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Energy & Resources Transfer Pricing

Middle East experiences and challenges

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The Energy & Resources (E&R) sector is the largest contributor to the economies of the Gulf Cooperation Council (GCC) countries. Contributing 40% to Saudi Arabia's Gross Domestic Product (GDP) as well as 30%, 60%, and 40% of the United Arab Emirates, Qatar and Kuwait's GDP's respectively. Whilst the GCC countries' vision focuses on diversifying their economies in order to reduce dependency on the E&R sector, this sector still remains in focus in the GCC region.

The governments of the GCC countries have established several initiatives aimed at developing the E&R sector such as the Dubai Energy Strategy 2030, Oman's Energy Master Plan and Saudi Arabia's National Transformation Program and Vision 2030, among others.

One of the most notable E&R projects that is currently underway in the region is the King Salman Energy Park (SPARK) in Saudi Arabia. SPARK is being developed to capture the full economic value from energy-related goods and services in Saudi Arabia and throughout the region with an objective of localizing value creation through dedicated industrial development.

In recent years, several countries in the GCC have introduced Transfer Pricing (TP) regulations. Given that some of the biggest related party transactions are reflected in the E&R sector in the region, this article looks at the biggest Transfer Pricing implications of TP regulations in the GCC. As a first step, we start by examining the supply chain in the industry.

E&R supply chain: An overview

The oil and gas sector comprises of three main sectors: upstream, midstream and downstream sectors. Each of which is essential to delivering the end product to consumers.

Upstream sector

The upstream Sector is responsible for finding economically viable sources of hydrocarbons and bringing them to the surface. Companies operating in upstream exploration and production focus on the acquisition, exploration, and development of properties for the production of crude oil and natural gas from underground reservoirs. This process generally takes several years to complete.

Midstream sector

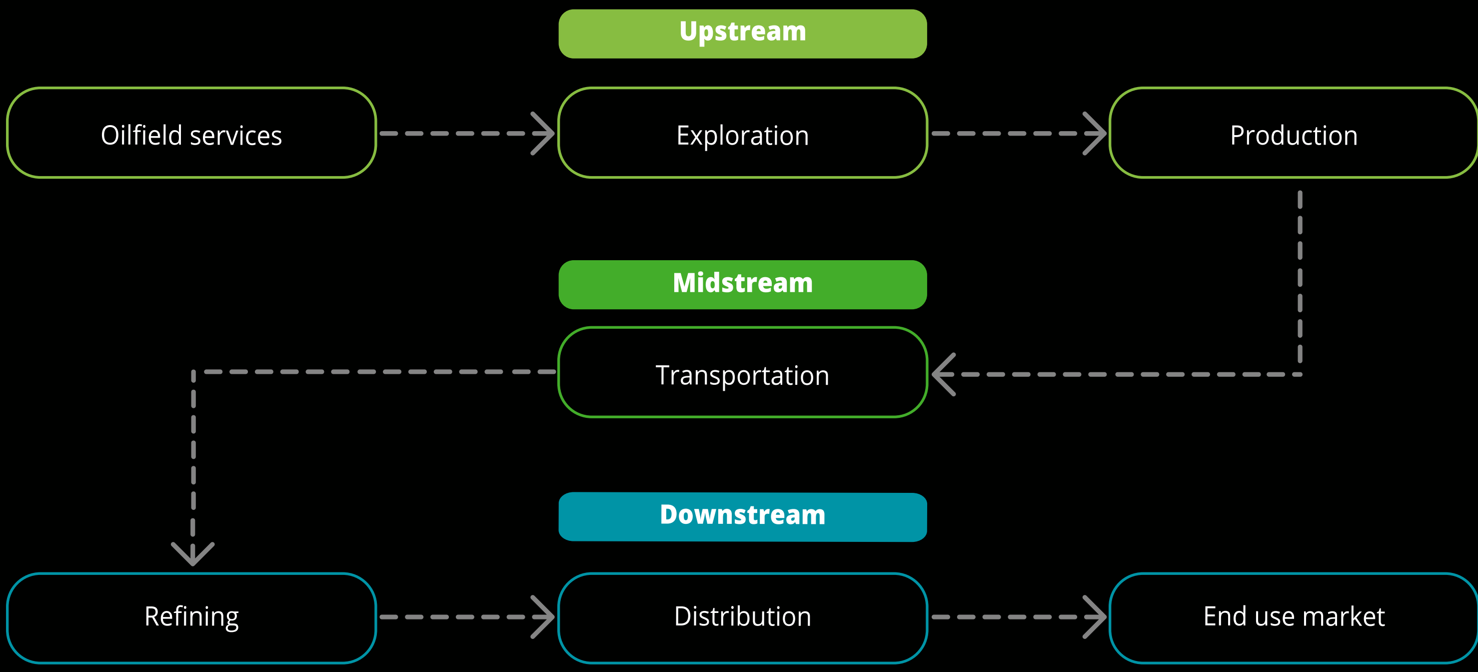
The midstream sector involves gathering, processing, storing, and transmitting natural gas and crude oil. Crude oil and other products are transported internationally in barges/tankers on water, and on land by trucks and pipelines. Natural gas typically moves through pipelines from the producer to the gatherer or transmission company, and then on to the distributor.

