

Fuels Pricing & Taxation

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RECENT DEVELOPMENTS



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INTRODUCTION

In 2005 the average spot price of petroleum products (diesel, illuminating paraffin and petrol) on international markets rose to just under 167 United States Cents per gallon and the effect was felt by South African consumers in all provinces. The 2005 fuel price increases have been substantial. In December 2004 the 93 octane retail petrol price was R4.66 cents per litre and by the end of the year it was R5.42 cents per litre in coastal cities.

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CUSTOMS AND EXCISE SYSTEMS AND PROCEDURES

Before 2 April 2003, petroleum product stocks were held in bond (duty free) at oil company depots, and excise duty and fuel levies were payable when products moved out of the depots as invoiced sales. This system of tax collection was replaced by Duty at Source (DAS), which commenced on 2 April 2003 and was intended to simplify the process of fuel tax collection. There are still many challenges facing DAS implementation but the industry, in conjunction with the South African Revenue Service (SARS), is steadily improving administration and controls.

Once running smoothly, DAS will assist both industry and SARS in achieving maximum compliance. There are still unresolved issues relating to acquittal documentation, and the treatment of Dual Purpose Kerosene, Unmarked Illuminating Paraffin and Unmarked Aliphatic Hydrocarbon Solvents. These issues are being addressed collectively by SARS, National Treasury (NT) and industry. Some issues could be temporarily addressed by concessions from SARS; others, however, can only be resolved through legislative amendments, which will only take effect during 2006/7.

The delay by SARS in changing the fuel marking technology is of major concern to the industry, as these changes were proposed nearly 3 years ago because the current technology compromises industry's efforts to comply with the rules and regulations concerning the marking of illuminating paraffin.

That the penalties imposed on companies are based on various tests or interpretation of law concerning marking of illuminating paraffin, rather than on any duties and levies due to SARS, worries the industry. The Customs and Excise Act has been amended to include a reference to the Road Accident Fund levy (in the DAS collection system). The amendment was published in the Government Gazette of November 2005. The move to collect at source will significantly increase the Road Accident Fund revenue, improve compliance and reduce under-collection of the RAF levy.

The redrafting of the Customs and Excise Act is continuing in stages. The industry was requested by SARS to comment on the draft Schedule No. 6 – Rebates and Refunds of Excise Duties and Fuel Levy. The draft Schedule dealt with structural changes and existing rebate items were moved to the various newly created sections. The drafting team has not released the draft on penalty provisions and the industry is looking forward to commenting on these provisions in 2006.

WESTERN CAPE PROVINCIAL FUEL LEVY PROPOSAL

In December 2002 the Provincial Treasury of the Western Cape commissioned the Bureau for Economic Research (BER) at the University of Stellenbosch to conduct research and investigate the feasibility of a fuel levy in the Province. The report was completed in November 2003 and public comments were invited in the first quarter of 2004. The report proposes a levy

of between 10 and 50 cents per litre with the initial level of 10 cents per litre. The final report was approved by the Western Cape Provincial Cabinet in November 2003 and the proposal has been submitted to the National Treasury for approval.

Sapia does not oppose the proposal in principle, as we recognise the constitutional authority of the Province to impose taxes when considered appropriate. Significant tax differentials between provinces will however materially and unreasonably prejudice economic activity across provincial boundaries. The best solution will be to implement the levy equally in all nine provinces.

However, if that cannot happen, the Province should consider how to avoid unintended consequences such as creation of scope for tax evasion on deliveries from depots within the Western Cape to customer delivery points outside the provincial boundary and vice versa. It is important to note that the implementation of a provincial fuel levy will require systems development and testing; the lead time for this change, once the details are known, should be at least 12 months.

The 2005 Government Medium Term Budget Policy Statement indicated that the proposal is being evaluated by the Minister of Finance, the Budget Council and the FFC in terms of the Provincial Tax Regulation Process Act and the relevant constitutional provisions. It would appear that in principle there are no objections to the proposed fuel levy in the Western Cape Province.

