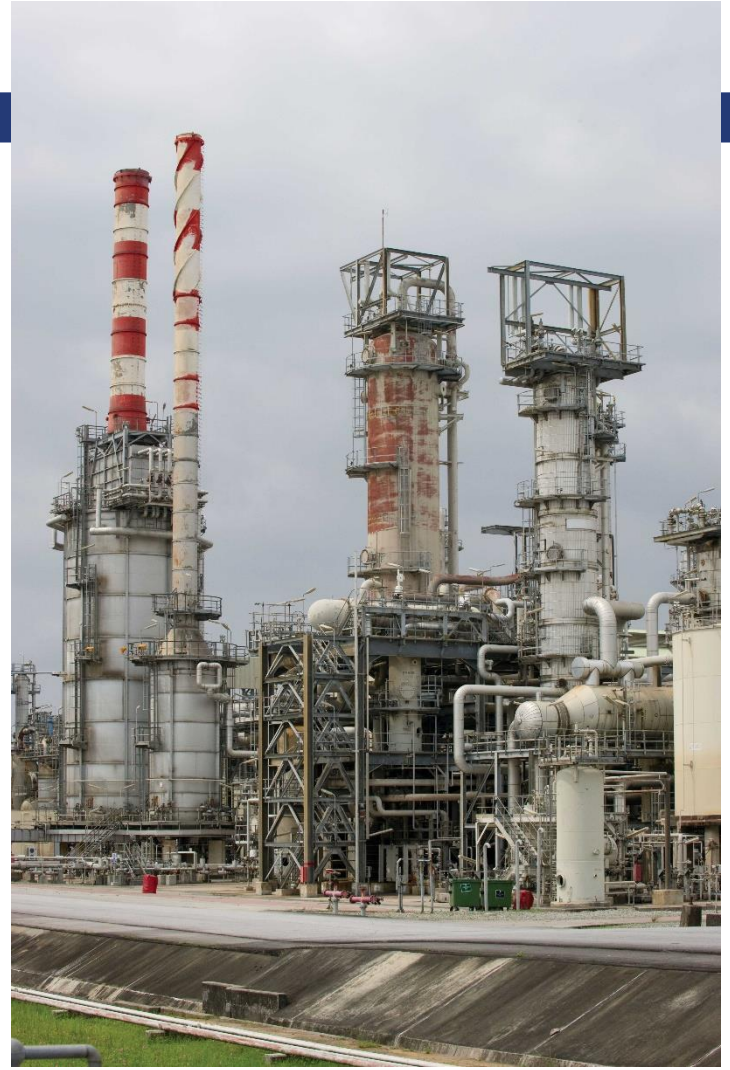


Presentation to Portfolio Committee on Minerals and Energy

25 March 2022

sapia | South African Petroleum Industry Association

About SAPIA

The South African Petroleum Industry Association (SAPIA) represents the collective interests of the South African petroleum industry. The Association plays a strategic role in addressing a range of common issues relating to the refining, distribution and marketing of petroleum products, as well as promoting the industry's environmental and socio-economic progress. SAPIA fulfils this role by contributing to the development of regulation in certain areas of South African policy; proactively engaging with key stakeholders; sharing research information; providing expert advice; and communicating the industry's views to government, members of the public and the media.

Background

- The Chairperson of the Portfolio Committee on Mineral Resources and Energy (PCMRE) requested the South African Petroleum Industry Association (SAPIA) to brief the PCMRE on our experiences relating to the fuel price increases and alternatives and / or considerations in addressing the increases in fuel increases.
- The petrol price is strictly regulated by the Minister of Mineral Resources and Energy. SAPIA notes the impact felt by the consumer caused by rising fuel prices but argues that there is little that it or its members can do to alleviate such price hikes without impacting the security of supply of petroleum products or jeopardising the sustainability of the industry.

