



**Definizione stile:** Punto elenco: Bordo: Casella : (Singola, Automatico, 0,5 pt Larghezza della riga)

**TELECOM ITALIA comments**  
**on the Public consultation on a draft ERG Opinion**  
**on proposed changes to the Commission Recommendation on**  
**Accounting separation and Cost accounting**

**PEA.AER**

**11/6/04**

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## Introduction

TI welcomes the ERG proposal aimed to revise the Commission Recommendation on Cost Accounting and Accounting Separation in order to properly take into account the new regulatory framework.

The proposed revision seems, however, not to fully consider, in a number of areas, the effects of the AI and US directives and that the principle of proportionality should apply when giving guidelines for the implementation of Cost Accounting and Accounting Separation; TI takes therefore the opportunity to propose some considerations and amendments, which are to be considered as a contribute to the ERG effort..

However, before answering the specific questions proposed in the public consultation, TI feels it necessary to make some general considerations about the following five "issues":

1. The regulatory framework and the necessity to define cost accounting and Accounting Separation remedies according to AID and USD framework ;
2. Purposes of Accounting Separation and Cost Accounting;
3. Cost Accounting principle;
4. Regulatory aggregates for accounting separation purposes;
5. Differences between LRIC and CCA methodology and section 8 of the Annex of ERG document.

Comments to specific pages of the Draft will also follow.

\* \* \* \* \*

**Issue 1: The regulatory framework and the necessity to define cost accounting and Accounting Separation remedies according to AID and USD framework**

**Comment**

**A) The application of the new Framework to SMP operators**

As a preliminary consideration, we want to put in evidence the following aspects:

1. The general structure of the new framework states- as the main pivot to justify the ex ante regulatory intervention in a telecommunications market- that NRAs have to ascertain – in each of the markets identified as relevant for the application of the new framework - the presence of operators with Significant Market Power.

2. The economic market analysis has to make an assessment of a **specific relevant market** and have not only to assess a situation of dominance but also to understand, with a forward looking perspective, the possible presence - **in that market** - of competition problems, their nature and the level of possible concern. The proportionality principle of the regulatory intervention requested by the new framework implies that the remedies have to be specifically tailored for those competition problems identified in **that** specific relevant market and that they must be proportional and necessary to correct the failure situation **of that specific market**.

3. The ultimate aim “is to reduce ex ante sector specific rules progressively as competition in the market develops” (recital 13 of Access Directive).

The present structure of the opinion expressed by the ERG to review the Commission Recommendation of 1998 on Cost Accounting (CA) and Accounting Separation (AS) should therefore provide deeper insight and guidelines according to the above principles . However we feel that the present structure of the opinion does not provide a clear guidance on the modulation of the regulatory intervention in relation with the nature of the problem identified and with the specificity of **the market to which** the intervention has to be related.

In other words the present structure is apparently oriented to define guidelines for CA and AS to be implemented by a “SMP Operator” (which is a concept no more valid in the new framework) instead of defining guidelines for CA and AS to be implemented by an Operator **with reference to that/those specific market/s where the Operator has been actually notified as having SMP**. The latter approach is the only one coherent with the new framework.

**B) The application of Cost Accounting and Accounting Separation as remedies to specific (different) markets**

The new framework states that:

1. Implementation of a **Cost Accounting** system, applies:

• to pricing issue for a specific interconnection/access service (application of the article 13<sup>1</sup> of the AID -Directive 2002/19/EC);

<sup>1</sup> Article 13 of the AID states: A national regulatory authority may, in accordance with the provisions of Article 8, impose obligations relating to cost recovery and price controls, including obligations for cost orientation of prices and obligations concerning cost accounting systems, for the provision of specific types of interconnection and/or access, in situations where a market analysis indicates that a lack of effective competition means that the operator concerned might sustain prices at an excessively high level, or apply a

• to retail tariffs , where an undertaking is subject to retail tariff regulation or other relevant retail controls (application of the article 17.3 and recital 26 USD (Directive 2002/22/EC);

2. Implementation of **Accounting Separation**, is related **exclusively to interconnection and/or access services** (art. 11 of AID<sup>2</sup>), also to guarantee the application of the non –discrimination principle (Art. 10<sup>3</sup> also in relation with art. 11 of the Access Directive).

## **TI position**

### **1) CA and AS: the Recommendation should therefore better clarify that:**

#### **>Accounting Separation**

According to what explicitly stated by the AID- the implementation of AS:

- a. is a remedy exclusively eligible for **wholesale markets**;
- b. is a remedy to be applied in a proportional way, according to the output of the market analysis.

With reference to point b) above the Recommendation should also give guidelines indicating the options of Accounting Separation that could be chosen in a given market, taking into account the principle of proportionality and the specific market failures to be dealt with.

#### **>Cost Accounting**

Even if Cost Accounting obligation could be in principle eligible both for a wholesale or a retail market, CA obligation, as requested by the USD, requires to perform a test that implies an assessment of the correspondent wholesale market (see Universal service Directive art. 17 and in Recital 26 ) and a decision that the relevant wholesale measures are not sufficient to achieve the objective of ensuring effective competition and public interest.

### **2) Cost Accounting and Price control**

The Recommendation should also clarify that Cost Accounting it is not necessary essential when a “cost orientation” remedy has been imposed. More specifically, the application of remedies that entail cost orientation (Art. 13 of the Access Directive) should be declined in relation with the nature of the market failure, and should take into account the different methods a NRA could adopt in order to guarantee “cost orientation” (e.g. strict cost

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price squeeze, to the detriment of end-users. National regulatory authorities shall take into account the investment made by the operator and allow him a reasonable rate of return on adequate capital employed, taking into account the risks involved

<sup>2</sup> Article 11 of the AID, on Obligation of accounting separation, at paragraph one states: A national regulatory authority may, in accordance with the provisions of Article 8, impose obligations for accounting separation in relation to specified activities related to interconnection and/or access. In particular, a national regulatory authority may require a vertically integrated company to make transparent its wholesale prices and its internal transfer prices inter alia to ensure compliance where there is a requirement for non-discrimination under Article 10 or, where necessary, to prevent unfair cross-subsidy. National regulatory authorities may specify the format and accounting methodology to be used.

<sup>3</sup> Article 10 of the AID on Obligation of non-discrimination, states: A national regulatory authority may, in accordance with the provisions of Article 8, impose obligations of non-discrimination, in relation to interconnection and/or access. Obligations of non-discrimination shall ensure, in particular, that the operator applies equivalent conditions in equivalent circumstances to other undertakings providing equivalent services, and provides services and information to others under the same conditions and of the same quality as it provides for its own services, or those of its subsidiaries or partners.

orientation on a “cost basis”, or Price Cap, or Network Cap, or Retail Minus approach, etc) according to the concrete competitive problem (e.g.: if it is at *access level*, or if it relates to a *wholesale* or *retail* service) and also in relation with the level of maturity of the market..

### 3) Application of art. 5 of Framework Directive

We would like to underline that the application of art. 5 of Framework Directive -that allows NRAs to request information with the objective to identify the proportionate remedy- should not be interpreted as a kind of ex-ante “horizontal remedy” that could be applied to any market without taking into consideration the market analysis outcome, the assessment of market power, the nature of the competitive problem to be addressed and the reasons justifying the specific request for information ( granting that only the necessary measures to correct a market failure situation are applied, avoiding overregulation).

- Therefore any “extension” of the present regulatory framework -clearly defined in AID and USD- should be decided, after careful consideration, only by the NRA; **by no means art. 5 of Framework Directive can be assumed –in the new Recommendation- as a general reference having immediate and direct effect , so allowing for instance an automatic extension of the AS obligations to retail activities.**
- The correct application of the above principle appears also particularly relevant in relation to emerging markets where the market leader “should not be subjected to inappropriate regulation” as stated in the Framework Directive and reiterated in the Recommendation of relevant market

**In conclusion, TI believes the ERG Opinion should be revised in order to align the text with the legal requirement clearly defined in the AID and in the USD in order to avoid uncertainty on the regulatory intervention allowed by a too wide discretionary powers implied in the Opinion and strengthened by the ERG remedy paper approach.**

**Accordingly we support a strong Commission role as provided by art. 19 of the Framework Directive that provide the Commission power to address to Member States Recommendations on the harmonised application of the provisions of the new framework and to require NRAs to inform the Commission on the reasoning applied when the NRAs choose not to follow the Recommendation guidance.**

## Issue 2: Purposes of Accounting Separation and Cost Accounting

### Comment

In the present version of the Recommendation, the goals and purposes of Cost Accounting and Accounting separation are not described in a unique preliminary section and in a systematic way, but are “spread” in the “recitals”, the “text of the articles” and the Annex, with some inconsistencies among them.

Following there are the references existing in present text, regarding the purposes of Cost Accounting and Accounting Separation:

- *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 business as if they had operated as separate businesses, and in the case of that vertically integrated undertakings which provide electronic communications networks, to ensure that they do not discriminate in favour of their own activities. (see Recital 1 and Art 1 of the Recommendation of ERG OPINION PREPARED BY THE IRG WORKING GROUP ON COST ACCOUNTING – 22 March 2004)*
- ***Accounting separation** can also ensure a systematic division of costs between retail and network. (see paragraph B) Accounting Separation, Section 1. Cost accounting and accounting separation of the Annex);*
- *“The purpose of imposing an obligation to implement a **cost accounting** system is to ensure that fair, pro-competitive and transparent criteria are followed by notified operators in allocating their costs to services. Criteria for the preparation of a cost accounting system are illustrated in Section 1a) of the Annex.” (see Recital 1 of the Recommendation of ERG OPINION PREPARED BY THE IRG WORKING GROUP ON COST ACCOUNTING – 22 March 2004)*
- *“A **cost accounting** system is therefore a set of rules to ensure the attribution and allocation of revenues, costs, assets, liabilities and capital employed to individual activities and services, in particular considering direct and indirect operating costs of services as well as past and future expenses. (see paragraph A) Cost Accounting, Section 1. Cost accounting and accounting separation of the Annex);*

Therefore, TI strongly suggests that the definitions and purposes of cost accounting and accounting separation should more clearly be stated or in the Introduction or at the beginning of each section (Section 1 – A for Cost Accounting and Section 1 – B for Accounting Separation) of the Recommendation, and in any case in full compliance with the articles of AID and USD (see **ISSUE 1**, above).

## **TI position**

### **TI proposes the following text:**

*The purpose of imposing an obligation regarding the set up of a Cost Accounting system is to ensure that fair, non discriminatory and transparent criteria are followed by notified operators in allocating their costs to regulated services (relevant markets).*

*The major resulting benefit should be a transparent illustration of the relation between costs and prices of those services whose prices are recommended to be cost oriented.*

*The purpose of imposing an obligation regarding Accounting Separation is to assure for “specified activities related to interconnection and/or access” the observance of transparency and non discrimination requirements, through a level of detail of information higher than that which can be obtained from the statutory financial statements of the notified operator; the goal is to reflect as closely as possible the performance of parts of the business as if they had operated by the undertaking as separate businesses, and- in the case of vertically integrated undertakings which provide electronic communications networks- to ensure that they do not discriminate in favour of their own activities.*

*In order to build up an Accounting Separation a NRA can impose on the notified operator a set of rules on how accounting information (including financial information) should be treated and reported. The transfer charges from one business to another within the organisation for specified activities related to interconnection and/or access can be thus explicitly identified so allowing to enforce non discrimination.*

**Issue 3: Cost Accounting principle**

ERG's point of view is that costs should be attributed to the services according to the "pro-competitive" principle.

