HMRC - OT19025 - PRT: Appendices - Valuation Of LPG

The approach of the OTO for valuing LPGs under FA87\Sch11.

1. GENERAL

UKOITC (The United Kingdom Oil Industry Committee, formed in 1965) Paper of February 1988 as amended and agreed by OTO, referred to at OT05345.

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1. GENERAL

This note only relates to the valuation of LPGs and does not cover condensates, methane or ethane.

The market valuation rules in OTA75\Sch3\Para2 as amended by FA87\Sch11 apply to NAL transactions and apply for chargeable periods ending after 31 December 1986. The terms of the hypothetical contract are set out in sub-para (2).

LPGs are significantly different from crude oil and are blended in a significantly different way. In the OTO’s view these differences make the (2C) method of valuation (i.e. average of daily average prices for each business day in the VRP) inappropriate for LPGs even if it were practicable. An alternative method of valuation under (2D)(b) is proposed.

It is the objective of the OTO to use their approach for valuing LPGs for the immediately foreseeable future.

The object of the valuation exercise is (as for crude oil) to arrive at a value for a month which represents the price at which propane (or butane) might reasonably have been expected to be sold under a contract which fulfils the Conditions.

Inter alia, the Conditions include the LPG to be delivered FOB at the pipeline terminal.

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2. DISTINCTIONS BETWEEN LPGs AND CRUDE OIL

For IH87 disposals of LPGs have been predominately concluded on term contract basis, although there have also been some spot disposals which can be of significant volumes. The volume of LPGs sold spot has varied from month to month.

Disposals of LPGs under term contracts tend to be priced by reference to the BP agreed price, the Shell scheduled price, or a combination of the two, prevailing at the time of delivery. This contrasts with crude oil where spot contracts predominate and the price is more commonly agreed at the time of concluding the contract.

There is not the cyclical pattern of trading over the 45 day VRP in LPGs as there is in crude oil.

Unlike Brent, a sophisticated paper market has not yet developed for LPGs. In consequence, there is not the multiple trading of cargoes which is a feature of crude oil trading.

The Industry has informed the OTO that LPGs are sold in a two tier market. Tier 1 is said to be the sale of LPGs by producers to intermediaries, usually on FOB terms. In Tier 2 it is said the intermediary may provide specialised storage, balance steady supply against fluctuating demand, provide specialised transport (Tier 2 sales are usually on CIF terms), etc and this may be reflected in the on sale price to the end user.

The OTO recognise to some extent that a two-tier market exists but the distinction in some cases is not clear cut. If for example one producer sold equity LPGs to another who did no more than combine them with his own equity LPGs and on sold a larger volume both prices seem to represent Tier 1 transactions. Similarly if a producer transferred his equity to an affiliate who merely on sold it for him that on sale price would seem to be a Tier 1 transaction. The OTO would like to talk to the Industry to clarify where the boundary between Tiers 1 and 2 lies (see 7.2 below).

From the UKOITC/OTO meeting on 11 February 1988, the OTO noted that the industry did not necessarily agree with the definitions of the two tiers and this will be included in the discussions (see sub-paragraph above).

The quality specifications of propane or butane from different fields are substantially the same and there are not, currently, pricing differences for LPGs delivered FOB at different terminals. In the circumstances, the OTO intend to provide only one market value for each of North Sea propane and North Sea butane.

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3. DATA BASE

The information available to the OTO on which to base valuations is as follows:

Returns of arm’s length disposals of equity by participators from PRT 1 return forms.

Returns of arm’s length non equity sales and purchases by participants from the PRT1A return forms.

Returns of arm’s length disposals and purchases by UK associates of the participator from PRT1A return forms.

Details of arm’s length disposals and purchases by foreign associates of the participator from the information supplied by participators on an informal request of the OTO.

Details of arm’s length disposals and purchases by foreign associates of the participator from replies to notices under FA84\S115 should it be necessary to issue them.

The information reported to the OTO will consist of actual prices under spot and term contracts. The OTO intends to bring into the database as evidence of the price at which LPGs could be sold any contract which satisfies the Conditions (or can be adjusted to correspond thereto).

