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By email to: TransferPricing@oecd.org

February 6, 2015

Dear Mr Hickman,

Comments on the Discussion Draft on the Transfer Pricing Aspects of Cross-border Commodity Transactions

Thank you for the opportunity to provide comments on the Public Discussion Draft on BEPS Action 10: *Discussion Draft on the Transfer Pricing Aspects of Cross-border Commodity Transactions* (the "Draft"), dated 16 December 2014.

PricewaterhouseCoopers LLP ("PwC"), on behalf of its international network of Member Firms, agrees with the OECD that ensuring a consistent transfer pricing approach to commodity-related transactions globally is important in protecting the consensus built around the arm's length principle. We also appreciate that tax authorities in developing countries have expressed concerns about the potential for the erosion of their tax base in relation to these transactions.

PwC supports the OECD's efforts to facilitate the administration of the arm's length principle in this specialist area. However, we are concerned that the language of some of the suggestions in the Draft may require some further clarification; both to become more meaningful for tax authorities to monitor and administer, and to become more consistent with existing market pricing to allow effective implementation by taxpayers. In the remainder of this letter we have identified a number of items for further consideration by the OECD in its next version of the document.

Detailed Comments:

1. Application of the comparable uncontrolled price (CUP) method

The Draft recognises that the use of quoted prices for commodity transactions between associated enterprises corresponds to the application of the CUP method. We support this reconciliation of the so-called sixth method with the OECD recognised methods as a sensible approach, preserving the consensus reached throughout the years.

PwC recognises that there are cases where the value chain is so integrated that, even though open market quotes exist, the applicability and reliability of the CUP method should not be taken for granted, but instead be assessed in the light of the 9-step comparability process described in Chapter III of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

(“Transfer Pricing Guidelines”). The most common example of such a situation is where related parties engage in highly integrated activities – for example by trading through a single book, where some subsidiaries originate products, while other related entities hedge and market the consolidated position and provide the capital (e.g. through payments in advance). For some of those arrangements, other methods (e.g. the profit split) might be appropriate and indeed better aligned with the arm’s length principle than the CUP method.

We further suggest that, when the CUP method is indeed the most appropriate, the wording is inserted to directly refer to existing guidance on the CUP method in order to minimise the potential for arbitrary use of the commodities paper as the only guidance in this area. We welcome the wording to be added to the body of the Transfer Pricing Guidelines as summarised in para 12 and suggest clarifying the wording of para 8 to be aligned with para 12.

In addition to preserving consistency, this would also address one of the ambiguities of the current Draft, i.e. limited reference to the internal comparable transactions which are commonly used by taxpayers. A reference to internal comparable transactions is likely to be welcomed by taxpayers who, in our experience, replicate market pricing for commodity-related transactions by pricing their transactions in a number of different ways, rather than just through the use of simple market reference prices.

A case in point is where third parties price transactions through a formula instead of using a single quote. In such situations, it is not uncommon that at the date of agreement third parties agree on the quantity and quality of the goods, delivery terms and conditions, price base (i.e. a reference to specific market quote), fixing date(s) or quotational period (i.e. the future date(s) when benchmark quote(s) are to be fixed) and any other premia or discounts. The current wording of the Draft can be read as imposing the use of a single price/ quote on a particular day which might not be aligned with such a third party behaviour.

The consistent use of a month average is another common method used between independent parties to fix the price base, eliminating the risk of creating a winner or loser from the exact timing within a month of a sale or shipment, and the same logic applies within a group. Such monthly averages (up to several months after the date of delivery) are commonly used in transactions involving commodities that require further processing before being readily marketable. The purpose of employing long quotational periods is to allow the refiner or processor to match the costs of inputs with the income derived from the sale of the commodity, whose transformation may require significant time, as well as to allow for effective hedging of the price risk.

Accordingly, while in certain cases the reference prices referred to in the Draft should be seen as a good approximation of spot pricing, the reliability of data reports varies depending on the transparency of the relevant market, the liquidity in that market, the nature of the commodity and the existing market practice, such as the examples described above.

Since the quoted (or reference) price is an exact number there is a huge risk of spurious precision (i.e. the number is taken as an objective truth) or ambiguity (e.g. when a whole range of high-frequency bid-ask mid-point quotes exists spanning a wide intra-day minimum-maximum range). The actual truth is that even before making the necessary adjustments (e.g. for quality, geography, level of the market etc.) independent transactional prices have occurred and will occur in a band around that

number and that band is narrower or wider depending on a range of factors including liquidity or intra-day price volatility.

This is consistent with the OECD's long standing recognition of what quoted and reported prices usually are and a reference to para 3.55 and, in particular, the final sentence of that paragraph would be appropriate ("It is also possible that the different points in a range represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish exactly the same price for the transaction"). This is undoubtedly true for commodity transactions, particularly when it comes to the adjustments that need to be made.

