Newfoundland and Labrador Hydro

Expert Report

Evaluating the Pricing Policy for Affiliate Common Services, Common Expenses and Corporate Services
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1 Introduction

1.1 Terms of Engagement and Independence
This report was prepared by Brad Rolph, a partner of Grant Thornton Consulting, a subsidiary of Grant Thornton LLP (collectively, “Grant Thornton”), at the request of the Newfoundland and Labrador Board of Commissioners of Public Utilities (the “Board”) in connection with public hearings to be held regarding the general rate application (“GRA”) made by Newfoundland and Labrador Hydro (“Hydro”) requesting new electricity rates effective January 1, 2014.

Grant Thornton has no business relationship with any of the parties to this matter that would impair my ability to render an opinion.

1.2 Brad Rolph, MA, BA
I am the National Leader of Grant Thornton’s transfer pricing practice in Canada.\(^1\) Transfer pricing involves evaluating the prices at which a company transfers physical goods and intangible property or provides services to a related party. The economics of transfer pricing has been my primary area of specialization since 1995.

1.3 The Assignment
The Board has asked me to prepare an independent expert report evaluating the reasonableness of the methods used by Hydro and its affiliates to determine the amounts charged by and to Hydro for services rendered or arranged by Hydro for the benefit of its affiliates or by its affiliates for the benefit of Hydro. I have not been engaged to evaluate or provide any opinions regarding any corporate structure or governance issues pertaining to Hydro.

1.4 Information and Data Relied Upon
In preparing this opinion, I have relied on the following information:

- The 2013 GRA and related appendices and exhibits submitted by Hydro to the Board;
- The responses from Hydro to the requests for information from the Board and the interveners; and
- Information obtained from public sources, as cited throughout this report.

The opinion expressed herein is subject to the general qualification that the information on which it relies is accurate and reliable.

In preparing this report and rendering this opinion, my sole responsibility is to the Board.

\(^1\) See Appendix A for a copy of my curriculum vitae.
I reserve the right, but will be under no obligation, to review all calculations referred to in this report and, if considered necessary by me, to revise my opinion or amend any part of this report in light of any new facts that become apparent to me subsequent to the date of this report.

1.5 Opinion

With respect to the common services that Hydro renders for its affiliates, it is my opinion that:

• Hydro renders common services (i.e., services related to human resources ("HR"), safety and health, and information services ("IS")) to its affiliates that would ordinarily be considered intra-group services;

• The affiliates derive value from the common services rendered by Hydro and would have been willing to pay for these services had they been rendered by an independent enterprise, or would have performed the activities on their own behalf in-house;

• Hydro renders common services to its affiliates for which an arm’s length price should be charged;

• Using an indirect charge method to determine an arm’s length price for the common services Hydro renders to its affiliates is reasonable;

• The common services-related cost to be recovered through the Administration Fee might not be fully burdened and, as a result, the amount to be charged by Hydro to its affiliates for these common services might be understated. The magnitude of the potential increase in the amounts to be charged by Hydro to its affiliates for rendering these common services would not be material;

• Allocating the HR, and safety and health-related costs to be recovered using FTEs as the allocator is reasonable;

• Allocating the IS-related costs to be recovered using average number of users as the allocator is reasonable; and

• Unless the ultimate recipient of the common service rendered is an energy project involving private interests, not marking-up the common service-related costs to be recovered is reasonable.

With respect to the common expenses that Hydro initially pays on behalf of itself and its affiliates, it is my opinion that:

• Hydro initially pays for the cost of common expenditures that benefit all of Nalcor Energy’s ("Nalcor") lines of business;

• The affiliates derive value from the common expenditures initially paid for by Hydro and would have been willing to pay for these expenditures on their own behalf;

• Hydro initially pays for the cost of common expenditures which should be allocated back to its affiliates at cost;

• The common costs to be recovered are fully burdened and do not include any non-operating expenses;

• Allocating the office-related costs to be recovered using square footage occupied as the allocator is reasonable;

• Allocating the telephone infrastructure-related costs to be recovered using the average number of users as the allocator is reasonable; and

• Treating these common expenses as flow through costs and charging them back without a mark-up is reasonable.
With respect to the other expenses that Hydro initially pays on behalf of itself and its affiliates, it is my opinion that:

- Hydro initially pays for the cost of certain other expenditures that benefit one or all of Nalcor’s lines of business;
- The affiliates derive value from these other expenditures initially paid for by Hydro and would have been willing to pay for these expenditures on its own behalf;
- Further clarification is warranted regarding which of the other expenses are initially paid for by Hydro and subsequently charged back to one of Nalcor’s other lines of business. Hydro should be asked to provide the dollar amount of the other expenses that were charged back to Nalcor’s other lines of business;
- With the exception of some potential shareholder costs, Hydro initially pays for the cost of certain other expenditures which should be charged back to a specific affiliate or allocated amongst its affiliates at cost; and
- Treating these other expenses as flow through costs and charging them back without a mark-up is reasonable.

With respect to the corporate services that Hydro renders for its affiliates and its affiliates render for Hydro, it is my opinion that:

- Hydro and its affiliates render corporate services that would ordinarily be considered intra-group services;
- Hydro and its affiliates derive value from the corporate services rendered by its affiliates or Hydro and would have been willing to pay for these services had they been rendered by an independent enterprise, or would have performed the activity on its own behalf;
- Hydro and its affiliates render corporate services to each other for which an arm’s length price should be charged;
- It is reasonable for Hydro and its affiliates to use an direct charge method to determine an arm’s length price for the corporate services it renders to its affiliates;
- The labour rates used to recover the costs of rendering these corporate services appear to be fully-burdened and do not include any non-operating expenses;
- The proxy used to calculate the portion of the labour rate intended to cover fringe benefits, including leaves of absence, should be re-evaluated on an annual basis; and
- Not applying a mark-up to the costs of rendering corporate services to be recovered is reasonable.

My opinion is based on:

- My expertise and experience in transfer pricing;
- The evidence submitted by Hydro in its 2013 GRA;
- The evidence submitted by Hydro in its responses to the requests for information;
- Publicly availability documents cited in this report; and
- The evaluation framework I developed in Section 3 of this report.
1.6 Outline of the Report

The remainder of this report is structured as follows:

• Section 2: A description of the affiliate transactions;
• Section 3: A framework for evaluating the affiliate transactions;
• Section 4: Evaluating the affiliate transactions;
• Section 5: Materiality of the affiliate transactions;
• Section 6: Conclusion
2 A Description of the Affiliate Transactions

2.1 Overview

Virtually every multinational company must make arrangements for a variety of services to be made available to its affiliates, including administrative, technical, financial and commercial services. The same can be said of a company which has multiple divisions or affiliates within the same country, as in the case of Hydro. An independent enterprise in need of a service can acquire that service from a service provider who specializes in providing that type of service or it can perform the service in-house. Similarly, a member of an affiliate group of companies in need of a service can acquire that service directly or indirectly from independent enterprises, from one or more of its affiliates, or it can perform the service itself. Intra-group services often include services that are typically available externally from independent enterprises, such as legal or accounting services, and those that are ordinarily performed internally, such as central auditing and training.

2.2 Nalcor Energy and the Emergence of Affiliate Transactions

2.2.1 Nalcor Energy

At the time of its last general rate application in 2006, Hydro was a Crown corporation owned directly by the Province. Although there were intra-company services transactions within Hydro between its regulated and non-regulated activities and minor intercompany services transactions with its subsidiary Churchill Falls (Labrador) Corporation Limited (“Churchill Falls”) which were recovered on a cost-recovery basis, it did not have any affiliate transactions involving shared services.

In June 2007 Nalcor was incorporated under a special act of the Legislature of the Province of Newfoundland and Labrador (the “Province”) as a Crown corporation to take a lead role in the Province’s participation in the development of the its energy resources. At that time, Nalcor became the parent company of Hydro, Churchill Falls and other subsidiaries owned by Hydro, and any new entity created thereafter to manage the Province’s investments in the energy sector.

Today, Nalcor’s business includes the development, generation, transmission and distribution of electricity; the exploration, development, production and sale of oil and gas; industrial fabrication; and energy marketing.

In Exhibit 1, I present Nalcor’s legal structure as at July 30, 2013. There are no known entities to be added or deleted from this chart.
2.2.2 Lines of Business

Nalcor has segmented its business into seven reporting units:

- Hydro;
  - Hydro Regulated
  - Churchill Falls
  - Energy Marketing
- Nalcor Energy – Oil and Gas Inc. (“Oil & Gas”);
- Nalcor Energy – Bull Arm Fabrication Inc. (“Bull Arm Fabrication”);
- Muskrat Falls Project (“Muskrat Falls”); and
- Corporate services and other activities.

2.2.2.1 Newfoundland and Labrador Hydro

Hydro is the primary generator and transmitter of electricity in Newfoundland and Labrador. During 2012, Hydro supplied about 87 percent of the Province’s electricity needs serving about 279,000 utility, industrial, residential and commercial customers in over 200 communities. It has $1.4 billion of capital assets located throughout the Province.

Within Hydro are three of Nalcor’s seven reporting units: Hydro Regulated, Churchill Falls and Energy Marketing.
2.2.2.1 **Hydro Regulated**

Hydro Regulated sells electricity to three primary customer groups:

- Newfoundland Power, an investor-owned utility that distributes electricity to over 251,000 customers on the island portion of the Province; Hydro Regulated supplies 93 percent of its energy requirements comprising 81.7 percent of regulated revenue;
- Over 37,000 residential and commercial customers in rural Newfoundland and Labrador comprising 14.8 percent of regulated revenue; and
- Major industrial customers primarily in the pulp and paper, mining and oil refining industries comprising 3.5 percent of regulated revenue.

2.2.2.1.2 **Churchill Falls (Labrador) Corporation**

Churchill Falls operates one of the largest underground hydroelectric powerhouses in the world, with a rated capacity of 5,428 megawatts (“MW”).

Hydro holds a 65.8 percent interest in Churchill Falls. The remainder is held by Hydro-Quebec.

2.2.2.3 **Energy Marketing**

The revenue and earnings realized by this reporting unit are derived primarily from sales of electricity to export markets in eastern Canada and the northeast United States as well as to the iron ore industry in Labrador. To access export markets, Nalcor has service agreements with Hydro-Quebec for 265 MW of long-term electricity transmission capacity from Labrador through Quebec to the Canada-United States border. This segment also includes the operations of the Menihek Generating Station which supplies power to Hydro-Quebec for its customers in the Schefferville region.

2.2.2.2 **Nalcor Energy - Oil and Gas Inc.**

Nalcor is a minority partner in three off-shore oil producing developments: the Hebron oil field, the White Rose Growth Project, and the Hibernia Southern Extension. Oil and Gas is also executing a comprehensive exploration strategy to accelerate the discovery of new resources in offshore locations.

2.2.2.2.1 **Hebron Oil Field**

The Hebron oil field is operated by ExxonMobil, which has a 36 percent interest in the project. ExxonMobil took control of the project from Chevron in October 2008. The joint venture partners in the field development are Chevron Canada Resources (26.7 percent), Petro-Canada (22.7 percent), StatoilHydro (9.7 percent) and the public sector company Energy Corporation of Newfoundland and Labrador (“ECNL”) (4.9 percent).²

2.2.2.2.2 **White Rose Growth Project**

The White Rose Growth Project is operated by Husky Energy (68.875 percent) on behalf of Petro-Canada (26.125 percent) and the Government of Newfoundland and Labrador who, through Nalcor, holds a 5 percent equity stake.³

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2.2.2.2.3 Hibernia Southern Extension

The Hibernia oil field is operated by ExxonMobil and owned by ExxonMobil Canada (27.4 percent), Chevron Canada Resources (23.6 percent), Petro-Canada Hibernia Partnership (Suncor) (19.5 percent), Statoil Canada Ltd. (10.5 percent), Nalcor Energy (10.0 percent), Canada Hibernia Holding Corporation (5.1 percent), and Murphy Oil (3.9 percent).4

2.2.2.3 Nalcor Energy – Bull Arm Fabrication Inc.

Bull Arm Fabrication is Atlantic Canada’s largest industrial fabrication site and generates revenue through leasing arrangements with large construction projects.

2.2.2.4 Muskrat Falls Project

Muskrat Falls, which was sanctioned on December 17, 2012, includes an 824 MW hydroelectric facility at Muskrat Falls on the lower Churchill River in Labrador, over 1,500 km of associated transmission lines in Newfoundland and Labrador linking the island of Newfoundland to Labrador, and the Maritime Link between the island of Newfoundland and Nova Scotia.

2.2.2.5 Corporate Services and Other Activities

This reporting unit includes corporate support functions, business development activities and certain non-sanctioned development projects including Phase 2 of the Lower Churchill Project (“Gull Island”).

2.3 Organizational Structure of Newfoundland and Labrador Hydro

Although Nalcor is not subject to regulation by the Board, the transfer of certain leadership positions from Hydro to Nalcor at the time it was created resulted in significant changes to Hydro’s organizational structure and the need for affiliate transactions. As shown in Exhibit 2 and Exhibit 3, Hydro is organized into three functional areas: Operations, Systems Operations and Planning, and Corporate Services.5

2.3.1 Operations

Operations is led by the Vice President of Newfoundland and Labrador Hydro who is responsible for the operation and management of Hydro’s generation, transmission, distribution and communications assets from asset inception to retirement. Operations is organized into three functional areas that are responsible for facilities used to provide regulated service to the Province: Hydro Generation, Thermal Generation and Transmission and Rural Operations. As depicted in Exhibit 2, with one exception, the Vice President of Hydro and Managers responsible for the functional areas within Operations are based with Hydro. The Manager of Exploits and Menihek Generation is employed by Nalcor.

2.3.2 System Operations and Planning

Systems Operations and Planning was formed as a standalone division of Hydro in April 2013. It is an amalgamation of the former System Operations and System Planning departments. The reorganization of this division has not been finalized.

4 http://www.hibernia.ca/hse.html
5 See Hydro’s 2013 GRA, Exhibit 1, Section 1.0.
Systems Operations manages the operation of the Island and Labrador Interconnected Systems through the Energy Control Centre ("ECC"). Systems and Operations also has responsibility for assessing and reporting power system performance, scheduling major equipment outages to enable effective system maintenance and upgrades, providing engineering support to the ECC, forecasting thermal plant fuel requirements and power purchase expenses, and communicating with Industrial Customers and Newfoundland Power to coordinate outage planning, switching, and power delivery arrangements. It previously reported to Operations.

System Planning is responsible for preparing operational and long-term planning load forecasts for interconnected and isolated power systems, recommending system modifications or expansions and completing system studies, and preparing thermal fuel price projections.

The Vice President, Systems Operations and Planning is based within Hydro as are the divisional managers.

Exhibit 2
Newfoundland and Labrador Hydro
Organization Structure
July 30, 2013

Source: Hydro’s 2013 GRA, Exhibit 1, Schedule 1, pages 3, 4, 5, 6, and 7.
2.3.3 Corporate Services

Corporate Services is organized into four divisions: Project Execution and Technical Services (“PETS”), Finance, Human Resources and Organizational Effectiveness, and Corporate Relations. Nalcor’s General Counsel and Corporate Secretary as well as its Internal Audit functions are also within this reporting unit.

2.3.3.1 Project Execution and Technical Services

The PETS division is responsible for rendering services to support asset management through the Office of Asset Management (“OAM”), the technical needs of the business and completion of the design, planning and delivery of operating and capital projects.

2.3.3.2 Finance

The Finance division includes separate departments for Finance and Corporate Services, Rates and Regulation, Financing, and Investment Evaluation.

2.3.3.3 Human Resources and Organizational Effectiveness

The Human Resources and Organizational Effectiveness division includes separate departments for Environmental Services, Safety and Health and HR.

2.3.3.4 Corporate Relations

The Corporate Relations division includes Communications staff and separate departments for Customer Service and Energy Efficiency.
Exhibit 3
Newfoundland and Labrador Hydro
Organization Structure
July 30, 2013

Source: Hydro’s 2013 GRA, Exhibit 1, Schedule 1, pages 8, 9, 11, and 12.
2.4 Services Rendered by Newfoundland and Labrador Hydro

2.4.1 Common Services

Hydro provides the following common services to Nalcor and its other business lines:

- HR;
- Safety and health; and
- IS.⁶

2.4.1.1 Human Resources

Hydro’s HR department consists of 11 employees who are responsible for the administration and coordination of all employee-related services including payroll, recruitment, employee benefit programs, pensions, training and the rewards and recognition program as well as the maintenance of the human resources database. Any changes to HR policies and programs are the responsibility of the HR department. The HR department also administers the performance appraisal system, conducts salary surveys, maintains organization charts, and responds to grievance resolution, arbitration cases, and collective bargaining negotiations. As shown in Exhibit 4, Nalcor’s only HR-related employee is the Manager of Human Resources & Labour Relations.

Exhibit 4
Newfoundland and Labrador Hydro
Human Resources Department
July 30, 2013


⁶ See Hydro’s 2013 GRA, Exhibit 8, page 2.
2.4.1.2 Safety and Health

The Safety and Health department provides occupational health services including coordinating corporate efforts with regard to employee safety as well as wellness, disability and sick leave management, and medical screening. As shown in Exhibit 5, Nalcor’s only safety and health-related employee is the Manager of Safety & Health.

Exhibit 5
Newfoundland and Labrador Hydro
Safety and Health Department
July 30, 2013

![Safety and Health Department Diagram]


2.4.1.3 Information Systems

The IS department provides assistance and support in the areas of software applications, planning and integration, and business solutions. This department is also responsible for the maintenance and administration of the company wide computer infrastructure and network and provides technical support. As shown in Exhibit 6, Nalcor’s only IS-related employee is the Manager of IS.

2.4.2 Common Expenses

Hydro also charges Nalcor and its other business lines for the use of:

- Office space;
- Telephone infrastructure, including the Local Area Network (‘LAN’); and
- Other expenses not covered by the Administration Fee.

Nalcor’s other lines of business occupying floor space at Hydro Place receive a rental charge from Hydro.

2.4.2.1 Telephone Infrastructure

Nalcor’s other lines of business receive a charge from Hydro for their share of telephone infrastructure costs, including long distance charges.

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7 See Hydro’s 2013 GRA, Exhibit 8, page 2.
2.4.2.2 Other Expenses

Hydro initially incurs other expenses that are not part of the Administration Fee that benefit one or more of Nalcor’s other lines of business. These expenses include:

- Advertising expenses administered by Nalcor;
- Audit expenses;
- Cell phone expenses;
- Corporate memberships;
- Directors’ expenses;
- Directors’ fees;
- Freight and courier expenses;
- Group insurance – premiums;
Insurance expenses;
• Nalcor annual report and annual general meeting expenses; and
• Treasury related fees.

2.4.2.3 Fees Charged by Newfoundland and Labrador Hydro to Affiliates for Services Rendered
As shown in Table 1, Hydro expected to charge its affiliates about $6 million for common services, common expenses and other expenses during the 2013 test year. Roughly 80 percent of these charges were to be for shared IS services and allocated office space. Hydro anticipates that the Administration Fee to be charged to its affiliates will be reduced slightly over the next 2 years. Through the Administration Fee, Hydro expects to recover about 5 percent of its operating expenses.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Newfoundland and Labrador Hydro Cost Allocations</th>
<th>December 31, 2011-2015</th>
<th>CAD 000s</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2011 (Actual)</td>
<td>2012 (Actual)</td>
<td>2013 (Forecast)</td>
</tr>
<tr>
<td><strong>Common Services</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Human Resources</td>
<td>525.6</td>
<td>636.7</td>
<td>666.6</td>
</tr>
<tr>
<td>Safety and Health</td>
<td>323.0</td>
<td>348.5</td>
<td>393.9</td>
</tr>
<tr>
<td>Information Systems</td>
<td>1,722.2</td>
<td>2,507.0</td>
<td>2,810.4</td>
</tr>
<tr>
<td><strong>Common Expenses</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Office Space</td>
<td>777.5</td>
<td>1,819.1</td>
<td>2,009.8</td>
</tr>
<tr>
<td>LANS</td>
<td>37.4</td>
<td>49.1</td>
<td>34.6</td>
</tr>
<tr>
<td>Telephones</td>
<td>56.1</td>
<td>73.7</td>
<td>80.2</td>
</tr>
<tr>
<td><strong>Other Miscellaneous</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.1</td>
<td>2.4</td>
<td>13.4</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total Administration Fee</strong></td>
<td>3,443.9</td>
<td>5,436.6</td>
<td>6,009.0</td>
</tr>
</tbody>
</table>

Source: Hydro’s 2013 GRA, PUB-NLH-169.
Note: numbers might not add due to rounding.
2.5 Corporate Services Rendered to and by Newfoundland and Labrador Hydro

Corporate services rendered by Nalcor or one of its other lines of business to Hydro are charged out to Hydro. Similarly, corporate services rendered by Hydro to Nalcor or one of its other lines of business are also charged out accordingly. Nalcor and its lines of business, including Hydro, provide the following corporate services:

- Management;
- General accounting;
- Treasury;
- Engineering;
- Project execution and administration;
- Purchasing; and
- Legal.

2.5.1 Management

The executive leadership team at Nalcor provides strategic oversight and general management. The team consists of the following employees:

- President and (“CEO”);
- Vice-President, Finance and CFO;
- Vice-President, Newfoundland and Labrador Hydro;
- Vice-President, System Operations and Planning;
- Vice-President, Project Execution and Technical Services;
- Vice-President, Human Resources and Organizational Effectiveness;
- General Counsel and Corporate Secretary;
- Vice-President, Corporate Relations; and
- Manager of Internal Audit.

In addition to being the President and CEO of Nalcor, Mr. Ed Martin is also the President and CEO of the following entities:

- Hydro;
- Churchill Falls;
- Oil and Gas; and
- Bull Arm Fabrication.

