

Deutsche Telekom's Comments on the ERG draft opinion on cost accounting and accounting separation

Executive Summary

- **Scope and purpose of accounting separation on the one hand and cost accounting on the other hand are entirely different.** Contrary to what is implied in the ERG draft opinion there is no direct link between an obligation to orient prices towards costs according to Art. 13 Access Directive and the obligation of accounting separation according to Art. 11 Access Directive as they are used to answer to different forms of market failure. Each remedy must be carefully assessed in view of proportionality.
- **Accounting separation is not suited for a dynamic and diversified market environment.** The concept of accounting separation within a vertically integrated firm may make sense in a simple world of vertical integration with a limited number of basic products and a relatively static market and technology environment. Taking the dynamics of modern telecommunication markets and the needs of modern cost accounting into account, it is highly questionable if the benefits of introducing accounting separation, in any, would ever be in due proportion to the costs of its implementation.
- **Accounting separation as proposed by the ERG would constitute an extremely intrusive remedy.** As it is not in line with modern standards of accounting and therefore implies the implementation of a dual book for regulatory purposes, accounting separation creates high costs to the notified company. Therefore the consideration of less intrusive remedies before imposing and defining accounting separation is crucial.

- **NRAs cannot request accounting data beyond the market where SMP was identified and accounting separation considered a proportionate remedy.** Even if an NRA found that an obligation of accounting separation is appropriate, any extension of an accounting separation regime to other - regulated or unregulated - markets would not be in line with the NRF. In particular, it should be clarified in the paper that there is no justification to collect accounting data of services which are not part of a regulated market on which the operator has SMP.
- **National and community rules of commercial confidentiality have to be respected under all circumstances.** Otherwise accounting separation and cost accounting would result in information asymmetries between the different market players and competitive distortions on the market. There is no “principle of transparency” under the NRF as referred to by the ERG in point 1 of the draft opinion, only the possibility for NRAs to impose transparency requirements where they are necessary and proportionate and respect business confidentiality.
- **Extreme caution should be applied when defining any specific guidelines for asset evaluation or cost allocation methods of cost accounting.** E.g., no fixed relation of joint and common costs should be established as it is not backed by empirical or scientific evidence. There are usually several different scientifically recognised methods for most of the topics discussed. In general, cost accounting should be based on the calculation of the regulated operator. If the NRA decides to impose cost orientation of prices, it then has to examine the scientific foundation of the methodology as well the correct application of the accounting system by the operator.
- If accounting standards and principles are dealt with in the document this should be done in a consistent way and should take into account the dynamics of telecommunication markets. Especially **network assets should be consequently revaluated according to their economic value, no preference for either top-down and bottom-up modelling should be stated and more concern should be given to the question of a more risk-adequate measurement of the cost of capital** in dynamically evolving electronic communications markets.

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Comments on the ERG consultation paper on cost accounting and accounting separation

Deutsche Telekom welcomes the possibility to comment on the ERG draft opinion for a Commission Recommendation on cost accounting and accounting separation and looks forward to the forthcoming debate on the scope and appropriateness of accounting separation and cost accounting obligations under the NRF. Deutsche Telekom would like to encourage a subsequent consultation with market participants on a draft Recommendation by the European Commission as the EU institution responsible for adopting the amended Recommendation.

We would like to refer to our comments in the framework of the ERG consultation on FL – LRIC modelling from September 2003¹ and the ERG consultation on a draft joint ERG/EC approach on appropriate remedies under the NRF from January 2004² which outline the main principles for the assessment of appropriate regulatory obligations and in particular the proportionality of price control obligations under the NRF.

I. Cost accounting and accounting separation under the NRF

1. Scope of the consultation

As a starting point, we would like to point out that although accounting separation and cost accounting principles are treated jointly in the ERG consultation paper, the scope and purpose of the two concepts are entirely different. Cost accounting standards and principles like LRIC etc. are used to assess cost orientation of prices where price control obligations have been imposed whereas accounting separation is designed as an instrument to check the (non-)existence of unjustified cross subsidies and ensure non-discriminatory treatment of internal and external suppliers where such obligation applies to an SMP-operator.

