HMRC - OT05030 - PRT: Computation - The Arms Length Rule - Examples

Example 1

A is a participator in field X but prefers to run oil from field Y through its refinery. A therefore enters into a contract with B, who has a supply of oil from field Y, whereby their respective liftings are exchanged. The agreement is recorded in a telex that describes the transaction as an exchange. A must pay B 20c per barrel to reflect the differing qualities and availabilities of the two crudes. The same number of barrels are to be exchanged but prices are agreed for each crude to enable a cash payment to be made to correct any unavoidable imbalances.

Under the above arrangement, A disposes of his equity in consideration of a supply of oil from field Y less a cash payment in respect of the quality etc. He receives no money consideration as such (apart from possibly some balancing payments). This is one transaction - an exchange - and the disposal of equity by A is not by way of sale. It falls within OTA75\S2(5)(b).

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Example 2

A and B are participators in field X and enter into an agreement to swap their entitlements of propane. A exchanges his May entitlement for B’s June entitlement. Equal volumes are to be exchanged, any unavoidable differences to be made up as soon as possible.

The agreement is recorded in a telex that describes the transaction as a swap. B pays A for the May lifting at the mean of the SSP and BPAP on the BOL date, within 30 days of that date. A pays B for the June lifting under the same terms. So, full cash payments are made at market rates by each party.

It may be argued that each party has sold its propane as it receives full cash consideration. Nevertheless this is one transaction and prima facie an exchange rather than a sale. The cash payments may be thought of as a mechanism for compensating A for the loss of one month’s cash flow and for recognising the possibility of a movement of prices between the delivery dates.

In practice companies accept that equity disposed of in transactions such as this are assessable at the statutory market value as in any event the disposals do not satisfy the conditions in OTA75\Sch3\Para1 (see below).

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Example 3

July Brent is shown on the IPE screen at $16.50 and August at $16.40. A thinks that the inter- month differential will shorten but B takes the opposite view. A and B therefore negotiate a July\August spread deal at $0.10 payable by B. This is commonly referred to as an inter- month spread deal. Although it is negotiated as one deal (normally on the basis of a price difference), there are usually two contract documents i.e. A sells July Brent to B and B sells August Brent to A, each with its own price ($16.50 and $16.40) and each leg of the deal may enter separate chains or be booked out in separate circles. A and B may close their positions with each other or with other parties.

As there are two contract documents each with separate destinies there are arguably two sales. Again however it is essentially one transaction - a spread - which is an exchange. The parties are indifferent to the absolute price of oil.

In practice companies do not use spread deals to dispose of equity as it is generally accepted that these deals fail to meet the conditions in OTA75\SCH3\PARA1 (see below).

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Example 4

A wishes to sell an equity cargo from field X with a delivery date in four weeks time, 15 March. He finds a refiner willing to take the cargo at these dates. As far as price is concerned, A would prefer to delay for a few days as he expects prices to rise. B would like the price to be determined at the date of delivery. But both want to secure the deal today.

So a price is agreed on the basis of the IPE screen price for April Brent plus\minus differentials to take into account the inter-month and quality differences. This deal is conditional however on a second transaction where B sells to A April 15-day Brent at the same IPE screen price. Two contract documents are drawn up, one for the field X oil and one for Brent.

As there are two contracts with separate destinies there are arguably two sales. Again however this is essentially one transaction whereby A and B exchange wet oil from field X and 15-day Brent. By the nature of the transaction, the two parties are indifferent to the absolute price of oil as represented by April Brent.

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Example 5

The facts are as in Example 4. A wants to sell wet oil to B. But the hedging transactions are carried out with two independent parties, C and D. A buys April Brent from C, and B sells April Brent to D. There is no corresponding transaction between C and D and no one broker is involved in all three transactions. A and B put each other on hold until their hedging transactions are lined up. The three transactions are then carried out simultaneously to avoid exposure to price movements.

In this case there is no exchange between A and B and as there is no linking transaction between C and D, no exchange around a circle. B has, with separate parties, exchanged a long wet position for a long 15 day position but this change of position has been achieved by two separately negotiated transactions. A and B must be interested in the absolute price of oil as they must use this not only in the transaction between themselves but also with their respective counter-parties in the hedging transactions.

Is the sale of equity a sale at arm’s length.

In a transaction that does involve a sale it is necessary then to examine whether the various conditions are satisfied.

In Example 3 above, suppose that A disposes of equity in the July leg of the spread. Even if the deal is regarded as two separately negotiated sale transactions, the consideration for A’s sale is not just the price of $16.50.

A would not enter the sale without having B’s agreement to the reciprocal transaction and vice versa. There is a mutual exchange of promises which constitutes consideration, additional to the prices in the contracts, and in neither case is the first condition in Para1 satisfied. Also the terms of each sale are affected by the wider bargain in that there is an implied condition in each transaction that the reciprocal transaction is effected; or alternatively, it could be argued that the terms of each sale would not exist but for the other transaction.

The same arguments apply in Example 4 but Example 5 is somewhat different. In this latter case there is only one transaction between A and B and no circle around which an exchange of mutual promises can be made. So there is no consideration other than the price, nor is there a wider bargain between the parties (or of which the parties are part) which can affect the terms of the transaction. In practice a careful examination of all the facts would be necessary but unless there are some other factors present, it is likely that the sale from A to B would qualify as arm’s length.

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