Background

- SAPIA supports a fair and transparent regulatory pricing system with periodic reviews but stronger oversight of regulations. This is necessary to ensure that pricing mechanisms keep abreast of developments and that unacceptable practises are not allowed to proliferate in the industry. This would be in the case of the pricing and supply of Liquified Petroleum Gas (LPG), the Basic Fuels Price (BFP), Magisterial District Zoning (MDZ), the Regulatory Accounting System (RAS) and import control amongst other practises and policies.
- This presentation will consider the entire price regulatory structure for petrol and Liquefied Petroleum Gas (LPG) and Illuminating Paraffin (IP) indicating where attention may be required to promote fair and transparent price regulation.

Elements of Petrol Price Regulation (25 March 2022)

	Petrol 95 ULP c/l	Petrol 93 ULP & LRP c/l
Wholesale margin	45.500	45.500
Secondary Storage	30.700	30.700
Secondary Distribution	17.940	17.940
Router Differential	0.000	0.000
Retail margin	228.800	228.800
Zone differential in Gauteng	64.900	64.900
IP Tracer levy	0.000	0.000
Fuel levy	393.000	393.000
Customs & excise duty	4.000	4.000
RAF levy	218.000	218.000
Petroleum Products levy	0.330	0.330
Slate levy	**46.060**	**46.060**
DSML	10.000	0.000
Pump Rounding	0.500	0.500
Sub-total	1 059.730	1 049.730
Contribution to the Basic Fuel Price	1 100.270	1 085.270
Retail Price	2,160.00	2,135.00

Elements of the Price Regulatory System

Price controlled via the Regulated Accounting System (RAS) adjusted annually in December

Zone differential (MDZ) dependent on pipeline and road costs and adjusted annually in April

Controlled by National Treasury

Determined by DMRE

Self adjusting slate levy mechanism to finance cumulative under recoveries accrued by the oil industry

Basic Fuel Price mechanism

Regulatory Accounting System (RAS)

- The objective of the system is to promote efficient and effective regulation by;
  - Clearly ring - fencing costs between regulated and unregulated activities
  - Standardise the presentation and reporting of information from companies
  - Rationalise price setting and price modification
  - Promote transparency and fairness in the setting of prices
- RAS system works within rules to define allowable costs and to determine allowable margins and a return on assets using the capital asset pricing model (CAPM)
  - Risk free rate within the model advised by the Reserve Bank (Prudential Authority)
- Margins adjusted annually in December

SAPIA believes that RAS provides the right degree of clarity, certainty and consistency for the future. Thorough consultation with affected stakeholders is required before any changes are implemented

Magisterial District Zoning

- Concept is to cover the costs of transport from a major supply point at the coast to its point of consumption.
- Consists of two elements (rail no longer relevant)
  - Pipeline tariffs – determined by NERSA after input from Transnet Pipelines according to a defined methodology determined by NERSA
  - Road Freight Association – Vehicle Cost Schedule determined biannually in January and July
- Together these costs inform the costs of transport to a magisterial district
- Zone pricing adjusted annually in April of each year

