

**Submission by TOTAL SOUTH AFRICA on the
discussion document for public comment**

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**

**as prepared by the Task Team appointed by the Minister of Finance in
May 2006**



TOTAL

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1. Summary

Government is considering the implementation of Windfall taxes on the liquid and synfuels industry. A task team was appointed by the minister of finance in May 2006 to conduct a study. The team did not as required in its term of reference consult with all the Oil companies, in particular with TOTAL.

This document provides an overview of economic issues, which should be considered before the implementation of Windfall taxes. The definitions of economic rent and economic profit are provided. We show that essential services and demand elasticity is not a suitable criterion to identify sources for windfall tax and those alternative criteria need to be developed. Consideration should be given to economic welfare and efficiency and the potential unintentional altering of industry structure by introducing windfall taxes. The economic benefits obtained by consumers due to past government involvement must form part of the process. It is also necessary to question if recent economic rents has in fact not been generated by intellectual property, rather than resource ownership. We show that requirement for Government support for Windfall losses, in the future in the oil industry is highly unlikely as it is an essential service with low elasticity in demand.

International experience has shown that Windfall taxes have a long-term negative impact on investment. Both the US and the EU have recently abstained from the implementation of such taxes. The teams' report suggests that unexpected refining margins should be subject to windfall tax. The BFP formula has mirrored these unexpected fluctuations since its inception and are therefore not unexpected.

The task team report makes numerous erroneous and unsubstantiated references to locational and neutrality benefits obtained by Natref due to Government support. These are corrected in this report by showing that Natref did indeed pay the same tariff as other producers to get product inland.

Our report also focuses on the role of Petronet, as the most important logistics service provider, in the industry. We show that the development and use of the pipelines were not beneficial to Natref specifically and that Petronet is operated as a profitable concern. Past under-investments by Petronet and the blocking of industry infrastructure development initiatives has resulted in a current logistical problem.

Government currently regulate industry marketing profitability by means of the MPAR system. We show that Industry is not receiving the intended compensation and that there is a current backlog of more than RB2.0 due to industry.

The current refinery margins receive much attention in the task team's report. We show that current margins are due to under-investment in refining capacity in the 80', and 90's and unlikely to be sustained into the future when more than 500 projects announced worldwide comes into production.

The task team insinuates that Natref received benefits from the purchase of Ogies crudes from SSF and the use of their infrastructure. These statements are incorrect as market related prices, inclusive of all cost components were paid for the crude. Natref purchased the SSF tanks in 1988. The team also suggest that TOTAL received benefits due to its joint shareholding in Natref with Sasol. This is again an unfounded statement as these two entities does business with one another at arms length and on a commercial basis.

The task team interpretation of the Competition Tribunals' document on the Sasol-Engen merger to infer that Sasol and TOTAL (through Natref) has market power is incorrect in its application on TOTAL. TOTAL use more than 90% of its own production to supply only its own customers and has the second smallest market share of the six majors in the inland market.

In conclusion we believe that the team has failed to formulate a case for the introduction of windfall taxes on the economy. We expect that the introduction of a windfall tax will have a

damaging impact on the country's economy by discouraging investment and causing capital and intellectual flight in the long run. The country urgently needs petroleum infrastructure and clean fuels investment in the short term. This will not happen if additional taxes are introduced. New BEE participants will suffer if burdened with a windfall tax outside the framework of their financial model. In short we do not support the introduction of a backward or forward looking windfall tax and feel that normal corporate taxes on profits and capital should remain as current.

2. Introduction

The recent high profits announced by International Oil Companies have drawn the attention of individual Governments for a review of the tax regime under which these companies operate. South Africa is undergoing a similar process as demonstrated by the public discussion document to which this submission responds.

"The National Treasury seeks through the 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:" (The terms of Reference)

- a) "Outline the international experience and approaches associated with a windfall tax;
- b) Comment on the contribution of the synthetic fuel industry to the South African economy;
- c) Where and if appropriate benchmark the synthetic fuel industry against the local and international petroleum (oil) refining industry;
- d) Review the role of fiscal support in the establishment and development of the synthetic fuel industry;
- e) 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.
- f) Provide an economic and financial analysis of the synthetic fuel industry as a basis for assessment of these and other fiscal regime options.
- g) 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.
- h) Comment on the appropriateness of the current price regulations with respect to petroleum products in so far as it impacts on windfall tax recommendations.
- i) Investigate the economic, financial and administrative implications of tax options identified and to draw where appropriate on international experience and practice.
- j) 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
- k) 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."

One of the requirements of the proposed process for the development of the report (as shown in Chapter 2 of the task team's document) required that the task team shall interact with the oil companies operating in South Africa. The task team did not interact with TOTAL South Africa at all. Several facts pertaining to TOTAL included in the task team's discussion document are therefore incorrect or misrepresented.

We are of the view that only points h, i and k included in the terms of reference are directly relevant to TOTAL. In our response we shall focus on the factors, statements and assumptions concerning these and also issues concerning Natref. We shall highlight the

incorrect statements and contradictions in the document, show unsubstantiated allegations and respond to some of the issues noted in the terms of reference. We will also submit economic issues for consideration and concepts on the potential impact of windfall tax on industry.

3. Economical Basis.

In the report you invite comment on the methodology used by the Task Team to define a windfall, as outlined in Section 4 highlighting the following:

- *Do you agree with our definitions and use of the concepts of “super-normal profit”, “economic rent”, “natural resource rent” and “windfall profits”? If not please give reasons and alternative suggestions.*
- *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?*
- *Do you agree that the distinction between backward looking retrospective windfall taxes and forward-looking taxation of economic rent has value as argued above?*
- *Do you agree with our arguments about “windfall losses” as made for both the infrastructure and essential services sectors, and the natural resource sectors?*
- *Are there other important considerations for the key concepts that we have missed?*
- *Do you agree with our interpretation of the examples and are there other cases that we should consider?*
- *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?”*

In order to ensure a common understanding of the concepts and principles used in the task team’s document we have consulted the Pricematrix Economist for assistance, whose contribution is presented in this chapter. Pricematrix has extensive experience in the local oil industry activities and were listed as an expert witness during the recent Sasol-Engen merger hearings. The application of the concepts is reviewed and comments provided on their applicability to the introduction of Windfall taxes on the oil industry.

The definition and use of the concepts in Section 4 are a very useful but an incomplete starting point for the economic evaluation of the effects of taxes on economic rents and economic profit in a specific industry and for the business sector in general. The term economic rent and economic or super-normal profit are similar but different concepts. Economic rent is the return or income to a factor of production over and above the amount required for its owner to supply the factor for use. It is the amount that companies are “willing to pay for an input less the minimum amount required to obtain it.”¹ Economic profit focuses on the output rather than the inputs of the firm and occurs when the revenues of a firm exceed its total opportunity costs including both explicit costs and implicit costs such as normal profit.

The report uses the terms economic rent and super-normal profit interchangeably. However, the terms are not necessarily the same and using them as such may cause confusion. For example, economic rent can exist when economic profit is zero. A case in point where one firm has a lower cost structure than other firms in a competitive industry, for instance because it has a patent or access to an input that allows it to produce at a lower average cost than its competitors. In the long-term economic profits in the industry will be zero but the firm with the cost advantage will earn a greater accounting profit (revenues less actual expenses and depreciation) than other firms in the industry. The same issue also arises in industries that are not perfectly competitive.

¹ Pindyck, R. SW., Rubinfeld D.L. (2005) *Microeconomics*, Pearson Education

Consequently, if a government decides to levy a tax on economic profit by taxing accounting profits where firms differ in their opportunity costs (and the liquid fuels industry is arguably a case) it needs to be able to establish whether the accounting profits in the industry are economic profit, economic rent or a mixture of both, otherwise firms that do not have economic rents or lower economic rents than other firms could make economic losses. These and other measurement issues are discussed later.

3.1 Essential service industries and infrastructure industries

The Report states that economic rents, which qualify for taxation ("qualifiable economic rent") include those that supply essential services including infrastructural services and "where customers have no alternatives" and argues that the liquid fuels industry falls into this category. The definitions of essential services or infrastructural services is not given in the Report and the terms are loose and potentially uninformative in that they could be applied to virtually any product depending on the perceptions of the observer. For example, consumers require food to survive. Is the food industry therefore an essential service that needs to be regulated and its rents or profits taxed beyond normal company taxation? Another example is that industries may provide essential services but have their profitability and economic rents severely constrained by imports.

There are also significant practical concerns. How is the term "consumers have no alternatives" as a determining factor to be assessed in reality? The Report points out that one criterion is a low price elasticity but this invites a number of questions: at what level is a price elasticity considered low and an industry become "essential," and should other measures of substitutability such as cross-elasticities be used as well? Evidence given at the Competition Tribunal's consideration of the Sasol-Engen merger last year stated that the price elasticity of petrol was about -0,3. Many foodstuffs and beverages have elasticities around this level. If price elasticity is a major criterion it would appear that taxes on items such as beverages should be considered for additional taxes, particularly as some manufacturers are likely to have high economic rents and economic profits, for instance in carbonated drinks and beer markets. If the government adopts a consistent and non-discriminatory approach based on the criteria outlined by the Report other industries that will qualify are telecommunications, some information technology markets, and the gas and electricity industries. On the other hand there are many industries that are non-essential or non-infrastructure industries based on the criteria of low price elasticity where there are large economic rents. In conclusion, criteria such as essential services or infrastructure are inadequate as a criterion for "qualifiable economic rent." Importantly, if it is used to identify the liquid fuels industry without other industries with the same characteristics, it is unfairly discriminating against the industry. In conclusion, a much more focused criterion for the nature of the industry to qualify for a windfall tax is needed if a sound conceptual basis is to be established for the government.

