

Trust in water

# **RAG 5.07 – Guideline for transfer pricing in the water and sewerage sectors**

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## Contents

1. Introduction	2
2. Licence authority	3
3. Financial penalties	3
4. The Competition Act 1998	3
5. Guideline principles	4
6. Applicability	5
7. Determining transfer prices	8
8. Principles of market testing	11
9. Cost allocation	14
10. Use of assets for non-appointed activities	16
11. Use of Bioresources assets for non-appointed activities	17
12. Appointee structure	17
13. Definitions	18
Appendix 1 Bioresource trade worked example	20

## 1. Introduction

- 1.1 Appointees are under a duty to trade at arm's length and to ensure that there is no cross-subsidy with respect to transactions between the appointed business and both associated companies and the non-appointed business. (A definition of terms is included in the RAG 2)
- 1.2 The onus is on individual water companies to ensure that their activities comply with the duty and this guideline is in place to assist appointees. If required, appointees should be able to demonstrate transparently to the Water Services Regulation Authority (Ofwat), and to the public and other audiences, that they are meeting their duty to trade at arm's length from associates and that cross-subsidy does not exist.
- 1.3 Abuse of monopoly power, for example through the exclusive use by an appointee of services provided by an associate, paid for at rates not in line with market rates, may lead to unfair competition in contestable local and national markets. It may lead to greater costs for the regulated business, and ultimately to higher bills for customers. It may also breach the Competition Act 1998. To guard against such risks, appointees should let contracts competitively where possible.
- 1.4 In addition, following the introduction of separate binding price controls at the 2014 price review, companies need to attribute or allocate costs between the controls. The revenue allowance for each price control is determined by the estimated costs specific to that particular price control and comparable information on actual costs will be needed for future price reviews. Therefore companies should also ensure that there is no cross subsidy between price control units.
- 1.5 Where cross-subsidy is found Ofwat will take account of this at price reviews to ensure that customers do not pay more as a result of this cross-subsidy. Breach of any licence condition could also warrant a financial penalty, under section 22A of the Water Industry Act 1991. It could also lead to action under general competition law.
- 1.6 The aim of the guideline is to establish a framework with which appointees should comply in setting transfer prices for regulatory accounting purposes. The guideline describes the key principles with which companies should comply and also reflects key areas of non-compliance highlighted by investigations into company activities.

## **2. Licence authority**

- 2.1 Section 2 of the Water Industry Act 1991 places a duty on Ofwat to ensure that transactions between appointees and their associated companies are at arm's length. Each appointee's licence reflects this duty, by prohibiting any cross-subsidy between;
- the appointed and non-appointed businesses,
  - from the appointee to any associate company, including the parent company or any water supply licensee or sewerage licensee within the group.
- 2.2 Condition B of water company licences gives Ofwat authority to set separate price controls for wholesale (water and wastewater) and retail services.

## **3. Financial penalties**

- 3.1 The Water Industry Act 1991 provides enforcement authorities (the Secretary of State, the Welsh Ministers and Ofwat) with powers to impose financial penalties of up to 10% of turnover on appointees and water supply licensees and sewerage licensees (licensees). Penalties may be imposed for contraventions, or contributing to contraventions, of appointment conditions, licence conditions, and other requirements as noted in the 'Statement of policy with respect to financial penalties' published by Defra, Ofwat and the Welsh Government, which had effect from 1 November 2010, and any subsequent revisions to this.
- 3.2 Ofwat's primary objective on transfer pricing is to ensure that cross-subsidy does not occur so that customers are not disadvantaged. Where relevant, we also want to ensure that that water companies do not show undue preference or undue discrimination in relation to the provisions of services by themselves, other appointees or licensees.

## **4. The Competition Act 1998**

- 4.1 Ofwat has concurrent jurisdiction with the Competition and Markets Authority to enforce the Competition Act 1998 in relation to commercial activities connected with the supply of water or the provision of sewerage services.

The application of the Competition Act 1998 to the water and sewerage sectors is considered in: Guidance on Ofwat’s approach to the application of the Competition Act 1998 in the water and wastewater sector in England and Wales (23 March 2017).

