Note on the hearing on cost accounting and accounting separation 2004-06-10

An ERG hearing was held on June 10, 2004 in Brussels, as part of the consultation procedure for the draft Opinion on the European Commission's Recommendation on Accounting separation and Cost Accounting (ERG (04) 15).

A summary of the discussion at the hearing is provided below. Views expressed are those of individual participants as perceived by the Secretariat.

Presentation of ERG (04) 15

Davide Gallino ("DG") of AGCOM presented the main features of ERG (04) 15 (Draft Opinion on Proposed changes to the Commission Recommendation of 1998 on Accounting separation and cost accounting) ("the document"). The slides of the presentation are annexed to this Note.

General remarks on the document

ECTA commended the document and expressed their content that it has been presented, stressing that cost accounting (CA) and accounting separation (AS) rules are key to implementing the 2002 framework and its remedies. ECTA expressed their view that the document was a very good one. ECTA further reminded the audience that, with regards to CA/AS, in several member states either the old or the new framework had not been successfully implemented.

ECTA suggested that some general principles should be set out in a general introduction in the beginning of the text. Three examples were provided of such principles: 1) objectivity in the attribution of common costs, 2) consistency in treatment over time: if there are material changes, the nature and impact of these should be required to be disclosed, and 3) transparency: any suitably informed reader should be able to understand how costs are attributed.

To avoid the impression that the document is a complete model for a method, ECTA would like to have, with regards to AS fewer examples in the paper, combined with a higher level of detail.

According to ECTA, the present general lack of transparency of regulated operators is so great it that is difficult to talk about second-level problems. In some countries there is a total lack of publication of separate and common costs. Where such figures have been published – the United Kingdom and Ireland – there is not less fierce competition than elsewhere. ERG should undertake a qualitative review as to how existing accounting systems actually work. This could be rapidly done by an external consultancy.

T-Mobile expressed concern with their impression that the purpose of the document is to apply the relevant obligations to a wide range of activities and companies, in particular in the mobile sector. Accounting separation obligations in those markets would mean that the accounting systems would have to be changed in the mobile companies, meaning effectively a doubling of accounting systems, imposing costs on the operators. The document is not dealing with how to achieve a proportionate approach or the issue of proportionality. In T-mobile's view, an instrument from the old framework has been taken and simply adjusted to the new framework without consideration of the new conditions.

Telefonica agreed with T-mobile that the document is very much based upon the old framework and the old recommendation, and is oriented in particular towards fixed networks. The Recommendation implies that LRIC can be applied to any type of situation, which is in fact not the case according to Telefonica.

Telecom Italia stated that the revision of the Recommendation should address more specifically the structure of the new framework, as the latter provides for indications as to on which markets measures can be applied - for example, in general not retail markets. Telecom Italia also would welcome guidelines as to how to apply the principles described in an appropriate, proportionate way.

France Telecom recalled that Article 13 of the Framework Directive makes clear that the system for cost accounting is intrinsically a confidential one. In light of this, the document needs to clarify what should be kept confidential and what should be published.

Colt very much welcomed the document. Responding to T-mobile and Telefonica, Colt noted its understanding that cost accounting and accounting separation are not linked to any particular framework, but rather are objective methodologies. The document was commended as outstanding. Colt also stressed the importance of getting the "nuts and bolts" in place in order to be able to execute effective remedies.

Tiscali France remarked that it could be useful to look at what is being done in the electricity regulation sector, and that the method for accounting separation used there could be followed. Tiscali also expressed worries about possible new predatory pricing schemes as a result of Wanadoo's merger with France Telecom.

Davide Gallino remarked as a general response that one of the key aims of the text is to provide applicable and linear concepts of accounting separation /cost accounting, introducing a clear distinction between them and other obligations that may be imposed, such as cost-orientation. Responding to ECTA, he stated that examples can certainly be improved, but that those in the text represent the minimal reference whose final shape is left to the individual NRAs.

T-Mobile asked if an underlying assumption of the document was that obligations of cost accounting and accounting separation could be used on non-SMP operators as a means of investigating if they have SMP.