ENVIRONMENTAL FISCAL REFORM

The National Treasury initiated a study on environmental fiscal reform in 2002. This culminated in an initial discussion document, which was presented to a wide range of stakeholders

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at a workshop in November 2003 to receive feedback on the proposed Environmental Fiscal Reform framework. The oil industry participated in this process and provided comments on the document.

Where appropriate, these comments were incorporated into the development of the National Treasury’s draft policy paper entitled “A Framework for Considering Market-Based Instruments to Support Environmental Fiscal Reform in South Africa”. The paper was released for public comments on 6 April 2006. The deadline for comments is 31 July 2006 and can be submitted to sharlin.hemraj@treasury.gov.za.

CLEANER FUELS PRICING

As from January 2006 leaded petrol and 3 000 ppm sulphur diesel were phased out of the market. Lead Replacement Petrol replaced leaded petrol and the 500 ppm sulphur diesel became standard grade for diesel. A niche 50 ppm sulphur diesel was introduced to the market. 93 unleaded petrol and 93 Lead Replacement Petrol are similarly priced and the same applies to 95 unleaded petrol and 95 Lead Replacement Petrol.

The exception is in the inland area where 95 unleaded petrol will carry a demand side management levy (initially of 10 cents per litre) to discourage motorists from wasting octane. With regards to the new diesel (50 ppm sulphur content) the maximum wholesale price will be fixed by the government.

MAGISTERIAL DISTRICT PRICE ZONES REVIEW

The magisterial district price zones are based on the cost of moving fuels from coastal refineries to the inland distribution centres by private bulk petroleum products transporters via

pipeline, rail, and road. These costs are adjusted annually subject to approval by the Minister of Minerals and Energy. The Department of Minerals and Energy is reviewing price zones because, over the years, road transport has been taking over from rail.

In December 2004, there was an increase in some zone prices due to a change in the transport tariff basis where both pipeline and rail are involved. The increase ranged between 4.0 c/l and 8.0 c/l.

LIQUID PETROLEUM GAS (LPG) PRICE

The Department of Minerals and Energy is striving to get affordable LPG into poorer homes throughout the country. This was emphasised in June 2004 in the budget vote speech by the Minister of Minerals and Energy.

Regulation of the maximum refinery gate price of LPG was introduced in December 2001. The DME and industry have been considering various alternatives that could be used to set the maximum refinery gate price.

In December 2005 the DME awarded a tender for the investigation into the margins of the LPG wholesaling, distribution and retailing sectors with the view of controlling the retail price of LPG and promotion of its affordability.

REGIONAL SERVICE COUNCIL (RSC) LEVIES AND JOINT SERVICES BOARD (JSB) LEVIES

The RSC and JSB levies are the regional establishment levy referred to as the ‘turnover levy’, being a percentage of gross turnover derived by a business including in certain cases interest, dividends, etc., as well as the regional services levy

or the 'payroll levy', payable on remuneration payable by an employer to its employees within a particular region. The 2005/6 Government Budget proposed to abolish the levies on June 30, 2006, to be replaced with alternative tax instruments or funding arrangements to ensure the continued independence and financial viability of municipalities.

The Government 2005 Medium Term Budget Policy Statement proposed alternative instruments to replace the levies. Sapia supports the allocation of a share of the general fuel levy to municipalities, distributed on the basis of the total fuel sales within each municipality. This instrument will be simple to administer and probably require a shorter lead time if aligned to the MDZ pricing methodology. This instrument is not 'turnover levy' and will go a long way towards relieving Sapia members' burden of dealing with sometimes high crude prices and other raw materials prices that contribute a significant portion to the companies turnover.

BIOFUELS TAXATION

The 2002/3 Government Budget proposed a rebate of 30% of the general fuel levy applicable on mineral diesel fuel in respect of bio-diesel. The implementation of this fuel tax concession was delayed to allow other processes to take place.