3.2 The need for alternative criteria

In its discussion of the essential services argument, the report errs in stating that firms that generate super-normal profits do so "at the expense of consumers" This is incorrect since firms can increase economic profit yet improve consumer welfare at the same time. It highlights a weakness in the Report's approach for assessing "qualifiable economic rent." The problem is the use of only economic rent and economic profit as criteria in assessing the performance of an industry. It is an incomplete, insufficient and potentially misleading guide for Government because it ignores the importance of consumer surplus and total economic surplus as concepts in determining the level of economic welfare in an industry.

The appropriate economic evaluation of a market's or industry's performance and consequently the need for government intervention is not just the economic rent or profit it generates but its contribution to economic welfare or economic efficiency, measured as consumer surplus and producer surplus. Consumer surplus is the difference between what a consumer is willing to pay for a product or service and what the consumer actually pays when buying it. Producer surplus is, for the sum of all units produced by a firm, the difference between the market price of a product and the marginal opportunity costs of production.

An industry is efficient when it maximises total surplus,² the sum of consumer and producer surplus. In a given industry total economic surplus is not necessarily maximised in a competitive market structure. Where there are economies of scale in production, an industry can be concentrated and earn economic profit or economic rent while contributing to a higher consumer surplus through lower prices than prices that would exist in a more competitive market structure without economic rents or profit and those economies of scale are not exploited. This result infers that governments introducing taxes on economic rent and profits can unintentionally alter an industry structure resulting in a loss of economic efficiency.

The criterion of total economic surplus is a useful one because it provides the government with a clear criterion and framework for measuring the effects of a policy. For example, it is widely accepted that any tax levied on a particular industry will reduce economic surplus in that industry but these costs need to be weighed against the social return i.e. the additional consumer and producer surplus created elsewhere in the economy when the government uses the tax revenue it has obtained from the industry.

What is important is that the use of economic surplus as a criterion for judging the effect of additional taxes on economic welfare can produce different conclusions than the use of solely economic rent and economic profit. The latter can lead to the wrong conclusions by taxing and hence discouraging the search by companies for economic profit and rents that are welfare-enhancing. The over-emphasis on supply rather than consumer demand also probably introduces an unintended bias elsewhere in the Report. For example in Section 5.8.4, which discusses the impact of previous government intervention in support of the industry, the authors state that "Consumers have borne the costs of establishing and maintaining synfuels producers over some 70 years." There is however, no mention of the benefits that consumers have obtained from the development of the synfuels industry. These include a degree of security of supply, the availability of low-sulphur fuel to the market and some currency fluctuation exposure protection.

3.3 Industries with Market Power

A further example of using an over-narrow set of criteria is in subsection 3 of Section 4 where it states that economic rents or profits caused by market power "could be reasonably clawed back" by additional taxes. Market power is usually defined in terms of pricing power where a firm in the long-run can charge prices above opportunity costs.⁴ However, market power is not necessarily harmful. A firm that seeks and successfully acquires substantial market power can have lower prices and provide superior products to consumers than firms with no or little market power. In this case the issue is the same as argued earlier: a government should not remove or reduce incentives that can improve economic welfare, such as improvements in productive and dynamic efficiency, just because it perceives there are economic rents in the industry. Additional taxes in these cases would unnecessarily harm economic surplus in an industry and, ceteris paribus, in the economy as a whole.⁵ In addition, the Report ignores the extremely difficult practical task of defining market power and distinguishing market power from superior efficiency, a controversial issue that is a perennial problem facing competition policy authorities. Getting it wrong can lead to taxing firms and industries that do not have substantial market power and lead to serious losses in economic welfare.

² This assumes that society values consumer surplus and producer surplus as equal. Some economists argue that consumer surplus should be valued more highly than producer surplus.

³ The Report rightly and persuasively points out the benefits of the synfuels industry to the economy and the fact that the industry support has been "successful." However, in its criticisms of previous government intervention it makes unsubstantiated comments such as "an oil industry which expects to be kept profitable at any cost" and "Total has benefited from the shared good fortune of being a joint refinery partner with a synfuels producer" which are unjustified.

⁴ A more general definition is the one set out in the Competition Act, "market power means the power of a firm to control prices, or to exclude competition or to behave to an appreciable extent independently of its competitors, customers or suppliers." Competition authorities are not generally concerned with market power per se but in the abuse of market power.

⁵ This ignores the other welfare reducing effects of an additional tax such as a deadweight loss.

3.4 Economic Rents from Efficiencies and Intellectual Property

The Report considers that super-normal profits or economic rents that result from efficiency improvements or the creation of valuable intellectual property (including technology) are not normally targets for additional taxation. Most economists will agree with this view. The Report's conclusion is important because it can be directly applied to the synfuels industry. A reasonably strong argument, and the Report indirectly supports it by stating that the ownership of coal resources does not create large economic rents, is that the source of economic rents in the synfuels industry is not the locational advantage of having access to a low cost natural resource (coal). Rather, it is the proprietary technology for the synthetic production of petrol, diesel, other liquid fuels, gas and chemical feedstock from coal that Sasol owns and which is supported by patents, the specialist knowledge and experience of its technical staff, and barriers to entry such as high sunken costs in its refinery operations. Without the technology and decades of experience, the coal resources are of little value. If the authors are right, and we strongly support their conclusion, there is little reason or justification to consider additional taxes on the synfuels industry. It would be a tax on innovation and technology and on a major South African competitive advantage in world markets. In addition, it would be inconsistent with other government policies, for example by the DTI and DME, which encourage the technological development of industry in the country. Further support to the Report's argument is that some sources of economic rent such as patents and copyright protection are deliberately created by governments to encourage innovation. It is contradictory for a government to provide incentives of this kind and then penalise the results of innovation through specifically targeted taxes on innovators.

3.5 Windfall Losses

We disagree with the statements in the Report relating to windfall losses. In criticizing the argument that governments using windfall taxes should also protect firms from windfall losses, it states:

"It is, however, often overlooked that this protection often applies, irrespective of whether explicit policies or regulatory mechanisms exist to provide such protection. Central infrastructure industries per definition have implied policy protection from the state. Because of their critical position in the economy, governments will not allow such industries to be bankrupted or to cease operations and will step in with bailout or other measures if required."

This is a weak argument. There is little risk of the need to bail out essential service industries or infrastructure industries because, as the Report itself points out, these industries tend to be profitable, partly because they face low elasticities of demand. The Report here is contradictory: it states there is a risk of these kinds of industries requiring state help and protection (page 31) but at the same time argues that these industries are prone to excessive profits – in reference to the industries it argues on page 29, "Essentially this means that higher monopoly profits are possible because of the low price elasticity that is normally associated with such goods and services." The comment ignores the fact that economic profit is derived largely from *own-price* elasticity rather than *market* elasticity but many economists would accept that in some cases these conditions will exist in these kinds of markets. If we accept the Report's argument in this respect, these industries are likely to have greater pricing power than non-essential services or non-infrastructure industries than other industries and hence face lower risks to profitability from adverse changes in demand or cost conditions, contrary to the assertions in the report. In fact, a more likely risk in these industries is the exploitation of consumers through excessive prices because, as already mentioned, the Report states consumers have few alternatives. Arguable cases are consumer perceptions regarding fixed line telecommunications and some banking services. Moreover, often, the only real dangers that occur in these kinds of industries are where they are subject to inefficient or inappropriate regulation. An example is where firms cannot recover adequately cost increases in prices because of poorly designed price controls.⁶ Besides these issues of principle, the Report also provides no evidence to support its assertions.

⁶ Another case is where a weak regulator allows firms in the industry to have higher than justifiable prices and returns on capital.

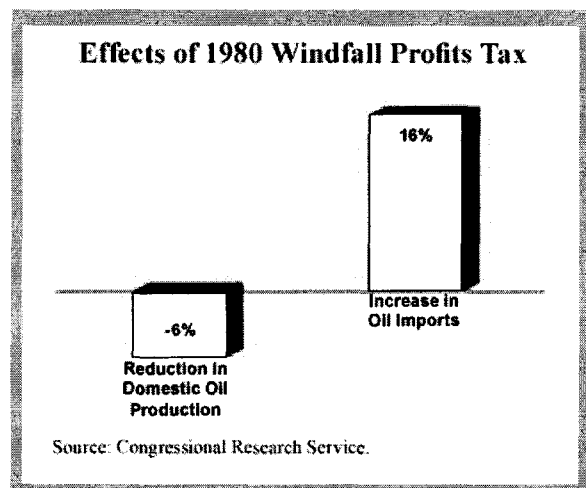
The Report states that firms that can rely on state support will have a lower cost of capital because of a reduction in systematic risk in terms of the capital asset pricing model (CAPM) used by investors in evaluating investment opportunities. We disagree. The nature of windfall losses is that they occur because of *specific* factors affecting an individual industry not *market* factors which affect all industries to a lesser or greater extent. The CAPM states that unique or unsystematic risks pertaining to an individual market or industry are risks that can be diversified away by investors with the result that the only relevant risk for them is the level of systematic or market risk. Consequently, an investor will not be rewarded for specific but only for market risk. As a result, the shifting of "firm risk" or specific risk onto the state will have no impact on an industry's "financing costs."

