SUBMISSION BY

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SHELL'S RESPONSE TO THE TASK TEAM APPOINTED BY THE MINISTER OF FINANCE REGARDING POSSIBLE REFORMS TO THE FISCAL REGIME APPLICABLE TO WINDFALL PROFITS IN SOUTH AFRICA'S LIQUID FUEL ENERGY SECTOR

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Table of Contents

Section A: Introduction ... 3
Section B: Definitions ... 4
Section C: Areas requiring further analysis ... 5
Section D: Fiscal Regime applied to Liquid Fuel Value Chain ... 6
Section E: Relationship between Fiscal, Minerals, Energy, Industrial and Environmental Policies ... 7
Section F: Methodology for Defining Windfall ... 7
Section G: History of the Liquid Fuel and Synthetic Fuel Industry – factual accuracy and interpretation of the material analysed ... 9
1. Regulatory measures in place to provide support and protection to the synthetic fuels industry ... 9
2. Conversion of the DWP to MRG in 1995 ... 11
Section H: Specific Questions to the Other Oil Companies ... 12
1. Why were Total and Shell permitted to procure their own crude for their SA refineries when the rest of the SA refiners were supplied by CEF? Were there any abnormal profits involved? ... 12
2. Have any form of incentives been granted to the oil companies to encourage refinery investments for upgrades to meet Clean Fuels specifications? ... 13
3. 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? ... 13
4. Why are OOC's ROA recorded in the SAPIA annual report so low and how do we explain the difference in Sasol vs. rest of oil industry profitability ... 14
Section I: Value Chain approach to Liquid Fuel Industry ... 14
Section J: Applying windfall methodology on the Liquid Fuel Value Chain to identify Economic Rent Streams ... 14
Section K: Comment on the Fiscal Measures identified in the Terms of Reference that the Task Team ... 14
Section L: Concluding Remarks ... 15

Section A: Introduction

1. We set out herein Shell's response to the questions posed by the Task Team appointed by the Minister of Finance in May 2006 to consider possible reforms to the fiscal regime applicable to windfall profits in South Africa's liquid fuel energy sector.

2. Based on the limited time and data available to Shell, we have primarily responded to the questions posed to the other oil companies as defined by the Task Team and as listed in section 9 of the Discussion Document. This submission represents Shell's preliminary response, which can be supplemented by way of a verbal presentation in the scheduled public hearings on 15 and 16 August 2006.

3. Generally speaking, Shell does not believe that the adjustments to the tax regime will be to the overall benefit of the South African economy. We are of the view that a very robust and onerous tax regime already exists in South Africa, which is evidenced from, inter alia, the following:

   - Income Tax, which provides for the Corporate Tax rate at 29%;
   - Incorporated in the Income Tax Act is the Secondary Tax on Companies (STC) at the rate of 12.5%;
   - We have also seen the introduction of the Capital Gains Tax with inception from 1 October 2001;
   - A tax on donations is also provided for in the Income Tax Act; and
   - Indirect Tax, which includes VAT, Customs and Excise duties, Stamp Duties and Transfer duties.

   The corporate tax rate was reduced in 2005 in order to promote investment in the South African economy as it was felt that the high corporate tax rate was an inhibitor to investment. The introduction of a Windfall Tax would, in our opinion, be contrary to Government's attempts to invite further investment in the South African economy

However, we recognise that in the case of certain elements of the synfuels industry where there are well-documented exceptional circumstances it may be possible to impose taxes for windfall or super profits.

3. Although, BFP is effectively a regulated price, profitability depends on the income stream used within especially the Upstream value chain. Accordingly, it may be that the synfuels industry enjoys a windfall profit element due to the fact that its prices are based primarily on coal feedstock (which has a lower input cost) and not crude oil production.