The President and CEO is accountable to the Board of Directors of Nalcor for the general direction, supervision and control of the activities of Nalcor and its affiliated companies.

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8 See Hydro’s 2013 GRA, Exhibit 8, page 2 and PUB-NLH-229.
2.5.2 Finance

The Finance department provides accounting and treasury services including external financial reporting.

The Vice-President, Finance & CFO is responsible for providing leadership and direction within Nalcor and across all of Nalcor’s lines of business in the functional areas of controllership, taxation, information systems, supply chain, treasury, financing, risk management, investment evaluation, financial planning, and rates and regulation.

2.5.3 Financial Planning

The Investment Evaluation department provides services to facilitate the production, review and distribution of annual long-term financial plans. As well, they provide long-term financial planning and analyses for various activities. The department’s responsibilities include, but are not limited to:

- Financial evaluation of potential investment opportunities;
- Medium and long-term financial planning;
- Due diligence activities;
- Activities to support Federal Loan Guarantee negotiation and implementation;
- Develop and maintain corporate financial and economic assumptions; and
- Support financial analysis for key strategic corporate initiatives.

2.5.4 Project Engineering and Technical Services

The PETS department includes senior project execution managers, discipline managers, engineers, and other staff that provide services in all engineering disciplines and covers such items as:

- Design, construction and project management;
- Engineering studies, technical specifications and construction coordination;
- Tender preparation and analysis including interaction with consultants; and
- Review and resolution of maintenance problems.
2.5.5 **Labour Relations**

The Labour Relations department provides services related to negotiating and administrating collective agreements, the resolution of grievances and all union/management communications. In addition, the department is responsible for the following:

- Recruitment and orientation;
- Compensation strategy and job evaluation administration;
- Performance management;
- Leadership development and training administration;
- Payroll and benefits administration;
- Succession and workforce planning;
- Employee engagement;
- Organization design and process/team improvement advisory services; and
- Collective bargaining, collective agreement advisory services, dispute resolution and ongoing labour-management relations.

2.5.6 **Environmental Services**

The Environmental Services department is responsible for auditing for compliance with government regulation and corporate policy, obtaining permits and approvals for proposed programs and advising on environmental matters. In addition, the department is responsible for the following:

- Maintenance of the ISO 14001 Environmental Management System;
- Coordination/oversight of the Company's annual continuous improvement plan;
- Environmental advisory/support services (environmental permitting; environmental emergency response; environmental protection plans; environmental impact assessment; etc.); and
- Project surveillance and compliance auditing.

2.5.7 **Legal**

The General Counsel and Corporate Secretary is responsible for providing legal and corporate secretarial services, governance and co-ordination of the Access to Information and Protection of Privacy Act, the Citizens Representative and Conflict of Interest matters to Nalcor and its affiliated companies including all of its lines of business.

2.5.8 **Risk and Insurance**

The Risk and Insurance department provides services related to the placement, policy and claims administration, risk control and risk financing of the corporate insurance program.

2.5.9 **Supply Chain Management**

The Supply Chain Management department coordinates all efforts related to procurement process activities including tendering, purchasing, and contract administration.
2.5.10 Internal Audit

The Internal Audit Department provides auditing services as determined in an annual audit plan as part of the annual update of the Five-Year Internal Audit Plan.

2.5.11 Fees Charged by Affiliates for Corporate Services Rendered

As shown in Table 2, Hydro expected to pay its affiliates, predominantly Nalcor, about $2.9 million for corporate services rendered during the 2013 test year. Roughly 65 percent of these charges were for services rendered by the PETS and Finance divisions. Hydro anticipates that the fees charged by its affiliates for corporate services rendered will decline by 8.2 percent during 2014 and not grow during 2015.

### Table 2
Newfoundland and Labrador Hydro Corporate Services Charged by Affiliates December 31, 2011-2015 CAD 000s

<table>
<thead>
<tr>
<th>Service</th>
<th>2011 (Actual)</th>
<th>2012 (Actual)</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive Leadership &amp; Assoc.</td>
<td>369.4</td>
<td>270.4</td>
<td>496.9</td>
<td>275.5</td>
<td>275.5</td>
</tr>
<tr>
<td>Legal</td>
<td>56.7</td>
<td>77.6</td>
<td>49.8</td>
<td>79.0</td>
<td>79.0</td>
</tr>
<tr>
<td>Internal Audit</td>
<td>119.8</td>
<td>103.1</td>
<td>164.1</td>
<td>104.5</td>
<td>104.5</td>
</tr>
<tr>
<td>Project Engineering and Technical Services</td>
<td>850.1</td>
<td>1,040.9</td>
<td>786.2</td>
<td>1,066.5</td>
<td>1,066.5</td>
</tr>
<tr>
<td>Environmental Services</td>
<td>40.4</td>
<td>49.9</td>
<td>26.0</td>
<td>51.6</td>
<td>51.6</td>
</tr>
<tr>
<td>Financial Planning Services</td>
<td>1,731.0</td>
<td>103.1</td>
<td>193.4</td>
<td>105.0</td>
<td>105.0</td>
</tr>
<tr>
<td>Risk and Insurance</td>
<td>74.0</td>
<td>75.1</td>
<td>72.5</td>
<td>76.2</td>
<td>76.2</td>
</tr>
<tr>
<td>Finance Services</td>
<td>607.8</td>
<td>666.4</td>
<td>1,069.4</td>
<td>863.5</td>
<td>863.5</td>
</tr>
<tr>
<td>Supply Chain Management Services</td>
<td>38.1</td>
<td>58.0</td>
<td>62.9</td>
<td>59.5</td>
<td>59.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>3,887.2</strong></td>
<td><strong>2,444.5</strong></td>
<td><strong>2,921.2</strong></td>
<td><strong>2,681.2</strong></td>
<td><strong>2,681.2</strong></td>
</tr>
</tbody>
</table>

Source: Own calculations based on information from Hydro’s 2013 GRA, PUB-NLH-228-R1, 231, 232-R1, 235, 236-R1, 239, 240-R1, 243, 244-R1, 247, 252-R1, 255, 256-R1, 259, 260, 263, 264-R1, and 267. R1 denotes Revision 1.

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9 The inputs to the Co-op Commerce bill rate were determined by estimating an annual salary of $40,000, benefits of $8,000, and 1,850 hours of working time per year. The HAY Grade Hourly calculation is the total salary plus benefits divided by the total number of hours worked per year. The bill rate calculation is the Hay Grade Hourly multiplied by a mark-up of 57 percent. Numbers might not add due to rounding.
2.5.12 Fees Charged to Affiliates for Corporate Services Rendered

As shown in Table 3, Hydro expected to charge its affiliates, predominantly Nalcor, about $2.8 million for corporate services rendered during the 2013 test year. Roughly 35 percent of these charges were for systems planning and engineering services through the PETS department, and finance and corporate services through the Finance department. Hydro anticipates that its fee for corporate services to its affiliates will increase by 32 percent and 3 percent in 2014 and 2015, respectively. Through the Administration Fee, Hydro recovers about 2.5 percent of its operating expenses.

<table>
<thead>
<tr>
<th>Table 3</th>
<th>Newfoundland and Labrador Hydro</th>
<th>Corporate Services Charged to Affiliates</th>
<th>December 31, 2011-2015</th>
<th>CAD 000s</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2011 (Actual)</td>
<td>2012 (Actual)</td>
<td>2013 (Forecast)</td>
<td>2014 (Forecast)</td>
</tr>
<tr>
<td>Corporate Relations</td>
<td>20.9</td>
<td>34.0</td>
<td>137.4</td>
<td>72.5</td>
</tr>
<tr>
<td>Executive Leadership &amp; Assoc.</td>
<td>84.1</td>
<td>75.0</td>
<td>59.6</td>
<td>62.4</td>
</tr>
<tr>
<td>Finance/CFO</td>
<td>881.0</td>
<td>963.0</td>
<td>878.3</td>
<td>1,031.9</td>
</tr>
<tr>
<td>Human Resources &amp; Org. Effect.</td>
<td>271.3</td>
<td>270.1</td>
<td>211.7</td>
<td>253.4</td>
</tr>
<tr>
<td>Project Execution &amp; Tech Serv.</td>
<td>2,260.1</td>
<td>1,175.1</td>
<td>972.4</td>
<td>1,365.0</td>
</tr>
<tr>
<td>Regulated Operations</td>
<td>754.1</td>
<td>810.9</td>
<td>533.5</td>
<td>899.6</td>
</tr>
<tr>
<td>Total</td>
<td>4,271.6</td>
<td>3,328.2</td>
<td>2,792.8</td>
<td>3,684.9</td>
</tr>
</tbody>
</table>

Source: Hydro’s 2013 GRA, PUB-NLH-170 (Revision 1), page 1.

2.6 Terms and Conditions

2.6.1 Billing and Collections

According to Nalcor’s intercompany guidelines, invoices for the recovery of affiliate transactions are to be issued on a monthly basis. Billings to and from affiliates are to be undertaken within 30 days of the service, resource or asset being provided. Receivables between affiliates are to be paid upon invoice receipt from an affiliate. If the invoice is not paid in full within 30 days from the date of invoice, Treasury and Risk Management will calculate an intercompany interest charge. The amount of the interest charge is to be such that there is no net financing impact on the affiliate to which the balance is owed. Finance charges are calculated by applying a rate to the intercompany balance(s) that is equal to the cost of short-term financing for the affiliate to which the balance is owed. If the affiliate to which the balance is owed is Hydro, then the rate applied to such balances is the last approved weighted average cost of capital (“WACC”), which is currently 7.53 percent.10

A Framework for Evaluating the Affiliate Transactions

3.1 Introduction

When unrelated companies transact with each other, the price of the goods bought and sold or the services rendered and received are determined by market forces. When related companies transact with each other, market forces might not be present. This situation creates the potential for mispricing, and in the case of Nalcor and Hydro the mispricing might affect the rate at which users pay for electricity in the Province.

In addition to my expertise and experience in transfer pricing, I considered the guidance provided by the following sources to develop a framework upon which to evaluate the reasonableness of the methods used by Hydro and its affiliates to determine the amounts charged by and to Hydro for services rendered or arranged by Hydro for the benefit of its affiliates or by its affiliates for the benefit of Hydro:

- Managerial and cost accounting literature;
- Industry practice; and
- Tax administration guidance.

3.2 Managerial and Cost Accounting Literature

I considered the guidance provided in the management accounting literature as a starting place for my evaluation framework. In particular, I relied, in part, on the following sources:


These sources describe the principles of shared services and provide guidance with respect to two relevant concepts: fully loaded cost and activity-based costing.

3.2.1 Principles of Shared Services

Shared services, sometimes referred to as shared internal services, or shared common services and corporate services, is a business strategy that involves sharing and leveraging resources, people and information to more effectively and efficiently render internal services such as finance, human resources, information technology systems, corporate communications and purchasing. The strategy is used predominantly by large and medium-sized organizations in the private sector to:
• Reduce overall costs of providing internal services;
• Minimize duplication of internal services across the business units of the organization;
• Improve service levels; and
• Help the business units focus on their core business.

Lately, shared services strategies have been adopted by public sector agencies as a solution to funding limitations. Although it incorporates elements of each, a shared services strategy is fundamentally different from the centralized, decentralized and, more recently, outsourcing models used to provide internal services. The basic model of shared services first centralizes internal services as a means to control costs and then charges users for those services on a fully loaded cost recovery basis. The fully loaded charge for internal services provides users with a realistic picture of what it actually costs to render the internal services they require.

3.2.2 Fully Loaded Costs
A fully loaded cost for rendering an internal service includes all of the direct and indirect costs associated with rendering the internal service. Traditional methods of allocating the costs of rendering internal services do not necessarily include costs of a general overhead nature, such as costs relating to office facilities, telephone, computer hardware and software, and management. A fully loaded cost should include an amount to cover these types of expenses as well as depreciation, finance charges and taxes. In an asset-intensive service, such office facilities, the cost of capital and depreciation also need to be built into the internal charge.

One of the common principles of pricing is to keep the model simple and have as few assumptions as possible. The more pricing models that are used the higher the costs of maintaining them. Detailed pricing on a per unit or hourly basis should be avoided in favour of more broadly defined fees. It is important to keep to a minimum the costs associated with pricing and billing internal services.

3.2.3 Activity-Based Costing
Identifying all costs associated with rendering internal services can be a difficult and time-consuming exercise. Some organizations have internal costing systems that enable them to identify specific charges related to an internal service. Others have to rely on the best available data or more complex means such as activity–based costing (“ABC”).

ABC establishes a cause-and-effect relationship between the internal services rendered, their related costs and their resulting output by tracing and allocating the costs by the activities performed to render the internal service. The steps involved to use ABC to determine the costs of internal services are:

• Identifying the services for which costing will be borne;
• Defining the activities performed to produce, market, and deliver the service;
• Identifying the causes of resources being consumed and activities being performed;
• Attributing direct and indirect costs to the activities being performed;

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11 See SMAC, page 2.
12 See SMAC, page 12.
• Linking activities and costs to the services; and
• Managing and controlling the business process activities and their cost drivers.\(^\text{13}\)

In other words, for each internal service that is rendered, the costs of providing those services are to be determined and allocated to the recipients of the services based on a metric closely linked to the service rendered. The groups of individual costs borne to render the services that are to be recovered are sometimes referred to as cost pools. When used for allocating costs, a cost driver is often called a cost-allocation base.\(^\text{14}\) It is an activity driver that best explains the link the service rendered and its cost pool.\(^\text{15}\)

As shown in Table 4, there are several possible activity drivers for specific types of costs.

<table>
<thead>
<tr>
<th>Cost Type</th>
<th>Related Activity Driver</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting costs</td>
<td>Number of billings</td>
</tr>
<tr>
<td>Accounting costs</td>
<td>Number of cash receipts</td>
</tr>
<tr>
<td>Accounting costs</td>
<td>Number of general ledger entries</td>
</tr>
<tr>
<td>Accounting costs</td>
<td>Number of reports issued</td>
</tr>
<tr>
<td>Accounting costs</td>
<td>Hours charged to lawsuits</td>
</tr>
<tr>
<td>Administration costs</td>
<td>Number of stockholder contacts</td>
</tr>
<tr>
<td>Engineering costs</td>
<td>Hours charged to design work</td>
</tr>
<tr>
<td>Engineering costs</td>
<td>Hours charged to process planning</td>
</tr>
<tr>
<td>Engineering costs</td>
<td>Hours charged to tool design</td>
</tr>
<tr>
<td>Engineering costs</td>
<td>Number of engineering change orders</td>
</tr>
<tr>
<td>Facility costs</td>
<td>Amount of space utilization</td>
</tr>
<tr>
<td>Human resources costs</td>
<td>Employee headcount</td>
</tr>
<tr>
<td>Human resources costs</td>
<td>Number of benefits changes</td>
</tr>
<tr>
<td>Human resources costs</td>
<td>Number of insurance claims</td>
</tr>
<tr>
<td>Human resources costs</td>
<td>Number of pension changes</td>
</tr>
<tr>
<td>Human resources costs</td>
<td>Number of recruiting contacts</td>
</tr>
<tr>
<td>Human resources costs</td>
<td>Number of training hours</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>Number of direct labor hours</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>Number of field support visits</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>Number of jobs scheduled</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>Number of machine hours</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>Number of maintenance work orders</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>Number of parts in product</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>Number of parts in stock</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>Number of price negotiations</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>Number of purchase orders</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>Number of scheduling changes</td>
</tr>
<tr>
<td>Manufacturing costs</td>
<td>Number of shipments</td>
</tr>
<tr>
<td>Marketing and sales costs</td>
<td>Number of customer service contacts</td>
</tr>
<tr>
<td>Marketing and sales costs</td>
<td>Number of orders processed</td>
</tr>
<tr>
<td>Marketing and sales costs</td>
<td>Number of sales contacts made</td>
</tr>
<tr>
<td>Quality control costs</td>
<td>Number of inspections</td>
</tr>
<tr>
<td>Quality control costs</td>
<td>Number of supplier reviews</td>
</tr>
<tr>
<td>Storage time (e.g., depreciation, taxes)</td>
<td>Inventory turnover</td>
</tr>
<tr>
<td>Storage transactions (e.g., receiving)</td>
<td>Number of times handled</td>
</tr>
</tbody>
</table>

Source: Bragg, Exhibit 8.2, page 203.

\(^\text{13}\) See SMAC, page 13.  
\(^\text{14}\) See Horngren, page 179.  
\(^\text{15}\) See Bragg, page 303.
3.3 Industry Practice

According to the evidence submitted in its 2013 GRA, the cost allocation methodologies used by Hydro are consistent with industry practice as well as industry best practices. Accordingly, I considered the guidance provided by the internal costing practices of other regulated Canadian energy companies to develop my evaluation framework. In particular, I relied, in part, on publicly available documentation regarding the manner in which the following six energy companies allocated shared services:

- Enbridge Inc. (“Enbridge”);
- EPCOR Water Services Inc. (“EWSI”);
- Newfoundland Power Inc. (“NPI”);
- Ontario Power Generation Inc. (“OPG”);
- Pacific Northern Gas Ltd. (“PNG”); and
- Terasen Gas Inc. (“TGI”).

The shared services cost allocation methodologies used by these energy companies are quite similar. Shared service expenses are generally organized into cost pools, which are then allocated to the service recipients using a cost driver(s) based on the cost causation principle.

The intercompany transactions involving these energy companies are non-arm’s length transactions. For transactions to be considered as comparable benchmarks, including those within the industry, the transactions need to involve the same or similar services rendered between arm’s length parties. Accordingly, I am only able to use the internal costing practices of other regulated Canadian energy companies to provide context for the evaluation framework. More robust guidance based on arm’s length transactions is required.

3.4 Tax Administration Guidance

Finally, I considered the guidance provided by the Organisation for Economic Cooperation and Development (“OECD”), the Canada Revenue Agency (“CRA”) and other tax administrators around the world to develop my evaluation framework. As described earlier in Section 2.1, when related companies transact with each other, the potential exists for the related companies to determine and use a price that can disadvantage one party over the other but, on the whole, generates a net benefit for the corporate group. This situation is a critical issue for tax administrators worldwide. Intercompany transfer pricing lies at the core of concerns expressed by tax administrators regarding the ability of multinational companies to reduce their effective corporate tax rate through the use of inappropriate transfer prices. Although the affiliate transactions involving Hydro do not transpire across international borders, there exists the potential for the parties to determine and use a transfer price for shared services that might affect the rate at which users pay for electricity in the Province.

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17 See Appendix B for a description of the cost allocation methodologies currently employed by the regulated Canadian energy companies listed.
18 See Appendix C for detailed tax administration guidance.
Accordingly, I relied, in part, on the following sources to develop my evaluation framework:

- The OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators,
- The CRA’s Information Circular 87-2R (“IC 87-2R”), and
- Internal Revenue Service’s (“IRS”) Internal Revenue Code §1.482-9.

### 3.4.1 The Organisation for Economic Cooperation and Development and the Arm’s Length Principle

The OECD is an international economic organization that promotes economic development and world trade by providing a platform for its 34 member states to compare policy experiences, seek answers to common problems, identify good practices and coordinate domestic and international policies.

The OECD’s Committee on Fiscal Affairs provides guidance regarding international standards on taxation, including transfer pricing. In its publication entitled *Transfer Pricing Guidelines for Multinational Enterprises* (“OECD’s Transfer Pricing Guidelines”), the OECD endorses the arm’s length principle. The arm’s length principle requires that the prices and the terms and conditions agreed to between related parties in their commercial transactions be the same as expected had the parties been dealing at arm’s length.

The arm’s length principle is the internationally accepted norm for evaluating the reasonableness of the prices used for cross-border inter-company transactions. It is also endorsed by the United Nations. As a member of the OECD and the United Nations, the Government of Canada and its tax administrator, the CRA, also endorse the arm’s length principle. Given that its provincial corporate tax rules rely on the federal rules, the Province of Newfoundland and Labrador indirectly endorses the arm’s length principle.

Accordingly, where a charge for a service is justified, tax administrators believe that the amount charged for the service should be determined in accordance with the arm’s length principle. According to the OECD, the CRA and the IRS, the primary test to determine whether a specific activity performed by a member of the multinational group for another member is a service for which a charge is justified is “whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself.”

If the activity is not one for which an independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered an intra-group service under the arm’s length principle.

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21 Canada’s transfer pricing rules are embodied in Section 247 of the ITA. Guidance with respect to the administrative application of those rules by the Canada Revenue Agency is published in IC 87-2R.
22 See OECD Transfer Pricing Guidelines, Chapter VII, Section B.2.1, paragraph 7.19 and IC 87-2R, paragraph 159.
23 See OECD Transfer Pricing Guidelines, Chapter VII, Section B.1, paragraph 7.6. See also IC 87-2R, paragraph 162 and §1.482-9(1)(i)(3)(ii)
Activities that ordinarily would be considered intra-group services can include:

- Administrative services;
- Financial services;
- Marketing services; and
- Services in staff matters.\(^{24}\)

Similarly, an activity would not be considered an intra-group service if:

- It duplicates an activity that the recipient has already performed itself or had a third party perform on its behalf;\(^{25}\)
- It benefits the owner of the controlled group and does not confer a benefit on the recipient (“Shareholder benefits”);\(^{26}\) or
- If the benefit results from the recipient’s status as a member of a controlled group.\(^{27}\)

The following are examples of shareholder activity-related costs provided by the OECD:

- Costs related to the legal structure of the parent company itself, such as the parent’s shareholder meetings, issuing shares in the parent company and the governance board costs;
- Costs related to the financial reporting or regulatory requirements of the parent company including the consolidation of the reports; and
- Cost of raising funds for the acquisition of an interest in a business.\(^{28}\)

In the absence of transactions between Hydro or one of its affiliates and a third party, or between two third parties, involving the same or similar services rendered by Hydro to its affiliates or by an affiliate to Hydro, which would yield arm’s length prices, the OECD and the CRA encourage multinational companies to consider cost recovery-based methods to determine an appropriate cost of a service.

