula tax, but it will be clear from our submission that Engen does not favour this approach either.

- **Incentivising Future Investment**

As stated above, Engen does not think that either synfuels producers or crude refiners should be subsidised to incentivise them to increase capacity.

In the case of the fledgling biofuels industry, there may be a case for special government support, even involving subsidies, to get the industry off the ground. However, before going this route government should make very sure that the projects concerned really serve the broader national interest and are deserving of the support given.

Engen draws a distinction between subsidies, which we regard as generally undesirable, and tax incentives for investment, which can indeed be appropriate tools for government to use. Should government consider local refining preferable to imports, for example, it could put in place a favourable fiscal environment for investors in local production (which should, of course, be the same for all players). Local refiners are also faced with the prospect of very large investments yielding little or no return, to enable them to produce the even cleaner fuels which are likely to be required in the next decade. It would be desirable for government to provide some incentives for such investments, either through tax incentives or reduced taxes/ levies on cleaner fuels or a combination of such measures.

3 Conclusion

On page 66 of the discussion document, it is stated that “As the local operations of the OOC’s are solely marketing and refining operations, these profits fall outside the scope of this Task Team”. Engen fully agrees with this statement. Yet the Task Team has chosen to comment quite extensively on these operations. Engen has therefore emphasised in its comments that windfall profits cannot properly be considered to arise in its part of the value chain, and at the same time sought to correct certain misconceptions regarding elements of that value chain.

Engen has stated its in-principle opposition to the concept of windfall profit taxes, as well as its general aversion to subsidy schemes and cost plus regulation.

Engen has stated its support for targeted investment incentives, available to all potential investors in the sector, in appropriate circumstances.

Engen trusts that its comments will be of assistance to the Task Team.

Annexure A

Section 9.4 Comment on the History of the Liquid fuel and Synthetic fuel industry

p41, para 2 – Contrary to what is stated here, there were no special incentives of any significance to the foreign oil companies to persuade them to establish refineries in South Africa. These investment decisions were made on normal economic grounds when demand became sufficient to warrant local refining.

p42, 5.3 Para 1 - Full offtake of local production at import parity prices has never been guaranteed to refiners by government. Any capital investment incentives granted were those available to all manufacturers, and not specific to the refining sector.

p43, Para 6 – As discussed in the body of our submission, the synlevy paid only partly compensated the refiners for their loss of margin.

p43, para 7 – We certainly do not agree with the statement that “It is generally agreed that, based on prospective disinvestment, the level of expenditure by the oil companies in maintaining their refineries was inadequate”. There is no basis for this assertion. Certainly Mobil had no need to expand the capacity of its refinery during those years, but it continued to maintain it adequately as per normal practice, with safety considerations in particular remaining of paramount importance.

p46, para 1 - The other oil companies did not “presumptuously” want the pipeline “reserved” for their usage as stated. Rather, their objection was to the fact that Petronet did a private deal with a competitor using publicly-funded infrastructure, in the process introducing a potential logistics constraint which has now become a reality. It is a matter of fact that Petronet at the time assured the Competitions Board and the industry that capacity would be available in the future when required. It is equally a matter of fact that this promise has not been kept. Industry has every right to feel aggrieved over this matter.

p47, para 2 example no. 2 – Government was never a party to the Sasol agreement. Further, the agreement was not a “gentleman’s agreement”, but became legally binding on all the parties to it although it was not signed.

p47, para 3, bullet 1 – The BFP formula was not the product of a signed agreement. The formula was developed jointly by DME and the members of Sapia, but only certain implementation matters, not the methodology itself, were the subject of an agreement between DME and industry.

p48, section 5.6.3. para 3 – The Ratplan expired at the end of 1999 and not 2002 as stated. Agreement could not be reached on a rollover to end 2002, and the Ratplan therefore became defunct.

p49, para 2 – Blue Pump agreement (modified for the advent of Secunda) came into operation in about 1982, not 1988 as stated.

p49, para 5 – Although there were several disputes between the parties, all were settled between the parties without being taken to formal arbitration.

p50, para 3 – The end of the upliftment agreement removed a very important aspect of the supply arrangements in the industry, but it was never part of regulation as stated.

p50, para 3 – It is stated that OOC's "aggressively" entered the inland market and shipped product there "at almost any price". This is an unfortunate and misleading statement. The OOC's were of course already active in the inland market. To preserve their refining margins on product they had available at the coast, they naturally used this product to the extent they could to supply their inland requirements, rather than forego refining margin to Sasol. This was a pure economic decision, which resulted in Natref becoming the swing refiner instead of the coastal refiners.