Downstream sector

The downstream sector consists primarily of refining and marketing activities for the refined products and natural gas. This includes the refining of crude oil into various products like gasoline, jet fuel and diesel. Once the oil products are refined, they are sold to wholesale distributors, who sell to retailers and industrial users.

The figure next page illustrates the various stages of the E&R supply chain.

E&R supply chain



Transfer Pricing regulations in the Middle East

Countries in the Middle East are increasing their focus on Transfer Pricing, as certain jurisdictions in the region have recently adopted new legislation that will significantly change Transfer Pricing documentation requirements for multinational enterprises (MNE) in the region. Certain jurisdictions that have not had Transfer Pricing rules in the past have enacted documentation requirements. Middle East governments may seek additional methods of boosting tax revenues in the future to fund any COVID-19 stimulus measures including a focus on Transfer Pricing regulations.

Saudi Arabia, Egypt, Qatar and more recently Jordan are the key Middle East countries that have issued Transfer Pricing regulations and implemented mandatory requirements to maintain robust Transfer Pricing documentation. In addition, Saudi Arabia has intensified Transfer Pricing audits in the last year and several major companies in the Kingdom are receiving requests to submit their Transfer Pricing documentation. The current practice of the Zakat, Tax and Customs Authority (ZATCA) for Transfer Pricing audits is to request Transfer Pricing documentation (the Master file & Local File) accompanied by supporting documentation including, e.g. intra-group agreements. This is followed by functional interviews by ZATCA and at times field inspections before the issuance of an assessment order. Based on TP documentation, ZATCA may apply Transfer Pricing adjustments retrospectively. Therefore, a Transfer Pricing risk review should not be limited to only the years Transfer Pricing regulations are applicable.

Transfer Pricing issues in the E&R industry

For Tax and TP practitioners, the energy sector can be challenging, as multinational enterprises in the E&R industry internally transact high volumes of products (oil, gas, and chemicals), technical engineering services, loans, and technology know-how. TP issues impact each of the streams in the E&R supply chain and in this article, we have summarized the potential TP challenges that may be faced by multinational enterprises in the E&R sector.

The largest related party transactions in the E&R industry involve the sale and purchase of crude oil, natural gas and refined products from upstream producers to the midstream and downstream sectors. Second to this are services that consist of the provision of engineering and technical services to the upstream sector. These services involve exploration for hydrocarbons using seismic and geological/ geochemical techniques and drilling, as well as testing, evaluation, completion, production, and stimulation of wells.

With so many types of related party transactions taking place in the E&R industry, tax authorities and taxpayers may take different approaches to determining the arm's length price for related-party transactions. The table below summarizes some of the TP methods and challenges that are often experienced by industry participants.