**Comment**

Ti agrees upon the fact that cost accounting and accounting separation are very important tools in order to guaranty a competitive contest where a SMP undertaking has been notified.

In order to be effective, Cost Accounting and Accounting Separation should be implemented respecting the principles of transparency, causality and non-discrimination.

However, TI does not agree upon the fact that Ca and AS should be defined in such a way not to be neutral but to be "pro-competitive", i.e. to be implemented in order to give - by definition - advantages to the new entrants;

On the contrary CA and AS should be defined in such a way to contribute to provide the necessary information needed by NRA, according to the principle of proportionality, to promote efficiency and sustainable competition , and maximise consumer benefits;

**TI position**

**The Recommendation should clearly state that:**

*Cost Accounting must be fair, transparent and not discriminatory.*

*Besides, accounting system must follow fair and transparent criteria in allocating costs to services.*

*The most relevant criteria to be followed in allocating costs to the services are:*

- *Causality: costs must be attributed to the services that caused the costs*
- *Objectivity (not discriminatory): costs must be attributed to the services in an objective way, so that not finalised to advantage the notified operator, any other operators, any services consistency*
- *Transparency: costs must be sufficiently disaggregated, allowing the identification of direct, indirect and common costs*

**Issue 4: Regulatory Aggregates for Accounting Separation purposes (see *Access network and Core network* , at page 12 of the annex)**

**Comment**

1. We remember that the Commission Recommendation of **8 April 1998** on interconnection in a liberalised telecommunications market required to disaggregate operating costs, capital employed and revenues into at least four “broad business lines”. In particular, it was requested to define two specific aggregates regarding access network and core network.

**Access network** was mainly aimed to avoid undue subsidies between “Access” and the other aggregates, given the *access deficit* was not fully rebalanced.

**Core network** was mainly aimed to provide the cost basis for RIO.

2. The Directives of the new framework require to make it clear the internal transfer charges of a vertically integrated operator notified in the relevant markets so that the NRA can check compliance with obligation for transparency and non discrimination where applicable (one of /more/all the notified markets).

According to this goal and **taking into account that the relevant markets have been already defined**, we think that the new Recommendation should not automatically adopt the same implementation mechanisms which were defined in the old recommendation of 1998.

More specifically, given that the cost accounting system should guaranty that costs of a specific activity or resource are properly allocated to the services, what is really necessary is to give adequate evidence of the allocation criteria/methodologies to be used for each activities/resources, in such a way that the auditor can check and verify them.

This cost allocation process has to be done for each activity/resource and in order to get the final result is by no mean necessary to use an “intermediate step” aimed at grouping the activities/resources into two different aggregates (i.e. **Access and Core Network aggregates**). In other words what is important is that the process can properly allocate the relevant costs of each activity or resource to each of the relevant wholesale market (e.g. *Wholesale unbundled access (including shared access) to metallic loops and sub-loops for the purpose of providing. broadband and voice services, , call origination, call termination, etc)* .

Even if the above considerations are already properly reflected in the figure 1 page 12 of the annex, we want to put in evidence that they are not reflected in table A1 of page 6 of the annex.

It can be easily checked that **table A1 is in contrast with figure 1 of page 12**.

3. The new regulatory schemes imposes **Accounting Separation obligation** only for wholesale market/services. Therefore, the basic Accounting Separation scheme should be organised in the light of art.11 of the AID- by relevant wholesale markets as defined in the Recommendation of February 2003. Such a scheme should be aimed to give evidence of the economic/financial aspects of the relevant (notified) wholesale markets for which the Accounting Separation remedy will have to be applied.

The obligation to implement a **Cost Accounting** system is mandated both for relevant wholesale and for retail market/services, as defined in the Access and Interconnection and USO Directives. Many of the Cost Accounting principles are common to retail and

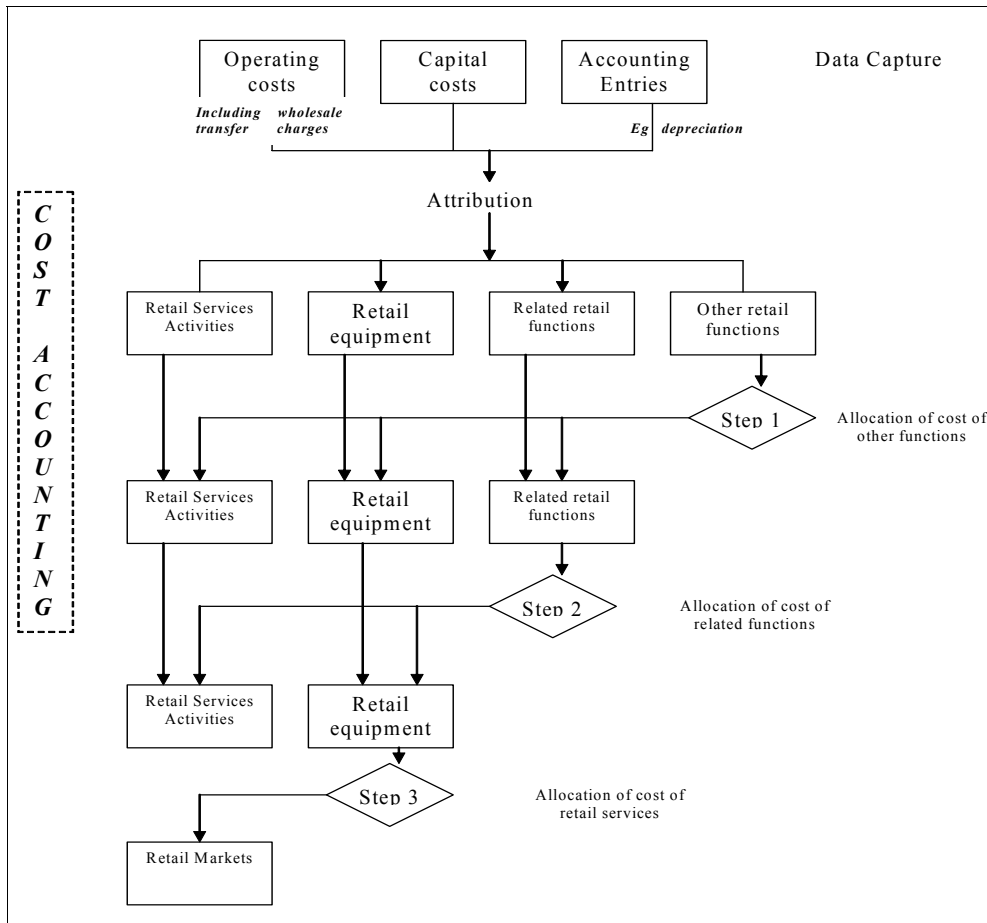
wholesale so that the logic underlying to the wholesale and retail system is basically the same.  
Therefore we propose to split figure 1 of page 12 into two different schemes (one for wholesale markets and the other for retail markets).

**TI position**

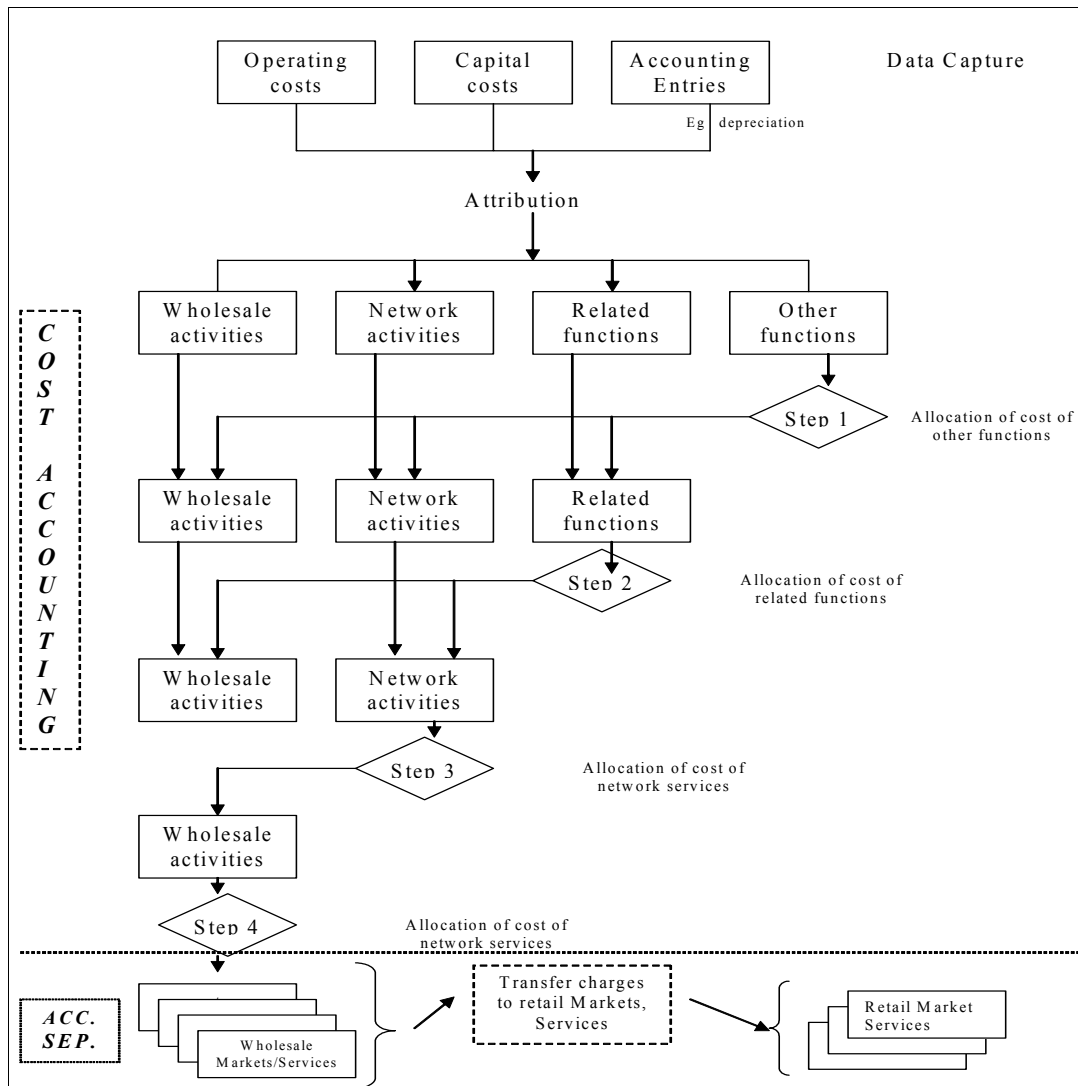
*Ti proposes to add in the recommendation the following specific schemes related to:*

- *Cost Accounting for SMP retail markets*
- *Cost Accounting and Accounting Separation for SMP wholesale market*

**Figure 1 - Stylized illustration of a cost accounting system for retail services/markets**



**Figure 2 - Stylized illustration of Cost Accounting and Accounting Separation for SMP wholesale market**



**Issue 5: Differences between LRIC and CCA methodology and Section 8 of the Annex of ERG Document**

**Comment**

In section 1B of the annex (Accounting Separation) it is written (page 5) that “*if a national regulator decides to impose accounting separation, the following specification shall be defined:*

- ....
- ....
- ....