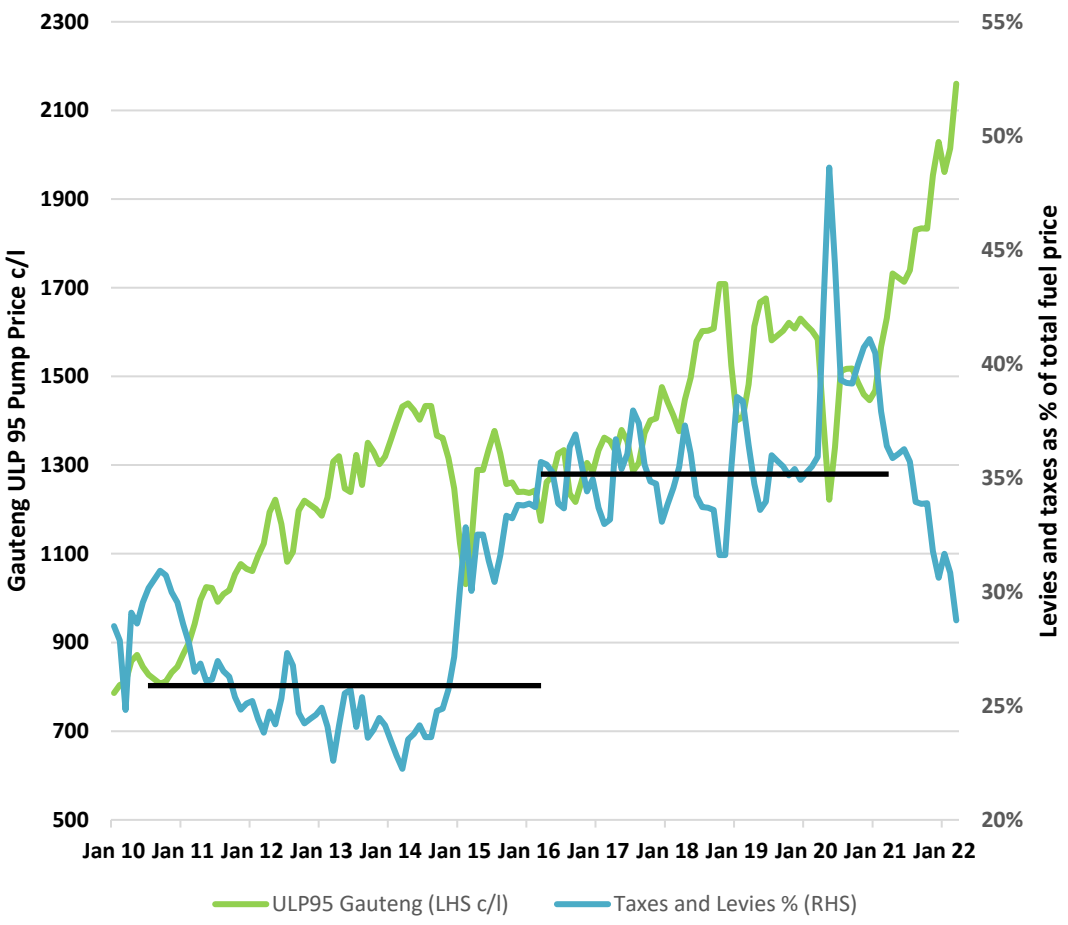
SAPIA considers there is little scope for adjustment without a complete review of the entire system and urges that the review started by the Department of Energy be fast tracked

Fuel Levy / Road Accident Fund and other levies

- Controlled by National Treasury and adjusted each year during April
- Levies paid by the oil industry to SARS based on dispatches from manufacturing warehouses or imports according to regulation in terms of the Customs & Excise Act
  - No charges levied by the oil industry for collection of these payments
  - Money recouped from the consumer on sale of product
  - Annually this amounts to ~ R130 billion
- The Fuel Levy includes a carbon tax on petrol and diesel which is set to increase to 9 and 10 c/l respectively from April
- The Customs and Excise levy, unchanged for decades, includes a nominal amount of refinery protection for locally manufactured product

The Fuel Levy is, in the consideration of SAPIA, the only significant area where relief is immediately possible – however this will impact the national budget and the shortfall will need to be funded from elsewhere

Levy History



Source: DMRE, NT, SAPIA

- History since 2010 consists of three identifiable periods (fortuitous ?)
  - Jan 2010 to Dec 2014 where levies were averaged around 25%
    - Levies steadily increased to maintain this level given the steady increase in fuel prices
  - Jan 2015 to Dec 2019 where levies were ~35% of the petrol price
    - Opportunity presented itself to increase levies while
  - Period post January 2020
    - Demand destruction in early 2020 saw levies reach close to 50% of the total price of fuel
    - Since that period levies as a% have steadily declined due to rise in prices
- Note South African taxes and levies are not exorbitant by world standards and vary widely
- Local taxes are higher than countries in the customs union which is why fuel in Botswana is cheaper

Self Adjusting Slate Levy Mechanism

- The self-adjusting Slate Levy Mechanism was introduced to finance the cumulative under recovery realised by the petroleum industry in respect to daily changes between the Basic Fuels Price (BFP) of all grades of petrol and diesel and the BFP applicable in the petrol and diesel and price announced monthly
  - Can be positive or negative dependent on market structure
    - In a rising price market, the slate will always be negative with the consumer owing the oil industry
    - In a falling market the slate will be positive – the oil industry owes the consumer
- Currently (end February) the cumulative under recovery was R5.102 billion resulting in a slate levy of 46.06 c/l according to the rules
- The industry slate balances are monitored by the DMRE and SAPIA and subject to audit and overall balance published monthly at the time of the press release