¹ http://www.erg.eu.int/doc/publications/call_input_lrict/dt.pdf

² http://www.erg.eu.int/doc/publications/call_input_draft_appropriate_remedies/dt.doc

Therefore, contrary to the implicit suggestion of the ERG paper, there is no direct link between an obligation to orient prices towards costs (and the related discussion about cost accounting, LRIC etc.) according to Article 13 of the Access Directive and the obligation of accounting separation according to Article 11 of the Access Directive as they are used to answer to different forms of market failure. The simultaneous application of these two remedies may even encounter particular problems as the cost accounting principles and the methods to calculate cost orientation of prices may follow a different logic than accounting separation methods. E.g., the consideration of efficiency aspects in calculating cost orientation of future prices under LRIC is not in line with the aim of accounting separation, which documents an actual cost allocation of regulated products within an integrated firm. Reassuring compatibility - if possible at all - between both obligations will create high costs for the affected company.

Generally, a simultaneous application of more than one remedy under Art. 9 – 13 of the Access Directive should be carefully assessed in view of proportionality and not be perceived as a generally suitable approach to regulation on wholesale markets.

Against this background and given the consultation launched by the ERG on FL LRIC in 2003, it is unfortunate that aspects of cost accounting are treated in the present consultation in such detail. Notwithstanding this reservation, Deutsche Telekom will provide comments on all major questions raised by the ERG.

As a general remark, we feel that the general approach of the draft to accounting separation and cost accounting in the telecommunication sector as well as the large number of detailed recommendations are not always sufficiently backed by theoretical and/or empirical evidence which would support the findings, e.g. in the form of reference to corresponding literature, studies etc..

2. Proportionality of accounting separation under the NRF

As a result of the market analysis and remedies assessment process under the NRF, NRA's are able to impose regulatory obligations on an SMP-operator. These obligations have to be proportionate, i.e. necessary and appropriate in view of the identified market failure and the least burdensome remedy for the operator concerned, Art. 8 (1) Framework Directive.

Under Art. 11 Access Directive NRAs may impose an accounting separation obligation only if it is necessary to identify unjustified cross-subsidies or discriminatory behaviour of internal and external suppliers and where no less burdensome remedy is available.

a) The choice of an accounting separation obligation

Accounting separation as proposed in the ERG document is an extremely intrusive remedy for the regulated firm, because it is not in line with modern standards of accounting. Modern accounting systems are designed to run the firm efficiently from an incentive point of view. To achieve this, they do not anymore rely on fully allocated costs which serves as the bases for accounting separation. Instead, accounting systems today are designed according to a number of Key Performance Indicators (KPI).³

Therefore, imposing accounting separation implies the implementation of a dual book for regulatory purposes only. Such an introduction of regulatory financial statements requires a lot of additional resources, creates a need for additional accounting processes including the corresponding hard- and software and is therefore very costly. Especially generating additional data which is not used for business purposes and constantly checking on the mid-term evolution of this data is extremely resource-intensive.

Certainly, the costs of implementing accounting separation can be lower in an environment with a low degree of portfolio complexity and low innovative dynamics. This may, e.g., have been the case when the business of former state owned telecoms monopolies was limited to the analogue subscriber line and voice calls or may be the case in other sectors with only a handful of products sold.

