HMRC - OT05012 - PRT: Computations - Outline

Oil (excluding light gases) valuation mechanisms were changed entirely by FA2006\S146, S147 and Sch18 with effect from 1 July 2006. These rules introduce mechanisms for calculating a series of daily values for all kinds of oil (other than light gases).

Reason for the change of legislation:

The mechanism introduced by FA87 was not capturing the full market value, for reasons explained below. The FA87 rules could not be modified to correct this, so a radically different set of mechanisms was introduced to solve this.

Background:

FA87 made major changes to the way that oil was valued for disposals not at arm’s length. Each kind of oil had a monthly value calculated for it, based upon contracts for delivery of oil in a specified month “M”, entered into in the six week “valuation reference period (VRP)”, starting at the beginning of the month preceding month M, and ending half-way through it.

It was recognized that this mechanism was at the root of certain behaviours by larger oil companies aimed at minimizing their PRT.

The minimization technique depended upon the ability of a company to sell its own production (“equity oil”) either into the market on arm’s length terms (AL) or to transfer their equity production internally, not at arm’s length (NAL). Only larger integrated oil companies could play this game, which was also associated with other avoidance type behaviours using the forward market (see OT05200 concerning the revised Nomination scheme) and their ability to choose which field a cargo of blended oil was purported to have been derived from (see guidance on attribution of blended oil at OT05800).

The six week VRP allowed a company to predict what the tax value or “tax reference price (TRP)” would be with increasing accuracy as the VRP unfolded. Combining this prediction with an informed view of what the AL market price might be in the short term allowed a company to decide whether to sell its equity production AL or NAL.

As an example - see

Conversely, for example - see

Another complication was the need to nominate an AL sale (technically they had to nominate NAL sales, but whether they did or not had no practical effect) to the Oil Taxation Office (as it was called up to April 2001) under the conditions imposed by the nomination scheme. Given their view of what the market price would be doing in the short term, traders could “spin” their trades and only nominate when they thought that the market had reached a local minimum price (that is, they thought that it would go up within the next day or so rather than down).

Research carried out by LBS Oil & Gas sector (the successor to OTO) in 2005 showed a significant “tax-gap”. Proposals were put to industry in a discussion paper of July 2005. After discussion with industry representative bodies, the new valuation rules in FA 2006 and the associated secondary legislation were introduced with effect from 1st July 2006.

The source of the problem was the long VRP that allowed the TRP to be predicted in advance (a phenomenon called “stale price arbitrage”). The solution was to remove this predictability by shortening the VRP. The detailed solution was to mimic the pricing clauses seen in genuine AL sales contracts.

These use a period of 5 days around a real or deemed loading date (“Bill of Lading” or BoL). The most popular period was the two days immediately before the BoL, the BoL itself and the two days immediately after it; the so-called “2-1-2” method. By following this method, the period of time in which the TRP can be predicted is greatly reduced, thus greatly curtailing the element of certainty that emerged towards the end of the old six week VRP. Further, the prices that are produced are a much closer reflection of the price in the market than the old six week average was

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