3.6 International Experience with Windfall Taxes

While acknowledging that the time for the study was extremely short, the Report could have analysed in more depth the experience of other countries that have implemented windfall taxes in the past, particularly their effects the subsequent performance of the industry. For example, the Report makes only a fleeting reference to the E.U. where the possible implementation of windfall taxes on the oil industry were recently rejected by Spain, Greece, Austria and Holland. Windfall taxes in the UK are only focused on the crude production environment.

The Report reviews the U.S. windfall tax but does not examine its effects except for a comment that revenue raised did not meet expectations. In its discussion of the U.S. tax (Section 4.4.4.), the Report outlines and describes the "Crude oil windfall profit tax" introduced by President Carter in 1980 and abolished by President Reagan in 1988. The Report mentions that the tax brought in \$80 billion in gross revenues from 1980 to 1988 compared to initial projections of \$393 billion. The Report does not include the results of research on the effects of the tax undertaken by the Congressional Research Service in 1990⁷. According to the study, besides realising only a small fraction of the expected revenue, the tax (an excise levy) "reduced domestic oil production from between 3 and 6 per cent, and increased oil imports from between 8 and 16 per cent." as shown below.

Figure 1. Effect of 1980 Windfall Profits tax in US



⁷ Details are in Lazzari, S. (September 12 1990), The Windfall Profit Tax on Crude Oil: Overview of the Issues," Congressional Research Service, quoted in a Heritage Foundation publication, "Raising Prices on Oil Companies Is No Way To Reduce Gas Prices," Web Memo, available from the organisation's website www.heritage.org. There are numerous other references to the study on the Web.

An article published by the Heritage Foundation⁸ concluded, "in effect, putting domestic oil producers at a disadvantage had the unintended effect of strengthening OPEC's hand. In the end, the tax hurt consumers more through higher energy prices than it helped them through higher tax revenues, which turned out to be far lower than originally predicted because the tax discouraged production... These unintended consequences were among the reasons why the windfall profits tax was repealed in 1988. Its effects, still linger: it likely slowed exploration and drilling of sources that would be producing today." The research findings are in line with the predictions of economic analysis and are a strong warning as to the likely efficacy of a windfall tax in this country.

3.7 Windfall Profits

We refer to the task team's section 4.2 for a review of Windfall Profits arising from unanticipated Economic Rent and Economic Profit, Backward Looking and Forward Looking Taxation

Windfall profits are essentially unexpected profits. They arise because of unforeseen market conditions such as sharply rising prices to consumers, which result in large increases in economic rents or profits that are perceived as being unfair or unjustified. Because they are seen as fortuitous, the argument goes, they should be taxed to redistribute from firms to other participants in the economy. This is the case for a retrospective tax. In addition if these conditions are likely to persist there is a case for forward-looking taxation of economic rent. Of interest here is the concept that ongoing economic rents should be taxed. However, this is not a windfall tax since by its nature windfall taxes occur sporadically and without being anticipated. Consequently, a windfall tax is confined to retrospective taxes or to a form of a 'knock-in' tax that is based on certain criteria being met in the future such as a price threshold. We believe that the government in its policy deliberations should distinguish between windfall taxes on unanticipated economic rent or economic profits and ongoing rent and profits in an industry.

In the event that Windfall taxes are only applied on unanticipated profits only, it can be demonstrated that the profits had indeed been expected in South Africa. The BFP pricing system is based on international marker prices and cost outside the control of the local oil companies. These prices are subject to external factors such as the Geopolitical situation, availability of tankers, period of the year and many others. These cause unpredictable fluctuations in values as shown by the posting of e.g. Diesel (figure 2) and shipping costs (figure 3). These fluctuations have always been part of the RSA pricing system and were as such always anticipated in policy.

Figure 2 . Fluctuation in Diesel AG posting 1999 to current (Source:Platts/Reuters)

⁸ Ibid

Figure 2 . Fluctuation in Diesel AG posting 1999 to current (Source:Platts/Reuters)

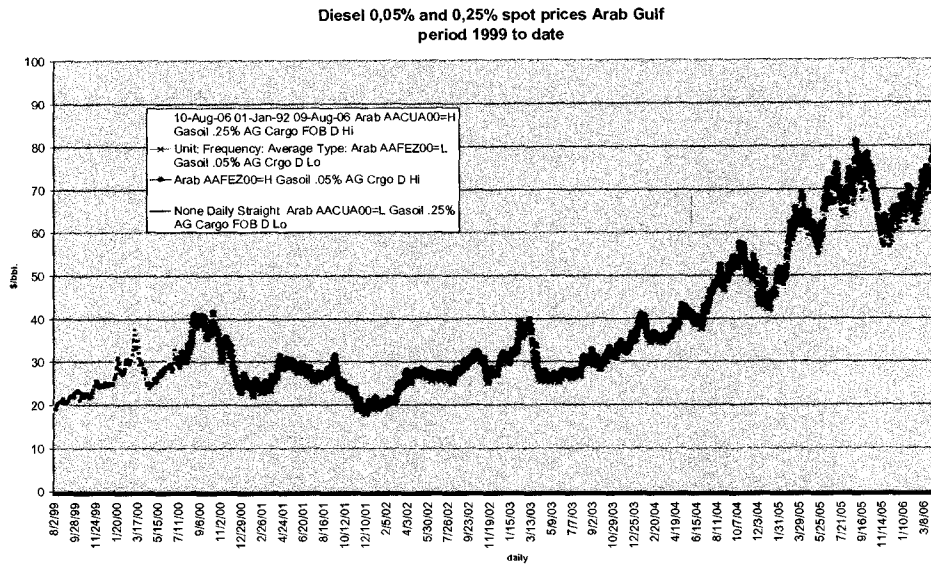
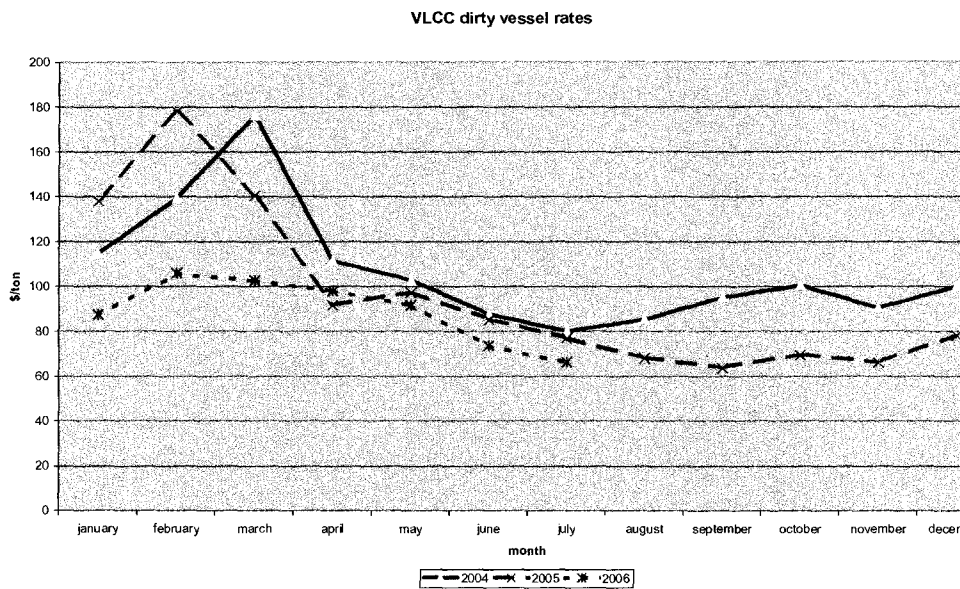


Figure 3. Fluctuation in shipping cost for crude carriers (Source : Platts)



We agree with the Report that windfall profits or rents are those that are unanticipated based on past decisions but, unlike the authors, think that a windfall tax policy can also be forward-looking in dealing with future windfall profits and be distinct from a policy that taxes on-going economic profits and rents. While there can be an overlap and some ambiguity, a windfall profit tax could be set based on, say, a future commodity price which is agreed upfront by the parties to be at a level that would result in economic profit or rents above an acceptable amount. Consequently, we disagree with the statement on page 38 of the Report that the U.S. tax on oil production from 1980-88 was not a windfall tax.⁹ While the issue is one of definition it is clear that the Americans see the tax as a windfall tax.⁹

⁹ Cf. The Congressional Research Service report.

3.8 Other Considerations

There are a number of issues relating to the methodologies set out in Section 4 that we would like to comment upon.

3.8.1 The need for an accurate assessment of the amount of economic rents and economic profits before a tax is levied.

We suggest that, in the event there is a decision to continue with the investigation into Windfall tax, the Task Team should investigate whether economic rents and super-normal profits exist in the synfuels and liquid fuels industry. There is public evidence of returns in the petroleum industry published by SAPIA and contained in the Report which indicate that, at first sight, economic profits do not exist since the after-tax returns on assets are significantly below the level investors would require in the South African capital markets and compare poorly with other sectors in the economy. The SAPIA data is aggregated so there is no indication of the returns made by any specific industry member, nor is there any information to estimate economic rents. In addition, the Task Team is aware that economic profits do not exist in the marketing and distribution activities because they are regulated on targeted returns on assets of between 10-20%, which most investors would not consider to be higher than alternative investments of a similar risk. However we presume these returns are based on accounting rather than economic principles and are therefore not necessarily a reliable guide for the purposes of Task Team.