Common Transfer Pricing issues in the E&R industry

Related party transaction	Prevailing method of pricing	Potential challenges
Crude oil / Product / Natural gas sales	Market Indices plus differential to account for factors such as location, crude/product type and any other factors.	Index pricing is normally accepted by tax authorities post-BEPS. However tax authorities may reject the market index applied and challenge the adjustments for location and crude/product type.
Marketing fees	Commission rate as a percentage of revenue or commission rate per barrel.	The right way to reward a marketing company is a very contentious issue. While strong support often exists for the value marketing organizations bring, and hence a high charge (commission or even profit split) anything in excess of a cost-plus mark-up is routinely challenged.
Crude, product & natural gas transportation	Volume based throughput fee.	Hard to find accurate comparables and hence tax authorities may challenge those used. May also challenge resulting return on assets in asset owning company.
Employee/secondment costs	Cost reimbursement.	Tax authorities may argue that a Fully Loaded Labor Rate (FLLR) cost base does not capture all costs related to the employees. The tax authorities may also challenge the absence of a mark-up.
Support services – operation & business services and technical services	Common to charge out for services at cost with some participants increasingly exploring the addition of a mark-up or value based charge.	One of the key issues for the industry. At cost charging is the industry standard but being put under real pressure by many tax authorities due to the lack of profit reported for a valuable services leading to an inconsistency with the post-BEPS rules.
Intangible property	Know-how from research and development, technology patents, exploration rights, downstream brands are priced in a variety of ways, including royalties derived through comparables, valuation techniques and profit splits.	Intangibles have historically been rarely charged for outside the oilfield services sub-sector but as the value they bring is increasingly recognized in an extractive context, charges are materializing. This in turn has led to it becoming an area which is increasingly being challenged. Assessing the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions is crucial here.
Lease rentals	The day rate charged for equipment and vessels is usually agreed either (i) giving a return on assets to the asset owner or (ii) giving a base cost plus return to the entity utilizing the asset.	Another area increasingly challenged, in particular where losses arise. In addition, the functions performed, and risks assumed by asset owners will be key to analyse. They should be commensurate with the return on assets earned on equipment and vessels and if functionality is absent, a risk free return is the likely result.
Intra-group funding	Interest rate and guarantee fee determination that take into account any implicit support to the borrower or entity being guaranteed. This reflects its own financial standing as well as its capacity to borrow.	Tax authorities will not usually accept quotes given from financial institutions on loans and do expect a full analysis reflecting any implicit support to the borrowing entities. Interest rates on loans from third party banks to be used as comparable interest rates, do need to factor in any required adjustments to reflect the terms of the tested intra-group loan. Interest limitation rules due to excess debt may apply and hence a borrowing capacity analysis is key.

Conclusion

Undoubtedly, tax authorities in the Middle East are focusing heavily on Transfer Pricing in order to boost tax revenues. Questions raised by tax authorities in the region in the E&R sector relate to various aspects of the E&R value chain. However, based on our experience we have noted repeated questions on issues around lease rentals of key assets (for example, rigs and rig equipment), fund movements between head offices and branches and the quantum of marketing fees, especially where recipients of intra-group income are treated tax favorably.

On this basis, taxpayers should focus on maintaining robust Transfer Pricing documentation and implementing sound Transfer Pricing principles and policies. Hence, taxpayers in the E&R sector, should proactively perform a TP policy assessment to ensure that their Transfer Pricing policies are sound and are being implemented properly. This assessment would also serve to highlight areas that tax authorities might be more likely to challenge as highlighted above.

Going forward, as the E&R sector gradually shifts its focus onto clean energy, we are likely to see new risk areas in the coming few years. In addition, with the expectation of corporate income taxes being introduced in zero tax countries within the GCC, this increases the probability of litigation concerning at least some of the issues described above. Hence, it is important for multinational taxpayers in the E&R sector to monitor Transfer Pricing regulation developments in the region and consult with practitioners for their existing transactions prior to taking a Transfer Pricing position.

Contact us

For further information, please get in touch with our experts listed below if this is relevant to you.

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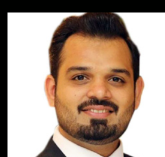

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