Without this levy oil companies will experience severe negative cash flows limiting the ability to purchase crude or imports which will impact security of supply

Basic Fuel Price

- The BFP, implemented in 2003, is;

"…the basis of determination of the **Basic Fuels Price (BFP)** are to represent the realistic, market-related costs of importing a substantial portion of South Africa's liquid fuels requirements,"

Which means determining the realistic costs of;

- Sourcing products meeting South African specifications from overseas centres
- Transporting this product by sea to South Africa in approved vessels
- Discharging this product into storage which includes the necessary costs of inspection, sampling, associated port costs, financing and storage
- It is not a true import parity as it does not model the cost of full importation of South African requirements
- More than 98% of the BFP is dependent on international factors, priced in US dollars, out of direct regulatory control and strongly dependent on exchange rates

Basic Fuel Price

- Working rules have been in place since 2003 and its construct exposes South African refineries to real world international pricing pressures which means;
  - South African oil refiners are not over - compensated for locally manufactured product
    - If it was the case, then expansions would have occurred to satisfy local and regional market demand – South Africa has been a net importer since 2006 !
    - Refining margins are slim and sufficient only to maintain operations
    - Refiners now seriously considering terminating operations in the light of new clean fuels regulations which are uneconomic to implement
  - Profits and losses can be made off BFP especially during times of international stresses such as piracy (freight), wars (increased FOB and insurance)
    - Currently there is a significant price disconnect between actual imports and BFP

The review started by the Department of Energy must be fast tracked - SAPIA submitted an expert report on this review.

Basic Fuel Price

- Elements in the Basic Fuel Price need to be reassessed from time to time and SAPIA actively encourages and supports that this be done to ensure that the model is truly reflective as it was designed
- Specifically, elements that need to be reassessed on a regular basis include
  - FOB elements – to ensure correct cargo assessments and pricing centres are used
  - Freight and Insurance – including the freight premium to SA ports as well as insurance to take into account temporary dislocations such as war or piracy
  - Demurrage – anticipated to rise due to projected increase in liquid fuel imports into South Africa as a consequence of Durban closures / pausings
  - Coastal storage – to ensure these are properly reflective of actual storage costs as determined by NERSA
- SAPIA does not control the BFP with <u>ALL</u> its price elements outside its control

Basic Fuel Price – reasons for recent increase

- The rapid increase in the price of fuel is attributable to BFP as a consequence of international events, which include;
  - The relaxation of the restriction on movements of people post the pandemic that has led to increased demand for all petroleum products – gases and liquids
  - Higher gas prices in Europe caused by a cold winter, less energy derived from renewables, increased demand for gas and consequent switching to other fuels
  - Compounded by Russia's illegal invasion of the Ukraine and the displacement of cargoes to Europe in anticipation of the potential widening of the conflict
- This has significantly impacted liquid fuel prices world - wide
  - There is nothing to adjust in the BFP in the short term to afford significant relief to the consumer
  - Any changes transfers risk to the importer with the significant possibility of stock outs if BFP cannot cover the cost of imports as is presently the case

What can / can not be changed in the short term

Pricing Element	Regulatory control	Possibility of change	Comments
Wholesale margin	Subject to RAS methodology	• Unlikely under current regulatory system • Petrol price fully price regulated - unilateral action impossible	RAS system needs periodic review and supported by SAPIA to ensure a just and equitable determination of margins
Secondary Storage			
Secondary Distribution			
Retail Margin			
Zone Differential	DMRE / NERSA	• Unlikely	Arbitrary reduction of TPL tariffs would affect TPL sustainability
Fuel Levies / RAF / Carbon levies	National Treasury	• Only realistic area for adjustment in short term	Any loss to Treasury needs to be recouped elsewhere
Slate Levy	DMRE	• Unlikely given rules governing slate	Any unilateral adjustment of the slate levy will affect security of supply
BFP	Elements approved by DMRE	• Unlikely in short term	Requires periodic review to ensure just and equitable