Although there is limited guidance provided by the OECD or the CRA regarding which costs to take into account when determining the cost of rendering a service, the IRS’ Internal Revenue Code defines total services cost as “all costs of rendering those services.”\(^{29}\) The term “all costs” generally includes direct operating costs (e.g., salaries and benefits) as well as indirect operating costs (e.g., overhead), but excludes non-operating costs, such as “interest expense, foreign income taxes, or domestic income taxes”\(^{30}\) as well as “shareholder costs.”

Once a cost base is determined, the cost base is allocated to the relevant service recipients to approximate the cost of service to those recipients. The guidance provided by the OECD is limited. It states the allocation can be
based on “turnover, or staff employed, or some other basis.”\textsuperscript{31} The guidance provided by the CRA is also limited to the following:

> “When choosing an allocator (e.g., sales, gross or operation profit, units used/produced/sold, number of employees, or capital invested), the taxpayer should consider the nature and use made of the service.”\textsuperscript{32}

Even the IRS provides limited guidance to taxpayers in terms of an appropriate allocation method.

> “Any reasonable method may be used to allocate and apportion costs. In establishing the appropriate method of allocation and apportionment, consideration should be given to all bases and factors, including, for example, total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent.”\textsuperscript{33}

To augment this limited guidance, I surveyed member firms of Grant Thornton to gain an understanding of the cost allocation methodologies used to allocate centralized services within multinational companies in 80 countries.\textsuperscript{34} The results indicate that 70 of the 80 countries that participated in the survey generally follow the OECD Transfer Pricing Guidelines or the arm’s length principle. Of the remaining ten countries, four do not have transfer pricing legislation and the remaining six countries base their transfer pricing methodologies on the following factors:

- The nature of the service, which is analogous to the OECD’s guidance;
- Gross income or net sales, which is consistent with the examples provided by Canada, France, Germany, and United States;
- Fair market value, which is embodied by the arm’s length principle; and
- Staff numbers and asset size, which is consistent with the examples provided by the OECD guidelines.

Once the cost of rendering a service has been determined, multinational companies must determine whether that cost of service should be marked-up, and if so, by how much. Although arm’s length service providers would normally seek to charge a fee for their service that generates a profit, there are circumstances in which an arm’s length party would not generate a profit from rendering a service.

In the context of multinational companies, tax administrators consider the value of the service being rendered to determine whether a cost of service should be marked-up. In general, tax administrators permit mark-ups on value-added activities and deny mark-ups on routine activities. Whether the common services rendered by Hydro or the corporate services rendered by its affiliates for Hydro and by Hydro for its affiliates might be marked up depends on the specific service rendered. For example, the safety and health, and IS-related services rendered by Hydro are services that, in my experience, would normally be marked-up because they require engineering and IT skills to perform these functions. Alternatively, the HR-related services rendered by Hydro are services that would not normally be marked-up. The common expenses and other expenses charged by Hydro to its affiliates would normally be treated as flow through costs and charged back without a mark-up. Whether a mark-up on a service is permitted by a tax administrator will also depend on the interaction of other intercompany transactions involving

\textsuperscript{31} See OECD Transfer Pricing Guidelines, Chapter VII, Section B.2.3, paragraph 7.25.
\textsuperscript{32} See OECD Transfer Pricing Guidelines, Chapter VII, Section A, paragraph 7.2.
\textsuperscript{33} See §1.482-9(k).
\textsuperscript{34} See Appendix D for a comprehensive list of the responses from each country.
the related parties. Ultimately, from a transfer pricing perspective, a mark-up will or will not be permitted to the extent that it facilitates the accurate and reliable calculation of taxable income.

Nalcor and Hydro are provincial crown corporations and are not subject to tax. Consequently, relying on the tax implications for guidance on this matter would be ineffective. Alternatively, I considered whether the absence on a mark-up would create an inappropriate subsidy. First, I considered the implications of Nalcor marking up the costs of rendering certain corporate services to Hydro. Such a mark-up would increase Hydro’s revenue requirements and the rates that it charges its customers. Accordingly, I believe that applying a mark-up to the costs of rendering corporate services to Hydro would be inappropriate.

I believe that the same answer applies to situations in which Hydro is providing common or corporate services for the benefit of the public energy projects of its affiliates. To do otherwise, would create a situation in which Hydro’s revenue requirement would decline at the expense of Nalcor, one of the public energy projects of its other lines of business or the Province. However, not all of Nalcor’s energy projects are entirely publicly owned; some of its energy projects are partially owned by other provincial governments or private interests. In the context of energy projects involving private interests, the absence of a mark-up on the costs of rendering common services or corporate services for the direct benefit of these private energy projects would lower the amounts charged for such services and increase the profits generated by these projects to the benefit of private interests. This outcome would create an inappropriate subsidy at the expense of Hydro and its customers. Accordingly, I believe that should Hydro render services to Nalcor or one of its other lines of business for the benefit of an energy project involving private interests, the costs of rendering such services should be marked-up by an arm’s length amount.

Whether or not Hydro or its affiliates apply a mark-up to the costs incurred rendering intercompany services should be considered from the perspective of materiality and practicality. Based on an analysis that I will present in Section 5, marking-up the costs to be recovered by Hydro from its affiliates, or vice versa, for rendering common or corporate services would not be material. Accordingly, the efforts to determine the magnitude of, and administer and monitor any such mark-up might not be practical.

### 3.5 Evaluation Framework

I developed the following evaluation framework based on my past experience, the managerial accounting literature, industry practice, and tax administrator guidance described above:

- A service must be rendered and justified;
- Where rendered and justified, the amount charged for the service should be consistent with the arm’s length principle;
- In the absence of arm’s length prices, the transfer price for services rendered to and by an affiliate should be determined using a cost recovery method;
- Where the services have been rendered to an identifiable affiliate and the costs can be reasonably quantified, the direct charge method should be used to determine the amount charged for services rendered to and by an affiliate;
- Where the services have been rendered to a number of affiliates and the portion of the value of the service directly attributable to each affiliate cannot be determined, the indirect charge method should be used to determine the amount charged for the services rendered to and by an affiliate;
- The costs to be recovered should include all operating expenses incurred to render the services to an affiliate, including depreciation, but excluding interest;
• When allocating the costs to be recovered amongst a group of affiliates, the allocator should have a causal relationship with the service rendered; and

• Unless the ultimate recipient of the service rendered is an energy project involving private interests, no mark-up should be applied to the costs to be recovered.
4 Evaluating the Affiliate Transactions

4.1 Overview
I evaluated the following affiliate transactions involving Hydro based on the evaluation framework I presented in Section 3.5:

- Common services rendered by Hydro to its affiliates;
- Common expenses incurred by Hydro and charged out to its affiliates;
- Other expenses incurred by Hydro and charged out to its affiliates; and
- Corporate services rendered by affiliates to Hydro and by Hydro to its affiliates.

4.2 Common Services Rendered by Newfoundland and Labrador Hydro
As described in Section 2.4.1, Hydro renders the following common services to Nalcor and its other lines of business:

- HR;
- Safety and health; and
- IS.

4.2.1 Human Resources

4.2.1.1 Determining Whether a Service had been Rendered
Evidence describing the HR-related services rendered by Hydro for its affiliates was presented in Section 2.4.1.1 and Section 2.5.5 of this report. Based on this evidence, I have concluded the following:

- These services would ordinarily be considered intra-group services;
- The affiliates derive value from the HR-related services rendered by Hydro and would have been willing to pay for these services had they been rendered by an independent enterprise, or would have performed the activity on its own behalf in-house; and
- Hydro renders HR-related services to its affiliates for which an arm’s length price should be charged.
4.2.1.2 Determining an Arm’s Length Price

Hydro determines the amount charged to each affiliate for which it renders HR-related services based on an indirect cost recovery method, without applying a mark-up to the costs.

As shown in Table 5, Hydro expected its costs to be recovered for rendering HR-related services to be $1.7 million during the 2013 test year. Most of these expenses are for salaries and fringe benefits for those employed in the HR department or for miscellaneous expenses. Hydro expects its HR-related costs to be recovered to increase by 10.1 percent and 2.9 percent in 2014 and 2015, respectively.

The starting point for Hydro’s calculation of the HR-related costs to be recovered is its HR department’s operating costs which include costs for salaries and fringe benefits, system equipment maintenance, office supplies, professional services, equipment rental costs, travel and miscellaneous expenses. Hydro excludes payroll taxes, which are included in miscellaneous expenses, recharges for corporate services rendered and advertising costs initially borne by Hydro that will then be charged back to Nalcor as an other expense.

Table 5
Newfoundland and Labrador Hydro Human Resources Costs to be Recovered December 31, 2011-2015 CAD 000s

<table>
<thead>
<tr>
<th>Itemized listing of operating costs</th>
<th>2011 (Actual)</th>
<th>2012 (Actual)</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries &amp; Fringe Benefits</td>
<td>1,044.9</td>
<td>1,356.0</td>
<td>1,234.8</td>
<td>1,492.4</td>
<td>1,537.2</td>
</tr>
<tr>
<td>System Equipment Maintenance</td>
<td>22.0</td>
<td>20.6</td>
<td>40.0</td>
<td>28.0</td>
<td>28.7</td>
</tr>
<tr>
<td>Office Supplies &amp; Expenses</td>
<td>41.1</td>
<td>38.6</td>
<td>55.0</td>
<td>38.4</td>
<td>39.4</td>
</tr>
<tr>
<td>Professional Services</td>
<td>192.1</td>
<td>171.5</td>
<td>190.7</td>
<td>211.2</td>
<td>216.4</td>
</tr>
<tr>
<td>Equipment Rentals</td>
<td>-</td>
<td>-</td>
<td>2.8</td>
<td>2.0</td>
<td>2.1</td>
</tr>
<tr>
<td>Travel</td>
<td>24.4</td>
<td>33.6</td>
<td>34.8</td>
<td>35.0</td>
<td>35.9</td>
</tr>
<tr>
<td>Miscellaneous Expenses</td>
<td>1,606.2</td>
<td>1,598.7</td>
<td>1,617.7</td>
<td>1,722.5</td>
<td>1,765.5</td>
</tr>
<tr>
<td>Building Rental &amp; Maintenance</td>
<td>0.1</td>
<td>0.2</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total operating costs</strong></td>
<td><strong>2,930.8</strong></td>
<td><strong>3,219.1</strong></td>
<td><strong>3,175.7</strong></td>
<td><strong>3529.5</strong></td>
<td><strong>3,625.2</strong></td>
</tr>
</tbody>
</table>

Determination of common service costs

<table>
<thead>
<tr>
<th></th>
<th>2011 (Actual)</th>
<th>2012 (Actual)</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recharged salaries</td>
<td>(63.2)</td>
<td>(78.0)</td>
<td>(81.3)</td>
<td>(83.4)</td>
<td>(85.9)</td>
</tr>
<tr>
<td>Advertising</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(25)</td>
<td>(25.6)</td>
</tr>
<tr>
<td>Payroll tax</td>
<td>(1,401.7)</td>
<td>(1,453.6)</td>
<td>(1,399.5)</td>
<td>(1,554.0)</td>
<td>(1,592.8)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,465.9</strong></td>
<td><strong>1,687.5</strong></td>
<td><strong>1,695.0</strong></td>
<td><strong>1,867.0</strong></td>
<td><strong>1,920.8</strong></td>
</tr>
</tbody>
</table>

Source: Hydro’s 2013 GRA, PUB-NLH-176.
The HR-related costs to be recovered are allocated based on FTEs.

As shown in Table 6, Hydro expected to charge its affiliates roughly $0.7 million for HR-related services rendered during the 2013 test year. By charging back these costs to its affiliates, Hydro expected to recover 39.3 percent of its HR-related costs. Hydro expects to recover 40.5 percent of its future HR-related costs by rendering services to its affiliates. There was no indication in the evidence provided to identify which of Nalcor’s other lines of business were the recipients of Hydro’s HR-related services.

Table 6
Newfoundland and Labrador Hydro
Human Resources Costs Allocated to Nalcor Energy’s Other Lines of Business
December 31, 2011-2015
CAD 000s

<table>
<thead>
<tr>
<th></th>
<th>2011 (Actual)</th>
<th>2012 (Actual)</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Costs allocated</td>
<td>1,465.9</td>
<td>1,687.5</td>
<td>1,695.0</td>
<td>1,867.0</td>
<td>1,920.8</td>
</tr>
<tr>
<td>B Hydro Regulated</td>
<td>827.6</td>
<td>813.7</td>
<td>858.8</td>
<td>887.8</td>
<td>887.8</td>
</tr>
<tr>
<td>C Other lines of business</td>
<td>462.6</td>
<td>493.0</td>
<td>556.7</td>
<td>604.5</td>
<td>604.5</td>
</tr>
<tr>
<td>D Total</td>
<td>1,290.2</td>
<td>1,306.7</td>
<td>1,415.5</td>
<td>1,492.3</td>
<td>1,492.3</td>
</tr>
<tr>
<td>E Cost per FTE (A / D)</td>
<td>1.1</td>
<td>1.3</td>
<td>1.2</td>
<td>1.3</td>
<td>1.3</td>
</tr>
<tr>
<td>F Hydro Regulated (B * E)</td>
<td>940.3</td>
<td>1,050.8</td>
<td>1,028.4</td>
<td>1,110.7</td>
<td>1,142.7</td>
</tr>
<tr>
<td>G Other lines of business (C * E)</td>
<td>525.6</td>
<td>636.7</td>
<td>666.6</td>
<td>756.3</td>
<td>778.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,465.9</strong></td>
<td><strong>1,687.5</strong></td>
<td><strong>1,695.0</strong></td>
<td><strong>1,867.0</strong></td>
<td><strong>1,920.8</strong></td>
</tr>
</tbody>
</table>


Although Hydro incurs professional HR-related services, there is no indication in the evidence that Hydro engages third parties to render any of the same HR-related services it renders to its affiliates. Nor is there any indication in the evidence that the affiliates engage third parties to render any of the same HR-related services Hydro renders to them. It is also likely that any such market data would include an unidentifiable profit element. Accordingly, there is no evidence that there are internal comparable uncontrolled transactions upon which to determine an arm’s length price using a comparable price method.

There are two potential issues to consider regarding the inclusion of payroll taxes in the HR department’s miscellaneous expenses line item. First, Hydro’s HR department is responsible for administrating payroll-related activities for all of Nalcor’s lines of business. As a result, it should be confirmed that these payroll taxes are attributed to Hydro employees and not employees of Nalcor or one its other lines of business. There is no indication in the evidence describing these payroll taxes or whether they have been properly allocated to the
appropriate affiliate, if necessary. Second, if these payroll expenses are attributable to Hydro employees, then it should be confirmed that any portion of these payroll taxes attributable to the HR department is accounted for in its costs to be recovered.

There might also be an issue with the way in which Hydro allocates the common expenses. Although Hydro allocates common expenses amongst Nalcor’s lines of business, there is no indication in the evidence that Hydro included in its HR-related costs to be recovered an amount accounting for the HR department’s share of common expenses. To illustrate my point, consider Exhibit 8. The diagram on the left, entitled Common Expense Allocation, represents the allocation of the common expenses between Hydro and its affiliates. To ensure that the charges for the common services rendered by Hydro to its affiliates are fully burdened, Hydro’s share of the common expenses need to be appropriately allocated to each of the departments within Hydro that are providing these common services: the HR department, the Safety and Health department and the IS department. In the absence of this internal allocation of Hydro’s share of common expenses, the costs to be recovered for rendering these common services might not be fully burdened and, as a result, the charge for such services by Hydro to its affiliates might be understated. The diagram on the right in Exhibit 8, entitled Departmental Allocation, illustrates the effective allocation of the common expenses after the departments within Hydro providing common services have included their share of common expenses in the costs to be recovered.

Exhibit 8
Illustrating the Need to Allocate Common Expenses to the Common Service Departments

Regarding the potential that Hydro might not have included the HR department’s share of common expenses in its HR-related costs to be recovered, I have estimated the amount potentially excluded from this cost base to be $0.17 million based on the 2013 test year. Nalcor’s other lines of business account for roughly 60.7 percent of the FTEs used to allocate Hydro’s HR-related costs to be recovered. Consequently, the potential understatement of HR-related charges to Hydro’s affiliates might be less than $0.07 million. Based on an analysis I will present in Section 5, a potential increase of this magnitude in the amounts to be charged by Hydro to its affiliates for rendering HR-related services would not be material.
Based on this evidence, I have concluded the following:

- Allocating the HR-related services rendered by Hydro to its affiliates using an indirect cost recovery method is reasonable. It would not be practical for Hydro to conduct research to determine a direct charge for such services based on market data;
- Further disclosure is warranted regarding Hydro’s treatment of the payroll taxes reported in the HR department’s operating costs;
- The HR-related cost to be recovered through the Administration Fee might not be fully-burdened and, as a result, the amount to be charged by Hydro to its affiliates for this common service might be understated;
- Allocating the HR-related costs to be recovered based on FTEs is reasonable; and
- Unless the ultimate recipient of the services is an energy project involving private interests, not marking-up the HR-related costs to be recovered is reasonable.

4.2.2 Safety and Health

4.2.2.1 Determining Whether a Service had been Rendered

Evidence describing the safety and health-related services rendered by Hydro for its affiliates was presented in Section 2.4.1.2 and Section 2.5.6 of this report. Based on this evidence, I have concluded the following:

- These services would ordinarily be considered intra-group services;
- The affiliates derive value from the safety and health-related services rendered by Hydro and would have been willing to pay for these services had they been rendered by an independent enterprise, or would have performed the activity on its own behalf in-house; and
- Hydro renders safety and health-related services to its affiliates for which an arm’s length price should be charged.

4.2.2.2 Determining an Arm’s Length Price

Hydro determines the amount charged to each affiliate for which it renders safety and health-related services based on an indirect cost recovery method, without applying a mark-up to the costs.

As shown in Table 7, Hydro expected its costs to be recovered for rendering safety and health-related services to be roughly $1.1 million during the 2013 test year. Most of these expenses are for salaries and fringe benefits for those employed in the Safety and Health department or for professional services. Hydro expects its safety and health-related costs to be recovered to decrease by 6.9 percent in 2014 and increase by 2.7 percent in 2015.

The starting point for Hydro’s calculation of the safety and health-related costs to be recovered is its Safety and Health department’s operating costs which include the same expenses itemized in the HR department’s operating costs plus building rental and maintenance. Hydro then excludes payroll taxes, which are included in

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38There is no indication in the evidence to explain why the Cost Recoveries are not the same as the Add Back Cost Recoveries for Administration Fee. The Total amounts in Table 7 do not include Cost Recoveries and Add Back Cost Recoveries for Administration Fee as detailed in Hydro’s 2013 GRA, PUB-NLH-184. These amounts should net to zero; however, in 2011, 2012, and 2013 there is a difference of $35,457, $41,750 and $47,241, respectively. The Total amounts in Table 8 are those reported in Hydro’s 2013 GRA, PUB-NLH-184.
miscellaneous expenses, recharges for corporate services rendered and advertising costs initially borne by Hydro that will then be charged back to Nalcor as an other expense.

Table 7
Newfoundland and Labrador Hydro
Safety and Health Costs to be Recovered
December 31, 2011-2015
CAD 000s

<table>
<thead>
<tr>
<th>Itemized listing of operating costs</th>
<th>2011 (Actual)</th>
<th>2012 (Actual)</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries &amp; Fringe benefits</td>
<td>620.9</td>
<td>707.9</td>
<td>724.8</td>
<td>630.9</td>
<td>649.9</td>
</tr>
<tr>
<td>System Equipment Maintenance</td>
<td>10.9</td>
<td>7.1</td>
<td>53.3</td>
<td>44.5</td>
<td>45.6</td>
</tr>
<tr>
<td>Office Supplies &amp; Expenses</td>
<td>32.6</td>
<td>36.2</td>
<td>38.0</td>
<td>34.3</td>
<td>35.2</td>
</tr>
<tr>
<td>Professional Services</td>
<td>211.1</td>
<td>169.3</td>
<td>189.1</td>
<td>243.2</td>
<td>249.3</td>
</tr>
<tr>
<td>Equipment Rentals</td>
<td>0.3</td>
<td>-</td>
<td>-</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Travel</td>
<td>37.9</td>
<td>51.6</td>
<td>44.4</td>
<td>45.8</td>
<td>46.9</td>
</tr>
<tr>
<td>Miscellaneous Expenses</td>
<td>3.5</td>
<td>2.8</td>
<td>2.6</td>
<td>4.6</td>
<td>4.7</td>
</tr>
<tr>
<td>Building Rental &amp; Maintenance</td>
<td>86.8</td>
<td>95.7</td>
<td>88.8</td>
<td>89.7</td>
<td>91.9</td>
</tr>
<tr>
<td><strong>Total operating costs</strong></td>
<td><strong>1,004.0</strong></td>
<td><strong>1,070.6</strong></td>
<td><strong>1,140.0</strong></td>
<td><strong>1,093.9</strong></td>
<td><strong>1,124.4</strong></td>
</tr>
</tbody>
</table>

Determination of common service costs

<table>
<thead>
<tr>
<th>Recharged salaries</th>
<th>(67.5)</th>
<th>(105.1)</th>
<th>(92.1)</th>
<th>(112.5)</th>
<th>(115.9)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td><strong>936.5</strong></td>
<td><strong>965.5</strong></td>
<td><strong>1,048.9</strong></td>
<td><strong>981.4</strong></td>
<td><strong>1,008.5</strong></td>
</tr>
</tbody>
</table>

Source: Hydro’s 2013 GRA, PUB-NLH-184.