- 4.2 Where the relationship between an appointee and an associate company may contravene licence conditions or the prohibitions in the Competition Act 1998 then Ofwat could proceed under either the Water Industry Act 1991 and/or use its powers under the Competition Act 1998. However, Ofwat cannot make an enforcement order or impose a financial penalty under the Water Industry Act 1991 if it considers that it is more appropriate to proceed under the Competition Act 1998. The customers of an appointed company do not meet any financial penalty, this cost will fall on the appointee’s shareholders.

## **5. Guideline principles**

- 5.1 The principles of this guideline are that:
- the appointed business pays a fair price for services and products received and receives a fair price for services and products it provides to other businesses in the appointee or other associate companies;
  - transfer prices for transactions between the appointed business and associate companies are based on market price. Where no market exists, transfer prices are based on cost;
  - transfer prices for transactions between price control units should be based on market price unless no market exists, in which case transfer prices should be based on cost;
  - transfer prices for transactions between the appointed business and non appointed business are based on market price. Where no market exists, transfer prices are based on cost;
  - market-testing<sup>1</sup> is used to establish market prices for supplies, works and services provided to the appointee; and
  - costs are attributed or allocated in relation to the way resources are consumed consistent with the principles in regulatory accounting guideline 2.

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<sup>1</sup> The principles of market-testing are set out in section 8.

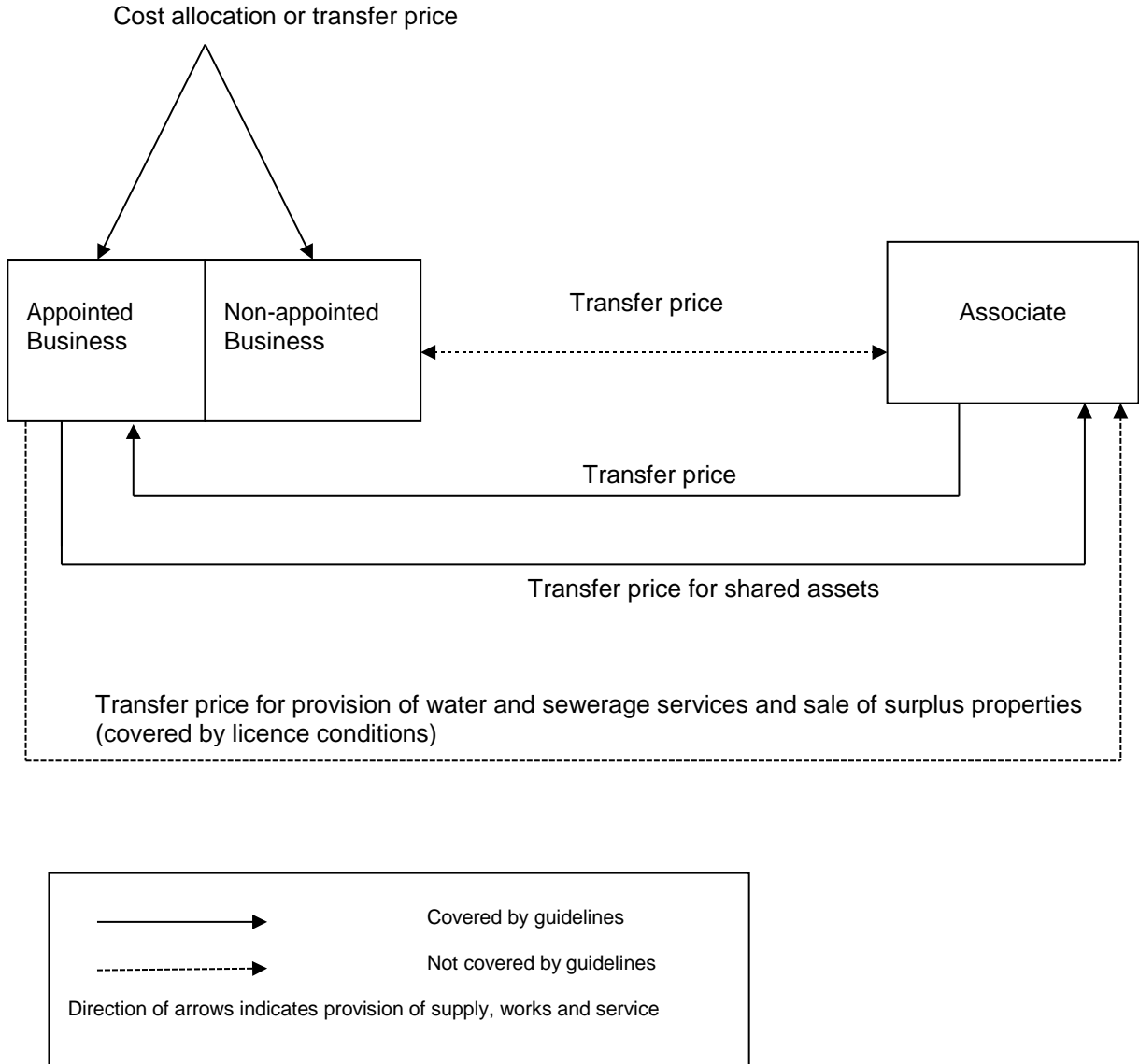
- 5.2 Appointees are required to demonstrate, through the application of these principles, the basis of arm's length trading and that cross-subsidy does not exist.
- 5.3 Within the framework of these guidelines, appointees should develop and maintain processes and procedures to ensure compliance; these processes and procedures should meet their own specific circumstances, and ensure that transactions are supported and documented.
- 5.4 These guidelines and principles will apply to all water only and water and sewerage companies including new entrants. Within each appointee the policies and methods adopted for cost allocation, transfer pricing, market-testing and reporting should be consistent with our guidance.

