

KPMG submission

Consultation Paper -
*Review of the PRRT
Gas Transfer Pricing
arrangement*

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Executive Summary

KPMG welcomes the opportunity to comment on the Consultation Paper of *Review of the PRRT Gas Transfer Pricing arrangements*

Our views on the specific questions raised are as follows:

Question 2: The CUP method is the most direct and reliable method to apply. The restrictive use of the CUP is the reason that it is the most direct and reliable method. Accordingly, the CUP rules are not too restrictive but the CUP rules contained in the PRRT Regulations should preferably be aligned to the OECD CUP method.

Question 3: Where a robust CUP is available it should be applied as this would result in the most reliable outcome. We are of the view that by relaxing the rules to deviate from the CUP method established by the OECD would compromise the reliability of the method.

Question 4: When dealing with PRRT, where the objective is to arrive at an arm's length price for the gas at the relevant taxing point, the 9 step approach to a comparability analysis may prove useful to accurately identify the most reliable method. If a CUP is not available based on the 9 step approach, the most reliable Transfer Pricing method would be applied to determine the arm's length price.

Question 5: In most projects there will be a difference between the taxing point for PRRT and the tolling point in the value chain for commercial purposes. Therefore, significant adjustments will need to be made to a tolling fee to allow for these differences to be considered a reliable starting point. We consider it highly unlikely that a tolling fee can be reliably adjusted to a starting point that can be applied in a reliable manner to all or even most of the Australian gas resource projects due to the significance of the differences between individual projects.

Question 6: A comparison of the LNG minus price and the RPM would not provide definite confirmation that downstream is deriving too high of a return, due to the fact that no two projects are identical and there are numerous variables both downstream and upstream that impact pricing and expected returns. If a comparison was to be incorporated into the PRRT regulations it would need to be performed on a per project basis. This approach would likely become counterproductive to the outcome sought from this consultation paper.

Question 7: There is a possibility that future projects may rely upon third party access to existing infrastructure. The obstacle that we foresee is that this information will not be made public and therefore it is unlikely that third party data could be used as an observable fee.

Detailed comments

1. General

- 1.1 KPMG welcomes the opportunity to comment on the Consultation Paper of *Review of the PRRT Gas Transfer Pricing arrangements* as published by Treasury in April 2019.
- 1.2 The Callaghan Review recommended that the current regulation be examined to identify changes that would achieve greater simplicity and transparency, ease of compliance and fair treatment of the economic rent for each stage of an integrated petroleum operation.

2. Feedback and comments to the Review of the PRRT Gas Transfer Pricing Arrangements Consultation Paper – April 2019

- 2.1 We set out our feedback in response to the invitation for feedback and comments on the PRRT Gas Transfer Pricing Arrangements dated April 2019. Since we have only looking at the paper from a transfer pricing perspective, we have limited our comments and feedback to Questions 2 to 7, which are the questions which deal with the technical application of transfer pricing.

3. Methodology

- 3.1 The GTP regulations provide three methods for calculating the transfer price and the order in which they are to be applied: Comparable uncontrolled price (CUP), Residual pricing method (RPM) and the Advance pricing arrangement (APA).

3.2 Comparable uncontrolled price (CUP)

- 3.3 A shadow pricing method in which the transfer price is determined by finding a comparable 'uncontrolled' transaction in similar circumstances. The CUP method requires a high level of comparability in order to be considered a CUP.
- 3.4 The regulations states that a CUP is a price for sale gas or natural gas that was obtained for a sale in a market that the Commissioner is satisfied is a relevant market in relation to the transaction.
- 3.5 In determining whether a market is relevant, the demand and supply characteristics of the market must be taken into account, including:
 - a) the composition of sales gas or natural gas sold in the market;
 - b) geographic differences between the production facilities and the product delivery point of the sales gas or natural gas sold in the market; and
 - c) the end use for the sales gas or natural gas sold in the market.Example: Retail, wholesale, manufacturing, feedstock, domestic.

- 3.6 In determining whether a market is relevant, the following factors must also be taken into account:
- a) the terms of contracts usual in the market, including volumes, discounts, exchange exposures and other relevant conditions that would reasonably be considered to affect the price;
 - b) market strategies;
 - c) the existence of spot sales (including market penetration sales) below or above marginal cost;
 - d) processing costs;
 - e) technology used in processing;
 - f) any other factors that it would be reasonable to consider.

3.7 Residual pricing method (RPM)

- 3.8 This method allocates part of the price received for LNG to the upstream (gas resource project) and part to the downstream (liquefaction plant). It does this by providing a return on capital to each component, an allowance for operating costs, and if there is any residual value, it is typically allocated equally between the two sides.
- 3.9 For offshore projects, the RPM applies if the alternatives of an APA or CUP are not available.