- *detailed public guidelines for the cost base (HCA, CCA) and cost methodology to use for **cost allocation** (fully distributed cost or FDC; **Long run incremental cost or LRIC**; others)”.*

Ti strongly argues that LRIC can be considered as a cost allocation methodology (alternative to FDC). On the contrary, LRIC is a forward looking **cost basis modelling approach** (which can be used as an alternative to HCA/CCA cost basis)

Additionally, there is a strong difference between HCA/CCA and LRIC

HCA and CCA are “costs basis” extensively used also for **Accounting separation** purposes which can be audited following established and accepted accounting guidelines. It is important to take into account that HCA accounting separation can be really reconciled with the Official Statutory Accounts and that also the results of CCA (if no subjective efficiency factors are introduced) can be reconciled with the Official Statutory Accounts.

On the contrary, LRIC is a *forward looking cost basis only suitable for cost accounting purposes*, because it implies “conceptual” cost models referred to a “virtual efficient network”. Therefore, LRIC outcomes cannot be reconciled with the statutory accounts **and Accounting separation** can not be based on LRIC approaches.

LRIC cost model can be used in assessing efficient prospective costs and for price control purposes. Therefore, while the traditional audit procedures can not be applicable in a LRIC cost modelling, we agree that LRIC implementation requires specific regulatory guidelines approved in advance by the NRAs

**TI position**

TI strongly suggests to introduce in the recommendation the following considerations:

*HCA, CCA and LRIC are cost basis which can be used in “**Cost Accounting**”.*

***Accounting separation** can only be implemented using HCA and CCA; HCA and CCA are cost bases suitable for Accounting separation, because they can be verified by external auditors, and can be reconciled with the Official statutory accounts.*

*Being LRIC a **cost model** based on a forward looking approach, it cannot be reconciled with the statutory accounts and cannot be used in accounting separation.*

*Furthermore, when using CCA the NRAs should clearly define which type of CCA efficiencies should be possibly considered, and should give all the necessary relevant guidelines in order to avoid discussion between the auditors and the SMP operator, in particularly when a MEA approach is used*

*Guidelines on LRIC costing models should be defined in a different document (for instance PIB). However, should the Commission decide to maintain an “LRIC cost modelling” section in this recommendation, then it should be clearly stated that LRIC cannot be used for accounting separation purposes.*

**SPECIFIC COMMENTS OF TELECOM ITALIA**

**References on the ERG draft document:**

**Section:** Proposed changes to Commission Recommendation of 1998 on Accounting separation and cost accounting (text with EEA relevance)

**Page of ERG document:** 1

**Paragraph:** Recital 1

**Original text:**

1) Whereas Article (5) of Framework Directive requires Member States to ensure that undertakings providing electronic communications networks and services provide promptly on request, and to the timescales and level of detail and required, all information to NRAs necessary to ensure conformity with the provisions of, or decisions made in accordance with, the Directives.

Notwithstanding, requests for information should be proportionate and do not impose an undue burden on operators;

**Comments/reasons to change (introduce new) text:**

Art. 5 of FD is generally directed to all the undertakings in the markets and has the purpose to give to the NRA sufficient power to collect data, in order to perform inquiries in the sector, as the case may be.

See also **ISSUE 1- TI position, point 3.**

In case of notified operators, the relevant provision is the art. 11.of AID, which specifically relates the AS obligation to the need to make internal transfer transparent and to comply with the obligations on non discrimination (art. 10) and transparency (art.9). For CAS services the relevant provision is the art. 6 of AID.

**Proposed changes (new wording- introduction of new text):**

1),  
Whereas Article 11 of directive on access and interconnection gives the NRA the authority to impose on the dominant undertaking the obligation of accounting separation in relation to specified activities related to interconnection and/or access; whereas article 6 of the same directive requires the accounting separation for the conditional access systems and without prejudice of art. 5 of Framework Directive;

**Eliminato:** Whereas Article (5) of Framework Directive requires Member States to ensure that undertakings providing electronic communications networks and services provide promptly on request, and to the timescales and level of detail and required, all information to NRAs necessary to ensure conformity with the provisions of, or decisions made in accordance with, the Directives.¶  
Notwithstanding, requests for information should be proportionate and do not impose an undue burden on operators

**Section:** Proposed changes to Commission Recommendation of 1998 on Accounting separation and cost accounting (text with EEA relevance)

**Page of ERG document:** 2

**Paragraph:** Recital 2

**Original text:**

2) Whereas undertakings providing public communications networks and 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;

**Comments/reasons to change (introduce new) text:**

This "Whereas" has not been transposed in a specific article of the draft Recommendation

**Proposed changes (new wording- introduction of new text):**

Introduction of a text. as in the FD Directive

**References on the ERG draft document:**

**Section:** Proposed changes to Commission Recommendation of 1998 on Accounting separation and cost accounting (text with EEA relevance)

**Page of ERG document:** 2

**Paragraph:** Recital 7

**Original text:**

7) Whereas NRAs may impose an obligation for cost orientation for access or interconnection in accordance with Article (13) of the Access Directive; **whereas an appropriate approach is one based on forward-looking long-run average incremental costs, 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; whereas, **when applying an LRIC-based price control to infrastructure where replication is feasible, the NRA may adjust a range of parameters to provide incentives for network competition;**

**Comments/reasons to change (introduce new) text:**

1. The Directives of the new framework do not mention specifically the forward looking long run average incremental cost as “**the**” approach to be used to reflect the costs of a competitive market nor any other costing standard.

This demonstrates that the EU parliament and the Council did not intend to give an unique mandatory standard to be used as a unique reference. The pricing requirements methodologies can therefore be differentiated according to the market they refer to and the competitive situation.

2. “*the NRA may adjust a range of parameters*” Ti strongly argues this statements.

As a matter of fact, The recital 20 of AID directive gives clear directions and guidance about the criteria to be adopted for cost orientation: “Price control may be necessary when market analysis in a particular market reveals inefficient competition...When a national regulatory authority calculates costs incurred in establishing a service mandated under this Directive, it is appropriate to allow a reasonable return on the capital employed including appropriate labour and building costs, with the value of capital adjusted where necessary to reflect the current valuation of assets and efficiency of operations. The method of cost recovery should be appropriate to the circumstances taking account of the need to promote efficiency and sustainable competition and maximise consumer benefits.”

So there is no room for other “adjustments” to foster competition, since they are already included in the main regulation.

3. The statement “*when applying an LRIC-based price control to infrastructure where replication is feasible, the NRA may adjust a range of parameters to provide incentives for network competition*” is not acceptable.

In fact if replication is feasible, there doesn't exist the need to regulate.

If the replication is not feasible there is the need to send correct signals to the marketplace without exogenous interventions: rules (and pricing rules) must be clear in advance. Incentives for network competition must not be automatically translated into the equation “benefits for competitors = disincentives for the incumbent”. This recital seems to call for a

discretionary power of intervention of the NRA in the pricing based on a case by case approach that cannot be accepted.

**Proposed changes (new wording- introduction of new text):**

7) Whereas NRAs may impose an obligation for cost orientation for access or interconnection in accordance with Article (13) of the Access Directive and no mandatory approach has been specified by the new framework; whereas an appropriate approach is one based on forward-looking long-run average incremental costs, 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; whereas, when applying an LRIC-based price control to infrastructure the NRA must apply detailed guidelines and take into account the relevant experiences in the field of cost accounting taking into account the general mandate of the directives in order to create a uniform European framework of reference;

**Eliminato:** whereas, when applying an LRIC-based price control to infrastructure where replication is feasible, the NRA may adjust a range of parameters to provide incentives for network competition;

**References on the ERG draft document:**

**Section:** Proposed changes to Commission Recommendation of 1998 on Accounting separation and cost accounting (text with EEA relevance)

**Page of ERG document:** 3

**Paragraph:** Recital 8

**Original text:**

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 Art 11 of the Access Directive; whereas new accounting systems can be based on activity based costing; whereas the coordinated use of top-down and bottom-up approaches is advised;

**Comments/reasons to change (introduce new) text:**

> Ti agrees that an LRIC methodology should be based on current prices related to a “virtual” efficient network (based on a forward looking approach).

However, this doesn’t imply that LRIC should necessarily be based on the Accounting system based on current cost evaluation of the existing network assets. (backward looking approach) .

In a LRIC approach it is necessary to evaluate the costs of a “virtual” efficient network which could require (compared with the existing network) different topologies, quantities, technologies, asset lives, etc.(e.g.: a SDH technology require a different transmission network topology and different quantities of assets as compared to PDH); in this context what is really necessary is the evaluation of of the “virtual assets” at current prices; this can be obtained by using the current “price list” of the manufacturers or of the external providers, (e.g. on the basis of what is defined by the Purchasing department of the Company)..

Consequently, values derived by the CCA Accounting system and reflecting the costs of the existing network are not relevant , and cannot be applied for an LRIC valuation .

> *Top down* or *bottom up* are two different approaches applicable for an LRIC methodologies. International experiences seem to suggest a *Top down* approach in a context where the constraints on network topology are relevant or in general where the replicability of infrastructure is deemed economically infeasible (this is the case of the copper access network , whose topology is also strongly related to actual customers distribution and other external constraints). In this context the Top down approach grants valuation of current prices which can reflect the specific economic variables (topology, customer dispersion, etc.) of that network. Current prices could be applied to “efficient” asset quantities, with forward looking asset lives. **However in these case international experiences show that is very difficult to get a reconciliation of top down and bottom up approaches.**

Indeed Bottom up approaches seem to be preferred in a network context where is relevant the role of the technology (e.g: transport network , which is also immediately and easily replicable). In this context it is appropriate the use of vendor current prices applied to the virtual assets quantities (quantities x prices). The international experiences show,

for this other network context, the possibility for a coordinate use of top down and bottom up approach.

In summary, TI believes that:

- in general LRIC has to be considered as a forward looking cost basis modelling approach, suitable only for cost accounting purposes and which require specific regulatory guidelines
- LRIC approaches are not to be necessarily based on (current costs) Accounting systems; vendors and manufacturers price list are however necessary.
- the coordinated use of top down and bottom up approach is not always possible;

**Proposed changes (new wording- introduction of new text):**

~~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 Art 11 of the Access Directive; whereas new accounting systems can be based on activity based costing; whereas the coordinated use of top down and bottom up approaches is advised;~~

8) whereas NRAs may specify the format and accounting methodology to be used, in accordance with Art 11 of the Access Directive, for accounting separation purposes; whereas new accounting systems can be based on activity based costing;

**References on the ERG draft document:**

**Section:** Proposed changes to Commission Recommendation of 1998 on Accounting separation and cost accounting (text with EEA relevance)

**Page of ERG document:** 4

**Paragraph:** Recitals

**Original text:**

None

**Comments/reasons to change (introduce new) text:**

See section 1/B – example of accounting separation for the fixed network

**Proposed changes (new wording- introduction of new text)**

Add following recital:

Whereas article 17(4) of directive 2002/22/EC (universal service) requires that the NRA shall ensure the necessary and appropriate cost accounting system where an undertaking is subject to retail tariff regulation or other relevant retail control; whereas such cost accounting systems are similar for retail and wholesale services or markets..

