



Accounting Separation and Cost Accounting: Providing Regulators with an essential toolbox

The Initiative of European Network Operators (IEN) is a German-based association of telecommunications network operators. Among the members are several of Europe's largest operators such as BT, Cable & Wireless, Colt, MCI and Tiscali.

All member companies share a special interest in creating a level playing field across Europe. As such, the IEN aims at ensuring that investment conditions are equally favourable in all EU member states. To date, the IEN has primarily been looking into developments in the Federal Republic of Germany such as the absence of Bitstream Access, the absence of Partial Private Circuits, the lack of transparency in market regulation and shortcomings of the newly adopted Telecommunications Act.

In its draft opinion of 26 April 2004, the European Regulator's Group sets out proposals in relation to Accounting Separation and Cost Accounting as obligations that might be imposed on operators with significant market power ('SMP'). The new opinion draws on and develops the Commission's recommendation 98/322/EC dated 8 April 1998 on the same topic. This response outlines the IEN position on the ERG proposals from the perspective of pan-european telecommunications operators that maintain businesses in Germany.

The IEN feels that transparency and non discrimination are fundamental to the regulatory picture, as is the cost orientation of prices for SMP wholesale service. This requires a cost accounting system. Accounting Separation is a mechanism that develops the cost accounting process further and puts some of its key factors into the public arena and addresses all these matters in a proportionate manner.

The IEN regards the draft opinion to be a useful basis for discussion on these two matters – which should be at the very centre of any regulation of SMP operators. Although the ERG have raised a series of detailed questions in their document, this response does not seek to address each one as we believe what is most important is the general position of the opinion.

Berlin, 11 June 2004

Overview

I.	Observations from Germany	3
1.	More than limited cost split	3
2.	Unclear reconciliation to statutory accounts	4
3.	Unclear whether incumbent prepares financial information that show the costs of network components.....	4
4.	No financial information prepared that shows the costs, revenues and charges for services.....	4
5.	No transparent interface showing how the incumbent's retail arm buys services.....	4
6.	No information available on revenue, network charges, total other costs and profit of the retail arm	4
7.	Alleged business secrets widely prevent publication and transparency.....	5
8.	Basis and reach of cost information obscure – unavailable, not published, intransparent	6
9.	Costing methodologies partly subject to consultation but no general approval of methodology or changes.....	7
10.	No audit of regulatory accounts	7
II.	Suggestions to the ERG.....	8
1.	Accounting Separation: Make timely publication and consultation key element of ERG opinion.....	8
2.	Principles for cost causality, driver definition and attribution methodologies: Emphasize meaning for full cost accounting models and make methodologies technology-neutral.....	9
3.	CCA implementation: Set transition guidelines.....	9

I. Observations from Germany

To date, implementation of Accounting Separation and Cost Accounting has been very limited in Germany. The IEN hope this position will be remedied promptly under the new rules. With regard to the detailed questions on Accounting Separation asked by the ERG, the IEN wishes to outline the following observations.

It is worth noting that the following information is based on secondary sources. The IEN is unable to review the accuracy of incumbent operator's calculation as this cost calculation is widely considered to be a business secret by the German NRA RegTP. As such, the calculations are not accessible to competitors.

The information provided in this document is mainly derived from RegTP's administrative rules containing guidelines on cost calculation in 2001. These rules were intended to implement the Commission Recommendation on interconnection (part 2 - accounting separation and cost accounting) of 8 April 1998. Moreover, RegTP publishes a yearly report that deals with the implementation of said rules in practice.

Under the old Telecommunications Act ("TKG"), the incumbent is obliged to provide comprehensive cost data. This obligation will roughly have the same scope under the new TKG, which has recently been adopted and will enter into force soon. In addition, under the new TKG, RegTP will be allowed to impose obligations as regards the cost calculation methodology on an undertaking with significant market power. RegTP will also have the power to publish the respective information. Furthermore, it will be entitled to monitor the compliance with such obligations itself or to instruct an independent auditor. Moreover, RegTP will be allowed to order undertakings with significant market power to apply specific tariffs systems or cost recovery methods.

1. More than limited cost split

Already by law, i.e. under the old TKG, the incumbent is obliged to calculate its costs in a way which allows rates regulation or rates control. The incumbent is obliged to calculate its costs according to a system, which allows the control of the rates of voice telephony services, transmission lines, specific access services and interconnection or other telecommunications services.

It has to be pointed out that also the new TKG will oblige undertakings with significant market power to file detailed cost data with RegTP. RegTP will be granted the power to order accounting separation.

