

# Transfer pricing in the energy market

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## *1. Why Transfer Pricing?. Methods*

In an increasingly interconnected world, where much of the international transactions are conducted within multinational companies, it is interesting to study how these companies are linked through internal exchanges and see some peculiarities as far as the energy sector is concerned. To this end the study of the prices charged intra-holding in their different business sections is very instructive to understand, via the treatment of this particular issue, more general relations and situations. One might think that the issue is relatively simple in this area. The oil, gas, and they derivatives have prices established in transparent markets so that is very easy to know they value at any moment. But the question changes as soon as we start to think about the capital (investment) goods required to extract these commodities in the same way as change when we consider the capital (investment) goods for take advantage of the renewable energy sources. Primarily, throughout the article, we will study the transfer price of these capital (investment) goods. The investment brings with it, in the traditional sector (oil and gas), the need for tangible and intangible assets increasingly **specific, differentiated and technologically advanced** because of the growing difficulties in the exploration and exploitation. The same applies to the renewable energy sector in light of rapid technological advancement, and the particular characteristics of energy sources, eg., the winds of the Argentinean Patagonia posses very different features from those existing in the Nordseeküste (German coast). We must also take into account the prevailing market structure in the energy sector. **Imperfect competition** is the result of certain market characteristics; to mention just two, the strong economies of scale in the traditional sector and the need of large and dynamic investments in R&D (Research and Development) in the renewable energy sector. It is also the absence of perfect competition in this sector, which brings as a corollary the practical impossibility of finding **transparent market** prices between independent parties. And given the characteristics we have been mentioning it is not easy to find the transfer price based on cost-plus method, which added a reasonable mark-up based on the profits of others companies with similar transactions to the costs of the good supported by the analyzed company, which is selling the good internally. It is difficult to find "similar companies". On the other hand also is not clear how to treat **R&D** costs (eg. How divided it among different projects). Moreover, if one corporation gets financial support at lower rates to develop R&D this also impacts the final price, and, is very probable that just the market position is what enables the lowest **financing**, therefore, there is no one with whom compare prices because nobody gets this funding so cheap. Thus it is unreasonable to compare the price that has a lower financial cost with another price that has a greater (both in the long run, therefore it integrate the cost of the good (see RT 17 [1] in Argentina and IAS [2] 23 and 39 in the international framework) because their profits are necessarily different at equal prices. In addition, the "resale method" which detracts the mark-up from a sell of the part who acquire the good in the internal transaction; does not apply to the case; as these goods are not sold beyond the original purchasers. Because they are just the "traditional transaction methods (which we discussed so far) that the OECD [3] prefers, we can begin to understand the complexity of the issue. Among non-traditional methods is the "profit split" that tries to allocate the profit according to some objective measure of contribution, such as administrative expenses or

engineering performed by both entities. According to the proportion that each entity operates in the total effort will be the allocation of profits. In a very simplified example, suppose there are 30 administrative employees, 20 work at headquarters and 10 in the controlled subsidiary. If we take this as criteria 2/3 of the profit would belong to the central entity and 1/3 to the subsidiary. Already in this simple example we can see the difficulty of this method, because the parent company employees may work for the subsidiary and vice versa. Furthermore, other difficulties arise because the different bases that are available can; a) does not exist, because, for example, one site does all the engineering effort; b) are not comparable, the engineers of the company who receives the good only do adjustment work; c) engineering costs can be far cheaper (relatively or absolutely) in one location than in another, hence the monetary comparison of items is not enough to show their relative contribution; d) the different bases available can give very different results. The method of "transactional net margin" compares operating margins (before taking into account the financial costs and taxes) upon sales, assets or costs. For example, apply the percentage margins upon sales of similar independent companies to the sales of the company that we tested and examine if the profits are at sufficiently similar levels to those performed in independent firms. In the case we work, we have shown above the addition to the price of borrowing/financial costs makes the use of this system extremely difficult. Also apply to it the point (d) of the critics to the previous method. In addition we should find comparable entities to establish such comparisons.

## *2. Practical regulations and partial conclusions*

Argentina's rules in Article 15 of the law of income tax (LIG) simply say "***that should be used the methods that are most appropriate to the type of transaction***" [4] without establishing a hierarchy between them. In the case of commodities with transparent market the law gives as mandatory the value in that transparent market the day in which these commodities are put in cargo in the case with international intermediary that are not the effective recipient of the goods, and leaves it of free application to other international operations when the case justify it. This seems to be the case of commodities we are talking about at first.

Further, to complicate matters, the issue of transfer pricing applies even in certain cases to situations where there is independence of the parties that are involved. When one can not "***set the international price -of public and notorious knowledge- through transparent markets***", such as prices of goods used in the investment energy sector, the LIG Article 8, provides that "***the taxpayer-exporter or importer shall provide to the Federal Public Revenue Administration the information that the Administration requires in order to establish that the prices declared reasonably fit to the market ones***". In fact, as we are examining a case where there is no "market", at least in the usual terms in which we think of it; the solution of the price that should be used could result undetermined. With regard to "reasonable product" of these comparisons of prices and/or allocation of profits exercises the OECD Guidelines [5] notes that transfer pricing is not an exact science.

Therefore is interesting the practice in USA and Europe. In these jurisdictions are possible to agree with the tax authority these transfer prices in advance, and thereby gain in **certainty**, that are so valued in models where private investment plays a leading role in economic growth. Another attitude to this intricate issue is that the state could has a much more active role in such developments; given that it is essential to take into account the complexities to which we were exposed through this article, namely the

nonexistence of transparent market prices, the specificities of the goods, the issue of financial costs, the practical impossibility of assimilating these transactions to the market-transactions; and many others.

Besides; the subject is of interest in that it presents "**intermediaries**" other than the merely financial ones, but closely related, which also must be taken into account when the issue is think about reforming the international financial system. Moreover, companies have no incentive to raise prices of goods to not move its earnings to countries with higher tax rates. This is reflected in the fact that such approach tend to stabilize prices in local currency against **devaluation**.

These issues, only outlined in this article, must be taken into account, because they affect the entire energy sector, not only the issue of transfer pricing. A sustainable policy approach, consistent and coherent in relation to the sector should confer attention to these topics in order to implement specific solutions to suit the big strategic guidelines to be given to the energy market.

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[1] RT stands for technical resolution and accounting standards used by Public Accountants in Argentina being performed by the Federación Argentina de Profesionales de Ciencias Económicas.

[2] IAS are international accounting standards.

[3] Organization for Economic Cooperation and Development

[4] All the translation of the legislation from Spanish to English was done by the author. Source: <http://www.infoleg.gov.ar/infolegInternet>; Ley de Impuestos a las Ganancias 20628 Texto Ordenado por Decreto 649/97 (B.O. 06/08/97), Anexo I, con las modificaciones posteriores.

[5] (OECD Guidelines, paragraph 1.12)