

**EVALUATING INCENTIVES IN THE TAX LEGISLATION
APPLICABLE TO THE SOUTH AFRICAN OIL, PETROLEUM AND
GAS INDUSTRY**

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“The fear of the Lord is the beginning of wisdom; all those who practice it have a good understanding. His praise endures forever!” Psalm 111:10

KEYWORDS

- Taxation of oil/petroleum and/or gas companies
- Income tax on oil/petroleum and/or gas companies
- Royalty tax on oil/petroleum and/or gas companies
- Tenth Schedule
- OP26
- Mineral and Petroleum Resources Royalty Act
- Royalties
- State-imposed costs in South Africa on oil/petroleum and/or gas companies
- Tax incentives
- Black Economic Empowerment

ABSTRACT

The oil and gas sector holds several advantages for South Africa: direct benefits include providing growth in the country's economy by optimising available oil and gas resources and minimising dependence on foreign oil and gas exporting countries, while indirect advantages include fiscal rewards to the government, technological and infrastructural improvement, as well as benefits to society. However, the country's oil and gas reserves are minimal in relation to several other countries worldwide, which is not beneficial for oil and gas ventures. Therefore, in the aim of promoting investment in the oil and gas sector of South Africa, attraction should be reached by other means, such as an alluring regulatory environment, in order to compensate for these poor reserves.

Given the characteristics of South Africa's oil and gas industry position, the research conducted in this study aimed to determine whether the tax legislation in South Africa provides sufficient incentive to oil and gas companies to compete for international investment in this industry. This was done by performing a literature review to establish the use, harmful effects and characteristics of meaningful tax incentives. The incentives contained in South Africa's oil and gas tax environment were evaluated, based on the above-mentioned characteristics supplemented by a comparison of other countries, to determine whether the incentives can competitively attract investment to the country's oil and gas sector.

Based on the results of the analysis conducted, it is concluded that the Tenth Schedule of the Income Tax Act No. 58 of 1962 and the Minerals and Petroleum Resources Royalty Act No. 28 of 2008 currently applicable to the oil and gas sector contain several tax incentives which adhere to the identified characteristics of meaningful tax incentives, which should enable South Africa to lure investment to the country's oil and gas sector. Nonetheless, it is contemplated that the total cost package to oil and gas investors should be considered as other tax-related costs such as Black Economic Empowerment and potential carbon emission tax costs deters oil and gas investment.

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UITTREKSEL

Die olie en gas sektor sluit menige voordele vir Suid-Afrika in: direkte voordele sluit groei vir die land se ekonomie in, deur beskikbare olie en gas reserwes te optimaliseer, sowel as die vermindering van afhanklikheid van buitelandse olie en gas uitvoerlande. Die land sal ook indirek baat vind deur die ontvangs van fiskale vergoeding deur die regering, tegnologiese en infrastruktuur bevordering, asook voordele aan die gemeenskap. Die land se olie en gas reserwes is egter minimaal in vergelyking met verskeie ander lande wêreldwyd, wat nie voordelig is vir olie en gas ondernemings nie. As gevolg van hierdie swak reserwes en met die oog op die bevordering van olie en gas belegging in Suid-Afrika, moet werwing dus op ander maniere bereik word, soos deur die daarstelling van 'n aanloklike regulerende omgewing.

Inaggenome die eienskappe van Suid-Afrika se olie en gas industrie, was die doel van die navorsing om te bepaal of die belastingwetgewing van die land genoegsame aansporing aan olie en gas maatskappye bied om mee te ding vir internasionale belegging. Dit was moontlik gemaak deur die uitvoer van 'n literatuurstudie om die nut, nadelige gevolge en eienskappe van betekenisvolle aansporings, te bepaal. Gebaseer op laasgenoemde, is die aansporings, bevat in Suid-Afrika se olie en gas belastingwetgewing, geëvalueer en ook aangevul deur 'n vergelyking met ander lande, om te bepaal of dit kompetender belegging na die land se olie en gas sektor kan lok.

Na aanleiding van die resultate van die ontleding, is daar tot die gevolgtrekking gekom dat die Tiende Bylae van die Inkomstebelastingwet Nr. 58 van 1962 en die Minerals and Petroleum Resources Royalty Act No. 28 of 2008, wat huidige op die olie en gas sektor van toepassing is, verskeie belasting-aansporings bevat wat voldoen aan die geïdentifiseerde eienskappe. Dit behoort Suid-Afrika in staat te stel om belegging na die land se olie en gas sektor te lok. Nietemin word dit aangevoer dat die totale koste van olie en gas beleggers oorweeg moet word, aangesien ander belastingverwante kostes, soos Swart Ekonomiese Bemagtiging en die potensiële belasting op koolstof emissie, olie en gas belegging ontmoedig.

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ABBREVIATIONS

B-BBEE	Broad-Based Black Economic Empowerment
Bbl	Barrels
BEE	Black Economic Empowerment
BEE Mining Charter	Broad-Based Socio-Economic Empowerment Charter for the South African Mining Industry, South Africa
cu m	Cubic meters
GDP	Gross Domestic Product
IAS	International Accounting Standards
Income Tax Act	Income Tax Act No. 58 of 1962
MPRDA	Minerals and Petroleum Resources Development Act No. 28 of 2002
OECD	Organisation for Economic Co-operation and Development
OPASA	The Offshore Petroleum Association of South Africa
PetroSA	The Petroleum, Oil and Gas Corporation of South Africa (SOC) Limited
Royalty Act	Minerals and Petroleum Resources Royalty Act No. 28 of 2008
SAPIA	South African Petroleum Industry Association
South Africa	Republic of South Africa
Tenth Schedule	Tenth Schedule of the Income Tax Act No. 58 of 1961

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CHAPTER 1

INTRODUCTION

1.1 BACKGROUND

1.1.1 The oil and gas industry and the economy

Natural resources and market size is perceived to be the largest driver of foreign direct investment in Sub-Saharan Africa (Ibi Ajayi, 2006:12), and with South Africa being a country endowed with abundant energy resources, this might secure opportunities for the country. Fossil fuels, such as coal, uranium, liquid fuels, and gas, play a central role in the socio-economic development of South Africa, while simultaneously providing the needed infrastructural economic base to become an attractive host for foreign investments in the energy sector (White Paper on Energy Policy, 1998:2).

Over and above the benefits of local investment (such as economic growth resulting in reduced unemployment and poverty), foreign direct investment generates additional benefits to a country due to various reasons, of which some were set out by Konings (2003:621). Firstly, foreign direct investment improves efficiency through strategic restructuring. This restructuring is possible through foreign firms' technology, knowledge and positive externalities. Secondly, foreign direct investment provides finance, leading to a reduced financial relationship between local companies and the government, that usually impose strict budget constraints, resulting in better performance. Konings (2003:621) stated that, as a result of these benefits, foreign direct investment always lead to increased productivity.

After an attempt to eliminate the demise of the previous OP26 regime, a new tax regime relating to the oil and gas industry was negotiated and finalised¹. It is evident that the South African government endeavours to retain and promote the active oil and gas investment in this sector (Futter, 2010:15). Despite the country's rich endowment of mentioned fossil fuels, South Africa only has small deposits of oil and gas. These small deposits, nonetheless, play a central role in South Africa's energy supply. Following coal and peat, oil contributes to 12.6% of the country's total primary energy supply (EIA, 2010:1). South Africa's refining capacity is the second largest in Africa at 703 000 bbl/day (SAPIA, 2010:37), only surpassed by Egypt with 726 250 bbl/day (EIA, 2010:3). Natural gas, on the other hand, plays a major role in the production of synthetic

¹ The Tenth Schedule was implemented following the previous OP26 regime.

fuels. The world's largest commercial natural gas-to-liquids plant is managed by State owned company, PetroSA, at Mossel Bay in the Western Cape, which has a capacity of 45 000 bbl/day (EIA, 2010:4). Along with coal, synthetic fuels provide 36% of the country's liquid fuel demand (Department of Energy, s.a.). The liquid fuel industry is a primary driver of economic growth, as 76% of the industry's production is used for transport and the balance for heating and power generating – influencing the economy directly (National Treasury, 2006a:64).

Forty-two African countries, of which South Africa is one, are net oil importers. Oil can be produced out of a variety of sources – liquids, coal and gas – however, South Africa still only produces 10.8% of the country's oil needs, and 50.4% of its gas needs². The National Treasury (2006a:8) stated that about 30% of South Africa's liquid fuel is produced from coal and natural gas. To satisfy demand, the remaining 70% needs to be imported, making South Africa particularly vulnerable to volatility in global fuel prices and dependent on foreign exchange to cover the country's domestic energy needs (Amigun, Musango and Stafford, 2011:1360). Oil price changes affect the entire economy: over and above the effect it has on an individual's fuel expenditure, it affects each and every for-sale item through higher transportation costs, accumulating to an elevated total product cost. According to Amigun *et al.* (2011:1360), the goal of South African production of oil and gas is therefore to reduce the high dependence on imported petroleum by developing domestic energy (including renewable energy) as far as possible.

Renewable energy technologies (RETs) in general, and bio-fuel specifically, offer developing countries some prospect of self-reliant energy supplies at national and local levels, with potential economic, ecological, social, and security benefits (Amigun *et al.*, 2011:1361). In a case study, Melamu and von Blottnitz (2011:138) conversely determined that investments into

² The following table provides an overview of South Africa's oil and gas production, consumption requirements and reserves:

South Arica	Oil	Gas
Production	191 000 bbl/day (2009 est.)	3.25 billion cu m (2008 est.)
Consumption	579 000 bbl/day (2009 est.)	6.45 billion cu m (2008 est.)
Exports	128 500 bbl/day (2007 est.)	0 (2008 est.)
Imports	490 500 bbl/day (2007 est.)	3.2 billion (2008 est.)
Proved reserves	15 000 000 bbl (2010 est.)	27.16 million cu m (2006 est.)

(CIA Factbook, 2010)

Production for own use = (Production – Exports) / Consumption

energy efficiency are a precondition for diverting cellulosic³ residues into bio-fuel production. They concluded that second-generation bio-fuels might be unsuccessful. In addition, some commentators are of the view that bio-diesel is produced in limited quantities and that it is highly unlikely to ever meet the growing demand for fuel (Biodiesel SA, s.a.). Even with bio-fuel as a possible solution to providing renewable energy – taking into account the abovementioned inefficiencies – the optimal exploration and production of petroleum and gas within the constraints of South Africa's limited reserves remain relevant, and given the potential benefits that investment in this sector may hold, attention must be given to this industry.

A developed oil and gas sector might reward South Africa's economy with less dependence on the Organisation of the Petroleum Exporting Countries, benefits of investment, and fiscal rewards, such as tax revenue, for the government. Major role players in this industry make a substantial contribution to South Africa's policy goals of growth. Sasol, for example, adds to the liquidity and market capitalisation of the Johannesburg Securities Exchange, being the second largest listed company by market capitalisation. Also, the development of the leading and tested syn-fuels⁴ production technology used in this industry, improves South Africa's technology to a world class standard (National Treasury, 2006a:68). Indirect benefits flowing to the community, such as technological and capital developments and the upliftment of historically disadvantaged persons, might also be consequential to the country: in 2010, SAPIA (2010:17), the South African Petroleum Industry Association, reported that a munificent R263 million was invested by the industry towards increasing the availability of skilled artisans and process operators since 2007. In order to attract these advantages of investment to the country, an understanding of the nature of the oil and gas industry is necessary, which will develop from a consideration of the industry's associated risks.

1.1.2 The risks associated with the oil and gas industry

The Concise Oxford English Dictionary (COED, 2008:1241) defined risk as “a situation involving exposure to danger”. Without risk, all companies would initiatively commence and be perfectly successful. The need for attraction is an indicator that risk is involved.

Otto, Andrews, Cawood, Doggett, Guj, Stermole, Stermole and Tilton (2006:15) identified several risks as reasons why the mining sector requires an incentivised operating environment.

³ Cellulosic is a plastic made from cellulose (Budinski & Budinski, 2010:203).

⁴ Syn-fuel is a product resulting from natural gas.

Firstly, substantial costs are associated with the industry: a lengthy exploration period exists during which no revenue is received. Also, during the development and construction phase, the amount of capital required is greater in comparison to most other businesses, and this capital of a built mine is captive, and not transportable. At the time a project closes, hefty costs will be incurred, such as reclamation. Additionally, significant costs unrelated to production, such as investment in communities, may be incurred. Secondly, due to the specialised nature of the industry, the equipment must be imported as it is only available from a few manufacturers worldwide, increasing mines' exposure to volatile exchange rates as well as costly waiting time for vital equipment. Thirdly, mines are usually associated with cyclical revenues as a result of extensive commodity price volatility, and as mines have the ability to have long business lives, it will be subject to regime changes and policy instability.

Oil and gas companies, in particular, take on projects that are increasingly complex and multibillion-dollar in nature. Numerous other factors, including stringent environmental legislation and the increasing application of relatively new technologies, have also increased the level of project risk (Donaldson, 2008:1). Donaldson declared that risk is a major concern for national oil companies that often have a significant national development responsibility: a project failure of scale could have highly undesirable wide-ranging social and political ramifications. It is therefore deduced that the main risks of the oil and gas industry relate to high initial capital investment, the uncertainty relating to exploration and volatile revenue, and political risks – including legislation. The latter will be elaborated in paragraph 1.1.3.

Given South Africa's low ranking in terms of proved oil and gas reserves, the potential cost of oil and gas exploration poses risk: the country is ranked 85th in the CIA Factbook (2010) Proved Oil Reserves list, with 15 million bbl of oil, and 103rd in the Proved Natural Gas Reserves list, with 27.16 million cu m of natural gas. As a country attempting to lure foreign direct investment, these resource rankings are not favourable, since the most significant risk for oil and gas investors in South Africa might be to waste millions in initial capital investment after unsuccessful exploration.

The State formed Soekor⁵ in 1965, after which the company commenced the prospection and exploration of oil and gas in South Africa (National Treasury, 2006a:16). Taking into account the Exploration Opportunities in South Africa map on the PetroSA (s.a.) website, it seems as though the activities in phases one (reconnaissance) and two (TCP) of the four phases of the oil and

⁵ Soekor (Pty) Ltd, Moss gas (Pty) Ltd, and parts of the Strategic Fuel Fund Association merged in January 2002 to form PetroSA (PetroSA, s.a.).

gas cycle⁶ have already been performed by Soekor (for those specific areas identified), which might reduce risk. Before exploration, however, there is no way of knowing the amount and quality of the oil or gas, thus keeping risk at a very high level.

High costs increase risk and high risk requires high returns (Jing & Zhao, 2010:1 and Mukherji, Desai & Wright, 2008:243). Investors may therefore need discount on taxes – incentives – and fiscal stability to reduce risk and make the venture worthwhile (Pouris, 2003). In order to perform a thorough investigation of the attractiveness of investment in the South African oil and gas sector, a study of the incentives and costs to these companies should not be limited to pure taxation, as this is not the only government cost oil and gas companies need to bear.

The next section considers the State-imposed costs that could affect the attractiveness of the tax environment to these companies.

1.1.3 The tax environment of the oil and gas industry

1.1.3.1 Taxation on oil and gas companies

Besides research, development and production costs, some of the most significant costs any company incur are those imposed by the State: 28% of a resident and non-resident company's taxable income accrues to the State (Income Tax Act No. 58 of 1962). The State requires compensation for the right of trade (income tax) and consideration for the depletion of resources (royalties). By imposing these costs on companies, the State is able to utilise these revenues for economic growth and indirectly to benefit the community.

⁶ The oil and gas cycle has four phases (MPRDA, 28/2002). Each phase has its own dangers and risks, however, the further a company progresses in this cycle, the higher the chances of reward.

- i. Reconnaissance: any operation carried out for or in connection with the search for a mineral or petroleum by geological, geophysical and photogeological surveys and includes any remote sensing techniques, but does not include any prospecting or exploration operation.
- ii. TCP (Technical Co-operation Permit): The holder of such a permit is allowed to do a desk top study, acquire copies of pre-existing seismic (relating to or caused by earthquakes or artificially produced earth tremors (Bosman, van der Merwe & Hiemstra, 2008:1645)) survey data from other sources, but does not include right of access to the surface of the area, thereby precluding any exploration activities (PetroSA, 2009a:5).
- iii. Exploration: the re-processing of existing seismic data, acquisition and processing of new seismic data or any other related activity to define a trap to be tested by drilling, logging and testing, including extended well testing, of a well with the intention of locating a discovery.
- iv. Production: any operation, activity or matter that relates to the exploration, appraisal, development and production of petroleum.

In 1910, the Union of South Africa was established, during which year the Mining Taxation Act replaced previous mining tax legislation and imposed taxation on profits from *all* types of mining (Van Blerck, 1990:C-2). According to the National Treasury (2006a:16), the fiscal policy towards oil and gas resources was developed during the apartheid sanctions period between the 1960's and 1980's with the objective of achieving national oil and gas self sufficiency. The State-owned Soekor was formed in 1965 to explore for oil and gas and was granted a prospecting lease No. OP26⁷ by the government under the Mining Rights Act of 1967. The company proceeded to sub-lease these rights to international companies, who were awarded off-shore concessions that led to numerous onshore and off-shore wells being drilled and some limited success in gas discoveries. Due to sanctions and comparatively poor prospecting, foreign interest waned. Until 1997, most exploration and production activities and associated expenditure were carried out by the State, through Soekor.

Previously, all mineral rights belonged to property owners and majors, such as Sasol. In 2002, the government introduced the Minerals and Petroleum Resources Development Act (28/2002) (MPRDA) that acknowledged that South Africa's mineral and petroleum resources belong to the nation and that the State is the custodian thereof. This was done in consideration of the State's obligation under the Constitution to take legislative and other measures to redress the results of past racial discrimination. The petroleum and gas sector became a highly regulated industry, which also led to the inception of the Minerals and Petroleum Resources Royalty Act (28/2008) (Royalty Act).