The period for review should be long enough to take into account the nature of the industry's investment decisions and the cyclical nature of its business. These are of a long time period: for example a new refinery of an efficient scale and configuration currently costs over \$5 billion (over R35 billion at the current dollar/Rand exchange rate) and takes at least 5 years to build. In addition, an oil refinery is largely a sunk cost, adding to the risk of the investment decision. Similarly, the establishment of a retail marketing and distribution network involves large amounts of capital. Refer to figure 6.

It is particularly important to recognise that both in South Africa and worldwide the oil industry is cyclical with periods of short-term economic profits balanced by times of poor profitability below the cost of capital. Refer to figure 8. International evidence shows that long-term returns in the oil industry are not significantly above average. In the U.S. between 1970 and 2003 the returns on investment in the industry averaged less than the rest of the economy, well below returns in, for example, the semiconductor, banking, household products, and pharmaceutical industries.

To obtain a reliable estimate the investigation also needs to calculate economic opportunity costs rather than accounting costs in its assessment. This is particularly important in the valuation of the industry's assets at the opening and closing dates of the analysis. The appropriate methodology is to use the modern equivalent asset methodology, which is the lowest cost of purchasing assets today that can deliver the same set of outputs as existing assets. The MEA is based on current, best-practice technology and uses the optimal configuration of assets to produce an industry's output. Secondly the assessment should be on ex ante weighted average cost of capital (the cost of capital that was used in assessing a project at inception) including an appropriate risk premium. We agree with the Task Team that the CAPM is an appropriate model for estimating the cost of equity capital.

3.8.2 Understanding the nature of profits in the industry.

A windfall tax is particularly harmful on a cyclical industry because it taxes profits in the "peak" of the profit cycle without compensating for downturns and troughs in the cycle. The problem is particularly severe in industries that have high operating leverage. The oil industry is an example. It is a capital intensive, high volume low margin industry where profitability is highly sensitive to changes in capacity utilisation. In the past the oil industry has suffered from excess capacity and an under-recovery of large fixed costs in refinery operations. In the last three years the growth in the economy has led to substantial increases in demand that have increased capital utilisation significantly. Since revenues have increased while overheads are

largely fixed the profitability of the industry has improved. It is therefore particularly unwise to tax an industry where increases in profitability are often the result of utilising its refinery facilities more productively.

In addition, to tax an industry with such large ongoing capital expenditure not only to improve products and increase capacity but also to meet environmental standards deprives the industry of capital to support its growth and future.

3.8.3 Harmful Effects of Windfall Taxes.

The Report does not contain a detailed analysis of the effects of a windfall tax although it mentions the impact on investor confidence. There are a number of significant disadvantages to the tax, which have led policy-makers in many countries not to adopt the tax. In summary, the tax violates the norms of good taxation policy of efficiency and certainty and harms investment, production and in the long-run consumers. A recent article in The Economist (3 November 2005) provides an overview of the problems with a windfall tax:

“Given popular anger over high energy prices, including for heating fuels as winter approaches, it is understandable that politicians want to be seen to be doing something. Unfortunately, the current populist frenzy has produced one really bad idea: the proposal, now being mooted seriously in Britain and America, for a windfall tax on oil companies’ profits.

Surely it is no bad thing to grab excess profits on a one-off basis? After all, it raises unanticipated revenues. Windfall taxes might even bring a grim smile of satisfaction to voters’ faces. But where should you stop? Why not take a swipe at over-paid hedge-fund managers, sports stars and sundry billionaires as well? Why not slap a tax on farmers if they benefit from a bumper harvest? How about a tax on Apple, which cannot sell its iPods fast enough?

Sadly for politicians, windfall taxes do cause harm. If they want to be trusted and effective, governments cannot go around arbitrarily grabbing legally earned money from successful companies or citizens—they grab plenty already in ways that people and firms can adapt to. And although windfall taxes do indeed bring in short-term revenues, they do significant harm because they distort long-term incentives. Worse, they purport to be able to distinguish between a healthy level of profits and an “excessive” one—something specialist antitrust authorities, not greedy governments, are best placed to judge. In the case of the oil industry, for example, one official investigation after another has failed to prove that consumers are the victims of price gouging at the petrol pump. Rather, prices are set in world trade and by the manipulative efforts of the OPEC cartel.”

One of the major misunderstandings of the tax is that it is borne by companies. This is not true. Companies are legal persons and therefore cannot bear any burden of taxation, which is instead borne by employees, shareholders, and consumers. In the case of shareholders one of the largest impacts of the tax will be a reduced return and cash flow to pension funds and individuals who have invested in equities through insurance companies and other financial institutions. The funds taken by the government if a tax is introduced, will force the industry to raise additional funds in the capital markets for future expansion needs and increase its cost of capital. This will be particularly unfortunate given the need of industry to contribute to the government’s efforts and commitments in raising the long-term economic growth of the economy. There is wide recognition that the government’s targets for growth require large-scale investment from the private sector. These levels of growth are significantly above the past experience and will lead to a substantial growth in the demand for petroleum products.

In the South African context one can pose the question : Will the windfall tax contribute to growth as envisaged in the accelerated and shared growth and investment strategy of South Africa (ASGi -SA) and will it result in more growth if money is channelled through the hands of government, rather than invested by the private sector?

4. Comments on specific references to Natref and TOTAL.

This section will look at specific comments made throughout the document and provide the correct information and place them in the correct context.

4.1 Natref Neutrality and Locational advantage.

The following comments were made in the document.

Para 5.3 "Although a coastal location was the most logical, given the need to import crude for the refinery, the government wanted increased security of supply inland and provided Natref with a range of incentives (additional to those granted previously to Mobil, Shell/BP and Caltex, for the construction of their refineries) to locate the refinery at Sasolburg. Natref was commissioned in 1971. Following the revolution in Iran in 1979, Sasol and TOTAL became the joint owners of Natref. Natref has enjoyed extra-ordinary support because of its inland location (together with the synthetic fuels plants).

Para 5.5 " Tariffs were initially based on rail tariffs. Rail tariffs are typically higher than pipeline tariffs over longer distances. Hence inland refiners that enjoyed "locational advantage" in price regulation gained an additional advantage."

Para 5.5 "As it turned out private sector proposals to build a refinery and petrochemical complex at Richard's Bay were blocked by Government."

Para 5.5 "One of the incentives was that crude oil would be shipped from the coast to Natref free of charge. This gave content to the concept of "Natref at the sea" which later was transformed into the concept termed "Natref neutrality". The latter arose from the findings of a Government Commission of Inquiry that found that it was no longer acceptable for Natref to enjoy free transport of crude oil. In order for Natref to be kept "neutral", that is to maintain its hypothetical coastal location (despite being 600 km from the sea) the tariff on the petroleum products pipeline had to be increased so that the differential between the two tariffs "kept Natref neutral" i.e. at the coast. The impact of this again for inland producers was that they enjoyed greater "locational advantage" than would otherwise have been the case."

Para 5.7.5.1 "Government incentivised Natref owners-Sasol, TOTAL, National Iranian Oil Company- to build Natref in Sasolburg by treating Natref as though it was a coastal refinery (cost of delivering products to the storage depot was the same as if the product had been delivered from Durban to the depot, compared to transporting crude to the refinery and then on delivering product from the refinery to the end user) From the Natref commissioning in 1971 to 1987 (17 years!), Natref was not charged for the transport of crude from Durban to Sasolburg by crude pipeline. Instead they were passed on to inland motorists"

Para 5.8.3 "Sasol benefits from its inland locational advantage being paid the full cost of transport from the coast to market through the BFP price whereas product is transported only from Secunda or **Natref** to market"

Para 7.4.4 "Sasol, Natref (Sasol and TOTAL) and Chevron (to a much lesser extent) have all benefited from free or subsidised pipeline transport in the past. It appears that this situation was the direct intention of government policy and this benefit could thus not be considered a windfall."

Our comments

The above demonstrates some confusion regarding the actual facts on crude and product transport to and from Natref and the concepts of locational advantage and neutrality.

Petronet prepared a document for the TDI forum in January 1999 which include the following definitions:

Locational advantage : An advantage derived from favourable differentials in transport cost and process inputs versus those of a competitor.

Transport Neutrality : The transport element recovered in the product price is offset by the transport cost of the products moved from the refinery to a common destination plus that of the crude transported into the refinery from a common coastal supply point. There is no margin made on transport

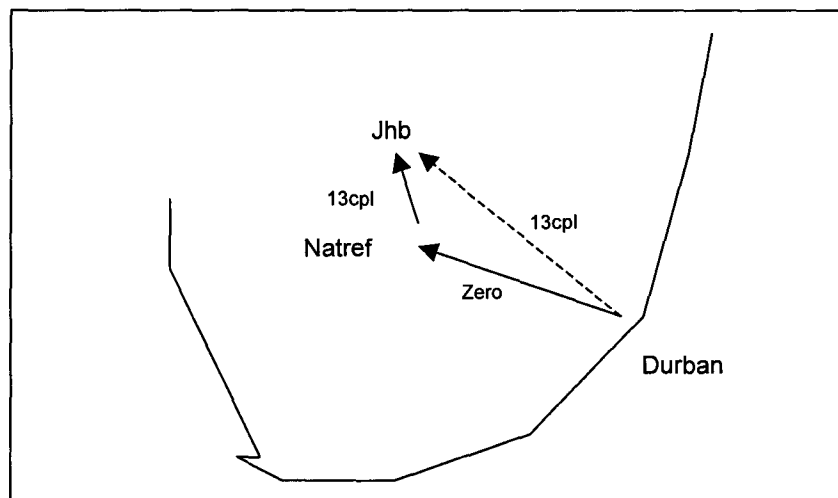
The notion that Natref received its crude free in the inland is incorrect. The actual situation regarding "locational advantage" was as follows .:

Due to Government's insistence to have Natref constructed inland TOTAL required that they be placed in a similar petroleum transport cost position as their competitors with refineries at the coast as the potential Natref owners were aware of the inherent disadvantages of an inland refinery rather than a coastal refinery. Several undertakings were given by Government to support this requirement. These inherent disadvantages related to:

- The additional costs for the transport of crude oil to the refinery, the losses associated with processing the oil to finished product and the cost to convey the finished product to its end destination.
- An inland refinery had restricted opportunities to take advantage of export opportunities.
- The ability to absorb fuel oil production inland since there was no shipping bunker market. This was mitigated by building a refinery at high cost to minimise fuel oil output.