**References on the ERG draft document:**

**Section:** Proposed changes to Commission Recommendation of 1998 on Accounting separation and cost accounting (text with EEA relevance)

**Page of ERG document:** 4

**Paragraph:** Recitals

**Original text:**

None

**Comments/reasons to change (introduce new) text:**

Please note that some recital regarding CAS should be added since the item has been considered below (Annex on page 7 par. C)

**Proposed changes (new wording- introduction of new text):**

Add following recital:

Whereas for the activities specified in annex I of the access and interconnection directive, regarding the conditional access system supplied by Conditional Access System Operators accounting separation is mandated;

**Formattato:** Tipo di carattere: Non Grassetto, Colore carattere: Automatico, Inglese (Gran Bretagna)

**Formattato:** Tipo di carattere: Non Grassetto, Colore carattere: Automatico, Inglese (Gran Bretagna)

**Formattato:** Tipo di carattere: Non Grassetto, Colore carattere: Automatico, Inglese (Gran Bretagna)

**Formattato:** Inglese (Gran Bretagna)

**References on the ERG draft document:**

**Section:** ERG opinion prepared by the IRG working group on cost accounting – 22 march 2004 - Makes the following recommendation:

**Page of ERG document:** 5

**Paragraph:** recommendation 1

**Original text:**

The purpose of imposing an obligation to implement a cost accounting system is to ensure that fair, pro-competitive and transparent criteria are followed by notified operators in allocating their costs to services. Criteria for the preparation of a cost accounting system are illustrated in Section 1a) of the Annex.

**Comments/reasons to change (introduce new) text:**

See Issue 3.

The obligation of Cost Accounting is provided by art 13 of AID and is related to the requirement of cost orientation.

The transparency and pro-competitive criteria are dealt with by art. 9, 10, and subsequently by articles 11 and 12.

The obligation of cost accounting is specific to the provision of art. 13 of AID price control (avoiding excessive prices or price squeeze to the detriment of end users in the frame of price control).

Any other obligation regarding the promotion of competition is a general mandate of the NRA under art. 8 of FD and is not specifically directed to the SMP operator: indeed is an industry requirement to enhance the entire sector of electronic communications.

**Proposed changes (new wording- introduction of new text):**

The purpose of imposing an obligation to implement a cost accounting system is to control prices, avoiding excessive prices or price squeeze to detriment to end users; a cost accounting system of the notified operators must follow fair, non-discriminatory and transparent criteria in allocating their costs to services. Criteria for the preparation of a cost accounting system are illustrated in Section 1a) of the Annex.

Eliminato: ensure that

Eliminato: pro-competitive

Eliminato: are followed by notified operators

**References on the ERG draft document:**

**Section:** ERG opinion prepared by the IRG working group on cost accounting – 22 March 2004 - Makes the following recommendation:

**Page of ERG document:** 7

**Paragraph:** recommendation 5

**Original text:**

It is recommended that NRAs make relevant accounting information from notified operators available on request to interested parties at a sufficient level of detail to ensure that there has been no undue discrimination between the provision of services 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.

In this respect, the publication by the notified operator of sufficiently detailed cost statements showing 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.

**Comments/reasons to change (introduce new) text:**

Accounting information includes highly sensitive information and could therefore not be made available to such a broad audience as “interested parties”. Even though “interested parties” is an imprecise term, at least competitors of the regulated company would qualify as interested parties. Sensitive information such as accounting information should therefore have to be considered accessible only by the Auditor and the NRA; the latter guarantee that the notified operator has properly implemented the cost accounting requirements.

**Proposed changes (new wording- introduction of new text): Art 5**

The publication by the notified operator of sufficiently detailed cost statements showing 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.

**Eliminato:** It is recommended that NRAs make relevant accounting information from notified operators available on request to interested parties at a sufficient level of detail to ensure that there has been no undue discrimination between the provision of services 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.¶ In this respect, the publication by the notified operator of sufficiently detailed cost statements showing 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.¶

**References on the ERG draft document:**

**Section:** ERG opinion prepared by the IRG working group on cost accounting – 22 march 2004 - Makes the following recommendation:

**Page of ERG document:** 7

**Paragraph:** recommendation 5

**Original text:**

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In this respect, the publication by the notified operator of sufficiently detailed cost statements showing 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 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.

**Comments/reasons to change (introduce new) text:**

There is no need to mention the USO financing scheme since it's completely separated from the Accounting Separation and based on different Accounting principles, as the avoidable cost methodology.

If the last paragraph is aimed to assure that **contributions** (revenues) coming from the US Fund will be properly recorded, then it seems not coherent with the framework of USD, which do not request Accounting Separation (and related revenues recording)

If, on the contrary, the last paragraph is willing to address **costing** aspects, then this means that a misunderstanding is arising; in fact:

- net costs related to US obligations (and to be considered for any US Fund) have to be calculated on a "**avoidable cost**" basis (US Directive Annex IV part A) and with reference to **those only services/situations where a net cost arises** (e.g. non profitable geographic areas in the country);
- on the contrary, Accounting separation is based on a FDC methodology (HCA or CCA) and has to include **all actual costs** (not only the avoidable costs), having to be reconciled with the Statutory Accounts. Therefore in a Accounting Separation recommendation is not possible to make recommendations related to different contexts, particularly when referring to avoidable costs approaches applied to part of the country or to specific situations..

We propose therefore to delete the last sentence.

**Proposed changes (new wording- introduction of new text):**

It is recommended that NRAs make relevant accounting information from notified operators available on request to interested parties at a sufficient level of detail to ensure that there has been no undue discrimination between the provision of services 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.

In this respect, the publication by the notified operator of sufficiently detailed cost statements showing 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.

**Eliminato:** In addition, for those Member States that operate schemes to finance Universal Service obligations, it is also recommended 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.¶

**References on the ERG draft document:**

**Section:** ERG opinion prepared by the IRG working group on cost accounting – 22 march 2004 - Makes the following recommendation:

**Page of ERG document:** 7

**Paragraph:** recommendation 7

**Original text:**

This Recommendation will be reviewed on the first occasion not later than three years after the date of application.

**Comments/reasons to change (introduce new) text:**

It seems better not to mention a “first occasion” but for instance a situation of sensible change of the economic situation or an unforeseen market development such as the introduction of a new technology.

**Proposed changes (new wording- introduction of new text):**

This Recommendation will be reviewed as soon as the market and or economic situation will show any such change that appears the references are no longer a fully applicable and in any case not later than three years after the date of application.

**Eliminato:** on the first occasion

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 1

**Paragraph:** A) Cost Accounting

**Original text:**

The purpose of imposing an obligation regarding the set up of a cost accounting system is to ensure that fair, **pro-competitive** and transparent criteria are followed by notified operators in allocating their costs to services.

**Comments/reasons to change (introduce new) text:**

“Pro-competitive” is not a cost accounting criterion.

See introduction – **Issue 3: Cost Accounting principle** and previous remarks on the same area

**Proposed changes (new wording- introduction of new text):**

The purpose of imposing an obligation regarding the set up of a cost accounting system is to ensure that fair, non-discriminatory and transparent criteria are followed by notified operators in allocating their costs to services.

**Eliminato:** pro-competitive

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 1

**Paragraph:** A) Cost Accounting

**Original text:**

A cost accounting system (and therefore we are in the price control domain of art 13) is therefore a set of rules to ensure the attribution and allocation of revenues, costs, assets, liabilities and capital employed to individual activities and services, in particular considering direct and indirect operating costs of services **as well as past and future expenses.**

**Comments/reasons to change (introduce new) text:**

When referring to a set of rules for a cost accounting system, is not clear the meaning of the statement :“as well as past and future expenses” in a context of HCA/CCA; it will be acceptable only in a LRIC context.

**Proposed changes (new wording- introduction of new text):**

A cost accounting system (and therefore we are in the price control domain of art 13) is therefore a set of rules to ensure the attribution and allocation of revenues, costs, assets, liabilities and capital employed to individual activities and services, in particular considering direct and indirect operating costs of services.

**Eliminato:** as well as past and future expenses.

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 1

**Paragraph: A) Cost Accounting**

**Original text:**

More precisely, a cost accounting system will be made of ways to establish a recordkeeping mechanism, keep track of costs and identify operational expenditures such as equipment maintenance. The major resulting benefit should be a transparent illustration of the relation between costs and prices, as the system should be able to break costs down in order to ensure that costs allocated to regulated services do not result in cross subsidies, excessive prices and, in general, that costs are efficiently incurred.

**Comments/reasons to change (introduce new) text:**

1) >Cost accounting rules have to ensure the right and neutral relationship between the infrastructure/resources used by service and related cost; in other words cost accounting has to ensure the pertinent cost allocation.

The cost accounting implementation cannot be given the “burden” of providing evidence of “not excessive prices”; it should be only given the role to allocate costs in a correct and neutral way.. If an excessive prices situation arises with respect to costs, it is not a problem of the costing methodology, but a “price problem”! **While recognizing that excessive prices are to be dealt with, it is important not to confuse between the conceptual step in which “costs” are evaluated (Cost accounting) and the step in which Prices are defined (pricing).**

>The concept of “cost efficiency” should not be used in a HCA/CCA approach, while it can be used in a Lric approach

2) Editorial comment (see **Issue 2**: Purposes of Accounting Separation and Cost Accounting)

All definitions of scope, objective attributed to cost accounting and accounting separation should be written in a specific paragraph rather than spread in the all document in order to ensure that they are coherently and univocally defined. Then, it's suggested to create a specific paragraph about objectives and not to repeat the topic in the rest of the text.

**Proposed changes (new wording- introduction of new text):**

More precisely, a cost accounting system will be made of ways to establish a recordkeeping mechanism, keep track of costs and identify operational expenditures such as equipment maintenance. The major resulting benefit should be the possibility of verify excessive prices and a transparent illustration of the relation between costs and prices, as the system should be able to break costs down in order to ensure that costs allocated to regulated services do not result in cross subsidies.

**Eliminato:** , excessive prices and, in general, that costs are efficiently incurred

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 2

**Paragraph:** A) Cost Accounting – a) Directly attributable costs

**Original text:**

Directly attributable costs are those costs that can be directly and unambiguously related to **a product or service**. Directly attributable costs include the following:

**Comments/reasons to change (introduce new) text:**

We propose to better define the “entities” to which cost can be attributed in a direct way; this could help in avoiding discussions with the auditor

**Proposed changes (new wording- introduction of new text):**

Directly attributable costs are those costs that can be directly and unambiguously related to activities, components, functionalities, products or services. Directly attributable costs include the following:

Eliminato: a

**References on the ERG draft document:**

**Section:** Annex Annex 1 - Cost accounting and accounting separation  
**Page of ERG document:** 2  
**Paragraph:** A) Cost Accounting – c) Unattributable costs

**Original text:**

Unattributable costs are those costs which can only be attributed on **an arbitrary basis**.