Legislation on oil and gas companies is currently regulated through the above-mentioned MPRDA. Income tax in respect of oil and gas companies is governed by the Tenth Schedule in accordance with section 26B⁸ to the Income Tax Act No. 58 of 1962 (Income Tax Act), which commenced on 2 November 2006. The aim of the Tenth Schedule is to provide these investors with the necessary incentives and stability required, while simultaneously forwarding a profit

⁷ OP26 leases were the previous mining leases which regulated income tax on oil and gas companies. These leases are taxable in accordance with the current provisions of the Income Tax Act, subject to the following: (i) in respect of deductions, the provisions of the Income Tax Act as at 1977 shall apply if they are more favourable than those of the current provisions; and (ii) certain other special tax consequences are also prescribed by the OP26 mining lease (Futter, 2010:20). The OP26 agreement contains fiscal stabilisation clauses that freeze the Income Tax as of 1977, which result in oil and gas companies having a choice in terms of each area of the tax acts – it may select either the 1977 regime or the current regime, whichever the company views as more beneficial (National Treasury, 2006b:15).

⁸ Section 26B: **Taxation of oil and gas companies**

1) The taxable income of any oil and gas company, as defined in the Tenth Schedule, shall be determined in accordance with the provisions of this Act but subject to the provisions of that Schedule.

take to the government (National Treasury, 2006b). In addition to income tax, petroleum royalties are charged in accordance with the above-mentioned Royalty Act. It came into effect on 1 March 2010 and the royalty is based on these companies' ability to pay.

1.1.3.2 Other tax-related costs on oil and gas companies

Besides the government's financial take, Otto *et al.* (2006:9) stated that the State might impose non-pecuniary requirements on companies, such as building and maintaining public roads, schools and hospitals. One of South Africa's non-pecuniary requirements is for a company to be BEE compliant (Broad-Based Socio-Economic Empowerment Charter for the South African Mining Industry, South Africa: s.a.) (BEE Mining Charter). Section 84 of the MPRDA emphasises that the granting of a production right may only occur if it furthers the objectives contained in sections 2(d) and 2(f)⁹, which in brief requires that an oil and gas company needs to be Black Economic Empowerment (BEE) compliant before a production right will be granted. According to the BEE Mining Charter, BEE compliance means that the mining industry must achieve a 26% historically disadvantaged ownership of the mining industry assets by each mining company within ten years from 2002. The Petroleum Agency of South Africa requires a company to share an additional participating interest of at least 10% with a historically disadvantaged South African entity or person (PetroSA, 2009a:7). BEE introduces a further cost on oil and gas companies as historically disadvantaged persons often do not have the means of acquiring these shares, which might lead to these companies relinquishing 36% of their shares, in addition to income tax and royalties payable. Rumney (2007:5) therefore contemplated that BEE costs are increasingly likely to be seen as a form of tax.

Another cost on the horizon for these companies is a potential carbon emissions tax, which, to date, has not been finalised. As uncertainty amounts to risk, investors will make their investment decisions keeping possible future amendments and/or additions to regulation in mind.

⁹ **Section 2:** The objects of this Act are to-

(d) substantially and meaningfully expand opportunities for historically disadvantaged persons, including women, to enter the mineral and petroleum industries and to benefit from the exploitation of the nation's mineral and petroleum resources;

(f) promote employment and advance the social and economic welfare of all South Africans;

1.1.3.3 Balance between the State and oil and gas companies' risks and rewards as a result of taxation

According to Sunley, Baunsgaard and Simard (2002:1) one of the most important benefits of developing the oil and gas sector in a country is its fiscal role of generating tax and other revenues for the government. Sunley *et al.* (2002:1) stated that the fiscal regime should be properly designed to ensure that the State as resource owner receives an appropriate share of the economic rent generated from the extraction of oil and gas to achieve its social and economic objectives. In addition, they declared that benefits accruing to the State do not need to be restricted to taxation income as a part of project profit – attaining an independent economy, for example, also construes an advantage (Amigun *et al.*, 2011:1360). It is therefore crucial for the State to secure a sense of balance between the government and investors' risks and rewards.

There is a fundamental conflict, nevertheless, between oil and gas companies and the government over the division of risk and reward from a petroleum project (Sunley *et al.* 2002:1). Both parties want to maximise rewards and shift as much risk as possible to the other. The right choice of fiscal regime can however improve the trade-off between each party's interests — a small sacrifice from one side may be a big gain for the other. A balanced sharing of risk and reward between the investor and the government is needed, where the aim should be for fair and rising government share of the resource rent, without scaring off potential investors. Sunley *et al.* (2002:1) therefore contemplated that the government will need to weigh its desire to maximise short-term revenue against any deterrent effects this may have on investment.

The State, as mineral resource owner, requires compensation for trade and for the extraction and depletion of non-renewable resources, whereas companies require stability and incentives as reward for the risk they take on. The National Treasury (2006a:63) was of the opinion that, because of high capital and operating costs, the synthetic fuels manufacturing industry – a sector where natural gas plays a major role – would not have developed had it not been for incentives and tariff protection. In a global study done by Otto *et al.* (2006:9), they acknowledged the fact that a government aims to find an optimal level of taxation. In finding the balance of taxation, the public usually supports higher taxes in the mineral sector, especially on large foreign companies, being unaware of the potential negative effects in the long-term (Otto *et al.*, 2006:13). If a government imposes an above-optimal level of taxation and fails to provide acceptable stability, it increases the perceived risk of an investment. This will not only be

detrimental for the oil and gas companies, but also for the State, as the companies will require a higher rate of return as compensation for the higher risk, resulting in less revenue for the State.

As countries are in competition with each other in attracting foreign investment, informed governments will recognise the fact that investors can distinguish between and choose which tax jurisdictions to invest in (Otto *et al.*, 2006:35). For this reason it is important to focus on achieving an appealing regulatory environment by way of, but not limited to, tax incentives, as this can provide the necessary base to attract such beneficial investment (Pouris, 2003:195).

1.1.4 Conclusion

The oil and gas industry in South Africa is important from a strategic perspective, as this developing, energy dependent country attempts to optimise the available oil and gas reserves of the country and grow through local and foreign investment. When attracting investment, an alluring regulatory environment is vital. Such an environment is possible with some aid from the government, providing an optimal balance between risk and reward – for both involved parties – taking into account the risks an investor would face in the South African oil and gas industry.

1.2 PROBLEM STATEMENT

Given the characteristics of South Africa's oil and gas industry's position as discussed in paragraph 1.1 above, the research conducted in this study aimed to answer the following research question:

Does the tax legislation in South Africa provide sufficient incentive to oil and gas companies to compete for international investment in this industry?

1.3 OBJECTIVES

In order to answer the research question in paragraph 1.2, the study aimed to achieve the following research objectives:

- i. To determine the characteristics of meaningful tax incentives which promote investment. This objective is addressed in Chapter 2 of this study.
- ii. To analyse the tax legislation applicable to the oil and gas industry in South Africa to determine whether it contains meaningful incentives to competitively promote investment in this sector. This objective is addressed in Chapter 3 of this study.

1.4 RESEARCH METHOD

The research will be conducted by means of a **literature review**.

A literature review was performed to establish the use, harmful effects and characteristics of effective tax incentives in order to evaluate whether South Africa's current oil and gas tax legislation provides meaningful tax incentives to investors. In addition, the country's incentives contained in the tax legislation were measured against comparable incentives of countries in a similar oil and gas position to determine whether it competes internationally.

The sources of this study were publicly available sources on academic commentators' perspectives on a variety of incentives introduced by governments. The primary sources on the taxation and other related costs on the oil and gas industry were the Minerals and Petroleum Resources Development Act (28/2002), the Minerals and Petroleum Resources Royalty Act (28/2008), the Income Tax Act No. 58 of 1962, and other relevant legislation to the oil and gas industry, including explanatory memoranda issued by the National Treasury. This was supplemented by academic commentators' views in mining and academic journals and various reports from entities such as Sasol, PetroSA, SAPIA, Energy Information Administration and the Central Intelligence Agency.

The study was largely confined to a qualitative analysis, as it may be difficult to quantify the effects of all the costs and initiatives. The scope of the State-imposed costs that was investigated was confined to income tax, royalties and additional tax-related costs, which was limited to BEE costs/State options, and the potential carbon tax/cap and trade system. The effect of the additional tax-related costs is not as quantifiable and specific as income tax and royalties, therefore the focus will primarily be on the latter taxes.

1.5 OVERVIEW

In Chapter 2 an analysis was provided of literature on tax incentives in general, determining the use, harmful effects as well as characteristics of meaningful tax incentives. Based on this analysis, the characteristics of meaningful tax incentives were established in order to evaluate whether the current South African oil and gas tax legislation and regulation contain meaningful incentives.

In the third chapter, the tax legislation and other tax-related costs that currently apply to this industry in South Africa were identified and evaluated against the criteria of meaningful tax

incentives as set out in Chapter 2. As part of this evaluation, certain aspects of the tax legislation containing incentives were compared to that of other countries with a similar oil and gas position. This overview was limited to: income tax, royalties and tax-related costs, such as BEE costs/State options and the potential carbon tax/cap and trade system.

The fourth and final chapter summarised the before-mentioned chapters and concluded on whether the taxation environment applicable to the South African oil and gas industry acts as sufficient incentive to competitively promote investment in the sector.

CHAPTER 2

TAX INCENTIVES AS A TOOL TO PROMOTE INVESTMENT

2.1 INTRODUCTION

In South Africa's quest to promote investment growth in the oil and gas industry, an alluring regulatory environment is essential. One of the tools often used by governments to lower investors' costs and therefore risks, is tax incentives (Pouris, 2003:195). This is one of the ways governments attempt to attract local and foreign direct investment in order to promote innovation and industrial growth (OECD, 2007:4).

In a study on tax incentives for business investment, Zee, Stotsky and Ley (2002:1498) defined a tax incentive in both statutory and effective terms. In statutory terms, a tax incentive would be "a special tax provision granted to qualified investment projects that represents a *statutorily favourable deviation* from a corresponding provision applicable to investment projects in general." This definition would imply that any provision that applies to *all* projects would not constitute a tax incentive. It also focuses on the *intention* of governments granting the incentive. On the other hand, in effective terms, it would be "a special tax provision granted to qualified investment projects that has the effect of *lowering the effective tax burden* on those projects, relative to the effective tax burden that would be borne by the investors in the absence of the special tax provision." This definition focuses on the *effect* of the incentives to taxpayers. It also implies that all tax incentives are meaningful, if one uses *lowering of effective tax burden* as only criterion for a meaningful incentive. Surrey (1970:705) defined a tax incentive as "a tax expenditure which induces certain activities or behaviour in response to the monetary benefit available." A tax incentive can also be defined as "a tax reduction afforded to people for particular purposes" (CIMA Dictionary of Finance and Accounting, 2003:266). From these definitions, it can therefore be derived that a tax incentive is a provision to lower the tax of a taxpayer in order to encourage certain actions or behaviour.

Pouris (2003:196) found that South Africa's innovation system, which includes tax incentives, received inadequate support from the State in relation to other countries, with adverse consequences on the country's competitiveness and its employment-offering capabilities. Consequences that were identified as a result of innovations not implemented or incorrectly implemented, included that local companies could find it more profitable to invest abroad, specialist employees could seek employment abroad, and foreign direct investment could be

impeded. As South Africa aims to attract investment to the oil and gas sector, the industry requires special treatment to encourage investment and compensate for the risks mentioned in paragraph 1.1.2. The country's government has already recognised this need for unique treatment in order to attract investment to the last-mentioned sector by revising the previous OP26 regime into the Tenth Schedule currently applicable to oil and gas companies (Futter, 2010:15). Commentators, however, have conflicting opinions regarding the use, strengths and weaknesses of tax incentives, which should be considered in order to determine whether an optimal balance of risk and reward in tax has been found for South African oil and gas investors.

2.2 THE ROLE AND USE OF TAX INCENTIVES

Various forms of initiatives, such as incentives, subsidies, grant assistance programs, tax holidays and discounts are used to encourage certain actions or behaviours. Surrey (1970) argued in favour of direct expenditure (grants and subsidies) as opposed to tax incentives. He stated that the tax incentive is inferior to the direct subsidy, as tax incentives are usually less equitable, since they benefit persons in high tax brackets most. He also contended that tax incentives are more difficult to develop and administer, since it is handled by tax committees and administrative agencies with little expertise in non-tax social policy. Zelinsky's (1986) counter-argument was that the same objective could be reached through both direct expenditure and tax incentive programs when developed effectively, though tax incentives are more cost-effective through lower transaction costs. These lower costs may be as a result of several factors, which include setting incentives in existing tax legislation instead of governments having to approach different companies, as well as the fact that a tax incentive requires no physical cash outflow from the government.

Offering tax incentives has become a global phenomenon to attract foreign investment (Li, 2006:62). Li (2006:63) found that, as tax incentive policy forms part of the host characteristics, host countries compensate for their lack in appropriate economic conditions, such as natural resources, infrastructure and modern technology, by offering generous incentives. Given South Africa's lack of resources mentioned in Chapter 1, the government may therefore need to incorporate tax incentives to the regulatory environment to encourage investment in the oil and gas industry.

The main outcome of a tax incentive is to increase an investor's after-tax return as to consequently make a venture more profitable, thereby luring investment to a particular sector (Pouris, 2003:195). Gupta and Hofmann (2003:2) found that the effect of the tax burden on

property affected new capital expenditures significantly negatively, whereas tax incentives on investment caused capital spending to increase, though at a declining rate. It is submitted that this declining growth would be as a result of investors becoming aware of the incentive and incurring considerable initial capital expenses, after which capital expenses decline as the existence of the initiative wears off. They stated that a 1% decrease in the income tax burden on property is associated with an estimated \$2 to \$6 million increase in capital expenditure. Specifically in relation to South Africa, other objectives where tax incentives have been used includes promoting training amongst employees by providing additional deductions in respect of learnership agreements (section 12H of the Income Tax Act (SARS, 2009)), generous deductions to motivate scientific or technological research and development (section 11D of the Income Tax Act (BDO, 2011)) and promotion of other specific economic sectors or types of activities, such as the oil and gas industry (Tenth Schedule of the Income Tax Act).

Furthermore, Zelinsky (1986) stated that the income tax system is a relatively inexpensive method of communicating federal policies and programs to those persons whose behaviour the government seeks to affect. He was of the view that investors are more likely to be aware of tax incentives than direct expenditures, as accountants, having thorough tax knowledge, could easily inform them of those available. Pouris (2003:196) identified several advantages of tax incentives over subsidies or grant assistance programs as a means of stimulating investment: According to him tax incentives –

- i. allow private-sector decision-makers to retain autonomy, as tax incentives entail less State interference in the marketplace. When considering direct expenditure, an investor usually gets assistance from the government before incurring any capital investment. On the other hand, an investor only qualifies for a tax incentive once the investor has already engaged in a certain activity.
- ii. entail less State involvement through fewer overheads, less paperwork and fewer layers of bureaucracy, which is important, as South Africa is a developing country with restricted administrative resources.
- iii. avoid the need to set nebulous and detailed requirements for receiving assistance by formulating clear qualifying criteria.
- iv. have the psychological advantage of evoking favourable industry reactions, as investors often prefer tax incentives over direct expenditure (Surrey, 1970:715).
- v. have a high degree of political feasibility, as it is less problematic to impose.

- vi. are an integral part of innovation policy and complement other initiatives.

Despite the advantages of tax incentives, Zee *et al.* (2002:1498) warned that the widespread use of tax incentives could have potentially severe adverse consequences. In the process of developing useful, effective tax incentives, these effects should also be taken into account.

2.3 HARMFUL EFFECTS OF TAX INCENTIVES

Bugher (2004:129) declared his scepticism on tax incentives because of the way incentives are granted to taxpayers, how it is paid for and how they are reviewed or benchmarked to determine their relative success in achieving its purpose. He emphasised that there is a certain conflict about the policies underlying tax incentives and tax spending, as policymakers continue to erode the tax base at the same time that they are clamouring for more money. The mining industry of South Africa currently illustrates this opinion, as it is under pressure due to some commentators' belief that the State's compensation from the industry is inadequate. The country is debating over the nationalisation of mines where it was proposed that the mining industry should be taken into the public ownership of the national government (Coetzee, 2010).

In a cross-national analysis performed by Li (2006:71), he identified a number of disadvantages of tax incentives:

- i. Firstly, investment incentives represent a form of State interference with the capital market.

If a market is in equilibrium relating to its competitiveness and efficiency, incentives cause distortion in the efficient allocation of resources in the host economy (Surrey, 1970:725). This inefficient distortion might cause available resources not to be optimised, thereby resulting in opportunity costs.

- ii. Secondly, tax incentives produce opportunity for corruption.

Bureaucrats may engage in corruptive practices, as incentive programs are not monitored closely and their costs remain unknown to the public. Re-election orientated politicians may also favour open-handed tax incentives, as it pursues these politicians' financial support, rather than maximising social wellbeing. Corruption is a big risk in South Africa, as the number of people affected by this misconduct, tripled from 1998 to 2003 and it is ranked as the second most common crime in the country, victimising 5.6% of the population (Van Vuuren, 2004).

- iii. Thirdly, the bidding amongst countries' governments in attracting investment, shrinks financial resources of the host countries and hurts their interests in the long-term.

Li (2006:63) stated that, as capital mobility and financial integration increase, governments compete with each other to attract and keep capital investment at home as rival firms compete in the market – this results in firms having gained more bargaining power relative to States. The fact that firms have the power in their hands, cause countries to be even more competitive, sometimes lowering their corporate income tax to such an extent as to be harmful to the country. The risk is therefore that companies deplete South African oil and gas resources without compensation to the country. In Chapter 1 the importance of finding an optimal level of taxation to balance risk and reward for both government and investor was emphasised. As countries compete with each other for investment by lowering the investors' tax liability and therefore risk, countries reduce their own rewards (fiscal compensation for the extraction of valuable resources), which may result in the country being even worse off than before the attracted investment. Furthermore, a country has a number of social and economic objectives and obligations, which require a certain amount of revenue. As governments reduce the rate on corporate income tax, this liability is shifted unto the middle class and the poor, weakening these groups and undermining democratic governance. Liard-Muriente (2007:187) stated that development policies (tax incentives) could be worthless, as the growth accomplished in one area will be at the expense of another, resulting in unchanged overall welfare. Bugher (2004:131) also supported the argument by stating that the burden of taxation on others that are paying the tax is increased every time the tax base is narrowed for any tax. Therefore, the design of tax incentives should include the implementation of some form of tax expenditure concepts, by either including it as an explicit component of the budget, or through thorough analysis of the revenue impact thereof. On the other hand, South Africa's oil and gas industry is still developing/growing and the required revenue for social and economic objectives and obligations might rather be covered by another, developed industry, providing the first-mentioned sector with a period for growth.