In summary, to account for these unique industry-specific facts, the OECD should encourage the use of taxpayers' own evidence of their internal data for application of the CUP method to establish at the very least which reference prices are the most appropriate (or how adjustments are made) or to confirm if a different methodology would be more appropriate.

2. Scope of the guidance

Just as commodity-related transactions are critical to developing countries, they are also fundamental to many supply chains. Accordingly, the guidance in the Draft is potentially widely applicable and its reach will go far beyond the extractive and agricultural sectors. PwC would support the inclusion of additional wording which explicitly states that the guidance provided applies to a range of industries i.e. those businesses that use and consume commodities as well as those producing them.

The paper does not specify what commodities are in scope, defining commodities as "*physical products for which a quoted price is used by independent parties in the industry to set prices in uncontrolled transactions*". PwC's concern here is that such a broad definition might result in the application of quoted prices/ adjustments/ deemed pricing to all products for which quoted prices exist, without verifying if these quoted prices meet the comparability thresholds required for reasonable and defendable CUPs.

Accordingly, PwC would welcome the final version of the Draft to distinguish between reference prices that are widely used to price independent transactions and those which are published 'for information' and are based merely on anecdotal evidence alone. In the latter case the only appropriate use that is consistent with the arm's length principle is as a sense check with the opportunity to explain differences between the prices used and those reported.

Conversely, in some cases useful quotes exist that allow for the pricing of non-physical services or activities critical for commodities transactions, for example shipping, virtual storage (economically corresponding to the function of forward and spot times) or risks (the risk of keeping inventory of a certain commodity includes the risk of its price changing while in storage, which can be hedged e.g. using options, and which can be priced using market quotations).

PwC believes that taxpayers would benefit from guidance contained within the Draft when pricing these, so the definition could be further expanded, for example to "*products and services for which a reliable quoted price is used by independent parties in the industry to set prices in uncontrolled transactions*".

For a number of commodities, there are already well established industry conventions in place to price the sale of the products. We strongly support the wording in the current Draft that a "*relevant factor*

in determining the appropriateness of using the quoted price for a specific commodity is the extent to which the quoted price is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled transactions comparable to the controlled transaction".

3. **Adoption of a deemed pricing date for controlled commodity transactions in the absence of evidence of the actual pricing date agreed by the parties to the transactions**

While clearly important given the scope for misuse and base erosion, we believe that the focus of the guidance should be on determining an arm's length price rather than focusing solely on the deemed date, which is only one of the elements of pricing in complex industries relying on commodity-related transactions.

We believe that what the OECD intends here is combatting deliberate base erosion rather than establishing a general principle along the lines of the existing text at paras 1.67-1.69 of the OECD Guidelines. If so, it would be helpful if that point were made more clearly and if it were recognised that consistency will often be an appropriate safeguard. For example, if spot transactions are always priced on the day of shipment there is no scope for manipulation. Similarly for term contracts (which will typically be the case for related party transactions) the use of month averages or other quotational period triggered by observable events (shipment date, arrival date, laydays, etc.) as noted above will usually eliminate the potential problem.

The reference to deemed transaction dates without appropriate clarification is particularly problematic given the breadth of application of this guidance (see above) because so many commodities with very different characteristics are affected. The agricultural sector is a good example as crops may be purchased well before harvest or even planting and thus well before quantities, qualities and shipment dates are ever known. Again, consistency and clarity in transfer pricing policies (addressed by a number of other recent OECD papers) will be an appropriate safeguard. PwC suggests that greater clarification is added in relation to the issue being addressed with reference to the existing guidance at 1.67-1.69.

In this regard, it is advisable for the concept of “reliable evidence” referred to in paragraph 14 of the Draft to be further expanded, as its current wording is open to interpretation, thus potentially increasing the administrative burden or setting reliability thresholds that could not be met by the taxpayers under any circumstances (i.e. requiring the contracts to be physically signed by the parties before a notary, when their representatives are based in different locations). In this sense, the practical experience of some Latin American countries that have applied the so-called sixth method provides valuable experience on this matter.

Moreover, the pricing date concept itself should be further clarified and linked to internal and external market evidence. This should allow taxpayers to follow market practice, for example with respect to the commonly used formulae pricing mechanism where there is more than one date in which the price is determined (e.g. the date when the agreement is executed and the quotational date or period in which the quote(s) applicable are determined and the final price is calculated).

Finally, PwC suggests wording be incorporated clarifying that where (under clearly defined circumstances) the pricing date is disregarded, the deemed pricing date must be applied consistently in every transaction, not only where it increases tax base.

4. Input requested on potential additional guidance on comparability adjustments

PwC welcomes the explicit recognition of the need to adjust the market quotes used in pricing for economically significant factors. In our experience, commodity-related adjustments are often significant (in particular transportation and product-specific premia/ discounts) and because they are additive may result in significant differences between the final price and the reference price particularly when dealing with intermediate products i.e. those requiring further refinement or processing. We believe this fact should be explicitly recognised to avoid controversies between taxpayers and tax authorities.