**Comments/reasons to change (introduce new) text:**

Even for Unattributable costs the attribution process has to be in any case justified; so, the attribution cannot be made in an “arbitrary” way.

**Proposed changes (new wording- introduction of new text):**

Unattributable costs are those costs only generally referred to “staff departments” (general ledger, personnel, etc.), so that they are caused by “all activities” of company. Those costs can be attributed to the services only using conventional criteria (direct and indirect costs previously attributed to the services) or using other “neutral” driver (for example, revenues of the services).

**Eliminato:** which can

**Eliminato:** be attributed on an arbitrary basis.

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 3

**Paragraph:** A) Cost Accounting – d) Evaluation of capital employed

**Original text:**

The evaluation of capital employed will be done at historical costs (derived from mean book value – see the “cost of capital” section) when using HCA, or at **current costs when using a forward looking approach** (for the latter case, see section 2 of this annex)

**Comments/reasons to change (introduce new) text:**

**The Current Cost Basis does not absolutely imply the adoption of a forward looking approach;** therefore we request to delete the reference to forward looking approach.

**Proposed changes (new wording- introduction of new text):**

The evaluation of capital employed will be done at historical costs (derived from mean book value – see the “cost of capital” section) when using HCA, or at current costs when using a **CCA**.

**Eliminato:** forward looking approach (for the latter case, see section 2 of this annex)

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 3

**Paragraph:** A) Cost Accounting – e) Rules for cost allocation of common/joint costs

**Original text:**

A clear methodology must be used for allocating costs between regulated activities and “other” (non-regulated) activities of the notified operator and to allocate costs to each activity in a proportionate and objective way.

**Comments/reasons to change (introduce new) text:**

>Cost allocation methods are to be independent of the “nature” of the services (regulated or non-regulated).

>Additionally, since there are a number of cost allocation methods (FDC -fully allocated costs, EDC, Floor, Ceiling) , and all these costs methodologies are in principle eligible for application, we suggest to make a clear statement., with reference to the most used cost allocation method (FDC)

**Proposed changes (new wording- introduction of new text):**

In an Accounting separation context the cost methodologies available for cost allocation of common costs is FDC (fully allocated costs). This cost methodology is applicable for HCA and CCA cost base.

**Eliminato:** A clear methodology must be used for allocating costs between regulated activities and “other” (non-regulated) activities of the notified operator and to allocate costs to each activity in a proportionate and objective way.

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 3

**Paragraph:** A) Cost Accounting – e) Rules for cost allocation of common/joint costs

**Original text:**

(iii) When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a cost driver computed by using the ratio of all expenses **directly assigned** or attributed to regulated and non-regulated activities.

**Comments/reasons to change (introduce new) text:**

The majority of PSTN elements are used by a large variety of services and customers (internal/external), as a consequence the amount of cost directly attributable to services, in the TLC businesses, is generally low; however, indirect costs are also present, which can be allocated with proper drivers; as a consequence, common cost can be attributed on the basis of both direct and indirect costs previously allocated to any service.

**Proposed changes (new wording- introduction of new text):**

(iii) When neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated based upon a cost driver computed by using the ratio of all expenses directly **and indirectly** assigned or attributed to regulated and non-regulated activities.

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 3

**Paragraph:** A) Cost Accounting – e) Rules for cost allocation of common/joint costs

**Original text:**

Services included in the definition of universal service shall bear no more than a reasonable, and clearly identified, to avoid double-counting, share of the joint and common costs of facilities used to provide those services.

**Comments/reasons to change (introduce new) text:**

1) Cost accounting for accounting separation is based on HC or CC base and on FDC standard cost.

2) Net cost of universal service is based on a LRIC base and in “avoidable cost standard”.

3) Therefore, costs considered in accounting separation for services included in USO are not comparable at all with the costs used in the USO net cost evaluation.

4) The differences in cost base and in standard cost determine that there is no problem of “joint and common costs”:

>they are not considered in USO net cost evaluation

>they are not “double counted” in cost accounting..

Consequently, there is not risk of double “cost counting” when setting national average tariffs.

**Proposed changes (new wording- introduction of new text):**

Eliminate

**Section:** Annex 1 - Cost accounting and accounting separation  
**Page of ERG document:** 3  
**Paragraph:** A) Cost Accounting – f) Definition of transfer charges

**Original text:**

There should be a clear rationale for the transfer charges used and each charge should be supportable. Charges should be non-discriminatory and there should be transparency of transfer charges in the separate accounts.

The transfer charges for internal usage should be determined as the product of usage and unit charges. The charge for internal usage should be equivalent to the charge that would be levied if the product or service were sold externally rather than internally.

**Comments/reasons to change (introduce new) text:**

Transfer charge is the evaluation of the cost for the use of a resource which is necessary in order to provide:

- a) wholesale services to OLO's (external usage);
- b) final services to the retail customers of the vertically integrated SMP operator (internal usage).

However in the two cases the wholesale and retail services generally require different "production chains", (e.g. a retail traffic service needs an "end-to-end" chain, whereas a wholesale traffic service is based on a "shorter" chain), with a different "mix" of network components or, when using the same network components, different "usage factors".

Furthermore, the provisioning of wholesale services requires specific resource (e.g. billing to OLOs, OLOs customer care, etc.) which are not necessary for internal usage (of course the SMP operator will have to charge and bill its final customers).

Therefore to state that "*the charge for internal usage should be equivalent to the charge that would be levied if the product or service were sold externally rather than internally*" makes little sense; what is really important, in order to guarantee the principle of "non-discrimination" is that the **unit charge of the network components** should be the same both when the component is used for internal usage (retail services) and when the component is used for providing wholesale services sold externally

**Proposed changes (new wording- introduction of new text):**

There should be a clear rationale for the transfer charges used and each charge should be supportable. Charges should be non-discriminatory and there should be transparency of transfer charges in the separate accounts.

The transfer charge for internal usage should be determined as the product of usage and unit charges. The unit charge of a network component (e.g. € cent/minute) should not discriminate between external and internal usage and therefore should be the same both when the component/activity is used for internal usage (retail services) and when the component/activity is used for providing interconnection/access services sold externally; while it is recognized that the usage factors of a network component or of an activity could be different in the two above cases, the Operator should give evidence that differences in the usage factors and inclusion of specific costs do properly reflect, according to the principle of causality, the different provisioning situations.

Specific wholesale commercial costs (eg OLOs billing , OLOs customer care, credit losses, etc) should be properly evaluated in a non discriminatory way, and attributed to the pertinent wholesale services.

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 4

**Paragraph:** A) Cost Accounting – f) Definition of transfer charges

**Original text:**

There shall be consistency of treatment of transfer charges from year to year. Any change should be transparent and satisfactory to the NRA.

**Comments/reasons to change (introduce new) text:**

We suggest that the NRA's approval of any proposed changes is made clear to the operator in time to implement it in the cost accounting system.

**Proposed changes (new wording- introduction of new text):**

There shall be consistency of treatment of transfer charges from year to year. Any change should be transparent and previously approved by the NRA.

Eliminato: satisfactory to

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 5

**Paragraph:** B) Accounting Separation

**Original text:**

- Detailed, public guidelines for the cost base (HCA; CCA) and cost methodology to use for cost allocation (Fully distributed cost or FDC; Long run incremental cost or LRIC; others)

**Comments/reasons to change (introduce new) text:**

Eliminate any LRIC reference (see previous points and Issue 5: Differences between LRIC and CCA methodology and Section 8 of the Annex of ERG Document)

**Proposed changes (new wording- introduction of new text):**

- Detailed, public guidelines for the cost base (HCA; CCA) and cost methodology to use for cost allocation (Fully distributed cost or FDC; )

**Eliminato:** Long run incremental cost or LRIC

**Eliminato:** ; others

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 6

**Paragraph:** B) Accounting Separation – a) Example of accounting separation for the Fixed network

**Original text:**

The Business Units under accounting separation should be at least articulated using “Wholesale”, “Retail” (further articulated over the national relevant markets) and “Other activities”. Wholesale could be separated in “Core” and “Access”

- **Core-Network** (circuit and packet switched infrastructure). The Core-Network covers the provision of interconnection services, transit and conveyance services and carrier’s carrier services.

- **Access-Network** (local loop infrastructure) The Access Network covers the provision of connections to the end users between the end users premises and the core network.5, including leased lines to intermediate users such as other operators.

- **Retail** The Retail business covers the activities mainly related to the commercial provision of electronic communications services, such as fixed telephony and leased lines to end users.

- **Other Activities** covers other activities provided by the notified operator which may include un-regulated activities as well as other type of regulated activities. Accounts for regulated and un-regulated activities need to be kept separate. Such accounts may help to ensure that unfair cross-subsidy between regulated and un-regulated services do not take place, at the expense of competition or to the detriment of market conditions.

**Comments/reasons to change (introduce new) text:**

See **Issue 4: Regulatory Aggregates for Accounting Separation purposes**

**Proposed changes (new wording- introduction of new text):**

The aim of AS is to render visible the internal transfer of a vertically integrated operator notified in the relevant markets so that the NRA can check compliance with obligation for transparency and non discrimination where applicable (one of /more/all the notified markets).

The structure of AS outlined in the recommendation of April 1998 is no more adequate for the purposes of the new regulatory framework

The new scheme of AS should be organised by relevant wholesale markets as defined in the Recommendation of February 2003.

Such a new scheme of AS shall individuate as many regulatory aggregates as relevant (notified) markets for which the AS remedy has to be applied

**Eliminato:** The Business Units under accounting separation should be at least articulated using “Wholesale”, “Retail” further articulated over the national relevant markets) and “Other activities”. Wholesale could be separated in “Core” and “Access” ¶¶

- Core-Network (circuit and packet switched infrastructure). The Core-Network covers the provision of interconnection services, transit and conveyance services and carrier’s carrier services.¶¶

- Access-Network (local loop infrastructure) The Access Network covers the provision of connections to the end users between the end users premises and the core network.5, including leased lines to intermediate users such as other operators.¶¶

- Retail The Retail business covers the activities mainly related to the commercial provision of electronic communications services, such as fixed telephony and leased lines to end users.¶¶

- Other Activities covers other activities provided by the notified operator which may include un-regulated activities as well as other type of regulated activities. Accounts for regulated and un-regulated activities need to be kept separate. Such accounts may help to ensure that unfair cross-subsidy between regulated and un-regulated services do not take place, at the expense of competition or to the detriment of market conditions.¶¶

**References on the ERG draft document:**

**References on the ERG draft document:**

**Section:** Annex 1 - Cost accounting and accounting separation

**Page of ERG document:** 7

**Paragraph:** B) Accounting Separation – d) Average cost of network component

**Original text:**

**SAMPLE STATEMENT OF COSTS OF NETWORK SERVICES (FIXED NETWORK)**

**Comments/reasons to change (introduce new) text:**

The table have to provide the average unit cost per service (retail and wholesale) sold externally and internally. Therefore the column related to “gradient peak and off-peak” should be deleted. These are pricing parameters and not cost parameters: these parameters are not included in a cost accounting system.