In paragraph 2.2 it was mentioned that the State is to a lesser extent involved with tax incentives than with direct expenditures. Although less State interference is seen as an advantage, it can also be argued to be a shortcoming. Companies engaging in high cost ventures, such as oil and gas companies, would prefer assistance *before* incurring large capital investment, as this will lower project risk and attract more investment. A guarantee of assistance *after* initial investment holds no current benefit and oil and gas companies may

consider these incentives as worthless, as they still bear the full risk of their initial investment if exploration is unsuccessful.

Opponents of incentives dispute that tax incentives have little influence on investment decisions, that revenue forgone outweighs benefits, and that they induce distortion in the location and form of foreign investment. These opponents are also of the opinion that it creates local resentment and grant unintended benefits (Liard-Muriente, 2007:187), demonstrated by the current debate on the nationalisation of South African mines, as certain commentators are of the view that generous treatment offered to mines is inappropriate (ANC YL, 2010).

In the oil and gas sector, however, resources not utilised are unearned revenue and do not benefit the government or investors. In addition, extracting South Africa's own oil and gas resources will have the strategic importance of reducing dependence on foreign countries for South Africa's oil and gas needs. Disadvantages do not always erode the benefit of economic growth gained by both parties. Both the use and the harmful effects of tax incentives should therefore be taken into account in finding a balance that may produce promotion, if and where the government finds it necessary. This ought to be done without eroding the resulting tax base, which may arise from the activities that were promoted, completely.

2.4 CHARACTERISTICS OF A MEANINGFUL TAX INCENTIVE

Paragraph 2.1 to 2.3 provided an in depth understanding of the role and use, as well as the harmful effects of tax incentives. This understanding provides a basis for the establishment of characteristics of meaningful tax incentives.

Competition amongst governments to secure the most attractive environment for investors leads to different regions becoming closer substitutes for the location of production, resulting in investment decisions becoming increasingly responsive to incentives (Liard-Muriente, 2007:186). This comes to show how sensitive investors can be to appealing incentives if other characteristics (such as reserves and quality of reserves) are similar. This sensitivity to an alluring environment could be used to benefit South Africa's oil and gas environment – if it is possible to determine what a meaningful tax incentive is.

For a tax incentive to be useful, effective and efficient, it has to conform to certain features. Although the characteristics in developing these distinctive tax incentives are not limited to those mentioned, four main qualities were identified by means of a literature study. In the aim of

optimising the associated advantages and minimising the relating disadvantages mentioned above, tax incentives should –

- i. have an objective. This will minimise opportunities for corruption, as the objective will limit the qualifying participants and projects. Moreover, having an objective will produce a balance between the risks and rewards of the State and investors, as governments will only be able to reach their objectives by providing reasonable legislation and regulation applicable to investors.
- ii. be effective. Efficiency limits the erosion of the tax base, as it will not result in a net cost to a country. Along with objectiveness, efficiency also provides an attractive environment, as it will only be possible if governments balance the risks and rewards between themselves and investors.
- iii. have stability. Stability should be present by minimising state involvement, resulting in a less volatile investment environment.
- iv. be transparent by avoiding nebulous requirements and setting out clear criteria.

These characteristics will maximise benefits and minimise harmful effects associated with tax incentives and will be elaborated on below.

2.4.1 Tax incentives should have an objective

To provide for efficient development of tax incentives, Pouris (2003:197) emphasised the importance of obtaining a clear definition and understanding of the proposed outcome. Although the methods of reaching the goal may vary, the current (starting point) and proposed (target) circumstances are essential in order to guide incentives in becoming effective. Bugher (2004) was of the opinion that one of the concerns with tax incentives is that it often grows out of political motivations that are not based on solid tax policy. Basing tax incentives on political motivations leads to tax incentives implemented for the wrong reason and without any due diligence from the legislators on the probable impact of these incentives (Bugher, 2004:130). Surrey (1970:713) therefore contended that each incentive should serve the purposes which the nation wants to achieve and is willing to finance, rather than let the market place determine the extent to which the results will be obtained. Otto *et al.* (2006:13) also warned against the danger of only focusing on short-term policy, thereby jeopardising long-term strategy.

Zee *et al.* (2002:1499) examined the conceptual validity of the various objectives of tax incentives by grouping all the factors that could have a bearing on a domestic or foreign

investor's decision to undertake an investment project in any country under four categories, as tax incentives are primarily granted for the motivation of stimulating investment.

- i. Tax-related considerations, being the features in the tax system that have an impact on the effective tax burdens on investment projects.
- ii. Non-tax-related economic considerations, referring to those that affect either the general macroeconomic or structural environment, or both.
- iii. Non-economic considerations, referring to those related to the legal, regulatory and political-economy environment.
- iv. Social policy considerations, being those that arise from equity concerns: producers from certain sectors, for example agriculture, may be considered as economically disadvantaged relative to other, more developed sectors, such as industry.

They stated that some authorities endeavour implementation of tax incentives to address *all* of the above considerations in order to stimulate investment. It should, however, only be used in the objective of producing favourable *tax-related* conditions, as it does not address the root-problems of the other considerations. They emphasised the fact that the first-best policy is to undertake corrective actions to remove deficiencies in each category separately with solutions relevant to the specific category, where in a tax-related environment one of the corrective measures may be tax incentives (Zee *et al.*, 2002:1500).

It is submitted that tax incentives for the oil and gas industry should have a clearly defined objective. These objectives could include promoting the benefits of a developed oil and gas sector mentioned in Chapter 1, which include investment in the industry to recover revenue from resources owned by the State and outsourcing this to the community. This could include that the State has to encourage the utilisation of resources that would otherwise be worthless, or promote the development of infrastructure and technology. The above-mentioned could all have an influence to secure overall wealth for South Africa's citizens, which will be in accordance with the aim of section 2 and 3 of the MPRDA¹⁰. The State should nonetheless still set these goals

¹⁰ **Section 2:** Objects of Act:

The objects of this Act are to-

(e) promote economic growth and mineral and petroleum resources development in the Republic;

(f) promote employment and advance the social and economic welfare of all South Africans;

Section 3: Custodianship of nation's mineral and petroleum resources:

(1) Mineral and petroleum resources are the common heritage of all the people of South Africa and the State is the custodian thereof **for the benefit of all South Africans.**

taking into account the present, as well as the future. These goals ought to form part of the formulation of a strategy for the South African oil and gas sector.

2.4.2 Tax incentives should be effective

In order to achieve a desired goal as mentioned above, Surrey (1970) contended that the advantages of incentives should be clear and compelling to overcome the losses that accompany the use of even the well-structured tax incentive. He contended that cost-benefit and cost-effectiveness are essential when determining whether a fiscal program will be effective.

While studying meaningful incentives in literature, the following factors relating to the efficiency thereof was identified, and will be discussed in further detail below¹¹:

- i. It is vital for a tax incentive to reach its set goal
- ii. Investors require that an incentive should increase the after-tax return of an investment
- iii. Flexibility provisions should be included in tax incentives
- iv. Tax incentives should be cost-effective, resulting in a net benefit for a country.

2.4.2.1 Dimensions of efficiency

As tax incentives increase the after-tax return earned by an investor, this revenue shortfall of the State will need to be made up elsewhere. If one party's revenue increases, it might affect another party's revenue, and the government needs to determine to what extent this should occur. Over and above the usual concept of efficiency that plays a role in the discussion of tax incentives, Zelinsky (1986) investigated efficiency in the common-law, which governments should bear in mind when shifting economic positions:

- i. Pareto Optimality. This notion states that a given economic state is efficient if, and only if, no participant's position can be improved except at the expense of some other actor. This is illustrated in Figure 1 below. For all dimensions of efficiency, accept line

(3) The Minister must **ensure the sustainable development** of South Africa's mineral and petroleum resources within a framework of national environmental policy, norms and standards **while promoting economic and social development**.

¹¹ References are listed below.

C1C2 as the place where the market is at its maximum. Pareto Optimality efficiency can be achieved anywhere on line C1C2: moving from D to C1, increases investor A's position, but decreases investor B's.

- ii. **Pareto Superiority.** A change in the economy is deemed efficient if, and only if, such change improves the welfare of one or more participants in the economy, while leaving the other participants at least as well off as before the change was made. See Figure 1 for an illustration of the concept: any move from F in the area bounded by EFG will be efficient. Moving from F to E increases investor A's position, while leaving investor B's position as before.
- iii. **Kaldor-Hicks Efficiency.** This notion contends that a change from one economic position to another is efficient if, and only if, the increase in one person's welfare is greater than the detriment to those hurt by the change. Examining Figure 1, it is clear that moving from F to H benefits investor B more than it decreases investor A's position.

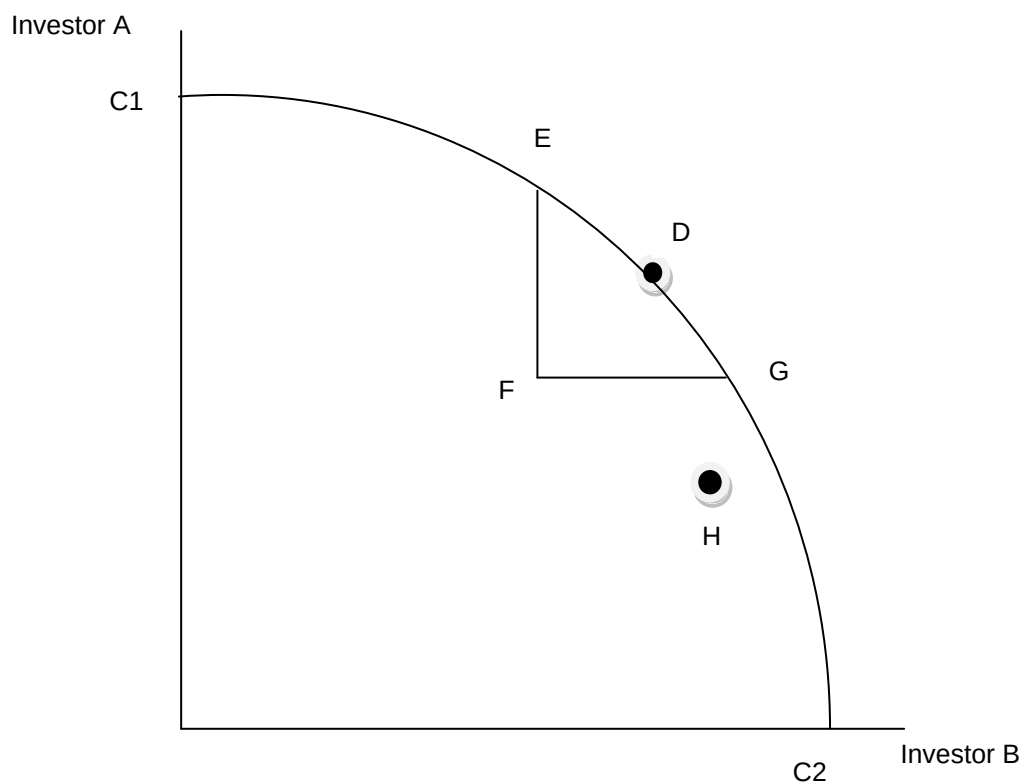


Figure 1: Illustrating dimensions of efficiency (Zelinksy, 1986)

It can be derived that these are three different dimensions of efficiency. Depending on different governments' aim, every country's meaning of an effective tax incentive will vary. It is submitted that any countries' short-term efficiency approach will normally be that of Pareto Superiority, as different sectors will not immediately experience the effects of a shortfall in governments'

revenue caused by another industry. For example, South African investors A and B both buy capital equipment in the use of their day-to-day activities. Investor A (a stationery manufacturer) will receive the purchase price of the equipment as a deduction from income over a few years (in accordance with the Income Tax Act which is applicable to all industries), whereas investor B (an oil and gas exploration company), will be eligible for an immediate 200% deduction from its income in accordance with the Tenth Schedule (a favourable deviation from the Income Tax Act applicable to oil and gas companies). It is clear that investor A is still in the same position as before the Tenth Schedule, but that investor B is in a more favourable position. The incentive applicable to investor B was therefore efficient by increasing its after-tax return. This drew the investor to the sector, thereby nearing the objective of the Tenth Schedule, which is to promote oil and gas investment in South Africa. The long-term will however produce the ultimate consequences, and if this is considered, it is contemplated that a Pareto Optimality efficiency approach exists in South Africa. For example, the oil and gas explorer is eligible to receive a 200% deduction on capital equipment bought (luring oil and gas investors to the country). As a result, the South African government experiences a shortfall in revenue, which might be the reason for the introduction of the 15% withholding tax on dividends paid by all companies to shareholders, compared to the previous secondary tax on companies rate of 10%. The South African government will therefore need to consider whether the dimension of efficiency currently applicable to the country is in line with the long-term strategy of the country's economy.

2.4.2.2 Reaching the goal

Balance between risk and reward for both government and investor should always be considered in creating the optimal regulatory environment. As mentioned earlier, both parties want to maximise return while taking on as little risk as possible (Sunley *et al.* 2002:1). This implies that efficiency will have a different meaning depending on the participant's viewpoint. Effective was defined as "producing a desired result" (COED, 2008:456), which implies that a tax incentive will be effective once the intended goal, for *all* involved parties, is reached. The government might wish to stimulate the economy by creating wealth for all South African citizens, whereas the oil and gas investors' goal might be to grow through revenue, technology and experience. Nonetheless, a tax incentive will only be effective when both parties are content with the achievement of its own objectives.

2.4.2.3 Increasing after-tax return

Zelinsky (1986:1033) stated that a meaningful tax incentive is one that maximises total profitability or consumer satisfaction after accounting for externalities or barriers to entry. Otto *et al.* (2006:12) further explained that a tax incentive will be effective if such an incentive increases a project's return, as investors who are deciding whether to invest in a venture are largely influenced by the expected return after taxes and risks. Oil and gas investors require that the expected return compensate them for the risk in the sector. If a government can succeed in increasing the oil and gas sector's return, investors will be more likely to invest, as this will be one of the objectives set by oil and gas companies. It is clear that both parties' goals are intertwined, which is shown in the following diagram:

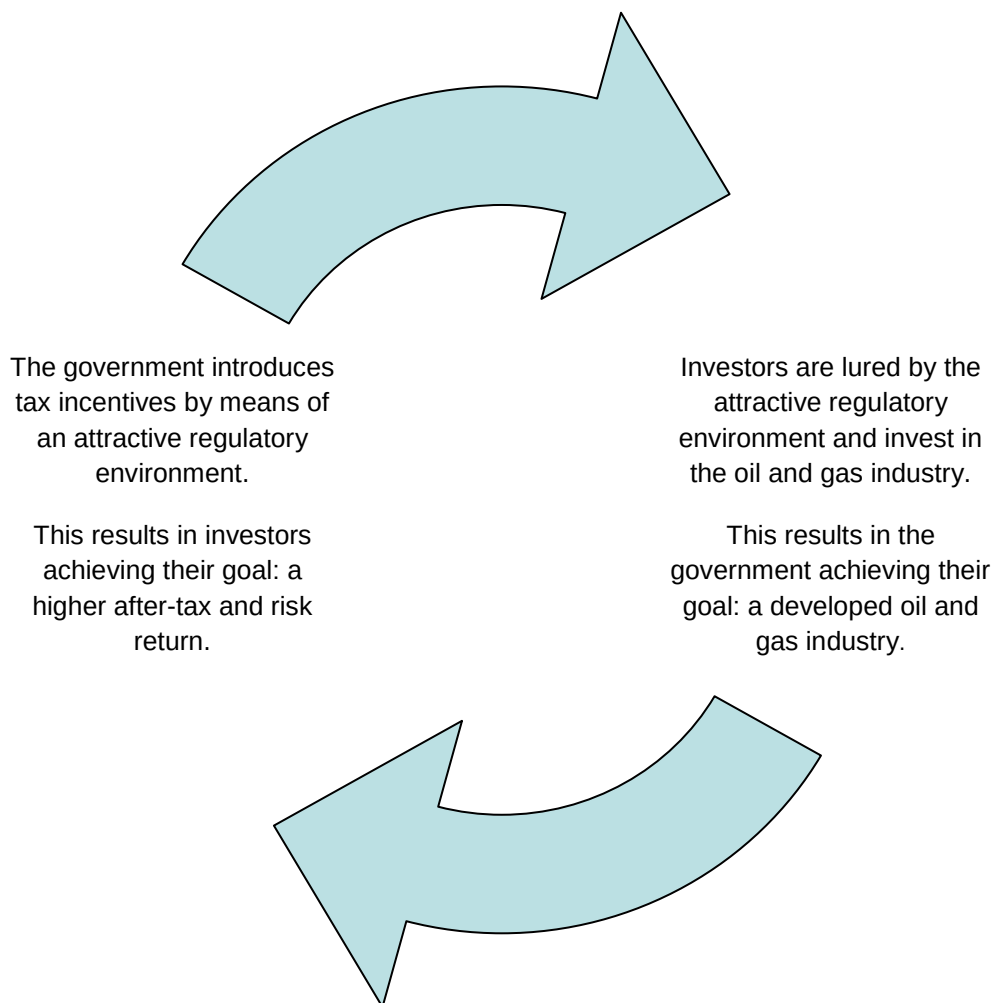


Figure 2: The relationship between the goal of governments and investors when determining an incentivised tax environment

2.4.2.4 Flexibility

Flexibility is also an important consideration in the design of effective tax incentives. Again, flexibility encompasses a different characteristic from the State's and an investor's viewpoint.

With regards to investors, flexibility in the tax policy so as to accommodate companies in various stages of their development is vital. Issues relating to newly established companies, new or unforeseen technologies, concerns of companies that do not at that time have tax liabilities against which a tax benefit can apply, should be covered in the policy and reconsidered on a continuous basis (Pouris, 2003: 197). As mentioned in Chapter 1, oil and gas investors spend significant amounts in initial capital - this burden should be lifted in some way. In relation to the State's viewpoint, flexibility should also exist: the South African government should leave room for possible adjustment to the tax legislation in order to be prepared for unpredictable future events.

2.4.2.5 Cost-efficiency

As the South African government aims to lure investment to the oil and gas industry, it has to be noted that the strategy should not be at the expense of the country's economy.