In order to create a balanced position between Natref and its competitors it was required that the cost to get 1 litre of product via Natref (crude to - and white product from Natref) to an inland depot would be exactly the same as the cost for a refinery delivering it via the white product pipeline directly from Durban (crude to Durban- and white product to depot). Transnet (then SATS – 100% Government) implemented a tariff (based on rail tariffs over comparable distances) where Natref shareholders paid for every litre delivered to a depot as if that litre has been pumped from the coast, which was exactly what the Durban refiners were paying. Natref was therefore in the same position i.t.o. crude and product transport as the coastal refiners and had no locational advantage when compared to other refiners. The figure below illustrates the situation. This position was changed in 1987 from which date Petronet did charge for transport of crude between Durban and Natref.

Figure 4 : Transport cost to the inland for a Durban refiner and for Natref.



Concerning the transport neutrality it can also be seen from the Petronet definition that the cost the Natref owners paid to get product inland was the same as the cost the coastal companies paid and recovered in the price to the end consumer. Natref was thus transport cost balanced in both instances.

The Petronet (SATS) tariff developed over time in consideration of the requirements at that time. The different periods and methods were:

- 1967 – 1981: The SATS principle was that **their** income would remain the same as if Natref product was dispatched from the coast. Natref paid the same white product tariff as coastal refiners. No separate tariff for crude.
- 1981 – 1987: The above process was difficult to manage and changed to Natref paying a Natref to Depot leg and the full Durban to Depot transport cost for refined product was recovered by SATS from Natref. No crude tariff charged.
- 1987 – 1991: The de Villiers report recommended that SATS decentralise and become more focused, As a result Petronet was created. Crude oil tariffs were re-introduced with differentiated tariffs between crude and rail.
- Post 1991: Agreement on a direct linkage between crude and oil white oil tariffs. This linkage governed by the yield of white product. Process managed by Sasol.

TOTAL's position on has always been that it wished to stay neutral.

4.2 Assistance for entry into the Market

The task team's comments

Para 5.3 "TOTAL's entry to the country was facilitated through the preferential granting of sites via the RATPLAN and by the preferential treatment it enjoyed as a shareholder in Natref"

Para 5.6.3 The RATPLAN was facilitated and administered by the DME and enjoyed an exemption from the Competition Act. It was used as a "lever" to assist TOTAL and Trek to establish marketing networks in the 1960's.

Para 5.6.9 "The RATPLAN further assisted the development of Trek by granting them double the number of quotas for new service stations than was available to the other oil companies."

Our comments

It is clear from the above that there was a conscious decision by the then Government to support the entry of both TOTAL and Trek into the market. We understand that this was in part motivated on the premise that these were the only companies with local shareholding at the time. The RATPLAN was already in place at the time of TOTAL's entry into the market.

We also need to highlight here that the RATPLAN was recently used to assist the entry of BEE companies such as Tepco and Afric Oil, into the market when SAPIA members allowed them to use the available new sites under the RATPLAN for their development.

The historical regulation of liquid fuels in South Africa also had negative consequences for the oil companies as they were forced to place Sasol pumps on their forecourts – thereby foregoing the potential sales via the pump and interference with the branding of the outlet. The MSA also forced oil companies to purchase synthetic fuel from Sasol and more recently from PetroSA. The RATPLAN obliged oil companies to retain uneconomical rural outlets.

The task team's reference in 5.3 above re "preferential treatment in Natref" is unsubstantiated and should be deleted

Government assistance to support business is common practice worldwide and can be seen in South Africa in the motor and textile industry. Unless all industries which have received government support in the past form part of this investigation, we do not see this topic as relevant to the discussion on windfall taxes.

4.3 Petronet activities.

Extracts from the task team's document :

- Para 5.7.3 "Product component pipeline link between Secunda and Natref provides opportunity to blend/upgrade components at Natref"
- Para 5.7.5.2 "Pipeline constructed from Natref to Johannesburg Airport. Sized and dedicated to accommodate Natref's jet fuel volumes only"
- Para 5.7.5.2 "As the storage of strategic oil stocks at Ogies fell away the pipelines connecting Secunda and Natref, some via Ogies became available for other purposes. Sasol was able to negotiate favourable terms for the interconnection of its two refineries with Petronet, as Petronet did not have another use for the pipelines. These interconnections have allowed Sasol to optimise its operations and output between its two inland refining centres. For example with the end of the Upliftment Agreement and the change in the inland market dynamics, Sasol was able to shift the role of swing producer from the target intended by the OOC's (Secunda) to Natref."
- Para 5.8.4 "Significant over investment in pipeline infrastructure in the 1960's and 1970's was borne by taxpayers. Even today when pipeline capacity is at a premium it is doubtful that some pipelines have recovered their costs"
- Para 5.8.4. "The cost of cross subsidisation of transport between the crude and white product pipeline was carried by inland consumers."
- Para 5.8.4 "The DWP pipeline was funded by setting product pipeline tariffs at rail tariffs and denying motorists the benefits of the more efficient form of transport"...
"Pipeline revenues have been used at times to cross subsidise other forms of state owned transport."

Our comments:

We refer you to a Petronet document that was presented to the TDI forum (Industry and Government Transport Forum) on February 3 , 1999 for background to the above comments.

- *"Initially the tariffs of pipeline transportation are linked to that of rail.*
- *Due to this link, huge profits were made by the Pipeline Department of the then SA Railways and Harbours Administration (SAR&H)*
- *Cross-subsidisation occurred within the SAR&H – loss making socio economic services on the one side and the pipeline on the other side.*
- *Diesel was transported at a much lower tariff than petrol to assist agriculture at the time.*
- *Crude oil was transported at no cost and the transportation was recovered through the transport of refined products.*
- *The W de Villiers (1986) report required the pipeline to:*
 - *Delink pipeline tariffs from rail*
 - *Charge investment related tariffs for every product conveyed through the system*
 - *Close the tariff gap between petrol and diesel*
 - *Move towards justifying tariffs from a return on capital argument and stop cross-subsidisation inside the SATS group.*

- *Since 1987 strategies were put in place to address Dr de Villiers' requirements*
 - *Delinking rail and pipe tariffs*
 - *Crude pay a specific tariff, linked to the so-called Natref neutrality principle*
 - *Petrol and diesel pay the same tariff.*
 - *The fairness of our tariffs have been judged based on return on assets managed (ROAM) since 1993 and..."*
- *With Petronet's audited 1997/8 results known, the actual ROAM figure..... leads to a real ROAM of 7%, which is just within the benchmark targets."*

The task team's para 5.7.3 is an indication of how Petronet and Sasol reacted to changes in the industry where both parties saw an opportunity, which made business sense. It is not clear why this is raised as a potential "benefit" to Natref only as this pipeline usage has been just as much a benefit to Petronet who were able to use under utilised assets.

The task team's statement in para 5.7.5.2 re. the sizing of the Jet pipeline is unsubstantiated. Jet was not transported in the refined product pipeline from Durban until ~2004. It is therefore logic to size the pipeline only for Natref usage. Johannesburg airport is of strategic importance to the country and it has been prudent to secure its supply by more than one mode of transport from more than one supply source i.e. Pipeline ex Natref and rail ex Durban (20% of volumes).

From the above it is clear that the task team's statement in para 5.8.4 "Even today when pipeline capacity is at a premium it is doubtful that some pipelines have recovered their costs" is not correct. The statement by Petronet of a real 7% return (ROAM) in 1999 further supports this point. Petronet had certain objectives to maximize its returns and has therefore utilized all opportunities to generate income by maximizing utilization of its pipelines, even in cases where it was to the so called "benefit" of Sasol or Natref.

The task team's further statement in 5.8.4 that ""Pipeline revenues have been used at times to cross subsidise other forms of state owned transport." Is also incorrect as it had been used to cross-subsidise loss making socio-economic services within the SAR&H. Similarly, it is common practice for the South African Government not to utilize specific income sources to fund specific expenses.

You are also referred to the task team's statement in para 5.8.4 "The cost of cross subsidisation of transport between the crude and white product pipeline was carried by inland consumers." As explained in chapter 4.1 of this document and in the Petronet reference quoted above, also seems to be incorrect as the transportation cost of crude was recovered from Natref through the transport cost of Natref's refined products.

It is noted that the task team do not quote or refer to the submissions of the inland refiners to the public hearings in mid 2003 to the Department of Mineral and Energy Affairs Portfolio Committee on the Pipeline Bill. In our opinion these submissions would help to clarify the actual situation at the time.

4.4 MPAR

Extracts from the task team's document :

Para 5.6.7 "The purpose of MPAR was to ensure that the return on marketing assets would be guaranteed in the 10-20% range. The MPAR indirectly guaranteed a return on refining benchmarked to international trends, given that the transfer price between the refinery and the marketing assets was taken as the IBLC price."