**Proposed changes (new wording- introduction of new text):**

The column related to “gradient peak and off-peak” should be deleted.

**References on the ERG draft document:**

**Section:** Annex 2 - Principles for cost causality, drivers definition and attribution methodologies

**Page of ERG document:** 9

**Paragraph:** 2.1 Principles for cost causality

**Original text:**

Identifying different types of costs and attributing these cost to individual services is an essential and complex issue. **It is believed** that allocations should be based on cost causality, objectivity, consistency and transparency.

**Comments/reasons to change (introduce new) text:**

These are fundamental principles to be applied in the allocation process!.

**Proposed changes (new wording- introduction of new text):**

Identifying different types of costs and attributing these cost to individual services is an essential and complex issue. ~~Allocations should be based on cost causality, objectivity, consistency and transparency.~~

**Eliminato:** It is believed that

**References on the ERG draft document:**

**Section:** Annex 2 - Principles for cost causality, drivers definition and attribution methodologies

**Page of ERG document:** 9

**Paragraph:** 2.1 Principles for cost causality

**Original text:**

All allocations may be subject to review by NRAs. To this end, a detailed list of the cost drivers should be delivered to NRA for assessment, in advance of the financial statement preparation.

**Comments/reasons to change (introduce new) text:**

Telecom Italia (and other EU notified operators) has been producing accounting separation and cost accounting since 1998. Both Financial statements and methodologies have been, year by year, audited by independent auditors who have certified the compliance with relevant regulatory rules and accounting standards. Recently AS and CA have been deeply renewed according to a specific provision issued by AGCom (Del. 152/02/CONS).

On this basis TI believes that the NRA's attention should be focused on important changes in the methodology adopted rather than reviewing any single driver or account; that would be time consuming and, moreover, would duplicate the work already done by the auditors.

TI believes that the NRAs and the independent auditors, due to the different roles, should be separate entities: NRAs should concentrate on defining the Cost Accounting principles and methodologies, while, on the other hand, the independent auditor should verify the compliance of the the methodologies adopted by the operators with the NRA's provisions and, moreover, that the financial statements submitted to the NRA's actually are produced according to the declared methodology.

Not taking into account these different roles will produce double efforts and overlapping.

**Proposed changes (new wording- introduction of new text):**

Notified operators should submit in advance to the NRA, for approval, important changes in cost accounting methodologies incurred in one year in comparison to the previous one. Refinements due to the evolution of the organisation and business should not be subject to the NRA control for the sake of efficiency  
In order to ensure that the regulatory accounting is submitted in an appropriate time (such as a few months later than the statutory accounts are approved and published) a deadline for the NRA approval of important methodological changes should be recommended.

**Eliminato:** All allocations may be subject to review by NRAs. To this end, a detailed list of the cost drivers should be delivered to NRA for assessment, in advance of the financial statement preparation

**References on the ERG draft document:**

**Section:** Annex 2 - Principles for cost causality, drivers definition and attribution methodologies

**Page of ERG document:** 10

**Paragraph:** 2.1 Principles for cost causality – Fully distributed cost

**Original text:**

Several approaches can be followed to calculate (indirect) costs:

**Fully distributed cost**

The Fully Distributed Cost (FDC) approach allocates costs that are directly and not directly attributed to services or products according to measures such as activity based costing, samples and surveys, revenues or price-proportional mark-ups.

**Long Run Incremental cost**

The Long run incremental cost (LRIC) approach allocates cost that are directly or indirectly attributed to services or products, often using cost volume relationships.

More information on this approach is provided in Section 8 of this Annex.

**Comments/reasons to change (introduce new) text:**

LRIC is not an allocation method; TI require to eliminate any reference to LRIC for a accounting separation purposes

**Proposed changes (new wording- introduction of new text):**

**Fully distributed cost**

The Fully Distributed Cost (FDC) approach allocates costs that are directly and not directly attributed to services or products according to measures such as activity based costing, samples and surveys, revenues or price-proportional mark-ups.

**Eliminato: Long Run Incremental cost¶**

The Long run incremental cost (LRIC) approach allocates cost that are directly or indirectly attributed to services or products, often using cost volume relationships.¶

More information on this approach is provided in Section 8 of this Annex.¶

**References on the ERG draft document:**

**Section:** Annex 2 - Principles for cost causality, drivers definition and attribution methodologies

**Page of ERG document:** 12

**Paragraph:** 2.3 The Cost allocation process

**Original text:**

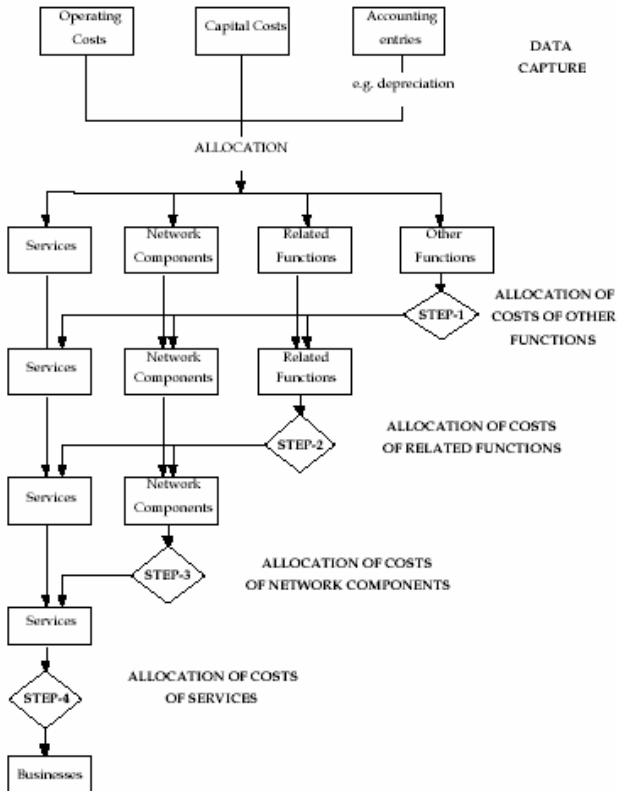


Figure 1 – A typical cost allocation process

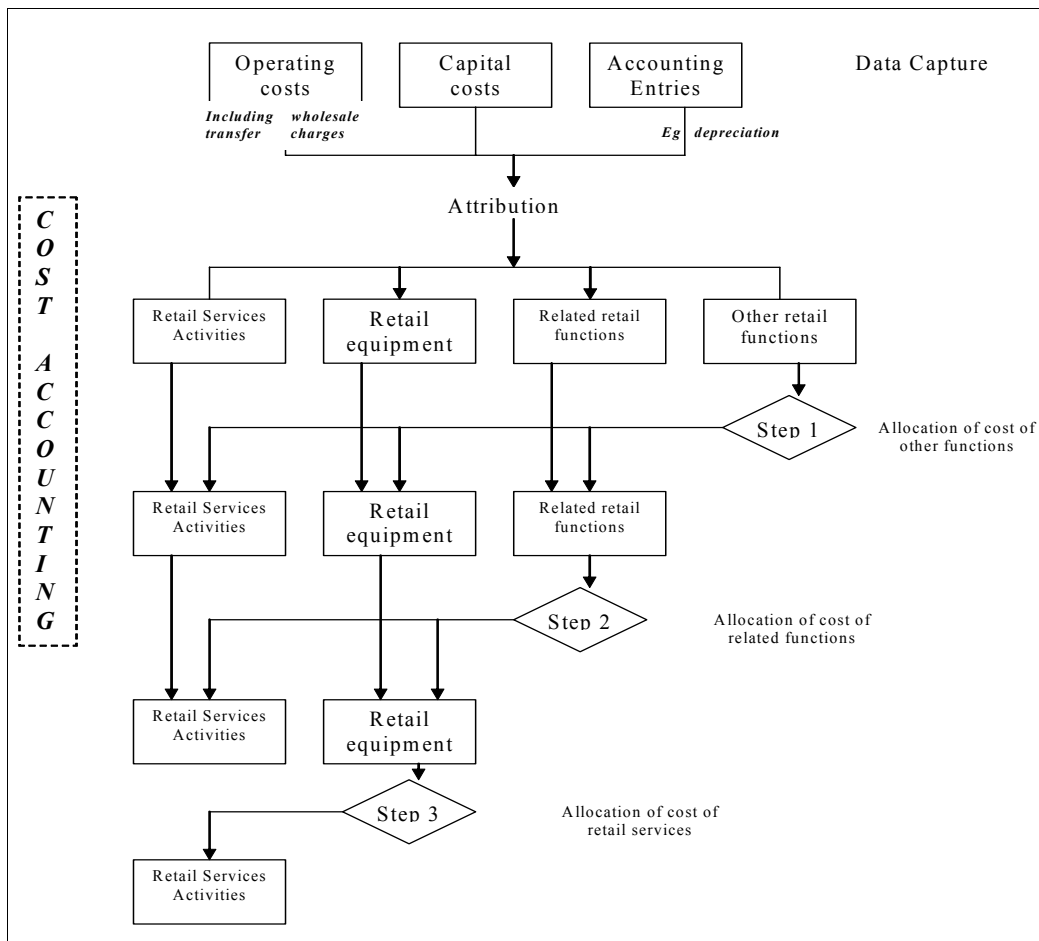
**Comments/reasons to change (introduce new) text:**

See Issue: Regulatory Aggregates for Accounting Separation purposes and See Section 1B – Example of accounting separation for the fixed network

