Cash pool leaders that are risk-takers enjoy more tax certainty

By Dinko DINEV, Director and Oleg TUPCHII, Manager, Transfer Pricing, Deloitte Luxembourg

ash pooling has recently gained in popularity, as businesses seek to optimize their liquidity amidst the turmoil of the Covid-19 pandemic. Tax rules, however, continue to pose challenges for any treasurer looking to set up such an arrangement.

The Organisation for Economic Co-operation and Development (OECD) recently published a dedicated guidance on the transfer pricing (TP) aspects of cash pools⁽¹⁾ but many practical questions remain. How can treasurers ensure relief from interest withholding tax? How can they set debit and credit rates consistently with TP rules? And how can they minimize maintenance costs?

The tax-driven costs and risks associated with a cross-border cash pool can sometimes outweigh the benefits. These benefits can already be low—for example, when using smaller pools or pools using low interest rate currencies like the euro. To make a cash pool work and be worthwhile, treasurers need certainty and simplicity on the tax side. This article examines physical cash pools and suggests that cash pool leaders that operate as risk-takers can enjoy better tax certainty and simplicity. We explain why this is the case, and what it takes in practice. And we also discuss pragmatic solutions for cases when a risktaker profile cannot be sustained.

Why operate as a risk-taker?

Pricing pool transactions is simpler as no interest adjustments are needed. The interest rates on credit and debit positions in the pool will mirror the bank rates that apply externally to the overall net pool balance. The leader will retain the pool's "netting benefit", without the complexity stemming from this benefit's full or partial al-



location to the participants through adjustments. The netting benefit is the interest saved from reduced external funding, i.e., less exposure to the "banking spread" (which is the difference between bank deposit and borrowing rates). Any tax base triggered by the netting benefit remains within one entity and jurisdiction, which simplifies the tax management process.

Replicating external bank rates in the pool allows participants to benefit from potentially better rates than ones they could negotiate locally, due to volume. The pool's volume benefit, if any, results from the participants' combined positions and shall be allocated fully and only to them, regardless of the leader's risk profile.

A risk-taker leader will face little doubt that it is the beneficial owner of the interest income it receives. Beneficial ownership is a key requirement for obtaining relief from foreign withholding tax under international instruments. Admittedly, there is no official guidance on how risk profile for TP purposes interacts with beneficial ownership. Leaders with a "mere coordination role" may still be able to enjoy withholding tax relief. However, in practice, risk-takers have a much stronger position when sustaining beneficial



ownership in the eyes of the tax authorities of the various countries involved.

What does it take to be a risk-taker?

The leader should take decisions to control the key risks inherent in the cash pool. This requires individuals with treasury qualifications, without the group's entire treasury team needing to be housed in the cash pool leader.

The central risk of cash pools is the liquid-ity risk—the risk that the pool may "go dry" and disrupt the participants' financing. The leader must ensure that the pool remains well-funded, either through internal sources (pool deposits) or external ones, such as a credit facility with the host bank. In practice, this requires the leader to monitor and forecast the cash positions across the group; to choose, negotiate and secure external financing as needed; and take any other steps to keep the pool liquid. The leader can outsource analytical tasks to related or unrelated parties, but it must effectively retain control and take the key decisions required to manage the liquidity risk.

Another relevant risk is the credit default risk—the risk that a participant may be

unable to repay the amounts drawn down from the pool. The leader must assess the size of the participants' debit pool balances against their credit strength, setting debit limits as needed, as well as maintain sufficient financial capacity (capital) to absorb potential credit losses.

Finally, multi-currency pools may give rise to foreign exchange (FX) risk. This risk arises when pool withdrawals in one currency are funded through sources in a different currency. The leader must assess the FX exposure and decide how to manage it; for example, by securing an appropriate FX hedge with a bank.

What if a risk-taker profile is untenable?

Sometimes the risks associated with a cash pool are insignificant or the leader lacks the functional or economic capacity to assume them. In these cases, the netting benefit is allocated to the participants. Debit and credit rates are still based on the bank rates that externally apply to the net pool balance, but they are adjusted (enhanced) to allow for the netting benefit allocation while retaining a modest compensation for the leader. Usually, the most reasonable basis to split the netting benefit among participants is by size of net pool position, whether positive or negative. The netting benefit results from combining (offsetting) credit and debit positions. This means that net depositors and net debtors contribute equally to that benefit, proportionally to their balance in the pool.

A practical difficulty with allocating the netting benefit is that its amount constantly changes. Mathematically, the netting benefit represents the overnight banking spread divided by the lower of all debit and credit positions in the pool—and these variables all fluctuate daily. It may be impractical or even impossible to make frequent manual adjustments to the pool rates to reflect these fluctuations. Perhaps the most efficient way to tackle this difficulty is through technology. Banks are constantly improving the technological side of their cash pool offerings. Software can make automatic, daily rate adjustments and corresponding interest accruals, according to a predefined computation model. We believe that going forward, we will see more and more banks offer these solutions in the marketplace.