Our comments

We fail to understand how the MPAR would guarantee a return on refining benchmarked to international trends. MPAR is a calculation to ensure the marketers receive a a return on their

marketing assets but all refining assets are excluded from this calculation. Whether or not a marketing company refines does not influence the calculation in any form.

The MPAR is adjusted by Government after submission of actual figures by industry to Government based on established rules. Government decides the value and date of the actual approval. The table below shows the required and actual value paid by Government. It is clear that the 10 –20% target is not achieved in all cases and that Industry experience financial distress due to the underpayments and delays in the process.

Figure 5. Requested and actual MPAR payments

Year	Amount requested c/l	Actual received	Date implemented
1999	3.81	1.23	6-12-2000
			2-5-2001
2000	6.75	2.94	2-1-2002
2001	6.93	1.9	6-11-2002
		2.09	4-12-2002
2002	8.73	5.0	5-11-2003
	0.24	3.97	3-12-2003
2003	3.21	2.0	2-12-2004

No MPAR adjustment has been made since the 2003 increase and it is estimated that current under-recoveries of funds, due to Industry is in excess of RB2.0.

4.5 Refining margin.

Extracts from the task team's document :

Para 5.7.5.1 "The Main Supply Agreement was extended to include Natref production (apart from TOTAL's share). Sasol's share of the output was therefore guaranteed import parity pricing for all its products from day one. The Natref refinery was designed to deliver a very high white product yield with an associated high capital investment."

Para 7.4.2 "based on the evidence of oil company managers, appears to be of the view that the BFP is higher than true import parity prices. Consequently economic rent is generated by the BFP. It is assumed that the regulator did not intend to put in place a regulation designed to generate profit in excess of normal profit, this is super-normal profit"

Para 7.4.2 "Such economic rents, from both of these sources, could be expected to continue to accrue, for so long as the BFP prevails and from time-to-time in future whenever higher oil prices prevail".

Our comments

You conclude in para 7.4.2 that economic rent is being generated by the BFP pricing mechanism. This may be true if one takes a snapshot view of the pricing differentials at a particular time but the opposite argument is also true. However, it needs to be viewed over a longer term to obtain a balanced view of the market situation. The following factors should also be considered.

- *Oil companies prepare annual budgets based on their best estimate of refining margins. Actual numbers may be above or below the expected due to many controllable and non-controllable factors.*

- Investment decisions are made on expected returns over 10 years or more. Years with higher than expected returns have to carry the years during which returns are below expectation. If the peak income is removed, investment risk will grow substantially.

Refining margins are currently high due to a worldwide shortage of refining capacity as illustrated in **figure 6** below. This is due to under-investment caused by low refining margins in the 80's and 90's and the unpredicted high growth in demand we currently see as shown in **figure 7** below.

Figure 6. Refining capacity utilization (Source: TOTAL International)

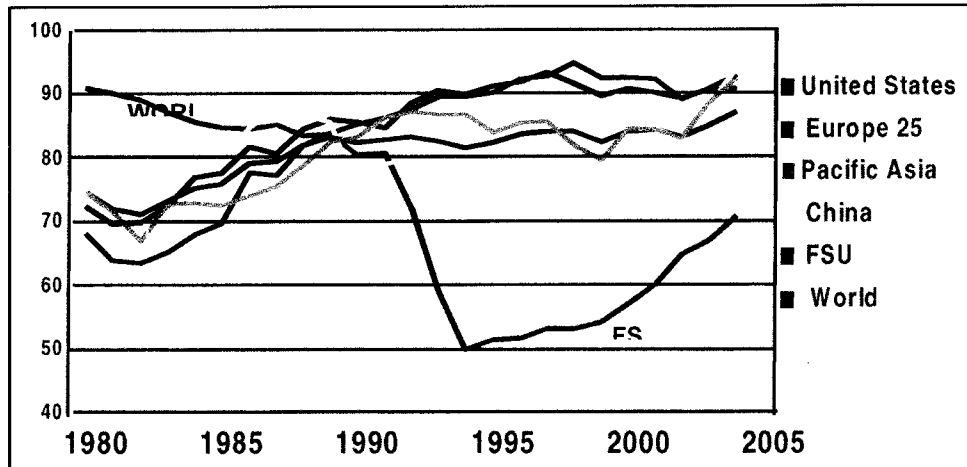
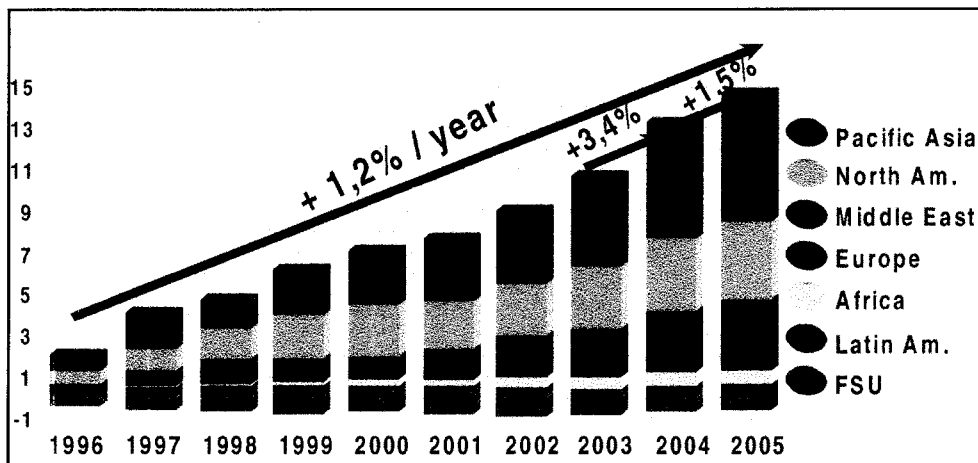


Figure 7. High demand growth from 2003 (Source: TOTAL International)

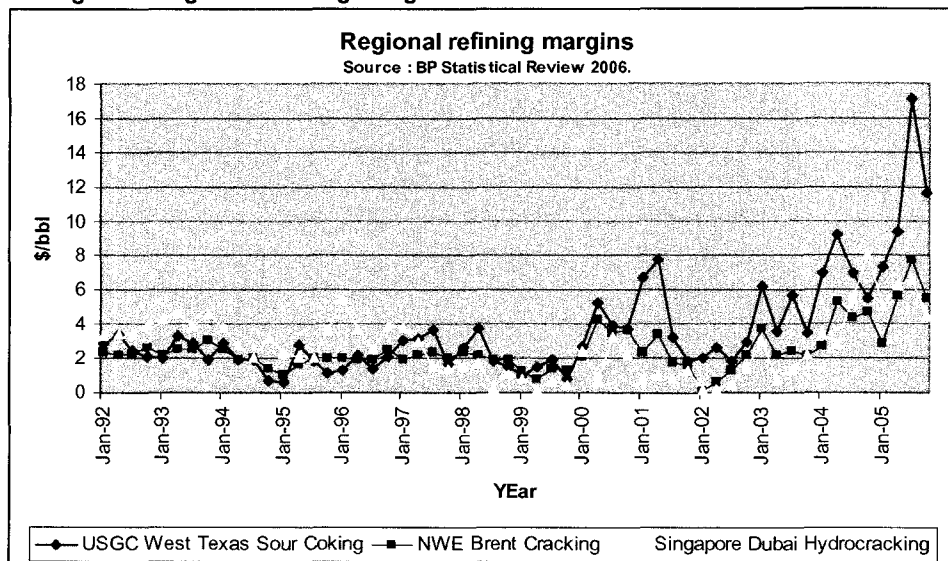


It is expected that the margins will reduce substantially from 2012, when new refinery capacity will come on stream. 500 projects have been announced. These are:

- 66 new refineries (16 Mbbls/day, realistic expectation is 8.5 Mbbls/day)
- 180 upgrading projects (4.7 M bbls/day)
- 180 projects to meet tightening fuel specification

- The shortage in worldwide refinery capacity has led to current imports reaching South African shores at above BFP prices. Importers are currently not making expected margins on these imports and will strive to recover the loss in future imports.
-
- The oil market is cyclical. The BFP pricing is based on applying the previous month market price during the current month (price lags one month). In a continuously increasing market this aids the marketer (buy low, sell high) but this turns against him in a declining market (buy high sell low). A snapshot view will be very misleading.
- The recent high variance in refining margins is also clearly shown in **figure 8** shown below. It is clear that the recent high worldwide margins are not normal and cannot be expected to be sustainable into the medium longer term.

Figure 8 Regional refining margins



- In referring to refining margins it is always important to consider margins after variable costs. Considering only the gross margin is simplistic since, for Natref, a higher unitary gross margin is only achieved through higher variable cost. Less complex refineries (such as in Durban) having configurations yielding a lower gross margin but also substantially lower variable costs and substantially lower depreciation charges.
- The Petroleum Charter required a 25% BEE participation in the full value chain of oil companies. This objective has been achieved in full by TOTAL South Africa. The continued success of the BEE participation will be placed under severe financial pressure in the event that the margins of the oil companies are curtailed at any point in its value chain (including refining) as the BEE participation was premised on expected returns in a known tax regime.
- Recent imports into the country to secure supply during refinery shutdown periods were done at prices substantially above BFP prices.

It also needs to be highlighted that Natref opted for the high capital investment cost resulting in a refinery configuration unsurpassed in South Africa today with two notable features of having the highest white oil yield of the mineral oil refiners (of the order of 90% compared to 70% of the coastal refiners).