According to the 2003 report on the implementation of RegTP's cost calculation rules, however, a disaggregation of the costs into the business lines core-network, local access-network, retail and other activities as required by the Commission Recommendation is not yet fully implemented by the incumbent. In spite of this, RegTP claims to be able to draw conclusions from the current cost calculations about the costs to be assigned to the four mentioned business lines. As we do not have any detailed cost information in Germany, we cannot verify this statement.

2. Unclear reconciliation to statutory accounts

The IEN does not have access to the incumbent's detailed accounting data. However, as the incumbent's statutory accounts are audited according to the rules set out in the German Commercial Code (Handelsgesetzbuch), we presume that the incumbent complies with the respective obligations to reconcile the accounts within a group of undertakings.

3. Unclear whether incumbent prepares financial information that show the costs of network components

The IEN does not have access to any detailed cost information. In its rates regulation decisions, RegTP often refers to the incumbent's network specific cost calculation and replaces it if it is not adequate or not detailed enough. For example, in its two EBC decisions, RegTP reasoned that this evidence was incomplete or wrong as regards the calculation of the capital costs, the costs for rent and the operating expenses and the distribution of the total costs to individual services.

4. No financial information prepared that shows the costs, revenues and charges for services

The IEN does not have access to the incumbent's cost calculations. As to the costs of services, according to the 2003 report on the implementation of RegTP's cost calculation rules, as regards the production and marketing costs, the incumbent now uses an activity-oriented cost calculation method (process cost calculation) as recommended in the Commission Recommendation. However, RegTP did not consider as valid the process times used, because they did not even allow a cost control from a plausibility point of view. As to the revenues/charges for these services, no public information is available.

5. No transparent interface showing how the incumbent's retail arm buys services

The IEN does not have access to the incumbent's cost calculations. According to RegTP's Report 2002/2003, in the incumbent's cost calculation system, the production and marketing costs are explicitly specified. This cost category corresponds to the category of indirectly attributable costs according to the Commission Recommendation. Moreover, the mentioned group of costs refers to costs incurred for the process necessary to make available the product or service for the retail customer comprising its development, marketing, order management, services provision, maintenance and billing. These are quantity related costs. However, we do not know whether these costs are specified in detail.

6. No information available on revenue, network charges, total other costs and profit of the retail arm

The IEN does not have access to any detailed cost information. However, according to RegTP's Report 2002/2003, in the incumbent's cost calculation system, the incumbent specifies production and marketing costs. However, we do not know whether this accounting category does not only show the costs incurred, but also the respective revenue and profit. As to the network charges and the total

other cost, there is no public information available on whether they are reflected in sufficient detail and according to the principle of causation.

7. Alleged business secrets widely prevent publication and transparency

As mentioned in our introductory remark, RegTP considers the incumbent's cost calculation a business secret, which is not accessible by competitors. None of it is published. IEN had to base the information given in this questionnaire on secondary sources. What is more, it is widely unclear which elements of the above are available at least to the NRA. In any case these are not transparent to competitors and other interested parties.

It is worth noting that non-publication is justified mainly on the basis of alleged business secrets. Under section 30 of the Administrative Procedures Act (Verwaltungsverfahrensgesetz), RegTP has in the past kept all documents secret that were marked as business secrets by the incumbent operator. The incumbent operator itself takes the view that cost calculations formed business secrets and therefore should not be made available to competitors or other third parties. However, inflationary markings as "business secrets" have cast doubt whether RegTP's practice infringe third-party the right to have a due procedure. Even if RegTP's decision is appealed by a competitor in a judicial proceeding, neither the competitor nor court have a per se right to access the respective records (Sec. 99 of the Administrative Court Proceedings Act (Verwaltungsgerichtsordnung)). RegTP has to decide whether the information contained is too sensitive to be provided in course of the judicial proceeding. This restrictive decision making practice, however, was challenged as regards the rates for unbundled elements of the local loop. The respective trial is still pending. In a preliminary injunction, the German Constitutional Court decided that RegTP cannot withhold the respective documentation if the information concerned does not (1) cover a recent business period, (2) contain any detailed data about individual products or services and (3) concern the actual cost situation. To date however, this decision did not enhance the situation of the incumbent's competitors significantly.

The fact that the Access Directive now entitles RegTP to publish cost information that would contribute to an open and competitive market will not substantially change this situation. The respective provision refers to the national and Community rules on confidentiality (Art. 11 para. 2 sentence 3 of the EU Access Directive) and is thus subject to the above-mentioned restrictions.

Business and trade secrets are defined as the facts which are related to an ongoing business and in which the owner of the business has a legitimate economic interest. This term comprises business secrets like technical facts e.g. about production methods and business process. Moreover also trade secrets, i.e. the administrative part of the business like calculations, market strategies and customer lists, for example, are protected. In principle, this definition means a business secret is what the incumbent operator regards to be business secret. RegTP has little interest in remedying this situation.

