HMRC - OT19040 - PRT: Appendices - Review Of LPG Methodology

The review of LPG methodology in 1994 referred to at OT05345.

Letter from UKOITC to OTO 27 April 1994 - VALUATION OF LPGs

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Thank you for your letter of 12 November. I am sorry for the delay in replying but it has taken us some time to give this issue the detailed consideration required. Much of this consideration is contained in the attached background paper surveying the current state of the market.

UKOITC believes that the current methodology agreed in 1988 is still appropriate for the following reasons:

VOLUME OF CIF SALES

Whilst the total number of CIF sales in the market may have increased in recent months they still represent only a small proportion of Tier 1 transactions.

INCLUSION OF SPOT SALES

Given the overriding need for security of offtake, spot sales of equity are very much the exception. There is a strong chance that such sales would be distressed because of the way the product and shipping markets work, and they could not be assumed to be representative of the market as a whole.

NETTING BACK

(i) loading ports,

(ii) discharge ports,

(iii) single and multiple discharges

(iv) spot charters and time charters

(v) small and large parcel sizes

(vi) smaller and larger time charter volumes

(vii) longer and shorter time charters.

These effects are more pronounced than in the crude market resulting in a wide band of actual shipping costs from $10 to over $20 per ton. Extrapolating back to a single representative value would be extremely difficult. Currently, small players tend to sell to companies with a large shipping presence, creating economies of scale which result in higher prices for Tier 1 sales. If freight costs were deductible for netting back, this would no longer be so relevant and the result could be higher freight and a lower tax reference price.

LPG MARKET

The volume of LPG produced in the North Sea has been increasing over the last twelve months, and will continue increasing this year. As the attached background paper shows, the gap between CIF prices and the FOB prices posted by BP and Shell has been decreasing and the increased production levels will almost certainly maintain this. The increased volumes and numbers of players will probably increase the size of the database and will underpin for the foreseeable future the representative nature of BPAP and SPP.

In view of the above, we recommend that the status quo be maintained on the valuation of LPGs subject to further review if it becomes clear that the market has not developed as outlined above over the next 12-18 months and there are significant variations between the tax reference price and BPAP and SPP.

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UKOITC paper of April 1994

For equity producers the most important factor to be considered in disposing of LPG is still security of offtake. Although propane and butane are valuable in their own right, the potential impact of shutting in oil production form a field through failing to have product lifted in a timely fashion dwarfs the revenue obtainable from LPG sales.

In addition, the limited nature of LPG storage means that it is much more difficult for individual owners to accumulate production over a period of months in order to lift a viable parcel than is the case on crude oil. Since terminal operators retain the right to insist that production be lifted in any month, most producers with insufficient production to make up a full cargo each month tend to sell their product FOB to a larger participant who can manage the operational problems. There is thus a sizeable amount of North Sea production sold on a term basis by equity producers, and as production levels in the North Sea increase (and the number of fields using each terminal increases) this is likely to rise.

The majority of such contracts are based on one or both of the posted prices (the Shell Scheduled Price or SSP and the BP Agreed Price or BPAP). Whilst the exact method of arriving at each price may differ in details, the overall approach is the same, namely that on the last day of each month BP and Shell separately agree with their suppliers and customers what a fair price would be for the next month. This is based on the evidence of deals done FOB and CIF in recent history for delivery in the relevant month with other factors being taken into account such as any abnormal qualify cargoes, distressed buyers or sellers in any of the past transactions, timing of deliveries and, if relevant, relative values from other markets from which product might be imported or to which product might be exported. The current market views of likely trading ranges might also be considered, but generally speaking the factual evidence of deals done is given greater weight.

In most months, there are more spot CIF deals than spot FOB deals and an important part of the monthly discussion centres around the FOB-CIF differential. For certain deals, the parties may try to assess the freight applicable to that deal, since some ports are known to have higher costs than others and some local sales may have relatively low freight. Where a number of cargoes have been sold into more or less “standard” ports such as Rotterdam, Teeside etc. then it may be easier to arrive at a general assessment of the CIF price and then deduct an assessment of the typical freight cost that would be incurred between North Sea terminals and those ports. This assessment tends to be based on term freight contracts rather than the spot rates, and the FOB-CIF differential thus tends to move more or less in line with the long terms freight market. The graphs attached show that between 1990 and 1993, the CIF-FOB differential has narrowed substantially reflecting a steady weakening in time charter rates for LPG tankers.

Describing all these elements which go into the setting of SSP and BPAP may make it sound like a very mechanistic process. In fact, a large amount of interpretation and commercial judgement is needed in order to synthesise all the available information into a single price. The check on the system is that the negotiations are between buyers and sellers in each case, and each side will ensure that incorrect, misleading or spurious information presented by the other side is discounted. Through this process, the system takes into account all the available information from the FOB and CIF/ex ship markets, and it is because of this that buyers and sellers are confident that the posted prices represent a fair market reference price.

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Letter from OTO to UKOITC 24 May 1994 - Valuation of LPGs

Thank you for your letter of 27 April. We are grateful for the paper and for the input of companies during the review.

We have now completed our review of the market and are content that the methodology agreed in 1988 remains appropriate for valuing. Your agreement to this is noted and valuations for 2H1993 will be issued using the current methodology. However, there are a couple of points arising from your letter.

From the review of the market it does not appear that the central features identified in the discussions in 1987/88 have altered materially; security of offtake, cost of infrastructure required and the complexities of freight remain the major determinants of trade in LPG. This is reflected in your letter and paper. Furthermore, companies have argued that the difference between OTO and posted prices will diminish as North Sea LPG production increases over the next two years. If, however, despite this increase, significant variations continued and the nature of the market remains as described above, I see no reason for further review of the methodology.

In view of the variation between OTO and agreed prices at present I do not consider that a proposal under SP14\93 for the disposal of LPGs reflecting posted prices and no premium would be appropriate. If companies wish to proceed under the Statement of Practice we would be pleased to discuss the matter with them.

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