## **6. Applicability**

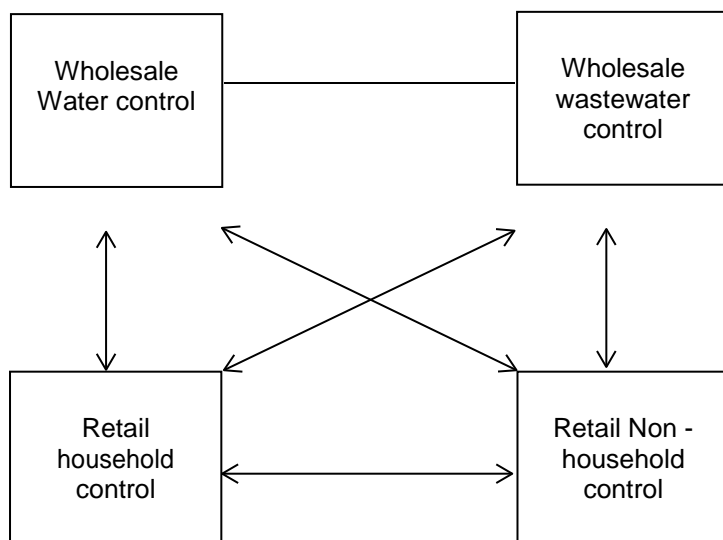
- 6.1 These principles apply to:
- cost attribution or allocation within the appointee between the appointed and non-appointed activities and between the separate price control units;
  - transfer prices for the provision of supplies, works or services between the appointed business and an associate company, and between the separate price control units within the appointed business, and between the appointed and non appointed business;
  - transfer prices for rechargeable works and services where the appointee or a price control unit is a monopoly supplier to the associate company, non appointed business or other price control unit, eg, for use of accommodation and other shared assets; or where the parent is monopoly supplier, eg, shareholder costs to the appointee and associates.

This is shown in figure 1a and figure 1b.