3.10 Advance pricing arrangement (APA)

- 3.11 As this is an agreed method between the Commissioner of Taxation and a taxpayer for calculating an arm's length price, we don't believe this needs to be discussed further for the purposes of this paper.

4. Our observations

- 4.1 What we have observed is that most if not all of the LNG projects in Australia are still vertically integrated.
- 4.2 It is difficult, if not impossible to obtain a CUP as this information is not publically available and even if a CUP was obtained it is arguably impossible to obtain all the information on the CUP to make the necessary and sufficiently reliable comparability adjustments needed for each LNG project.

Our views on the specific questions are as follows:

5. Question 2

Are the CUP rules too restrictive, even if there was a scenario where a CUP is available?

5.1 Response

- 5.2 The CUP rules provided for in the PRRT regulations are substantially based on the OECD CUP method. We believe it would be appropriate for the regulations to align the approach to establishing a CUP with that of the OECD's latest recommendations.
- 5.3 The OECD defines a CUP as "A transfer pricing method that compares the price for property or services transferred in a controlled transaction to the

price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances”¹.

- 5.4 Where possible to locate a CUP, this method is the most direct and reliable way to apply the arm’s length principle. Consequently in such cases the CUP method is preferable over all other methods.
- 5.5 However, the CUP method requires a high level of comparability in order for a reference price to be considered a CUP. In order to assess comparability, regard should be had to the following five comparability factors contained in the OECD Guidelines.
 1. Characteristics of property or services;
 2. Functional analysis;
 3. Contractual terms;
 4. Economic circumstances; and
 5. Business strategies.
- 5.6 We set out below some factors that may require adjustments to result in an appropriate CUP:
- 5.7 **Gas Quality:** Varying qualities result in different operating costs due to additional gas processing and requirements.
- 5.8 **Development concepts/costs:** Individual geological and geographical features necessitate different development concepts. There are differences between onshore and offshore projects e.g. offshore project fields are found at various depths and we have also seen different infrastructure solutions exist in ranging from conventional fixed platform structures to integrated Floating Liquefied Natural Gas solutions. These factors can all have an impact on costs and therefore associate selling prices.
- 5.9 **Transport:** The costs associated with transporting the offshore gas to shore-based plants vary significantly from project-to-project.
- 5.10 **Offtake agreements:** An offtake agreement is an agreement between a producer and a buyer to purchase or sell portions of the producer's future production. An offtake agreement is normally negotiated prior to the construction of a facility to secure a market for the future output of the facility.² Generally, offtake agreements in Australia are negotiated for very long periods of time compared to different markets. These extended periods have a material impact on pricing.
- 5.11 **Markets:** Where sales gas is sold into the domestic market, this is under the Western Australia’s domestic gas reservation policy, making the resulting price incomparable to other regions. A domestic market for the majority of the Australian gas resource presently does not exist. Countries like the US have much larger markets, which also has an impact on pricing.
- 5.12 This section details some of the challenges faced in the comparability analysis. Adjusting for all of the abovementioned comparability factors would not in our view be reasonable and in some cases may not prove possible.

¹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations July 2010 and 2017

² <https://www.investopedia.com/terms/o/offtake-agreement.asp>

- 5.13 The differences/comparability disparities listed above are present both between US and Australian gas resource projects and between different Australian gas resource projects.
- 5.14 These comparability factors are aligned with the relevant market factors that need to be taken into account to apply a CUP under the PRRT regulations.
- 5.15 When applying the CUP method the comparability factors are generally narrowly applied due to the fact that minor differences in comparability may have a significant bearing on the price of a product or service.
- 5.16 The OECD guidelines provide that the CUP method will be the most appropriate method to test the price in a controlled transaction, provided one of two conditions are met, 1) none of the differences (if any) would materially affect the price in the open market, or 2) reasonably accurate adjustments can be made to eliminate the effect of such differences. If neither of the two conditions are met, the CUP method will not be the most appropriate method to be applied to a specific scenario.
- 5.17 The OECD also states that the CUP method would generally be an appropriate method to determine a transfer price for commodities. "Commodities" should be understood to encompass physical products for which a quoted price is used as a reference by independent parties in the industry to set prices. "Quoted prices" refer to the price of the commodity in the relevant period obtained in an international or domestic commodity exchange market. Since there is no comparable commodity exchange market for sale gas it makes the application of the CUP method more difficult. Accordingly, the CUP method has to be applied by relying on other external data in the absence of a quoted price, while taking the strict comparability factors outlined above into account.
- 5.18 The restrictive use of the CUP method has also been considered by various courts both in Australia and abroad. We set out below some extracts from these cases on the use of the CUP method:
- 5.19 *Finland vs A Group*³ the Administrative Court noted, "in applying the CUP method, it is essential that the OECD Guidelines set very high standards of similarity when assessing comparability". The court found that due to the uniqueness of the assets, the differences in the transaction could not be corrected. The CUP method has therefore not been reliably applied in these circumstances and has therefore not been the most suitable transfer pricing method.
- 5.20 The approach adopted in this case reinforces the strict comparability requirement that is needed in order to reliably apply the CUP method.
- 5.21 *SNF (Australia) Pty Ltd v Commissioner of Taxation*⁴ the Court found that the CUP method is the most appropriate methodology where direct transactional data is available, but noted that the application of the CUP method does not require the 'exactness' of comparability as suggested by the Australian Tax Office (ATO).
- 5.22 This case reinforces the notion that strict comparability is required in order to reliably apply the CUP method but the potential CUP need not be an