Section B: Definitions

1 For ease of reference, the following terms used herein have the meanings set out in this paragraph unless otherwise indicated:

1.1 "BFP" means Government legislated Basic Fuel Price;
1.2 "BP" means BP Southern Africa (Proprietary) Limited;
1.3 "Chevron" means Chevron South Africa (Proprietary) Limited;
1.4 "Downstream" means from the refinery gate to the market;
1.5 "Discussion Document" means the discussion paper released by the Task Team on or about 20 July 2006 to provide a basis for public discussion of the issues that the Task Team is required to address regarding possible reforms to the fiscal regime applicable to windfall profits in South Africa's liquid fuel energy sector, with particular reference to the synthetic fuel industry;
1.6 "DME" means the Department of Mineral and Energy Affairs;
1.7 "Engen" means Engen Limited and its subsidiaries;
1.8 "Natref" means the crude oil refinery owned by Sasol and Total and situated in Sasolburg;
1.9 "Other oil companies" mean BP, Chevron, Engen, Shell and Total in this context;
1.10 "Petronet" means the Petronet division of Transnet Limited;

1.11 "PetroSA" means The Petroleum Oil and Gas Corporation of South Africa (Proprietary) Limited;

1.12 "Sasol" means Sasol Limited and its subsidiaries, including, Sasol Oil (Proprietary) Limited;

1.13 "Shell" means collectively Shell South Africa Energy (Proprietary) Limited and Shell South Africa Marketing (Proprietary) Limited and Tepco Petroleum (Proprietary) Limited;

1.14 "Task Team" means the team commissioned by the Minister of Finance in May 2006 to advise him on possible reforms to the fiscal regime applicable to windfall profits in South Africa's liquid fuel energy sector;

1.15 "Total" means Total South Africa (Proprietary) Limited;

1.16 "TOR" means the terms of reference setting out the scope of the Task Team's investigation and analysis;

1.17 "Upstream" means exploration and production up to but excluding the refining process.

Section C: Areas requiring further analysis

1 Shell supports the utilisation of the value chain approach adopted by the Task Team but believes that further analysis is required here. To assist the Task Team, Shell proposes that the following areas be examined to enable further analysis; namely:

1.1 the crude oil industries have a completely different value chain from the synfuels industries and these must be separated in the analysis;

1.2 even the synfuels industries themselves are not alike in their value chains, as Secunda and Sasolburg synfuels plants have both coal and gas as a feedstock, whilst Mossref is based on gas condensate;

1.3 the current analysis does not recognise the close ties between the chemicals facilities and the liquid fuels units and the ability to reconfigure the units between chemicals and fuels, and the effects on supply streams resultant from changes in reaction to any additional taxes.

1.4 the current analysis overlooks the fact that the synfuel petrochemicals businesses (including the marketed gas business) could also earn super

normal profits on the same base feedstock as the liquid fuels businesses and thus any tax on one leg without considering the other could inadvertently affect the supply chain of either;

1.5 there is no order of magnitude quantification of the size of the economic rents identified which would highlight the parts of the value chain which are giving rise to super normal profits.

2 Shell believes that it would be helpful to the analysis if the discussion on the liquid fuels industry and the economy were based on more current data (beyond 1995).

3 We believe that the Discussion Document could be further improved by completing benchmarking of the synfuel industry refineries by covering the relative refining costs (currently only crude oil refining is discussed).

Section D: Fiscal Regime applied to Liquid Fuel Value Chain

1. The questions posed by the Task Team cannot be addressed in isolation. In particular reducing the royalty tax by a percentage may not achieve the intended objectives. In our submission, it makes no difference whether or not there is a reduction in the royalty tax rate. We believe that the focus needs to be on the main driver behind the super taxes.

2. Royalty tax does not constitute a uniform tax and therefore could have the effect of discouraging investment. Super normal profits are by definition fortuitous, and until the introduction of capital gains taxes, they were not taxable as they were of a capital nature.

3. Since October 2001, 50% of capital profits are taxable. Any additional tax regime (for example, windfall taxes) over and above this would have to address the question as to how the mechanics of this windfall tax regime will operate in tandem with the capital gains tax regime. Furthermore, secondary taxes on companies (STC) are payable when profits (in the form of dividends) are repatriated to shareholders. In imposing the windfall tax regime, is it being

anticipated that such a tax regime would incentivise further investments of profits, where for instance, shareholders would, instead of repurchasing their own stock, opt to invest their profits in expanding, maintaining or repairing their refineries.

4. Keeping the tax rate on production as low as possible generally encourages investment in exploration. By way of example, high tax rates in the United Kingdom from 1983 to 1993 resulted in an 83% tax relief after the UK Government concluded that the high tax rate was leading to too much ill-targeted exploration spending.