However, for a vertically integrated firm acting today in a rapidly changing market environment as on mobile and broadband markets, it is difficult to imagine that accounting separation as presented in the ERG draft documents could be sensibly applied. For an undertaking which, e.g., offers a multitude of wholesale and retail services on the basis off different networks (e.g., PSTN, IP, ATM) in a highly competitive and dynamic market where new products emerge frequently and demand shifts with large scales, introducing and maintaining accounting separation on the basis of fully allocated costs imposes enormous additional costs on the operator. Therefore, the idea of accounting separation as a means to solve the

³ For classical references refer to Johnson, h. Thomas and Kaplan, Robert S (1987/ 1991): *Relevance Lost – The Rise and Fall of Management Accounting*, esp. Chapter 10 and 11, or Brealey, Richard R. and Myers, Steward C. (2000): *Principles of Corporate Finance*, 6th edition, p. 316-341.

specific regulatory problem of preventing discriminatory prices (presumed cross-subsidies etc.) within a vertically integrated firm may make sense only in a simple world of vertical integration with a limited number of basic products and a relatively static market and technology environment.

In order to comply with the proportionality principle NRAs therefore have to choose a less intrusive instrument to deal with the identified market failure wherever possible. In the case of an obligation for non-discriminatory provision of wholesale services to competitors it is usually sufficient to calculate whether an efficient competitor is able to compete with the relevant retail offer of the SMP-operator. If this is the case, no discriminatory behaviour takes place and there is no need to analyse all transfer relations within the regulated undertaking. In this case, the imposition of accounting separation would clearly contradict principle of proportionality.

Therefore, taking the dynamics of modern telecommunication markets and the needs of modern accounting into account, it is highly questionable if the benefits of introducing accounting separation, if any, would ever be in due proportion to the costs of its implementation, from an operational point of view as well as under national welfare aspects.

b) Proportionate implementation of accounting separation

The proportionality principle has not only to be considered in the context of the decision on whether to impose accounting separation or not. It also has to be respected concerning the way accounting separation is implemented in case the obligation is considered necessary by an NRA. The ERG consultation paper states on page 11 of the annex: *“The initial costing information should also refer to all relevant services/ products provided by the company, independently of its status in other market.”* Although citing the proportionality principle, the ERG’s recommendation goes far beyond what is generally a necessary and appropriate implementation of cost accounting under the EU regulatory framework.

Firstly, the accounting separation obligation according to Art. 11 of the Access Directive focuses explicitly on activities related to interconnection and/ or access. Secondly, generating accounting separation data should be limited to the specific relevant markets, where it has been imposed as an obligation as a result of the market analysis procedures. Under Art. 8-13 of the Access Directive and Art. 17 of the Universal Service Directive no obligations can be imposed on other markets than those where an operator has been identified as having SMP. The proposed disclosure of information for additional markets would amount to a breach of

the Directives. The ERG is conscious about the difficulties to limit accounting separation on the identified SMP-Market and the corresponding services (page 43 of the annex). It should be clarified in the paper that there is no justification for the NRA to request accounting data beyond this scope. Especially accounting data of services which are not part of a recommended market should be explicitly excluded from accounting separation.

3. Respecting national and Community rules on commercial confidentiality

Under the New Regulatory Framework, information requirements can only be imposed where they are necessary and proportionate and respect business confidentiality, Art. 5 (1) and (3) Framework Directive and Art. 8, 9 and 11 Access Directive. No “principle of transparency” as referred to by the ERG in point 1 of the draft opinion exists which would justify information requirements which go beyond what is necessary and proportionate in view of a specific competition problem encountered on a relevant market.

The extensive reporting and publication obligations proposed by the ERG would be contrary to the requirement of commercial confidentiality as ensured under national constitutional and Community law and to the objectives of the Framework Directive. One of the objectives of the Directive is the promotion of competition in the provision of electronic communications networks, electronic communication services and associated facilities. According to article 8 paragraph 2 lit. b of the Directive the promotion of competition is *inter alia* achieved by preventing distortion of competition. If national and community rules of commercial confidentiality are not fully respected, this will result in information asymmetries between the different market players and a competitive advantage for competitors not subject to an accounting separation obligation, thereby creating a distortion of competition. Against this background, the proposed requirements also contradict the proportionality principle laid down in Art. 8 (1) of the Framework Directive.