Another solution—and one that is well known in practice—is to perform the TP adjustments only at certain reporting periods, e.g., quarterly or annually, based on the period's average figures. This solution can be applied either on an *ex-ante* basis, taking forecasted averages into account, or on an *ex-post* basis, taking actual averages into account.

The *ex-ante* approach requires a financial forecast but provides upfront certainty about the debit and credit rates that apply for the period. Rates are only adjusted on a go-forward basis. However, the danger of this approach is that the forecasted figures may materially deviate from the actuals and, consequently, the applied pool rates may cause distortions, such as a loss-making leader.

The *ex-post* approach eliminates this danger. However, it involves retrospective adjustments of interest rates. It is essential to ensure that the retrospective crossborder adjustments are treated as interest payments consistently across the countries involved, to minimize challenges to the characterization of payments for withholding tax purposes.

Conclusion

Cash pool leaders operating as risk-takers face reduced complications and risks from both a TP and withholding tax perspective. Sustaining a risk-taker profile requires the exercise of appropriate risk control functions. In cases where a risktaker profile cannot be sustained, pragmatic solutions exist to minimize the risks and costs of the tax compliance process.

Gas and Renewables Investments in Uzbekistan

By Nadezda KOKOTOVIC, Brussels Energy Club Director

The Brussels Energy Club (BREC) held an online meeting on 27 November 2020 within the framework of its emerging markets series. The topic of discussion was «Gas and Renewable Energy of Uzbekistan» and presentations were made by key experts of the ministry of Investments and Foreign Trade of this Central Asian state: Aziz Khamidov, Head of Department Energy and Infrastructure, Shokhrukh Abdurakhmanov Chief Investment Specialist and Bahodir Husanov, Head of Energy, Geology, Chemicals and Infrastructure. The meeting was opened by the introduction of H.E. Dilyor Khakimov, ambassador of Uzbekistan to the EU, and as per established tradition, was moderated by Dr. Marat Terterov, founder of BREC, currently Head of Expansion at the Energy Charter Secretariat in Brussels.

Uzbekistan has become a hot topic in energy circles after the country's leadership changed in 2016. Shavkat Mirziyoyev came into power following the death of Islam Karimov and his 25-year rule of this presidental republic. Mirziyoyev served as a prime minister from 2003 and the fact that he was well acquainted with the structural problems of the country gave impetus to the fast pace reforms that started from the moment he entered office. According to Mirziyoyev himself, Uzbekistan is now "on the path of innovative development aimed at radical improvement of all spheres of life of the state and society". Inefficient energy system with state-owned enterprises (SOE), old loss-generating infrastructure and an energy mix heavily dependent on natural gas (85%) are core issues that the new leadership is set to address in the current decade.

The government has therefore focused its reform efforts on modernization of the energy system and its enterprises while working with financial institutions to attract foreign investors that would help the country build up its energy production and introduce renewable energy sources (RES).

Bahodir Husanov presented the gas sector overview and reform strategies. The gas industry today is regulated by the ministry of Energy (established in February 2019) and operated by three, recently unbundled, SOEs for upstream and downstream, transportation and distribution. A group of foreign companies (Lukoil and Gazprom in Russia, Epsilon in Texas, USA) and joint ventures (New Silk Road Oil and Gas with China, Uz-Kor Gas Chemical with South Korea, etc.) operate in the oil and gas sector and Ustrangaz purchases gas from them into the national gas network at higher prices. The existing model is not efficient in the context of rapidly growing demand, but also does not meet international standards, as concluded by the analyses of the World Bank, the Euro-Bank for Reconstruction and Deve (EBRD) and the Asian Development Bank (ADB).

aim is to reduce political interference and ensure priority of corporate interests in the energy sector.

In terms of RES, in accordance with the strategy of reducing dependency on gas and expected increase in electricity demand from the current 69 to 120 billion kWh by 2030, Uzbekistan has adopted its Renewable Energy Law and the Law on Public Private Partnerships. In 2018, Uzbekistan has set a goal to increase the amount of RES in total electricity production to 20% by 2030.⁽³⁾ In concrete terms, it means another 10-GW capacity and 37 billion kWh (in 2018 it was 5.9 billion kWh), which would save around 8.1 billion cubic meters of natural gas annually. The 10 GW would be split between 5 GW of solar energy, 3 GW of wind-generated energy and 2 GW of hydropower. Being a party to the Paris Climate Agreement, Uzbekistan RES recognized as a solution for CO2 emissions, and the government expects it to contribute to emission reduction by 10% by 2030 relative to 2010.