Section E: Relationship between Fiscal, Minerals, Energy, Industrial and Environmental Policies

In our submissions, tax should not be used as the sole driver to influence economic policies; for example, environmental-related taxes should act as an incentive for encouraging proactive rather than penal driven tax policies, and the tax burden must be proportionate with the intended environmental benefit. We do not at this stage see any coherence in these policy spheres in as far as they apply to windfall profits. The potential to achieve other economic and social benefits must be used to ensure the required synergy between the different policies.

Section F: Methodology for Defining Windfall

1. In circumstances where a windfall tax regime is in place, economic rents would qualify for taxation, when by definition they constitute windfall profits. We agree with the definitions of the terms as set out herein, but wish to point out that there appears to be a contradiction. We make this comment because on page 30 of the document, the following is said about windfall profits: "At times circumstances arise unexpectedly, leading to the unanticipated generation of economic rent, at the expense of consumers or society in the absence of appropriate fiscal measures. For instance, this can occur as the result of unanticipated large changes in commodity prices, unexpected emergence of market power, or

unexpected regulatory failure. Under these circumstances we refer to these gains as windfall profits." This is somewhat contradicted on page 31 when the following statement is made: "…windfall profits or future expected economic rent." On the one hand, windfall profits are referred to as "unexpected and unanticipated generation of economic rent", and on the other, as "future expected economic rent". Windfall profits are either unexpected or expected economic rent, it cannot be both. We support the definition of it being unexpected or unanticipated economic rent.

2. The distinction between backward looking retrospective windfall taxes and forward-looking taxation is vital. Certainty forms the very basis of any tax legislation. Taxpayers must be certain about their tax liabilities and retrospective application creates an environment of uncertainty.

3. A distinction between upstream and downstream is required; this is because in the main, tax allowances and profit build-up for the two operations are not the same

4. Outlined below are some additional perspectives on windfall taxes and the concept in general terms in so far as it influences international and local investors:

- **Windfall definition:** A pure windfall tax would tax only genuinely windfall gains. Such gains would be entirely unexpected and therefore unaffected by and should not affect the actions of *any* party. However, even if the windfall gain was unanticipated ahead of time, taking away such gains after the fact might still affect future conduct.

- **'Ex post' perspective:** A windfall tax imposed on the basis of the actual realisation of profits may create significant distortion. A situation where zero economic rent is expected on average may deliver positive economic rents in some eventualities and negative economic rents in others. To tax the positive rents on an ex post basis without taking account of the risks involved risks transforming the situation into one where rents are, on average, insufficient to

recover investments. It is therefore vital that the assessment of any windfall gains is made from the right time perspective.

- **Efficient production and revised subsidy regime:** Efficiency indicates that synthetic fuel should be produced only where the variable costs associated with an additional barrel of production are less than the cost of an equivalent volume of crude based imported fuel. An arrangement, which subsidises synthetic oil production when imported oil prices are low and taxes it when imported oil prices are high may encourage inefficient production.

- **Taxation and excessive pricing:** While taxing holders of market power may allow some monopoly rents to be extracted, it is also likely to exacerbate any distortions through excessive pricing, as prices will normally increase as a result. Fiscal authorities need to take account of this in setting an optimal taxation structure. Another issue of concern is the potential for cumulative inefficiencies where taxes inflate prices at each stage in the value chain.

- **Efficiency allowances:** In practice it is generally difficult to isolate 'windfalls' from the results of innovation and efficiency improvement. Taxing windfalls may therefore tax and discourage innovation.

Section G: History of the Liquid Fuel and Synthetic Fuel Industry – factual accuracy and interpretation of the material analysed

1. Regulatory measures in place to provide support and protection to the synthetic fuels industry

1.1 To assist the Task Team in its assessment, we examine the preferential transport cost given to inland refineries by Petronet, a Division of Transnet Limited.

1.2 With reference to the concept of "Natref neutrality" referred to on page 45 of the Discussion Document, Shell confirms that the concept was based on the rationale that Natref as a refinery should have been located at the sea and in order to compensate its shareholders of the time, including Sasol and Total, and afforded the shareholders various benefits within the regulatory framework for

example, subsidised crude tariffs. Currently, the preferential pipeline tariffs persist and, as such, the finished product pipeline tariff subsidises the crude pipeline tariff.