**Figure 1a Cost allocation and transfer pricing**



**Figure 1b Cost allocation and transfer pricing between price control units**

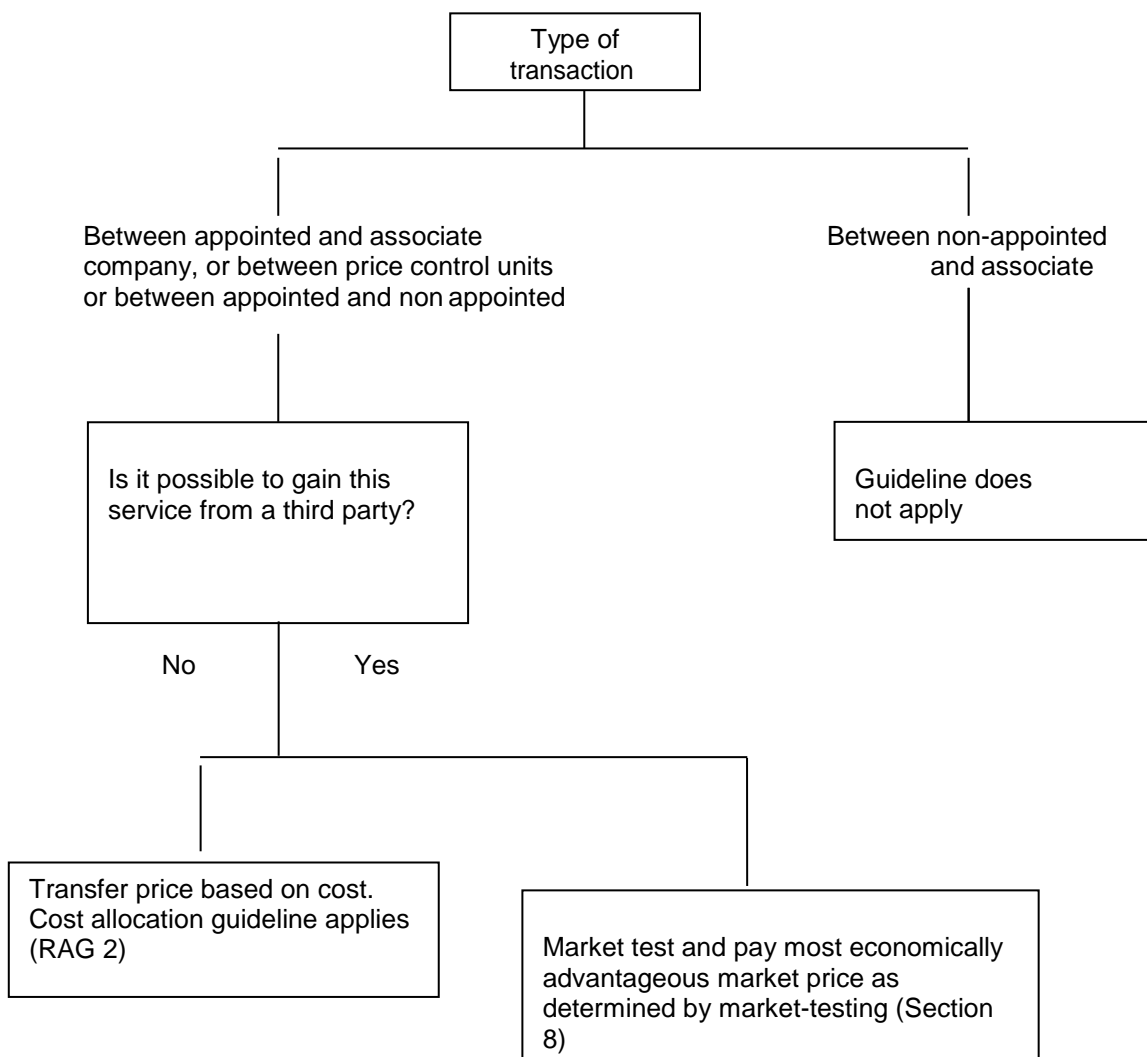


Transfer price and cost allocation for services & for use of shared assets all covered by guidelines

- 6.2 This guideline will apply to transactions with all associate companies. An associate company is any “Group Company” or a “Related Company” as defined in licence conditions. For the purposes of this guideline, and to ensure complete transparency, any associate determined in accordance with ‘Financial Reporting Standard 102 (FRS 102) should also be treated as a Related Company. Any exceptions to this must be agreed with Ofwat.
- 6.3 The onus will be on appointees to determine whether or not any company with whom they trade is an associate company. Appointees will need formalised procedures to check whether a company with whom they trade is an associate. Figure 2 provides an overview of the guidelines and the key decision points relating to cost allocation and transfer pricing.



**Figure 2 Overview of guidelines**



## 7. Determining transfer prices

### Principles of transfer pricing

7.1 The primary principle is that transfer prices should where possible be based on market price and that market price should be determined by market-testing. The principles of market-testing are described in Section 8. Market price should be the most economically advantageous price taking into account objective criteria such as completion date, quality, running cost, after sales service, technical merit, security of supply, effectiveness, whole life cost, capability, capacity, etc.