Zee *et al.* (2002:1501) lists four types of costs consequential to the granting of tax incentives, which will be discussed in detail below:

- i. Distortion caused as a result of granting incentives only to specific investments
- ii. Forgone revenue
- iii. Administrative resources required to administer tax incentives
- iv. Social costs of corruption and/or rent-seeking activities connected with the abuse of tax incentive provisions

As these costs could amount to be significant, the use of tax incentives is likely a misguided strategy, as the benefits are obscure and not easily quantified (Rego, 2003:32). However, tax incentives can be imposed more easily, as enforcing a policy through an existing income tax system would require less valuable administrative resources. No initiative is cost-free: the question is whether a net benefit (financial *and* non-financial) exists after implementation of tax incentives in the oil and gas industry.

- i. Distortion caused between investments granted incentives and those without it

As mentioned before, investment incentives represent a form of State interference with the capital market causing distortion (Li, 2006:71). Even if these incentives are used to correct externalities, the distortion costs could still arise, as the amount of incentives granted may not conform exactly to the extent of the externalities involved, due to the intrinsic complications in

measuring the latter. As South Africa's total amount of oil and gas reserves have not been established yet, it is hard to determine the ranking of the country and therefore difficult to decide to what extent incentives, as compensation for the few resources, would be necessary. It is therefore deducible that these costs would also arise whenever tax incentives are erroneously granted to investment projects with no positive externalities, as could happen through mistreatment and exploitation of the system (Zee *et al*, 2002:1501). This distortion cost will not be quantifiable or result in a physical determinable cash flow as with the other costs. On the other hand, an argument may exist that the aim of the MPRDA¹² implies that the State should intervene when necessary, as resources that are not optimised cause opportunity cost of the lost revenues and other benefits to the country.

ii. Forgone revenue

Surrey (1970:719) stated that it is probable that investment projects would still be undertaken even in the absence of tax incentives. Typically the projects that are granted tax incentives are those with the highest profitability, and therefore also economic merits, and tax incentives represent free gifts to these investors. Successful oil and gas companies may generate substantial profit. Examples include PetroSA's net profit margin of 39.86% in 2006 (PetroSA, 2007:127). In the case of foreign investors, these incentives will symbolise a bonus for the treasury of their home countries in the case of tax systems based on the residence principle. Another dimension of the forgone revenue is the fact that, even when disregarding the negative impacts of tax incentives in attracting investment discussed above, the mere existence of tax incentives entails revenue loss, as it opens doors to potential abuse by investors not eligible to receive them (Zee *et al.*, 2002:1501). Alternatively, it can be argued that no oil and gas activity will be encouraged in the absence of tax incentives. It will then not be possible to optimise available oil and gas resources to benefit the community of South Africa, which will fall short of the aim of the MPRDA as mentioned earlier.

iii. Administrative resources required to administer tax incentives

Bugher (2004:130) stated that the administrative burden of imposing and administering tax incentives, as well as the compliance costs associated therewith, such as ensuring that only qualified oil and gas taxpayers take advantage of the sector's incentives that are adopted, is often not realised by law makers. This view was also shared by Zee *et al.* (2002:1501) when they declared that abuse and leakage are recurrent problems with tax incentives and the

¹² **Section 2:** One of the objects of this of this Act is to (e) promote economic growth and mineral and petroleum resources development in the Republic;

effective prevention can often absorb a considerable amount of quality administrative resources – a scarce commodity in most developing countries, including South Africa. They stated that tax collection as a whole could be jeopardised as the more scarce resources are devoted to administering tax incentives, the more other important administrative tasks would be impaired.

- iv. The social costs of corruption and/or rent-seeking¹³ activities connected with the abuse of tax incentive provisions

In the aim of properly enforcing tax incentives, a far more serious problem with these provisions often relates to the mistreatment of such provisions being unofficially overlooked or even encouraged by officials charged with the responsibility of administering these incentives. Socially unproductive rent-seeking behaviour is also induced by tax incentives, as investors fortunate enough to have captured the rents, will have an inherent interest to maintain the status quo. This clarifies, disregarding economic grounds, the complexities of eliminating or even phasing out tax incentives once they are granted (Zee *et al.*, 2002:1502).

2.4.2.6 Monitoring the effectiveness of tax incentives

Succeeding in passing incentives and following up to find out whether these incentives reached the intended goal are two different, but vital, tasks in improving the effectiveness of tax incentives (Bugher, 2004:130). Pouris (2003:197) emphasised the importance of monitoring the effectiveness of a tax incentive on a real-time basis across a number of dimensions, including:

- i. understanding and controlling the net cost of the tax incentive policy,
- ii. understanding and measuring the policy's differentiated effects across industries and technologies,
- iii. understanding and making explicit the innovation gains from the policy, and
- iv. safeguarding the policy against misuse.

Through monitoring of incentives in the oil and gas industry, it will be possible to determine the effect it has on the sector: does it provide the necessary investment, or could this 'loss in revenue' be better utilised in a different way? As licenses to oil and gas companies are issued by the Department of Energy (Department of Energy, s.a.), it may be efficient for this department to monitor and report on the meaningfulness of tax incentives provided to these

¹³ The practice of an individual, company, or government attempting to make a profit without making a product, producing wealth, or otherwise contributing to society (Farlex Financial Dictionary, 2012).

companies. This will place no additional burden on oil and gas companies, and the Department of Energy will benefit from the activity, as it will provide useful information on the attractiveness of the industry in South Africa.

2.4.3 Tax incentives should have stability

The instability of fiscal obligations leads to uncertainty, which increases the inherent risks which companies are faced with, as well as scaring off potential investors (Ochieze, 2007:2). As discussed in Chapter 1, companies that incur higher risk, require increased return before investment will be considered. In order to create an enabling environment for oil and gas investment, stability is therefore an essential element.

After assessing growth in 17 OECD countries, it was found that policies reducing economic fluctuations may enhance growth (Staehr, 2007:5). Ochieze (2007:2) stated that, due to the huge financial implication which the extractive industry requires and the long period of capital return, there is a desire by foreign oil companies to see that the terms of contracts are respected by the host government throughout the life of the project. Providing a stable tax environment in the oil and gas sector might mitigate the risk of uncertainty in a country's tax regime, reducing the risk and improving growth in the sector, thereby creating a more attractive environment in which speculators can invest in.

2.4.4 Tax incentives should be transparent

In the development of legislation over the years, it is clear that transparency plays a key role, as it must be comprehensible for investors and not only governments. A lack of transparency may easily lead to the unintentional maltreatment of legislation because of the lack of understanding. Zee *et al.* (2002:1502) supported the administrative dimension of transparency where the formulation of qualifying criteria for tax incentives should be simple, specific and objective in order to minimise the need for subjective interpretation and application by the administering officials of the incentive system, as well as to ease monitoring and enforcement responsibilities on the part of tax administrators.

All tax incentives should be based on the same statutory basis as relevant tax laws to avoid possible conflicts, inconsistencies and overlaps across different laws. Additionally, the rationale for imposing these incentives should be made clear on the basis of thoroughly thought-out economic arguments, estimating the economic impact and revenue costs of granting the

incentives based on clearly stated assumptions and methodologies. The estimated revenue costs should also be subjected to public scrutiny in the budgetary process as tax expenditures (Zee *et al.*, 2002:1502). Furthermore, Otto *et al.* (2006:14) contended that a sector can either foster or hinder growth, with the outcome being largely determined by the manner in which the State uses the taxes and other funds they gain from it – implying that this relevant information should be available.

South Africa's tax incentives for oil and gas companies will therefore need to be comprehensible, clarifying the goal of the State. The qualifying criteria of tax incentives should be clear and compelling, minimising the opportunity for subjective interpretation by participants. Additionally, the incentives should also be based on the common gross income, capital and residency principles that the current Income Tax Act of South Africa encompasses.

2.5 CONCLUSION

The discussion in this chapter illustrated that the use and design of tax incentives have been debated by commentators for years. The indirect costs of tax incentives are usually more quantifiable than the advantages gained from these provisions, resulting in conflicting views as to whether these incentives could result in any net benefit for a country. It is, however, deduced that there are some circumstances where the use of tax incentives can be justified. Governments should be conscious of the fact that tax incentives are indeed an expenditure – even though it does not necessarily take the form of cash outflow, it removes the State's right to receive the differential fiscal income. Tax incentives will therefore lead to reduced income which will have to be made up through other sources as discussed in paragraph 2.4.2.1. Tax incentives may, however, provide various opportunities that could otherwise not be achieved: resources not utilised are resources gone to waste. All the benefits of meaningful tax incentives could form part of the non-financial, strategically important independence and growth of the oil and gas sector, and consequently, the economy of South Africa.

In determining the effect State-imposed costs has on the competitiveness of the oil/petroleum and gas industry in South Africa, it is necessary to evaluate the current provisions of these costs against identified characteristics to determine whether South Africa competitively promotes this field.

i. All tax incentives should have a **goal**

A government should firstly determine its need and then ensure that the intended objective is defined clearly: it is important that both investors and governments obtain a clear understanding of the proposed outcome the State aspires to reach to determine whether they will be able to accomplish it. As discussed in paragraph 2.4.1, the State ought to ensure that this goal is not only short-term orientated, but ultimately provides for the future and is for the common wealth of all of the country's residents.

ii. Tax incentives should **achieve the set goal**

The goal is not only revenue-related, but could encompass non-financial goals such as developing communities, infrastructure and other objectives. If a tax incentive arrives at the predetermined objective, the incentive approximates efficiency as mentioned in paragraph 2.4.2.2. The involved parties should be satisfied with the result of the tax incentive by measuring it against the predetermined objectives before introduction thereof. However, this characteristic can only be verified after implementation of the initiatives, as a period of time is needed to test the progression of matters.

iii. Tax incentives should **competitively increase the after-tax return of an investment**

Investors' decisions as to whether to invest in a venture are mainly influenced by the expected return after taxes and risks as identified in paragraph 2.4.2.3. Oil and gas investors will not be drawn to South Africa if its after-tax return in comparison to other countries is not favourable – initiatives should therefore be competitive in relation to international norms. Furthermore, as South Africa does not have abundant oil and gas resources, the after-tax return ought to be a way of compensating for these other pejorative conditions.

iv. Tax incentives should be **flexible**

This characteristic includes providing for companies in different stages of their life cycles and with different risk profiles. A new company may have substantially more risk than a settled company as a result of uncertainty. Incentives provided to oil and gas companies should focus on attracting new companies and maintaining the investment of settled companies, by, for example, developing generous incentives for investors to start up, and less open-handed initiatives for existing entities. As discussed in paragraph 2.4.2.4, incentives should also be

flexible from the State's viewpoint: it ought to be customisable to adapt to changes in the economic environment once investors have already entered the field.

v. Tax incentives should be **cost-effective**

Costs are more easily quantifiable than the benefits of tax incentives. Benefits should still, nonetheless, be weighed against probable costs, determining whether the provision would be worthwhile. Additionally, tax incentives open doors to potential abuse by investors not eligible to receive it and absorb a considerable amount of administrative resources. It should, however, be noted that resources not optimised, represent forgone revenue. From the analysis in paragraph 2.4.2.5, it is clear that the benefit of the tax incentive should overrule possible disadvantages, both financial and non-financial.

vi. Additionally, investors require **fiscal stability**, which was examined in paragraph 2.4.3

In order for oil and gas companies to incur significant amounts, investors need the assurance that favourable conditions will still apply at a later stage. Stability will also assist in increasing the after-tax and risk return for oil and gas investors, by lowering risks.

vii. In paragraph 2.4.4 it was determined that **transparency** plays a fundamental role in the development of a meaningful tax incentive

Tax incentives should be easy to administer and difficult to misuse by setting lucid criteria and implications for qualifying investments to apply, minimising the need for subjective interpretation and application. This characteristic will assist in making incentives more cost-effective, as administration and costs of non-compliance will be minimised.

In order to determine whether the country provides a competitive regulatory environment which will attract investment to the oil and gas industry, the current South African taxation costs on these companies will be evaluated against the above-mentioned characteristics.

CHAPTER 3

EVALUATION OF INCENTIVES PROVIDED IN SOUTH AFRICAN TAXATION LAW APPLICABLE TO OIL AND GAS COMPANIES

3.1 INTRODUCTION

In the literature of foreign direct investment, Ibi Ajayi (2006:29) determined four main motives for seeking investment abroad, which are broadly described as resource seeking, market seeking, strategic asset seeking and efficiency seeking. In the case of resource seeking, investors position themselves abroad in order to secure cheaper supplies of raw materials or inputs that are not available at home, including natural resources such as oil and gas. Market seeking foreign direct investment opens up new markets in the host country or neighbouring countries, whereas with strategic asset seeking foreign direct investment locates in a place in order to take advantage of what is available in terms of research and development and other benefits. Efficiency seeking foreign direct investment, on the other hand, attempts to produce in as few countries as possible, with each one having advantages in terms of location, endowment and government incentives.

As South Africa is not one of the leading oil and gas reserve countries (resource seeking), the country needs to focus on attracting foreign direct investment by being efficient, through an alluring regulatory environment. In the preceding chapter, tax incentives as a tool to promote investment were investigated, where it was found that it might encourage investment in the oil and gas industry if it meets the characteristics of a meaningful incentive. Based on GDP (gross domestic product) per capita information on Nationmaster (2010), South Africa ranks 101st out of 220 countries in the world and 6th in Africa. It is therefore deduced that the country is one of the leading developing countries worldwide, and attracting investment to the country introduces opportunities to valuable economic growth. On the base of the clearly set out criteria from the previous chapter, the objective of this chapter is to evaluate whether South Africa's current taxation costs on oil and gas companies serve as incentive to attract investment to this sector in order to result in economic growth. In order to attract investment to the oil and gas sector, South Africa's tax system should be internationally competitive, as contemplated in paragraph 2.5. For the purposes of this study, three countries were chosen to compare the incentives contained in South Africa's tax legislation to, based on the fact that they are net import countries and therefore dependant on other countries for oil and gas: China, India and the United States of

America. According to the CIA Factbook (2010), the following data relate to the chosen countries' oil and gas reserves:

Table 1: The United States of America, China, India and South Africa's relative gas and oil positions (CIA Factbook, 2010)

Gas					
Rank (Reserves)	Country	Imports/ Consumption	Net Imports/ Consumption	Imports>Exports	Production/Reserves (per year)
6	United States of America	16%	12%	Yes	8.56524249%
13	China	9%	5%	Yes	2.73729373%
26	India	25%	25%	Yes	3.59534884%
102	South Africa	50%	50%	Yes	0.04355984%

Oil					
Rank (Reserves)	Country	Imports/ Consumption	Net Imports/ Consumption	Imports>Exports	Production/Reserves (per day)
13	China	54%	49%	Yes	0.01961179%
14	United States of America	61%	51%	Yes	0.04736402%
23	India	97%	73%	Yes	0.01515000%
87	South Africa	85%	1%	Yes	0.00093857%

Even though the chosen countries' reserves are much higher than that of South Africa, these countries are regarded as leading net import countries (based on the ratio of production over reserves) and therefore South Africa might improve its legislation based on the knowledge gained from these countries'.

In the following sections, the criteria of meaningful incentives identified in paragraph 2.5, in conjunction with a comparison of South Africa's oil and gas tax incentives to that of the chosen

countries, will be the base to evaluate whether South Africa's tax legislation applicable to the oil/petroleum and gas industry acts as an incentive in order to competitively lure investment to the country. The study of the comparison between incentives contained in South African oil and gas tax legislation and that of the selected oil and gas countries, will be limited to the findings of a study conducted by Ernst & Young in 2009¹⁴.

3.2 EVALUATION OF INCOME TAX ACT PROVISIONS PERTAINING TO OIL AND GAS COMPANIES

South Africa's previous investment regime for oil and gas exploration and production was established in terms of prospecting lease OP26, which was granted in 1965. OP26 mining leases are taxable in accordance with the current provisions of the Income Tax Act, subject to the following: (i) in respect of deductions, the provisions of the Income Tax Act as at 1977 shall apply if they are more favourable than those of the current provisions; and (ii) certain other special tax consequences are also prescribed by the OP26 mining lease (Futter, 2010:20). The OP26 agreement contains fiscal stabilisation clauses that freeze the Income Tax as of 1977, which result in oil and gas companies having a choice in terms of each area of the tax acts – it may select either the 1977 regime or the current regime, whichever the company views as more beneficial (National Treasury, 2006b:15).

The Tenth Schedule is in accordance with section 26B to the Income Tax Act No. 58 of 1962, and applies to any year of assessment of a qualifying company that commences on or after 2 November 2006. Section 26B of the Income Tax Act states that the taxable income of any oil and gas company, as defined in paragraph 1 of this Schedule, should be determined in accordance with the provisions of the Income Tax Act, subject to the provisions of the Tenth Schedule. This Schedule is therefore limited to only qualifying companies, which are oil and gas companies, defined to be companies that hold any oil and gas rights or that engage in exploration or production in terms of any oil and gas right. It is submitted that the provision of a clear scope for the Schedule, by limiting the application thereof to only qualifying participants, prohibits the misuse of the Tenth Schedule.

National Treasury (2006b:16) contemplated that the reason for change from the previous regime was due to uncertainty around the renewal of the fiscal provisions contained in OP26, which led to certain companies postponing any further investment until this vagueness was

¹⁴ Refer to Appendix 1 for a summarised table of the findings.

resolved. The government's aim with the Tenth Schedule was to create transparency and certainty for the taxation of oil and gas exploration and production, by formalising key aspects of OP26 into explicit law (National Treasury, 2006b:16). The revised new legislation applicable to the oil and gas industry, clarifies that the government's objective with the Tenth Schedule is to create an incentivised environment for oil and gas companies in order to lure investment to the country, which was previously postponed due to uncertainty regarding the old regime. By defining the scope of the Tenth Schedule, it is clear that the government's focus is on the oil and gas sector and by creating an incentivised environment, both the government's (luring investment to the oil and gas industry) and investors' (receiving an increased after-tax and risk return) goals may be achieved, increasing the meaningfulness of the incentive. Once this environment is achieved, it will be possible for the government to optimise the oil and gas resources of the country and to distribute the benefits gained to the community, achieving the aim of the MPRDA.