The effect on Natref was a reduction in output from 108 000 to 94 000 bbls/day. There has been no state support for Clean Fuels upgrades.

8. Specific questions from Para 9.5 and 9.6

Below issues raised in paragraph 9.5 and 9.6 with out response.

"Please comment on whether the Task Team's concern about the potential for transfer pricing of windfall gains across the value chain is valid or not. If so, how do you suggest the transfer pricing risk could be mitigated?"

We are of the view that there is no scope for transfer pricing for a non-upstream producer in the RSA environment. In the case of TOTAL crude is purchased on the international markets from any suitable source at market prices. Transfers pricing from refining to marketing is usually at the prevailing BFP price. The profits from both refining and marketing in TOTAL's case also resides in the same business entity on which normal company tax is paid. We do not see any action required by the authorities in this regard as it may hamper the successful realisation of Governments' targets for economic growth.

"Please comment on the preliminary analysis of the individual value chain elements as presented in the table and accompanying text, highlighting any possible omissions or differences in interpreting the data."

Refer to Chapter 3 and 5 of this document.

9. Specific questions from Para 9.7

Below issues raised in paragraph 9.7 with out response.

"Any comments that you may have on the merits and demerits of these potential fiscal measures for addressing anticipated future economic rent, namely: Revised subsidy regime Cost-based administered price regime..., Progressive formula tax..., Investment-linked tax and subsidy options..."

We do not comment on the individual methods proposed but will focus on the broader issues of concern. You are also referred to our chapter 3.8 for further economic considerations.

The implementation of any fiscal measures for anticipated future economic rent needs to be thoroughly studied in the context of the longer-term economic welfare on the country.

The implementation of any tax on a specific industry, where there are many others with the same characteristics, is unfair discrimination against such industry. Similarly can the super performance of any industry over a period, irrespective of the cause of such performance, not be used as a trigger for additional taxation. The fiscus will gain its appropriate share of such profits via normal corporate taxes. Targeting unanticipated margins should look at all industries and not at any those with a high public profile. In the case of the oil industry the high variance in refining margins due to the BFP pricing system do not result in unanticipated margins as the variance is inherent to the formula and has been anticipated in the formula from its inception.

All Government will positively support some industries from time to time to promote growth and enhance the overall economic performance of the country to the benefit of its citizens. Similarly a negative intervention can permanently alter the economy in the long term to the detriment of its citizens by causing amongst others capital and

intellectual flight. In the case of the local oil industry the implementation of an additional tax may divert any future investment in crude refining capacity or synfuel production offshore to a more tax-friendly environment, thereby foregoing the potential economic benefits from raw material beneficiation. Ironically the output from such offshore investment can end up in South Africa as refined product import.

The Energy White Paper of 1998 spells out Governments' intention to allow market forces to govern the oil industry with minimum intervention. The country's' fuel supply and logistics situation is currently at the crossroads where decisions on future investment is required. Any negative interference from any source may derail the process and put future economic growth plans for the country at risk.

10. Conclusion

TOTAL was not consulted by the task team as requested in their terms of reference before finalisation of the report. This report was subsequently completed in a very limited time. The process followed by the task team to get an all-inclusive view was not effective.

We have strived to address the issues which relate to the Natref refinery and TOTAL in particular in our response. Where possible we have attempted to correct incorrect statements and perceptions.

The economic concepts and information contained in the task team document has not been sufficiently researched to present an accurate view of the potential impact and prevailing historical conditions at the time and as such cannot be used to support any meaningful conclusions on the implementation of Windfall taxes. We have provided some economic issues which should be included in a thorough study such as the requirement for clear definitions of economic rent and super-normal profit, essential and non-essential services and the need to include consumer welfare and economic surplus concepts. The current status of an industry and the long-term impact of a new tax on the economy should be pivotal in any decision.

It is clear from the information we have supplied that the current refining margins experienced by the crude refiners is a worldwide phenomenon brought about by the lack of investment in refining capacity in the 1990's and geopolitical situations. It is unlikely to be sustained into the future due to the expected proliferation of new capacity in the near term. The experience of the US and Europe with Windfall taxes also show that its implementation is not beneficial to the economy over the longer term and results in a reduction in investment and eventual higher prices for the consumer.

Our view is that the implementation of Windfall taxes based on a historic perspective will severely harm the industry by minimizing investment and deterring new investors. It will be unfair to burden new BEE entrants and established participants to the oil industry with unexpected taxes. It is also unlikely that enough accurate information is available for such a retrospective exercise. We also feel that the report does not pay enough consideration to other industries in the country for the potential implementation of windfall taxes and is very biased to the oil industry. There are many other industries, which were developed with and supported by Government assistance over many years.

The South African Oil Industry is at a very critical stage and is faced with increases in demand, logistical and supply constraints, high input costs and variances in the market mechanics outside our control. Energy supply to the country is suffering and new investment is required in infrastructure in the short and medium term. New forward looking taxes will curtail such investments.

We do not make any comments on mining royalties or the potential for transfer pricing from mining to synfuels.

We do not support the introduction of backward or forward-looking Windfall taxes on liquid fuel refining and marketing activities. Companies should be subject to normal corporate taxes on profits and capital gains.

August 10, 2006
IB/KB/AN/AdP/RD/GvS
PJ/RC/JM/NN
MH

4.6 Alleged benefits from SFF activities.

Extracts from the task team's document :

Para 5.7.5.2 "Natref crude was/is stored in the SFF constructed crude storage tanks in Durban Harbour and then transferred to Natref."

Para 5.7.5.2 "Natref enjoyed the bulk shipping benefits of joint procurement and shipping with SFF cargoes of crude oil"

Para 5.7.5.2 "When the Government's strategic stocks held at Ogies were relocated to Saldanha Bay, the most cost effective means of doing so was to sell the inland crude oil to Natref and to purchase replacement oil for storage at Saldanha Bay. The logistical challenge and costs of moving crude oil from inland to the coast meant that Natref received this crude oil at a very favourable price"

Para 9.4 "Did Natref benefit from the purchase of crude oil stocks at "discount" prices for processing at their refinery when government decided to reduce stocks?"

"What was the extent of the benefit to Natref from the purchase of Ogies strategic stocks? Was this benefit shared with TOTAL?"

Our comments

The SFF tanks in Durban were constructed and operated for strategic purposes by Government who at the time was also the only shareholder in Sasol and its share in Natref. It is difficult to see how in the 1960's state sanctioned refinery investments coupled with the establishment of an inland strategic stock holding could not have been accomplished without the establishment of a corresponding tank farm in Durban to feed these facilities. Similar strategic activities, albeit at a much larger scale, was also undertaken by Government at Saldanha Bay. The Durban tanks carried stock for Natref, but the Durban refineries could also be supplied if required. The Durban tanks were sold to Natref at market value in 1988 from which date SFF had no involvement in its operation. The land on which the tanks are situated was bought from Airports Company in 2002 based on market values.

Optimal crude shipping is done in Very Large Crude Carriers (VLCC's) which carry up to 2,000,000 barrels of crude. This is too large a volume for any one refiner as it requires large stockholding capacity and also represent a working capital burden. Oil companies worldwide will therefore, where possible, share crude movements. In the case of Natref, Government was importing crude for strategic stock and for the operation of its share in Natref. The refinery was designed to use mainly Iranian crude (NIOC also a shareholder in the refinery) requiring the bulk of imports from this source. It therefore made good economical sense for all parties to participate in these shared imports. All South African companies currently continue to share ships for crude imports. The task team's statement that Natref shareholders enjoyed shipping benefits is therefore not correct.

It therefore made economical sense for Government to sell the crude to Natref in the 1990's. (We believe some crude oil was also pumped from Ogies to supply the coastal refineries at time). Sasol and TOTAL purchased the crude over an extended period from SFF. Prices were negotiated on a monthly basis, based on a replacement cost for the crude, which was in turn based on ruling international crude prices for similar crudes. The price included all associated costs at current prices at the time, amongst which a transport element to recover the pipeline cost SFF incurred for movements from Durban to the mines. A large portion of the crude was also mixed with fuel oil with heavy metal contamination and not of good quality. Only small consignments could be used on a monthly basis when blended with good quality crude imported by the Natref shareholders. It can be noted here that SFF used the services of a Mr L Walliser to provide expert witness to on the quality of the crude, which influenced the subsequent pricing. There was no economical benefit the TOTAL in the purchase of the mine crudes.

4.7 Alleged benefits to TOTAL due to joint Natref shareholding with Sasol.

Extracts from the task team's document :

Para 5.3 "TOTAL's entry to the country was facilitated through the preferential granting of sites via the RATPLAN and by the preferential treatment it enjoyed as a shareholder in Natref."

Para 5.8.5 "TOTAL has benefited from the shared good fortune of being a joint venture refinery partner with a synfuels producer, Sasol."

Para 5.7.5 "Although Natref is a crude oil refinery and not a synfuels manufacturer it is considered here because Sasol is a majority shareholder and as a result it has been able to introduce important operational synergies between its synfuels operations and Natref operations."

Para 5.7.5.2 "...Sasol to optimise its operations and output between its two inland refining centres. For example with the end of the Upliftment Agreement and the change in the inland market dynamics, Sasol was able to shift the role of swing producer from the target intended by the OOC's (Secunda) to Natref."

Para 9.4 Why does Natref continue to benefit from location, and other factors enjoyed by synfuels?"

Our comments.

