



UK Oil and Gas Fiscal Regime - Valuation of non arm's length sales of Gas

Discussion document

Publication date: 10 May 2011

Closing date for comments: 2 August 2011

Subject of this document:	Views are invited on possible changes to the tax rules within the UK Oil and Gas Fiscal Regime on valuing non arm's length (NAL) sales of gas.
Scope of this document:	The Government is considering whether to introduce changes to the current legislation which determines how NAL sales of gas are valued for the purposes of the North Sea Fiscal Regime.
Who should read this:	Companies (and their tax advisors) involved in the sale and purchase of gas within the North Sea Fiscal regime.
Duration:	The consultation will end on 2 August 2011
Enquiries and how to respond:	Any enquiries or responses should be sent to: Tony Chanter, Large Business Service Oil & Gas, HM Revenue & Customs, 3rd Floor North, 22 Kingsway, London WC2B 6NR
Additional ways to become involved:	HMRC will be inviting oil & gas companies, industry representatives and other interested parties to meet with members of the Oil & Gas Policy team in order to discuss the issues raised in the document.
What next:	Responses to this document will inform whether or not to recommend to Ministers proposals for amending the current gas valuation rules.

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1. The Process

This document is intended to start a discussion about possible changes to the gas valuation rules between HM Revenue and Customs (HMRC) and oil & gas companies, industry representatives and other interested parties. This process is being conducted in line with the principles outlined in the document "Tax policy making - a new approach" published alongside the 2010 Budget which sets out three stages for policy development:

stage 1 - set out objectives and identify options;

stage 2 - determine the best option and develop a framework for implementation, including detailed policy design; and

stage 3 - draft legislation to effect the proposed change.

This document is being issued during stage 1 of the process. The purpose of the document is to seek views on the suggested policy option and to identify any suitable possible alternative approaches, before consulting later on any specific proposal for reform.

How to respond

Responses should be sent by email, post or fax:

e-mail: Tony.Chanter@hmrc.gsi.gov.uk

post : Large Business Service Oil & Gas, 3rd Floor North, 22 Kingsway,
London WC2B 6NR

Fax: 0207 438 7602

Paper copies of this document or copies in alternative languages and formats may be obtained free of charge from the above address. This document can also be accessed from the HMRC Internet site at <http://www.hmrc.gov.uk/consultations>. All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000

(FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HMRC.

HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

2. Executive Summary

The valuation of non-arm's length (NAL) sales of gas for tax purposes has followed a similar process for more than 15 years – ever since the current legislation for valuing gas was introduced in 1994. Since that time the gas markets have undergone significant transformations and the era of the “life of field” depletion contract is long gone (although a few such legacy contracts still exist).

In addition the valuation of NAL sales of crude oil for tax purposes underwent significant changes in 2006 when legislation was introduced which provided that most crude oil values would be based on an average of published reported agency prices. This freed up a significant amount of resource and gave greater transparency to the valuation process.

In light of the above Large Business Service (LBS) Oil and Gas has undertaken a review of the current processes and methodologies adopted by industry for valuing gas to consider whether there are alternative ways of doing this, and in particular whether a price reporting agency-based approach could be adopted similar to that used in the valuation of crude oil.

The current method of negotiating with each company the value for tax purposes of NAL sales of gas is resource intensive and the process (dictated to a large extent by the legislation) does not lead to either a consistent or transparent valuation methodology. Consideration is being given to the use of a price reporting agency-based method and is the subject of this consultation.

HMRC will be inviting oil & gas companies, industry representatives and other interested parties to meet with members of the Oil & Gas Policy team in order to discuss the issues raised in this document. Responses to this document will inform whether or not to recommend to Ministers proposals for amending the current gas valuation rules.

3. Background

Most developed tax regimes apply some sort of transfer pricing legislation to transactions between persons made otherwise than at arm's length. That is, a value – usually referred to as a market value (MV) – is used for tax purposes and replaces the actual value used in the transaction.

For the UK Oil & Gas Fiscal Regime (from now on referred to as the Ring Fence Regime or just the “ring fence”) specific legislation exists to arrive at a MV for the non arm's length (NAL) sale of oil and gas. These rules apply only to physical (equity) sales of oil and gas by production companies and it is these rules that are under consideration. However the concept of equity sales within the Ring Fence Regime is extended to include appropriations where oil or gas is used outside of the ring fence for non-production purposes. An example of this would be oil used (but not sold) by a production company for refining purposes.

The Ring fence Regime consists of three taxes – Petroleum Revenue Tax (PRT), Ring Fence Corporation Tax (RFCT) and the Supplementary Charge (SC). The normal corporation tax transfer pricing rules at Part 4 of Taxation (International and Other Provisions) Act 2010 do not apply to sales within the ring fence which has its own specific legislation.