The safety and health-related costs to be recovered are allocated based on FTEs.

As shown in Table 8, Hydro expected to charge its affiliates roughly $0.4 million for safety and health-related services rendered during the 2013 test year. By charging back these costs to its affiliates, Hydro expected to recover 39.3 percent of its safety and health-related costs. Hydro expects to recover 40.5 percent of its future safety and health-related costs by rendering services to its affiliates. There was no indication in the evidence provided to identify which of Nalcor’s other lines of business were the recipients of Hydro’s safety and health-related services.
### Table 8
#### Newfoundland and Labrador Hydro
#### Safety and Health Allocated to Nalcor Energy’s Other Lines of Business
#### December 31, 2011-2015
#### CAD 000s

<table>
<thead>
<tr>
<th></th>
<th>2011 (Actual)</th>
<th>2012 (Actual)</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Costs allocated</td>
<td>901.0</td>
<td>923.7</td>
<td>1,001.6</td>
<td>981.4</td>
<td>1,008.5</td>
</tr>
<tr>
<td><strong>Allocations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B Hydro Regulated</td>
<td>827.6</td>
<td>813.7</td>
<td>858.8</td>
<td>887.8</td>
<td>887.8</td>
</tr>
<tr>
<td>C Other lines of business</td>
<td>462.6</td>
<td>493.0</td>
<td>556.7</td>
<td>604.5</td>
<td>604.5</td>
</tr>
<tr>
<td>D Total</td>
<td>1,290.2</td>
<td>1,306.7</td>
<td>1,415.5</td>
<td>1,492.3</td>
<td>1,492.3</td>
</tr>
<tr>
<td>E Cost per FTE (A / D)</td>
<td>0.698</td>
<td>0.707</td>
<td>0.708</td>
<td>0.658</td>
<td>0.676</td>
</tr>
<tr>
<td><strong>Allocations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F Hydro Regulated (B * E)</td>
<td>577.9</td>
<td>575.2</td>
<td>607.7</td>
<td>583.9</td>
<td>600.0</td>
</tr>
<tr>
<td>G Other lines of business (C * E)</td>
<td>323.1</td>
<td>348.5</td>
<td>393.9</td>
<td>397.5</td>
<td>408.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>901.0</strong></td>
<td><strong>923.7</strong></td>
<td><strong>1,001.6</strong></td>
<td><strong>981.4</strong></td>
<td><strong>1,008.5</strong></td>
</tr>
</tbody>
</table>

Source: Hydro’s 2013 GRA, PUB-NLH-184.

Although Hydro incurs professional safety and health-related services, there is no indication in the evidence that Hydro engages third parties to render any of the same safety and health-related services it renders to its affiliates. Nor is there any indication in the evidence that the affiliates engage third parties to render any of the same safety and health-related services Hydro renders to them. It is also likely that any such market data would include an unidentified profit element. Accordingly, there is no evidence that there are internal comparable uncontrolled transactions upon which to determine an arm’s length price using a comparable price method.

Regarding the potential that Hydro might not have included the Safety and Health department’s share of common expenses in its safety and health-related costs to be recovered, I have estimated the amount potentially excluded from this cost base to be $0.07 million based on the 2013 test year. Nalcor’s other lines of business account for roughly 60.7 percent of the FTEs used to allocate Hydro’s safety and health-related costs to be recovered. Consequently, the potential understatement of safety and health-related charges to Hydro’s affiliates might be less than $0.03 million. Based on an analysis I will present in Section 5, a potential increase of this magnitude in the amounts to be charged by Hydro to its affiliates for rendering safety and health-related services would not be material.
Based on this evidence, I have concluded the following:

- Allocating the safety and health-related services rendered by Hydro to its affiliates using an indirect cost recovery method is reasonable. It would not be practical for Hydro to conduct research to determine a direct charge for such services based on market data;
- The safety and health-related cost to be recovered through the Administration Fee might not be fully-burdened and, as a result, the amount to be charged by Hydro to its affiliates for this common service might be understated;
- Allocating the safety and health-related costs to be recovered based on FTEs is reasonable; and
- Unless the ultimate recipient of Hydro’s safety and health-related services is an energy project involving private interests, not marking-up the safety and health-related costs to be recovered is reasonable.

4.2.3 Information Systems

4.2.3.1 Determining Whether a Service had been Rendered

Evidence describing the IS-related services provided by Hydro was presented in Section 2.4.1.3 of this report. Based on this evidence, I have concluded the following:

- These services would ordinarily be considered intra-group services;
- The affiliates derive value from the IS-related services rendered by Hydro and would have been willing to pay for these services had they been rendered by an independent enterprise, or would have performed the activity on its own behalf in-house; and
- Hydro renders IS-related services to its affiliates for which an arm’s length price should be charged.

4.2.3.2 Determining an Arm’s Length Price

Hydro determines the amount charged to each affiliate for which it renders IS-related services based on an indirect cost recovery method, without applying a mark-up to the costs.

As shown in Table 9, Hydro expected its costs to be recovered for rendering IS-related services to be $7.6 million during the 2013 test year. Most of these expenses are for salaries and fringe benefits for those employed in the IS department or for professional services. Depreciation expense and a return on rate base at the WACC for costs capitalized such as servers and software are included in the cost base. Costs that are incurred solely for a particular line of business are charged to that line of business and are excluded from the determination of shared costs (i.e., software maintenance costs).

The starting point for Hydro’s calculation of the IS-related costs to be recovered is the IS department’s operating costs which include the same expenses itemized in the Safety and Health department’s operating costs. Hydro then adds depreciation and a return on rate base for capitalized costs and excludes software maintenance costs initially borne by Hydro that will then be charged back to Nalcor or one of its lines of business as an other expense.
Table 9
Newfoundland and Labrador Hydro
Information Systems Costs to be Recovered
December 31, 2011-2015
CAD 000s

<table>
<thead>
<tr>
<th>Itemized listing of operating costs</th>
<th>2011 (Actual)</th>
<th>2012 (Actual)</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries &amp; Fringe benefits</td>
<td>3,439.1</td>
<td>3,504.7</td>
<td>4,130.6</td>
<td>4,000.9</td>
<td>4,120.9</td>
</tr>
<tr>
<td>System Equipment Maintenance</td>
<td>296.7</td>
<td>274.2</td>
<td>305.5</td>
<td>312.2</td>
<td>320.0</td>
</tr>
<tr>
<td>Office Supplies &amp; Expenses</td>
<td>114.0</td>
<td>132.6</td>
<td>107.6</td>
<td>163.1</td>
<td>167.2</td>
</tr>
<tr>
<td>Professional Services</td>
<td>1,227.7</td>
<td>1,460.4</td>
<td>1,501.7</td>
<td>1,505.1</td>
<td>1,542.8</td>
</tr>
<tr>
<td>Equipment Rentals</td>
<td>96.9</td>
<td>102.4</td>
<td>107.0</td>
<td>109.3</td>
<td>112.1</td>
</tr>
<tr>
<td>Travel</td>
<td>49.9</td>
<td>62.1</td>
<td>101.5</td>
<td>103.7</td>
<td>106.3</td>
</tr>
<tr>
<td>Miscellaneous Expenses</td>
<td>4.5</td>
<td>10.8</td>
<td>7.9</td>
<td>8.1</td>
<td>8.3</td>
</tr>
<tr>
<td>Building Rental &amp; Maintenance</td>
<td>0.3</td>
<td>0.4</td>
<td>1.0</td>
<td>1.1</td>
<td>1.1</td>
</tr>
<tr>
<td><strong>Total operating costs</strong></td>
<td><strong>5,229.1</strong></td>
<td><strong>5,547.5</strong></td>
<td><strong>6,262.9</strong></td>
<td><strong>6,203.6</strong></td>
<td><strong>6,378.7</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Determination of common service costs</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation and return on rate base on common assets</td>
<td>1,828.3</td>
<td>1,774.2</td>
<td>735.2</td>
</tr>
<tr>
<td>Recharged salaries</td>
<td>8.2</td>
<td>4.5</td>
<td>-</td>
</tr>
<tr>
<td>Software Maintenance Costs</td>
<td>256.6</td>
<td>386.6</td>
<td>404.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4,964.3</strong></td>
<td><strong>6,984.7</strong></td>
<td><strong>7,632.9</strong></td>
</tr>
</tbody>
</table>

Source: Hydro’s 2013 GRA, PUB-NLH-192.

1 The IS-related costs to be recovered are allocated based on an average user basis.

2 As shown in Table 10, Hydro expected to charge its affiliates roughly $2.8 million for IS-related services rendered during the 2013 test year. By charging back these costs to its affiliates, Hydro expected to recover 36.8 percent of its IS-related costs. Hydro expects to recover 38.9 percent of its future IS-related costs by rendering services to its affiliates. There is no indication in the evidence provided to identify which of Nalcor’s other lines of business were the recipients of Hydro’s IS-related services.
Table 10
Newfoundland and Labrador Hydro Information Systems Allocated to Nalcor Energy’s Other Lines of Business December 31, 2011-2015

<table>
<thead>
<tr>
<th></th>
<th>2011 (Actual)</th>
<th>2012 (Actual)</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Costs allocated</td>
<td>4,964.3</td>
<td>6,984.7</td>
<td>7,632.9</td>
<td>6,607.4</td>
<td>6,688.8</td>
</tr>
<tr>
<td>B Hydro Regulated</td>
<td>872.4</td>
<td>912.7</td>
<td>885.7</td>
<td>926.5</td>
<td>926.5</td>
</tr>
<tr>
<td>C Other lines of business</td>
<td>463.4</td>
<td>511.0</td>
<td>516.2</td>
<td>589.1</td>
<td>589.1</td>
</tr>
<tr>
<td>D Total</td>
<td>1,335.8</td>
<td>1,423.7</td>
<td>1,401.9</td>
<td>1,515.6</td>
<td>1,515.6</td>
</tr>
<tr>
<td>E Cost per FTE (A / D)</td>
<td>3.716</td>
<td>4.906</td>
<td>5.445</td>
<td>4.360</td>
<td>4.413</td>
</tr>
<tr>
<td>F Hydro Regulated (B * E)</td>
<td>3,242.1</td>
<td>4,477.7</td>
<td>4,822.4</td>
<td>4,039.2</td>
<td>4,088.9</td>
</tr>
<tr>
<td>G Other lines of business (C * E)</td>
<td>1,722.2</td>
<td>2,507.0</td>
<td>2,810.5</td>
<td>2,568.2</td>
<td>2,599.9</td>
</tr>
<tr>
<td>Total</td>
<td>4,964.3</td>
<td>6,984.7</td>
<td>7,632.9</td>
<td>6,607.4</td>
<td>6,688.8</td>
</tr>
</tbody>
</table>

Source: Hydro’s 2013 GRA, PUB-NLH-192.

Although Hydro incurs professional IS-related services, there is no indication in the evidence that Hydro engages third parties to render any of the same IS-related services it renders to its affiliates. Nor is there any indication in the evidence that the affiliates engage third parties to render any of the same IS-related Hydro renders to them. It is also likely that any such market data would include an unidentified profit element. Accordingly, there is no evidence that there are internal comparable uncontrolled transactions upon which to determine an arm’s length price using a comparable price method.

Regarding the potential that Hydro might not have included the IS department’s share of common expenses in its IS-related costs to be recovered, I have estimated the amount potentially excluded from this cost base to be $0.44 million based on the 2013 test year. Nalcor’s other lines of business account for roughly 63.0 percent of the FTEs used to allocate Hydro’s IS-related costs to be recovered. Consequently, the potential understatement of IS-related charges to Hydro’s affiliates might be less than $0.16 million. Based on an analysis I will present in Section 5, a potential increase of this magnitude in the amounts to be charged by Hydro to its affiliates for rendering IS-related services would not be material.

Based on this evidence, I have concluded the following:

- It is reasonable for Hydro to use an indirect charge method to determine an arm’s length price for the IS-related services it renders to its affiliates. It would not be practical for Hydro to conduct research to determine a direct charge for such services based on market data.
• The IS-related cost to be recovered through the Administration Fee might not be fully-burdened and, as a result, the amount to be charged by Hydro to its affiliates for this common service might be understated; and
• Allocating the IS-related costs to be recovered based on average users is reasonable; and
• Unless the ultimate recipient of Hydro’s IS-related services is in an energy project involving private interests, not marking-up the safety and health-related costs to be recovered is reasonable.

4.3 Common Expenses Charged Out by Newfoundland and Labrador Hydro

As described in Section 2.4.2, Hydro charges out the following common expenses to Nalcor and its other business lines:

• Office space;
• Telephone infrastructure, including the LAN; and
• Other expenses not covered by the Administration Fee.

4.3.1 Office Space

4.3.1.1 Determining Whether a Service had been Rendered

Evidence that Nalcor’s other lines of business occupy Hydro’s office space was presented in Section 2.4.2.1. Based on this evidence, I have concluded the following:

• The affiliates derive value from occupying the office space at Hydro Place and would have been willing to pay for this office space had it been provided by an independent enterprise, or would have leased alternative office space owned by an independent enterprise on its own behalf; and
• Hydro provides office space to its affiliates for which an arm’s length price should be charged.

4.3.1.2 Determining an Arm’s Length Price

Hydro determines the amount charged to each affiliate for the office floor space occupied at Hydro Place based on an indirect cost recovery method, without marking up the costs.

As shown in Table 11, Hydro expected its costs to be recovered for renting office space at Hydro Place to its affiliates to be $4.6 million. Most of these expenses are for salaries and fringe benefits, system equipment maintenance, and depreciation expense and a return on rate base at the WACC for capitalized common assets costs shown in the accounts as interest.
The common assets depreciated in this cost recovery model include:

- Furniture for offices, cubicles and common areas;
- Fitness equipment;
- Cafeteria equipment;
- Printers and fax machines;
- Mailroom equipment; and
- Network services equipment.

The office-related costs to be recovered are allocated based on the amount of office floor space occupied and a square footage rental rate.

As shown in Table 12, Hydro expected to charge its affiliates $2.0 million for office space at Hydro Place during the 2013 test year. By charging back these costs to its affiliates, Hydro recovered 43.5 percent of its office-related costs. Hydro expects its office-related costs to decrease by 14.1 percent and increase by 1.1 percent in 2014 and 2015, respectively. Hydro expects to recover 44.5 percent of its future office-related costs by renting floor space to its affiliates. No evidence was provided to indicate how much floor space was rented by Nalcor and each of its other lines of business.
Based on this evidence, I have concluded the following:

- The office-related costs to be recovered are fully burdened and do not include any non-operating expenses;
- Allocating the office space-related costs to be recovered based on floor space occupied as the allocator is reasonable; and
- Treating the office space-related costs to be recovered as flow through costs and changing them back without a mark-up is reasonable.

### 4.3.2 Telephone Infrastructure

#### 4.3.2.1 Determining Whether a Service had been Rendered

Evidence that Nalcor and its other lines of business share in the use of Hydro’s telephone infrastructure was presented in Section 2.4.2.2. Based on this evidence, I have concluded the following:

- The affiliates derive value from using Hydro’s telephone infrastructure and would have been willing to pay for the use of this telephone infrastructure had they been provided by an independent enterprise, or would have incurred similar costs had they built and maintained a telephone infrastructure for its own behalf; and
• Hydro provides access to telephone infrastructure to its affiliates for which an arm’s length price should be charged.

4.3.2.2 Determining an Arm’s Length Price

As indicated in Section 2.4.2.2, Hydro charges Nalcor and each of its other lines of business their share of telephone infrastructure including long distance charges.

Based on information shown in Table 13 and Table 14, Hydro expected its costs to be recovered for its telephone infrastructure to be $0.42 million. There was no evidence provided to indicate the types of expenses included in the costs to be recovered.

The LAN costs provided by the Network Services department are divided by the total number of LAN ports to derive a cost per user. The telephone costs provided by the Network Services department are divided by the number of telephone, fax, and modem lines to derive a cost per telephone per user. The average number of users for each line of business is the allocator.

As shown in Table 13 and Table 14, Hydro expected to charge its affiliates $0.11 million for telephone infrastructure-related costs during the 2013 test year. By charging back these costs to its affiliates, Hydro recovered 27.2 percent of its telephone infrastructure-related costs. Hydro expects its telephone infrastructure-related costs to grow by 2.2 percent in 2014 and 2015. Hydro expects to recover 33.8 percent of its future telephone infrastructure-related costs by allocating these common expenses to its affiliates. There is no indication in the evidence provided to identify the amount of Hydro’s telephone infrastructure-related costs allocated to Nalcor or its other lines of business. Based on the evidence provided there is insufficient detail to determine the proportion of Hydro’s telephone infrastructure-related costs that are allocated to Nalcor or its other lines of business.
Table 13
Newfoundland and Labrador Hydro
Network Services (LANS) Allocations to Nalcor Energy’s Other Lines of Business
December 31, 2011-2015
CAN 000s

<table>
<thead>
<tr>
<th></th>
<th>2011 (Actual)</th>
<th>2012 (Actual)</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Costs allocated</td>
<td>195.3</td>
<td>195.3</td>
<td>186.0</td>
<td>190.1</td>
<td>194.8</td>
</tr>
<tr>
<td>B Hydro Regulated</td>
<td>795.8</td>
<td>736.9</td>
<td>1,010.1</td>
<td>953.8</td>
<td>953.8</td>
</tr>
<tr>
<td>C Other lines of business</td>
<td>188.2</td>
<td>247.1</td>
<td>230.9</td>
<td>287.2</td>
<td>287.2</td>
</tr>
<tr>
<td>D Total</td>
<td>984.0</td>
<td>984.0</td>
<td>1,241.0</td>
<td>1,241.0</td>
<td>1,241.0</td>
</tr>
<tr>
<td>E Cost per LAN (A / D)</td>
<td>198</td>
<td>198</td>
<td>150</td>
<td>153</td>
<td>157</td>
</tr>
<tr>
<td>F Hydro Regulated (B * E)</td>
<td>157.9</td>
<td>146.2</td>
<td>151.4</td>
<td>146.1</td>
<td>149.7</td>
</tr>
<tr>
<td>G Other Nalcor lines of business (C * E)</td>
<td>37.3</td>
<td>49.0</td>
<td>34.6</td>
<td>44.0</td>
<td>45.1</td>
</tr>
<tr>
<td>Total</td>
<td>195.3</td>
<td>195.3</td>
<td>186.0</td>
<td>190.1</td>
<td>194.8</td>
</tr>
</tbody>
</table>

Source: Hydro’s 2013 GRA, PUB-NLH-207.
Table 14
Newfoundland and Labrador Hydro
Network Services (Telephones) Allocations to Nalcor Energy’s Other Lines of Business
December 31, 2011-2015
CAN 000s

<table>
<thead>
<tr>
<th></th>
<th>2011 (Actual)</th>
<th>2012 (Actual)</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A Costs allocated</td>
<td>223.8</td>
<td>223.8</td>
<td>236.1</td>
<td>241.3</td>
<td>246.5</td>
</tr>
<tr>
<td>B Hydro Regulated</td>
<td>561.8</td>
<td>502.9</td>
<td>449.1</td>
<td>392.8</td>
<td>392.8</td>
</tr>
<tr>
<td>C Other lines of business</td>
<td>188.2</td>
<td>247.1</td>
<td>230.9</td>
<td>287.2</td>
<td>287.2</td>
</tr>
<tr>
<td>D Total</td>
<td>750.0</td>
<td>750.0</td>
<td>680.0</td>
<td>680.0</td>
<td>680.0</td>
</tr>
<tr>
<td>E Cost per Telephone (A / D)</td>
<td>298</td>
<td>298</td>
<td>347</td>
<td>355</td>
<td>362</td>
</tr>
<tr>
<td>F Hydro Regulated (B * E)</td>
<td>167.6</td>
<td>150.1</td>
<td>156.0</td>
<td>139.4</td>
<td>142.4</td>
</tr>
<tr>
<td>G Other Nalcor lines of business (C * E)</td>
<td>56.2</td>
<td>73.7</td>
<td>80.2</td>
<td>101.9</td>
<td>104.1</td>
</tr>
<tr>
<td>Total</td>
<td>223.8</td>
<td>223.8</td>
<td>236.1</td>
<td>241.3</td>
<td>246.5</td>
</tr>
</tbody>
</table>

Source: Hydro’s 2013 GRA, PUB-NLH-208.

Based on this evidence, I have concluded the following:

- Further inquiry is warranted to confirm that the telephone infrastructure costs to be recovered by Hydro from Nalcor and its other lines of business are fully burdened and do not include any non-operating expenses;
- Allocating the telephone infrastructure-related costs to be recovered using the average number of users as the allocator is reasonable; and
- Treating the telephone infrastructure-related costs to be recovered as flow through costs and charging them back without a mark-up is reasonable.
4.3.3 Other Expenses

4.3.3.1 Determining Whether a Service had been Rendered
Evidence that Hydro incurs other expenses not covered by the Administration Fee that also benefit, in part, Nalcor’s other lines of business was presented in Section 2.4.2.3. Based on this evidence, I have concluded the following:

- Hydro initially pays for the cost of certain other expenditures that benefit one or all of Nalcor’s lines of business; and
- The affiliates derive value from these other expenditures initially paid for by Hydro and would have been willing to pay for these expenditures on its own behalf.

4.3.3.2 Determining an Arm’s Length Price
As indicated in Section 2.4.2.3, Hydro charges out some of the other expenses it incurs on behalf of its affiliates either directly or through an allocation.