For certain commodities quoted in liquid markets by recognised and reliable data providers, pricing methodologies already exist and are publicly available. As these describe in detail the key material adjustments made to prices by third parties to turn them into publicly available and standardised quotes, this information might easily be reverse engineered to identify the key adjustments to be made.

We note that recent clarification of the Brazilian 'PECEX method' enumerates a range of adjustments which, subject to application in practice, appears consistent with the OECD's reconciliation with the CUP method. Those adjustments include: market premium(market valuation, quality, characteristics of the product and substance content), business conditions (terms of payment, negotiated quality, climate influences in the characteristics, intermediation costs, packaging, freight and insurance, cost of landing, storage, customs and taxes). More pertinently, these identify the nature of the adjustment without undue specificity on the application of the adjustments on the basis that market evidence will usually exist (externally or internally) to demonstrate how these are made and in what magnitude.

For commodities/ markets where less reliable data is available or where industry practice is more varied, the evidence may be supplemented or adjustments deduced from other commodities with similar market or industry characteristics. It would not be advisable to create a closed list of factors to adjust for as these will vary by commodity, increase the compliance costs, and essentially magnify the risk of economic double taxation.

5. Disclosure

Although we fully support transparency and disclosure as part of the documentation process, it is important that the OECD recognise that often the data required to apply the CUP method to commodity transactions is often commercially sensitive (particularly for internal data) and public disclosure or application may have legal or regulatory implications (e.g. competition law). As the effect of other recent papers by the OECD may well be that documentation becomes more widely distributed, the current wording of the suggested addition to 2.16 item 4 in Section B in Chapter II of the Transfer Pricing Guidelines is potentially problematic and may actually impede the best use of the evidence available.

It would be helpful if the stipulations of item 4, para 12 were clarified to make it clear that documentation should establish the principles of the calculation. The detailed market data (external or internal) for applying the calculation to any shipment or period would, of course, be available to the relevant tax authorities either in a local file or on request.

Given the risk of spurious precision that arises from the use of quoted or published reference prices (for the commodities themselves as well as for adjustments) and the OECD's long standing recognition of the appropriate use of ranges, this would also help focus on the most material elements of the

pricing formulae and analysing their economic impact and importance. This is likely to be a much more efficient use of tax authorities' (and taxpayers') time and resources.

6. Other comments

Many points made in the Draft will be affected by other BEPS action points (in particular the Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains and the Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (Including Risk, Recharacterisation, and Special Measures)) or the existing Transfer Pricing Guidelines. It is highly likely that the final version of this paper will be referred to extensively by tax authorities and taxpayers alike. It would be helpful to provide some clarity on scope. For example, is it merely intended as a reconciliation of the so-called sixth methods to the CUP method or is it intended as formal guidance on the specific transfer pricing analysis required for commodity transactions and to be linked up to guidance on other matters, such as the use of profit splits.

Although in principle PwC supports the OECD's view that the mutual agreement process has the potential to function as an effective tool for addressing tax controversies (and welcomes the addition to Section B in Chapter II of the Transfer Pricing Guidelines), in our experience access to these is very limited in developing countries which may lack both the extensive treaty network and the resources to make effective use of them. As a result, taxpayers sometimes have to accept a higher risk of double taxation as a practical consequence on their investment in developing countries. The potential value of this paper in helping to establish a cross-border consensus on commodity transactions is therefore high but so too is the risk of uncertainty if the clarifications and explanations listed above are not made.

7. Summary of Key Points

We welcome the release of the Draft and agree with the OECD that ensuring a consistent transfer pricing approach to commodity-related transactions is important in protecting the consensus built around the arm's length principle.

Our recommendations summarised in detail in this paper focus on the following aspects:

- Ensuring consistency with the existing consensus around the selection of the most appropriate transfer pricing method to the circumstances of the case;
- Recognition of the value of using taxpayers' internal comparable data, industry standards, existing guidance and the practical experience gained by taxpayers and tax authorities that have applied the so-called sixth method over the years;
- Recognition that at arm's length, pricing in commodity-related transactions is likely to result in a range of outcomes, rather than a single pricing point;
- Clarifying the scope and the applicability of the guidance, in particular with respect to the use of the deemed pricing date.

The language of some of the suggestions in the Draft in the areas listed above may require further clarification; but, once this is addressed, we believe the revised paper will assist taxpayers in ensuring their transfer pricing remains arm's length and will address concerns tax authorities have raised about the potential for the erosion of their tax base in this area.

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On behalf of the international network of PwC Member Firms, with the contribution of our colleagues Szymon Wlazlowski, Jose Maria Segura, Dale Bond, Jonas Van de Guch, Kathryn O'Brien, Aamer Rafiq, Andrew Casley and Juan Carlos Ferreiro, we respectfully submit our response to the Public Discussion Draft on BEPS Action 10: *Discussion Draft on the Transfer Pricing Aspects of Cross-border Commodity Transactions*. For any clarification of this response, please contact the undersigned or any of the contacts below.

Yours faithfully,

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