national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

WINDFALL TAXES ON THE LIQUID FUELS INDUSTRY

Response to the task team report on
windfall profits in the liquid fuels industry

INTRODUCTION

In the February 2006 Budget the Minister of Finance Trevor A Manuel, MP announced the appointment of a task team to investigate whether windfall profits were being generated by the liquid fuels industry, in particular the synthetic fuels industry, and whether a windfall tax should be imposed if such profits existed.

The task team, headed by Dr Zavareh Rustomjee, also included Ms Almorie Maule, Dr Grové Steyn, Dr Boni Mehlomakulu and Dr Rod Crompton. The task team worked energetically to submit its final report to the Minister of Finance on 9 February 2007. The report was published on 23 February 2007 for further public comment by 31 March 2007. After receiving comment from key stakeholders, Minister Manuel asked the National Treasury to submit a formal response to the fiscal recommendations of the task team.

BACKGROUND

The investigation into windfall profits in the liquid fuels industry was initially raised in the October 2005 Medium Term Budget Policy Statement (MTBPS) in the context of a possible structural increase in the price of crude oil, which had increased from an average of US$29/barrel[1] in 2003 to a high of US$60/barrel in the third quarter of 2005.

The task team's report documents in great detail the development of South Africa's liquid fuel industry. In this respect the report will be of great use to all those who wish to obtain a better understanding of the dynamics and complexity of this industry.

The task team makes a number of fiscal and regulatory recommendations. This response deals only with the task team's fiscal proposals, as the regulatory recommendations have been referred to the Ministry of Minerals and Energy for consideration.

GOVERNMENT RESPONSE TO TASK TEAM REPORT

Definition of windfall

The National Treasury considered the definition of windfall profits as used in the task team report. The report points out that the concepts "windfall profits" and "excessive profits" are used loosely and interchangeably, as are the concepts "economic profits"

[1] Brent crude

and “economic rent”. The report defines windfall profits as excess profits, of which conceptually there are two possible types: those of a temporary or cyclical nature (called “quasi rent” or “economic profits”), or more structural or permanent (called “economic rent”).

Using this definition, the task team concluded that there is evidence that the synthetic fuel industry generates windfall profits of a cyclical nature (economic profits or quasi-rents), but did not conclude it was of a structural or permanent nature (economic rents).

SA corporate tax system

Generally, the inquiry raises the broader question whether additional profit taxes are needed from an economic perspective. National government raised more than 80 per cent of its total tax revenue from four tax instruments (Personal Income Tax, Corporate Income Tax, VAT, Fuel Levy) in 2006/07, which suggests that South Africa has a well-functioning tax system. Government wishes to reinforce this track record, especially since corporate tax collections remain strong. We are mindful that in considering the imposition of a windfall tax, the following principles that have guided tax policy after 1994 should not be compromised:

a. Simplifying the taxation of companies;
b. Providing predictability in tax policy;
c. Avoiding intervention in particular sectors, unless it is explicitly part of approved industrial or economic (e.g. natural resources) policy;
d. Aiming for time consistency in tax policy (avoiding perceptions of ex-post taxation).

Cyclical or structural windfall profits

The report cites a number of international examples where taxes on windfall profits were applied. In some cases these were once-off events, due to regulatory failures and/or flawed privatisation procedures. In others, the intent was to tax economic rent, especially in the crude oil extraction sector.

Having established that there are instances where windfall profits are generated, the question to consider is whether such profits are cyclical or structural in nature. This is because although the taxation of pure economic rent of a structural nature does not affect companies’ behaviour, the taxation of rents of a short or cyclical nature will affect companies’ behaviour and have an impact on resource allocation, resulting in distortions. In such instances, windfall taxation is normally avoided. It is therefore essential to distinguish between permanent and temporary rents.

From its analysis of the report of the task team, government believes that the key question to be considered is: Does the current price of crude oil now reflect a structural or permanent change that would justify a new fiscal intervention? It is not possible to come to a definite conclusion at this stage, which is an argument for not proceeding with a windfall tax on existing synthetic fuel producers. We note that most oil-rich countries share in the gains of their mineral wealth by way of royalties, production-sharing agreements and/or state equity stakes or normal corporate income tax, rather than through imposition of windfall taxes.

Strategic considerations

Government has also taken a range of strategic considerations into account in considering the task team report, including:

- The negative effect any new tax might have on investment;
- Constraints on the supply of energy – both electricity and liquid fuel, and
- Adherence to higher environmental standards.

A key policy priority is to reduce South Africa's dependence on imported fuel. This will support the initiatives associated with the accelerated and shared growth initiative (ASGISA) and shore up fuel security at a time of uncertainty in world oil markets.

It is important that energy companies operate in an environment of fiscal and regulatory certainty. Such certainty in a competitive environment supports increased investment in production and exploration, which in turn supports continued economic growth and stability.

We accept that in the current scenario considerations should be given to partnering with the private sector to kick-start investments in new oil refining and / or synthetic fuel production capacity.

