

ERG OPINION

on

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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 the Access Directive gives 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 in a relevant market (hereinafter referred to as “notified operators”);
- 2) Whereas undertakings providing public communications networks or publicly available electronic communication 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 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, in particular in the case of a vertically integrated company's obligations to make transparent its wholesale prices and its internal transfer prices, *inter alia*, to ensure compliance where there is a requirement for non-discrimination or, where necessary, to prevent unfair cross-subsidy;
- 4) Whereas Article 13 of the Access Directive allows NRAs to impose cost orientation obligations and price controls, including the implementation by notified operators of a suitable cost accounting system for these purposes;
- 5) Whereas when an obligation for accounting separation is imposed on an operator with SMP in one or more markets, the imposition of accounting separation may cover non-SMP markets. The imposition of accounting separation on non-SMP markets is possible only in so far as an NRA can justify that the provision of such information is necessary to carry out its regulatory tasks; the imposition of such an obligation must be based on the nature of the problem identified, proportionate and justified, in accordance with the provision of Article 8.4 of the Access Directive;
- 6) Whereas Article 13 of the Access Directive requires that NRAs 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, where NRAs impose an obligation for cost orientation in accordance with Article 13 of the Access Directive an appropriate approach is one based on forward-looking long run average incremental cost, since it most accurately reflects that of a competitive market; whereas this approach does not preclude the use of justified "mark-ups" as a means of recovering such forward looking joint and common costs of an efficient operator as would arise under competitive conditions;
- 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 Article 11 of the Access Directive; whereas accounting systems can be based on activity based costing; whereas the coordinated use of top-down and bottom-up approaches can be envisaged, where applicable; whereas in accordance with Article 13 of the Access Directive for the purpose of calculating the cost of efficient provision of services, NRAs may use cost accounting methods independent of those used by the undertaking;
- 9) Whereas Article 13 of the 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, that compliance with the cost accounting system has to be verified by a qualified independent body, and that a financial statement concerning compliance has to be published annually; whereas allocation rules need to be displayed at a

level of detail that makes clear the relationship between costs and charges of network components and services; whereas the basis on which directly and indirectly attributable costs have been allocated between different accounts also needs to be provided;

- 10) Whereas in accordance with Article 11 of the Access Directive, NRAs can require undertakings providing electronic communications networks to supply accounting records on request, including data on revenues received from third parties 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 in accordance with Article 17 of the Universal Service Directive, NRAs shall ensure where an undertaking is subject to retail tariff regulation or other relevant retail controls, the necessary and appropriate cost accounting systems are implemented. NRAs may specify the format and accounting methodology to be used. A NRA should also ensure that compliance with the cost accounting system is verified by a qualified independent body;
- 12) 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
- 13) 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 policy objectives and included an EU action plan in the field of company law and corporate governance; the Commission Recommendation (2002/590/EC) of 16 May 2002 on “Statutory Auditors’ Independence in the EU: A Set of fundamental principles on statutory auditors’ independence”¹ establishes a sound framework against which auditors’ independence can be tested, where relevant;
- 14) 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 the implementation of accounting separation, cost accounting systems, price controls and cost orientation may be justified;
- 15) Whereas the Communications Committee set up set up by Article 22 of the Framework Directive has been consulted;

¹ O.J. L191/22 of 19.7.2002

MAKES THE FOLLOWING RECOMMENDATION:

1. This Recommendation concerns the implementation of accounting separation and cost accounting systems by operators designated by their NRA as having significant market power in 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 to implement a cost accounting system is to ensure that fair, objective and transparent criteria are followed by notified operators in allocating their costs to services in situations where they are subject to obligations for price controls or cost-orientated prices. Criteria for the preparation of a cost accounting system are illustrated in Section 1A of the Annex.

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 notified operator’s business as if they had operated as separate businesses, and in the case of vertically integrated undertakings, to prevent discrimination in favour of their own activities and to prevent unfair cross-subsidy.

It is recommended that NRAs require the notified operators to provide the disaggregation of their operating costs, capital employed and revenues at a level required to be consistent with the principles of proportionality, transparency and regulatory objectives mandated by national or Community law.