The implementation of the bio-diesel fuel tax concession was delayed to allow for the development of the required bio-diesel standards and specifications for the South African market, the endorsement thereof by the National Association of Automobile Manufacturers of South Africa (NAAMSA), and the development of the necessary Customs and Excise rules by SARS.

This process was completed in March 2006 and the concession was implemented on 1 April 2006 as announced in Budget 2006

to coincide with the beginning of the new 2006/07 fiscal year. The rebate of the general fuel levy was increased at the same time to 40% to reflect the higher than anticipated production costs faced by the emerging bio-diesel industry.

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PRICING OF PETROLEUM PRODUCTS – A REVIEW



“Sapia believes that it is important that while Government continues to set prices, the systems employed should be transparent and understood by the public.”

Sapia has stated that it believes that free market forces should set the prices of all petroleum products. However, it accepts that this will only happen once certain social objectives spelt out by Government have been met.

In the interim, the price of petrol at the pump, and the maximum wholesale prices of diesel and paraffin will be set by Government in terms of various regulatory systems. During April 2003, in order to ensure that energy is available to the poor at affordable prices, control over the maximum retail price of paraffin sold “naked” was introduced in the form of a national maximum price – published monthly. In addition, control over the retail price of LPG is under consideration.

Sapia believes that it is important that while Government continues to set prices, the systems employed should be transparent and understood by the public.

Towards this end Sapia has consistently provided information on the pricing system in its Reports. In this article this information is brought up to date and the movements in the price build-ups of petrol and diesel between October 1996, March 1999 and June 2005 are analysed. (This period covers a cycle in which crude oil prices (Dubai) fell from \$22/bbl to \$10/bbl and ended at \$53/bbl in June 2005.)

OVERVIEW

There are two main constituents of the prices of the controlled products – i.e. petrol, diesel and paraffin. These are:

- The external factors – the dollar price of the product on world markets multiplied by the dollar:rand exchange rate.
- The internal factors – the rand based dealer and oil company marketing margins, transport costs and taxes and levies.

The external factors move constantly and account for most of the monthly movements in prices. Both the world market price of oil and the exchange rate are outside the control of the industry.

The Monthly Pricing System, whereby the controlled prices are changed on the first Wednesday of the month, takes account of movements in these factors.

When the various internal factors are adjusted – usually once a year for each – these movements are also included in the relevant monthly price change. (See appendix 12)

On page 71 the price build-up charts show the detail of the build-up of the petrol and diesel prices as at 30 June 2005.

THE MECHANICS OF THE MONTHLY PRICING SYSTEM

World oil and financial markets respectively drive movements in petroleum products prices together with the dollar:rand exchange rate, and these movements are dealt with through the Monthly Pricing System.

Until March 2003 this system, named the “In Bond Landed Cost” system, was based on the daily average of five published world oil prices for the product concerned. These were the posted prices of three refineries in Singapore, an assessment of the Singapore spot market price and the posted price of a refinery in Bahrain. In April 2003 the system was changed to use spot prices instead of posted prices. The spot prices used are:

- For petrol: 50% Mediterranean/50% Singapore
- For diesel and paraffin: 50% Mediterranean/50% Arabian Gulf

The new system is called the “Basic Fuels Price” (BFP) formula.

On the basis that, if prices are to be controlled, it is prudent for the control mechanism to be linked to world markets, the BFP formula represents an important improvement in way in which the system links to world markets.

The cost of shipping and related costs of importing into South Africa are added to these prices. The resultant dollar “basic price” is converted to rand at the daily dollar:rand exchange rate ruling at 11h00 South African time.

As it would be cumbersome to adjust pump prices daily, the average price ruling during the previous month is used as the price for the next month, with the actual price change taking place on the first Wednesday of each month. There are detailed “working rules” dealing with the timing effects and the under-and-over recoveries that result from this use of the previous month’s price. The whole system is managed by the Central Energy Fund, is fully transparent and is subjected to monthly audit.