8. Basis and reach of cost information obscure – unavailable, not published, intransparent

To IEN information, the financial information provided by the incumbent is based on historical costs caused by using the existent network. RegTP say they replaced this calculation method by current cost accounting (forward looking). To our information, the incumbent's cost accounting system uses some form of cost allocation but it is unclear whether this is FAC. However, RegTP developed cost models applying LRIC instead.

It is widely unclear whether the financial information is inclusive of cost of capital for network costs. According to RegTP's guidelines on cost calculation, the incumbent should calculate capital costs using a bottom-up approach and base the calculation on the replacement costs. RegTP, however, does not recognize this calculation, because it thinks the incumbent's capital structure is not represented realistically enough by this approach.

As regards cost of capital calculations, the incumbent uses the capital asset pricing method and the weighted average cost of capital model. RegTP, however, does not accept this and insists on calculating the interest rates according to the values contained in the incumbent's balance sheet instead of using market prices like the incumbent. Moreover, the incumbent and RegTP do not agree on the relevant return on investment rate.

It should be pointed out that there is no general financial information available to both the NRA and the public. Where the regulated entity has to provide financial data, this is done on a per case basis within single rates regulation cases rather than on a frequent (eg annual) basis. This does cause consistency problems.

There are no publications by the incumbent. As regards CCA valuations, RegTP published "analytical cost models" for both the regulation of interconnection rates and rates for access services to the unbundled local loop. These models are based on current cost accounting. Please note, however, that for calculating the relevant rates, RegTP does not only refer to these models. Instead of calculating the costs only for a hypothetical efficient network, to a certain extent, it also takes into account the fact that the incumbent uses a realistic network. As RegTP did in the past not regard the cost data provided by the incumbent operator to be sufficient, RegTP also used an EC benchmark instead.

As regards LRIC methodologies, there are models developed by RegTP for interconnection rates and rates for access services to unbundled local loop are based on the LRIC cost calculation method.

Revenue apportionments are not published. The "analytical" models mentioned above only provide for the calculation of costs, not the apportionment revenues. This is confirmed by RegTP's recent decision making practice using these analytical models, which is costs-oriented and does not refer to revenues.

Cost apportionments however are covered but not published. The analytical models mentioned above use the so-called TELRIC (Total Element Long Run Incremental Cost) approach, according to which the relevant LRIC standard shall refer to the elements needed for providing the specific services. So

the relevant costs are the incremental costs for providing this element as compared to a situation, in which the element (or its function) does not exist. Shared costs are directly attributed via a common measure to the different services that use these network elements. The apportionment of assets and other capital employed is set out in a reference document (“An Analytical Cost Model for the National Interconnection Network”), on which the respective analytical cost model is based, the calculation of the operative costs involves the apportionment of the necessary business assets.

9. Costing methodologies partly subject to consultation but no general approval of methodology or changes

The assumptions made in the analytical models for both interconnection services and access to the local loop were published and discussed with all network operators in 1998. They haven't been changed to date so there have been no discussions with operators since.

There is no “general” approval of methodology. RegTP approved the analytical models in principle by using them as a factor to be considered in its rates regulation proceedings. However, there is no RegTP decision conveying a legally binding effect to those decisions. Moreover, although RegTP based its above-mentioned decisions on the analytical cost models in part, these models were not the only relevant factor to be considered. For example, in its EBC decisions, instead of calculating the costs only for a hypothetical efficient network, to a certain extent, RegTP also takes into account the fact that the incumbent uses a realistic network and uses benchmark data instead. It is worth noting that the benchmark methodology was not discussed with operators and changed between the 2001 and 2003 decisions.

The analytical cost models were developed by a research institute and are not legally binding. There is no RegTP decision conveying a legally binding effect to those models. Only the rates regulation decisions themselves are binding. In its decisions, RegTP usually determines a point in time from which on and period of time during which the respective rates shall be valid. However, RegTP can revoke these decisions any time if the underlying facts change or if there are new conclusions as to the adequacy of the pricing model.

10. No audit of regulatory accounts

There is no audit of regulatory accounts, and there is no obligation to conduct such an audit. The incumbent's statutory accounts are audited by the statutory auditor instructed by the incumbent. In order to pass the statutory audit, the accounts have to comply with the general standards of bookkeeping set out in the German Commercial Code (HGB). By law, the statutory auditor is independent and is obliged to report neutrally according to the HGB rules on bookkeeping. At the same time, however, the auditor also owes duties to the undertaking to be audited which instructed him. In its decisions which referred to these models, RegTP pointed out that the incumbent's cost calculation did not comply with all cost calculation requirements set out by RegTP. So RegTP did not confirm that the financial information had been prepared in accordance with the relevant methodology.