The current oil and gas valuation rules are part of the PRT legislation. However, any value that is agreed and used for PRT is then applied for the purposes of the RFCT and SC regimes by virtue of s280-285 of Corporation Taxes Act (CTA) 2010. Any changes to the valuation legislation will therefore have an impact on all taxes within the Ring Fence Regime.

When PRT was first introduced NAL sales and appropriations of both oil and gas were valued using the same legislation in Schedule 3 of Oil Taxation Act (OTA) 1975. Indeed for the purposes of the PRT legislation the term “oil” refers to both (crude) oil and gas. However for the purposes of this document hydrocarbons other than gas will be referred to as crude oil or just “crude”.

The first change in respect of gas valuation came with the introduction of section 134 and Schedule 18 of Finance Act (FA) 1982 in respect of ethane used for petrochemical purposes. This provided companies the certainty of using a long term basis for valuing gas in line with the contracts in place.

In 1986 this legislation was extended by virtue of Schedule 21 of FA 1986 to cover most light gases (except gas sales subject to an election under section 109). This applied to the predominantly long term contracts in place at that time but it became apparent that the legislation as extended was quite complicated in practice and could produce anomalous results. The FA 1986 rules now only apply to a small number of fields.

Para 3A

A new method of valuing light gases was introduced in FA 1994 by virtue of Paragraph 3A of Schedule 3 (para 3A). This applies to all sales of light gas on or after 1st January 1994 where light gases are defined as gas that consists mainly of methane or ethane or a combination of both. The only exceptions are ethane used for petrochemical purposes or gas sold under a pre 1 January 1994 contract and still subject to an election under section 109 FA 1986.

Para 3A values gas by deeming it to be sold under a hypothetical arm's length contract with a willing buyer subject to exactly the same conditions as the NAL contract. The hypothetical contract must require the gas to have been delivered and subjected to appropriate initial treatment before delivery. In practice this means that the gas meets the necessary national transmission system specifications.

The legislation also requires that the gas is valued at the place in the UK where a seller could be reasonably expected to deliver the gases. This means that the gas is valued "at the beach" or, in practice, at the gas terminal to which it is delivered.

Crude Oil

Valuation methods for crude oil have been subject to a number of changes since PRT was introduced but crude has always been valued by reference, either directly or indirectly, to the markets. Furthermore, for a particular delivery date, a single value is used irrespective of which company is selling the crude. Prior to 1st July 2006 NAL crude was valued by reference to arm's length (AL) crude sales carried out at or around the time of the NAL sale. Crude oil values were calculated in arrears by HMRC using information provided to it in supplementary returns. It was impossible for companies to calculate these values in advance of submitting their tax returns so all NAL crude oil sales had to be returned using estimations of HMRC's crude oil values.

For all sales of crude after 30 June 2006 FA 2006 introduced a method of valuation which uses an average of price assessments issued by three price reporting agencies. In this way any sale of crude on a particular day will attract a specific value based on known rules thus providing both companies and government with certainty as to what the imputed MV for a NAL sale will be. Because HMRC publishes these values in advance of the filing of returns companies are able to self-assess the values for their NAL crude sales when they make their returns.

Gas - details

Because Para 3A refers to a hypothetical contract and includes the phrase "having regard to all circumstances relevant to the disposal" a company/transaction-based approach is necessarily used. This contrasts with

the valuation of crude oil where the same single value for a particular delivery date is used by all companies. For gas the reference to a contract and circumstances relevant to the disposal points towards valuing the gas sold under a particular contract and hence for an individual company.

Sales at the beach

Para 3A requires NAL gas sales to be valued at the place in the UK where a seller could be reasonably expected to deliver the gases. Where there is more than one such place then it is the place nearest to the place of extraction. In practice this means valuing the gas at the terminal prior to entry into the National Transmission System (NTS) and this also reflects the expenditure legislation at section 3(1)(f) of OTA 1975 which allows transportation costs for the seller to that place or place of first landing.

Increasingly gas sales contracts are stipulating the place of delivery of gas to be at the National Balancing Point (NBP) which is a virtual trading location within the NTS for the sale and purchase and exchange of UK natural gas. This is the point of sale on which the quoted market prices are based. Where a NAL contract specifies the NBP as the delivery point then an adjustment needs to be made to value the gas at the terminal (sometimes referred to as “the beach”). However, as the capacity charges for entry into the NTS are published then this is a simple calculation and presents no practical difficulties.

Re-negotiating a valuation with a company

Once HMRC has agreed a market value for NAL gas sales under the terms of a contract then there is usually no need to renegotiate this during the life of the contract unless the terms of the contract are changed.

However if the contract is renegotiated so that, for example, the seller grants enhanced swing facilities¹ to the purchaser then this should be reflected in a change to the price. This would be an example where the gas value should be renegotiated.

