ERG OPINION PREPARED BY THE IRG WORKING GROUP ON COST ACCOUNTING – 22 March 2004 –

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PROPOSED CHANGES TO COMMISSION RECOMMENDATION

of 1998

on Accounting separation and cost accounting

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(Text with EEA relevance)

Having regard to the Treaty establishing the European Community,

Having regard to Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive),

Having regard to Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (Access Directive),

Having regard to Directive 2002/22/EC of the European Parliament and of the Council of 7 March 2002 on universal service and users' rights relating to electronic communications networks and services (Universal Service Directive),

Having regard to Directive 2002/77/EC of the Commission of 16 September 2002 on competition in the markets for electronic communications networks and services (Competition Directive),

Having regard to the Commission Regulation 1725/2003/EC of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC)No 1606/2002 of the European Parliament and of the Council:

1) Whereas Article (5) of Framework Directive requires Member States to ensure that undertakings providing electronic communications networks and services provide promptly on request, and to the timescales and level of detail and required, all information to NRAs necessary to ensure conformity with the provisions of, or decisions made in accordance with, the Directives. Notwithstanding, requests for information should be proportionate and do not impose an undue burden on operators;

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2) Whereas undertakings providing public communications networks and services which have special or exclusive rights for the provision of services in other sectors may be required under Article (13) of the Framework Directive to keep separate accounts, so as to identify all elements of cost and revenue, for the activities associated with the provision of electronic communications networks or services, to the extent that would be required if these activities were carried out by legally independent companies;

3) Whereas the Access Directive gives national regulatory authorities for electronic communications (NRAs) an important role in securing adequate access to, and interconnection of, electronic communications networks, in accordance with Community law; whereas, in particular, Articles (9), (11), (13) of the Access Directive allow NRAs, following a market analysis, to impose obligations on transparency, accounting separation, price controls and/or cost accounting systems as appropriate, on operators designated as having significant market power on a relevant market (hereinafter referred to as "notified operator");

4) Whereas Article (11) of the Access Directive allows NRAs to impose obligations on notified operators for accounting separation in relation to specified activities related to interconnection and/or access, and in particular in the case of a vertically integrated company obligations to make transparent its wholesale prices and its internal transfer prices inter alia to ensure compliance where there is a requirement for non-discriminationor, where necessary, to prevent unfair cross-subsidy;

5) Whereas Article (13) of Access Directive allows NRAs to impose cost orientation obligations, including the implementation by notified operators of a suitable cost accounting system for this purpose;

6) Whereas Article (13) of Access Directive requires that national regulatory authorities shall ensure that any cost recovery mechanism or pricing methodology that is mandated serves to promote efficiency and sustainable competition and maximise consumer benefits;

7) Whereas NRAs may impose an obligation for cost orientation for access or interconnection in accordance with Article (13) of the Access Directive; whereas an appropriate approach is one based on forward-looking long-run average incremental costs, since it most accurately reflects that of a competitive market; whereas this approach does not preclude the use of justified "markups" as a means of recovering such forward-looking joint and common costs of an efficient operator as would arise under competitive conditions; whereas, when applying an LRIC-based price control to infrastructure where replication is feasible, the NRA may adjust a range of parameters to provide incentives for network competition;

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8) Whereas an approach based on forward-looking long-run average incremental costs entails an accounting system based on current costs rather than historic costs; whereas NRAs may specify the format and accounting methodology to be used, in accordance with Art 11 of the Access Directive; whereas new accounting systems can be based on activity based costing; whereas the coordinated use of top-down and bottom-up approaches is advised;

9) Whereas Article (13) of Access Directive requires NRAs to ensure that a description of the cost-accounting system, showing at least the main categories under which costs are grouped and the rules used for the allocation of costs to access and interconnection, is made publicly available; whereas allocation rules need to be displayed at a level of detail that makes clear the relationship between costs and charges of networks components and services (that is to say, usage factors); whereas the basis on which unattributable costs have been allocated between different accounts also needs to be provided; whereas compliance with the cost accounting system has to be verified by the national regulatory authority or some other competent body independent of the operator and approved by the NRA; whereas a financial statement concerning compliance has to be published annually, also to ensure transparency for the market players;

10) Whereas in accordance with Article (11) of Access Directive, NRAs can require undertakings providing electronic communications networks to supply accounting records, including data on revenues received from third parties, promptly on request and to the level of detail required, in order to facilitate the verification of compliance with obligations of transparency and non-discrimination;; whereas NRAs may publish such information as would contribute to an open and competitive market, while respecting national and Community rules on commercial confidentiality;

11) Whereas the application of the principles of this Recommendation is without prejudice to the duty of the Member States and of undertakings to comply fully with the Community competition rules;

12) Whereas the Communication (2003) 284 from the Commission to the Council and the European Parliament on “Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward” defined the politicy objectives and included an EU action plan in the field of company law and corporate governance;

13) Whereas the ERG has published a common position on appropriate remedies in the new regulatory framework which provides guidance on the circumstances in which different remedies are appropriate, and in particular on the circumstances in which cost orientation may be justified;

14) Whereas the Communications Committee set up set up by Article 22 of Framework Directive has been consulted,

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MAKES THE FOLLOWING RECOMMENDATION:

1. This Recommendation concerns the implementation of obligations for accounting separation and cost accounting systems by operators designated by their NRA as having significant market power on relevant markets as a result of a market analysis carried out in accordance with Article 16 of the Framework Directive. Operators with such obligations are hereinafter referred to as "notified operators".