II. Suggestions to the ERG

Under the 'old' regime the implementation of the directives in this regard was, as demonstrated, at best limited. The new regime mandates a consistent approach to these matters and we hope that there will be a greater consistency of approach going forward. If NRAs in countries such as the UK and Ireland see the implementation of published Accounting Separation statements and methodologies as an essential remedy for Significant Market Power, we hope the same will be true elsewhere. Exceptions should be rare and justified on a case by case basis. We would welcome a strong stance by the ERG on this matter. The IEN thinks the German example demonstrates clearly how a lack of publication and transparency hampers regulatory action. The IEN would like to reinforce that publication, consultation and transparency are key elements for turning accounting separation and cost accounting in a useful tool to regulators.

1. Accounting Separation: Make timely publication and consultation key element of ERG opinion

The development of a cost accounting system and accounting separation is fundamental to any NRA's ability to regulate the activities of an SMP operator. Publication of the methodologies and key financial data is an important part of the same process; permitting comparisons over time and internationally and the scrutiny of the outcomes of the process by all interested parties. Transparency allows operators and other interested parties to support NRAs by identifying anomalies or possible regulatory and competition issues. It also enables them to see the extent to which regulation is operating as proposed by the absence of any such potential anomalies. The ERG is urged therefore to make publication and consultation a key element of their opinion.

The detailed points of formats of the accounts appear to relate to a fixed network. These requirements cover a wider range of operators and we recommend that the ERG develop a wider set of principles; supported by some more detailed worked examples. The examples of extracts from the statements are not sufficiently detailed to ensure that the financial statements would include:

1. the build up of costs for network components,
2. the aggregation of these component costs into service costs, and
3. the transfer charge of these services to the SMP operator's own downstream operations.

These are essential ingredients for such statements, as is the disclosure of the reconciliation of the SMP accounts to the aggregate accounts for the legal entity overall.

As a lesson learned from Germany, the IEN believes the legislation on business secrets has been overstated. The existence of switches, duct, routers, engineers and sales costs within the incumbents cost base is no business secret but can be taken for granted. The methodologies by which the value of such items are distributed between services is of public interest and demonstration that a fair and reasonable approach has been taken should be in the interests of all parties. It is equally reasonable that the approach taken to costing different products and services should be seen to be equitable.

The absolute values may be confidential but the approach should not be. Hiding behind this legislation leads to mistrust and suspicion, casting doubt on the goodwill of the SMP operator to an equitable costing solution. The ERG, if it is to develop trust in the process, should address this matter within its opinion.

The IEN welcomes that Belgacom has developed Accounting Separation statements for 2000-2001 and that and BIPT undertakes efforts to have these published. We urge ERG to set a framework where consultation and publication is the norm.

The timing of information publication is also important and it is suggested that the ERG push for a 'catch up' process, whereby those SMP operators who have got to publish date on an annual basis are required to start with recent years first; rather than the earlier years.

2. Principles for cost causality, driver definition and attribution methodologies: Emphasize meaning for full cost accounting models and make methodologies technology-neutral

The detailed points of the methodologies are based around a single technology, and fixed network. These requirements cover a wider range of operators and we recommend that the ERG develop a wider set of principles; supported by some more detailed worked examples. The examples of methodologies within the draft opinion is neither detailed enough to set a framework nor basic enough to set a firm set of principles from which a more detailed framework can be set by each NRA. In terms of principles there needs to be a basis premise that the methodologies will be neutral as between the operators and the SMP operator, as outlines in the UK approach.

There has been a tendency to develop bottom up models to provide cost data for specific services. These are useful to inform NRA and offers about specific issues in the absence of other data but these cannot be seen as a substitute for a full cost accounting model covering the whole range of activities of an SMP operator. While the NRA and other operators are interested in the SMP activities only a full system that reconciles an entity's statutory accounts can be relied on to identify the actual costs and revenues of all relevant activities, and, critically, confirm that downstream activities purchase SMP upstream services on arms length prices.

3. CCA implementation: Set transition guidelines

Where there is not full LRIC and CCA based information the ERG is asked to set guidelines for transition to that data. Fully allocated historic cost audited published accounts, showing details of transfer changes between SMP upstream and downstream activities that were based on methodologies that had been debated in public would be a huge step forward in many member states. Moves to introduce current costs and then LRIC could be made subsequently. Few, if any, operators can have no relevant financial date, so the first steps should be achievable in a short time frame; with LRIC on a forward looking basis following with 12 months or so. Guidance of this type should be included within the ERG opinion.