³ 2018, Supreme Administrative Court, Case No. KHO: 2018:173

⁴ [2010] FCA 635

exact match to the transaction being tested. This approach is consistent with the OECD Guidelines which provides that a CUP can be applied provided that none of the differences would materially affect the price or reasonable adjustments can be made to neutralise the effect that such differences may have on the price. When making adjustments it is important to remain cognisant of the strict comparability required in order to avoid making adjustments to the extent that it can no longer be considered a CUP. Adjustments should therefore be kept to a minimum.

- 5.23 If a CUP was determined, each project would need to undertake comparability adjustments to the extent that it could eliminate the effect of such differences. The concern with this approach is that it would be counterproductive to the outcome sought from this consultation paper (i.e. providing greater simplicity and ease of compliance).

6. Question 3

In what way could the CUP rules be revised in order to provide greater flexibility to use arm's length prices to derive a CUP as new commercial arrangements arise?

6.1 Response

- 6.2 The OECD CUP method is an internationally recognised method used to test the arm's length nature of an intercompany transaction. Being the most direct method to test the arm's length nature of a price, any revision or changes to the criteria of its application may cause the results to be skewed and less direct and therefore less reliable.
- 6.3 Increasing the flexibility in the application of the CUP method would result in a reduction in comparability and increased uncertainty with reference to established transfer pricing practices and case law. Given the CUP method is reliant upon high comparability, reducing the comparability would diminish the value of any potentially comparable transaction and is likely to lead to the failure to establish a true CUP. As such, this may lead to a counterproductive outcome.
- 6.4 During the OECD/G20 Inclusive Framework on BEPS, the OECD did not make any changes to the use of the CUP method, arguably because this method was considered robust enough in its application.
- 6.5 The OECD Guidelines also provide for a more flexible approach to the CUP method by acknowledging that practical considerations may dictate a more flexible approach to enable the CUP method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy.
- 6.6 This approach may, similar to that discussed in paragraph 5.2.3, become counterproductive to the outcome sought from this consultation paper (i.e. providing greater simplicity and ease of compliance).
- 6.7 Accordingly, we believe that where a robust CUP is available it should be applied as this would result in the most reliable outcome. We are of the view that by relaxing the rules to deviate from the CUP method established by the OECD would compromise the reliability of the method and increase uncertainty regarding compliance with the PRRT.

7. Question 4

How could the OECD Guidelines be best used to inform an arm's length outcome in the gas transfer pricing regime?

7.1 Response

7.2 The OECD Guidelines are underpinned by the arm's length principle and provide guidance on the use of methods to arrive at conditions that are consistent with the arm's length principle. Application of the arm's length principle is generally based on a comparison of the conditions of a transaction under consideration with the conditions in transactions between independent entities. In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable.

7.3 The OECD Guidelines provide for a typical 9 step approach to be followed when performing a comparability analysis. This process is set out below:

Step 1: Determination of years to be covered.

Step 2: Broad-based analysis of the taxpayer's circumstances.

Step 3: Understanding the controlled transaction(s)⁵ under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account.

Step 4: Review of existing internal comparables, if any.

Step 5: Determination of available sources of information on external comparables where such external comparables are needed taking into account their relative reliability.

Step 6: Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator (e.g. determination of the relevant net profit indicator in case of a transactional net margin method).

Step 7: Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors.

Step 8: Determination of and making comparability adjustments where appropriate.

Step 9: Interpretation and use of data collected, determination of the arm's length remuneration.