Movements in the rand-based elements (internal factors) are subject to Government control. They are increases in taxes and levies, transport costs and increases in the oil company marketing margins and the dealer margin.

The overriding rationale of the control of prices and margins should be to ensure that the various stakeholders in the industry earn fair returns. The returns should be sufficient to encourage the needed investment in the industry, while not being such as to represent over-reward.

The control systems in place should encourage efficiency. This is true of the systems which control the margins earned by the oil companies as is explained below.

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HOW THE INDUSTRY EARNS ITS PROFITS

Sapia's policy of greater openness and transparency implies an on-going effort to increase understanding of key aspects of the oil industry. Sapia believes it is important that everyone should have an understanding of the factors that drive the profitability of the industry.

The Monthly Pricing System, described above, includes in the price build-up an industry marketing margin, controlled by Government, and determined by the use of the Marketing of Petroleum Activities Return (MPAR) system, and a refining margin.

MARKETING PROFITS

Marketing profitability is governed by the Marketing of Petroleum Activities Return (MPAR) system.

This system has its roots in the 1970s when the government of the day applied price control to various industries. The key elements of the formula are income before tax and interest as a percentage of total assets. When depreciation is calculated, an adjustment is made to recognise the effects of inflation. Similarly, stock profits and losses are excluded.

The formula is applied one year behind current reality (i.e. those seeking to motivate a 2005 margin increase would quote 2004 figures).

Under the MPAR system, an aggregate oil industry marketing profit acceptable to Government is between 10% and 20% of assets. Should returns fluctuate within the 10-20% band, then no increase or decrease is due. Should returns go above 20%, then a margin decrease is indicated. Should the return fall through the 10% 'floor', a margin increase is indicated.

When an adjustment is made, the new cents per litre marketing margin is set at a level which would have delivered a 15% return for the year under review.

The easiest way to explain the formula is to give an actual example, and the most relevant one is the arithmetic behind the 2003 industry MPAR application for a 3,21c/l margin increase.

Key elements in the equation for 2002 are shown in the table below. The system is relatively simple. It acts as an encouragement to competition as the margin is based on the total income and assets of all companies. An individual company can improve its relative profitability by reducing its own costs and assets. Each time this is done, it has the effect of reducing the industry total assets and costs. Competition causes the process to be repeated – leading to ongoing cost reductions and increased efficiency for the whole of the South African oil industry. Sapia believes, however, that in principle free competition is far more desirable.

The MPAR system is currently under review and the outcome of the review will be covered in a future Annual Report.

A	Aggregate income in 2003	R1 319m
B	Total assets in 2003	R13 567m
C	Return (A/B x 100)	9,72% (below 10% so an adjustment is due under formula)
D	Amount needed to give 15% (B x 0,15)	R2 036m
E	Shortfall in actual income (D-A)	R717m
F	Volume in 2002	R22,3 billion litres
G	Adjustment in cents/litre (E/F)	3,21 c/l

Government granted a 2,00c/l interim increase in December 2004. The balance of 1,21c/l is outstanding.

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REFINING PROFITS

A refinery separates crude oil into its component parts. For every 100 tons of crude fed in, about 93 tons of refined product is produced, the rest is consumed in the process, mainly as fuel.

Obviously, for income to be earned, the refining process must add value over and above the cost of the processes and the cost of the initial 100-ton input.

Two categories of product are created:

- Higher value products (e.g. petrol, diesel and paraffin).
- Lower value products (e.g. furnace and bunker fuels).

The percentage of higher or lower value products produced by the refinery depends on three principal factors:

- The type of crude being refined.
- The equipment used.
- The efficiency of operations.

Higher value products may be resold for higher prices. Crudes which intrinsically contain more higher value product tend to be more expensive.