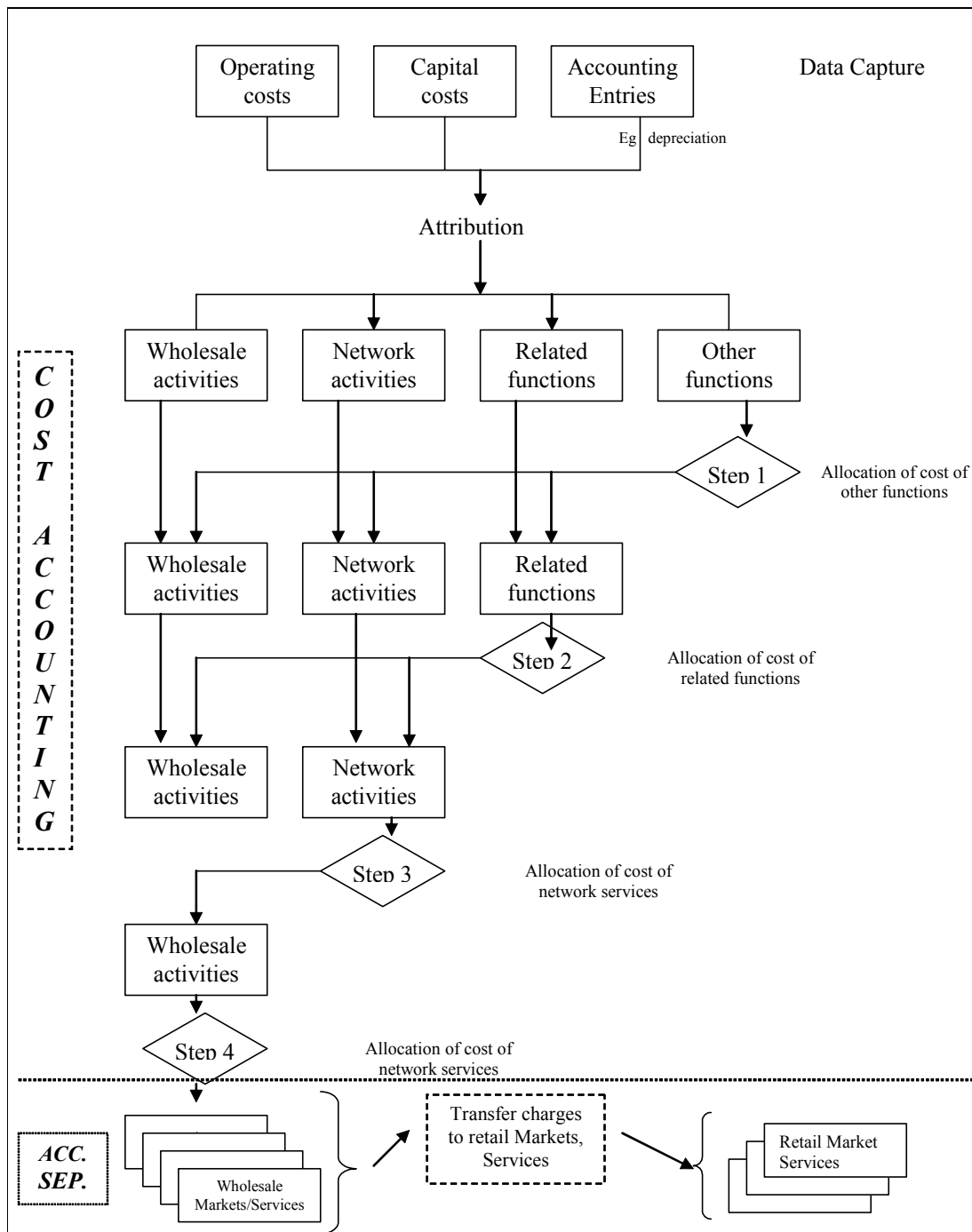
**Proposed changes (new wording- introduction of new text):**

See Figures 1 and 2

**Figure 1 - Stylized illustration of a cost accounting system for retail services/markets**



**Figure 2 - Stylized illustration of Cost Accounting and Accounting Separation for SMP wholesale market**



**References on the ERG draft document:**

**Section:** Annex 2 - Principles for cost causality, drivers definition and attribution methodologies

**Page of ERG document:** 12

**Paragraph:** 2.3 The Cost allocation process

**Original text:**

The attribution methodologies should be comprehensively documented so as to be transparent to NRAs. A description of attribution methodologies should also be published by the notified operator.

**Comments/reasons to change (introduce new) text:**

>It has to be considered that regulatory accounting system of national TLC operators are extremely complex systems. The regulatory accounting process would benefit from a clear –ex ante- definition of costing methodologies to be applied. That will ensure that the notified operator can adequately define the granularity and the structure of its regulatory accounting system –data capture (financial, quantitative, operational), software development, activities and cost pools structure, primary costs allocation drivers, attribution drivers, etc - in time for the financial statements provision. Costing methodologies, particularly in the TLC sector, are quite complicated and a previous agreement on them can avoid misunderstandings and future arguments.

Attribution methodologies, instead, depend on the agreed methodology and represent the (mere) detailed application of it. In TI's opinion costing methodologies could usefully be shared and approved by the NRA before the regulatory accounting is prepared; this will ensure that the subsequent steps are implemented coherently and in time.

The verification of detailed attribution methods –including their compliance with the approved costing methodologies- should instead finally be submitted to the independent auditor.

>It is important that clear deadlines are defined for the approval by the NRA.

**Proposed changes (new wording- introduction of new text):**

The costing methodologies have to be approved by NRAs, before the financial statement preparation, and provided to the external auditor for the accounting separation and cost accounting audit. It is recommended that the NRA approval is subject to a deadline in order to guarantee an adequate timing to the regulatory accounting process. ~~Costing methodologies modifications by NRAs are not acceptable after the financial statement audit.~~

**Eliminato:** The attribution methodologies should be comprehensively documented so as to be transparent to NRAs. A description of attribution methodologies should also be published by the notified operator.

**References on the ERG draft document:**

**Section:** Annex 2 - Principles for cost causality, drivers definition and attribution methodologies

**Page of ERG document:** 14

**Paragraph:** 2.4 Operating cost

**Original text:**

The final column of the tables provides an indication **of the principal business** to which it might be expected that the majority of the operating costs in question would be allocated.

**Comments/reasons to change (introduce new) text:**

The principal business have to strictly related to the services provided by operator in the relevant markets

**Proposed changes (new wording- introduction of new text):**

The final column of the tables provides an indication of the relevant markets to which it might be expected that the majority of the operating costs in question would be allocated.

**Eliminato:** of the principal business

**References on the ERG draft document:**

**Section:** Annex 2 - Principles for cost causality, drivers definition and attribution methodologies

**Page of ERG document:** 16 - 24

**Paragraph:** 2.4 Operating cost and 2.5 Capital employed

**Original text:**

Table 2.3. Methods of allocating operating costs

Table 2.4 Methods of allocating capital employed for the fixed network (example for the mobile network could be developed as well)

**Comments/reasons to change (introduce new) text:**

There are two main reasons to update such those tables:

Firstly, in order to consider wholesale markets specific costs, TI believes it is necessary to clearly include also some specific wholesale activities and costs, like commercial costs (OLOs billing, OLOs customer care, bad debts,...);

Secondly, in order to consider new "objects" of accounting separation and cost accounting (wholesale markets ; retail markets) as it is explained previously (**See Issue 4: Regulatory Aggregates for Accounting Separation purposes**)

**Proposed changes (new wording- introduction of new text):**

(see below , tables 2.3 and 2.4)

Table 2.3. Methods of allocating operating costs <sup>4</sup>

<b>Category of Operating cost</b>	<b>Description</b>	<b>Possible Method of Allocation</b>	<b>Markets</b>
Depreciation	Depreciation	The allocation of depreciation should follow the allocation of the fixed assets to which it relates (see Section 5)	<b>Wholesale markets</b>
Provision and installation of equipment	Payroll costs	Direct to network components/ <del>other plant</del> <b>activities</b> where possible; otherwise allocate based on the time spent carrying out installation work.	<b>Wholesale markets</b>
	Installation, contract and maintenance costs	Direct to network components/ <del>other plant</del> <b>activities</b> on the basis of the plant installed or maintained where possible.	<b>Wholesale markets</b>
Maintenance and repair costs	Payroll costs	Direct to network components/ <del>other plant</del> <b>activities</b> where possible; otherwise allocated based on the time spent carrying out installation work	<b>Wholesale markets</b>
	Other costs	Direct to network components/ <del>other plant</del> <b>activities</b> where possible	<b>Wholesale markets</b>
Network planning and developments costs	Payroll and external costs	Direct to network components/ <del>other plant</del> <b>activities</b> where possible	<b>Wholesale markets</b>
Network management costs	Payroll costs	Allocate to network components/ <del>other plant</del> <b>activities</b> on the basis of the time spent by staff to manage each type of plant , <b>where possible</b>	<b>Wholesale markets</b>
	Other costs	Allocate to network components/ <del>other plant</del> <b>activities</b> on the basis of the plant managed where possible.	<b>Wholesale markets</b>

<sup>4</sup> Residual unattributable costs should be identified by operations and their treatment considered separately by NRAs.

Marketing and sales costs	Payroll	Direct to products and services where possible; otherwise allocate between products based <del>on labour time</del> <b>on a reasonable basis (e.g labour time or other driver)</b>	<b>Retail markets</b>
	Cost of sales of equipment	Allocate to customer equipment services within “Other activities”.	<b>Retail markets</b>
	Publicity Promotions Market research Distribution fees Other costs	Direct to products and services where possible. Otherwise, for those costs where multiple services are being marketed or promoted, cost should be attributed to the related services on a reasonable basis	<b>Retail markets</b>
<b>Retail</b> Billing and collection costs	Payroll costs	Direct to <b>retail</b> products and services where possible; otherwise allocate between products based <del>on labour time</del> <b>on a reasonable basis (e.g labour time or other driver)</b>	<b>Retail markets</b>
	Other billing costs (incl. Bad debts <b>and receivables</b> )	Direct to <b>retail</b> products and services where possible; other wise allocate between products based on usage (e.g. number of bills produced) <b>or on a reasonable basis</b>	<b>Retail markets</b>
<b>Wholesale</b> Billing and collection costs	Payroll costs	Direct to <b>wholesale</b> products and services where possible; otherwise allocate between products based <del>on labour time</del> <b>on a reasonable basis</b>	<b>Wholesale markets</b>
	Other billing costs (incl. Bad debts <b>and receivables</b> )	Direct to <b>wholesale</b> products and services where possible; other wise allocate between products based on usage (e.g. number of bills produced) <b>or on a reasonable basis</b>	<b>Wholesale markets</b>
Operator services costs	Payroll costs	Direct to services where possible. The costs of staff that carry out tasks for several operator services should be allocated to the related operator services based on time spent on different tasks	<b>Retail markets</b>
Directory services costs	Payroll and others costs	Direct to products and services	<b>Retail markets</b>
Payments to other operators	Out-payments for outgoing International traffic		<b>Retail markets</b>

Support costs	Payments for interconnections agreements	Direct to products and services	<b>Retail markets</b>
	Human resources function costs	Direct to products and services	<b>All</b>
	Finance and other head office support functions	HR function costs should be allocated to the staff that are overseen by the HR function and allocated using the same basis as the payroll costs of HR staff, <b>where possible. Otherwise on a reasonable basis</b>	<b>All</b>
	Building costs and rent	If related specifically to a product, service or business allocate accordingly, <b>where possible. Otherwise on a reasonable basis</b>	<b>All</b>
	General computing/IT costs	Costs should be allocated in the same way as land and building (see Section 5), <b>where possible. Otherwise on a reasonable basis</b>  Allocate to the applications run by the operator on the basis of the use of the computers to support each application. Costs allocated to applications can then be attributed to those products and services that they support, <b>where possible. Otherwise on a reasonable basis</b>	<b>All</b>

Table 2.4 Methods of allocating capital employed for the fixed network (example for the mobile network could be developed as well)

Category of Operating cost	Description	Possible Method of Allocation	Markets
Tangible assets Primary Plant- Switching equipment	Local switching equipment  Tandem switching equipment  International switching equipment  Switching equipment for special services networks  Other switching equipment	Direct to <del>access or</del> network components, where possible. Otherwise allocate to <del>Local Access Network services and</del> to network components on the basis of the relevant cost of the equipment dedicated to provide customer lines and of the parts dedicated to switch traffic, respectively. <del>Local switch network components can be allocated to products and services based on seconds of use.</del>  Direct to network components where possible, otherwise allocate based on <del>seconds of use</del> a reasonable basis  Direct to network components where possible, otherwise allocate based on <del>the seconds of use</del> a reasonable basis  Direct to <del>core</del> network components where appropriate/required by regulation or to the specific services provided by other networks-e.g. data transmission switching equipment should be allocated directly to data transmission services.  Direct to network services where possible, otherwise allocate to other switching network components on <del>the basis of the use of the equipment</del> a reasonable basis	<b>Wholesale markets</b>  <b>Wholesale markets</b>  <b>Wholesale markets</b>  <b>Wholesale markets</b>  <b>Wholesale markets</b>
Transmission equipment	Traffic-sensitive	Direct to network components where possible, otherwise allocate	<b>Wholesale</b>