Sasol and South Africa's tax regime

It is a matter of national interest that Sasol's valuable intellectual capital, co-financed by Government over the years and acquired through intensive domestic research, is further developed to keep South Africa on the cutting edge of synthetic fuel technology. We have weighed this strategic consideration against the possible benefits of a windfall tax.

The task team points out that during the so-called Pim Goldby protection era, Sasol received R3.73 billion in tariff protection (subsidies), and recommends *"that the fiscal options in response to excessive economic profits proposed elsewhere in this document be the preferred instrument for resolving any uncertainties that may remain…"*

This recommendation of the task team, however, falls away, as we can confirm that Cabinet effectively released Sasol from the obligation to repay any outstanding subsidies received during the Pim Goldby era in 1998, provided it continued to develop the petrochemicals sector.

Government is keen to signal a shift from a backward-looking approach to a forward-looking one, where the focus is on new investments in the liquid fuel sector by Sasol and all other players in this industry. In this respect, Government welcomes the commitment made by Sasol to the feasibility of investing in Project Mafutha, for a new coal to liquid (CTL) plant. The possibility of a gas to liquid (GTL) plant is also under consideration.

Upstream oil and gas production

The task team also suggested amendments to the fiscal system pertaining to offshore oil and gas exploration and extraction. It recommends that:

"the tax authorities should either introduce a linkage between royalty levels and the respective commodity price curve in the Royalty Bill, or incorporate a progressive tax mechanism into the schedule of the Income Tax Act that ultimately replaces the OP26 mining lease currently in operation (p.13)".

The task team correctly notes that in the event of major oil or gas fields being found in South Africa's jurisdiction, it could trigger calls for windfall profit taxes during times of high commodity prices. However, as Government we wish to point out that the OP26 lease was replaced in October 2006 by the Tenth Schedule to the Income Tax Act, in line with changes in the mining and exploration rights regime. The new legislation captures most of the fiscal provisions in the previous OP26 lease agreements, but does so in a much more transparent manner. We therefore do not see the need to change this approach, given the need for policy certainty in order to encourage companies to continue exploration, which is generally a high-risk investment.

SUMMARY OF TASK TEAM RECOMMENDATIONS

The task team makes a number of fiscal recommendations, including:

- The imposition of a windfall tax on existing synthetic fuel producers;
- An incentive regime for investments in the production of liquid fuel from indigenous raw material (i.e. synthetic fuel and biofuel);
- A possible progressive tax regime for upstream oil and gas producers;
- Tax on the "must have volumes" of liquid fuel Sasol supplies to the inland market; and
- Investigating whether Sasol is still obliged to repay subsidies it received between 1989 and 1995 under the so-called Pim Goldby subsidy regime.

All these fiscal recommendations are well-reasoned and deserved careful consideration by Government.

CONCLUSION

In summary, we note the complex nature of the delineation between cyclical and structural windfall profits in the synthetic liquid fuels industry. Secondly, we hold Sasol to its commitment to significantly expand its synthetic fuel production capacity in support of the national interest in terms of fuel security and macroeconomic stability. And lastly, given the broader tax policy objectives, we recognise the need for fiscal certainty for the liquid fuels industry.

It is therefore Government's view, on the basis of evidence presented, that although it agrees with the task team that a potential exists for the generation of quasi-rents, the imposition of a windfall tax on existing synthetic fuel producers is not appropriate. We accept that at this stage that public interventions must focus on facilitating the expansion of liquid fuel supply capacity in the interest of domestic energy security and macroeconomic stability.

Government has initiated an inter-governmental process to promote the long-term development of the domestic liquid fuel industry. We expect that the industry as a whole (including Sasol, PetroSA and all the oil majors) will respond positively within an agreed timeframe to invest a significant share of its profits in expanding capacity in South Africa and the region.

With regard to the fiscal recommendations of the task team, Government:

- Agrees with the task team that windfalls have been generated in the domestic synthetic fuel industry, though it cannot be concluded that this is due to a structural or permanent change in the price of oil;
- Agrees to explore an incentive regime for investments in the production of liquid fuel in new synthetic plants to reduce dependency and promote fuel security, and will consider biofuel and other options; and
- Agrees to consider the task team's recommendation on royalties through the process to finalise the Mineral and Petroleum Royalty Bill. Like all other inputs into this process, Government will consider such proposals within its policy framework based on gross sales as the tax base, whilst providing appropriate relief for marginal mines.

Government has also decided:

- Not to proceed with a tax on the windfall profits earned by existing synthetic fuel producers in the interest of a conducive environment for additional investments in domestic fuel security;
- Not to implement a progressive tax regime for upstream oil and gas companies, given the recent enactment of the Tenth Schedule to the Income Tax Act ; and
- Not to consider a tax on the "must have volumes" supplied by Sasol to the inland market, but to explore a levy on refined products to contribute to the construction of excess capacity in relation to the proposed New Multi-Product Pipeline.

On behalf of Government, I would also like to thank the Task Team for its sterling work, and want to point out that its report will be seen as the catalyst that helped Government to finalise measures to create a climate of certainty for the liquid fuel industry. It also lays the basis for Government to take appropriate measures to ensure the success of initiatives like Project Mafutha and other projects, and the role of the private and public sectors in such projects.

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