Report on “Internal Transfer Prices”

Summary and conclusions

Background to the investigation

The Office of Energy Regulation of the Netherlands Competition Authority (hereinafter "NMa"), supervises the energy market independently with the aim of ensuring that this market operates as effectively as possible. In the recent past, the NMa has received reports from various market parties[1] alleging that network managers cross-subsidise parts of energy companies which are involved in 'free-market activities' (hereinafter "the affiliated companies"). Within these companies, internal transfer prices, which are not in line with the market, are apparently charged for services which the affiliated companies supply to the network manager. By charging prices internally which are too high, the affiliated companies are placed at an advantage. These additional revenues may result in these companies' realising high profits, but can also be used to reduce tariffs for services supplied to third parties (for instance, the supply of energy to consumers), resulting in an improvement in the competitive position of the affiliated company. Although no formal complaints have been submitted by market parties, the NMa sees it as its duty to investigate these reports and, if necessary, to take action, partly because such persistent rumours may wrongly undermine confidence in the energy market.

In this regard, it should be noted, in particular, that preferential treatment of affiliated companies by the network manager may occur in various ways: preferential treatment through the provision of information,[2] preferential treatment through trade and production,[3] and preferential financial treatment.[4] This investigation focuses on one possible way in which affiliated companies receive preferential treatment, namely preferential financial treatment through cross-subsidisation. Naturally using various instruments the NMa also supervises and monitors whether energy companies give preferential treatment to affiliated companies through other possible forms of preferential treatment. These possible forms of preferential treatment are discussed in the report which is still to be drawn up within the context of the Independent Network Management Act *[Wet Onafhankelijk Netbeheer*].

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[1] See, for instance, “Energiereus misbruikt monopolie op netwerk” and “Concurrentie op energiemarkt in geding: grote energiebedrijven werpen barrières met behulp van winsten uit netbedrijven”, *Het Financiële Dagblad* of 4 September 2006, “Energiemarkt geen vrije markt”, *DeTelegraaf* of 5 September 2006, “Vet”, *Het Financiële Dagblad* of 5 September 2006, and “Tweede Kamer is nu zelf aan zet voor lagere energieprijzen: drie oorzaken hoge winsten energiebedrijven”, “Stroomreuzen mangelen kleine concurrent”, *Trouw* of 5 September 2006, *Het Financiële Dagblad* of 12 September 2006.

[2] For instance, by making the network manager's customer database available to the affiliated companies.

[3] For instance, by purchasing network losses, the delayed connection of decentralised electricity generators to the grid, solving transmission constraints by using one's own production or disconnecting competitors in emergency situations.

[4] The integrated energy company can allocate costs as far as possible to the grid manager ('cross-subsidisation') or may use the network (the assets) as collateral for obtaining loans for free-market activities, or may use the grid manager's profits to finance loss-making market activities ('cross–financing').

Aim of the investigation

The aim of the investigation is to obtain more insight into whether cross-subsidisation occurs within the vertically integrated energy companies. The most important and generally accepted indicator of this type of cross-subsidisation is the internal transfer pricing system, that is, whether or not the energy company applies an adequate and consistent system for determining and charging internal transfer prices. If an energy company applies a consistent system for internal charging, and in doing so applies uniform internal transfer prices, this reduces the risk that higher costs will be charged to the network manager than to other group companies. Having a consistent and adequate system is not sufficient. Such a system must be anchored in the internal organisation (including governance, reporting systems, internal control, budgeting and documentation), the grid manager must be able to operate independently within this and the system must be subject to internal and external auditing.

For this reason, the investigation focused on assessing the transfer pricing system of the energy companies. In this regard, the following research questions were formulated:

1. Does an adequate and consistent internal transfer pricing system exist, which is anchored within the group?
2. Can the holding company influence negotiations between the network managers and other divisions?
3. Is the internal transfer pricing system audited by independent auditors?
4. Are uniform internal transfer prices applied?

The NMa's investigation focused on the four largest integrated energy companies: Delta N.V., Eneco Holding N.V., Essent N.V. and N.V. Nuon.[5] Together these companies manage more than 90% of the energy network in the Netherlands.

The investigation was carried out by the NMa in cooperation with an independent accountancy firm. The investigation consisted mainly of analysing the internal transfer pricing system on the basis of data-based research. In addition, the operation of the system was assessed on the basis of interviews with key employees of the companies and with their independent auditors. By this means, an impression was obtained of the way in which the internal transfer pricing system operates.

[5] The size of these companies differs considerably per activity (trade, production, supply, network management and other activities).

Answering the research questions

Question 1) Does an adequate and consistent internal transfer pricing system exist, which is anchored within the group?