The information reported to the OTO will also consist of Tier 1 and Tier 2 prices. Prima facie, Tier 2 prices are capable of inclusion in the data base. For the time being however the OTO intends to exclude Tier 2 prices in arriving at valuations (but see 2.5 above).

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4. APPLICATION OF (2C) METHOD OF VALUATION TO LPGs

The (2C) method of valuation is to be used unless it is impracticable or inappropriate so to do. For the reasons set out below it is not considered to be appropriate for LPGs for the immediately foreseeable future.

If the (2C) method of valuation were to be used, there will be some prices to include (under (2A)(2B) in the 45 day database which relate to sales made by producers and their associates under contracts which satisfy the Conditions.

To these could be added (under (2D)(a)) prices under other contracts which could be adjusted to correspond to the Conditions. For example, a CIF price could be adjusted to an FOB one or a price for non-standard credit terms adjusted for standard ones if there is sufficient information available to do so.

However, for many term deliveries of LPGs the price is determined at the time of delivery. This has two undesirable consequences for the (2C) method of valuation. Firstly prices under term contracts for delivery in the 2nd half of the month of delivery would not satisfy the conditions in (2B) and would be excluded; being prices determined outside the VRP. Secondly, since all (or almost all) term prices are determined in the month of delivery, there will be few (if any) term prices in the VRP for days in the month preceding that of delivery.

Because there is not a developed paper market for LPGs the number of spot transactions is much smaller than for crude oil so the database will be small in this respect. Further, there is not the same developing pattern of sales for deliveries in the valuation month during the VRP. Apart from the practical difficulties it is the absence of this pattern which makes the crude oil method of valuation using the 45 day VRP inappropriate for LPGs.

For the business days in the VRP for which there are no prices reported to the OTO from which to establish a daily average price it might be possible (under 2D(b)) to impute daily average prices having regard to other information. There will be prevailing BP agreed and Shell schedules prices for LPGs and there may be some published information on prices.

However, leaving aside the practical difficulties in imputing prices, it is not appropriate to do so. This method would bring into the database imputed daily average prices (largely in M-1) while leaving out actual term prices for the second half of the valuation month. A further and in this context undesirable aspect of the (2C) method would be to give as much weight to a business day on which a low volume spot deal has been done as to a day on which several term prices representing a much larger volume have been included in the database.

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5. APPLICATION OF (2D)(b) TO LPGs

In looking for a method of valuation which is ‘appropriate in the circumstances’ under (2D)(b), the first step is to include all Tier 1 spot sales entered into in the relevant VRP where the contract satisfied the Conditions.

To the information in 5.1 will be added Tier 1 contract prices for deliveries at any time in the valuation month. To be included the contract must still satisfy the (2A)(2B) requirements, other than (2)(c) of the conditions or be capable of suitable adjustment, to correspond to them (e.g. CIF to FOB price).

A volume weighted average will be taken of all prices included in 5.1 and 5.2 above to produce a market value for the valuation month.

Paragraphs 5.1 to 5.3 above were superseded following a meeting on 12 May 1988. The position is now as follows:

For a month, the market value will be the weighted average of all Tier 1 contract prices for delivery at any time in that month. Contracts will be included if they satisfy the (2A)(2B) requirements, other than (2)(c) of the conditions, or be capable of suitable adjustment to correspond to them (e.g. CIF to FOB price).

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6. INFORMATION DISSEMINATION

The OTO will supply their market values as before to participators who have a direct interest in such values for those months and for those LPGs for which valuations are required.

The OTO agreed to provide the ratio of arm’s length sales to non arm’s length sales for propane and butane separately.

Although not agreeing to supply any other information, the OTO agreed to consider the supply of other ratios, if appropriate.

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7. MEETING WITH UKOITC

Upon hearing the above approach from the OTO at a meeting on 11 February, UKOITC expressed its concern on a number of aspects and agreed to reply when the OTO position had been confirmed in accordance with the above.

UKOITC accepted the OTO’s invitation to discuss the details (both theoretical and practical) of the 2 tier market and agreed that discussions with individual companies would be the most practical route. The OTO will arrange such meetings as appropriate.

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