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

The costing system of the notified operators needs to be capable of reporting regulatory financial information to demonstrate full compliance with regulatory obligations. It is recommended that this capability be measured against the qualitative criteria of relevance, reliability, comparability and materiality. More information on this subject is provided in Section 2 of the Annex.

It is recommended that NRAs satisfy themselves as to the adequacy and effectiveness of the cost accounting systems; such systems may be subject to public consultation.

It is recommended that an NRA, when assessing the features and specification of the cost accounting system, reviews the capability of the notified operator’s

cost accounting system to analyse and present cost data in a way that supports regulatory objectives. In particular, the cost accounting system of the notified operator should be capable of differentiating between direct costs², or indirect costs³ or can prepare financial information in accordance with agreed long run incremental cost (“LRIC”) methodologies.

It is recommended that NRAs, having adopted a decision on a cost accounting system based on current costs, set clear deadlines and a base year for their notified operators’ implementation of the new cost accounting systems. 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, estimating the costs faced by equivalent operators as if the market were vigorously competitive, is a key element of the “current cost accounting” (“CCA”) methodology. This requires that the depreciation charges included in the operating costs be calculated on the basis of current valuations of modern equivalent assets, and consequently the reporting on the capital employed also needs to be on a current cost basis. Other cost adjustments may be required to reflect not only the current purchase cost of an asset but also its operating cost base.

It is recommended that NRA’s have due regard to price and competition issues that might be raised when implementing CCA.

3. It is recommended that NRAs have due regard to further adjustments to financial information in respect of efficiency factors, particularly when using cost data to inform pricing decisions, in recognition of the fact that the use of cost accounting systems (even when applying current cost accounting methodologies) may not fully reflect efficiently incurred or relevant costs⁴. Efficiency factors may consist of an evaluation of different network topology and architecture, of depreciation techniques and 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 a statement of capital employed for each of the regulatory reporting entities (based on the relevant markets and services/products). Transfer charges or purchases between markets and services/products need to be clearly identified in sufficient detail to justify compliance with non discrimination obligations. These accounting separation reporting obligations may require the preparation and disclosure of information for non-SMP markets in order for the notified operator to demonstrate and the NRA to verify compliance with non-discrimination obligations.

For consistency and data integrity, it is recommended that the financial reports of the regulatory accounts be consolidated into a profit and loss statement and a statement of capital employed for the undertaking as a whole. A

² Direct costs are those costs wholly and unambiguously incurred against specified activities.

³ Indirect costs are those costs that require apportionment using a fair and objective attribution methodology.

⁴ 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.

reconciliation of the separate regulatory accounts to the statutory accounts of the operator is also required. These statements should be subject to an independent auditors' opinion or an NRA compliance audit (subject to the availability of suitably qualified staff).

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

In this respect, the publication by the notified operator of sufficiently detailed cost statements showing, for example, 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 notified operators put in place a specific accounting separation methodology for Universal Services, separated from regulated services, and 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. Although the cost accounting system(s) will provide important data for regulatory decisions regarding cost orientation and pricing, there are other considerations that an NRA may wish to take into account. It is recommended that NRAs, when considering or determining cost recovery mechanisms and values, have due regard to the principles of cost causation, distribution of benefits, effective competition, cost minimisation, reciprocity and practicality.
7. 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.
8. This Recommendation will be reviewed not later than [three years after the date of application.]
9. This Recommendation is addressed to the Member States.

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 regulatory accounts).

Section 1B describes the accounting separation concept as in the defined markets of notified operators

Section 2 outlines attribution methodologies and the application of the cost causality principle .

Section 3 provides guidance on the implementation of current cost methodologies.

Section 4 provides guidance on long run incremental cost methodology.

Section 5 provides guidance on the cost of capital calculation

Section 6 provides principle describing the main qualitative characteristics expected of regulatory accounting information.

Section 7 provides guidance on transparency, confidentiality, market definition limitation and publication

Section 8 provides reporting and verification requirements.