In order to increase the volume of foreign direct investments (FDI) in the RES sector, tenders and auctions are held in cooperation with international financial institutions based on the Build-Own-Operate model, with long-term contracts of up to 25 years. In addition, there are several projects that are established via direct bilateral contracts under broader govern mental cooperation between states. Conditions should be satisfying for both parties, in the words of Aziz Khamidov and Shokhrukh Abdurakhmanov, who jointly presented the overview of RES sector, so the government has adopted a whole set of preferences and benefits for investors. The government supports payment obligations of the transmission company as a guarantee for the investor. Over time the government plans to reduce this form of support for the transmission company. The first solar project contract was signed on a bilateral basis in 2019 with Total Eren in France for the construction of a 100-MW solar power plant in Samarkand and the construction process has subsequently started. Last year, with the assistance of the International Finance Corporation (IFC), another solar plant agreement was reached with Masdar, which is part of the Mubadala Investment Company from the United Arab Emirates (UAE). The project has one of the lowest tariffs in emerging countries, 2.670 US cents/kWh. The construction is about to start and it is expected to be finalized by the end of 2021. In June 2020 a request for quotes (RFQ) was announced for the development of 2 solar power plants, each with a 200-MW capacity, in the Samarkand and Jizzakh regions. Applicants from the Middle East, Europe and Africa responded and after evaluation it is expected that commercial contracts with bidders will be signed in the first quarter of 2021. The government and the IFC are aiming to announce in 2021 another two tenders for 300 MW in the Bukhara and 200 MW in the Namangan regions. The Asian Development Bank is a partner for investment projects of solar plants announced in June 2020 for the development of 100 MW in Surkhandarya (evaluation ongoing) and soon another project of 300 MW in the same area will be announced.

The World Bank and EBRD conducted a study to identify appropriate locations with good potential for wind plants in different regions. The EBRD is supporting Uzbekistan with the implementation of the first wind power investment projects. The RFQ was launched for 100 MW wind in Karakapalstan with 17 applications received from Europe and the Middle East. In January 2021 the winning bidder will be an-nounced and a commercial contract will likely be signed. Construction will start in the second quarter of 2021. In order to meet the 2030 goals, this project is scaled up and an additional 200 MW capacities were initiated. In June 2020, a bilateral contract was signed with Masdar for the construction of 500 MW, one of the largest wind plants in the world, in Navoiy reion. Construction is about to start in 2021. Uzbek istan initiated negotiations with ACWA Power from Saudi Arabia for the construction in 2021 of a wind plant with total capacity of 500-1000 MW in the Bukhara region. Globally, solar and wind tariffs are decreasing, so the government has decided to introduce the lowest possible tariffs instead of feed-in tariffs (FIT). The World Bank will also support the modernization of Uzbekistan's transmission system. in order to allow efficient integration of RES into a single electric power system.

Uzbekistan has indigeneous energy production that covers the nation's energy demand. Its total proven gas reserves amount to 1.2 trillion cubic meters, with annual production of 56 billion cubic meters⁽¹⁾. Uzbekistan is among the most energy-intensive countries in the world, but primary energy consumption per capita in Uzbekistan in 2019 was only 54 gigajoules (by comparison Belgian consumption is 235, whereas Romania's is 70⁽²⁾), so the electricity demand is expected to double by 2030. The problem, however, is that around 50% energy installations are 30-to-40-year old, which leads to frequent disruption in supply for the 33 million inhabitants of this former USSR republic.

The main goal of the reforms is then set to increase gas sector efficiency and reduce dependency on it through diversification and greater levels of power generation from RES. Several important milestones were reached in this regard and now the following step is the liberalization of the natural gas market by establishing a gas hub and creation of a national market with transparent cost-reflective prices and tariffs. In the legal and regulatory realm, a new Gas I aw and Code of Natural Gas network should be adopted, as well as a law on energy efficiency and environmental framework. In the financial sphere, it is expected that SOEs will start operating in accordance with International Financial Reporting Standards (IFRS) standards in order to have access to credit rating and financing. The vision for 2024 is phasing out supply monopolies.

In political terms, the ministry of Energy is seen as an independent market regulator that sets the vision and strategy for the sector and creates legislation, while the ministry of Investments and Foreign Trade plays the role of a focal point, a one-stop shop that provides support and guidance to foreign investors. The overall

Uzbekistan has shown great prospects for foreign investors and the Brussels Energy Club will keep monitoring energy development in this and other countries of Central Asia. Our next emerging markets online meeting is dedicated to Bangladesh, a country with rapidly growing energy demand which also faces severe challenges at the level of climate change.

 BP Statistical Review of World Energy 2020 <u>https://www.bp.com/en/global/corporate/energy-economics/statistical- review-of-world-energy.html</u>
BP Statistical Review of World Energy 2020 <u>https://www.bp.com/en/global/corporate/energy-economics/statistical-review-of-world-energy.html</u>
Ministry of Energy of the Republic of Uzbekistan <u>http://minenergy.uz</u>