- 7.2 The market-testing process must be applied in a fair, open and transparent manner with no guarantee of success in a competitive bid for associate companies. This will facilitate fairness of treatment between potential contractors and ensure that competitive tension is maintained within the process. This provides the greatest assurance that cross-subsidy of associates is not taking place. Where a service is market tested, the process should be fair, effective and proportionate to the value and complexity of goods, works or services being procured. The work should be awarded to the tender<sup>2</sup> that is the most economically advantageous. This should be determined by reference to the objective criteria set out above.
- 7.3 Where an associate company gains a substantial proportion of its turnover from the appointed business, ie, then the charges levied by the associate should incorporate a discount from the external market price to reflect the following:
- inherent long-term guarantee of work;
  - volume of work;
  - lower marketing and sales costs;
  - lower bad debt risk;
  - lower commercial risk;
  - reduced credit period.
- 7.4 Where no market exists for particular supplies, works or a service, the transfer price should be based on cost, and the cost allocation principles and guidelines in sections 9-11 and RAG 2 followed.
- 7.5 There will also be instances where the transfer price for some internal services and activities should be based on cost, even though a market may exist, for example activities such as treasury, legal services, or payroll etc. Provided the service or activity are company specific and are being provided internally to all of the price control units, or being provided solely to both the appointed and non-appointed business then the transfer price should be based on cost. In those instances charges must be related to the services provided and the cost allocation principles and guidelines in sections 9-11 and RAG 2 followed.

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<sup>2</sup> All references to tender include related terms, such as bid or proposal to supply.

- 7.6 On occasion, the appointee may choose to use the services of an associate for strategic reasons. For example, it may wish to retain intellectual properties within the group or it may require a particular product or service which can only be provided by an associate. Under these circumstances, the transfer price should be based on cost.
- 7.7 If there is a market for a service or good and the appointed business does not choose to test the market for that service/good then transfer prices should be at cost and the reasons for not market testing should be documented. Appointees should also consider bringing the activity within the appointed business. An appointee that uses an associate company for a service, for which there is a market, without market-testing the prices paid cannot demonstrate arm's length trading. For price setting purposes, Ofwat will assume that such supplies, works or services under these circumstances are provided at cost to the appointed business, as if the services have been delivered within the appointee.

### **Other transfer prices**

- 7.8 Not only do transfer prices apply to goods, services and supplies, they can also apply to staff where they provide services or are seconded to associate companies and vice versa. Where appointee staff undertake work for associates, the appointee should be reimbursed to reflect the individual's salary and overheads associated with that individual's employment, ie, accommodation, pension, car. This also includes staff that are seconded or work on services provided across multiple price control units.
- 7.9 Appointees should have systems to record details of staff and time spent on non-appointed activities and where staff work on services provided across multiple price control units. This is also relevant for board members, non executive directors and independent non executive directors. Where the appointee employs or trains associate staff, it should document the requirements for that individual and the basis of remuneration.
- 7.10 In some circumstances companies may choose to transfer assets into and/or out of the appointee. Where assets are transferred out of the appointee to an associate, the associate should pay a fair price, as determined by fair value for those assets. Associates should not receive assets from the appointee at a price below that which would be charged by a third party. Assets should only transfer between price control units where the primary use has been redesignated and the transfer should be at fair value.

## 8. Principles of market testing

8.1 Market-testing is a process used to determine a market price for particular supplies, works or services. Transfer prices for transactions between the appointed business and associate companies can typically only be at a market rate if they are a result of market-testing. This is essential to ensure that the price paid for a product or service is comparable to a fair market price. Appointees that let contracts in a competitive manner to associates and third parties alike should be able to demonstrate that trade with associates is conducted at arm's length.

### Methods of market-testing

8.2 There are a number of methods of market-testing:

- competitive letting;
- comparison to published list prices;
- third party evaluation;
- benchmarking.

8.3 The water sector to date have used all of these methods to determine transfer prices, with varying degrees of success. The most robust means of determining a fair market price is to invite independent contractors to tender a price for given supplies, works or services, ie, competitive letting of a contract. Competitive letting is the only means of market-testing which objectively tests and preserves the competitive market.

8.4 Where companies use comparison to published list prices, third party evaluation and benchmarking there can be a large element of subjectivity involved. These methods of market-testing may involve a judgement of a fair market price and/or interference in the market and tend to compare a predetermined price with the market, as a means of justifying the original price. Competitive letting avoids this problem as it inherently discovers the market price without interference in or judgement of the market.