II. Cost accounting and accounting separation: definitions and principles

The following comments under II. and III. will cover specific issues raised in the consultation document. Referring to our fundamental concern as outlined in part I. of these comments, this does not imply any acceptance of the ERG's approach to the imposition of accounting separation and specific cost accounting obligations.

1. Definition of direct, indirect, joint and common costs

The definitions introduced for „directly attributable, indirectly attributable und unattributable costs“ can serve as an example of how costs can be attributed. However, the different categories are not distinguished with sufficient clarity. E.g., so-called „network related operating costs“ (e.g., repair and maintenance costs) are seen as directly attributable costs even though as a rule they cannot be attributed to a single service but only to specific network components, which, however, are themselves explicitly mentioned as part of the indirectly attributable costs.

Moreover, in this context the introduction of the additional set of terms „joint/common costs“ including the subcategories mentioned on p. 3 of the Annex does not appear to be consistent. According to the subcategories mentioned they can be part of the „indirectly attributable“ or the „unattributable costs“. To achieve more transparency in the Recommendation, a systematic and mutually consistent definition of terms should be introduced.

Beyond the specific questions addressed in the ERG document, the discussion about cost allocation principles should move in the direction of Ramsey pricing. The paper, as other ERG documents before, dismisses Ramsey pricing as “practically unfeasible”. The practical difficulties of collecting data to enable the use of Ramsey pricing are, however, often exaggerated and may in fact be lower than those required to build a robust alternative model for allocation of joint and common costs. Deutsche Telekom believes that it is not adequate to dismiss Ramsey pricing in the way that the ERG paper does. If cost orientation in regulatory price control intends to mimic competitive market prices, Ramsey prices as the accepted key concept of efficient market allocation cannot be ignored.

2. Relationship between direct and common costs (90:10)

Deutsche Telekom does not agree with the statement on page 9 of the annex that a costing system should allocate at least 90% of the cost on the basis of direct or indirect cost-causation. There is no empirical evidence, that a „good“ costing system – especially in this area of network-industries – is defined by a relationship of 90% direct/ indirect costs to 10% common costs. Even if a company reaches to fulfil such a requirement, this could also be interpreted as evidence of an unrealistic allocation of common costs. Furthermore there is no fixed relationship between directly/ indirectly attributable and common costs over time. Especially with increasing technical progress and decreasing network prices for a given service as a result, the relative part of common costs could increase.

Generally, in our view no exact number for the relation between direct and common costs should be given in the forthcoming recommendation. The proposed relation between direct and common costs is neither backed by empirical data nor by scientific evidence. Setting such targets in an axiomatic manner would only lead to distortions within the cost allocation process.

3. Transfer charges

The setting of transfer charges has in any case – regulated or not - to be in compliance with the national and international rules and guidelines on transfer pricing like those issued by the OECD. By satisfying these requirements, which are regularly verified within the yearly financial auditing process, ‘market-compliant’ and non-discriminatory behaviour is already checked. Therefore, there seems very limited need for additional regulatory controls.

The logic of the OECD guidelines concerning transfer prices relies on market prices rather than on costs which form the basis of an accounting separation approach. The guidelines also determine that transfer prices should reflect and document the actual exchange relationship within the integrated firm. Contrary to what is stated in the ERG draft opinion, if there is no exchange between two business units, there are also no transfer charges put in place. Therefore, integrating transfer pricing in an accounting separation approach is not in line with the usual business requirements and thereby leads to high costs of implementation.

Moreover it should be clearly pointed out in the paper that consistency requirements applied to transfer charges only make sense concerning the methods applied and the legal framework. Consistency cannot mean setting more or less the same transfer charges from one year to the next. Changes in regulated prices, production structure, market prices etc. will lead to constantly changing transfer charges from one year to another.

4. Bottom-up vs. top-down

The recommendation should not state a preference neither for bottom-up nor for top-down approaches in cost modelling. Different carriers use different cost accounting methods and follow different business philosophies. The cost accounting approach chosen by the operator should always be the starting point when cost orientation is identified as the proportionate remedy.