LPG and Illuminating Paraffin

- Both LPG and Illuminating Paraffin (IP) are price regulated to the extent that a maximum retail price is gazetted by the Minister
- Recent price increases for these fuels have the same underlying drivers as that experienced for petrol and diesel
  - In the case of LPG, the Saudi CP March contract pricing is now at an eight - year high
- For LPG, the maximum retail price has a significant number of local components related to distribution, cylinder management and allowable margins
  - Adjustments to these components requires study so as to not compromise the supply chain
  - For immediate relief, reducing VAT or waiving VAT in its entirety could be considered
- IP has a single maximum retail price but there is no VAT nor levies applied to this product making other forms of support necessary
  - IP is a fuel generally used by the poor and particular attention needs to be paid to support

Specific considerations are required for illuminating paraffin directed only at poor consumers

Summary

- Liquid fuels price control covers the entire value chain ex refinery gate / imports
- The BFP mechanism reflects a realistic cost of substantial imports into South Africa
  - Exposes both refiners and importers to international pressures
  - The methodology is almost wholly determined by international factors
  - Recent international events is the major reason for large price increases
- Allowable margins in the supply chain post refinery gate or imports are determined using approved methodologies from the DMRE
- Reviews across the supply chain should be conducted regularly to ensure efficient margin and price setting mechanisms

Summary

- The slate levy mechanism has to be retained to finance under recoveries as a consequence of the BFP pricing system
- Short term price relief for LPG consumers has potential through lowering or waiving VAT (there are no duties and levies on LPG)
- Innovative ways to offer short term price relief to IP consumers needs to be urgently considered since there are no levies or VAT applied to the product and it is a fuel used largely by the poor
- Outside a thorough review of the whole system, the only realistic short - term relief to consumers for main fuels (petrol and diesel) is through waiving levies and duties
- If levies, duties and VAT on products is reduced, the money will still need to found from elsewhere to balance the national budget

End

Thank you
Dankie
Ngiyathokoza
Ke a leboha
Ke a leboga
Ke a leboga
Siyabonga
Inkomu
Ndo livhuwa
Enkosi
Ngiyabonga

ADDENDUM – BASIC FUEL PRICE DETAIL

Basic Fuel Price – what this means

Pricing component	What this means	BFP component	Comment
Realistic Costs	Using reputable pricing agencies to price products	Free on Board (FOB) quotations from Platts ($ related)	To avoid periodic market distortions average of pricing centres used
Substantial Portion	This does not mean ALL product requirements		If ALL or most product was required the BFP would need to be reassessed in particular the freight and demurrage components. This is because if all refineries were shut down, South Africa would require a fleet of ~30 MR type vessels to service its fuel requirements. This is likely to increase freight rates due to ships dedicated to the South African leg
South African Specifications	Must meet local petrol and diesel specifications	Not presently accounted for	South African product is generally contra season to the pricing centres and seasonality (summer / winter) affects specifics qualities which all have pricing impacts