- 8.5 Though competitive letting produces the most robust transfer price, there are circumstances where the competitive letting process is demonstrably impractical. For example, where a contract of small value is not suitable for inclusion in a framework agreement, or where, for example, group services may not be provided at cost. In these rare circumstances market-testing by comparison to published list prices, third party evaluation and benchmarking could be used to demonstrate arm's length trading.
- 8.6 In exceptional circumstances the appointee may need to engage the services of a third party at short notice to deal with operational needs. This would include dealing with emergency situations where the prompt action required would not enable a full procurement exercise to be undertaken. To alleviate concerns, the appointee should fully document the operational emergency, the reasons for selecting the associate, and any supporting information on any mark up to cost. This process should accord with the appointee's stated emergency procedures.
- 8.7 The appointee must be able to make a strong case for using methods other than competitive letting and demonstrate the robustness of the methods used. Only well-documented and cogent exercises will allow the appointee to demonstrate that transfer prices are at market rates. However, Ofwat does not expect there to be many such instances, as competitive markets exist for almost all goods, works or services that appointees procure.
- 8.8 A number of companies have previously been unable to demonstrate arm's length trading due to weaknesses in their market-testing processes. Where this has been the case, Ofwat made downward adjustments to declared costs at price reviews. Ofwat assumed that some supplies, works and services were provided at cost to the appointee and future price limits were set on this basis. Where there has been inefficient pricing, appointees may also face additional challenge as part of the price review incentives.

### **Market-testing procedures**

- 8.9 Appointees should establish and apply clear policies and procedures for market-testing. The reasons for the methods, thresholds and criteria adopted should be transparent and should be capable of withstanding scrutiny by Ofwat, customers and competing contractors.

- 8.10 Where water companies are unable to demonstrate arm's length trading because the competitive letting process was not set down in advance, Ofwat may adjust companies' costs for the purposes of price limits, as it has done in the past and or it may take enforcement action.
- 8.11 Transparent, well-documented market-testing processes that record the steps and decisions in the procurement process will help appointees to demonstrate compliance with these guidelines. Appointees should be able to demonstrate that the price paid for the goods or services provided does not exceed a fair market price.
- 8.12 Prior to commencing the competitive letting process the appointee should ensure the following decisions are taken:
- contractual arrangement to be used and the circumstances in which they will be used, eg, fixed price, schedule of rates, partnering, term, negotiated and call-off contracts;
  - the minimum number of bids to be obtained dependent on materiality of the contract;
  - qualification processes for potential contractors;
  - an evaluation process;
  - policy on informing tenderers of results.
- 8.13 When inviting companies to tender, appointees should ensure that the qualification requirements do not give any undue advantage to associates. Appointees should ensure that they do not abuse a dominant position or enter into agreements or concerted practices which might breach the prohibitions in the Competition Act 1998.
- 8.14 The tender evaluation process and respective weightings for each criterion should be set out and documented by the appointee in advance of any tenders being opened. This will help demonstrate that associate companies and external companies undergo the same tender process, without any preferential treatment or guarantee of success for the associate.
- 8.15 Appointees should be able to demonstrate that the assessment criteria are relevant to goods, works or services in the procurement exercise

## **Frequency of market-testing**

- 8.16 To demonstrate a fair market price the appointee will need to undertake frequent market-testing that produces valid results relevant to transfer pricing. There is a balance between the advantages of frequent market-testing of short-run contracts and the benefit of stability, continuity and possibly lower costs for longer term work.
- 8.17 Repeat market-testing is likely to be necessary when there is any material alteration to an existing contract, for example where an increased volume of work is conducted than had been envisaged when the contract was let. Market-testing that does not match the current profile of work will not remain valid.
- 8.18 In general, the greater the likelihood of fresh competition and new technology emerging, then the shorter the period between market-testing. Appointees should have regard to these issues in determining their strategy as relevant to determining market prices for transfer pricing purposes.

## **Unacceptable practices**

- 8.19 Market-testing procedures should comply with EU and prevailing standards. Appointees should not split contracts or use artificial methods to calculate the value of contracts in order to circumvent applicable thresholds or the aggregation rules of the EU.
- 8.20 Market-testing should be used to award contracts to the most economically advantageous tender, not as a device to justify prices paid to associate companies. Where examples of this practice are found, Ofwat will assume these works, supplies and services are provided at cost, as arm's length trading cannot be demonstrated. This could also constitute grounds for an investigation under the Competition Act 1998.

