



Treasury Chambers, Parliament Street, SW1P 3AG

01-~~XXXXXXXXXX~~ 233 4749

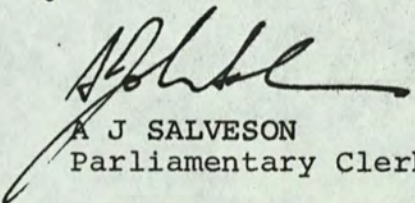
13 July 1982

*Dear Member*

FINANCE BILL 1982 - REPORT STAGE

The Chancellor of the Exchequer has asked me to let you have the attached background paper on Clause 129 and Schedule 16.

*Yours sincerely*

  
A J SALVESON  
Parliamentary Clerk

BACKGROUND TO CLAUSE 129 AND SCHEDULE 16

1. Where a deal is at arm's length the Inland Revenue has to accept the actual price determined by the contract as the basis for taxation. Where contracts are under long term price formulae, tax follows the formula, even if other deals in the same commodity take place over the period of the contract at widely differing prices.
2. In the crude oil and naptha markets arm's length deals are made either under spot contracts at prices agreed for each separate delivery or, more commonly, under term contracts where prices are renegotiated at frequent intervals (usually, once a quarter).
3. Arm's length sales of light gases such as ethane are normally by long term contract. These contracts typically incorporate a base price and an escalator which will change the price over the duration of the contract in accord with some published price index (or combination of price indices). The reason for these long term contracts is the need both parties have for a fair degree of certainty when they have to tie up large amounts of capital investment in a single deal, and when alternative dispositions are difficult to make once supply arrangements are fixed.

4. Non-arm's length deals in North Sea hydrocarbons are valued on the basis of the price the particular oil and gas concerned would fetch in an arm's length deal between independent parties. This accords with a principle which is internationally accepted for tax purposes and which is preserved in Clause 129. The existing legislation however prescribes valuation on a current monthly basis. This is appropriate enough for spot or term deals where there is a single price or the price is re-negotiated frequently. But it is less appropriate for the sort of gases where long term pricing formulae are adopted in arm's length deals.

5. What Clause 129 does is to put inter-affiliate deals on all fours with arm's length transactions by enabling them to be valued according to a long term pricing formula provided it is comparable with the sort of formula which would have been agreed in a comparable arm's length deal for the same volumes of ethane, over the same period. It is a measure to preserve the arm's length principle, by ensuring that non-arm's length deals do not face a greater degree of uncertainty on price and valuation than arm's length deals. It does not of course remove all uncertainty on price in relation to an inter-affiliate deal. Some uncertainty is inherent (as it would be in arm's length transaction) both in the future movements of the escalator and in the provisions for review after 5 years. On the other hand, since the clause aims to reflect the position of arm's length deals, it does not, and should not, neutralise any real competitive differences which may arise from the availability of different forms of feedstock.

6. The clause therefore retains the arm's length principle which is the basis of the existing 1975 legislation. What had become anomalous in that legislation is that the way the arm's length test is there defined is inappropriate for ethane and mixed streams which are now becoming available in large quantities.

#### ICI's REPRESENTATIONS

ICI have suggested that the legislation will provide a hidden subsidy to their integrated oil company competitors

7. For the reasons explained above the Government do not believe that this objection is justified. The essence of Clause 129 and Schedule 16 is the provision for tax valuation purposes of a more accurate arm's length analogue, thus removing an anomaly in the present legislation which discriminates against non-arm's length deals. Ministers do not accept that the legislation will provide a hidden subsidy. They would not have agreed to it if it did. The Inland Revenue/<sup>are</sup>specifically required to reject an election unless they are satisfied that it meets the arm's length test.

ICI have said that their objections have been largely ignored

8. This is not so. There have been detailed discussions and correspondence with ICI at both official and Ministerial level both preceding Committee Stage and subsequently. The Chancellor has himself seen ICI representatives twice since the Standing Committee debate on the clause. Every effort has been made (within the accepted constraints of Revenue confidentiality) to clarify points of doubt and to give all reasonable reassurances on the principle and operation of the clause. Where the Government and ICI do not agree, the reasons for the view taken by the Government have been fully explained to ICI.

Government proposal to extend to mixed streams

9. The essential justification for including mixed streams of gas of which ethane is the largest component is that, like ethane, they would be sold under long-term contracts with a pricing formula in arm's length deals and their inclusion simply puts similar non-arm's length deals onto a comparable basis.

ICI have suggested that the ethane content of such streams should come within the scope of the clause

10. The Government do not think such a limitation would be justified. It would mean that inter-affiliate deals would be treated on an unfair and discriminatory basis compared with an arm's length deal in such a stream because an arm's length deal would set a price formula covering the whole stream. As the whole point of the tax provision is to ensure inter-affiliate deals are treated as if they were arm's length deals it would be very difficult to defend introducing a deliberate artificiality of this kind. It is true that other components of a mixed stream can include LPGs (propane and butane) but the clause requires that of three possible components - methane, ethane, and LPGs - ethane must be the largest component by volume. The valuation of such a stream would need to reflect the LPG content and would not be solely based upon ethane as ICI has suggested.