In 2010, however, OPASA (2010a) passed the concern to the National Treasury that the Tenth Schedule includes unclear consequences to certain transactions. Some commentators, therefore, believe that the State's intention for a transparent oil and gas regime has not yet been achieved. In the discussion below, the criteria for a meaningful tax incentive identified in paragraph 2.5, will be evaluated against separate sections of the current income tax legislation applicable to the oil and gas industry, which will determine whether the government succeeded in their aim of creating an incentivised environment for the oil and gas sector.

3.2.1 Evaluation of income tax rates applicable to oil and gas companies

Prior to 1 April 2012, non-resident oil and gas companies' tax rate did not exceed 31% and these companies were not liable to pay secondary tax on companies in South Africa. According to the Tenth Schedule, local companies paid secondary tax on companies at a rate of between 0% and 5%, compared to companies other than oil and gas companies' 10%. A rate of 0% was applicable if all of the local company's oil and gas income was solely derived by virtue of an OP26 right. According to the National Treasury (2006b:17), the reason for charging secondary tax on companies at a rate of 0% on OP26 right companies, was to avoid volatility in legislation, as these companies were not required to pay secondary tax on companies under the previous OP26 regime. This was also done in an effort to reward those companies who were arguably taking the highest risk, as opposed to later entrants who may emerge after more significant deposits are found, reducing risk on the latter's part. This indicated that the government catered

for oil and gas companies with different risk profiles by providing stability and flexibility in the previous provision applicable to this high risk sector.

According to the Tenth Schedule of the Income Tax Act, income tax rates on oil and gas companies will currently not exceed the rate also imposed on companies in other industries, which is 28%. The new section 64G of the Income Tax Act, which became effective on 1 April 2012, introduced a 15% dividend-withholding tax by South African companies as well as foreign companies listed on the JSE on dividends paid to shareholders, not exempting oil and gas companies.

Prior to 1 April 2012, non-resident companies not in the oil and gas sector paid tax at 33%, and oil and gas companies enjoyed an incentivised 0.6% (2%/33%) reduction (with the assumption that no subsidiary was formed in South Africa). Non-resident tax rates were recently reduced to the resident corporate tax rate of 28% and oil and gas companies do not enjoy an advantage above investors not engaged in oil and gas activities. Taking into account this legislation, oil and gas companies also do not enjoy a benefit of withholding a lower percentage of dividend-withholding tax compared to other sectors (South Africa, 2012).

Even though it is often argued that the oil and gas industry requires higher than average rates of return on capital due to its inherent risk, the tax rates introduce no incentive for investment by paying tax at a rate more favourable than companies from other sectors. In paragraph 2.1 it was stated that any provision which applies to all projects does not constitute an incentive. As no beneficial tax rate is levied on South African oil and gas companies compared to other sectors, Futter (2010:20) found that the provision is not aimed at attracting investors.

The country's corporate income tax applicable to oil and gas companies does, however, compare favourably to other countries': with the exception of China (with a tax rate of 25%), South Africa's tax rate is lower than that of India (tax rate of 30% on domestic companies and 40% on foreign companies) and the United States of America (tax rate of 35%). Some countries also have additional surcharges that are payable to the government, should the income of the oil and gas company exceed a certain amount. India, for example, has an additional surcharge if the income of the oil and gas company exceeds INR10million. South Africa does not charge any windfall taxes for profits over and above certain amounts. In paragraph 2.2 it was mentioned that tax incentives form part of a country's economic features and are often used to compensate for lacking conditions. It is therefore deduced that South Africa's tax rate is lower than the above-mentioned countries' in order to compensate for the low ranking of the country in terms of its proved oil and gas reserves.

Even though South Africa's tax rate applicable to oil and gas companies is equal to companies from other sectors of the country, it compares competitively to the rate of other oil and gas importing countries. Oil and gas companies investing in South Africa might therefore be lured to the country as a result of an internationally higher after-tax return.

3.2.2 Evaluation of deductions from income derived from oil and gas activities

3.2.2.1 Operating and capital expenditure

The Tenth Schedule allows for a full deduction of all operating expenditure and losses actually incurred, other than in respect of the acquisition of any oil and gas right. In addition, paragraph 5(2) of the Schedule allows capital expenditure in respect of *exploration* in terms of an oil and gas right to be deducted at 200%, and capital expenditure in respect of *production* in terms of an oil and gas right to be deducted at 150%.

This increased capital deduction acts as an incentive to incur significant amounts of high-risk capital expenditure that probably represents long-term sunken capital (National Treasury, 2006b:18). In paragraph 2.4.2.4 it was explained that an incentive should cater for companies with different risk profiles, and this characteristic is demonstrated in the capital deduction provision, as it provides different incentives for companies engaged in the oil and gas exploration and production activities respectively. The exploration activities are exposed to higher risks, as it includes the possibility of unsuccessful searches for oil and gas resources, and these activities should therefore enjoy a higher benefit. The fact that incentives usually hold no current benefit and that companies that engage in activities requiring significant capital outlays would prefer the benefit once the expenditures are paid, was also discussed in paragraphs 2.2 and 2.3. Although the provision does not lead to an immediate cash inflow, Otto *et al.* (2006:11) stated that accelerated depreciation can postpone the flow of tax, and based on the net present value theory, a deferral of taxation saves costs and might therefore lead to immediate expenditure savings. This will, in effect, increase the after-tax return for oil and gas companies, making the incentive effective. These generous 150% deductions might even have the effect of no tax being payable by oil and gas companies for several years (Ochieze, 2007:10), which might explain why the legislator allowed South Africa's tax rate to be higher than some other countries, such as China. In PetroSA's (2011:107) 2011 financial statements, it was declared that the Tenth Schedule provided for unredeemed capital expenditure to be brought forward from the previous OP26 regime, which effected a deduction of R10.8 billion in 2008. This caused the company to be in an assessed loss position, and the company stated

that it is envisaged that it will remain in such a position for the foreseeable future. PetroSA did not recognise a deferred tax asset, which, according to IAS 12 (IASB, 2010:A472), implies that the company does not expect that future taxable profit will be available against which these unused tax losses can be utilised. The following example illustrates this point:

For a company to not pay tax, its income should equate to or be less than the sum of allowable tax deductions. To simplify this example, taxable income before capital allowance on production/exploration assets is deemed to be net profit before tax and depreciation on these assets. The following symbols are used in the example:

Description	Symbol
Average net profit margin*	N
Production asset over turnover ratio	Pa
Exploration asset over turnover ratio	Ea
Amount of years before an oil and gas company pays income tax	Y
Capital allowance on production assets according to Tenth Schedule	Cp
Capital allowance on exploration assets according to Tenth Schedule	Ce

* Net profit *margin* is used, as using monetary amounts would lead to additional assumptions been needed – Refer to Appendix 2.

Appendix 2 explains the following formula:

$$N \times Y = (Pa \times Cp) + (Ea \times Ce)$$

Based on the historical financial information of PetroSA (2006-2011) and after conservatively assuming a 50:50 ratio between production and exploration assets (refer to Appendix 2), an oil and gas company may achieve the following ratios:

Description	Ratio
Adjusted net profit margin	25%
Production asset over turnover ratio	100%
Exploration asset over turnover ratio	100%

According to the Tenth Schedule, a capital allowance of 150% will apply on production assets and 200% on exploration assets. The equation above leads to the following amount being calculated, which indicates the number of years before income tax is payable:

$$25\% Y = (100\% \times 150\%) + (100\% \times 200\%)$$

$$Y = 14 \text{ years}$$

Based on this information, it is therefore deduced that an oil and gas company might only be paying tax in its 15th year after achieving ratio's as mentioned above.

Example 1: Hypothetical example to determine when an oil and gas company will start paying income tax based on current income tax legislation

Example 1 clearly illustrates that the tax liability of an oil and gas company in South Africa might be materially deferred, which compares favourably to the tax holiday of seven years provided by India for companies undertaking commercial production of or refining of mineral oil. This generous South African incentive is only applicable to the oil and gas industry and will increase the after-tax return of those investors, attracting more investment. This could, however, pressurise the South African government to raise taxes in other industries in order to fulfil existing obligations, indicating a Pareto Optimality dimension of efficiency as discussed in paragraph 2.4.2.1. This dimension of efficiency could ultimately be harmful to other parts of the country's economy. In order for an incentive to indicate value, it should be cost-effective, and therefore the South African government should determine whether the total benefits of luring investment to the oil and gas sector will exceed the associated costs, as the government may not receive tax from oil and gas investments for several years.

Internationally, countries such as India and the United States of America offer accelerated depreciation and incentives in their Income Tax Acts. The advantage of accelerated depreciation is achieved over a few years, whereas South Africa's capital allowance is claimed immediately and is also uplifted. Oil and gas investors in South Africa will therefore enjoy a higher after-tax return compared to other leading oil and gas countries. It should however be remembered that the country's oil and gas reserves are scarce compared to these other countries (increasing the investment's risks) and should therefore lure investment by providing an enhanced incentivised environment.

3.2.2.2 Assessed losses

According to the Tenth Schedule, an oil and gas company's assessed loss may be carried over indefinitely against oil and gas income of that company, as well as income from the refining of gas derived in respect of any oil and gas right held by that company. As with assessed loss provisions found elsewhere in the Income Tax Act, these assessed losses may not exceed the income. Investment is also spurred by allowing an additional 10% of an oil and gas company's assessed loss to be set off against any other income derived by that company. The purpose of the assessed loss rule is to provide relief for ordinary working capital (National Treasury, 2006b:19).

The assessed loss provision of the Tenth Schedule is once again clearly set out, defining the losses that may be set off, the types of income it may be set off against, as well as the period for which it may continue to be set off. This illustrates that the provision is transparent and avoid nebulous conditions. As the provision is easily interpretable, the legislator reduced the opportunities for misuse of the provision, thereby reducing costs associated with non-compliance.

Generally, oil and gas companies in South Africa only engage in oil and gas activities (with the exception of Sasol) and may therefore never be able to utilise the incentive of setting 10% of its assessed loss off against other income. On the other hand, this incentive could direct oil and gas companies to engage in other activities as well, causing the companies to utilise this incentive, and governments to receive tax income from the non-related activities. The provision to disallow further setting off of oil and gas losses indicates that the Sate considered the cost-effectiveness of the incentive by limiting the set off of assessed losses as a result of capital allowances discussed above against other income, which should be present in a meaningful tax incentive. Oil and gas companies are able to carry over assessed losses indefinitely, compared to industries other than mining's limitation of seven years. India and the United States of America also only provide the carry forward of losses for eight and 20 years respectively. This provides oil and gas companies with yet another opportunity to increase after-tax return compared to other sectors in the country, as well as oil and gas sectors internationally, drawing attention to the country's industry and attaining the objective of the Tenth Schedule.

3.2.2.3 Acquisition costs in respect of oil and gas rights

The Tenth Schedule does not provide for any deduction of acquisition costs. The only incentive for acquiring oil and gas rights is when the participation treatment rules are chosen¹⁵ at disposal of such a right which will be elaborated in paragraph 3.2.4.

¹⁵ Paragraph 5 of the Tenth Schedule: **Deductions from income derived from oil and gas activities**

- 1) For purposes of determining the taxable income of an oil and gas company during any year of assessment, there will be allowed as deductions from the oil and gas income of that company all expenditure and losses actually incurred (other than any expenditure or loss actually incurred in respect of the acquisition of any oil and gas right, except as allowed in paragraph 7(3)) in that year in respect of exploration or production.

3.2.3 Evaluation of the provision for thin capitalisation in oil and gas income tax legislation

Thin capitalisation prevents taxpayers from deducting interest in respect of excessive amounts of debt existing in relation to equity (De Koker, 2011:§17.60). These excessive amounts relate to overseas financial assistance from connected persons. Paragraph 6 of the Tenth Schedule serves as security by fixing the ratio of calculating these excessive amounts that the Commissioner may not disallow to 3:1 for oil and gas companies. The legislation indicates that the Commissioner may, in some instances, allow excessive amounts, which could indicate an incentive, as it will increase oil and gas investors' after-tax return. On the other hand, this raises a concern, as the provision is vague and might therefore not be transparent. Furthermore, paragraph 6(2) of the Schedule states that the Commissioner may, on good cause shown, allow excessive deductions for financial assistance for a temporary duration. The concept of "good cause shown" is not defined and is therefore also open for subjective interpretation. Paragraph 6(3) states that a loan will only be interest bearing during a year of assessment if interest is actually incurred during that year. This provision will assist oil and gas companies with interest-bearing obligations, as deemed interest might be incurred by the company, but will not be taken into account when calculating excessive interest, thereby decreasing total costs compared to companies in other sectors whose deemed interest paid will also be taken into account. This will result in an increased after-tax return for South African oil and gas companies, which is one of the criteria of meaningful incentives as discussed in paragraph 2.4.2.3.

Thin capitalisation legislation applicable to companies outside the oil and gas sector does not contain an explicit ratio of 3:1 debt to equity, but allows "arms-length" interest. This ratio would therefore be calculated for each company separately without the option of a fixed 3:1 ratio applicable to oil and gas companies. Taking this into account, it would seem as though the legislator attempted to provide more certainty and stability to oil and gas companies by providing the fixed ratio.

Oil and gas companies might perceive the provision as an incentive to invest in this hazardous sector, as it is more beneficial to the oil and gas sector compared to other economical areas. This initiative might also result in a higher after-tax return, as oil and gas companies' deductible interest expenses may not be limited as easily as other sectors'. On the other hand, it was identified in paragraph 2.4.4 that transparency is one of the criteria of a meaningful incentive. The thin capitalisation paragraphs of the Tenth Schedule contain several vague provisions and might open the legislation to subjective interpretation and misuse, which might lead to corruption and other costs of non-compliance. In effect, these factors could lead to an incentive

that is not cost-effective and does not reach the objective set for it (to lure oil and gas investment to the country) as a result of the nebulous conditions.

3.2.4 Evaluation of the provisions for disposal of an oil and gas right, or shares in a company that owns an oil and gas right

The Income Tax Act is subject to the Tenth Schedule: all transactions' tax will be calculated with reference to the Income Tax Act, except where the Tenth Schedule provides exceptions, in which case the latter will apply (Section 26B of the Income Tax Act). In addition to the provisions of disposals of capital assets contained in the Eighth Schedule of the Income Tax Act, paragraph 7 of the Tenth Schedule provides two options for calculating disposal taxation on oil and gas rights. These two options, the rollover treatment and the participation treatment, may only be chosen in the case where the market value of an oil or gas right exceeds tax cost (base cost in the case of a capital asset and cost price in the case of trading stock). The provision of two additional options on disposal of oil and gas rights indicates flexibility in the legislation, as different oil and gas companies will be able to utilise these provisions according to its unique circumstances and needs. The discussion below also deals with the disposal of shares in a company that owns an oil and gas right.

3.2.4.1 Rollover treatment on the disposal of an oil and gas right

The *rollover treatment* basically enables any gain for the seller, capital or income, to be ignored. The original tax cost of this right will then be deemed to be the base cost, in the case of a capital right, or the cost price, in the case of trading stock, for the purchaser. Therefore any gain will be rolled over to the next owner of the oil or gas right.

By selecting this provision, any gain would be passed on to the purchaser, leaving the seller with no taxable gain. This would also be beneficial if the seller is in an assessed loss position, where the gain may be used to utilise the loss. In addition, the purchaser benefits from the possibility that no gain might exist when the right is sold off at a later stage, consequential of i) a lower than current market value, ii) the purchaser rolling the gain on to a next purchaser, or iii) the purchaser using the right for the rest of its legal duration. This initiative is similar to the corporate rules found in sections 41 to 47 of the Income Tax Act, where companies in the same group will not be liable for taxation on any capital or profit gain from the intergroup sale of an

asset. In this case, however, no requirement is set for the involved parties to be from the same group of companies.

The criteria in this provision are lucid and transparent, as envisaged in paragraph 2.4.4, minimising chances of subjective interpretation and misuse, which reduces costs relating to this incentive. The legislator created an opportunity for a tax liability against which the taxpayer can apply its tax benefit in the event that the sale of the right resulted in a gain which was utilised against the assessed loss. In addition, selecting this provision will always result in a higher after-tax return in comparison with the options available to companies in different sectors. As mentioned earlier, the provision also provides flexibility, as different companies may choose different options. These factors amount to that of a meaningful tax incentive which contributes to the Tenth Schedule's goal – to attract investment to the oil and gas sector.

3.2.4.2 Participation treatment on the disposal of an oil and gas right

If the *participation treatment* is chosen and a *capital* gain results from the sale of an oil or gas right, this gain will then be deemed to be gross income in the hands of the seller. The same amount will be deductible from oil and gas income of the purchaser. On the other hand, if a gain of an *income* nature exists after an oil or gas right was sold, this amount would still make out gross income in the hands of the seller, and be allowed as a deduction from oil and gas income of the purchaser.

The *participation treatment* would probably only be chosen in the case of an oil and gas company with an assessed loss, enabling the selling company to utilise this loss. An oil and gas entity would only have assessed losses as a result of allowances that are greater than taxable income. The assessed loss would most probably be due to significant capital expenditure resulting in 150% to 200% deductions as discussed earlier. In the case of the sale of the right as capital goods, the purchaser would also be able to immediately deduct this amount from its oil and gas income at 100%, whereas it would have been a postponed 66.6% if included as base cost of the right as a capital asset. Effectively, this provision forwards the deduction of one oil and gas company to another, resulting in the first company being able to utilise its assessed loss, and the second company to deduct its capital expense immediately. As with the *rollover treatment*, the *participation treatment* is not available to taxpayers in other sectors and indicates the existence of an incentive. The provision is also flexible, as it provides the taxpayer with an additional option. As discussed in paragraph 2.4.2.4, the legislator created an opportunity for a tax liability against which the taxpayer can apply its tax benefit. In addition, the criteria contained

in the provision are clear and reduces chances of misuse. The provision will also increase after-tax return if selected in the appropriate circumstances, providing an alluring environment for oil and gas companies to invest in South Africa.

3.2.4.3 Disposal of shares in a company that owns an oil and gas right

With the Tenth Schedule being subject to the Income Tax Act, paragraphs 2(1)(b)(i) and 2(2)(a) of the Eighth Schedule imply that a shareholder who is not a tax resident in South Africa will only be subject to a tax on capital gains realised on the disposal of shares if 80% or more of the market value of the shares is attributable directly or indirectly to immovable property situated in South Africa. According to Clegg (1989:5A-7), immovable property only excludes trading stock, therefore oil and gas rights are considered to be immovable property for this purpose. The capital gains tax implications of the disposal of the shares will therefore depend on the makeup of the company and the tax residency of the shareholders (Futter, 2010:25). This implies that non-residents might benefit to a larger extent from this provision than residents, which will specifically promote foreign direct investment in oil and gas companies of South Africa, introducing additional benefits, such as improved technological knowledge, to the country as discussed in Chapter 1.