## **9. Cost allocation**

### **Principles of cost allocation**

- 9.1 In RAG 2 we set out the principles for cost attribution and allocation that appointees should use for historic cost capital and operating costs. These

principles apply to allocation across all parts of the value chain, between price control units and to allocation between appointed and non-appointed activities within the appointee.

- 9.2 For transfer prices from associate companies where no external market exists (including services received from the parent company, or where costs are incurred commonly by appointed and non-appointed activities) costs should be allocated in relation to the way resources are consumed consistent with RAG 2. For these transactions allocations based entirely on turnover, volume or direct labour rates should not be used as they are unlikely to reflect the activities involved.
- 9.3 Where cost is used as a basis for transfer pricing, the appointee should have access to the costs of the relevant associate and should conduct validation exercises to ensure that transfer prices are at cost. This should be incorporated within the contract monitoring process agreed by the parties.
- 9.4 Application of the principles in RAG2 should prevent appointed activities cross subsidising non-appointed activities and also ensure no cross subsidy between price control units. All costs must ultimately be attributed or allocated, including, where appropriate, depreciation charges on assets and financing charges.
- 9.5 The onus is on companies to ensure that all costs are ultimately attributed or allocated in accordance with this guideline.

### **Services provided by the parent company**

- 9.6 There may be instances where appointees pay a charge to the parent company for services provided. It is important that the basis of charging used by the parent company reflects the group structure at the time charges are being levied and actual services provided. The charges paid to the parent must be related to the services provided and such parent company services (e.g. legal services and treasury services) should be charged at cost. The onus is on the appointee to demonstrate charges reflect the costs incurred by the parent company as provider of the service. Management fees should not be inflated by additional costs beyond those actually incurred, eg, where the parent treasury function provides a guarantee to the appointee, a charge should not be made for the provision of that guarantee beyond that paid by the parent.



- 9.7 In some cases it may not be possible to charge for services on an activity basis; eg, for shareholder management costs (Register, Company Secretary, AGM etc). Costs of this type should be distributed fairly between each subsidiary of the parent and in a way that reflects the activities the parent undertakes on behalf of the individual subsidiaries. Distributing charges to associates on the basis of profitability or turnover of individual associates will not provide a proxy for activity, and apportionment on this basis should be avoided. Discrepancies between treatment in the regulatory and statutory accounts should be avoided.

### **Marginal cost allocations**

- 9.8 Allocations based on short run marginal costing techniques should not be used in ensuring the full allocation of costs within the appointee and providing the basis for transfer prices. In some instances it may be admissible to use long-run marginal costing techniques for transfer pricing purposes. For instance between appointed and non appointed business , where a water only company, uses appointed assets and staff to bill and collects payments for another sewerage services on behalf of a water and sewerage company. In cases where a company considers that a marginal costing technique is the most suitable means of charging for a particular service within a group, it will be expected to justify its reasons for using this technique.

## **10. Use of assets for non-appointed activities**

- 10.1 When a non-appointed activity includes the optional use of an asset owned and also used for an appointed activity, then it is appropriate that both shareholders and customers should benefit. This objective can be achieved in one of two ways.
- 10.2 If the use of an asset for a non-appointed activity involves a disposal of protected land (which includes the creation of any interest or right in or over land), then the requirements of the licence apply. For this purpose, land includes buildings and other structures, land covered by water and any estate, interest, easement, servitude or right in or over land. Examples of disposals of protected land include permission for the installation of fibre

optic cables in sewers, the erection of aerials and the granting of fishing rights.

- 10.3 If the use of an asset for a non-appointed activity does not involve a disposal of protected land then costs for use of the asset should be allocated between the appointed and non-appointed business. RAG 2 and section 9 sets out the principles companies should use when allocating costs. Special consideration has been given to what would constitute a fair allocation of such costs in the case of bioresources activities consistent with the development of a market in bioresources<sup>3</sup>. This is set out in section 11 below.
- 10.4 Appointees should consider if it is appropriate to move assets from the appointed to non-appointed business, eg, if an asset is in future to be used primarily for non-appointed activities.