1.3 The tariff linkage agreement was concluded between the Natref shareholders and Petronet in 1992 with the intention that adjustments on crude oil and white product transport tariffs do not negatively impact on the profitability of Natref. The agreement provides that any increase in the crude oil tariff will not exceed the weighted average increase of tariff for certain products, provided Petronet's pipeline network is used to convey Natref's crude requirements. The agreement was a response to Petronet increasing its rates and Natref' shareholders responding with their proposal to build their own crude line. The agreement has a three-year notice period.

1.4 The tariff linkage agreement ensures that a gap between crude and finished product tariffs is maintained. Shell is of the view that this gap should have been narrowed for two reasons. Firstly, currently more product is produced from 1 litre of crude due to improved efficiencies at Natref than in 1992. Second, since 1992, the "supply direction" from Sasolburg has moved "northwards" (that is to say that more product is pumped north and less, if any, south) and the practice of back-hauling product (that is to say the transportation by rail tanker from Natref towards Durban) has diminished. Natref was also allowed an element of compensation for moving product back towards the coast in the linkage formula, having already paid to have the product or its crude equivalent moved inland.

1.5 It is Shell's view that there should be no undisclosed subsidies in the transport tariffs to private companies, which the consumer ultimately pays for. Were Government to afford any subsidies to Natref or any other oil refinery, this should be done in an open and transparent manner, and preferably as a direct payment outside the regulated pricing structures.

2. Conversion of the DWP to MRG in 1995

2.1 It should be pointed out that the conversion of the DWP to that of an MRG line did not receive the support of the Other Oil Companies for the following reasons:

2.1.1 it limited the strategic logistic alternatives in the event of one or more inland refineries not being able to produce product;

2.1.2 it limited the coastal refineries ability to place product in the inland market in the future;

2.1.3 effectively it prevented the Engen and Shell depots at Witbank from being supplied from the coast.

3. Other comments

3.1 We do not agree with the very broad statement that the refining industry has not maintained their facilities adequately (p43 of the Discussion Document). We cannot comment on other facilities but we do not agree that this is the case for Sapref.

3.2 It must be noted that a substantial part of Government initiatives and regulation implemented to support Government strategy in the past afforded substantial benefits to synfuel producers, some of which are still in existence today, for example:

- Petronet pipeline network affords greater access and benefits to Sasol;
- Negotiated volume off-takes at BFP – this has since been amended to the "willing buyer willing seller" basis but BFP is still the benchmark for negotiations.

3.3 On page 50 of the Discussion Document, reference is made that Mossgas does not having a marketing arm, which is factually incorrect as PetroSA is active in the commercial market (non-retail).

3.4 On page 62 of the Discussion Document, there is an inference that the oil industry expects to be kept profitable at any cost – we do not agree with this statement - we expect the regulator to apply the regulatory framework in a consistent and equitable manner (level playing field) such that there is certainty and stability in the general business environment to enable the oil industry to implement profitable business strategies – in this regard one of the mandates of the regulator is to address profitability shortfalls in the industry. Recent very substantial clean fuels investments were not subjected to any fiscal assistance.

3.5 On page 67 of the Discussion Document, there is reference to significant profitability of international refineries and whilst this may be true it does not mean that the same quantum applies to RSA refineries. Refinery profitability is highly cyclical and refining has been historically a poor financial yield business. Furthermore margins are critically linked to unit availability and any off line period results in substantial lost margin.

3.6 On page 84 of the Discussion Document, there is reference to "guaranteed" margins. It should be pointed out that there is no guaranteed return on retail site investments as the implementation of the return is at the discretion of the regulator and there is historic evidence of several years of no adjustments to margins. Thus, although there is a margin mechanism in place there is no guaranteed return. In addition, the mechanism makes use of a balanced slate approach that does not take into account slate under-recoveries (current slate under-recovery is about R1.6 billion negative), which the oil industry has to bear unless there is intervention by the regulator within the pricing framework.

Section H: Specific Questions to the Other Oil Companies

1. Why were Total and Shell permitted to procure their own crude for their SA refineries when the rest of the SA refiners were supplied by CEF? Were there any abnormal profits involved?