The task team's statement on page 43 that TOTAL's entry to the country was "facilitated...by the preferential treatment it enjoyed as a shareholder in Natref" is not substantiated. TOTAL entered the South African market in 1954 (barely a year after the commissioning of the Mobil refinery in Durban in 1954), about ten to twelve years before TOTAL considered participation in a local refinery and a full 16 years before the commissioning of Natref. To thus link TOTAL's entry into South Africa with the establishment of Natref is not correct.

It is not clear on what the statement in 5.8.5 quoted above is based, as it is not substantiated in any way. Any refinery which was supported in any way by Government can be subject to the same observation. The statement should be removed from the task team's document.

Sasol may have obtained some synergies between their synfuel and crude operations. These were implemented by Sasol for their own benefit. TOTAL did for a period buy some petrol and diesel components from Sasol, to blend into the fuels pool, at market related prices and based on TOTAL's alternate cost to obtain similar production. TOTAL therefore had no financial "benefit" from the synergies (if any) between Secunda and Natref.

The move by Sasol to make Natref the swing producer at the end of the MSA has led to periods in 2004 during which the continued operation of Natref was at risk. This forced TOTAL to increase refinery usage at no benefit to ensure continued operation and supply to the inland market. The association with Sasol, who has a more profitable refinery close to Natref in the inland (with a target for maximum utilization), therefore carries a great operational risk for TOTAL.

The task team's comment 9.4 is unsubstantiated. It should be removed from the document.

4.8 Natref share purchase

Para 9.4 "How was NATREF financed through government and the IDC?"
"At what price did Sasol and TOTAL acquire the NIOC share of Natref?"

The entry of TOTAL into Natref as the technology partner was financed by TOTAL International. The 17.5 % shares held by NIOC were sold to Sasol (52.5%) and TOTAL (30%) in the ratio of their shareholding at the time of the withdrawal of NIOC in a commercial arms-length transaction between the parties involved. Sasol therefore already was the majority shareholder in Natref before the NIOC withdrawal. (ref your para 5.7.5) This gave Sasol 64.64% and TOTAL 36.36% shares. This transaction was done based on arms length commercial principles.

We are not aware of how the Government financed their participation in Natref and what the terms of the agreement

4.9 Alleged Market power

Extracts from the task team's document :

Para 7.4.7. "Sasol and TOTAL (through Natref) are in the opinion of the Competition Tribunal able to exercise market power. Whether or not these inland producers have benefited unduly from sympathetic treatment from Petronet and thus increased this market power requires clarification. Until these transport constraints have been addressed it can be argued that there is a need for intervention"

Our comment

We strongly believe that the task team has misinterpreted the opinion of the competition Tribunal.

TOTAL is the smallest of the six big oil companies in the country and also has after Sasol the smallest market share in the inland. More than 90% of TOTAL's inland production is used to service its own customers. The remaining production is exchanged or sold to the other companies. It is therefore impossible for TOTAL to exert any market power (input foreclosure or price leader) as stated by the Competition Tribunal. The Tribunal also noted that the advent of the New Multi Product Pipeline (NMPP) from Durban to the inland would remove any barriers to move product inland and effectively create one market comprising of the KZN area and the inland. The expected deregulation of the petroleum market as envisaged in the Energy White Paper of 1998, will further support the diminishing of any potential market power in the inland. The Tribunal has addressed the potential of market power and we therefore see no need for any further intervention in the market by Government.

5. Value chain approach

The task team's adopted approach to review the components in the value chain for taxation purposes holds some inherent risks for an unbalanced intervention. (see your para 9.6)

We are of the view that there are only 2 main groups that need to be considered being companies with and companies without local upstream raw material sources i.e. only refining and marketing.

Companies with local upstream (crude, gas or coal) capacity.

It is only the synfuel and future biofuel producers that fall into this category, as there is no crude production in the country. It is debateable if the supply of LNG from Mozambique to Sasol can be placed in this group. We have given a comprehensive view on the potential to impose windfall taxes on such entities in chapter 3. Please refer to these views.

Companies with refining and marketing activities.

All the oil companies fall into this category. Refining and marketing oil companies in South Africa are integrated entities sharing systems and procedures and other services. It will be difficult, if not impossible to split revenues and costs accurately between the different value chain revenue and cost elements identified in the task teams' table 13. The mere definition of the different cost allocation methods will result in a different interpretation in every company.

The oil industry procures its raw material in the internationally traded markets and the local environment is regulated. Both the input costs and returns received are therefore transparent. Any opportunity for undetected transfer pricing between any of the steps in the value chain is therefore highly unlikely.

We have demonstrated in many instances in this document that taking a short-term view on any of the steps in the value chain and implementing any backward or forward looking taxes will harm the industry, hamper future investment and result in a long-term loss for the economy of the country.

We are of the view that there is no scope for additional taxation in the value chain for a refining and marketing company in South Africa.

6. Specific questions from Para 9.2

Below issues raised in this paragraph with out response.

"What liquid fuel investments have been made to date to meet environmental requirements and what investments are still to be made?"

Recent investment for clean fuels 1 by Natref amounted to RM 520. The next clean fuel implementation is expected to cost Natref well in excess of RM 2000.

"Is it appropriate for RSA to consider a regulatory and fiscal dispensation that would support another round of investment in synfuels or in bio fuels or in both? If so, how should it best be done and how should any perceived errors in past attempts be avoided?"

It is predicted that worldwide crude sources will last for more than 40 years. The BP statistical review (2006) indicated proven reserves of 1,200 Billion barrels of crude. Daily production at the end of 2005 was 81 Million bbls/day. New technology such as the extraction of oil from tar sands is pushing this date even further. Crude extraction cost and the geopolitical situation have resulted in high prices, which are expected to stabilise at new higher levels than before meaning that alternate energy sources previously too costly, such as Second Generation biofuels are now viable in some cases. We are of the view that the country should strive to further decrease its dependence on external energy sources where possible, subject to the economic viability of projects. Government should support these projects for National Interest with incentives until they are viable, whereafter it must be left to private industry to commercialise and develop it further. It should however not be to the detriment of the end consumer. Government can further support the process by establishing stable long-term fixed policies to enable sustainable development of alternate fuels.

7. Specific questions from Para 9.4

Below issues raised in paragraph 9.4 with out response.

"Logistics Infrastructure - Are industry participants (Crude-based or synfuels) deriving any specific preferential commercial gain through the particular way in which they access nationally-owned infrastructure? If so, does this situation continue to prevail? If so, how would you quantify the differential benefit and how can this situation be rectified?"

We cannot comment on potential benefits to the other oil companies. We do however wish to highlight the following:

The nationally owned infrastructure has been more of a hindrance than a support in the development of the oil logistics. For example:

- Road distribution was limited to an 80km radius and later 300 km around depots to force companies to use rail transport. This resulted in a large uneconomical and dispersed infrastructure.
- Petronet stop supply to depots linked to the pipeline such as Pietermaritzburg forcing the use of less safe and more costly transport modes.
- Petronet stop pumping product from Natref to Kroonstad to allow them to optimise their income. The option for Natref to supply this area was removed and higher cost road or rail transport was to be used. The current logistics problems to supply the inland would not have occurred had this pipeline been constructed.
- Petronet is the sole owner of petroleum pipelines. Sasol and TOTAL was prevented by Transnet to construct its own crude pipeline in 1998 as this would have resulted in the under utilisation of the Petronet assets.
- Spoornet is currently not able to provide the service required by industry and we are forced to use expensive and less safe road transport to move product over long distances.
- Petronet delayed its investment in a new white product pipeline from Durban too long resulting in the current supply problems to the inland.
- Petronet pipeline capacity allocation methods make entry for new entrants or growth for existing entrants difficult.
- Petronet made an exclusive arrangement with Sasol to use the Lily pipeline to transport gas. The current logistics problems to supply the inland would not have occurred had this pipeline been available to transport liquid fuels.

Our view is therefore that should the petroleum industry have been allowed to develop their own infrastructure the industry logistics would currently have been at the correct level to provide service to all its customers at more competitive prices.

"Quantification of historic benefits received by OOC's. What was the difference between support received by Natref and other oil companies?"

We have addressed the alleged support received by Natref previously in the document. We are not able to comment on the benefits received by the other oil companies.

"Were the multinational companies compensated for mothballing refining capacity to accommodate Sasol 2 and 3 in any other way apart from the payment of the synlevy?"

Our information indicates that this was the only compensation received. The issue of the shut-in of production facilities and "synlevies" (page 43) deserves comment. The location of Natref precluded any reasonable and immediate access to export opportunities. Thus TOTAL, as a result of Government interventionist strategies, was the most disadvantaged due its refining location. Coastal refiners had the opportunity to utilise some of their mothballed capacity to do exports, which was not an option available to Natref due to its inland location.

"Why are the OOC's return on assets as recorded in the SAPIA Annual Report so low?"
 "How do the OOC's explain the difference between their profitability and that of Sasol Oil?"

We do not understand the relevance of this question in relation to the task team's study. The reference used is also not useable as the SAPIA figures are a summary of all the industry participants, each of which have an individual set of results due to different company productivity, different marketing assets and different customer profiles.

"Have any form of incentives been granted to the oil companies to encourage refinery investments for upgrades to meet Clean Fuels specifications?"

The oil industry has previously petitioned the DME and Treasury for tax incentives for clean fuels. This was however not supported by Treasury. Because of prevailing low margins, a pessimistic outlook on product demand growth and other factors, limited investment decisions were made by the refiners to conform to clean fuels requirements.