3.2.5 Evaluation of fiscal stability provided in oil and gas income tax legislation

A fiscal stability clause is viewed as important to facilitate future oil and gas investment, given the high costs of initial sunken capital, combined with high risk and delayed potential profit (National Treasury, 2006b:23). Sunley *et al.* (2002:8) confirmed the assurance provided by a fiscal stability agreement as an incentive, and stated that the costs of the reduced flexibility to the government will be carried by the increased tax on a given project in the future.

Paragraph 8 of the Tenth Schedule entitles the Minister of Finance to enter into a fiscal stability arrangement with an oil and gas company. This agreement fixes all fiscal regulations relating to a specific right for the duration of the oil and gas right while it is held by the entity, and enables the owner to terminate the agreement whenever future legislation might be even more favourable. The stability agreement may also be assigned to any new owner in the case of the disposal of an *exploration* right, and to a company within the same group of companies as the entity transferring the fiscal stability right in the case of a *production* right. The fiscal stability provision ensures stability to most of the provisions contained in the Tenth Schedule and

indicates to investors that these contracts are respected by the South African government. Other countries, such as China, India and the United States of America do not provide for a stability clause in its oil and gas tax legislation, which should be advantageous to investors in the South African oil and gas sector.

Although this provision seems open-handed, Futter (2010:57) identified three short-comings of the current fiscal stability agreement envisaged in the Tenth Schedule in comparison with the previous regime: i) the agreement does not encompass all taxes (over and above income tax) levied on an oil and gas company, ii) it does not prevent the introduction of new taxes to the oil and gas sector (such as the newly introduced dividend-withholding tax) and iii) it restricts the transfer of the fiscal stability agreement to only intergroup parties once the production stage has been entered into by the taxpayer. Furthermore, this clause does not protect against amendments in the body of the Income Tax Act (OPASA, 2010*b*). Although the legislator attempted to create stability as an attracting incentive, new entrants (subject to the Tenth Schedule) will not enter on a level playing field to existing participants (subject to the previous OP26 regime). Coupled with the low ranking of South Africa's reserves in this industry, it might discourage new investment.

It is however important to note that new investors will determine *current* after-tax and risk return, irrespective of previous figures, and as long as it is still rewarding, entities will engage in oil and gas activities. It should also be remembered that flexibility is an important element of a meaningful tax incentive. Futter's (2010:57) criteria of providing oil and gas companies, which are in the production phase, with fewer incentives than the exploration companies, indicate flexibility. Oil and gas companies engaged in exploration activities carry higher risks due to the uncertainty of available resources. The legislator acknowledged the various phases of the oil and gas cycle mentioned in Chapter 1, and catered accordingly. Furthermore, the shortcomings of the stability clause mentioned above, leaves room for the government to adjust legislation when deemed necessary, for example when the current provisions are not cost-effective anymore. Even though this flexible provision might not eliminate uncertainty completely, it does, to a large extent, address stability and therefore it is deemed to be a meaningful incentive.

3.2.6 Evaluation of the provision for foreign currency gains or losses in oil and gas income tax legislation

Oil and gas companies must determine their currency gains or losses with reference to the translation method used for purposes of financial reporting, thereby using its functional

currency. This gain or loss will then be translated to South Africa's currency by applying the average exchange rate for the applicable year.

Non-resident companies are able to rely on their own currency as their base currency for tax purposes, thereby reducing currency gain and loss taxation. In an analytical study between the previous OP26 regime and the Tenth Schedule, however, Futter (2010:30) found that the Tenth Schedule compares poorly to the previous regime, in that it provides for foreign currency gains and losses to be determined with reference to the currency and translation method used by a company for financial reporting purposes. For example, for financial reporting purposes, unrealised foreign currency gains and losses are recognised on translation, namely the financial year-end. The previous OP26 prospecting and OP26 prospecting sub-lease lessees were taxed in accordance with the Income Tax Act as at 1977, and would therefore not recognise unrealised foreign exchange gains or losses for tax purposes. Companies now have to recognise unrealised foreign exchange gains or losses for tax purposes, which previously was not necessary, which is an example of one of the short-comings of the Tenth Schedule: the fiscal stability clause does not protect investors against amendments to the body of the Income Tax Act. Also, the fact that instability of fiscal obligations leads to uncertainty which increases the inherent risks of an investment, was discussed in paragraph 2.4.3.

Even though the provisions relating to foreign currency gains or losses might be less attractive than the previous regime, it is still more beneficial to oil and gas companies compared to companies in other sectors of South Africa. The country also holds an advantage over several other countries that do not provide any fiscal stability clause. The foreign currency gains or losses provision's criteria are set out clearly, making it rigid and therefore effortless to comprehend. Moreover, it seems that the government decided to exercise the flexibility put into the previous OP26 regime and to amend legislation to the current provision contained in the Tenth Schedule.

3.2.7 Summarised findings on the Tenth Schedule

When studying the Tenth Schedule, it is submitted that the State's intention was twofold: to provide more deductions, stability and greater transparency, as discussed in paragraph 3.2. Even though some commentators believe that these goals were not completely achieved by the State, several incentives were identified in the Tenth Schedule. The Schedule is designed in such a way as to provide oil and gas companies the opportunity of not having to pay tax for several years. As contemplated earlier, the State ought to consider the cost-effectiveness of the

latter provision and determine whether it will negatively influence the rest of the economy, which might be a result of other sectors having to cover the revenue forgone caused by the oil and gas sector. The latter effect may however provide the oil and gas industry with an opportunity of valuable growth, where other developed industries might temporarily provide the State with the shortfall of revenue.

Furthermore, South Africa's income tax legislation compares competitively to the incentives provided by leading oil and gas importing countries. Some of these countries, however, have the ability of producing more than 5,000 times¹⁶ more oil and nearly 20,000 times¹⁷ more gas (relative to the reserves of the country) than South Africa. This is most probably as a result of a more developed oil and gas industry in these countries, which may be due to elements such as technological development. These countries' oil and gas reserves also exceed that of South Africa¹⁸, which may make incentives more dispensable in these countries.

With the exception of the few vague provisions, such as thin capitalisation discussed in paragraph 3.2.3, the Tenth Schedule was formulated using lucid criteria which are easily comprehensible by a person with a reasonable tax background. The Schedule was also developed on the same basis as the Income Tax Act, reducing misuse opportunities and making it transparent. This will have the effect of lowering any administrative costs of non-compliance to the government, increasing the cost-effectiveness of the incentives included in the legislation.

In relation to the previous OP26 and the current stability clause, however, different oil and gas companies could have a variety of legislation applicable, causing bookkeepers and accountants to diversely calculate the same transaction. This leads to an Act that could be troublesome to administer and easy to mistreat.

The stability clause currently contained in the Tenth Schedule, provides stability to oil and gas companies to a large extent, but allows the legislator to amend the legislation if necessary. The introduction of dividend-withholding tax applicable to all companies is an example of flexibility exercised by the government, where oil and gas companies were to a great extent exempt from the previous secondary tax on companies. Although the Tenth Schedule includes a fiscal

¹⁶ Oil: 0.04736402% (USA: Daily production/reserves ratio) / 0.00093857% (South Africa: Daily production/reserves ratio). Refer to paragraph 3.1.

¹⁷ Gas: 8.56524249% (USA: Yearly production/reserves ratio) / 0.04355984% (Yearly production/reserves ratio). Refer to paragraph 3.1.

¹⁸ Refer to paragraph 3.1.

stability agreement, investors might see the last-mentioned short-coming of the agreement as uncertainty, increasing the inherent risk of oil and gas activities.

Nonetheless, the Tenth Schedule succeeded in clarifying some vague provisions of the previous regime and contains several meaningful incentives weaved through the legislation. This will competitively increase the after-tax return of an oil and gas investor compared to an investor in other sectors of South Africa, as well as the oil and gas sector of other countries. Oil and gas companies will be able to plan their financial strategies in advance, knowing the income tax consequences to a large extent. These factors may lower the inherent risk of oil and gas activities in South Africa, luring investors to the sector and thereby attaining the ultimate goal of the Tenth Schedule.

3.3 EVALUATION OF ROYALTY TAX ACT PROVISIONS PERTAINING TO OIL AND GAS COMPANIES

1 March 2010 marked the first day that mineral and petroleum royalties would be charged in South Africa in accordance with the Minerals and Petroleum Resources Royalty Act No. 28 of 2008. This legislation was the end product of a process that started when the National Treasury published the first bill on 20 March 2003 for comment (National Treasury, 2003). During the development of this legislation, the division between risk and reward proved to be problematic as the State, as custodian of the nation's mineral and petroleum resources (MPRDA, 28/2002), and the mines, as economic promoters of the country, started negotiating the royalty bills. After prolonged discussions between mining companies and the State, the National Treasury released the fourth and final Minerals and Petroleum Resource Royalty Bill on 3 June 2008 (National Treasury, 2008). Still, some commentators are of the view that there are certain litigious issues that may need future amendment (Van der Zwan, 2009:69).

Previously, South Africa was one of the few countries in the world without a royalty system (Otto *et al.*, 2006). The Royalty Act was imposed in order to compensate the State for the extraction and depletion of resources, which is in line with the aim of the MPRDA, and thereby reforming to international norms. It should be remembered that a royalty causes an expense, similar to income tax, and can therefore not in itself be an incentive. It can however, contribute to an attracting regulatory environment compared to the rest of the world.

Cawood and MacFarlane (2003:214) stated that a mineral royalty is compensation to the government, as holder of the rights for the extraction of these minerals from the land, as well as for trading with these minerals on markets. Royalty systems aim to balance two sometimes

opposing objectives: To compensate the resource owner and to encourage the development of the resource (PWC, 2009:3). Low mineral prices and increased risk in developing these minerals cause mining investors to be highly selective when deciding on investment destinations (Cawood & MacFarlane, 2003:231). They were also of the opinion that natural mineral wealth no longer secures prosperity for the host nation necessarily, and with South Africa's poor oil and gas resources, it may be necessary to implement favourable investment rules to attract investment to this industry. Oil and gas are both minerals as defined in the MPRDA, making it subject to the Royalty Act. As royalties are another cost to be borne by oil and gas investors, the question to be considered is whether royalties should be charged on oil and gas in South Africa at all. Otto *et al.* (2006:3) warned the government to warily consider the immediate fiscal rewards from high tax levels such as royalties, against long-term benefits to be gained from a sustainable mining industry, as these companies will contribute to long-term development, infrastructure and economic diversification. They also recommended that a nation should consider to either forgo royalty tax and rely on the current tax system or recognise investors' preference for being taxed on the ability to pay, when desiring to attract investors.

The trigger for royalties to be charged is the *transfer* of a mineral resource, which is defined by the Royalty Act as the disposal, export thereof, or the consumption, theft, destruction or loss of a mineral resource, other than by way of flaring or other liberation into the atmosphere during exploration or production if the latter had not previously occurred. The Royalty Act also distinguishes between refined and unrefined minerals. Schedule 1 to this act places oil and gas in the refined category, which serves as incentive, as resources in this category are subject to a lower royalty rate, thereby securing higher after-tax rewards compared to an unrefined minerals investor.

3.3.1 Evaluation of royalty rates applicable to oil and gas companies

The royalty rate formulae, according to section 4(1) of the afore-mentioned Act, for refined mineral resources is:

$$0.5 + [\text{EBIT} / (\text{Gross sales in respect of refined mineral resources} \times 12.5)] \times 100$$

where EBIT is earnings before interest and taxes.

This rate, which is capped at 5%, will be multiplied by the gross sales of an extractor determining royalties payable.

Section 5 of the Royalty Act defines earnings before interest and tax for refined mineral resources, in summary, as gross sales less the deductible amounts in terms of the Income Tax Act. These deductible amounts are in respect of the use of assets, or expenditure incurred to win, recover and develop refined mineral resources, but exclude amounts from the disposal of assets of a capital nature. Section 5(5) further limits earnings before interest and taxes to zero if it is a negative amount, providing a minimum royalty rate of 0.5% to the State.

Oil and gas companies might therefore pay royalties on gross sales at a rate of between 0.5% and 5% on gross sales. This formula provides for oil and gas companies to pay royalties based on profitability, protecting the new or less successful entities. The before mentioned provision indicates flexibility to companies in various stages of its development and also acknowledges the warning of Otto *et al.* (2006:3), which was to base the royalties on the investor's ability to pay, as mentioned earlier. A royalty based on ability to pay spreads the risks of mining evenly between the government and companies (Otto *et al.*, 2006:10). Furthermore, the minimum rate addresses the concern of the Revenue Watch Institute (2008:1) that a pure profitable formula would have resulted in no royalties for the State, even though these minerals are still extracted. The provision therefore assists to attain the objective of the Royalty Act, which is to gain compensation for the State for the extraction and depletion of mineral resources.

Van der Zwan (2009) stated that one of the concerns with the use of earnings before interest and tax as a profitability indicator was that the term was not defined in the accounting frameworks and exposed the tax authorities to disputes. This term also exposed the royalty regime to the misuse of accounting estimates, such as depreciation and amortisation, but was addressed by allowing the use of deductions in terms of the Income Tax Act (Van der Zwan, 2009:64), increasing the transparency of the provision. Oil and gas income will therefore be calculated with reference to the provisions of the Income Tax Act, including the Tenth Schedule, instead of using accounting profits.

The importance of competitiveness when attempting to lure investment to a country was discussed in paragraph 2.5. South Africa succeeded in providing a favourable royalty rate compared to leading net import countries', as shown in the table below:

	South Africa	China	India	United States of America
Royalties	0.5% - 5%	0% - 12.5%	5% - 12.5%	12.5% - 30%

Table 2: South Africa, China, India and the United States of America's royalty rates (E & Y, 2009)

These rates should, however, effectively be compared after taking the royalty tax base into account as well. This will be discussed in the following section.

3.3.2 Evaluation of the royalty base applicable to oil and gas companies

Royalties payable to the State are calculated as a percentage of gross sales. Section 6(1) defines gross sales for refined mineral resources as any amount received or accrued during the year of assessment or that would have been received or accrued in respect of the transfer thereof at an arm's length value. Section 6(3)(a) excludes any amount received or accrued in respect of transport, insurance and handling of the final product or any amount to effect its disposal. Allowing the exclusion of some receipts and accruals in terms of section 6(3)(a) is more favourable than some of the previous draft royalty bills if it is read together with the formulae for the rates. (Van der Zwan, 2009).

One of the recommendations that Cawood and MacFarlane (2003:231) made in their report to the National Treasury, was that the royalty rate should be applied on net smelter return, rather than on gross sales. Net smelter return income is defined as "gross value minus processing, refining, transport from the mine to the point of sale, handling fees, insurance, sampling and assaying during transport and marketing costs". It is submitted that the National Treasury decided on a higher effective rate after consideration that this will provide a higher net benefit for the country and its citizens.

A study of the impact of the Royalty Act revealed that effective royalty rates of 9.6% of profit (EBIT) could occur on refined minerals of successful projects (Nel & van der Zwan, 2010:94). This is as a result of the royalty base and rate selected by the National Treasury in the Royalty Act. Analogous criteria should however be compared, and the royalty base used by other net importing countries, reveal a similar royalty tax base than that of South Africa.

	South Africa	China	India	United States of America
Royalty Tax Base	Gross sales	Annual gross output	Wellhead value of crude oil and natural gas. Calculated by reducing the marketing and transportation costs from the sale price of crude oil and natural gas.	Gross wellhead value of the production

Table 3: South Africa, China, India and the United States of America's royalty tax bases (E & Y, 2009)

Based on the findings discussed above, South Africa charges a lower effective royalty rate than other similar oil and gas importing countries and therefore competes for international investment. As mentioned in paragraph 3.2.7, South Africa may have been forced to charge lower effective royalty rates to compensate for the country's higher risks (less oil and gas reserves) in order to be competitive to these countries.

3.3.3 Evaluation of the provision for rollover relief in oil and gas royalty tax legislation

Section 9 of the Royalty Act deems a mineral resource not to be disposed of if it is part of a going concern disposal, and the acquirer of that mineral resource will then be deemed to be the extractor that won or recovered the mineral resource. Similar to the rollover provision in the Tenth Schedule, the Royalty Act stipulates that any gain will be transferred to the acquirer. This results in a royalty saving for the seller and a royalty tax for the purchaser when the resources are transferred.

If not for this clause, a stumble block – a possibly immense royalty liability – would exist to exit the oil and gas sector, if a specific investor did not succeed. These high costs of departing from an uncertain sector could have prevented investment in the sector if not provided for. Once again the legislator acknowledges businesses in various stages of its development, including the closing thereof. Providing this rollover relief also results in royalties being charged to the person that truly transfers the oil and gas resources, which is in line with the normal principles of taxation of taxing the entity to which the income accrues. Supplying the oil and gas industry with this provision, lowers the risk of the investment while being cost-effective, as the royalties that would have been payable by the investor closing down, are paid by the purchaser of the going concern.

3.3.4 Evaluation of fiscal stability provided in oil and gas royalty tax legislation

Similar to the Tenth Schedule, which regulates income tax on oil and gas companies, the Royalty Act contains a fiscal stability agreement, securing the rate at which companies will be liable for royalties in the future if such an agreement is concluded. These rights may also be assigned to the purchaser if such a right is transferred, and terminated by the holder of such right at any time. Such termination would be exercised if future legislation becomes even more attractive to investors, limiting the royalty rate to a maximum. The legislator supplements this provision, assuring investors that the State will be liable for any damage or loss that the investor

suffers, should the government fail to comply with such fiscal agreement, revealing the intention of the South African government to honour the agreement. In addition, no similar stability agreement is found in the tax legislation of the comparative countries China, India or the United States of America, thereby lowering the risk of uncertainty for South African oil and gas investors.

The Royalty Act, however, only provides fiscal stability regarding the formula for calculating the rate at which royalties will be payable, where the Tenth Schedule freezes all the provisions of the Act. According to the Revenue Watch Institute (2008:5), this provided the State with more flexibility regarding any possible future changes rather than to guarantee agreements as had been proposed in the third draft bill. This clause seems to be beneficial for both government and investor by providing some security to investors, but also suppleness to the State, indicating an effective incentive.