On the basis of its investigation, the NMa has concluded that the internal transfer pricing systems have been adequately designed and documented. In addition, the systems are anchored in the internal management of the businesses, the internal reporting systems, the internal budgeting cycle, the internal auditing process and the variable reward structures.

It also emerged from the investigation that the service provision agreements[6] submitted to the NMa and the management agreements[7] constitute an integral part of the internal transfer pricing systems and are based on these. These agreements are also subject to internal and independent audits. A service provision agreement has been entered into for almost all internal deliveries and services. It has emerged that the network managers give critical attention to the formulation of the service provision agreements since these form the basis of their budgets, internal reports and results, or bonuses and rewards.

Question 2) Can the holding company influence negotiations between the network managers and other divisions?

Negotiations take place between the divisions with regard to the (largest) service provision agreements and budgets. To ensure that an internal transfer pricing system functions well, it is important that the holding company does not influence these negotiations. The network manager must be in a position to operate independently in this regard so that actual negotiations occur between the network manager and the affiliated company. The drawing up of budgets, the internal audits and the reports on these confirm that the network managers are sufficiently independent with regard to agreements on internal transactions. Formally the network managers have an independent position within the energy companies (their own annual accounts, reports, Supervisory Boards, governance, independent auditors etc.). However, more in-depth research is necessary in this regard within the framework of the report on the Independent Network Management Act. With regard to the drawing up and the nature of budgets, reports, responsibilities, critical performance indicators, maintenance of administrative records and the reward structure, the NMa found no evidence that the holding companies can intervene easily in the business processes of network managers.

Question 3) Is the internal transfer pricing system audited by independent auditors?

An important indicator of the proper functioning of an internal transfer pricing system is whether it is audited by independent auditors. The NMa has concluded that the independent auditors of the companies involved check whether the costs incurred by group companies for the network company were actually incurred. In addition, they assess, for instance, the composition of the internal hourly rates, internal controls, the anchoring of the service provision agreements within the management of the business, the correctness of the costs which are passed on, the separation of tasks and the independence of the network company.

Question 4) Are uniform internal transfer prices applied?

A final indicator as to whether an internal transfer pricing system operates properly is whether the transfer prices applied are uniform. This consists of two elements. Firstly it is important that uniform prices and/or allocation formulas are applied for products and services supplied within the group. Secondly, the same price (including a profit mark-up) must be charged for products and services which are not only supplied within the group, but also to third parties. Both elements were investigated. The NMa notes that no investigation

[6] This is an agreement entered into by the designated network manager to outsource activities within the framework of carrying out its statutory duties.

[7] This is an agreement between the owner of the network and the designated network manager with regard to the use of the network or the transfer of economic ownership of the network.

was carried out to ascertain whether the internal transfer prices are in line with the market. This means that the NMa cannot draw conclusions with regard to the absolute level of the internal transfer prices applied.

With regard to the first element, it emerged from the investigation that the internal allocation formulas are the same for all subsidiaries. A distinction is not made between the charges (with regard to price and quantity) passed on to the network manager and other parts of the group. Consequently there may still be a risk that the charges which the head offices pass on to all the subsidiaries are too high. The NMa has no reason to assume that there is a significant risk in this regard, in the light of the independence of the subsidiaries and the network managers, in particular the method of budgeting, the way in which the companies are managed, the way in which negotiations take place with regard to these costs, the way in which costs are passed on, the internal reports, and the internal and independent audits which take place in regard to these matters.

With regard to the second element, it did not emerge from the investigation, although this was based on samples, that different costing (of materials, hourly salaries and standards per activity) was used in calculations in relation to third parties than that used internally in relation to the network manager. Furthermore, the parts of the company responsible for managing the physical infrastructure purchase a considerable proportion of their capacity from third parties. There was no evidence that the amounts passed on to the network managers in relation to these costs are different. There was also no evidence that too many costs were passed on to the network managers by, for instance, the infrastructure companies or that these costs were too high. The same conclusion applies to the integrated infrastructure companies (which are therefore part of the network management company).

Conclusion

The NMa concludes that the companies have a transparent and adequately designed (and documented) internal transfer pricing system. This transfer pricing system is anchored in the internal processes of these companies and, in so far as NMa has been able to conclude, results in uniform internal transfer prices within the companies. NMa received no evidence or reports during the investigation which necessitate a more in-depth investigation into cross-subsidisation or into whether the tariffs charged internally are in line with the market. NMa therefore is of the opinion that there is little likelihood of preferential treatment due to cross-subsidisation, that is, passing on too many costs or costs that are too high to the network managers.