According to the evidence provided in Hydro’s 2013 GRA, the following expenses are clearly related to one of Nalcor’s other lines of business and, as a result, Hydro charges the amount back to that line of business directly:

- Audit expenses;
- Cell phone expenses;
- Directors’ expenses;
- Directors’ fees;
- Freight and courier expenses;
- Group insurance – premiums; and
- Treasury related fees.\(^{36}\)

In its response to a request for information made by the Board, Hydro provided a table summarizing the amount of these other expenses incurred and expected to be incurred by Hydro from 2007 to 2015.\(^{37}\) The amounts for 2011-2015 are reproduced in Table 15. These amounts do not reflect the amounts initially paid by Hydro and subsequently charged back to one of Nalcor’s other lines of business. The amounts in the table submitted into evidence represent only the amount of these other expenses that Hydro Regulated actually incurred. To clarify the record, Hydro should be asked to confirm that these other expenses are initially paid for by Hydro on behalf of Nalcor’s other lines of business and then subsequently charged back to the appropriate line of business. Should Hydro confirm in the positive, a request should be made by the Board to have Hydro provide a table indicating the dollar amount of these other expenses initially paid for by Hydro, the dollar amount it subsequently charged back to one of Nalcor’s other lines of business, and the dollar amount that Hydro Regulated ultimately bore. Apart from the group insurance premiums, the magnitude of these other expenses are not material.

\(^{36}\) See Hydro’s 2013 GRA, Section 3.4.3.3, pages 3.16-3.18.
\(^{37}\) See Hydro’s 2013 GRA, PUB-NLH-155.
According to the evidence provided in Hydro’s 2013 GRA, insurance expenses are either direct billed or allocated as per industry standard. In its response to a request for information made by the Board, Hydro provided a table summarizing the amount of these insurance expenses incurred and expected to be incurred by Hydro from 2007 to 2015. The amounts for 2011-2015 are reproduced in Table 16. In its response to a separate request for information made by the Board, Hydro stated that insurance premiums related to Hydro’s regulated and non-regulated activities are billed directly to Hydro and allocated using allocations provided by the insurance broker. There was no evidence to verify that Hydro initially paid for insurance premiums on behalf of Nalcor’s other lines of business and then subsequently charged them back to one of Nalcor’s other lines of business. To clarify the record, Hydro should be asked to confirm that insurance premiums are initially paid for by Hydro on behalf of Nalcor’s other lines of business and then subsequently charged back to the appropriate line of business. Should Hydro confirm in the positive, a request should be made by the Board to have Hydro provide a table indicating the total amount of these insurance premiums initially paid for by Hydro, the amount of these insurance premiums that it subsequently charged back to one of Nalcor’s other lines of business, and the amount of these insurance premiums that Hydro Regulated ultimately bore.

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38 See Hydro’s 2013 GRA, Section 3.4.3.3, page 3.17.
40 See Hydro’s 2013 GRA, PUB-NLH-160 (Revision 1).
The costs of corporate memberships encompass costs related to industry and professional organizations. With the exception of memberships with the Canadian Electric Association (“CEA”), according to the evidence provided in Hydro’s 2013 GRA, the majority of corporate memberships are initially paid for by Hydro and subsequently charged back to Nalcor and its other lines of business directly. CEA memberships are allocated by Hydro based on megawatts of generation, energy sales and kilometres of transmission line. Hydro expects to incur $100,000 in 2014 and 2015 for its share of CAE memberships. There is no indication in the evidence regarding the total amount that Hydro will spend on corporate memberships, including CEA memberships, and subsequently charge back to one of Nalcor’s other lines of business. The amount of these corporate memberships is not expected to be material.

According to the evidence provided in Hydro’s response to a request for information, advertising is administered by Nalcor for all of its lines of business. Further evidence provided in Hydro’s response indicates that Nalcor allocates these advertising expenses to Hydro on a case-by-case basis. However, evidence provided in Hydro’s 2013 GRA indicates that it is Hydro that initially pays for these advertising expenses and allocates them back to Nalcor’s other lines of business. In its response to a request for information made by the Board, Hydro provided a table summarizing the amount of these advertising expenses incurred and expected to be incurred by Hydro from 2007 to 2015. The amounts for 2011-2015 are reproduced in Table 17. There was no evidence to verify that Hydro initially paid for advertising expenses on behalf of Nalcor’s other lines of business and then subsequently charged back to one of Nalcor’s other lines of business. To clarify the record, Hydro should be asked to confirm that advertising expenses are initially paid for by Hydro on behalf of Nalcor’s other lines of business and then subsequently charged back to the appropriate line of business. Should Hydro confirm in the positive, a request should be made by the Board to have Hydro provide a table indicating the total amount of these advertising expenses initially paid for by Hydro, the amount of these advertising expenses that it subsequently charged back to one of Nalcor’s other lines of business, and the amount of these advertising expenses that Hydro Regulated ultimately bore.

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Table 16
Newfoundland and Labrador Hydro Insurance Expenses December 31, 2011-2015 CAD 000s

<table>
<thead>
<tr>
<th></th>
<th>2011 (Actual)</th>
<th>2012 (Actual)</th>
<th>2013 (Forecast)</th>
<th>2014 (Forecast)</th>
<th>2015 (Forecast)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hydro regulated</td>
<td>1,965.0</td>
<td>2,109.0</td>
<td>2,500.0</td>
<td>2,735.0</td>
<td>2,804.0</td>
</tr>
<tr>
<td>Hydro non-regulated</td>
<td>24.0</td>
<td>57.0</td>
<td>60.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>1,989.0</td>
<td>2,166.0</td>
<td>2,560.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Hydro’s 2013 GRA, PUB-NLH-155 (Revision 1), 160 (Revision 1).

*See Hydro’s 2013 GRA, PUB-NLH-042 for details regarding the July 1, 2013 premium renewal. There is no indication in the evidence that the amount expected to be paid by Hydro’s non-regulated activities changed based on the premium renewal.

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41 See Hydro’s 2013 GRA, PUB-NLH-157.
42 See Hydro’s 2013 GRA, Section 3.4.3.3, pages 3.16 and 3.17.
43 See Hydro’s 2013 GRA, PUB-NLH-156 (Revision 1).
According to the evidence provided in Hydro’s 2013 GRA and its response to a request for information made by the Board, annual general meeting and annual report expenses are shared between Nalcor’s lines of business and allocated on a case-by-case basis. As shown in Table 18, Hydro expected to incur $18,400 in 2013 and 2014 and $18,860 in 2015. Unless the annual general meeting and annual report expenses were incurred by Hydro for its own governance purposes, they should have been charged back to Nalcor and not allocated to its lines of business as they are stewardship expenses and should be borne by the parent company.

Based on this evidence, I have concluded the following:

- Further clarification is warranted regarding which of the other expenses are initially paid for by Hydro and subsequently charged back to one of Nalcor’s other lines of business. Hydro should be asked to provide the dollar amount of the other expenses that were charged back to Nalcor’s other lines of business;

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44 See Hydro’s 2013 GRA, Section 3.4.3.3, page 3.17 and PUB-NLH-165.
• With the exception of some potential shareholder costs, Hydro initially pays for the cost of certain other expenditures which should be charged back to a specific affiliate or allocated amongst its affiliates at cost; and

• Treating these other expenses as flow through costs and charging them back without a mark-up is reasonable.

4.4 Corporate Services Rendered to and by Newfoundland and Labrador Hydro

4.4.1 Determining Whether a Service had been Rendered

Evidence that Nalcor or its other lines of business rendered corporate services to Hydro and that Hydro rendered corporate services to Nalcor or its other lines of business was presented in Section 2.5 of this report. Based on this evidence, I have concluded the following:

• These corporate services would ordinarily be considered intra-group services;

• Hydro derives value from the corporate services rendered by Nalcor or its other business lines and would have been willing to pay for these corporate-related services had they been provided by an independent enterprise, or would have performed the activity on its own behalf in-house;

• The affiliates derive value from the corporate-related services rendered by Hydro and would have been willing to pay for these corporate services had they been provided by an independent enterprise, or would have performed the activity on their own behalf in-house; and

• Hydro and Nalcor rendered corporate-related services for which an arm’s length price should be charged.

4.4.2 Determining an Arm’s Length Price

Nalcor and its affiliates determine the amount charged to each affiliate for which corporate-related services are rendered based on the direct charge method, without including a profit margin.

The amount charged by Nalcor or any of its lines of business, including Hydro, for corporate-related services rendered is based on the amount of time spent by an employee performing the service and the employee's labour rate.

Nalcor employees that perform corporate-related services, including those at Hydro, are required to complete weekly time sheets which allocate their time to specific work orders. Time is coded in 30 minute increments.

An employee’s labour rate is determined on a cost recovery basis designed to recover salary, benefits, and indirect overhead. It does not include a profit margin. The labour rate includes a billing rate and a fixed charge.

The billing rate is determined based on an employee’s hourly wage amount plus a variable component equal to 57 percent of the hourly wage amount to recover fringe costs (e.g., CPP, Public Service Pension Plan), insurance, company costs (e.g., payroll taxes, bonus), and leave (e.g., statutory holidays, jury duty, standby allowance, and sick leave).45

45 See Appendix E for a detailed listing of the components for the bill rate.
The bill rates are reviewed annually and updated accordingly.

The fixed charges are intended to recover overhead costs (non-salary and benefit costs) directly associated with employees. The following costs are included in the fixed overhead charge calculation:

- Common services rendered by Hydro to Nalcor’s lines of business;
- Office space costs allocated by Hydro to Nalcor’s lines of business; and
- Other employee related expenses such as telephone and fax, books and subscriptions, membership and dues, conferences, training and other employee expenses.

The fixed charge rate is reviewed annually and updated accordingly by Nalcor for all of its lines of business. As shown in Table 16 the rate for 2012 was $13.10 per hour to a maximum of $98.23 per day. This rate is has not been modified yet for 2013 or subsequent years. Although most employees who render shared services are located in Hydro Place, this rate is also used as a proxy for employees working from other locations.

In the case of overtime, the labour rate is not applied and overtime is billed as incurred in accordance with the standard overtime policy.

<table>
<thead>
<tr>
<th>Table 19</th>
<th>Newfoundland and Labrador Hydro Summary Schedule of Fixed Charge December 31, 2011–2013 CAD per Hour</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>2012*</td>
</tr>
<tr>
<td>2011</td>
<td>2012*</td>
</tr>
<tr>
<td>Other Employee Related Costs</td>
<td>2.33</td>
</tr>
<tr>
<td>Hydro Place IS Share</td>
<td>2.40</td>
</tr>
<tr>
<td>Hydro Place HROE Share</td>
<td>1.67</td>
</tr>
<tr>
<td>Subtotal</td>
<td>6.40</td>
</tr>
<tr>
<td>Hydro Place Operating &amp; Capital Expenses</td>
<td>4.27</td>
</tr>
<tr>
<td>Computer Costs</td>
<td>-</td>
</tr>
<tr>
<td>Telephone Costs</td>
<td>-</td>
</tr>
<tr>
<td>LAN Costs</td>
<td>-</td>
</tr>
<tr>
<td>Total Fixed Charge Hourly Rate</td>
<td>10.67</td>
</tr>
<tr>
<td>Hours per day</td>
<td>7.50</td>
</tr>
<tr>
<td>Daily Fixed Charge Rate</td>
<td>80.03</td>
</tr>
</tbody>
</table>

Source: Hydro’s 2013 GRA, PUB-NLH-268 and 269.

* In 2012, the methodology was revised to be consistent with the Administration Fee.
Although it is likely that Nalcor and its affiliates incur professional corporate-related services, there is no indication in the evidence that they engaged third parties to render any of the same corporate-related services rendered amongst the affiliates. It is also likely that any such market data would include an unidentifiable profit element. Accordingly, there is no evidence that there are internal comparable uncontrolled transactions upon which to determine an arm’s length price using a comparable price method.

Based on this evidence, I have concluded the following:

• Charging corporate-related services rendered by Nalcor or any of its lines of business to an affiliate using a direct charge method is reasonable;
• Basing the labour rate on an employee’s base wage plus a variable component to recover benefits and other employee costs and a fixed component to recover indirect overhead is reasonable;
• The proxy used to calculate the portion of the labour rate intended to cover fringe benefits, including leaves, should be re-evaluated on an annual basis; and
• Not applying a mark-up to the costs of rendering corporate services is reasonable.
## 5 Materiality

As shown in Table 20, Hydro expected its affiliate transactions to be $15.6 million during the 2013 test year. Of the $15.6 million of affiliate transactions, $12.7 million involved charges from Hydro to its affiliates for service rendered or common expenses initially borne by Hydro and charged back to its affiliates. The remaining $2.9 million involved charges to Hydro from its affiliates for services rendered. If the amount charged by Hydro to its affiliates was understated or the amount charged to Hydro by its affiliates overstated, Regulated Hydro’s revenue requirement would be overstated as would the rate increase sought by Hydro.

<table>
<thead>
<tr>
<th>Table 20</th>
<th>Newfoundland and Labrador Hydro Projected Affiliate Transactions December 31, 2013 CAD 000s</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Common services charged to affiliates 7,741.8</td>
</tr>
<tr>
<td></td>
<td>Common expenses charged to affiliates 2,124.6</td>
</tr>
<tr>
<td></td>
<td>Other expenses charged to affiliates 13.4</td>
</tr>
<tr>
<td></td>
<td>Corporate services charged to affiliates 2,792.8</td>
</tr>
<tr>
<td></td>
<td>Sub-total 12,672.6</td>
</tr>
<tr>
<td></td>
<td>Corporate services charged by affiliates 2,921.2</td>
</tr>
<tr>
<td>Total</td>
<td>15,593.8</td>
</tr>
</tbody>
</table>

Source: Own calculations based on information from Tables 1, 2, and 3.

To demonstrate that the rate increase sought by Hydro is not very sensitive to the potential refinements to Nalcor’s intercompany pricing policy identified in Section 4, I undertook the following sensitivity analysis.
5.1 Sensitivity analysis

As shown in Table 21, I estimated the effective rate per kWh required by Hydro to achieve its estimated revenue requirement for Newfoundland Power during the 2013 test year to be 8.1 cents.

<table>
<thead>
<tr>
<th>Table 21</th>
<th>Newfoundland and Labrador Hydro</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Projected Effective Rate per kWh</td>
</tr>
<tr>
<td>December 31, 2013</td>
<td>CAD</td>
</tr>
</tbody>
</table>

| Revenue requirement | 453,005,298 |
| Estimated usage (kWh) | 5,594,300,000 |
| Effective rate (kWh) | 0.081 |

Source: Hydro’s 2013 GRA, Exhibit 13, Schedules 1.3.1 and 1.3.2.

Based on a rate model that is consistent with Hydro targeting the same return on equity as Newfoundland Power Inc., any change in the amounts charged by or to Hydro for the Administration Fee or corporate services would alter Hydro’s revenue requirement and, in turn, the effective rate per kWh. For example, an increase of $1 million in the amount charged for common services rendered by Hydro to its affiliates would reduce Hydro’s revenue requirements by a corresponding amount. As shown in Table 22, that $1 million change in the amount charged by Hydro to its affiliates would not have a material impact on the effective rate per kWh. An adjustment of $3 million in either direction would be required before changing the effective rate per kWh for Newfoundland Power by one-tenth of a cent. Accordingly, the potential underestimation of the amounts charged by Hydro for rendering common services to its affiliates as described in Section 4.2.1.2 of this report would not be material.

<table>
<thead>
<tr>
<th>Table 22</th>
<th>Newfoundland and Labrador Hydro</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sensitivity Analysis</td>
</tr>
<tr>
<td>December 31, 2013</td>
<td>CAD</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Increase/Decrease in charges for affiliate transactions</th>
<th>Change in required revenue</th>
<th>Revised Revenue</th>
<th>Estimated Usage (kWh)</th>
<th>New Effective Rate</th>
<th>Change in Effective Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>+$3,000,000</td>
<td>$3,000,000</td>
<td>$456,005,298</td>
<td>5,594,300,000</td>
<td>$0.082</td>
<td>+$0.001</td>
</tr>
<tr>
<td>+$2,000,000</td>
<td>$2,000,000</td>
<td>$455,005,298</td>
<td>5,594,300,000</td>
<td>$0.081</td>
<td>$0.000</td>
</tr>
<tr>
<td>+$1,000,000</td>
<td>$1,000,000</td>
<td>$454,005,298</td>
<td>5,594,300,000</td>
<td>$0.081</td>
<td>$0.000</td>
</tr>
<tr>
<td><strong>Base Case</strong></td>
<td></td>
<td><strong>$453,005,298</strong></td>
<td><strong>5,594,300,000</strong></td>
<td><strong>$0.081</strong></td>
<td></td>
</tr>
<tr>
<td>($1,000,000)</td>
<td>($1,000,000)</td>
<td>$452,005,298</td>
<td>5,594,300,000</td>
<td>$0.081</td>
<td>$0.000</td>
</tr>
<tr>
<td>($2,000,000)</td>
<td>($2,000,000)</td>
<td>$451,005,298</td>
<td>5,594,300,000</td>
<td>$0.081</td>
<td>$0.000</td>
</tr>
<tr>
<td>($3,000,000)</td>
<td>($3,000,000)</td>
<td>$450,005,298</td>
<td>5,594,300,000</td>
<td>$0.082</td>
<td>($0.001)</td>
</tr>
</tbody>
</table>

Source: Own calculations based on Hydro’s 2013 GRA, Exhibit 13, Schedules 1.3.1 and 1.3.2.
6 Conclusion

With respect to the common services that Hydro renders for its affiliates, it is my opinion that:

- Hydro renders common services (i.e., services related to HR, safety and health, and IS) to its affiliates that would ordinarily be considered intra-group services;
- The affiliates derive value from the common services rendered by Hydro and would have been willing to pay for these services had they been rendered by an independent enterprise, or would have performed the activities on their own behalf in-house;
- Hydro renders common services to its affiliates for which an arm’s length price should be charged;
- Using an indirect charge method to determine an arm’s length price for the common services Hydro renders to its affiliates is reasonable;
- The common services-related cost to be recovered through the Administration Fee might not be fully burdened and, as a result, the amount to be charged by Hydro to its affiliates for these common services might be understated. The magnitude of the potential increase in the amounts to be charged by Hydro to its affiliates for rendering these common services would not be material;
- Allocating the HR, and safety and health-related costs to be recovered using FTEs as the allocator is reasonable;
- Allocating the IS-related costs to be recovered using average number of users as the allocator is reasonable; and
- Unless the ultimate recipient of the common service rendered is an energy project involving private interests, not marking-up the common service-related costs to be recovered is reasonable.

With respect to the common expenses that Hydro initially pays on behalf of itself and its affiliates, it is my opinion that:

- Hydro initially pays for the cost of common expenditures that benefit all of Nalcor’s lines of business;
- The affiliates derive value from the common expenditures initially paid for by Hydro and would have been willing to pay for these expenditures on their own behalf;
- Hydro initially pays for the cost of common expenditures which should be allocated back to its affiliates at cost;
- The common costs to be recovered are fully burdened and do not include any non-operating expenses;
- Allocating the office-related costs to be recovered using square footage occupied as the allocator is reasonable;
- Allocating the telephone infrastructure-related costs to be recovered using the average number of users as the allocator is reasonable; and
- Treating these common expenses as flow through costs and charging them back without a mark-up is reasonable.
With respect to the other expenses that Hydro initially pays on behalf of itself and its affiliates, it is my opinion that:

- Hydro initially pays for the cost of certain other expenditures that benefit one or all of Nalcor’s lines of business;
- The affiliates derive value from these other expenditures initially paid for by Hydro and would have been willing to pay for these expenditures on its own behalf;
- Further clarification is warranted regarding which of the other expenses are initially paid for by Hydro and subsequently charged back to one of Nalcor’s other lines of business. Hydro should be asked to provide the dollar amount of the other expenses that were charged back to Nalcor’s other lines of business;
- With the exception of some potential shareholder costs, Hydro initially pays for the cost of certain other expenditures which should be charged back to a specific affiliate or allocated amongst its affiliates at cost; and
- Treating these other expenses as flow through costs and charging them back without a mark-up is reasonable.

With respect to the corporate services that Hydro renders for its affiliates and its affiliates render for Hydro, it is my opinion that:

- Hydro and its affiliates render corporate services that would ordinarily be considered intra-group services;
- Hydro and its affiliates derive value from the corporate services rendered by its affiliates or Hydro and would have been willing to pay for these services had they been rendered by an independent enterprise, or would have performed the activity on its own behalf;
- Hydro and its affiliates render corporate services to each other for which an arm’s length price should be charged;
- It is reasonable for Hydro and its affiliates to use an direct charge method to determine an arm’s length price for the corporate services it renders to its affiliates;
- The labour rates used to recover the costs of rendering these corporate services appear to be fully-burdened and do not include any non-operating expenses;
- The proxy used to calculate the portion of the labour rate intended to cover fringe benefits, including leaves of absence, should be re-evaluated on an annual basis; and
- Not applying a mark-up to the costs of rendering corporate services to be recovered is reasonable.

My opinion is based on:

- My expertise and experience in transfer pricing;
- The evidence submitted by Hydro in its 2013 GRA;
- The evidence submitted by Hydro in its responses to the requests for information;
- Publicly availability documents cited in this report; and
- The evaluation framework I developed in Section 3 of this report.
Newfoundland and Labrador Hydro

Expert Report

Evaluating the Pricing Policy for Affiliate Common Services, Common Expenses and Corporate Services

Appendices A-E
Appendix A: Brad Rolph’s Curriculum Vitae

Brad Rolph
Partner - National Transfer Pricing Leader

Experience
For the past 19 years, Mr. Rolph has helped multinational companies address their transfer pricing issues. Euromoney has recognized Brad as one of Canada’s leading transfer pricing advisers in its 2013 Guide to the World’s Leading Transfer Pricing Advisers. He was the first economist hired by any accounting firm in Canada to practice transfer pricing exclusively.