7.4 The above should typically be followed in most cases where an arm's length outcome is sought. When dealing with PRRT, where the objective is to arrive at an arm's length price for the gas at the relevant taxing point, the above process may prove useful to accurately allocate functions, assets and risks between the different stages of a gas resource project.

⁵ Controlled transaction refers to the transaction under consideration between related entities

- 7.5 If a CUP is not available based on the 9 step approach, the most reliable transfer pricing method should be applied to determine the arm's length price.
- 7.6 Most if not all of the gas resource projects in Australia are highly integrated, which is likely to be evidenced by following steps 1 to 5 of the above 9 step approach. When transactions are so highly integrated, the OECD Guidelines provides that the use of a RPM or transactional profit split method may be appropriate given that "the main strength of the transactional profit split method is that it can offer a solution for highly integrated operations for which a one-sided method would not be appropriate".
- 7.7 Based on this and given the nature of the industry and limited publically available data, it would appear that the use of the RPM may be more appropriate to determine the value at the relevant taxing point for PRRT.

8. Question 5

How might the regulations be amended to allow for an observable tolling fee to be used as a basis for, or to inform, the calculation of the price of gas at the PRRT taxing point? What kind of adjustments might be required?

8.1 Response

- 8.2 In a toll manufacturing arrangement, a company provides its raw materials or semi-finished goods to a third-party service provider. The service provider, who often has specialised equipment or infrastructure, provides a subset of manufacturing processes on behalf of the company using those materials or goods for a fee (toll). Typically, the entity performing the tolling does not take ownership of the materials or goods being processed. With regard to the LNG industry, natural gas would be provided to an entity operating a liquefaction/processing plant for conversion to LNG. The owner of the natural gas would pay a fee for the conversion/processing.
- 8.3 Third party tolling arrangements are not currently observed in Australia with most if not all projects being vertically integrated at this stage. There may be observable third party tolling arrangements located in the US that could be considered a potential data point but significant comparability adjustments (as outlined earlier) would need to be made if these are to be applied to a specific project based in Australia.
- 8.4 In most projects there will be a difference between the taxing point for PRRT and the tolling point used for commercial purposes. Therefore adjustments will need to be made to a tolling fee to allow for these differences.
- 8.5 Another obstacle with applying a comparable tolling fee is that the taxing point falls between cohesive functions (i.e. processing and liquefaction) which poses an additional obstacle to find a reliable data point that can be applied to arrive at an arm's length price at the relevant taxing point.
- 8.6 Based on the above, we consider it highly unlikely that reliable adjustments can be made to an observable tolling fee to be applied in a reliable manner to Australian gas resource projects. In our view, due to the lack of observable data, and the difference between the taxing point and the tolling point in the value chain, amending the PRRT regulations may not add considerable value.

9. Question 6

If the LNG sales price minus the arm's length prices for marketing, shipping and tolling (if paid for by the seller) were higher than the RPM price for the same project, would it be an indication that RPM was delivering too high a return to the downstream? Could a comparison be incorporated into the regulations?

9.1 Response

- 9.2 Such a comparison would not provide definite confirmation that downstream is deriving too high of a return, due to the fact that no two projects are identical and there are numerous variables both downstream and upstream that impact pricing and expected returns.
- 9.3 Obtaining an arm's length price on each function (especially marketing and shipping) may prove to be difficult due to the fact that each function would have to be completely separated from each other, as well as the fact that this level of detail is generally not available in comparable data. Comparable data on functions is generally only available at a whole-of-entity level, which is based on the premise that the entity is exclusively engaged in the same or broadly comparable functions as those being examined. Therefore, isolating specific activities may, in our experience, present practical difficulties.
- 9.4 Another point of consideration is if this comparison was to be incorporated into the PRRT regulations it would need to be performed on a per project basis. This approach would likely become counterproductive to the outcome sought from this consultation paper.

10. Question 7

Are there future projects which rely upon third party access to existing infrastructure in order to be commercial? How is a tolling fee for the use of existing infrastructure likely to be negotiated?

10.1 Response

- 10.2 It is our understanding that there is a possibility that future projects may rely upon third party access to existing infrastructure. The obstacle that we foresee is that this information will not be made public and therefore it likely possible that this third party data could not be used as observable data.
- 10.3 The tolling fee will be negotiated under normal commercial business terms and we believe this will be different for each project. Some of the factors that would need to be taken into account in determining this price include:
- Composition and volumes of the product to be processed;
 - Age in the infrastructure;
 - Timing of the project (is there spare capacity);
 - Processing costs;
 - Technology used in processing; and
 - Any other factors that would be reasonable to consider.