   The purpose of imposing an obligation regarding accounting separation is to provide a higher level of detail of information than that derived from the statutory financial statements of the notified operator, to reflect as closely as possible the performance of parts of the business as if they had operated as separate businesses, and in the case of that vertically integrated undertakings which provide electronic communications networks, to ensure that they do not discriminate in favour of their own activities.

   The purpose of imposing an obligation to implement a cost accounting system is to ensure that fair, procompetitive and transparent criteria are followed by notified operators in allocating their costs to services. Criteria for the preparation of a cost accounting system are illustrated in Section 1a) of the Annex.

   The cost orientation of prices obligation regarding the provision of specific types of interconnection and/or access is one of the possible obligations that NRA may impose to notified operators according to Article (13) of the Access Directive.

   It is recommended that NRAs require from their notified operators the disaggregation of their operating costs, capital employed and revenues to the extent justified by the objective pursued and the nature of the problem identified by the market analysis referred to in point 1. The level of disaggregation required should comply with the principles of proportionality, transparency and competitive requirements demanded by national or Community law.

2. It is recommended that the allocation of costs, capital employed and revenue be done in accordance with the principle of cost causation (such as activity-based costing: "ABC").

   The costing system of the notified operators needs to be sufficiently detailed to permit - as far as possible - the allocation of costs to unbundled network components, for example to determine the cost of unbundled interconnection and access services. More information on this subject is provided in Section 2 of the Annex.

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A well defined cost-allocation system will enable at least 90% of the costs to be allocated on the basis of direct or indirect cost-causation[1].

It is recommended that the recovery of costs be done in accordance with the principlesof cost causation, distribution of benefits, effective competition, cost minimisation, reciprocity and practicality.

It is recommended that unattributable costs (the cost which can only be attributed on an arbitrary basis) be clearly identified in a specific account and if subject to a specific treatment by the NRA (that is, distributed according to the rules determined by each Member State, in accordance with the Community's competition rules and in compliance with the principles of transparency and proportionality) in the most transparent way.

It is recommended that the NRA undertakes a public consultation with market players on the adoption of sound allocation methods and on the specific treatment to be given to unattributable costs.

It is recommended that the methodology and criteria for the evaluation of network assets at current value is fixed by the NRA after a public consultation with market players. It is recommended that NRAs, having adopted a decision on cost accounting system based on current costs, set clear deadlines and a base year for their notified operators' implementation of new cost accounting systems based on current costs. An outline of a current cost methodology is presented in Section 3 of the Annex

Evaluation of network assets at forward-looking or current value of an efficient operator, that is, at the value that would prevail if the market were vigorously competitive, is a key element of the "current cost accounting" (CCA) methodology. This requires, inter alia,that the depreciation charges included in the operating costs be calculated on the basis of current valuations of equivalent assets, and consequently the reporting on the capital employed also needs to be on a current cost basis.

3. With regard to the derivation of interconnection and access pricing, NRAs may require efficiency factors to be applied in recognition of the fact that the use of CCA values for the network may not fully reflect the costs of an efficient operator[2]. Efficiency factors may consist of evaluations of different network

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1 Directly attributable costs are those costs that can be directly and unambiguously related to a product or service. Indirectly attributable costs are those costs that can be apportioned to products or services on a measured non-arbitrary basis based on the relationship of the costs with directly attributable costs (i.e. using usage factors for each consuming shared resources).

2 Some of the assets may be in excess of requirements or network architecture may be sub-optimal. Implementation of a bottom-up economic/engineering model will help provide information about these inefficiencies.

topology and architecture, of depreciation techniques, of technology used or planned for use in the network.

4. It is recommended that notified operators required to report accounting separation provide a profit and loss statement and statement of capital employed for each of the separate businesses. Transfer charges or purchases between market/businesses need to be clearly identified.

   For consistency, it is recommended that the financial reports of these separate regulatory accounts be consolidated into a profit and loss statement and a balance sheet for the company as a whole. A reconciliation of the separate regulatory accounts to the statutory accounts of the operator is also suggested.

5. It is recommended that NRAs make relevant accounting information from notified operators available on request to interested parties at a sufficient level of detail to ensure that there has been no undue discrimination between the provision of services internally and those provided externally, and to enable the average costs of unbundled services, and the method in which thay have been calculated, to be identified.

   In this respect, the publication by the notified operator of sufficiently detailed cost statements showing the average cost of network components will increase transparency and raise confidence on the part of competitors, that there are no anti-competitive cross-subsidies. This is considered to be particularly important for wholesale services.

   In addition, for those Member States that operate schemes to finance Universal Service obligations, it is also recommended that NRAs make available sufficient accounting information from notified operators to ensure that there is no discrimination between charges levied on other operators and those levied (implicitly) internally.

6. These accounting guidelines are concerned with regulatory reporting and they are not intended as a replacement for any statutory financial reporting that may be required in the Member State.

7. This Recommendation will be reviewed on the first occasion not later than three years after the date of application.

8. This Recommendation is addressed to the Member States.

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Annex

Guidelines on implementing accounting separation and cost accounting

INDEX

Section 1a) of the Annex defines the main cost accounting system requirements (recommended principles for allocating costs, capital employed and revenues when preparing separate accounts).

Section 1b) provides the scope of accounting separation for each business of the relevant network

Section 2 outlines principles for cost causality/drivers definition and attribution methodologies.

Section 3 provides guidance on modern asset valuation and current cost adjustment methodologies.

Section 4 provides guidance on the cost of capital calculation

Section 5 provides principle describing the main qualitative characteristics required for data preparation and usage.

Section 6 provides guidance on transparency, confidentiality, market definition limitation and publication

Section 7 provides reporting and verification requirements.

Section 8 provides guidance on long run incremental cost methodology.