Davide Gallino responded that the proportionality principle must be applied in all cases. As it is already explained in other documents, it would not need to be elaborated here. However, he clarified that the obligations that may be imposed on operators are in the Directives. The purpose of the document was not to create a new situation or modify the view on when cost accounting and accounting separation could be imposed, but rather to provide clear guidelines on how to design and implement them.

Comments on specific topics

Main cost accounting requirements

Davide Gallino explained that the document attempts to clarify the general principles and requirements of cost accounting, as well as referring to the possibility of publishing them. The document identifies the main families of costs; notably directly, indirectly attributable and common costs. By providing several detailed guidelines, NRAs may be helped in imposing, when required, accounting obligations. It must be recognized that so far, few NRAs have published the general principles for preparing cost accounting systems and even less so have published figures, but that may change in the future.

BT suggested that the document should, in order to clarify ERG’s position, reiterate some basic fundamental principles, such as should already be understood by everyone but nevertheless need to be spelled out.

Scope of accounting separation

Telecom Italia noted that cost accounting and accounting separation are quite well defined in the Access Directive, and sought clarification as to how much discretion NRAs have to interpret that. Telecom Italia further recommended that some guidance on the relationship between Article 5 of the Framework Directive and the possibilities to impose cost accounting and accounting separation should be given in the document.

Davide Gallino responded that the text on pages 4-5 in the document’s annex tries to deal with the information NRAs are empowered to request. The NRA should justify the request for information under art. 5.1 of the FD, motivated by the need to carry out its responsibilities. This said, and with the principle of proportionality in mind, DG continued, the principle in the document is that regulatory accounting data is needed in advance of remedies imposition. Actual knowledge of notified operators’ cost may lead to not imposing remedies which otherwise could have been imposed on the ground of less substantial evidence, such as international benchmarking. DG added that given the way a company operates, its network and retail structure is not designed to disjointly offer regulated and unregulated services.

T-mobile remarked that once cost accounting and/or accounting separation is imposed as an obligation on an operator, all its services are de facto subject to regulation – and asked how proportionality can be applied in such a case.

Davide Gallino replied that the document is written having in mind that, in general, data will be asked by the NRAs for the purposes of following the relevant markets, but that the scope of accounting obligations must follow the proportionality principle.

Cost causality and allocation principles

Davide Gallino explained that the text regarding this subject had not moved too much from the previous text. Some small improvements and clarifications were attempted. The keyword is transparency along the whole process. While the directly attributable costs are allocated in a straighforward way by definition, in the case of indirectly attributable and common costs, a traditional problem is that the NRA might not have discussed enough previously with the notified operator what the actual cost drivers are The suggestion in the text is, or should be if it is not clear enough, that NRAs should take up the subject for discussion with the operators and make it part of the consultation process of the cost accounting system.

O2 stated that they fully support allocation of costs on the basis of causality. However, O2 is concerned that the document does not consider correctly joint and common costs, which cannot be allocated totally on a causality basis. Stating that 90 percent of the costs can be allocated on the basis of direct or indirect cost-causation is arbitrary and definitely too high. No figure should be named.

BT remarked on the issue of transparency and business secrets that accounting methods are no secrets. There are also a number of costs that are similar for all operators. These are not secrets and should be published. It should be possible to clarify which cost figures are confidential.

Telefonica expressed support for O2’s statement regarding the ability to allocate costs, adding that it is difficult to develop a table such as that of page six in the annex as some of the allocations, for example wholesale/retail, are highly debatable. Telefonica explained that they will submit detailed comments in written form on the topic.

Davide Gallino responded that the 90 percent figure is an inevitably arbitrary attempt to provide a viable threshold, which has normally not caused too much trouble so far. If there are reasons for deviating from this reference threshold, those are normally discussed with NRAs’ and auditors... Responding to one comment by ECTA, it was pointed out that the text features a table with usage factors and average costs; that the degree of transparency should be acceptable for the operators; and that confidentiality of such aggregated data should not be an issue.

Current cost accounting

BT suggested that one does not have to move directly from historic costs to current costs, but rather start with the access network where there is a clearer need, and then gradually expand the current cost methodology to other areas. Some kind of progression could be recognized in the paper.