His areas of expertise include planning, implementing and documenting intercompany transactions for tangible goods, services and intangibles in a tax-efficient, defendable manner (“TESCM”); building models to price complex financial transactions; resolving audit disputes at the field, appeals and Competent Authority level; negotiating advance pricing arrangements (“APA”); and providing litigation support.

Brad has served companies based in Canada, the United States, England, Ireland, Finland, France, Germany, Sweden, Saudi Arabia and Japan. He has dealt with issues in the following industries: Aerospace, Mining, Metals and Minerals, Pulp and Paper, Transportation, Heavy Manufacturing, Steel, Utilities, Automotive, Chemical, Pharmaceutical, Food and Beverage, Electronic, Financial Services, Wholesale Trade, Apparel, Consumer Goods and Entertainment. He also has extensive experience with Japanese trading companies and web-based businesses.

Previously, Mr. Rolph was a Partner and the Chief Economist of the Canadian transfer pricing practice of a Big Four firm. He also held senior leadership positions with two transfer pricing boutiques.

Brad is a frequent speaker and commentator on transfer pricing matters. He has been published in International Tax Review, Euromoney and Tax Management International.

In addition to an Honours Bachelor of Arts degree in economics from Wilfrid Laurier University and a Masters of Arts degree in economics from Queen’s University, Brad has completed the course work and comprehensive theory exams in economics at the Ph.D. level at York University.
Recent Transfer Pricing Engagements

TESCM

• Restructured the supply chain of a Canadian-based manufacturer to address U.S. customs issues.
• Planned the transfer pricing policies for a Canadian-based start-up internet media publishing company with US operations.
• Planned the transfer pricing policies for buy-sell tangible goods transactions between a Canadian pharmaceutical company and its limited function/risk US subsidiary so as to maximize profits in Canada.
• Planned and documented transfer prices for chemicals sold by a manufacturing parent in Saudi Arabia to European customers through subsidiaries in Switzerland and the Netherlands fees so as to maximize profits reported in Saudi Arabia.

Financial Transactions

• Supported the quantum and related interest rates for intercompany loans between a Canadian-based professional services firm and its U.S. subsidiary.
• Determined fees for parent guarantees provided by a Canadian manufacturing company to subsidiaries in the Aerospace and Transportation industries.
• Estimated the credit rating for a Canadian subsidiary of a Swedish heavy manufacturing company.
• Developed a Monte Carlo simulation model to determine the base rate of interest for profit participating debt instruments between:
  ○ Belgium and Latvia affiliates of a Finnish utility company;
  ○ Belgium and Lithuania affiliates of a Finnish utility company; and
  ○ Canadian and Luxembourg affiliates of a US water treatment business.
• Developed a Monte Carlo simulation model to convert a fixed rate of interest to a floating rate for intercompany loans involving countries for which Bloomberg’s Swap Manager does not have such capabilities.
• Estimated loan guarantee fees between related parties of a Finnish utility company.
• Estimated credit ratings and developed a methodology to determine interest rates on short-term and long term loans for 33 subsidiaries in Finland, Sweden, Norway, the Baltics, Russia, France and England for a Finnish utility company. This project required estimating credit ratings for unregulated utilities, unregulated power companies, regulated utilities, service companies and five captive finance entities.
• Estimated credit ratings for almost 20 US and foreign subsidiaries and provided preliminary estimates of associated interest rates on long term debt for a French heavy manufacturing company.
• Estimated the credit rating and used regression analysis to determine the discount rate on preferred shares issued by a Singapore affiliate of a French mining company.
• Estimated the credit rating and the discount rate on preferred shares issued by a US affiliate of a Canadian steel company.
• Determined an interest rate for funds advanced periodically to fund pre-export activities on sales of coal by a Columbian subsidiary of a US mining company.
• Estimated the credit ratings, the interest rate on intercompany loans and the discount rates on preferred shares between subsidiaries in Finland, Spain and Turkey for a Canadian mining company.

Audit Dispute Resolution
• Negotiated a settlement of transfer pricing adjustments at the Appeals Branch of the Canada Revenue Agency (“CRA”) for the Canadian subsidiary of a U.S. provider of information technology services. The transactions involved the provision of information technology services by the Canadian subsidiary to its U.S. parent.
• Developed a model to defend the transfer pricing policies of a Canadian food processor against a CRA reassessment at Competent Authority. The transaction at issue was a buy-sell tangible goods transaction involving a limited function/risk distributor.
• Obtained a downward adjustment for the Canadian subsidiary of a US business service provider during a transfer pricing audit.
• In anticipation of an audit, measured the exposure related to transfer pricing policies for transactions involving the sale and purchase of tangible goods used as inputs between a Canadian pulp manufacturer and affiliated paper manufacturers in Canada and the US.

Advanced Pricing Arrangements
• Requested a unilateral APA with the Canada Revenue Agency (“CRA”) for a Canadian subsidiary of a US pharmaceutical company.
• Requested a bilateral APA between the CRA and the Internal Revenue Service for a US alcoholic beverage company.
• Negotiated a unilateral APA for a Canadian subsidiary of US automotive parts supplier.

Expert Witness/Litigation Support
• Supporting counsel to appeal transfer pricing adjustments assessed against a Canadian food harvester on its sales of food product to an off-shore affiliate.
• Prepared expert witness reports at the request of counsel on a matter involving intercompany services rendered and arranged by a Canadian service provider to an off-shore, web-based affiliate. The first report was issued in support of a notice of appeal issued to the Appeals Branch of the CRA. The second report was issued in support of the audit defense for subsequent taxation years.
• Prepared draft expert witness reports at the request of counsel on a matter involving the appropriate discount rates for the factoring of accounts receivable. The matter is currently before the Federal Court of Appeals.
• Supported the work of an expert witness on a matter involving the tax treatment of lawsuit settlement expenses. The matter is currently before the Tax Court of Canada.
• Supported the work of an expert witness on a matter involving the appropriate rate for guaranteeing bank deposits that was before the Tax Court of Canada. The matter was settled.
• Supported the work of an expert witness on a matter involving the transfer pricing policies of a North American automotive manufacturer that was before the Ontario Superior Court.
Recent Presentations

- Related Party Pricing & Transfer Pricing in the Oil and Gas Industries, presenter with Joy Nott and Lisa Zajko, Canadian Importers and Exporters Association, Western Regional Conference, February 27, 2014, Calgary, Alberta.


- Customs Valuation and Transfer Pricing: Review of the Methodologies, presenter with Joy Nott, Canadian Importers and Exporters Association Webinar Series, April 18, 2013.

- Customs Valuation and Transfer Pricing: Starting from the Beginning, presenter with Joy Nott, Canadian Importers and Exporters Association Webinar Series, April 4, 2013.


Understanding the Economics of Transfer Pricing, presenter, Infonex, Key Issues in Global Transfer Pricing, April 1, 2011, San Diego, California.

An Introduction to Transfer Pricing, presenter, Infonex, Key Issues in Global Transfer Pricing, Pre-conference Workshop, March 30, 2011, San Diego, California.


Recent Publications


NHL Needs to Stop Rewarding Losers, editorial in the National Post, April 22, 2013.


To mark-up intra-groups services or not, that is the question, Insights: Transfer Pricing, a Charles River Associates’ publication, June 2012.

In the circumstances: The Supreme Court of Canada hears the GlaxoSmithKline transfer pricing case,

Canada’s obsession with the CUP method leads to strange ruling in Alberta Printed Circuits case, Euromoney Yearbooks, Transfer Pricing Review 2011/12, pp. 33-37.


Limited-Function Distributors: Alternatives to the Canada Revenue Agency’s Co-Distributor Approach,
Appendix B: Cost Allocation Methodologies of Regulated Canadian Energy Companies

Enbridge Inc.

Enbridge is organized such that each business unit is operationally self-sufficient. However, it has centralized certain services for efficiency purposes. The centralized service group in one business unit may provide services to more than one business unit or a business line within the business unit. For example, Enbridge has implemented an “integrated” operating model which involves the corporate office effectively managing the decision making and operating activities of its business units and affiliates. The corporate office sets strategy, policies and standards and the business units operate in accordance with those policies and standards. The corporate office is a service provider to the business units.

It is Enbridge’s policy to directly charge costs whenever possible. However, certain costs must be segregated and allocated to the other business units. This allocation is required to properly assess the financial performance of each business line and to ensure that there is no cross-subsidization between regulated and non-regulated activities.

Enbridge’s cost allocation methodology is designed to ensure that appropriate and relevant cost information is segregated, accumulated and documented. Allocations are measured using a fully burdened cost. Each cost or group of costs is allocated using a basis that reflects the cost driver that appropriately reflects the benefits and the cost of rendering the service.¹ Three allocation bases are used:

- Fixed Parameter Basis: used to allocate costs based on identifiable parameters such as deemed common equity, capital employed, FTEs, kilometres/miles of pipe, square footage, etc.;
- Time Estimate Basis: used to allocate costs based on time spent; and
- Direct Labour Basis: used to direct charge costs based on actual labour hours using time sheets and business unit charge-out rates. This basis is used only when charging to projects or third parties.

Timesheets are used when charging a capital project or a third party, otherwise time estimates based on periodic time studies are used. The labour rate used to charge capital projects or third parties includes a labour rate and an overhead rate. The labour and overhead rates are calculated once per year during the budget process and are in effect for the entire year.

¹ See Enbridge, Cost Allocation Methodology, March 17, 2009.
The costs associated with the following functional areas are allocated to the other lines of the business:

- Accounting;
- Taxation;
- Public Affairs;
- Health and Safety;
- Environment;
- Planning;
- Record Management;
- Office Services;
- Law and General Counsel;
- Regulatory Affairs;
- Human Resources;
- Fleet Management;
- Corporate Security;
- Regional Operations: Pipe Maintenance;
- Employee Communications;
- Systems Measurement (Meters);
- Aviation;
- Regional Operations;
- Control Centre Operations; and
- Shipper Services.

**EPCOR Water Services Inc.**

EWSI obtains corporate services from its parent corporation, EPCOR Utilities Inc. (“EUI”). Corporate services include activities that are centrally managed for the EPCOR group due to their nature and/or to realize economies and greater effectiveness. Consistent with its approach in previous years, EUI allocates corporate service costs to EPCOR business units using the following five step process:

1. Categorize corporate service costs as directly assignable or allocable.
2. Assign directly assignable costs to the appropriate business unit.
3. Review/modify allocation method for allocable costs
4. Apply allocation method to allocable costs.
5. Conduct a final review for reasonableness.

A functional cost causation allocator has been used where the costs can be allocated using an identified cost causation driver (such as headcount). The composite cost causation allocator has been used where the costs cannot be allocated using a functional cost causation allocator. The latter types of costs tend to be related to corporate services that are of a governance nature, or such that the costs could not be reasonably allocated.
with a meaningful functional cost causation allocator, and it is appropriate that these types of costs be allocated based on a combination of the business unit's share of EUI revenues, assets, capital expenditures and headcount.\(^2\)

The following is a list of departments that are allocated by EUI:

- Executive and Executive Assistants;
- Board;
- Corporate Finance;
- Treasury;
- Human Resources;
- Business Services;
- Associate General Counsel and Assistant Corporate Secretary;
- Public and Government Affairs;
- Regulatory Affairs;
- Supply Chain Management;
- Health, Safety and Environment;
- Strategic Planning;
- Risk, Assurance and Advisory; and
- Incentive Compensation – Corporate.

**Newfoundland Power Inc.**

An Inter-Affiliate Code of Conduct ("Code") has been created to establish standards and conditions for interaction between Newfoundland Power Inc. ("NPI") and its Utility and Non-Utility Affiliates. Whenever NPI provides services or resources to an Affiliate or receives services or resources from an Affiliate, the intent is for these transactions to be in accordance with the provisions of the Code.\(^3\)

The principles underlying the code consist of the following:

- All Inter-Affiliate transactions shall be fully transparent and subject to the scrutiny of the Board;
- All Inter-Affiliate transactions shall be prudent, and the prudence of such transactions, when required, be demonstrated to the satisfaction of the Board;
- NPI shall ensure that Inter-Affiliate transactions will not disadvantage the interests of ratepayers and furthermore that ratepayers and the Utility will derive some demonstrable benefit from such transactions;
- With regard to the provision of staff and other services to its Affiliates, benefits should be transparent, demonstrable and maximized to the advantage of the ratepayers;

\(^2\) See Epcor Utilities Inc., Corporate Services Charges Allocation Methodology, Appendix D-3.

\(^3\) See Newfoundland Power Inc., Inter-Affiliate Code of Conduct, May 2011.
• Inter-Affiliate transactions should only be entered into insofar as they provide a net benefit to ratepayers and they do not compromise the operational or managerial integrity of NPI;
• Charges associated with Inter-Affiliate transactions must be supported by the principles of cost causality; and
• The onus is on the utility to show that it is in compliance with this Code.

The specific section within the Code regarding Shared Corporate Services states:

“Where NPI determines it is prudent to do so, it may obtain Shared Services from an Affiliate or provide Shared Services to an Affiliate. NPI shall periodically review the prudence of Shared Services and make whatever adjustments are necessary to ensure that NPI and its affiliates bear their proportionate share of costs. The charges to each Affiliate for a Shared Service will reflect all of the costs incurred in providing the service. Cost will be allocated on a basis that reflects causality. Where a causal relationship cannot be established, the costs will be allocated on the basis of proportionate benefits.”

**Ontario Power Generation Inc.**

OPG is structured such that certain Services Provider groups provide services and incur costs in support of the regulated and unregulated business segments with OPG. The groups being allocated include:

- Business & Administrative Services – IT Outsourcing;
- Business & Administrative Services – IT Work Programs;
- Business & Administrative Services – Supply Chain;
- Business & Administrative Services – Real Estate and Business Services;
- People and Culture;
- Finance;
- Corporate Centre;
- Commercial Operations & Environment;
- Hydroelectric / OSL Shared; and
- Centrally held costs in OPG’s cost allocation model.

There are two methods to distribute shared costs among business units – direct assignment and allocation. The OPG methodology uses direct assignment wherever possible. The primary direct assignment methods include:

- Specific, indicating specific identification of labour or other resources;
- Estimates, indicating management estimates of time;
- Asset Service Fees, for utilities costs based on location; and
- Pension / OPEB, based on amounts charged to payroll.
In cases where neither specific identification nor estimation of costs to a Business Segment are possible, it is necessary to allocate the costs of the resources to the Business Segments or stations using cost drivers. A cost driver is a formula for sharing costs among those who cause the costs to be incurred.\(^4\)

The selection of cost drivers should be based on cost causation, with consideration to the practicality of obtaining the data necessary to develop the allocator, the stability of the data over time and whether additional data would materially affect the result of the cost allocation. The types of cost drivers used typically include:

- Physical (e.g., full-time employees or FTEs; LAN IDs);
- Financial (e.g., labour costs; total OM&A cost);
- Blended (e.g., capital plus OM&A); and
- Internal (e.g., BAS costs allocated for Finance are re-allocated to Business Segments and stations in proportion to the overall allocation of Finance costs).

**Pacific Northern Gas Ltd.**

PNG provides a number of administrative, accounting and regulatory, and other reporting services to Pacific Northern Gas (N.E.) Ltd (“PNG NE”). PNG first determines a cost pool for its shared services. The division of costs is completed using the following shared service cost pools:\(^5\)

- Management;
- Administration;
- Customer Care;
- Billing Services;
- Accounting;
- Technical Services;
- Drafting;
- Safety & Training;
- Corporate;
- Vertex Billing Services;
- Special Services; and
- Insurance.

Next, PNG allocates its costs for such shared services using a number of different cost allocators, including allocators based upon relative time, relative number of customers, relative number of employees and relative rate base. PNG’s allocation methodology is characterized by the following elements:

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- Defensible cost causation linkage: The driver provides a causal link based on a level of effort or investment with PNG NE service activity for costs to be allocated to PNG NE;
- Freedom from bias: The cost driver selected would not be viewed to favour PNG NE unfairly;
- Transparency: The driver used and the source or basis on how it is determined is visible to all parties affected;
- Stability: The identified driver fluctuates as expected based upon the level of effort and investment. It would not be expected that this driver would have to be amended or replaced in less than 12 months;
- Accuracy: The identified driver allocates costs without users having to apply estimation or judgment and the resulting allocation reflects a quantifiable allocation;
- Sustainability: The identified driver can be supported into the foreseeable future without undue cost burden on PNG;
- Cost versus benefit for effectiveness: The cost to identify, capture data and utilize the identified cost driver is not too burdensome relating to the benefits of its application; and
- Availability of information to apply drivers: The information needed to apply the cost driver is readily accessible.

Terasen Gas Inc.

TGI provides shared services to Terasen Gas Vancouver Island Inc. (“TGVI”) and Terasen Gas Whistler Inc. (“TGW”) that enable both companies to capture benefits from economies of scale by having a single management and support structure. The following departments comprise the shared services to TGVI and TGW:

- President & CEO’s Office;
- Distribution;
- HR & Operations Governance;
- Marketing;
- Business & IT Services;
- Gas Supply & Transmission; and
- Finance & Regulatory Affairs.

Operations and maintenance (“O&M”) costs for shared services allocated from TGI to TGVI and TGW are calculated at the cost center level. Costs relating to shared services are accumulated into cost pools in each cost center. These costs also include overhead costs which are distributed across all departments. These cost pools are then allocated to TGVI and TGW using a specific cost driver. The cost drivers used by TGI in its allocation are number of employees, number of customers, and time estimates. TGI’s allocation methodology is characterized by the following elements:

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• Regulatory precedence: The cost allocation methodology should be tested and approved (i.e., an acceptance of reasonability has previously been established) through regulatory reviews of TGI or other regulated utilities;

• Reflective of Service or investment: The allocation methodology is reflective of the work required to perform the service for TGVI/TGW or reflective of the investment value in TGVI/TGW (i.e., time, assets, and revenue);

• Supportable Methodology: The allocation approach is supported by a defined and documented methodology, model, and other support documentation. The allocation driver is also linked to a Services Level Agreement that is updated and reviewed on a consistent basis;

• Cost Effective: The allocation driver is calculated and maintained from readily available information resulting in minimal time and expense;

• Stable over time: The allocation methodology can accommodate changes to the size of the allocation driver from test period to test period and is scalable given changes in the amount of cost and types of services being allocated; and

• Objective results: The use of the allocation driver results in an objective allocation amount that is reasonable for a company of that size for the services being rendered.
Appendix C: Tax Administration
Detailed Guidance

2.1 Determining Whether a Charge for a Service Rendered is Justified

Under the OECD’s Transfer Pricing Guidelines, the CRA’s IC 87-2R and IRS’ Internal Revenue Code, the primary test to determine whether a specific activity performed by a member of the multinational group for another member is a service for which a charge is justified is “whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if performed for it by an independent enterprise or would have performed the activity in-house for itself.”

If the activity is not one for which an independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered an intra-group service under the arm’s length principle.

Activities that ordinarily would be considered intra-group services may include:

- Administrative services such as:
  - Planning,
  - Coordination,
  - Budgetary control,
  - Financial advice,
  - Accounting,
  - Auditing,
  - Legal,
  - Factoring, and
  - Computer services;

- Financial Services such as:
  - Supervising cash flows and solvency,
  - Capital increases,
  - Loan contracts,
  - Managing interest and exchange rate risks, and
  - Refinancing;

- Assistance in the fields of:
  - Production,
  - Buying,
  - Distribution, and

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7 See OECD Transfer Pricing Guidelines, Chapter VII, Section B.1, paragraph 7.6. See also IC 87-2R, paragraph 162 and §1.482-9(1)(3)(i).
Similarly, an activity would not be considered an intra-group service if:

- It duplicates an activity that the recipient has already performed itself or had a third party perform on its behalf;\(^8\)
- It benefits the owner of the controlled group and does not confer a benefit on the recipient (“Shareholder benefits”);\(^9\) or
- If the benefit results from the recipient’s status as a member of a controlled group.\(^10\)

Although it would also be unusual for a group member to incur a charge for a service performed by another member of the group if that activity is performed by the member itself or by an arm's length party on the member's behalf, in some cases there may be a valid business reason for duplicating a service.\(^12\)

The following are examples of shareholder activity-related costs provided by the OECD:

- Costs related to the legal structure of the parent company itself, such as the parent’s shareholder meetings, issuing shares in the parent company and the governance board costs;
- Costs related to the financial reporting or regulatory requirements of the parent company including the consolidation of the reports; and
- Cost of raising funds for the acquisition of an interest in a business.\(^13\)

**2.2 Determining an Arm’s Length Charge**

Where a charge for a service is justified, the amount charged should be determined in accordance with the arm’s length principle. Determining the arm’s length price for a service should be considered from the perspective of both the supplier and the recipient of the service. The arm’s length price will not only be a function of the cost incurred by the supplier providing the service, but also a function of the value of the service to the recipient and how much an arm's length entity would be prepared to pay for such the service in comparable circumstances.\(^14\)

In its Transfer Pricing Guidelines, the OECD recommends two methods that, when applied correctly, result in an arm's length price for the provision of services.\(^15\) These methods are the comparable uncontrolled price.