A similar balancing of the scales is apparent when examining the profit-earning capabilities of refining equipment. The more extensive and sophisticated the equipment, the greater the anticipated yield of higher value product. This is not only good for the company, but also good for the country as optimum output of high value products saves foreign exchange on crude oil imports. However, the more modern and sophisticated the equipment, the greater the capital investment.

The key point of difference in the relative profitability of refineries therefore tends to be the efficiency of operations, or how management and labour maximise the yield of high value product for a given type of crude with the available equipment.

A major factor beyond the control of the refiners is the prevailing margin between the cost of crude oil and refined products in international markets. Oil is an internationally traded commodity. These margins therefore fluctuate in line with global trends in supply and demand and the perceptions and sentiments of a global marketplace. World prices are outside the control of the authorities or other interested parties in South Africa.

An important factor in the economics of refining in South Africa is that the cost of shipping crude oil in very large vessels is cheaper per litre than importing refined product in smaller vessels.

This freight saving contributes to the sustainability of local refining, to foreign exchange saving and to the creation of jobs in the local refining industry and its suppliers.

The world price of a refined product landed in South Africa at any given time is referred to as the Basic Fuel Price (BFP), or the "external factors" referred to in description of the Monthly Pricing System.

The above sets out the present pricing system.

It is Sapia's opinion that any regulated pricing system should be:

- Market related.
- Arm's length, transparent and defensible.
- Capable of easy, fair and consistent administration.
- Capable of achieving the agreed goals.



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Sapia believes that with the improvements brought about by the introduction of the BFP, the system used in South Africa meets these criteria.

Those who wish to have more detail on pricing of petroleum products than it is possible to give in this brief synopsis are invited to contact Sapia.

AN ANALYSIS OF PETROL AND DIESEL PRICE MOVEMENTS

An explanation of the reasons for increases and decreases, and of certain seasonal fluctuations in prices follows. Dollar crude oil prices (Dubai) have fluctuated in recent years from \$22/bbl down to \$10/bbl and up to \$60/bbl, before coming down and going up again.

The weakening and subsequent strengthening of the dollar-rand exchange rate has added to the price movements in South Africa, and normal seasonal changes on the global market have also had their effect.

An analysis of world prices, from 1996 to 2005, shows that dollar crude prices peaked in October 1996 at \$22/bbl and then declined for the next two and a half years when they actually fell below \$10/bbl during February 1999. (See Appendix 6 of this report for monthly average crude oil prices.)

In March 1999 OPEC acted to restrict crude oil production and, on this occasion, the world oil market responded sharply.

The crude price rose 50% in less than five months from around \$10/bbl to \$15/bbl between February and June 1999. Thereafter the price continued increasing and eventually exceeded \$30/bbl in late 2000.

OPEC then embarked on a programme of seeking to maintain prices between \$22/bbl and \$28/bbl by increasing or reducing production. They have successfully maintained prices in this range for some time. However in 2004, as a result of political tensions in the Middle East and protracted US dollar weakness, prices have moved well above this range. The strength of the rand has meant that rand oil prices have not increased as much. This increase in the crude price drove international petroleum product prices up.

The relationship between product prices and crude prices varies with world market conditions, as do the relative movements in the prices of different refined products. The most marked of these movements is that petrol has a seasonal high during the northern hemisphere summer (the “driving season”) and distillates (paraffin and diesel) peak in the northern winter. These trends are mildly beneficial to South Africa as our summer driving season coincides with the seasonal low for petrol and peak paraffin usage with the seasonal low for that product. Our summer rainfall peak usage of diesel by farmers is unfortunately when that product reaches its seasonal high.

The analyses (given in appendix 15) of the price movements between October 1996, when crude prices peaked, March 1999, when crude prices bottomed, and June 2005 show that there has been a relatively modest increase in the internal (rand based) factors in the six years since March 1999 (83c/l for petrol and 64c/l for diesel); that most of the overall increases, 275c/l and 267c/l respectively are due to increases in the basic price, reflecting movements in world oil market prices and in the rand: dollar exchange rate.