Contract-based rules

Since para 3A looks at a hypothetical contract between third parties containing identical conditions to those in the NAL contract then the gas should be valued taking into account these terms. So for example this will include the amount of swing, force majeure rights, responsibility for non-delivery etc. HMRC’s published guidance at OT05390² gives a flavour of the implications for calculating the gas value; to take into account all of the factors is potentially very complicated.

¹ A swing contract allows one of the parties – usually at the behest of the purchaser – some flexibility in the amount of gas delivered. This is usually expressed as a percentage of what is normally delivered.

² Oil Taxation Manual at <http://www.hmrc.gov.uk/manuals/otmanual/OT05390.htm>

The point of principle here is that one should look for a similar arms length contract having as many of the features as possible of the NAL contract and having been agreed at a similar time.

However it may be extremely difficult (or impossible) to find an AL contract which contains the same or similar terms as those of the NAL contract under consideration. Changes in the gas market and an increase in the number of NAL contracts as compared to AL (which are often the older long term contracts) make this increasingly difficult and in practice gas valuation is a matter of negotiation. Whilst such negotiations will take into account the terms of the contract it is usually not possible in practice to find a similar AL contract and take that price.

4. Current Gas Valuation Method

There are essentially three elements to arriving at a market value for gas - the underlying market value, entry/capacity charges and any adjustment (discount) for risk of non-delivery effectively taken by the purchaser of the gas.

Underlying market value

Even if gas is sold at the beach (rather than at the NBP) a current contract (whether AL or NAL) will almost always reference its price to a quoted NBP based price. For most companies this will be either the Month Ahead (MAH) or Day Ahead (DAH) price from a recognised published market price such as Argus or ICE (International Commodities Exchange). Although currently entered into contracts are often for a period of a year or more the fact that relatively short period ahead prices are used reflects the fact that producers are reluctant to take on too much in the way of long-term pricing risk. One of the main reasons for this is because, all other things being equal, it is the producer who will bear the cost of failing to deliver the amount of gas specified in the contract. This is explored in more detail below.

Entry/capacity charges

A deduction is made from the NBP price to reflect the fact that the legislation requires gas to be valued at the beach (in practice at the gas terminal) and therefore entry capacity charges levied by the NTS owners are deducted from the NBP price. These charges amount to just over 1p/therm for St Fergus terminal and less than 1p/therm for the others. There is little difficulty here in that the entry/capacity charges are set by the NTS owners and are well understood.

Adjustment for Production Risk

This is the most contentious and difficult to value element of the gas price. The adjustment relates to the risk of non-delivery of gas by the producer. The buyer is usually committed to on-selling the purchased gas and needs certainty that the producer/seller will deliver the amount promised under the contract (often referred to as the DCQ "Daily Contracted Quantity"). If the producer fails to deliver the DCQ the buyer may have to go to the markets and buy additional gas to meet its obligations. This is not without economic risk as, depending on how much warning the producer is able to give, the buyer may have to buy gas within day, the price of which can be extremely volatile especially in winter in times of shortage.

In recognition of this the producer will typically pay a risk premium to cover the potential costs the buyer will have to incur in respect of non-delivery. Alternatively the contract might stipulate that the producer will incur financial penalties for non-delivery.

It is unlikely that the production company would be required to purchase gas from the market itself in the case of non-delivery and if it were to do so such costs would not be allowable for Ring Fence tax purposes.

All of these risks (as well as other risk-related terms within the contract such as swing facility or buyers/sellers nomination) will in theory be taken into account in arriving at the risk discount.

Other adjustments

Whilst production risk is typically the main factor to be taken into account in calculating the transfer of risk/reward between seller and buyer there are other factors to be taken into account. These include credit risk, market liquidity and price volatility but set against this is the opportunity afforded to the marketing company in exploiting movements in the gas market and selling the purchased gas at a profit.

Issues arising from current methodology

Resource cost

The gas markets are complex and gas valuation is a complicated process. To undertake a full root and branch review and agree a valuation methodology is not dissimilar to carrying out a full transfer pricing enquiry which would typically take many months of work with input from appropriate technical specialists.

Since the legislation requires HMRC and a company to consider the contract and all circumstances relevant to the disposal, inevitably each agreement between HMRC and a company is peculiar to the specific contract. It is therefore difficult to apply such an agreement to a different contract, different company and a different set of circumstances which therefore makes the current methodology very resource intensive.

Consistency and Transparency

There is quite a range of agreed gas values when looking across a number of companies and it is difficult to establish why this is so. One factor is the breadth of the commercial and contractual arrangements adopted by companies which are accommodated within the current methodology. However, such a methodology does not lead to easy comparability between companies, which is in sharp contrast to the effect of the single price method adopted for valuing crude.

