Public consultation on a draft ERG Opinion on proposed changes to the Commission Recommendation on Accounting separation and cost accounting

26 April 2004

1. Introduction

Article (7) and 8(3)d of the Framework Directive[1] require the NRAs and the Commission to co-operate in a transparent manner on the consistent application of the provision of the new regulatory framework for electronic communications networks and services and, in particular, to seek agreement on the instruments and remedies best suited to address specific types of situations in the market place or, to ensure the development of consistent regulatory practice and application of the regulatory framework.

In line with this obligation to promote a consistent regulatory approach, the ERG in close cooperation with the Commission Services has prepared a draft Opinion on proposed changes to Commission Recommendation 98/322/EC of 8 April 1998 on interconnection in a liberalised telecommunications market[2] (Part 2 – Accounting separation and cost accounting) in order to bring it in line with the requirements of the new regulatory framework. The ERG is publishing this draft document for comments prior to finalising its Opinion. The final version of the document may differ from the present one and will take account of the submissions received where appropriate, after which it will be submitted to the Commission as an ERG Opinion.

In order to ensure the maximum transparency of the process involved, interested parties are hereby invited to submit their views in writing to the ERG secretariat (erg-secretariat@cec.eu.int) in electronic form before close of business on the 11th of June 2004.

Comments will be made available to the ERG members and the Commission Services and unless marked as confidential, will be published on the ERG website (http://erg.eu.int).

Comments should be sent in English or in any other official language of the EU.

2. Structure of the draft document

The draft document is comprised of two main sections: the draft ERG Opinion on the proposed changes to the Commission's Recommendation on cost accounting and accounting separation of 1998, and the Annex.

The Recommendation concerns the implementation of accounting separation and a cost accounting system. Such obligations may be imposed on operators designated as having significant market power on a specific market as a result of a market analysis carried out in accordance with the provisions of the Framework Directive. The purpose of these obligations is to provide the NRAs with detailed information on the notified operator's costs and to avoid the possibility that vertically integrated undertakings discriminate in favour of their own activities, or to support price controls in situations where the market analysis indicates that a lack of effective competition means that the operator concerned could follow anti-competitive pricing practices.

The Annex includes 8 sections reflecting the content of the proposed changes to the Recommendation, and illustrates in a practical way the approach that NRAs should follow to improve a cost accounting system. The content of each section is briefly outlined below:

[1] 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), OJ L 108, 24.4.2002, p.33
[2] OJ L141, 13.5.1998, p.6.

- 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 principles 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.

3. Areas where submissions are particularly invited

In order to focus responses the ERG would particularly welcome views on the following:

<u>Draft ERG Opinion on proposed changes to the Commission Recommendation on cost accounting and accounting separation of 1998</u>

Do you agree that the proposed changes to text of the Recommendation as set out in the draft ERG Opinion addresses correctly, in general, the issue of cost accounting and accounting separation obligations, or do you think that is there any part that should be expanded/reduced? If so, please provide details.

Do you think that the proposed changes to the text of the Recommendation as set out in the draft ERG Opinion provides sufficient practical guidance on how to implement a cost accounting system and accounting separation? If not, please highlight the areas where you would wish to see more guidance provided and why.

<u>Cost Accounting:</u>

Do you agree with the general rules established to prepare a cost accounting system?

Do you agree with the definition of directly attributable, indirectly attributable, joint and common costs?

Do you think common and joint costs allocation criteria are set out in a proper way?

Do you agree with the given definition of transfer charges?

Accounting separation:

Do you think that the accounting separation requirements contained in the document allow to properly provide the regulator, the industry, customers and other stakeholders with detailed information on the regulated services?

Do you think that the given examples for accounting separation are useful to understand how to allocate the cost components to each service? Are you aware of any another relevant example that could be useful in this context?

Do you think that accounting separation could be effectively implemented using any of the cost bases indicated in the text (HCA and CCA)?

Principles for cost causality, driver definition and attribution methodologies:

Do you agree with the principles for cost causality, driver definition and attribution methodologies set out in the text?

Do you agree on the fact that all cost allocation methods, hence a detailed list of the cost drivers, should be reviewed by NRAs for assessment before financial statement preparation?

Do you think that the cost allocation process illustrated in Figure 1, although simplified, could provide a useful guide for the logic to be followed in cost allocation?

Is there any further principle, in addition to those set out in the text that you wish to propose? If so, please justify it/them.

Guidelines for CCA implementation:

Given the key role played by network asset revaluation in the application of a current cost accounting methodology, in your opinion should network assets subject to valuation be jointly identified by the NRAs and the operators?

Do you agree that NRAs should illustrate and submit to public consultation the parameters and factors chosen for current cost accounting modelling?

Do you think the definition of net replacement cost, deprival value and economic value given in the text are correct?

Do you agree with the given definitions of CCA capital maintenance methodologies, namely operating capital maintenance (OCM) and financial capital maintenance (FCM)?

Cost of capital and capital employed

Do you agree that WACC is the correct way to calculate cost of capital?

Do you agree with the way CAPM is proposed to be applied for regulatory purposes? In particular, do you agree with the definitions of the input parameters?

Do you agree with the fact that, besides CAPM, other methodologies could be correctly utilised to determine the cost of equity?

Qualitative characteristics of accounting information

In your opinion, in the absence of regulatory accounting guidelines, should NRAs require the notified operators to apply IAS (International Accounting Standards) for regulatory financial statements assessment? If not, what accounting principles should be applied?

In order to guarantee comparability and consistency over time, do you agree on the fact that changes to the regulatory aggregates and sub-aggregates in the financial statements should take place only if previously approved by the NRAs?

Do you think the two concepts of "materiality" given in the text are consistent?

4. Other comments

Please provide a concise description of any other issues that you believe the document should address or a critique of any other aspects of the document that you consider relevant. In doing so please refer to actual or potential problems encountered in electronic communications markets, as well as to any relevant case law and/or other precedents.