3.3.5 Summarised findings on the Royalty Act

Similar to the Tenth Schedule, the Royalty Act was developed on the same basis as other South African tax acts. No vague provisions were identified in the before mentioned Act and criteria in the legislation are clear and compelling. This will induce the correct interpretation of the legislation and reduce misuse of the Act. The fiscal stability clause contained in the Royalty Act also provides taxation certainty to oil and gas investors, reducing the inherent risk of the hazardous sector's activities. Although the Royalty Act introduces an expense to oil and gas companies, it provides a more attractive legislative environment for these investors compared to other oil and gas importing countries. Imposing a lower effective royalty rate than these countries might compensate investors for other pejorative conditions, such as South Africa's low oil and gas resources. Providing the opportunity for a higher after-tax return might reach the government's goal of luring investment to the oil and gas sector, while compensating the State for the extraction and depletion of the country's mineral resources.

3.4 EVALUATION OF OTHER TAX-RELATED COSTS PERTAINING TO OIL AND GAS COMPANIES

Investors weigh up costs against return when deciding to take on a project. A net present value assessment includes all costs: those of the project, as well as other costs imposed by governments. Even though this study focuses on income and royalty tax, one should bear in

mind that the purpose of the study is to determine whether South Africa's total taxation package provides sufficient incentives to attract investors to the oil and gas sector. No tax instrument should be seen in isolation, as this is not the only compulsory cost introduced by the government: all of the royalties, fees and taxes paid by the investor to the State are called the total "government take" and it is this total package that matters from a public policy perspective (PWC, 2009:3). Otto *et al.* (2006:10) also stated that the taxation package influences the division of risk between the government and the mining companies. As discussed in the previous sections, the Income Tax Act and Royalty Act contains balanced, meaningful incentives, which compares competitively to other oil and gas net importing countries. These incentives are of such a nature as to attract investment to the oil and gas sector of South Africa, but the other costs imposed by the State could neutralise the positive effect of the incentives previously identified, and should therefore be taken into account. Considering the high risk of South Africa as an oil and gas investment location as a result of the poor reserves, high exploration costs, as well as income and royalty tax some may perceive as being too high, other tax-related costs will indeed influence an investment decision. These costs will be limited to BEE costs and the potential carbon tax/cap and trade system (a potential tax to be imposed in an attempt to reduce carbon emissions).

3.4.1 Black Economic Empowerment

The first democratic election of the Republic of South Africa took place on 26, 27 and 28 April 1994. After this event, major changes were made to South Africa's legislation. One of the laws that originated is the Broad-Based Black Economic Empowerment Act No. 53 of 2003. The aim of this Act was to promote the achievement of the constitutional right to equality through effective participation of all citizens to result in a more stable and prosperous economy (Broad-Based Black Economic Empowerment Act No. 53 of 2003).

Section 9 of this Act allows the Minister to issue codes of good practices in the Government Gazette on issues such as further interpretation and indicators on how to measure broad-based black economic empowerment. This code was published in the Government Gazette No. 29617 on 9 February 2007.

The BEE Codes of Good Practise (The Code) (Department of Trade and Industry, 2007) applies to all public companies and companies engaging in business with any organs of the State or public entities. The Code (Department of Trade and Industry, 2007:7) ensures measurement of the seven generic scorecard elements:

- i. Ownership, which measures the effective ownership of enterprises by black people
- ii. Management control, relating to the measure of effective control of enterprises by black people
- iii. Employment, being the measure of initiatives intended to achieve equity in the workplace mentioned under the Act and the Employment Equity Act
- iv. Skills development, which measures the extent to which employers carry out initiatives designed to develop the competencies of black employees
- v. Preferential procurement, relating to the extent to which enterprises buy goods and services from suppliers with strong B-BBEE procurement recognition levels
- vi. Enterprise development, which measures the extent to which enterprises carry out initiatives, intended to assist and accelerate the development and sustainability of other enterprises
- vii. Socio-economic development, which measures the extent to which enterprises carry out initiatives that contribute towards socio-economic development or sector specific initiatives that promote access to the economy for black people

The Code (Department of Trade and Industry, 2007) provides for three levels of compliance based on the size of turnover: exempt micro enterprises, qualifying small enterprises and medium to large enterprises (Broad-Based Black Economic Empowerment Act, 53/2003). The criterion for being a medium to large enterprise is that a company's turnover must exceed R35 million. Oil and gas companies, such as Sasol whose total¹⁹ turnover was R122 256 million in 2010 (Sasol, 2010:86), will most likely fall into the latter category. Medium to large enterprises must naturally meet the most stringent criteria before being BEE compliant.

As mentioned in Chapter 1, oil and gas companies have to adhere to the requirements of section 100²⁰ of the MPRDA, which state that they should comply with the regulations of the Broad-Based Socio-Economic Empowerment Charter for the South African Mining Industry (South Africa, s.a.). The BEE Mining Charter requires a mine to achieve 26% historically

¹⁹ Although this study focuses on oil and gas activities, Sasol's turnover size regarding BEE will not only be based on its oil and gas income, but on the total income of the company.

²⁰ **Section 100(2)(a):** To ensure the attainment of Government's objectives of redressing historical, social and economic inequalities as stated in the Constitution, the Minister must within six months from the date on which this Act takes effect develop a **broad-based socio-economic empowerment Charter** that will set the framework, targets and time-table for **effecting the entry of historically disadvantaged South Africans into the mining industry, and allow such South Africans to benefit from the exploitation of mining and mineral resources.**

disadvantaged ownership of the mining industry assets in ten years from 2002. Over and above these, the Petroleum Agency of South Africa requires a company to share a minimum participating interest of 10% with a historically disadvantaged South African entity/person (PetroSA, 2009a:7). This accumulates to 36% of the shares of an oil and gas company. Nevertheless, the charter also specifies that these transactions will take place in a transparent manner and for fair market value. In practise however, BEE companies (or shareholders) may not necessarily have the required finance to purchase the shares of a company, but are also aware of their privileged position, as the oil and gas companies are dependent on them for their BEE status according to the BEE Mining Charter. In order for the oil and gas companies to secure its BEE status, a share scheme is frequently established in terms of section 44 of the Companies Act (71/2008), where the company sells its shares to a BEE company at fair market value, but commonly on an interest free loan (Sasol, 2010:231). In some agreements, the dividends resulting from the shareholding may be offset against the capital outstanding until the loan is abolished, which could result in no cash outflow for the BEE company.

The attainment of an acceptable BEE score card – measured in levels one (highest) to eight – is of significant value to South African companies due to a variety of reasons. A BEE certificate might provide a company with:

- i. contracts. As the State imposed this BEE legislation, compliance therewith serves as motivation to be acknowledged when different companies tender for State contracts.
- ii. less competition. In relation to the previous, companies struggle against competitors. A satisfactory BEE score card serves to level the battle field between entities.
- iii. existence. As most companies are subject to the Code, an adequate generic score card serves as safe guard for existing companies not to be taken over by competing BEE complying firms.
- iv. foreign investment. Apartheid brought sanctions over South Africa, which was lifted after the new era. Foreign investors are attracted to BEE compliant companies as it indicates equality in the workplace.
- v. economic growth. As skills development is one of the seven elements of the scorecard, this development will benefit the country's economy through capability and adroitness. All of the above factors will accumulate to improve economic growth.

Makwiramiti (2011) was of the view that economic empowerment of previously disadvantaged people can be an important tool in improving their livelihoods and reducing poverty. A

successfully implemented empowerment policy can give these people the opportunity to become more economically active by providing them with skills and enterprise development, which will in turn help to create jobs and to develop sectors possibly under - or not developed. Krüger (2011:207) conversely stated that in an empirical survey, conducted in March/April of 2010 among the top local South African businesses ranging from small, medium to large multinational companies, the perceptions, thoughts and anticipations of 500 individual managers on the impact of BEE on ten selected dimensions of business performance were sought. Alarming, most of the respondents disagreed with the notion that BEE compliance would improve the performance of the companies they worked for, specifically with regard to overall and international competitiveness, service excellence and client satisfaction, quality, productivity, entrepreneurial spirit and innovation, production performance, human development, staff morale, business ethics and transparency, sales and access to markets, and financial performance.

Even though some commentators might believe the consequences of forced BEE to be damaging, non-compliance with the BEE Mining Charter might have detrimental effects on oil and gas companies. These detrimental effects include factors such as not being able to supply goods or services to companies that are complying with the codes of the charter, not qualifying for government licences, as well as not qualifying to do business with the government (Rumney, 2007:5). In order for oil and gas companies to do business in the South African economy, they should therefore, according to law, be willing to dispose of 36% of their shares, along with paying the income tax and royalties discussed above.

Black Economic Empowerment is a cost not easily measured, as it encompasses more than a direct expenditure. It is therefore not easily comparable to other countries and the effect it has on the oil and gas industry of South Africa is unquantifiable. Although this is a rare occurrence with other countries, BEE is not unique to South Africa, as similar costs, such as community royalties, may exist worldwide. Similar costs have not, however, been identified with the selected three countries China, India and the USA. These countries do, nevertheless, have other costs applicable to their oil and gas industries, such as minimum alternate tax, production sharing contracts, bonuses and special oil gain levies²¹ that return South Africa to a competitive level. Compliance to the BEE Mining Charter may however diminish the value of the meaningful incentives identified in the Income Tax and Royalty Tax Acts to a great extent. BEE does not encompass any elements of initiatives and is therefore perceived to be a clear-cut cost of

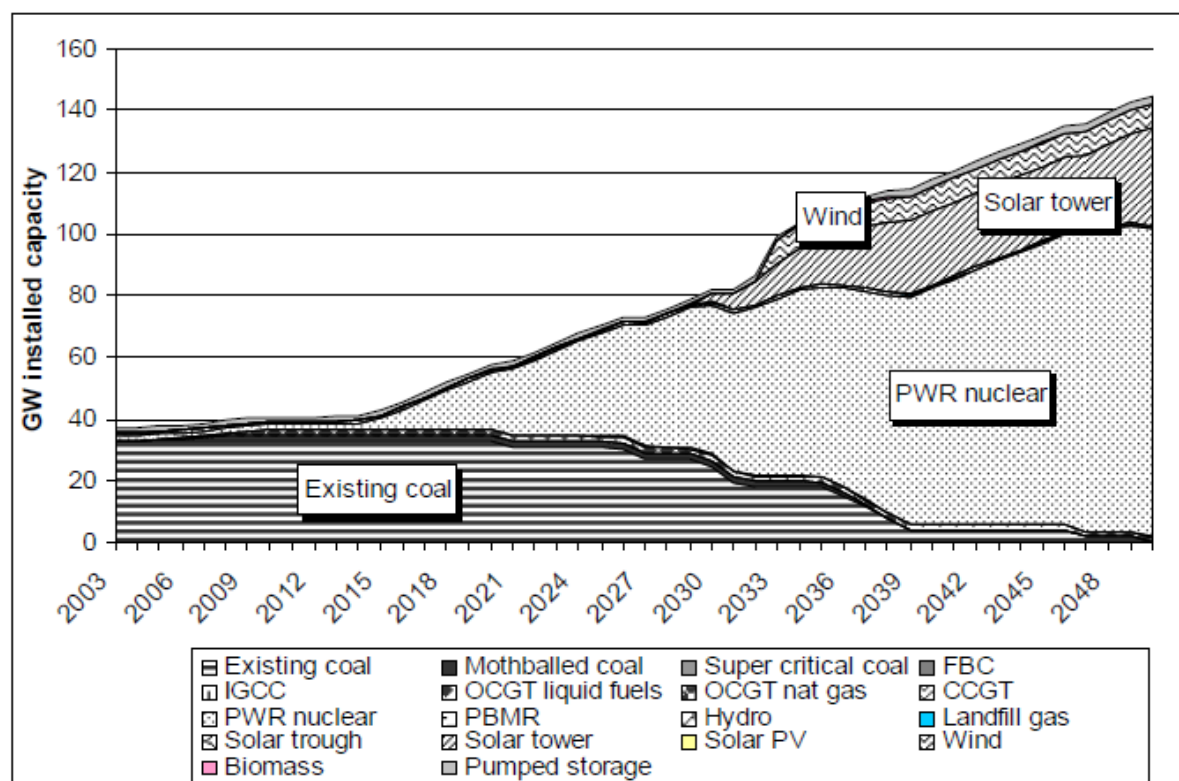
²¹ Refer to Appendix 1.

parties investing in South Africa. Many firms deem costs relating to BEE as an additional cost the firms have to bear, reducing the after-tax return of oil and gas investors, and depleting chances of business success in South Africa.

3.4.2 Potential carbon tax/cap and trade system

The effects of pollution are well known: sickness, change in weather and overall damage to the planet. In an attempt to reduce greenhouse gas emissions, the National Treasury contemplates to introduce a tax instrument on carbon (National Treasury, 2006c).

In a Discussion Paper on carbon tax, the National Treasury (2010:3) identified two main economic policy instruments to inhibit greenhouse gases and to value carbon: carbon tax and emissions trading schemes. Carbon tax attempts to reduce emissions directly through a price mechanism, whereas the trading schemes seek to target specific levels of emissions in the trade in allowances. In a study conducted by Winkler and Marquard (2009:7), carbon tax was shown to be the most efficient greenhouse gas reducer. It was found that energy-intensive industries were very sensitive to the tax and energy would be produced by other means as can be seen in the following graph:



Graph 1: An estimate of the effect of a carbon tax on the resources that will be used to produce energy (Winkler & Marquard, 2009:7)

However, Winkler and Marquard (2009:7) recommended that revenues from a carbon tax should be combined with reduced taxes or incentives to the poor, as the overall tax incentive package would then be better aligned with major development priorities. Lachapelle (2009:22) also stated that carbon tax is an obscure concept and implementation in the world of politics is difficult.

The potential carbon tax/cap and trade system illustrates that oil and gas companies are not exempt from new taxes being introduced in the industry. Although the Income Tax Act and the Royalty Act contain fiscal stability clauses, it does not exempt these companies from the introduction of other taxes, such as the afore-mentioned, which might cause uncertainty and increase inherent risk of oil and gas activities. Although the potential tax might generate income for tax authorities and benefit the country through eventual lower carbon emissions, the latter may be achieved through other means, as current investors might have to close divisions down that currently only make a contribution to fixed costs. New investment may also be deterred, resulting in even further losses for the companies, and indirectly, South Africa.

South Africa is not the only country that is affected by carbon tax/cap and trade, as the whole world is aiming for a greener future – it has become a global phenomenon. Different rates and provisions may apply to different countries, but the aim remains the same: reducing pollution to such an extent as to minimise our carbon footprint on Earth. If South Africa comes to the decision of imposing carbon tax/cap and trade, it will be level to competing countries worldwide, depending on the rate that is set. Potential investors will await finality over the possible new legislation as this potential cost will affect their investment decision through a decreased after-tax return.

3.4.3 Summarised findings on other tax-related costs

Contrary to the incentives that were evident in the Income Tax Act and Royalty Act applicable to the oil and gas industry of South Africa, it was found that the other State-imposed costs investigated portray additional costs and might mitigate the positive effects of the incentives previously identified. Comparing these regulations with the guidelines contained in paragraph 2.5, no incentives were revealed, as these taxes cause uncertainty, instability and a reduction in after-tax and risks rewards to oil and gas investors. The Tenth Schedule and Royalty Act compete on a global level, but it should be remembered that investors take all State-imposed costs into account before deciding to invest in a country. Care should therefore be taken that

these additional costs do not lower South Africa's ultimate competitive position in the worldwide battle to gain oil and gas investment.

3.5 SUMMARISED FINDINGS ON THE INCENTIVES PROVIDED IN SOUTH AFRICAN TAXATION LAW APPLICABLE TO OIL AND GAS COMPANIES

The criteria laid down in paragraph 2.5, provided a structure of the characteristics of meaningful tax incentives, which was used to evaluate South Africa's oil and gas tax legislation. South Africa introduced and adapted tax legislation on oil and gas companies in order to conform to international norms while attempting to competitively attract investment to the oil and gas sector.

The Tenth Schedule's provisions were found to be lucid, simplifying comprehension thereof, and a stability clause is contained in the Schedule, providing certainty in this high risk sector. The Schedule also provides flexibility and acknowledges companies in various stages of their development by providing additional options for certain transactions. The flexible provisions contained therein also provide the State with the option of altering the legislation if necessary. In addition, it provides the opportunity for oil and gas investors to competitively increase their after-tax and risks return by allowing generous capital deductions which might postpone the payment of income tax for several years. The cost-effectiveness of the Tenth Schedule might however be debated, as the government might not receive payment for the trading of its mineral resources. It should nonetheless be remembered that several other benefits, such as technological and infrastructural improvement, might be attained by the country, which may make the Schedule cost-effective in the long-term. The provisions in the Tenth Schedule were found to work together in attaining the objective of the Tenth Schedule: to promote oil and gas investment in the South Africa.

No vague provisions were identified in the Royalty Act and chances for subjective interpretation were minimised by setting out clear criteria. Similar to the Tenth Schedule, the Royalty Act provides flexibility by calculating the royalties on companies' ability to pay, while still fixing a minimum royalty payable to the State in order to attain the goal of the Royalty Act, which is to compensate the government for the extraction and depletion of mineral resources. The fiscal stability clause contained in the Royalty Act reduces uncertainty and therefore risk in the oil and gas industry, while leaving room for the government to amend the legislation at a later stage. The competitive effective royalty rate also secures a higher after-tax return to investors. As a result of the rigid legislation, administration costs and costs of non-compliance is submitted to

be low. Coupled by the fact that the country's government will receive a minimum royalty, the provisions contained in the Royalty Act appear to be cost-effective and compensate the State for the extraction of oil and gas resources, thereby attaining the goal of the act.

BEE costs and the uncertainty around the carbon tax/cap and trade system will however affect after-tax and risk profit and might undermine the meaningful tax incentives identified in the Tenth Schedule and Royalty Act. As a result, investors will determine whether the reward is sufficient before investing in South Africa, which might discourage longed for investment.