1.1 Following the UN oil embargo against South Africa, the oil companies operating in South Africa could no longer import crude oil through their international

affiliates. The government convened a group of traders to secure crude oil on behalf of the oil companies in South Africa. Procurement of crude oil through this newly formed entity was optional, and Shell and Total elected not to participate, as they were confident that they had the expertise in their respective companies to purchase and import their crude oil themselves. This government initiative later was absorbed into the CEF around 1977.

1.2 During the sanction years, no abnormal profits were achieved by Shell not joining the CEF.

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

No incentives were given to Shell to upgrade their joint venture refinery for the cleaner fuels specification changes that where introduced in 2006 in South Africa. Costs in the order of R700 million were incurred at Sapref. Depot infrastructure upgrades cost a further R30 million for Shell.

3. 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?

Sustainable investment in the oil industry must be demand driven and all options should be explored including synfuels, biofuel, crude and imports. The options that have the lowest input cost to the South African economy and meets Government's key growth and development objectives should be chosen provided that rules and fiscal dispensations are transparent. Ideally all options should be neutrally impacted by regulatory intervention to ensure the best solution for the economy is chosen.

4. Why are OOC's ROA recorded in the SAPIA annual report so low and how do we explain the difference in Sasol vs. rest of oil industry profitability

The returns quoted in the SAPIA report are after tax while Sasol's are before tax. In addition, a fundamental issue is that Sasol has a lower input cost (coal versus crude input cost)

Section I: Value Chain approach to Liquid Fuel Industry

The concern for transfer pricing is valid when connected parties are involved in the supply value chain to ensure considerations for supplies of goods and services or tax arbitrage opportunities are not manipulated. However, we believe that the current transfer pricing section in the Tax Act, coupled with general anti-avoidance rules should be sufficient to cover the windfall regime.

Section J: Applying windfall methodology on the Liquid Fuel Value Chain to identify Economic Rent Streams

Whilst we support this approach, we feel that it is too simplistic and that the value chain in its present form does not present an accurate reflection of the economic rent generation stream in the South African liquid fuels industry.

Section K: Comment on the Fiscal Measures identified in the Terms of Reference that the Task Team

1. To the extent that the Government implements a revised fiscal regime, it would be very important to ensure that this regime does not adversely affect the effective tax rate of the respective corporate entities, and in our view, it should target specifically the unanticipated economic rents generated in the synfuels industry.

2. The ***cost-based administered price regime*** is not advocated, as this could amount to a form of price control. This in turn could adversely affect growth targets. We are of the view, which seems to be an accepted one, that the existence of price controls would act as a counter-measure to initiatives aimed at ensuring economic growth and investment in the South African economy.

3. A ***progressive formula*** can be open to abuse if entities are permitted to deduct or offset losses on capital investments, which effectively allows entities to place themselves in a non-tax paying position regardless of profitability. It is generally accepted that tax regimes should not be punitive and the proposed tax seems more punitive than economically advantageous and does not in any way incentivise investors.

4. ***Investment-linked tax and subsidy options*** are also not favoured. Tax should not be the sole driver in influencing economic policy. What should be striven for is certainty and stability from a tax regime perspective.

Section L: Concluding Remarks

1. By way of comparison, in the United Kingdom's Upstream environment, proposed fiscal regimes are almost always considered in light of the effects such a proposal would have on investor behaviour and as a result, the value created for the country, the Exchequer and the investor.

2. Other issues, which are considered in assessing, proposed changes to the fiscal regime include the competition effects of the proposed regime as well as the fairness of the proposed regime. Care should be taken to ensure an understanding that high crude oil prices in the international market do not equate to high profits in the Downstream market.

3. Shell is in principle opposed to any adjustments to the existing tax regime, and in particular, the introduction of a windfall tax regime. The only industry, in respect of which this tax regime could have relevance to, would be the synfuels industry

given that the prices that are received by the synfuel industry (with a feedstock obtained locally and other than oil) are set as a function of the crude oil price.

4. Any regime should be underpinned by equity; fairness and it should be reasonable. It should not take into account that South Africa has a developing economy and that in whatever form this tax may be introduced, it must not serve as a disincentive nor should it deter investment and economic growth from a South and Southern African perspective.

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