HMRC - OT05455 - PRT: Valuation Of Non-Arm's Gas - Gas Substitution Within An Allocation Agreement - Example

Take two fields, A and B, where a substitution agreement is in place. In period 1 A has excess gas production. B has no production in the period but has a contract to supply gas to a third party. To satisfy the contract B borrows A’s excess gas and then repays the gas in period 2.

The first approach, treating borrowing and repayments as disposals

In period 1 A has produced gas and has disposed of the element ‘lent’ to B. The gas is clearly delivered to B but not under a contract of sale. The gas has therefore been disposed of otherwise than in a sale at arms length within the terms of OTA75\S2(5)(ca). Under this section there can be no PRT liability on B as that field has not won any oil to be brought in to charge, although it may have disposed of gas in a sale at arm’s length.

Similarly the reverse situation arises in period 2 when B repays its ‘borrowing’: no PRT liability arises on A, who disposes of the gas to an end user but liability does arise on B in respect of its production.

The value of the gas disposed of under the substitution agreement is the market value ascertained in accordance with OTA75\SCH3\PARA3A (OTA75\S2(5)(ca)) or under the terms of an election under FA86\S109 if appropriate.

Alternative approach for commingled stream

The second possible approach can only apply to fields within a commingled system. The argument here is that substitution agreements are part of the commercial allocation arrangements between fields, which are recognised for PRT purposes under FA87\S63 and SCH 12 (see OT05600). Thus, when a field finds itself unable to meet its obligations to a buyer, it is temporarily allocated additional gas from the system which it must repay within the time allowed. In the example above therefore, when B ‘borrows’ A’s gas, the gas in question is attributed to field B and not A, with the converse applying on repayment.

Although gas allocation systems and substitution agreements have common features, there are usually many differences in the detail. So each system and agreement needs to be examined on its own facts. Where however an allocation system (accepted for the purposes of FA87\S63) includes a substitution agreement designed solely to ensure that participators can continue to meet their buyers’ contract nominations during temporary operating difficulties, LB Oil & Gas accepts the substitution agreement as being within the allocation procedure provided:

the gas borrowings are balanced at least once a year, and

the amounts available for borrowing are subject to appropriate limits, and

the arrangement does not lead to a permanent transfer of value between the fields.

The consequences of the acceptance of such arrangements for PRT purposes is that the responsible person and the participators should return on forms PRT2 and PRT1 any gas ‘borrowed’ as the production of the borrowing field and, conversely, repayment gas as production of the original lender. This allocation will also apply for oil allowance purposes - (see OT17000).

It follows then that there is no disposal by the participators in one field to the participators in another and if the disposals to the buyer are otherwise arm’s length under OTA75\SCH3\PARA1 then there is no question of the sale price being displaced by the market value.

The arm’s length rule operates in the normal way, but substitution arrangements can be within FA87\S63 whether or not the gas is disposed of arm’s length or non-arm’s length under the normal operation of the rule.

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