## **11. Use of Bioresources assets for non-appointed activities**

- 11.1 Where a non-appointed business or associate provides a service for processing bioresources and uses assets belonging to the appointee which are also used for other activities, the contribution the user makes to these assets should reflect the margin made by the user on the sale of its bioresources activities over and above the incremental costs incurred by both parties in providing the service.
- 11.2 Companies may therefore set the transfer price for the use of the appointee's assets in such transactions so that, as a minimum, it covers the incremental cost incurred by the appointee in supplying the bioresource processing service but also includes a proportion of the margin referred to in section 11.1. The period over which incremental costs are considered should be aligned with the trading arrangements.
- 11.3 In deciding what proportion of that margin referred to in section 11.1 to include in the transfer price, companies should consider the investment

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<sup>3</sup> See [Water 2020: our regulatory approach for water and wastewater services in England and Wales – Appendix 2, May 2016](#)

risks taken by both parties in order to provide the service, with a greater relative risk meriting a greater share of the reward. Appointees should also take account of balancing the interests of customers of the appointed business and shareholders.

- 11.4 Transfer prices could impact on the price charge by the non-appointed business for the bioresource activity. Companies are responsible for ensuring the market price charged by for the bioresource activity is compliant with competition law.
- 11.5 We will review whether these provisions continue for be appropriate for bioresources activities before 2025.

## 12. Appointee structure

- 12.1 Systems should be in place to ensure that directors or senior managers who have responsibilities in both the appointee and associate companies, or companies with whom the appointee trades, do not face a conflict of interest.
- 12.2 No individual, in such a position, should be able to influence either the purchase or supply of goods, services and supplies. Ofwat has also set out principles for both regulated and holding companies which companies should comply with. Companies must also comply with relevant licence conditions.

## 13. Definitions

Marginal costing – see definition at Section 5 of RAG2.

Incremental cost – is the cost caused by the provision of an identified increment of output, given that some level of output (which may be zero) is already being produced. The incremental cost should reflect forward-looking increases (or decreases) in operating costs and the forward-looking capital costs associated with provision (or non-provision) of the increment. The costs associated with the provision (or non-provision) of an increment are related to the period of time over which the increment is provided.

Increment - is the output over which the costs are measured, and theoretically there is no restriction on what products, services or outputs could collectively or individually form an increment. *In extremis*, the cost of providing an extra unit of

output of a service will equal the marginal cost, whilst the incremental cost of providing the entire output of an undertaker will equal the total cost of the undertaker. More commonly, increments are related to the output of a discrete activity and could relate to, for example, a contract, a group of contracts, a customer, a group of customers or a division.

## Appendix 1 Bioresource trade worked example

### Without trade

Appointed Bioresources business		Non-appointed business	
	£m		£m
Revenues	100	Revenues	
Opex	<u>-70</u>	Opex - recharge from appointed	<u>        </u>
Operating profit	30	Operating profit	

### Proposed trade;

- £10m market price to treat sludge (charged by non-appointed)
- £1m administrative cost incurred by non-appointed
- £4m incremental cost appointed business will incur in treating sludge
- Company considers the investment risk and interests of customers means that a 50:50 margin share is appropriate

	£m	
Revenues	10.0	50:50 margin share means appointed business must benefit by 50% of £5.0m ie £2.5m
Opex	<u>-5.0</u>	
Margin	5.0	

### With trade

Appointed Bioresources business		Non-appointed business	
	£m		£m
Revenues	100.0	Revenues	10.0
Opex	-74.0	Opex - recharge from appointed	-6.5
Negative opex	<u>6.5</u>	Opex - administration	<u>-1.0</u>
Operating profit	32.5	Operating profit	2.5

- Lower overall opex benefits customers in the next AMP (assuming similar price control)  
 - Left unchecked, additional profit would be retained by shareholders.  
 So we adjust as follows;

Transfer price is; incremental cost + 50% of margin (£4m+£2.5m)

Profit retained by non-appointed business

#### Revenue reconciliation

	£m
Actual Revenue	100.0
Add margin share element	<u>2.5</u>
Adjusted revenue	102.5

The impact of this is the revenue deemed to have been collected in the first year of the trade is increased by £2.5m. The mechanism which calculates the 'allowed revenue' which can be collected from customers in future years in the AMP is therefore reduced by £2.5m. This will be reflected in lower charges in future years.