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\(^8\) See OECD Transfer Pricing Guidelines, Chapter VII, Section B.1, paragraph 7.14. See also IC 87-2R, paragraph 162 and §1.482-9(1)(3)(i).
\(^9\) See OECD Transfer Pricing Guidelines, Chapter VII, Section B.1, paragraph 7.11.
\(^10\) See OECD Transfer Pricing Guidelines, Chapter VII, Section B.1, paragraph 7.9.
\(^11\) See OECD Transfer Pricing Guidelines, Chapter VII, Section B.1, paragraph 7.13.
\(^12\) See OECD Transfer Pricing Guidelines, Chapter VII, Section B.1, paragraph 7.11.
\(^13\) See OECD Transfer Pricing Guidelines, Chapter VII, Section B.1, paragraph 7.10. See also IC 87-2R, paragraphs 156 and 157, and Internal Revenue Code §1.482-9(i).
\(^14\) See OECD Transfer Pricing Guidelines, Chapter VII, Section B.2.3, paragraph 7.29 and IC 87-2R, paragraph 162.
\(^15\) See “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators,” OECD.
The United Nations and CRA endorse the use of these methods. The United Nations and CRA endorse the use of these methods. The United Nations and CRA endorse the use of these methods. The United Nations and CRA endorse the use of these methods. The United Nations and CRA endorse the use of these methods. The United Nations and CRA endorse the use of these methods. The United Nations and CRA endorse the use of these methods.

For U.S. tax purposes, the arm’s length price charged for rendering services to related parties must be determined under one of the following six methods listed in §1.482-9:

- Service cost method;
- Comparable uncontrolled services price method;
- Gross service margin method;
- Cost of services plus method;
- Comparable profits method; and
- Profit split methods.

Each method must be applied in accordance with the provisions of §1.482-1, including the best method rule, the comparability analysis, and the arm’s length range.

These methods endorsed by the OECD, the UN, the CRA and the IRS, can be generally categorized into methods that evaluate the actual price of a service (the “comparable price methods”) and methods that are based on the recovery of costs incurred by the service provider, plus a mark-up, if appropriate (“cost recovery methods”).

**2.2.1 Comparable price methods**

Comparable price methods compare the price charged for services rendered between related parties in controlled transactions to the price charged for services rendered between unrelated parties in uncontrolled transactions in similar circumstances. Evidence that would permit the application of the comparable price methods may arise where:

- The taxpayer or another member of the group receives or renders a service of substantially the same quality, in similar quantities and under comparable terms from/to arm’s length parties in similar markets (internal comparable uncontrolled transactions); or
- An arm’s length party receives or renders a service of substantially the same quality, in similar quantities and under comparable terms to another arm’s length party in similar markets (external comparable uncontrolled transactions).19

Accordingly, the comparable price methods are likely to be used where there is a comparable service rendered between third parties in the recipient’s market, or by the related party providing the service to a third party in comparable circumstances.

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15 See OECD Transfer Pricing Guidelines, Chapter VII, Section B.2.3., paragraph 7.31.
17 See IC 87-2R, paragraphs 160 and 162.
18 See OECD Transfer Pricing Guidelines, Chapter II, Section B, paragraph 2.13.
19 See IC 87-2R, paragraphs 64 and 161.
The CRA believes that the CUP method provides the best evidence of an arm’s length price because it focuses directly on the price of a transaction and requires a high level of comparability.\(^{20}\)

Transactions may serve as comparable transactions despite the existence of differences between those uncontrolled and the controlled transactions, if the differences can be reasonably quantified and appropriate adjustments can be made to eliminate the effects of those differences.\(^{21}\) However, at some point, the differences may become so significant that the CUP method cannot be relied upon to produce arm’s length price and other transfer pricing methods may have to be considered.\(^{22}\)

### 2.2.2 Cost Recovery Methods

In cases where comparable price methods cannot be reliably applied, the OECD encourages taxpayers to consider alternative methods which involve identifying an appropriate cost of a service. Once an appropriate cost of rendering a service is identified, the taxpayer must determine whether that cost of service should be marked-up, and if so, by how much.

The cost of providing such services may be borne initially by the parent company or alternatively, by a specially designated group member or by any group member.\(^{23}\)

Affiliate services can be charged out to the recipients using either the direct charge method or the indirect charge method. Under the direct charge method, an affiliate is charged based on the costs incurred for a specific, readily-identifiable service. Under the indirect charge method, an affiliate is charged based on an allocation of costs incurred for a central beneficial service.\(^{24}\)

### 2.2.3 Determining the Cost Base

There is limited guidance provided in OECD’s Transfer Pricing Guidelines and the CRA’s IC-87-2R regarding which costs to take into account when determining the cost of rendering a service. However, the IRS’ Internal Revenue Code defines total services cost as “all costs of rendering those services.”\(^{25}\) The term “all costs” will generally include direct operating costs (e.g., salaries and benefits) as well as indirect operating costs (e.g., overhead), but will exclude non-operating costs, such as “interest expense, foreign income taxes, or domestic income taxes”\(^{26}\) as well as ”shareholder costs.”

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\(^{20}\) See IC 87-2R, paragraph 53.

\(^{21}\) See IC 87-2R, paragraph 66.

\(^{22}\) See IC 87-2R, paragraph 55.

\(^{23}\) See OECD Transfer Pricing Guidelines, Chapter VII, Section A, paragraph 7.2.

\(^{24}\) See OECD Transfer Pricing Guidelines, Chapter VII, Section B.2.2, paragraph 7.20-7.27.

\(^{25}\) See §1.482-9(j).

\(^{26}\) See §1.482-9(j).
2.2.4 Determining the Allocation Method

Once a cost base is determined, the cost base is allocated to the relevant service recipients to approximate the cost of service to those recipients. The guidance provided by the OECD in its Transfer Pricing Guidelines is limited. It states the allocation may be based on “turnover, or staff employed, or some other basis.”

The guidance provided by the CRA is also limited to the following:

“When choosing an allocator (e.g., sales, gross or operation profits, units used/produced/sold, number of employees, or capital invested), the taxpayer should consider the nature and use made of the service.”

Even the IRS provides limited guidance to taxpayers in terms of an appropriate allocation method.

“Any reasonable method may be used to allocate and apportion costs. In establishing the appropriate method of allocation and apportionment, consideration should be given to all bases and factors, including, for example, total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent.”

2.2.5 Determining whether a Mark-up should be applied

Arm’s length service providers would normally seek to charge a fee for their services in such a way so as to generate a profit, rather than merely charging for the service at cost. However, there are circumstances in which an arm’s length party would not generate a profit from rendering a service. Accordingly, it need not always be the case that an arm’s length price will result in a profit for an associated enterprise that is performing an intragroup service.

The guidance provided by the CRA mirrors that of the OECD on this issue. According to the CRA, determining whether a mark-up is appropriate and, if so, the quantum of the mark-up requires careful consideration of the following factors:

- The nature of the activity;
- The significance of the activity to the group;
- The relative efficiency of the service supplier; and
- Any advantage that the activity creates for the group.

With the exception of the services cost method, the methods by which the IRS determines arm’s length amounts charged in affiliate services transactions include a profit element. The services cost method allows a zero mark-up. The services cost method may be applied if the following conditions are met:

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27 See OECD Transfer Pricing Guidelines, Chapter VII, Section B.2.3, paragraph 7.25.
28 See OECD Transfer Pricing Guidelines, Chapter VII, Section A, paragraph 7.2.
29 See §1.482-9(k).
30 See OECD Transfer Pricing Guidelines, Chapter VII, Section B.2.3, paragraph 7.33. In the context of determining whether to add a mark-up to a service-related cost transferred between related parties, the OECD distinguishes between situations in which one of the related parties renders the service and situations which one of the related parties involved acts solely as an intermediary on behalf of the other related party or parties to acquire services from an arm’s length party. In the latter situation, the OECD suggests that it may be appropriate to pass on these costs to the group recipients without a mark-up because they are costs that the group recipients would have incurred directly had they been independent parties (See OECD Transfer Pricing Guidelines, Chapter VII, Section B.2.3, paragraph 7.36). The CRA provides similar guidance on the issue of flow-through costs (See IC 87-2R, paragraphs 165).
31 See IC87-2R, paragraph 164.
1. The service is a covered service;\textsuperscript{32}
2. The service is not an excluded activity;\textsuperscript{33}
3. The service is not precluded from constituting a covered service by the business judgment rule;\textsuperscript{34} and
4. Permanent books of account and records are maintained for as long as the costs with respect to the covered services are incurred by the renderer.\textsuperscript{35}

\textsuperscript{32} See §1.482-9(b)(3).
\textsuperscript{33} See §1.482-9(b)(4).
\textsuperscript{34} See §1.482-9(b)(5).
\textsuperscript{35} See §1.482-9(b)(6).
Appendix D: Allocation Methodologies for Intra-group Services

1. Introduction

Grant Thornton surveyed its member firms to gain an understanding of the cost allocation methodologies used in 80 countries. These allocation methodologies pertain to the allocation of centralized or cross-border intra-group services rendered to related multinational enterprises. Using the responses from these member firms, Grant Thornton has prepared the following summary of global best practices.

2. Organisation of Economic Cooperation and Development

The Organisation of Economic Cooperation and Development (“OECD”) has published guidelines to assist multi-national enterprises and tax administrations with respect to the pricing and evaluation of cross border intercompany transactions (the “OECD Guidelines”). The OECD relies on the use of the arm’s length principle to put “associated and independent enterprises on a more equal footing for tax purposes” and “promote the growth of international trade and development”. The CRA’s views reflect that of the OECD Guidelines. In paragraph 7.25 of the OECD Guidelines, the OECD states that an appropriate allocation should consider the nature and usage of the service being rendered. Potential allocation keys are number of staff for the provision of payroll and number of group members for expenditure on computer equipment.

37 See OECD Guidelines, Chapter I, ¶ 1.8.
38 See OECD Guidelines, Chapter I, ¶ 1.8.
3. Survey Responses by Country

3.1 Algeria

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: There is no specific guidance or rules issued by the Algerian tax authority.

3.2 Argentina

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: There is no specific guidance or rules issued by the Argentinian tax authorities. There is no reference in Argentinian law to the OECD rules. However, the OECD Guidelines are generally accepted as a reference, but the situations are analyzed by the Argentinian tax authorities on a case-by-case approach.

3.3 Armenia

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Armenia currently does not have Transfer Pricing legislation. It is expected that TP legislation will be applied from January 2015.

3.4 Australia

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: There are no guidelines issued by the tax authority Australian Taxation Office (“ATO”), Taxation Ruling TR 1999/1: Whether an multinational enterprise (“MNE”) uses either a direct or indirect method of charging for services, to conform with the arm’s length principle, the charge used for tax purposes should be the best possible approximation of the arm’s length consideration for those services. It is recognized by the ATO that choosing an allocation method to estimate the shares of expected benefits is a matter of judgment. It is required that taxpayers put forth their best effort to apply an indicator that approximates the expected sharing of benefits in the particular circumstances faced at the time the service is provided. Determining whether the allocation key is appropriate depends on the nature and usage of the service. Some keys may be suitable for more than one type of service and the total amounts to be allocated in respect of several services may be able to be allocated with the one key.
3.5 Austria

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: None.

3.6 Belgium

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: The Belgium tax authorities have not published any specific guidance in the context of cross-border intra-group services. Generally speaking, the Belgian tax authorities will accept OECD Guidelines.

3.7 Brazil

OECD Country: No.

Method of Allocation: Reasonable allocation.

Additional Commentary: The Brazilian transfer pricing rules does not follow the international standards (OECD or US guidelines), nor does the Brazilian Tax authorities publish specific guideline regarding metrics. The definition in Brazilian law for allocations is that it should be reasonable and consider the nature of the expenses that will be allocated. However, no definition reasonability is provided in the Brazilian law.

3.8 Bulgaria

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: The Bulgarian tax authorities issued a transfer pricing manual, which is analogous to the OECD Guidelines.
3.9 Canada

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: The Canada Revenue Agency (“CRA”) administers tax law in Canada. Canadian transfer pricing law is legislated in Section 247 of the Income Tax Act (“the Act”). Section 247 of the Act focuses exclusively on transactions that occur between the taxpayer and a non-resident party with whom the taxpayer does not deal at arm’s length. Transfer pricing legislation in Canada does not provide guidance with regards to a specific set of allocation keys to apply when determining the cost allocations between related parties for shared services. However, the CRA has published Information Circular 87-2R-International Transfer Pricing CRA [1999] (“IC87-2R”) which documents CRA’s views with respect to the interpretation of Section 247 of the Act. In paragraph 171 of IC 87-2R the CRA states that the taxpayers should consider the nature of the services when allocating costs to related parties for shared services. In paragraph 171 of IC 87-2R, the CRA also provides the taxpayer with the following potential allocation keys: sales, gross or operating profits, units used/produced/sold, number of employees, or capital invested. IC87-2R is not the law, but rather a source of information with respect to the policies behind the Act and the application of the transfer pricing rules. As a result, the courts are not bound by the legislations or policies published by the CRA and the courts are free choose their own interpretation.

3.10 Cayman Islands

OECD Country: No.

Method of Allocation: The Cayman Government gives no guidance on allocations. There are no Income taxes, corporate taxes, succession duties or Property taxes in the Cayman Islands.

Additional Commentary: The Cayman Islands is not a tax haven, since duties are paid on everything that is brought into the islands. Only regulated companies require an audit; all other companies do not require an audit, nor are they required to file financial statements.

3.11 Guernsey

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Guernsey does not have transfer pricing rules. The Guernsey tax authority follows the OECD model as a basis for groups involving other territories.

3.12 Chile

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: None.
3.13 China

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: China has not published any ruling specifically for the allocation key of service cost base. In practice, the OECD approach is followed and tax authorities would normally assess the reasonableness of the proposed allocation key based on the service nature.

3.14 Croatia

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: The tax treatment of the cross-border intra-group services in Croatia is regulated by the Corporate Tax Act and Rules on the Corporate Income Tax. There is no detailed guidance on transfer pricing issue provided by the Croatian tax authority, but generally, OECD Directive on transfer pricing is applied. The methods described and the preferences of the methods are the same as described in the OECD Guidelines.

3.15 Cyprus

OECD Country: No.

Method of Allocation: Arm’s length principle.

Additional Commentary: Refer to Section 33 of The Income Tax Laws (2002) for transfer pricing rules.

3.16 Czech Republic

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

3.17 Denmark

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: None.

3.18 Estonia

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: None.

3.19 Finland

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: None.

3.20 France

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: The French tax authority relies on guidance from the OECD Guidelines and the European Union (“EU”) Join Transfer Pricing Forum Guidelines on low value added intra-group services. There are no French regulations, guidance or Supreme Court Cases specific to the allocation of inter-company service charges other than general deductibility rules. These general deductibility rules state that services must be effectively needed and used by the recipient (benefit test) and corresponding charges must be arm’s length. From the French Tax Administration’s interpretation of OECD and European Union guidelines, the following practices apply:

- Where no direct allocation of specific services to particular recipients is workable, sharing a cost base through the use of relevant allocation keys is possible;
- Allocation keys must reflect the economic nature of the service (e.g., headcounts for HR services, users/log ins for IT, turnover for sales administration);
- The use of only one allocation key (e.g., turnover for a bundle of services different in nature is not recommended);
- The results of the allocations must be consistent and proportionate with expected benefits; and
- The arm’s length principle generally requires a mark-up.
3.21 Georgia

**OECD Country:** No.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** In Georgia, the regulation of issues related to transfer pricing has been adopted only recently (December 2013) and is generally based on the OECD Guidelines.

3.22 Germany

**OECD Country:** Yes.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** German rules are based on the OECD Guidelines. The rules are provided in a decree of the German tax authorities (3.2 Apportionment Formula):

- The formula that is most appropriate in the individual case must be selected. Where two or more formulas are equally appropriate, the management has discretion in selecting the formula.
- The factors on which the standard of apportionment may potentially be based include without limitation the following: unit quantities used, manufactured, sold, or anticipated in a line of products; cost of materials; machine hours; number of employees; total payroll amount; value added; capital invested; operating profit; and sales revenue.
- Other factors may be appropriate under the circumstances of the specific case. For instance, a multi-factor formula may be appropriate where different factors are weighted for apportionment purposes.

3.23 Gibraltar

**OECD Country:** No.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** In Gibraltar, there is no specific case law or guidelines issued by the tax authority with respect to allocation keys or metrics in the context of cross-border intra-group services. The Gibraltar Commissioner of Income Tax will only accept that a payment to a connected party is at arm’s length if he is convinced that the payment in respect of a specific product or service and that the amount paid has been computed in accordance with OECD transfer pricing principles. Accordingly, Gibraltar would follow OECD guidelines, Chapter VII (Intra-group Services).

3.24 Greece

**OECD Country:** Yes.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** Greece does not have any specific transfer pricing rules.
3.25 Guatemala

OECD Country: No.

Method of Allocation: Transfer pricing legislation in Guatemala was suspended until 2015.

Additional Commentary: Transfer pricing legislation in Guatemala was suspended until 2015.

3.26 Hong Kong

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Hong Kong’s Departmental Interpretation and Practice Notes No. 46 Transfer Pricing Guidelines – Methodologies and Related Issues, states that when determining whether the amount of the charge is in accordance with the arm’s length principle, both the basis of charging and an appropriate margin must be determined. The OECD Transfer Pricing Guidelines suggest two main methods: the direct charge method and the indirect charge method. Charges could be calculated on the basis of head count (for HR costs), turnover (for marketing costs), number of computer terminals in use (for IT support), etc.

3.27 Hungary

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: In general Hungarian legislation follows OECD Guidelines. According to Hungarian law (Act on Corporate Income Tax and a Finance Ministry), low value added services can consist of the following:

- IT services (codes according to the classification of products by activity: 62.01, 62.02, 62.03, 62.09, 63.11);
- Real property management (68.32);
- Legal, accounting activity, translation, interpretation, market research (69.10, 69.20, 74.30, 73.20);
- Education (85.59, 85.60);
- Administration services (82.1, 53.20);
- Transportation, forwarding, cargo handling, warehousing, storage (52.10, 49.41, 52.2); and
- Accommodation service (55.9), canteen service (56.29.2) and safe-guarding services (80.10.12).
3.28 Iceland

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: There is no any legislation, case law, or guidelines that specifically relate to allocation keys or metrics in the context of cross-border intra-group services issued by the tax authority in Iceland. Even though there is no guidance published, and no specific transfer pricing rule in force, the OECD guidelines may serve for purpose of interpreting the general arm’s length principle under the Icelandic tax act, in cross-border-cases, but it does not have direct legal effect in Iceland. A general arm's length principle is applicable under the Icelandic law, with regards to cross-border-cases.

3.29 Indonesia

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: There is no specific guidance on the determination of allocation keys to review cross-border intra-group services. However, the guidance on how the tax office should conduct transfer pricing audit suggests that the Indonesian tax office adopts Chapter VII of the OECD TP Guidelines when reviewing the intra-group services. The audit guidelines on intra-group services suggest that the taxpayer should use allocation keys which is appropriate for the nature and type of services rendered. For more information refer to the Director General of Taxation Regulation no. PER - 22/PJ/2013 and Director General of Taxation Circular no. SE - 50/PJ/2013.

3.30 Iran

OECD Country: No.

Method of Allocation: Arm’s length principle.

Additional Commentary: Except for a few treaties for avoiding double taxation, there are no specific regulations in the Iranian tax code regarding transfer pricing. However, there is a good amount of discussion, number of circulars, etc. by the Iranian Ministry of Finance in this respect. The Iranian Ministry of Finance emphasizes "common international practice" which is analogous to conducting transactions on an arm's length basis.

3.31 Ireland

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Ireland has not published specific guidance in relation to intra-group services. There is a publication from the EU Joint Transfer Pricing Forum guidelines on low value adding intra-group services and as Ireland is part of the EU it would be expected to follow these rules along with the OCED’s
Chapter VII – Intra group services. EU Joint Transfer Pricing Forum guidelines outlines that no matter which approach or allocation method is chosen, it “must be capable of being justified and applied consistently”.

3.32 Israel

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Transfer pricing rules in Israel are generally based on both the OECD Guidelines and the US Transfer Pricing Regs. The Israel tax authorities recommend that the tax payer perform a benefit test while also applying the arm's length principle to determine an appropriate allocation key.

3.33 Italy

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: According to Inland Revenue (Circular dated 09.22.1980 n. 32 - Min Finance - Direct Taxes): “usually the consideration, or better, the participating “quota” of each associated company [to cost sharing arrangements] is pre-established according to fixed formulas based on the ratio between the turnover of the recipient and the total turnover of the Group, or on other parameters (invested capital, number of employees, operating capacity, etc.)”.

3.34 Jamaica

OECD Country: No.

Method of Allocation: Arm's length principle.

Additional Commentary: Jamaica has no transfer pricing rules. However, Jamaica does have anti-avoidance rules that seek to ensure that transactions between related parties are conducted at arm's length values and do not have tax avoidance as a primary purpose. Section 17 of the Income Tax Act states that: 17. (1) Where the Commissioner is of the opinion that (a) any transaction carried out between connected persons was carried out for a consideration substantially different from that obtainable at arm's length or for no consideration; and (b) the effect of this would be to reduce the amount of tax payable by any person, the Commissioner may, for the purposes of that person's tax liability, treat the transaction as having been carried out for such consideration as would in his opinion have been obtainable at arm's length: Provided that this subsection shall not apply if that person shows to the satisfaction of the Commissioner that- (i) the transaction did not have as its object, or one of its objects, the avoidance of tax; and (ii) the consideration for which the transaction was carried out was of a value not less than the cost incurred by the person receiving the consideration in providing the subject matter of the transaction (including a reasonable sum for overheads). (2) Without prejudice to subsection (1), where the Commissioner has reason to believe that any transaction carried out for a consideration substantially different from that obtainable at arm's length, or for no
consideration, was so carried out with the object of reducing the amount of tax payable by any person, or for purposes including that object, he may treat the transaction as having been carried out for such consideration as could in his opinion have been obtainable at arm's length.