Among regulators, academics and operators it has been discussed for some time in the context of fixed access networks whether a bottom-up or a top-down model is adequate for cost accounting, especially calculating LRIC. In these discussions, many scientists seem to support bottom-up modelling whereas in business practice top down approaches are used more frequently, given the fact, that the traditional accounting systems in general were top-down orientated. Meanwhile however, some carriers like DT have implemented a bottom-up approach for business purposes of fixed network management and want to continue to follow it. If the ERG or individual NRAs would now express their preference for a top-down approach and force carriers like DT to implement it additionally to their system in use, huge adjustment costs would arise.

In a regulatory framework, where cost orientation is only one of many possible remedies and probably of lesser importance in the future, it makes no sense to force the operator to implement an additional cost accounting system for regulatory purposes while most of its business is not subject to cost orientated price control.

III. Guidelines for implementation of Current Cost Accounting (CCA), cost of capital and capital employed

1. Guidelines for implementation of CCA

The guidelines for CCA implementation prove to be misleading as they recommend to measure the costs of a new entrant. The basis for the cost orientation of regulated prices – if this method of price control is found to be proportionate - has to be the costing data of the operator in consideration.

For the purpose of CCA, NRAs should not alter the quantity structure of network assets as given by the regulated operator. By definition CCA represents a method for revaluating actual assets. It is used to determine forward-looking and actual costs. Calculation of actual costs (i.e. costs of actual assets), however, requires CCA to take into account the actual quantitative structure of network assets as revaluated at replacement costs. To rely on the asset portfolio of a hypothetical, fully efficient operator when calculating the operating costs is therefore misleading. In its conclusions, the recommendation should clarify that the only objective of CCA is the revaluation of actual network assets.

2. Definition of net replacement costs, deprival value and economic value

The recommendation lacks a clear distinction between gross replacement costs and net replacement costs. We therefore propose to add the following definition: “Gross replacement costs equal the actual costs of a similar new asset, while net replacement costs equal the actual costs of a similar used asset. In the former case, revaluation of assets is based on today’s prices of completely new assets. In the latter case it is based on today’s prices of assets of “similar characteristics and age”.

In addition, the recommended rule of revaluation (i.e., that the lower the net replacement costs and deprival value are, the higher the economic value and the recoverable value) contains a logical error. It is stated that net replacement costs of fully depreciated assets on the balance sheet should “normally” equal zero. Above mentioned rule therefore values such assets not above zero (i.e. the lower of zero and deprival value may not exceed zero). This contradicts the nature of CCA which intends a positive value for any asset still in use. Deutsche Telekom proposes to remove this contradiction by not referring to the net book values of assets.

3. OCM vs. FCM

Deutsche Telekom supports the abstract definitions of OCM and FCM in the ERG draft opinion. However, the meaning of “holding gains or losses” and their relation to general inflation remains unclear. The document should therefore explain the theoretical concept of holding gains or losses and their application in practice.

The draft also lacks a statement on structural differences between OCM and FCM. In particular, it should be established that only FCM does not discriminate between initial and new investments because FCM requires maintenance of investors’ financial capital. Financial capital will only be maintained if shareholders and creditors receive the required return. Hence FCM guarantees a suitable compensation for the provision of capital which is the main condition for financial capital maintenance.

It should be stated as well that FCM predicts the concept of economic depreciation. The charge of economic depreciation equals the change in market value of an asset. Since shareholders and creditors value the firm depending on the market value of its asset portfolio, economic depreciation reflects the change in the capital market value of the firm. Hence financial capital is maintained when the firm reinvests an amount equal to the charge of eco-

conomic depreciation.

For this reason the use of a linear depreciation method would not be suitable in the case of assets with decreasing replacement costs, because this would not assure the complete recovery of the invested funds. Instead, the use of economic depreciation reflecting the development of prices is to be preferred.