Telefonica stressed that it is vital to be coherent in the allocation of cost elements. There is a feeling that the regulator can always pick and choose the most convenient methodology at the time. Operators in general do not have the same choice - they need to stick to a current cost model and exercise that.

Telecom Italia stated that LRIC is not relevant for mobile communications market and that historical costs are preferable in the mobile case

DT stated that network asset evaluation in current cost accounting should be stressed. Depreciation and capital requirements should only be concerned with economic value, and financial capital maintenance should be the leading principle of capital maintenance.

Cost of capital and capital employed

DT pointed out that focussing on WACC in a world of technological development and innovation does not allow for specific risk needs to be evaluated more clearly and in a more sophisticated way. DT stated that this question is not yet answered.

BT commented that the apportionment of capital employed needed more guidance.

T-Regs expressed support for DT's position on WACC and asked if one should not step away from particular methodology and examine how the operator raises capital on the market in a more practical way.

Davide Gallino acknowledged that WACC is used by the financial community together with other models, but that for regulatory purposes it is necessary to have only one model.

Telekom Austria: recommended to use forward looking methods for some specific parameters in the domain of risk assessment.

Davide Gallino noted that some problems with WACC might lie in the lack of commonly accepted definitions, which are now provided in the text. The Beta parameter, for example, may define several different instances. . It was acknowledged that some elements in the WACC model hardly allow for looking into the future. In general, DG continued, the evaluations of the cost of capital issued by NRAs have been more generous than those done by investors, and that this reflects the prudent approach of NRAs to this issue. Another problem with past usage of WACC, DG added, is lack of transparency. However, if parameters used are made public, there will be more certainty and predictability.

Cost modelling (Top down – bottom up models) and cost recovery

DT reminded the audience that it was one of the few operators who had already started applying a bottom-up model, and that this would be costly to change. Therefore, DT suggested that the model should be the choice of the operator.

Annex: slides from the presentation.

Draft ERG Opinion on the revision of the Commission Recommendation 98/322 on Cost accounting and accounting separation

Davide Gallino (AGCOM)

Two parts of the same document
prepared by the WG- RA
issued for consultation:

The Draft ERG Opinion on the Review of the Recommendation on cost accounting and accounting separation (98/322 or “Old Rec”);

The Annex to the Draft ERG Opinion.

Consultation text development

- Working period:
  - Initial phase: Sept 2003 – Dec 2003
  - Drafting phase: Jan 2004 – March 2004
  - Consultation phase: 30 April – 11 June 2004
  - Redrafting phase: June/July 2004

- the Working group on Regulatory accounting <u>has unanimously approved the text for consultation</u>

Key features of the texts for the consultation (Draft Opinion + draft Annex) :

- Update legal references to the New regulatory framework
- Cover, in principle, all kind of electronic communications networks (and not only the fixed network like in the old Rec); the actual obligations are, nevertheless, imposed via the Directives (not the Rec)
- could also cover access (and not interconnection only like in the old Rec);
- would be more careful about the use of current cost methodology, given the difficulties in developing and implementing such methodology, but providing at the same time a clear guidance which could promote harmonization if a NRA decide to implement

Key features / 2

- would be more neutral in some technical choices regarding the current cost methodology, like the use of Financial capital maintenance (=higher cost for the OLOs using a notified's operator network) or Operational capital maintenance (=higher cost for the notified operator because the cost of maintenance are only partially recovered by OLOs), whereas the old Rec was definitely more in favour of FCM;

- would be more open than the old Rec in the choices available to the NRAs when choosing some parameters used in the calculation of the cost of capital, in particular for the choice of the market risk (choice between capital asset pricing model and other methodologies ie factorial models);

Key features / 3

- would be more detailed on the preparation and publication of data and in general more precise about the transparency which should be inherent to the process of regulatory accounting;
- more emphasis on data conservation/traceability
- would be more detailed with regards to the verification and auditing process of the regulatory accounting data.

Input from consultation and consultant

- Consultation response expected to be rather massive and rich in quality/depth of expected tributes.
- Audit firm hired by Cion to assess text in the light of current practice

Next steps

- Assessment of inputs to consultation
- Text re-drafting
- New submission to ERG (contact network)
- Approval (ERG Plenary, Sept 2004?)
- Send to Communications Committee and Council???