Basic Fuel Price – what this means

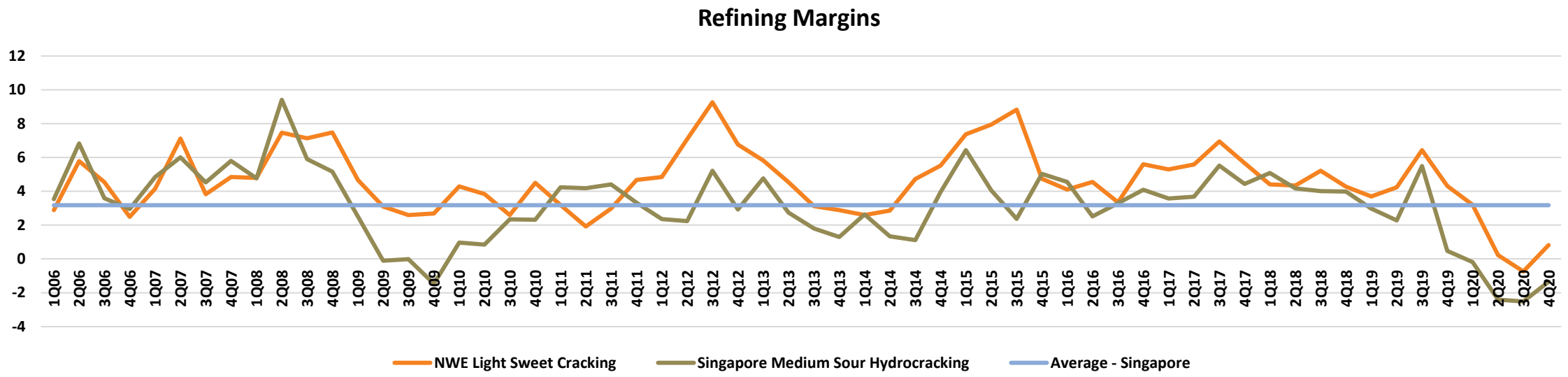
Pricing component	What this means	BFP component	Comment
Transport by sea	Movement in approved carriers that can be accommodated in local ports	Freight component ($ related)	Freight costs directly proportional to the size of the vessel – large SA ports can only accommodate MR type vessels (25 – 45 DWT).
Demurrage	Paying for time when the ship is not utilized according to agreement (charter party)	Demurrage – 3 days ($ related)	Demurrage for a voyage is for both loading and discharge and often exceeds 3 days especially if Durban is congested
Insurance	Insurance charges cover the vessel and cargo	0.15% of FOB cost plus freight ($ related)	This component also covers charges related to inspection, sampling, laboratory costs etc. Assumes carriage during peace time but insurance can vary significantly during war time / piracy / embargoes etc
Ocean loss	Losses occur as a consequence of cargo handling, remain on board, intermixtures etc	0.3 % on the sum of the FOB, Freight and Insurance values ($ related)	Unavoidable losses associated with carriage by sea and transfers onto and off the vessel

Basic Fuel Price – what this means

Pricing component	What this means	BFP component	Comment
Cargo dues	Charges from TNPA for use of port facilities	Presently set at 3.244 cpl (Rand related)	Adjusted annually by TNPA
Coastal Storage	Charges associated with storage in tank onshore	Currently set at 6.141 cpl (Rand related)	Originally based on 3 $/t per month for product and converted at current exchange rate and escalated at PPI. This NO LONGER reflects the real costs of storage of product which now amount to ~ 20 cpl. Maximum charges are regulated by NERSA
Stock Financing	Insurance charges cover the vessel and cargo	Set at Prime – 2% (Rand related)	This provision may not be sufficient for smaller importers who may need to provide for higher chargers

ADDENDUM – A NOTE ON REFINING MARGINS

Crude Oil Refining Margins



- Margins assume the processing of one crude oil through a refinery of typical configuration for the region
- South African margins typically follow Singapore – average refining margin since 2006 is $/bbl 3.2
  - Average margins for 2020 were $/bbl – 1.6 !
- Margins ($/bbl) are variable including energy costs but DO NOT include fixed cash costs such as labour, nor servicing of interest, nor maintenance expenses etc
  - In 2019 the total cost of labour for the four crude refineries was R2.5 bn which would equate to a fixed cash cost of ~ $/bbl 0.90 at R/$ 15.
  - Total fixed costs can amount to $/bb/ 2 – 2.5 making no room for expansions

Source: BP Statistical Review

South African oil refining

- The South African refining fleet is an important part of the economy (see link)
  - Provides significant employment directly and indirectly
  - Contributes to security of supply even though crude oil is imported
  - Contributes significantly to related industries such as plastics and road construction
  - Provides significant capital expenditure on an annual basis
- The refining fleet erroneously regarded as ‘old’ and ‘small’
  - Refinery size is suited to local requirements without having to compete for exports with larger refineries in India or the Persian Gulf – all refined product locally consumed
  - Refineries regularly maintained to ensure they are kept abreast of technological developments, efficiencies and ensure safe operations
  - A comparison of local refinery size finds that they fit within the mid range of the US refining fleet

https://www.sapia.org.za/portals/0/MediaStatements/SAPIA_EIA_Exec%20Summary.pdf