Windfal Tax discussion document – comments

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The following contains comments on the document entitled: ‘Possible reforms to the fiscal regime applicable to windfall profits in South Africa’s liquid fuel energy section, with particular reference to the synthetic fuel industry’, dated July 20th, 2006 by the Windfall Tax Task Team. These comments are made in my personal capacity and refer to Section 9.3 (Methodology for defining windfall), Section 9.6 (Applying windfall methodology on the liquid fuel value chain to identify economic rent streams) and Section 9.7 (Request for comment on the fiscal measures identified in the TOR that the Task Team has been requested to consider). The headings relating to the comments follow the headings used in Section 9 of the document for ease of reference.

9.3 Methodology for defining windfall

Question 1 Definitions and Question 3 forward v backward looking

1. The definitions of ‘economic rent’, ‘supernormal profits’, ‘natural resource rent’ and ‘windfall profits’ are accurate and appropriate. In particular the distinction between backward looking retrospective windfall taxes and forward looking taxation of economic rent is helpful.

2. In my opinion backward looking windfall taxes carry a high risk of contributing to regulatory uncertainty, particularly in the context of emerging markets. This perception of regulatory uncertainty could permeate other areas of the South African economy that are currently subject to economic regulation and thereby have significant unintended consequences, raising the risk premia and associated cost of capital for investment in diverging network industries including important input industries such as the electricity and telecommunications industries. Notwithstanding the historic context of the South African liquid fuels industry, in considering a windfall tax, the Task Team would for the reasons outlined above be well-advised to recommend such tax in a forward looking manner.

Question 2 Conditions

3. The conditions stated provide a useful framework for justification of regulatory intervention. The case is not necessarily made for taxation as the regulatory intervention of choice. Therefore, the analysis on page 29 that ‘economic rent generally qualifies for taxation when the following conditions apply’ would be enhanced by adding ‘economic regulation’ to ‘taxation’ as a possible remedy for economic rents arising under the conditions specified.

4. It is particularly important to note the existence of low price elasticity of demand that is normally associated with essential goods and services as mentioned in this Section.

Question 4 Windfall losses

5. The case for windfall losses being cushioned by implicit or explicit protection in infrastructure and essential services industries is clearly made. Likewise royalties in natural resource extraction industries are supported.

Question 5 Other considerations

6. As mentioned above, where the case is made for regulatory intervention price regulation should be considered as an alternative to taxation.

Question 6 International examples

7. The examples of international experiences are narrowly focused on windfall taxes and would benefit from a widening to regulatory interventions that could be considered to remedy windfall or supernormal profits, including price regulation.

Question 7 Resource stabilisation funds

8. The discussion of resource stabilisation funds is lacking in one important area, namely the recognition of private sector risk. The cyclical nature of commodity or international energy coal prices is well-known and should be dealt with appropriately by the private sector companies operating in the natural resource industries. A stabilisation fund may be an appropriate response to such cyclic prices, but this should be initiated by those bearing the risk.

9. In the case of public owned corporations facing such risks, such as is the case with energy coal prices, this risk should be carried by the regulated entity or public owned corporation in an appropriate manner, with limitations for the pass through of cost implications to consumers and incentives for efficiency in managing this risk.

9.6 Applying windfall methodology on the liquid fuel value chain to identify economic rent streams

Question 1 Usefulness of the value chain approach

10. The value chain approach is useful as it allows for differentiation between the role of price, cost and volumes in windfall profits.

Question 2 and 3 Analysis of value chain elements and key conclusions

11. The discussion of the various elements in the table is largely correct in my opinion. However, the BFP part of the price (row 2) and the volume elements (row 6 and 7) of the downstream economic rent components warrant further discussion.

12. The use of the BFP formula to arrive at the downstream price for liquid fuels is problematic. The rents thus created were partly windfalls as policy could not have accurately anticipated the size of these rents. These rents thus warrant a policy response, and the table on p 77 correctly includes ‘regulatory’ as well as ‘fiscal’ policy measures. My suggestion is to include price regulation as a possible candidate for addressing future rents of this nature.

13. The uplift agreements and infrastructure constraints also create windfalls that could not in their entirety have been anticipated in policy. These also qualify for regulatory intervention, although the choice of intervention being a windfall tax is not necessarily supported. Alternative forms of economic regulation should be investigated in this instance.

9.7 Request for comment on the fiscal measures identified in the TOR that the Task Team has been requested to consider

14. Regarding the fiscal measures identified in the Terms of Reference the following should be noted. The measures listed, including the cost-based administered pricing regime, all involve high prices leading to windfall profits, corrected for by a certain type of tax. This presumes that the problem that the Task Team is primarily concerned with is one of high profits that can only be corrected by fiscal measures and overlooks the possibility that economic regulation be applied to the elements giving rise to such windfall profits. Measures addressing the correction of high prices are not considered.

15. From an economic regulation point of view, pricing that bears no relation to cost is suboptimal and can only occur in the event of market or regulatory failure. The justifiable economic rent that may be present in the synthetic fuels industry due to technological advances, such as the Fischer Tropsch technology, is overshadowed by the windfall profit that is generated by linking the price of such fuel to international oil prices which are unrelated to its cost base. The problems with import parity pricing are highlighted in many areas of the South African economy and warrant special attention.

16. It should be considered that high fuel prices are problematic in their own right as they give rise to inflationary pressures and impact disposable income disproportionately.[1]

17. A windfall profit tax may thus generate fiscal revenue but at continued cost to the consumer. This type of taxation is likely to be regressive, particularly in the case of price inelastic demand for fuel. Regulation of the price of (synthetic) fuel on the other hand would not generate any fiscal revenue but would dampen

[1] Environmental and other policy considerations that would preclude a ‘low’ fuel price are not considered here. Additional taxation and levies could obviously be applied to correct for prices that are considered below their full economic cost.

inflationary pressure from increasing oil prices and not affect disposable income negatively.

18. In addition the downside of windfall taxation should be considered. As mentioned earlier, such taxation can be construed as punitive and is likely to lead to regulatory uncertainty, particularly if this is applied retrospectively. (It could be argued that clawing back the payments that were not made under the 'gentleman's agreement' mentioned in the report are not the same as a windfall tax and will not lead to the same regulatory uncertainty).

19. The consideration of a windfall tax should therefore be widened in scope and allow for other regulatory interventions such as price regulation. In essence, a regulatory mechanism should to be devised that passes any windfall gains back to the motorists.

20. Regarding the fiscal measures identified the following comments apply.

    a. A revised forward looking subsidy scheme and a progressive tax formula as outlined in the TOR will correct for windfall profits but carry a significant administrative burden. These measures will also not address the problems associated with high fuel prices per se. Out of the options proferred such as system may be best suited to allow a pass through of windfall gains to the motorist.
    b. The cost-based administered price regime is qualified by the following: 'an excess profit tax would fall on the gap between synthetic/alternative fuel production costs and standard refinery costs' and does not appear to lead to cost-based prices as the standard refinery costs are maintained. The document would benefit from further analysis of this qualification. In the alternative, cost-based price regulation could be considered.

Summary

21. In summary my comments have concentrated on the role of the BFP in the generation of windfall profits and contain the suggestion to consider fuel price regulation as an alternative to fiscal measures.