Specific requirement to have regard to fuel value

11. ICI has suggested that the clause does not require the fuel value of ethane to be taken into account. In fact the requirement (paragraph 2(1) of Schedule 16) that the price formula should not differ materially from what would be agreed in an arm's length contract achieves this. No company at arm's length would sell to a petrochemical firm for a price below what it could secure from a fuel purchaser. An amendment at Committee Stage made this even more explicit

by putting it beyond doubt that the arm's length contract with which comparison is made could be one for fuel use.

12. ICI has argued for a specific link with heavy fuel oil value in valuing ethane as a bulk fuel. Ministers are advised that there is no simple marker price of this sort for fuel use which can be adopted consistently with the arm's length principle. Gas pricing is a complex matter and depends on all the circumstances surrounding a deal including the volume and specification of the gas and the timing. The suggestion that a floor price should be written into the legislation would once again depart from the arm's length principle.

#### Annual Reviews

13. The re-opener provision (paragraph 6 of the Schedule) provides for review five years after first delivery and is designed as a rough proxy for the sort of hardship clause found in arm's length contracts and the sort of re-negotiations which go on where a substantial and lasting change in economic circumstances renders a price formula unrealistic. Arm's length deals would not necessarily fix the re-opener period at five years. Indeed some long-term contracts have no re-opener at all. Five years is in the Government's view a reasonable balance to have struck. Annual reviews as suggested by ICI (as opposed to regular and frequent alterations to the price under the escalator) would be inconsistent with arm's length analogues and would continue the existing tax anomaly (albeit in a slightly modified form). It is also important to bear in mind that the provision does not provide total certainty for 15 years or indeed for any other period. Apart from the re-opener, the formula itself will undoubtedly include an escalator clause (as any similar arm's length contract would). The price is not therefore a fixed one but one which is regularly and realistically varied in line with some published indicator (which might in a petrochemical context be the cost of rival feedstocks).

### Overcapacity

14. The Government recognises that the petrochemicals industry is going through a difficult period and the arrival of ethane on the scene, whether from the North Sea or the Middle East, will clearly cause problems for naphtha based crackers. Clearly no-one can guarantee the long term future of any particular plant in a rapidly changing world. ICI accepts that ethane based crackers are likely to have a natural advantage over naphtha based ones. On the other hand, ethane crackers cannot take over completely from naphtha crackers since they do not make all the petrochemical products which can be produced from naphtha. Efficient crackers such as ICI's cracker at Wilton should be well able to stand up against the competition. If it were at risk it will not be because of Mossmorran alone (which will add under 5% to forecast ethylene capacity in Western Europe by 1985) and still less to Clause 129 which removes an anomaly and is not a subsidy. It would be wrong to use an anomaly in our tax system to protect naphtha based plant against the inevitable competition from ethane based plant. In the long run this could only prejudice the UK petrochemical industry as a whole. Indeed we understand that ICI accept that the present law contains an anomaly but differ on the way it should be rectified.

### Postponement of legislation

15. ICI has suggested that there is no need for legislation this year. Ministers recognise that projects likely to be affected by this legislation do not come on stream for some time. But the legislation is needed now if the companies concerned are to be given the same degree of relative certainty as those dealing at arm's length. They need this before committing themselves to very substantial capital expenditure. If the provision is not enacted this year and there was the prospect of substantial changes, projects could as a result be put in jeopardy. In these circumstances Government do not think that they would be justified in deferring action to rectify a clearly identified tax anomaly.

Treaty of Rome

16. ICI have suggested that Clause 129 is covered by Article 92 of the Treaty of Rome as constituting a state aid to industry and have recently initiated legal action for a declaration to this effect. This is now a matter for the Courts to decide and it would be wrong to prejudge the outcome. But the Government's advice is, quite apart from the general question of whether Article 92 is apt to cover direct tax measures at all, that this clause is not a state aid since it does no more than put inter-affiliate deals on all fours with arm's length deals for tax purposes, and in so doing follows the internationally accepted principle of arm's length valuation.





Minister of State, Treasury

Mr Schofar

FINANCE BILL CLAUSE 129:  
BRIEFING FOR SELECTED MEMBERS

I attach a copy of the background briefing which has been circulated this morning to :-

All members of the Finance Bill Standing Committee,

All members of the Energy Standing Committee,

Peter Thorne

Dick Douglas } Mossburn is in  
Willie Hamilton } their constituency

Brian Mawhinney - our PPS.

20 copies have also been made available in each of the Whip's offices (Tory + Labour).

Jim Milner  
13 July 82