4. WACC and capital employed

Deutsche Telekom proposes a clear recommendation in favour of models strictly reflecting the terms and conditions of capital markets. Operators have to accept the terms and conditions of capital markets because they do not dominate either national or international capital markets. This strict orientation towards the terms and conditions of capital markets should include the average cost of capital as well as the costs of equity and debt. Today's electronic communications markets are characterised by new technologies and constantly developing services inducing high upfront investments and depend increasingly on elements that are not controlled by the operator (e.g. content development). This has implications for the risk operators are facing. This can only be reflected by terms and conditions on capital markets.

The WACC should therefore be calculated using the market values of equity and debt. Book values are not suited to reflect the terms and conditions of capital markets. Furthermore the recommendation should contain a clear preference for using a market oriented method like CAPM when calculating the costs of equity and debt.

The WACC thereby is only a minimal return on equity. On average incumbents have to pay a return on top of the WACC. This is reflected by so called return on capital employed (ROCE). ROCE equals regulated operators earnings before interest and tax (EBIT) in a given period divided by the capital employed in that period. Thus ROCE contains the cost of capital as given by WACC and an on top return called EVA (economic value added), i.e. $ROCE = WACC + EVA / \text{capital employed} = EBIT / \text{capital employed}$.

Moreover, as laid out in detail in our comments on a joint approach by ERG and Commission to remedies under the NRF, for all assets which are or could be duplicated and where sustainable competition can therefore be achieved, regulators must adjust their policies to the new, significantly more dynamic market conditions by implementing risk-covering access rules in cases where access is still considered a proportionate remedy. These measures should contain risk-adjusted prices such as pricing based on option values and/or the use of

various pricing-related elements like, e.g., differentiated contract conditions such as minimum quantity and contract periods, limitation of access to standard wholesale offerings and sunset clauses.

5. Efficiency factors

If an NRA decides to base its price control on LRIC, future efficiency factors are usually considered. Starting from the CCA-data, the NRA can evaluate reachable efficiency potentials for the time period under consideration. "Reachable efficiency" within this context can only mean to evaluate realisable efficiency potentials of the operator and the network considered. To the contrary, hypothetical efficient networks cannot serve as an estimate for efficiency gains because they assume an overall inefficient complete replacement of the current network.

Usually, reachable efficiency is part of the target costing of the operator. Therefore, the most efficient way of gathering information about efficiency factors is to in principle rely on the costing data of the operator and carefully verify it in the regulatory procedure. Only in cases where the operator fails to provide plans about cost savings, it can be appropriate to estimate efficiency factors with other instruments such as analytical cost models.

6. LRIC

LRIC modelling is one approach which may be used to calculate "efficient" access prices. Generally however, cost-orientation must be considered as a particularly intrusive measure where a public body (the NRA) takes over one of the most important functions of competition, namely the finding of prices. In dynamic and competitive industries, such as, e.g., the mobile industry, it is hard to see how a public authority can possibly perform better than market players in achieving efficient results.

Especially dynamically evolving markets such as broadband and mobile markets are subject to rapid and unforeseeable technological and demand changes (s. above under pt. 4). Under these circumstances cost modelling has to take care of constant revaluation and remodelling. LRIC approaches used for regulatory purposes do not match these needs at all. They so far give no room for scenario analysis and suggest a misleading stability of costing for a longer period. Because there is a very high risk of miscalculating future costs, a LRIC approach should therefore not be used for regulatory price control in dynamically evolving markets. This should be clearly stated in the document.

This corresponds with the principles of the New Regulatory Framework. Cost orientated price control as the most intrusive remedy under the Directives is designed as a measure of last resort. As shown in our comments on the LRIC- and Remedies consultation documents of the ERG, LRIC-based price regulation can only be proportionate in mature markets with persistent bottleneck structures. Accordingly, cost oriented pricing should not be applied in cases where several parallel networks exist or network duplication or inter-platform (inter-modal) competition is feasible. In those circumstances, other remedies to determine prices, if price control is exceptionally applicable, would be more adequate and less intrusive (e.g. benchmarking or “reasonable” prices).