Some valuation methodologies agreed have their basis in history with perhaps relatively small subsequent changes to the underlying contracts. However after a number of years and many such minor amendments the position may

differ considerably from that existing when the methodology was first agreed. It can sometimes then be difficult to reconcile the current position with that of a similar contract entered into more recently by a new entrant to the North Sea.

However this lack of consistency and transparency is perhaps more a reflection of the difficulty in valuing a contract which may be unique in the context of the terms and conditions relating to that contract. As already mentioned this difficulty is a reflection of the problems inherent in finding an AL contract with similar terms – in fact in practice such AL comparators usually cannot be found.

For HMRC the lack of transparency and consistency makes it very difficult to assess the fiscal risks associated with gas sales.

5. Alternative method for valuing gas

One alternative to valuing gas on a contract by contract (and thus company by company) basis is to adopt a price reporting agency based methodology. Using a similar method to that for valuing crude oil (for which relevant legislation was introduced in FA 2006) gas valuations could be based on one or more sets of published prices. Such an approach would appear to address the issues identified with the current method.

The method would be transparent because it would rely on publicly available prices. There would also be consistency in that all companies would use the same MV for gas sold on any particular day. It would also remove the need for lengthy negotiations between industry and HMRC, thus freeing up valuable resource.

Industry engagement

There has been some engagement between HMRC and industry on this issue, both with industry representatives and with individual companies. Industry recognises the resource issues inherent within the current methodology but has a number of concerns with the alternative basis proposed.

One concern is that gas differs from crude in that a gas producer needs to guarantee physical delivery of gas often months in advance. Thus it is argued that the MV needs to reflect an adjustment to cater for the risk of non-delivery taken on by the purchaser of the gas. Industry further argue that each purchaser bears a different amount of risk depending on the terms of the contract and the size and nature of the group's portfolio.

For example a gas producer with a single gas field will present more risk to the purchaser than a producer with say ten fields. The producer with ten fields can offset the risk of a loss of production of one field with production from the other nine fields whereas the single field producer cannot hedge this risk in such a way. Thus adopting a reporting agency-based MV, even if it reflects a discount for risk, will not cater for the different levels of risk.

Against this it could be argued that a purchaser will look to buy gas as cheaply as possible and will look for the best deal regardless of where the gas is sourced. There is also further debate to be had as to the extent of the differentiation in risk between one gas producer and another.

Another concern is that there are long term NAL contracts where the pricing formula as originally agreed is not referenced by current market prices. For such contracts it may not be appropriate to impose a market-based formula and in such circumstances consideration might be given to carve out certain contracts from any new rules and agree (or retain) a separate valuation methodology. There is a precedent for this in the current crude valuation rules in that "Category 2" blends of crude oil are taken outside of the main

“Category 1” price reporting agency-based method and a value agreed separately.

Issues to be considered.

Whether to value gas at the beach as is the case currently or amend the legislation to value at the NBP. Valuing at the beach means that the valuation of gas is consistent with that of oil although does not reflect the fact that the gas markets value gas at the NBP. However valuing gas at the NBP would mean that the expenditure rules would need to be amended to allow further transportation and entry capacity costs with a resultant mismatch with the methodology for crude oil (which would still be valued at the beach). There might also be a knock on effect in connection with the deemed tariffing rules on gas sold offshore.

What market prices to use. Many companies seem to favour a MAH based price although there are concerns by some companies that this would not be flexible enough. For example a MAH approach might not be suitable in say 10 years time when the markets might have changed. An alternative would be to use a weighted average of MAH and DAH prices to reflect the fact that companies tend to sell most of their gas forward (e.g. MAH) with the balance being sold closer to, or at, DAH prices. Another suggestion is to have an option to choose from a basket of quoted prices to best reflect individual circumstances.

Whether to include an adjustment for production risk and, if so, how this should be arrived at. One option is to negotiate a risk discount as is done now. But this would defeat one of the objects of the exercise in that there would be little reduction in resources used as the need to negotiate with companies on an individual basis would remain. Alternatively one could adopt a fixed adjustment (say 0.5p per therm of gas sold) or a percentage (say 1 per cent) of the MV used.

6. Summary of Views Sought

HMRC would welcome the views of industry on the possible adoption of a price reporting agency-based valuation method for valuing sales of NAL gas. Questions to be considered include:

- Is the approach suggested in part 5 the most appropriate one available and can industry suggest alternative options, bearing in mind the issues raised in part 4?
- What problems does industry envisage with such an approach and what can be done to overcome these?
- What views does industry have on the market price or prices to use?
- In what circumstances should a Category 2 type of carve-out be used?
- How should an adjustment to reflect production risk be computed?
- Should gas continue to be valued at the beach or alternatively at the NBP?