3.35 Japan
OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: There are no official guidelines provided by the Japanese tax authority regarding allocation keys or metrics for inter-company services. However, Japanese transfer pricing rules (Commissioner’s Directive on the Operation of Transfer Pricing (Administrative Guidelines) National Tax Agency of Japan) are in line with the OECD guidelines.

3.36 Kazakhstan
OECD Country: No.

Method of Allocation: Arm’s length principle.

Additional Commentary: Kazakhstan has a law on Transfer Pricing, which regulates public relations, subject to transfer pricing for preventing state revenue deprivation with respect to international business deals. However, in the presence of ratified international agreement provisions of which stipulate different approach, the provisions of the latter shall be followed. The Law determines the methods for defining the market price, provides definition of related parties and “arm’s length” principle and others.

3.37 Kenya
OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: In Kenya, the Income Tax legislation does not provide for allocation of keys or metrics for cross-border intra-group services. Given that there is no provision in the Kenyan legislation for this, the Kenyan tax authorities will generally follow OECD Guidelines, Chapter VII (Intra-group Services).

3.38 Korea
OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: According to the Law for Coordination of International Tax Affairs (“LCITA”) of Korea, where the price for a transaction of service deemed necessary for business management, financial advertising, payment guarantee, support to an electronic system or technical support, or any other service
between a resident and a foreign related party is the one for a transaction of service that meets all of the following requirements, such a price shall be deemed as the arm’s length price.

- The service provider shall make an agreement in advance and actually provide such a service in accordance with the agreement;
- There shall exist an additional benefit or a reduction in expenses, which the person who has such service provided expects from the service;
- The price for the service provided shall be computed in an arm’s length principle; and
- There shall be proper documents prepared and preserved for providing the relevant facts.

It also states that in case the services are actually provided in accordance with the aforementioned article, it should be supported with the relevant data such as work schedule of service provision, table showing progress of service provision, information on the service provider and its employees, details of the expenses incurred, etc.

### 3.39 Liechtenstein

**OECD Country:** No.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** Liechtenstein has no formal transfer pricing legislation or documentation requirements, although all related party transactions with Liechtenstein entities must be carried out on arm’s length terms; Since 2011 the Liechtenstein Tax Act includes expressis verbis the arm’s length principle in article 49; Further, Liechtenstein follows the OECD transfer pricing guidelines; As Liechtenstein adheres to the OECD transfer pricing guidelines it also applies the respective methods proposed therein; Regarding transfer pricing allocation methods the Liechtenstein Tax Authority does apply the Swiss standards

### 3.40 Lithuania

**OECD Country:** No.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** Lithuania has no transfer pricing legislation, case law or guidelines with respect to allocation keys or metrics issued by the tax authority in Lithuania.

### 3.41 Luxembourg

**OECD Country:** Yes.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** In Luxembourg, there is no transfer pricing legislation, with the exception of intragroup financing activities (i.e., Luxembourg companies in back to back arrangement). For the other
matters, the Luxembourg tax authority generally refers to the OCDE Guidelines without any specific provisions implementing them in the Luxembourg law.

3.42 Macedonia

**OECD Country:** No.

**Method of Allocation:** Arm’s length principle.

**Additional Commentary:** Macedonian law states that the taxpayer, at the request of the tax authority, should present sufficient information and analysis to confirm the terms of transactions between related parties under the arm’s length principle. The Macedonian tax authority will refer to the OECD Guidelines for all situations that are not considered and covered with the explanations provided in the Macedonian law. More information can be found in the Corporate Income Tax Law (Official Gazette of RM No. 80/1993...79/2013) and the Rule Book on the manner of calculation and payment of the Corporate Income tax and avoidance of double taxation relief or double taxation (Official Gazette of RM No. 173/2011).

3.43 Malaysia

**OECD Country:** No.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** Malaysian transfer pricing Guidelines state that an allocation key must be appropriate to the nature and purpose of service rendered, which is similar to the OECD guidelines.

3.44 Malta

**OECD Country:** No.

**Method of Allocation:** No transfer pricing legislation.

**Additional Commentary:** Malta does not have transfer pricing legislation though there are general anti-avoidance rules which stipulate that the Commissioner may ignore any transaction which is artificial and entered into with the sole purpose of reducing taxation. However, this provision has rarely been enforced, with the exception of transactions relating to immovable property situated in Malta.

3.45 Mexico

**OECD Country:** Yes.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** None.
3.46  Moldova

OECD Country: No.

Method of Allocation: Arm’s length principle.

Additional Commentary: The Moldovan tax law does not provide any transfer pricing documentation requirements. However, the tax authorities envisage the introduction of formal transfer pricing requirements in the Moldovan tax law starting in 2015. Transactions between co-owners or interdependent persons can be taken into account provided that the respective interdependence has not influenced the outcome of the transaction. It is important to mention that transactions carried out between related parties should observe the arm’s length principle, whereas transactions that do not follow this rule may be disregarded for tax purposes. Moreover, in case that the tax authorities determine (based on documented evidence) that the company has delivered/supplied goods/services at a price lower than the market value, the company will be required to additionally compute VAT on the difference between the market value and the respective selling price.

3.47  Morocco

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: In Morocco, there are no specific transfer pricing regulations. Morocco follows the regulatory framework presented in the OECD Guideline.

3.48  Mozambique

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: The Mozambican Tax Authority does not issue specific guidelines or legislation in relation to allocation keys or metrics. Mozambican has a very basic transfer pricing regime and is based on the ALS and the OECD guidelines.

3.49  Namibia

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: The Namibian tax authority refers to the OECD guidance and arm’s length principles. For more information refer to Section 95A in the Namibian Income Tax Act.
3.50 Netherlands

**OECD Country:** Yes.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** The Netherlands follow Chapter VII of the OECD Guidelines. Especially 7:20 through 7:28: "The allocation might be based on turnover, or staff employed, or some other basis. Whether the allocation method is appropriate may depend on the nature and usage of the service."

3.51 New Zealand

**OECD Country:** Yes.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** New Zealand Inland Revenue fully endorses the positions set out in chapters 1 to 8 of the OECD guidelines and proposes to follow those positions in administering New Zealand's transfer pricing rules. Consequently, New Zealand's guidelines should be read as supplementing the OECD guidelines, rather than superseding them. There are a number of allocation keys that might be applied to allocate costs between members of a group. The OECD guidelines, for example, make reference to allocation keys based on turnover, staff employed, and capital applied (paragraph 7.25).

3.52 Norway

**OECD Country:** Yes.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** None.

3.53 Philippines

**OECD Country:** No.

**Method of Allocation:** Determined based on the nature of the service.

**Additional Commentary:** There is neither specific reference to the inter-group services chapter of the OECD guidelines but there is an end-note in the guidelines that the OECD guidelines may be referred to for guidance and examples. Revenue Regulations No. 2-40, as amended by Revenue Regulations No. 16-86 on the allocation of Head Office expenses to branches:

- Gross income from sources within the Philippines to the total gross income.
- Net sales in the Philippines to total net sales.
- If any other method of allocation is adopted, a written permission from the Commissioner of Internal Revenue shall first be secured.
Revenue Audit Memorandum Order No. 01-98 (July 7, 1998) providing for the Audit Guidelines and Procedures in the Examination of Interrelated Group of Companies has the following provisions in relation to cost-sharing arrangements: 3.4.2 In determining the appropriateness of the sharing arrangement, factors such as benefits-received, size of the company, participation in the venture, and etc. should be considered.

3.54 Poland

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Polish transfer pricing regulations do not provide any direct guidelines with respect to the allocation costs in cross-border intra group-services. Furthermore, domestic tax authorities haven’t issued any guidelines in that scope so far. An allocation key shall directly reflect the benefits achieved by each recipient of the services. Forum performed in the period April 2009 to June 2010, Point 53 of the communication determines the following allocations keys in the context of the low-value added services:

- IT: number of PCs,
- Business management software (e.g., SAP): number of licenses,
- Human Resources: headcount,
- Health and safety: headcount,
- Management development: headcount,
- Tax, Accounting, etc.: turnover or size of balance sheet,
- Marketing services: turnover,
- Vehicle fleet management: number of cars.

3.55 Portugal

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Portugal does not have specific legislation, case law, or guidelines issued by the tax authority with respect to allocation keys or metrics in the context of cross-border intra-group services.

3.56 Puerto Rico

OECD Country: No.

Method of Allocation: Arm’s length principle.

Additional Commentary: Puerto Rico has not published specific guidelines on transfer pricing and does not necessarily follow OECD Guidelines. Law § 30179 (2011-PRIRC 1040.09) & Reg. § 1047-2: states that the tax authorities support the Arm’s Length Principles.
3.57 Qatar
OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Qatar has not yet published specific guidance regarding transfer pricing and it is generally follow OECD guidelines.

3.58 Romania
OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Romanian transfer pricing legislation does not include specific guidelines with respect to allocation keys or metrics. Romania follows the provisions of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in respect of intra-group services and allocation keys on a case-by-case basis.

3.59 Russia
OECD Country: No.

Method of Allocation: Russian transfer pricing legislation is based on OECD approach.

Additional Commentary: Russia is not currently OECD member and OECD Guidelines (and in particular Chapter VII (Intra-group Services) is not applicable in Russia. Although Russian transfer pricing legislation is based on OECD approach, there is no guidance with regards to special cost allocation principles for intra-group services. In other words, there are no any special transfer pricing law provisions to be used in the context of cross-border intra-group services (in particular with regard to indirect-charge methods). It is also necessary to note that the Russian tax authorities usually pay great attention to economical feasibility and documental support of the intra-group services provided (this is relevant for expenses deductibility purposes).

3.60 Saudi Arabia
OECD Country: No.

Method of Allocation: Fair market value.

Additional Commentary: There are no detailed transfer pricing rules in Saudi Arabia. In the absence of such transfer pricing rules, the Saudi Tax authority generally accept a price if they are satisfied that it represents a fair market value of the subject services or supplies. Transaction between related parties must be conducted on the basis that the parties are independent. The lack of specific transfer pricing rules unfortunately provides wide powers to the Saudi Tax authority to accept or reject any particular pricing mechanism.
3.61 Serbia

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Serbia’s transfer pricing rulebook has been created in accordance with OECD Guidelines. First transfer pricing guideline (statutory act) proclaimed at the end of 2013. The rulebook (10 pages) includes rules about proposed basic methods. 2013 will be first year that must be covered by transfer pricing study. The Serbian tax authorities will refer to the OECD guidelines in case of any misunderstanding.

3.62 Singapore

OECD Country: No.

Method of Allocation: Gross sales, income or receipts, loans and deposits, staff numbers, floor area and asset size, etc.

Additional Commentary: The Singapore transfer pricing guidelines and circulars are generally consistent with the OECD Guidelines. However, there are some differences between the OECD Guidelines and those in the IRAS supplementary circular on “Transfer Pricing Guidelines for Related Party Loans and Related Party Services” (a copy of which is enclosed for your reference). These differences are: services provided by a Singapore taxpayer in a cost pooling arrangement should not be its principal activity. Services are considered its principal activity if the costs relating to the provision of the service exceed 15% of its total expenses in the financial year; and cost pooling can only be used for “routine” services. IRAS Supplementary e-Tax Guide Section, Transfer Pricing Guidelines For Related Party Loans and Related Party Services 3.3.4 states that the Indirect charge methods entail the use of an appropriate apportionment basis/allocation keys to charge/bill for the service provided, such as gross sales, income or receipts, loans and deposits, staff numbers, floor area and asset size, etc.

3.63 Slovak Republic

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Slovakia in general follows OECD guidelines, Chapter VII (Intra-group Services).

3.64 Slovenia

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Slovenia has no legislation, case law, or guidelines have been issued by the tax authority with respect to allocation keys or metrics.
3.65  South Africa

*OECD Country:* No.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** South Africa has no specific method of allocation and does not yet have any Transfer Pricing related case law. However, Practice Note 7 of 1999 to the Income Tax Act does provide support to follow the OECD Guidelines: 18. Intra-group Services 18.1 Chapter VII of the OECD Guidelines deals specifically with intra-group services. The Commissioner considers the guidance provided in that chapter relevant and recommends that taxpayers follow the guidance in establishing arm’s length conditions in international agreements with connected persons involving intra-group services.

3.66  Spain

*OECD Country:* Yes.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** Spain’s tax authority does not provide examples or any allocation key. However, Spain’s legislation states that companies should follow rationale criteria. The nature of the services, the circumstances and the benefices should be taken into account in order to fulfil with the rationale criteria.

3.67  Sweden

*OECD Country:* Yes.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** Sweden does not have any specific regulations on allocation keys.

3.68  Switzerland

*OECD Country:* Yes.

**Method of Allocation:** Generally follows the OECD Guidelines.

**Additional Commentary:** Switzerland has no formal transfer pricing legislation or documentation requirements, although all related party transactions with Swiss entities must be carried out on arm’s length terms. In general, Switzerland follows the OECD transfer pricing guidelines (exception for interest rates on loans granted to or from shareholders or related parties). Since Switzerland adheres to the OECD transfer pricing guidelines it also applies the respective methods proposed therein. Based on current Swiss tax practice, the profit margin for service companies must be determined in accordance with the arm’s length principle, and thus, each taxpayer must consider an appropriate margin on the basis of comparable uncontrolled transactions. The Swiss Federal tax authorities imply that the cost plus method is the most appropriate method for service companies to price their services based on functional and risk analysis. In general, a full cost approach is applied (including all direct and indirect costs). Typically, the profit margin for such services is 5% - 10% which is preferably substantiated by a transfer pricing documentation. The
taxpayer may prove that the actual margin is lower by appropriate documentation in line with the OECD transfer pricing guidelines. For financial and management services the cost plus method is accepted in exceptional cases only. Switzerland generally follows the OECD transfer pricing guidelines, and thus, also on chapter VII (intra-group services).

3.69 Taiwan

OECD Country: No.

Method of Allocation: Arm’s length principle.

Additional Commentary: Taiwan’s tax authority stats that allocation methods should be based on a reasonable approach. For more information refer to Article 19 and 20 of Regulations Governing Assessment of Profit-Seeking Enterprise Income Tax on Non-Arm’s-Length Transfer Pricing (2004.12.28 Announced). In Taiwan, allocations based on percentage of total sales are the most common method used.

3.70 Thailand

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Thailand does not have a specific guideline on the allocation keys. Thailand generally follows the OECD guidelines. If it relates to IT services costs, the Thailand tax authority will recommend using the number of users as a base. For allocating costs based on revenue (and others), you have to ensure that there are very clear pieces of evidence showing that the Intra-group Services benefited the Thai subsidiary, that the services provided included the Thai subsidiary, and the expenses were incurred for the purpose of generating a profit for the business in Thailand. If not, the allocated intra-group cost will be disallowed as a deductible expense in Thailand. Thailand is a Civil law country. Thus, case law generally does not stand before the Court.

3.71 Turkey

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Guidance provided by Turkey’s tax authority states that “In conformity with the arm’s length principle, in determining whether the intra-group service is rendered, it shall be considered whether a commercial or economic value strengthening the commercial position of the group company buying the service is provided or not. Where a related company buys an unneeded service from the parent company or from another company of the group companies or when a service is rendered to any group company just because of its being one of the group companies, it is not acceptable that the company in question gets intra-group service”. For more information refer to the “Disguised Income” notion included in the repealed Corporate Tax Law No. 5422, and article 13 of the Corporate Tax Law No. 5520.
3.72 United States

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: The US regulations 1.482-9 state that any reasonable method may be used to allocate and apportion costs under this section. In establishing the appropriate method of allocation and apportionment, consideration should be given to all bases and factors, including, for example, total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent.

3.73 Uganda

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Uganda generally relies on OECD guidelines.

3.74 Ukraine

OECD Country: No.

Method of Allocation: Determined based on the nature of the service.

Additional Commentary: Ukraine does not follow OECD Guidelines. All of principles and methods regarding transfer pricing legislation are set forth in Tax code of Ukraine. Tax code of Ukraine, Paragraph 39.3.7.9. - “For the allocation of total or remaining income (loss) from controlled operations for all Parties of these operations the following parameters should be taken into account:

- Amount of expenses incurred by each Party of controlled transactions in connection with the creation of intangible assets the use of which affects the size of actual profits (losses) from controlled transactions;
- Characteristics of the personnel involved by each Party of controlled operations, including its size and qualifications; personnel time spent, the amount of labor costs that had an impact on the amount of actual profit earned (incurred loss) by each Party of controlled operations;
- Market value of the assets that were used by each Party of controlled transactions and had an impact on the size of the actual profits (losses) of controlled operations; and
- Other metrics that relate to the performance of functions, using assets, taking of commercial risks and the size of actual profits (losses) of each Party of controlled transactions”.
3.75 United Arab Emirates

OECD Country: No.

Method of Allocation: No transfer pricing legislation in place.

Additional Commentary: The UAE is a tax free country and therefore has no transfer pricing legislation in place.

3.76 United Kingdom

OECD Country: Yes.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: The United Kingdom tax authorities state that, if possible, a direct charge method should be used, relating to the provision of the service to each recipient. If this is not practicable, then it may be necessary to use an indirect charge method (i.e., to use an allocation key that provides a reasonable proxy for the sharing out the value of the service). For example, if the level, intensity, type and quality of service delivered to different recipients is similar and the volume of service correlates relatively well with the benefit derived by the service recipients, then each recipient’s share of the volume of service delivery could be used to allocate the total cost and mark up between service recipients.

3.77 Uruguay

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Uruguayan transfer pricing regulations do not contain any provisions or guidelines regarding allocation keys and generic tax regulations do not contain any such provisions or guidelines either. Regulations are very similar to the Argentinean regulations and follow the OECD guidelines in most aspects. There is a ruling of the tax authority (Consulta 5.214), in which a taxpayer made the following query to the tax authority; the parent company of the Uruguayan branch hired technical services related to several works, among them works performed in the Uruguayan office. The parent company then invoiced the expenses to the Uruguayan branch. The branch’s query was if the allocation key of such expenses could be the hours destined to the Uruguayan project. The tax authority answered that such criterion would be technically acceptable as long as it reflects the effective services rendered to the branch.

3.78 Uzbekistan

OECD Country: No.

Method of Allocation: Arm’s length principle.

Additional Commentary: Transfer pricing laws in Uzbekistan are set forth by the Uzbek Tax Code. An extract from Tax Code, Article 40: If related parties use in their commercial and financial operations prices different from than third parties, in determination of taxable object (entity), taxable base computed for selling
goods and services, state tax authorities use prices which are used/applicable for third parties (arm's length transaction principle will be applied according to the Tax code).

3.79 Vietnam

OECD Country: No

Method of Allocation: Generally follows the OECD Guidelines

Additional Commentary: In the case of intra-group services in Vietnam, allocation methods are not supported within domestic transfer pricing regulations. Vietnam is not an OECD member, though often following OECD guidance and party to tax treaties with several OECD members. Ministry of Finance through the General Department of Taxation: Circular No. 66/2010/TT-BTC: Allocation is allowable in two circumstances, firstly in the case of removing significant differences from comparable data on the ratio of costs or revenue incurred or arising in relation to the significant difference (for example to compare two goods transactions, one FOB, one CIF, using the CUP method to compare sales prices; the additional cost in providing the goods CIF should be used as a basis to reduce the price of the CIF product for comparison against the FOB product). Secondly, in the case of the profit split method, profit is allocated based on the costs incurred by the relevant parties using the single step method, or, if the two-step method is used, the additional profit (as defined in the second step) is allocated according to the costs incurred for research and development, or, the value (net of depreciation) of intangible property or intellectual property used for the development of the profit-generating item.

3.80 Zimbabwe

OECD Country: No.

Method of Allocation: Generally follows the OECD Guidelines.

Additional Commentary: Zimbabwe has not published any rules or regulations regarding transfer pricing. Zimbabwe has anti-avoidance legislation and to a large extent follows the OECD guidelines.

4. Summary of Survey

The results of our survey indicated that 70 of the 80 countries that participated, generally follow the OECD Guidelines or the arm’s length principle. Of the remaining ten countries, four do not have transfer pricing legislation and the remaining six countries base their transfer pricing methodologies on the following factors:

- The nature of the service, which is analogous to OECD guidance;
- Gross income or net sales, which is consistent with the examples provided by Canada, France, Germany, and United States;
- Fair market value, which is embodied by the arm’s length principle; and
- Staff numbers and asset size, which is consistent with the examples provided by the OECD guidelines.
## Appendix E: Listing of the Components for the Bill Rate

### E.1 Salary Cost Components:

1. Salaries & Temporary Salaries including the payroll code for Easeback/Return to Work
2. Other Salary Costs - Retroactive Pay

### E.2 Mark-up Components:

#### Table E-1
Newfoundland and Labrador Hydro
Mark-up Components of the Operating Bill Rate
July 30, 2013

<table>
<thead>
<tr>
<th>Fringe Benefit Costs</th>
<th>Insurances</th>
<th>Company Costs</th>
<th>Leave</th>
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<td>Canada Pension Plan</td>
<td>Life Insurances</td>
<td>Payroll Taxes</td>
<td>Training Hours</td>
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<td>Employment Insurance</td>
<td>A D&amp;D Insurance</td>
<td>Bonus</td>
<td>Short-Term Sick Leave</td>
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<td>Public Service Pension Plan</td>
<td>Medical Insurance</td>
<td>Performance Contracts</td>
<td>Long-Term Sick Leave</td>
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<td>Group Money Purchase Plan</td>
<td>Dental Insurance</td>
<td>Signing Bonus</td>
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<td>Employee Future Benefits expense</td>
<td>Medical Appointments</td>
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<td>Workplace Health Safety and Compensation Premiums</td>
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<td>Banked Overtime</td>
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Source: Hydro’s 2013 GRA, Exhibit 8, Appendix A.