Nonetheless, South Africa's Tenth Schedule and Royalty Act applicable to oil and gas companies contain meaningful incentives and compete among some of the leading oil and gas importing countries worldwide, leading to competitive after-tax and risks returns. Providing competitive legislation was done in an attempt to promote investment in the oil and gas sector, and while some commentators might be pessimistic, the evidence is in the outcome: Business Monitor International (2011) reported that oil and gas production in South Africa grows steadily and predicts oil production to grow with 20.2% from 2010 to 2015, and gas production with 40.5% within the same period. These could be reasonable indicators that return after all costs (including BEE costs and the potential carbon tax/cap and trade system) is sufficient, and that South Africa is succeeding with attracting investment to the country's oil and gas sector.

CHAPTER 4

CONCLUSION

4.1 INTRODUCTION

Investment, in particular foreign direct investment, in a developing country is deemed to be one of the greatest criteria for a country's economic growth (Ibi Ajayi, 2006:15). Developing the oil and gas industry of South Africa will lead to generous advantages and ultimately promote the country's economic development. Several advantages that have been identified include independence of oil and gas export countries, fiscal rewards for the government, technological and infrastructural improvement for the country as a whole, as well as benefits to society. In 2010, SAPIA (2010:16) contributed R158 million to corporate social investment projects. Although South Africa is endowed with several energy resources, the country's oil and gas reserves are few (CIA Factbook, 2010). These resources should however still be optimised in order to fulfil the aim of section 2 and 3 of the MPRDA, which is to develop mineral and petroleum resources for the benefit of all South Africans.

Being dependent on foreign countries for the supply of crucial resources, and therefore volatile currency, forms a struggle to fuel South Africa's economic growth. Also, given South Africa's poor geological prospects as a result of low oil and gas reserves, the country needs a different form of attraction in order to focus the attention of investors to the country's oil and gas industry. Some commentators are of the view that attraction of investment may be achieved through creating a competitive, alluring regulatory environment (Ibi Ajayi, 2006 and Pouris, 2003).

Commentators have been debating the use of tax incentives over other forms of initiatives, such as tax holidays and government grants, for years. It is however submitted that tax incentives might result in a net benefit to a country in certain circumstances, due to a lower administrative burden and costs to the State compared to other forms of government initiatives.

In paragraph 1.3, the objectives of this study were determined: to determine the characteristics of meaningful tax incentives which promote investment, as well as to analyse the tax legislation applicable to the oil and gas industry in South Africa in order to determine whether it contains meaningful incentives to competitively promote investment in this sector.

In order to determine whether South Africa will be able to employ tax incentives as a means of luring investment to the country, it was necessary to establish the use, harmful effects and characteristics of meaningful tax incentives. These characteristics were then used to measure

South Africa's tax legislation and other tax-related costs that currently apply to the oil and gas industry to, in order to identify available tax incentives. As South Africa competes for international investment, the incentives currently contained in the country's tax legislation were compared to that of other countries in similar oil and gas positions, to determine whether the country's tax incentives are competitive.

4.2 SUMMARY OF FINDINGS

4.2.1 The characteristics of meaningful tax incentives which promote investment

In order to attain the objective as mentioned above, Chapter 2 studied the use, harmful effects and the characteristics of tax incentives. The criteria laid down, provided a structure against which to measure South Africa's oil and gas tax legislation and regulation. Seven characteristics were thoroughly set out by this chapter:

- i. All tax incentives should have a clearly defined goal. In paragraph 2.4.1 it was stated that it is important for governments to decide on the objectives that need to be attained in order for a tax incentive to be effective.
- ii. Tax incentives should achieve the set goal. Governments normally want to lure investment when setting incentives, and as tax incentives frequently lead to forgone revenue, not attaining increased investment will cause a country's economy to mitigate. It is therefore important that tax incentives are set realistically in order to achieve the set objectives as contemplated in paragraph 2.4.2.2.
- iii. A tax incentive should increase the after-tax return of an investment, which should compare competitively in relation to other countries. In paragraph 2.4.2.3 it was discussed that investors generally compare cost versus return and opt for the maximum return after tax and risks. Tax incentives should therefore competitively increase investors' after-tax return in order to lure investment to a specific country's industry.
- iv. Flexibility should be present. Companies go through various stages in their life cycles. As a result, provision should be made for companies with different risk profiles. In addition, it was stated in paragraph 2.4.2.4 that legislation should be adaptable by the government, as different circumstances might apply at a later stage.
- v. A tax incentive's cost should be lower than the benefits gained. Investment in a country might introduce non-financial benefits along with the financial benefits, as

discussed in Chapter 1. In order for a tax incentive to be effective, total benefits should outweigh the cost of the incentive as mentioned in paragraph 2.4.2.5.

- vi. Investors require fiscal stability. Providing a stable tax environment in the oil and gas sector might mitigate risks and improve growth in the sector. In paragraph 2.4.3 it was mentioned that fiscal stability satisfies the desire of the extractive industry by proving that the terms of contracts are being respected by host governments.
- vii. A tax incentive should be transparent. Criteria in tax incentives should be easily comprehensible in order to decrease the risk of manipulation of the legislation. This will also aid the cost-effectiveness of the tax incentives, as costs relating to non-compliance of the legislation will be minimised as discussed in paragraph 2.4.4.

Based on the above mentioned, it was established that tax incentives have both constructive and dire consequences and that it should only be imposed after thorough investigation and where benefits exceed detrimental outcomes and costs. Tax incentives that adhere to the criteria mentioned above, have the ability to promote investment.

4.2.2 Analyses of the tax legislation applicable to the oil and gas industry in South Africa in order to determine whether it contains meaningful incentives to competitively promote investment in this sector.

In Chapter 3 the current taxation costs applicable to the oil and gas industry in South Africa was set out. It thoroughly analysed these provisions and measured it against countries in a similar oil and gas position, and by using the criteria set out in Chapter 2, it was possible to identify incentives and to determine the relative quality thereof. This was done in order to determine whether the incentives incorporated into the current tax legislation are meaningful, in order to attract investment to South Africa's oil and gas sector.

The objective of the Tenth Schedule, discussed in paragraph 3.2, is to promote the oil and gas sector of South Africa. The provisions contained therein are set out on the same base as the Income Tax Act, thereby inducing comprehension and minimising opportunities for subjective interpretation. It was contemplated in paragraph 3.2.2 that the Schedule is also flexible by considering oil and gas companies in various stages of their development and provides opportunities for companies with assessed losses to utilise it, as well as for thriving companies to not pay tax for several years, which is clearly illustrated in Example 1. Cost-effectiveness was also considered by the lucid criteria set out in the Tenth Schedule, reducing the costs of non-

compliance. In addition, investment in the country will attract several non-financial benefits, such as uplifting the previously disadvantaged, and technological and infrastructural improvement as detailed in Chapter 1. The Tenth Schedule compares excellently to leading oil and gas net importing countries, which was considered throughout the Tenth Schedule section of Chapter 3, by providing a higher after-tax profit as well as by including a fiscal stability agreement into the legislation, which paragraph 3.2.5 mentioned to be a short-fall in many other countries.

The Royalty Act's aim is to compensate the State for the extraction and depletion of resources, thereby attaining the objective of the MPRDA. The provisions are set out in a transparent manner and no vague provisions were identified, which reduces the possibility of misinterpretation and misuse. It was conferred in paragraph 3.3.1 that the Royalty Act provides flexibility by taking oil and gas investors' ability to pay into account, but also ensures a minimum royalty payable to the State, thereby securing cost-effectiveness. Other than many leading oil and gas importing countries, the Royalty Act also includes a fiscal agreement, examined in paragraph 3.3.4, assuring investors that the provisions of the contract will be honoured by the South African government. In paragraphs 3.3.1 and 3.3.2 it was contemplated that the Act provides for a lower effective royalty rate compared to leading oil and gas importing countries, which secures an increased after-tax return.

In addition, other taxation related costs which could affect oil and gas investors' decision as to where to invest, were identified in paragraph 3.4. In paragraph 3.4.1 it was found that BEE is an additional cost to investors, which might cause an oil and gas company to relinquish 36% of its shares. Moreover, in order to be BEE compliant, a company has to adhere to several strict criteria, such as providing employment opportunities and training for employees, which might significantly add to a company's cost structure. Additionally, the potential carbon tax/cap and trade system, discussed in paragraph 3.4.2, grants reason for uncertainty to oil and gas entities. Although introducing a carbon emissions tax to the country will cause reform to international standards, the tentativeness might cause these investors to linger in their decision of whether or not to invest in South Africa.

4.2.3 Overall conclusion

The research conducted in this study aimed to determine whether the tax legislation in South Africa provide sufficient incentive to oil and gas companies to compete for international investment in this industry, as discussed in paragraph 1.2. Based on the findings of the study

conducted, it is concluded that South Africa's oil and gas tax legislation contains several meaningful tax incentives which is competitive against other leading oil and gas importing countries'. It should however be noted that these leading countries have much higher production rates as well as more proved oil and gas reserves, which might pressure the South African government to introduce better tax incentives compared to those countries. In addition, the effects of BEE and the potential carbon tax/cap and trade system might deter investment to South Africa. Nonetheless, it was proved in paragraph 3.5 that the oil and gas sector in South Africa is growing, and that it is expected for these trends to continue in the foreseeable future. This indicates that the tax legislation applicable to the South African oil/petroleum and gas industry acts as incentive to promote investment in the sector.

4.3 CONTRIBUTION OF THIS RESEARCH

This study determined whether the taxation costs on oil and gas companies competitively promote investment, which was determined on the base of clearly set characteristics of meaningful tax incentives. This should benefit existing and potential oil and gas companies to gain an understanding of the competitive incentives weaved through the current tax legislation, as well as the revenue authorities, such as SARS and the National Treasury to firstly, determine reasons why investors are lured to a country, and secondly, whether the State-imposed costs applicable to this sector, serves as intended. In addition, it provides comprehensible characteristics on which to base future tax incentives on.

It is concluded that several meaningful tax incentives are found throughout the Tenth Schedule and the Royalty Act. As contemplated in paragraph 3.5, it is recommended that revenue authorities consider the total taxation cost package to oil and gas investors in detail when considering the attractiveness of the tax legislation and regulation as incentive. Taxation related costs, such as the BEE costs and the potential carbon tax/cap and trade system, should be considered by authorities as this will form part of the cost versus benefit decision for investors and might mitigate the benefits of incentives included in the tax legislation. If the government's objective is therefore to further increase investment in the oil and gas sector, it might be an indication that the tax-related costs, such as BEE costs and the potential tax on carbon emissions, should extensively be examined and reconsidered.

4.4 SUGGESTIONS FOR FUTURE RESEARCH

This study is not considered exhaustive by the author in relation to all concerns regarding the competitiveness of South Africa's oil and gas tax legislation.

The scope of the other tax-related costs investigated was limited to BEE costs and the potential carbon tax/cap and trade system. This study does not examine similar costs from countries in comparable oil and gas circumstances. Such a study might clarify whether South Africa's costs, relating to taxation, effectively lowers oil and gas investment in the country. In addition, a detailed international comparison could further the comprehension of competitiveness of South Africa's oil and gas tax legislation.

As this study was developed awaiting the potential carbon tax/cap and trade system, further study could relate to the effect of such legislation if it is imposed.

Further studies could also endeavour to determine the return that oil and gas companies require before investment is undertaken in a country and whether this could be achieved in South Africa.

APPENDICES

Appendix 1: International comparison of South Africa's revenue tax on oil and gas companies

In 2009, Ernst & Young conducted a study to compare oil and gas tax in different countries. The following table provides a concise summary of the main results of the three chosen countries (E & Y, 2009):

Description	South Africa	China	India	United States of America
Income Tax Rate	Resident companies and OP26 companies: 28% Non-resident companies: 31%	All companies: 25%	Domestic companies: 30% Foreign companies: 40% Additional surcharge payable if income of company in excess of INR10million	All companies: 35%
Incentives	Indefinite carry forward of losses Generous asset disposal Very generous capital allowances 150 % Research and development	150% Research and development Companies may be eligible for certain indirect tax exemptions	Tax holiday (7 years for undertaking commercial production of or refining of mineral oil) 100% Research and development Accelerated depreciation 8 Year carry forward of losses	Accelerated depreciation Accelerated write-off for intangible drilling costs 20 Year carry forward of losses Research and development
Fiscal Stability Clause	Yes, binds state to Tenth Schedule and Royalty Act	None	None	None
Production Sharing Contract (PSC) or Bonuses	None	PSC based on production volumes	PSC based on production volumes	Bonuses: Onshore: negotiated or bid

Description	South Africa	China	India	United States of America
		Signature bonuses are defined in the PSC and take into account the volume of petroleum resources and the economic value of the field		with mineral interest owner Off-shore: competitive bid process
Royalties	0.5% - 5%	0% - 12.5%	5% - 12.5%	12.5% - 30%
Royalty Tax Base	Gross sales	Annual gross output	Wellhead value of crude oil and natural gas. Calculated by reducing the marketing and transportation costs from the sale price of crude oil and natural gas.	Gross wellhead value of the production
Other	STC or Dividend Tax Indirect Taxes	Special oil gain levy calculated in accordance with a formula in circumstances where the monthly average weighted price per barrel of crude oil is sold greater than US\$40 per barrel Indirect taxes if not exempt	Minimum alternate tax if total tax income < 15% of accounting book profit Certain costs not eligible for cost recovery Certain withholding taxes Indirect taxes	Severance tax on extraction Alternative minimum tax regime of 20%

Description	South Africa	China	India	United States of America
		Service contracts ranging from 3% - 20%		

Table 4: Comparison of South Africa's tax legislation against countries in a similar oil and gas position (E & Y, 2009)

Appendix 2: Estimating when an oil and gas company will start paying income tax based on current income tax legislation

For a company to not pay tax, its income should equate to, or be less than the sum of allowable tax deductions. To simplify this example, taxable income before capital allowance on production/exploration assets is deemed to be net profit before tax and depreciation on these assets.

Information according to PetroSA's financial statements from 2006-2011:

	2006	2007	2008	2009	2010	2011	Average
Revenue	6,722,311	8,094,870	10,283,291	12,116,814	8,088,421	10,565,042	
Net Profit before taxation	2,679,290	2,761,503	2,650,243	2,229,661	1,005,033	957,664	
Production asset balance at cost	16,426,541	16,427,897	18,313,107	18,544,919	18,873,930	19,861,937	
Depreciation on production assets	579,334	626,003	444,305	187,322	471,003	663,107	
Net profit before taxation and depreciation on revenue ratio	48%	42%	30%	20%	-7%	15%	24.85%
Production asset ratio	244%	203%	178%	153%	233%	188%	199.96%

According to the table above, the following average ratios were achieved by PetroSA over the past six years:

Net profit margin before taxation and depreciation	25%
Production asset over turnover ratio*	200%

* PetroSA's financial statements only disclose production assets in the statement of financial position. It is therefore unclear whether the exploration assets are included therein or whether it was previously written down in the statement of comprehensive income.

Sources: PetroSA (2007), PetroSA (2008), PetroSA (2009*b*), PetroSA (2010) and PetroSA (2011).

As most oil and gas companies have exploration as well as production assets, it will conservatively be assumed that 50% exploration assets are included in the production asset balance and that the exploration asset balance was not previously written down in the statement of comprehensive income. Therefore assume the following:

Adjusted net profit before taxation and depreciation margin	25%
Production asset over turnover ratio	100%
Exploration asset over turnover ratio	100%

Assume a turnover of R10 000 000²² per financial year. The following can then be derived based on the above ratios:

Turnover per year	R10 000 000
Net profit before taxation and depreciation per year	R2 500 000
Production assets balance	R10 000 000
Exploration asset balance	R10 000 000

Assume an estimated mine life duration of 20 years. The taxable income over the mine life will then be as follows:

Adjusted net profit bore taxation and depreciation over mine life (2 500 000 x 20)	R50 000 000
Capital allowance for production assets @ 150% (10 000 000 x 150%)	(R15 000 000)
Capital allowance for exploration assets @ 200% (10 000 000 x 200%)	(R20 000 000)
Taxable income over mine life (50 000 000 – 15 000 000 – 20 000 000)	R15 000 000

²² This is a hypothetical amount for illustration purposes.

In the process of determining when an oil and gas company will start paying income tax, it will be necessary to determine when the net profit before taxation and depreciation over the mine's life equates the capital allowance received:

$$\text{Net profit per year} \times \text{Mine life in years before company pays income tax} = \text{Capital allowance} \times \text{Production assets}^{23}$$

$$2\,500\,000 \times Y = (150\% \times 10\,000\,000) + (200\% \times 10\,000\,000)$$

$$Y = 14 \text{ years}$$

Therefore, it is deduced that PetroSA will not be paying income tax for the following 14 years.

Using a turnover of R10 000 000 is hypothetical. This could be addressed by only working with ratios, cancelling out hypothetical assumptions. Previous ratios used:

Net profit margin	25%
Production asset over turnover ratio	100%
Exploration asset over turnover ratio	100%

Assume the following symbols:

Description	Symbol
Average net profit margin	N
Production asset over turnover ratio	Pa
Exploration asset over turnover ratio	Ea
Amount of years before an oil and gas company pays income tax	Y
Capital allowance on production assets according to Tenth Schedule	Cp
Capital allowance on exploration assets according to Tenth Schedule	Ce

²³ This is a balance and therefore does not need to be multiplied by the amount of mine life years.

The following equation can be derived:

$$N \times Y = (Pa \times Cp) + (Ea \times Ce)$$

In PetroSA's case, this equation will be as follows:

$$25\% Y = (100\% \times 150\%) + (100\% \times 200\%)$$

$$Y = 14$$

It is important to note that these ratios are not fixed and will vary, as each oil and gas company's own ratios should be used. The formula will be more accurate the more years an oil and gas entity has been operating (with more financial figures available enabling an increased accurate average). Every oil and gas company's own ratios should therefore be used in the following formula to estimate when it will commence paying income tax:

$$N \times Y = (Pa \times Cp) + (Ea \times Ce)$$

Doubt may exist whether this formula can also be used for an oil and gas company in its inception period, as the net profit before taxation and depreciation margin will probably be much lower, but this will also be reflected in the asset over turnover ratio²⁴, cancelling the effect out to a great extent.

It can be argued that the net profit over a mine's life should take time value of money into account (at, for example the consumer price index rate). The capital deductions will then, however, also be discounted, as a tax deduction at year one will not have the same value as a tax deduction in year twenty, thereby obtaining the same result.

²⁴ Turnover will also be much lower in an oil and gas company's inception period.

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