p50, para 5 – The upliftment agreement was specifically exempted by the Competitions authorities until it expired. It was not a matter of its not being challenged.

p51, para 1 et seq – Reference is made to a "generous import parity price build-up". Engen disputes the notion that the import parity formula has always been too generous, and that this was deliberate in order to incentivise multinationals to invest and remain in SA during the apartheid years. In fact the IBLC remained market-related for many years. It was only in the 90's that IBLC started moving out of line with market reality, largely because the posted prices it used became increasingly less representative of the prices at which products were actually traded. As a result of this trend, the IBLC was modified in 1994, and then completely replaced by the BFP in 2003.

p52, para 2 – The PAR mechanism, which monitored overall refining and marketing profits and was used to adjust wholesale (marketing) margins if necessary, retained the 15% overall return benchmark which had also applied prior to the introduction of PAR in 1984, but it provided no "guarantee" of returns. This 15% benchmark applied, incidentally, to other regulated industries, so that it cannot be argued that government intended to give the oil industry favoured treatment. By 1990 it had become necessary to make large investments in additional refining capacity, and the distortions resulting from integrated profit monitoring made it very difficult for refiners to justify such investments. DME therefore agreed to delink marketing and refining. MPAR was introduced to regulate marketing margins, and refining was effectively "deregulated" and allowed to earn whatever return was attainable based on import parity pricing ex refinery. Contrary to various assertions in the report, objective examination of the history will show that neither the MPAR mechanism nor its predecessors have yielded excessive returns to local oil companies over the years.

p52, para 3 – The equalisation fund was originally established for the purpose of smoothing price fluctuations at the pump in order to benefit the consumer, not to meet government commitments to the oil industry.

p56, table 5 – It is Engen’s understanding that the cap of 30% was never in fact reduced to 20% as proposed by the Arthur Andersen report (see table 5 on p 56 of the discussion document).

(Further comment on the history: Engen and the OOC’s regarded the Arthur Andersen report and recommendations as seriously flawed, and therefore strongly objected to and distanced themselves from these in the Liquid Fuels Industry Task Force. In our view, the fact that the synfuels industry undoubtedly received more tariff protection than was necessary and for much longer than necessary, and was not obliged to repay any of this when prices rose significantly above the “floor” level, was an entirely predictable consequence of Cabinet’s decision to implement these recommendations. Therefore, what accrued to the synfuels industry under the tariff protection regime cannot be regarded as a “windfall”. It would be completely inappropriate for government to seek to change now, with retroactive effect, the decision it made in 1995.)

p58, para 3 – Both Sasol and Total purchased the NIOC shares in proportion to their existing holdings at the time. SASOL was the majority shareholder even prior to the NIOC share purchase.

p58, para 5 – It is implied that Natref made a profit on transport between 1971 and 1987, which is not the case as far as Engen is aware. Natref was just kept neutral as no location differentials accrued to them at the time. Location differentials originally accrued to SAR&H and not to Natref. Only later, when Natref started paying for crude transport and being paid location differentials on products, were the distortions favouring Natref introduced.

P59, para 1 bullet 6 – There was never an intention by the OOC’s for Secunda to be the swing refiner as opposed to Natref (refer also response to p50, para 3 in this regard).

p61 – The last paragraph in 5.8.3 is inaccurate (refer previous response to p58, para 5).

p61 item 5.8.4, bullet 2 – Import parity is a fair benchmark for building up regulated prices, and it is not true that the oil industry has benefited at the expense of motorists. Furthermore, refiners have never been guaranteed IPP on all of their volumes (e.g. some volumes were exported, and in any case prices are not regulated at an ex-refinery level).

p61 item 5.8.4, bullet 3 – Engen does not agree that there was significant over investment in pipeline capacity as Sasol 2 and 3 were not in prospect at the time it was decided to install this capacity. It was government’s subsequent strategic decision to invest in Secunda that rendered this pipeline capacity surplus.

p62, para 3 – There was never any expectation on the part of Engen to be kept profitable at any cost. All that was expected was that government would apply agreed regulatory mechanisms consistently and fairly. It is Engen’s view that the lack of petrochemicals production based on crude refining and the country’s reliance on coal for petrochemicals are not unplanned outcomes, but the logical consequence of the local resource base and resultant economic considerations. It is also not correct that investments in crude oil refining were largely brought about through the regulatory framework.

p65, para 3 – For the crude oil refiners, manufacturing costs are largely determined in foreign currency. Only for synfuels manufacturers do rand costs predominate. It is not certain that this distinction comes across clearly.