

1   **Q.    Please fully explain how Mr. Rolph’s markup of between 2% and 5% reconciles**  
2   **with “arms-length” inter-affiliate pricing principles currently in place for**  
3   **Newfoundland Power.**

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6   **A.    Whenever Newfoundland Power Inc. (“Newfoundland Power”) provides or receives**  
7   **services or resources to or from an affiliate, it does so in accordance with the provisions**  
8   **of the Inter-Affiliate Code of Conduct (the “Code”).<sup>1</sup>**  
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10       Pursuant to paragraph 3.0, the principles underlying the Code are as follows:

- 11           •   All Inter-Affiliate transactions shall be fully transparent and subject to the
- 12               scrutiny of the Board;
- 13           •   All Inter-Affiliate transactions shall be prudent, and the prudence of such
- 14               transactions, when required, be demonstrated to the satisfaction of the Board;
- 15           •   NPI shall ensure that Inter-Affiliate transactions will not disadvantage the
- 16               interests of ratepayers and furthermore that ratepayers and the Utility will
- 17               derive some demonstrable benefit from such transactions;
- 18           •   With regard to the provision of staff and other services to its Affiliates, benefits
- 19               should be transparent, demonstrable and maximized to the advantage of the
- 20               ratepayers;
- 21           •   Inter-Affiliate transactions should only be entered into insofar as they provide a
- 22               net benefit to ratepayers and they do not compromise the operational or
- 23               managerial integrity of NPI;
- 24           •   Charges associated with Inter-Affiliate transactions must be supported by the
- 25               principles of cost causality; and
- 26           •   The onus is on the utility to show that it is in compliance with this Code.
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29       It is evident that the principles underlying the Code do not contain the phrase “arm’s

30       length.” And yet, it is clear from paragraph 6.0 of the Code, entitled *Transfer Pricing*,

31       that it is the intent of the Board that Newfoundland Power determine and use arm’s length

32       prices in its dealing with its affiliates.

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34       I believe that the arm’s length principle is captured in the underlying principles of the

35       Code at paragraph 3.0(iii) where it states that “Newfoundland Power shall ensure that

36       Inter-Affiliate Transactions will not disadvantage the interest of ratepayers...” Ratepayers

37       would be disadvantaged if Newfoundland Power paid higher than an arm’s length price

38       for services or resources received from an affiliate. Ratepayers would also be

39       disadvantaged if Newfoundland Power charged lower than an arm’s length price for

40       services or resources provided to an affiliate.

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<sup>1</sup> See Newfoundland Power Inc., Inter-Affiliate Code of Conduct, May 2011

1 I believe that when a charge for a service between affiliates is justified, the amount  
2 charged should be determined in accordance with the arms' length principle. In the  
3 absence of a market price for the service, I believe that it is reasonable for the price to be  
4 determined using a cost recovery method.

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6 Arm's length service providers would normally seek to charge a fee for their service in  
7 such a way so as to generate a profit, rather than merely charging for the service at cost.  
8 Accordingly, depending on the circumstances, the arm's length price for a service  
9 provided by or received from an affiliate might include a mark-up on the costs incurred  
10 rendering the service.

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12 I believe that paragraph 6.3 of the Code, *Pricing Where No Competitive Market Exists*,  
13 permits consideration of an arm's length mark-up on the costs incurred by Newfoundland  
14 Power rendering a service to an affiliate, where it states that "Newfoundland Power shall  
15 charge no less than the Fully Distributed Cost to provide that service, resource, product,  
16 or asset."

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18 However, the Code does not anticipate a mark-up in the case of Shared Services, where at  
19 paragraph 6.5 it states that the "charges to each Affiliate for a Shared Service will reflect  
20 all of the costs incurred in providing the service. Cost will be allocated on a basis that  
21 reflects causality. Where a causal relationship cannot be established, the costs will be  
22 allocated on the basis of proportionate benefits."

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24 This is seemingly at odds with the principles underlying the Code, where it states that  
25 regarding "the provision of staff and other services to its Affiliates, benefits should be  
26 transparent, demonstrable and maximized to the advantage of ratepayers." In some  
27 circumstances, maximizing the benefit to ratepayers from Shared Services could involve  
28 applying a mark-up to the costs incurred rendering a service for an affiliate.

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30 Under circumstances where applying a mark-up would be appropriate, Newfoundland  
31 Power should add a mark-up to the Fully Distributed Costs charged to an affiliate for  
32 rendering a service. The mark-up should be consistent with the returns on cost earned by  
33 third parties rendering similar services. To ease the administrative burden of taxpayers,  
34 the OECD has proposed a mark-up on cost from 2 percent to 5 percent as a safe harbor,  
35 meaning a mark-up that taxpayers can use without being challenged by a tax  
36 administrator, to be added to the costs incurred to render one of the following services to  
37 an affiliate:

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- 40 • Accounting and auditing;
  - 41 • Processing and management of accounts receivable and accounts payable;
  - 42 • Human resources;
  - 43 • The monitoring and compilation of data relating to health, safety,  
environmental and other standards regulating the business;

- Information technology services where they are not part of the principal activity of the group;
- Internal and external communications and public relations support (but excluding specific advertising or marketing activities as well as development of underlying strategies);
- Legal services;
- Activities with regard to tax obligations; and
- General services of an administrative or clerical nature.

Symmetrical treatment is not afforded to services received by Newfoundland Power from an affiliate. Pursuant to paragraph 6.3, Newfoundland Power “shall pay no more than the Fully Distributed Cost to acquire” a service from an affiliate. This implies that a mark-up is not permitted to be added to the costs incurred by an affiliate rendering services to Newfoundland Power. Although this may be consistent with the principles underlying the Code, it may not be consistent with the arm’s length principle.