Other primary network assets	transmission equipment	based on the usage of circuits	<b>markets</b>
	Cable and wire	Direct to access or network components where possible, otherwise allocate to components based on the amount of cable used to provide different services <b>a reasonable basis</b>	<b>Wholesale markets</b>
	Local loop equipment	Direct to products where possible (e.g. separately identifiable ISDN access equipment), otherwise allocate between access services based on line usage	<b>Wholesale markets</b>
	Radio and satellite equipment	Direct to network components where possible, otherwise allocate based on the usage of channels.	<b>Wholesale markets</b>
	Transmission equipment for special services networks	Direct to the specific non-PSTN/non-ISDN services provided by the network – e.g. data transmission equipment directly allocated to data transmission services	<b>Wholesale markets</b>
	Internation/submarine cable	Direct to network components where possible, otherwise allocate based on usage <b>a reasonable basis</b>	<b>Wholesale markets</b>
	Special network plant	Plant and equipment that is used solely to provide one specific service should be allocated directly to the relevant services. Examples may include: <ul style="list-style-type: none"> <li>- Intelligent networks equipment</li> <li>- Data transmission equipment;</li> <li>- Multimedia equipment</li> </ul>	<b>Wholesale markets</b>
	Customer premises equipment	Direct to products and services	<b>Retail markets</b>
Public payphones and related equipment	Direct to service	<b>Retail markets</b>	

Support Plant	Ducting	Ducting can be allocated to the cable and wire that it supports and allocated to products in the same way as cable and wire , <b>where possible. Otherwise on a reasonable basis</b>	<b>Wholesale markets</b>
	Power equipment	Allocate to primary plant groups on the basis of the use of power equipment to support each plant – e.g. kilowatts per hour. Assets should be allocated to products in the same way as the relevant primary plant groups	<b>Wholesale markets</b>
	Network management systems	Allocate to primary plant of the different networks provided on the basis of the use of the systems to support each plant – e.g. time spent to control local exchanges, tandem exchanges and international exchanges , <b>where possible. Otherwise on a reasonable basis</b> Costs should be attributed to products and services in the same way as the related primary plant group.	<b>Wholesale markets</b>
<del>Non-network</del> <b>Other</b> fixed assets	Land and buildings	Allocate to products, services and network components on the basis of the space occupied (i.e. floor space) to support each product, service or network component, <b>where possible. Otherwise on a reasonable basis.</b>	<b>All</b>
	General computers	Allocate to the applications run by the operator on the basis of the use of the computers to support each application, <b>where possible. Otherwise on a reasonable basis.</b> Costs allocated to applications can then be attributed to those products and services that they support	<b>All</b>
	Motor vehicles	Allocate to the products and network components based on usage <b>where possible. Otherwise on a reasonable basis.</b>	<b>All</b>
	Furniture and office equipment	Allocate to the products and network components based on usage <b>where possible. Otherwise on a reasonable basis.</b>	<b>All</b>

Intangible fixed assets	Intangible fixed assets	Direct to products where possible <b>or to network components</b> . Any residual or unattributable assets will need to be allocated on an arbitrary basis <del>to be agreed with the NRA</del>	<b>All</b>
Working capital	Fixed asset investments	Direct to <del>“Other activities”</del> <b>retail markets</b>	<b>Retail markets</b>
	Pure financial investments	Direct to <del>“Other activities”</del> <b>retail markets</b>	<b>Retail markets</b>
	Investments in unrelated activities; <b>other investments in external network business unit</b>	Direct to the services to which the investments are related, <b>or network component (e.g (estate company, power equipment company))</b> . Otherwise allocate based on usage	<b>All</b>
	Short-term investments (including cash at bank and in hand)	Direct to business where possible, otherwise allocate based on the operational requirements of each business	<b>All</b>
	Stocks	Stocks should be allocated directly to products and services	<b>All</b>
	Trade debtors/receivables	Trade debtors may be allocated to products and services based on billing system information where possible. Unattributable balances will need to be allocated on an arbitrary basis, <del>to be agreed with the NRA</del>	<b>All</b>
	Other debtors/receivables	Other debtors/receivables should be apportioned to products and services if possible. Unattributable balances will need to be allocated on an arbitrary basis, <del>to be agreed with the NRA</del>	<b>All</b>
	Trade creditors	Trade creditors should be allocated directly to products and services if possible. Unattributable trade creditors will need to be allocated on an arbitrary basis, <del>to be agreed with the NRA</del>	<b>All</b>

	Long term provisions	Direct to the activities that give rise to the provisions in question	<b>All</b>
	Liabilities for taxation and dividends	No allocation required. Instead average liabilities should be taken into account when considering the operational cash requirements of each (see “Short-term investments”)	<b>All</b>

**References on the ERG draft document:**

**Section:** Annex 3 - Current cost Accounting: guidelines for implementation

**Page of ERG document:** 25

**Paragraph:** Introduction

**Original text:**

“One study prepared for the Commission stated that “To a new entrant operator about to build a network, current costs will generally equate to costs of new equipment. On the other hand, to an incumbent operator current costs may need to be measured with reference to a modern equivalent asset (MEA) with the same, or similar, service potential. This will usually be measured by adjusting the cost of a modern asset for functionality, capacity and so on to give the adjusted replacement cost.

The MEA asset valuation of an incumbent operator may, therefore, differ from the replacement cost valuation of a new entrant – even though both are attempting to measure current costs. This is likely to be important when trying to reconcile the results of any bottom-up model with the results on an incumbent operator.<sup>8</sup>”

The key aspect of current cost methodology is that it requires firms to update the value of assets to reflect their current value (in a process that according to the methodology in use may explicitly take into account inflation and other factors, or not).

However, it must be noted that several factors contribute to the differences in cost changes across assets. The unit costs of real estate, cable, electronic equipment such as switches and routers, capital and other major inputs can escalate at rates that diverge greatly from the overall rate of inflation, depending, among other things, on the rates of economic growth and unemployment, the business cycle and the availability of funds in international capital markets and the rate of technological progress in electronic equipment.

For practical purposes (consistency, transparency and comparability) though, only some factors can be taken into account in the various application of the current cost methodology. It is important that the NRA in charge of its application renders transparent and explicit the factors employed in its CCA valuations and cost modelling and that the parameters and the factors used are illustrated and submitted to public consultation before adopting the methodology.

As stated several times in the text, the use of current cost evaluation is intended to replicate the approach of a competitor in a market, which, willing to contend shares or profits in that market, has to offer services at a price that allows him to recover current costs.

In the absence of regulation, while certain goods are valued at current costs by definition (i.e. labour), some other goods can be valued paid at current costs if they are purchased on the market (i.e. new equipment) or at historical costs (if they are used by the notified operator for instance).

When access and interconnection are regulated, if current cost is used to re-evaluate the network assets of the notified operator, then these assets will be offered to the new

entrants in a modality which more closely resembles the situation in a competitive market. While it is up to each NRA to decide which obligations shall be imposed on the operators, if a decision is taken regarding current cost methodology then it is important that such a decision is consistent, albeit not identical, across the single European market. To this end some guidelines are hereby provided for application.”

8 Study on the preparation of an adaptable bottom-up costing model for interconnection and access pricing in European Union Countries – A final report For Information Society Directorate-General of the European Commission by Europe Economics, April 2000.

#### Comments/reasons to change (introduce new) text:

In this paragraph, the reference to the study prepared for the commission can cause a misunderstanding.

**That study referred to a long run incremental costs model** of interconnection services for EU Member States, and it emphasized the effects of different network models on accounting results. Moreover, it stressed that the application of the same methodology (i.e. CCA methodology, which is recommended in the commission recommendation of 8 January 1998 in order to analyse interconnection costs) to different network models could provide different results.

**In conclusion, the study is not related to CCA, therefore it is suggested to cancel the reference.**

#### Proposed changes (new wording- introduction of new text):

The key aspect of current cost methodology is that it requires firms to update the value of assets to reflect their current value (in a process that according to the methodology in use may explicitly take into account inflation and other factors, or not).

However, it must be noted that several factors contribute to the differences in cost changes across assets. The unit costs of real estate, cable, electronic equipment such as switches and routers, capital and other major inputs can escalate at rates that diverge greatly from the overall rate of inflation, depending, among other things, on the rates of economic growth and unemployment, the business cycle and the availability of funds in international capital markets and the rate of technological progress in electronic equipment.

For practical purposes (consistency, transparency and comparability) though, only some factors can be taken into account in the various application of the current cost methodology. It is important that the NRA in charge of its application renders transparent and explicit the factors employed in its CCA valuations and cost modelling and that the parameters and the factors used are illustrated and submitted to public consultation before adopting the methodology.

In the absence of regulation, while certain goods are valued at current costs by definition (i.e. labour), some other goods can be valued paid at current costs if they are purchased on the market (i.e. new equipment) or at historical costs (if they are used by the notified operator for instance).

**Eliminato:** One study prepared for the Commission stated that “To a new entrant operator about to build a network, current costs will generally equate to costs of new equipment. On the other hand, to an incumbent operator current costs may need to be measured with reference to a modern equivalent asset (MEA) with the same, or similar, service potential. This will usually be measured by adjusting the cost of a modern asset for functionality, capacity and so on to give the adjusted replacement cost.”

The MEA asset valuation of an incumbent operator may, therefore, differ from the replacement cost valuation of a new entrant – even though both are attempting to measure current costs. This is likely to be important when trying to reconcile the results of any bottom-up model with the results on an incumbent operator.<sup>54</sup>

**Eliminato:** As stated several times in the text, the use of current cost evaluation is intended to replicate the approach of a competitor in a market, which, willing to contend shares or profits in that market, has to offer services at a price that allows him to recover current costs.<sup>55</sup>

When access and interconnection are regulated, if current cost is used to re-evaluate the network assets of the notified operator, then these assets will be offered to the new entrants in a modality which more closely resembles the situation in a competitive market. While it is up to each NRA to decide which obligations shall be imposed on the operators, if a decision is taken regarding current cost methodology then it is important that such a decision is consistent, albeit not identical, across the single European market. To this end some guidelines are hereby provided for application.”

8 Study on the preparation of an adaptable bottom-up costing model for interconnection and access pricing in European Union Countries – A final report For Information Society Directorate-General of the European Commission by Europe Economics, April 2000.

**References on the ERG draft document:**

**Section:** Annex 3 - Current cost Accounting: guidelines for implementation

**Page of ERG document:** 27

**Paragraph:** 3.1 Calculation of current cost asset values – Economic value

**Original text:**

Economic value ('EV') is a measure of the value of an asset based on the net present value of future cash flows.

**Comments/reasons to change (introduce new) text:**

The economic value reflects the value of a quoted company, verified every year by an independent auditor who states that the statutory financial statements, taken as a whole, may be relied upon.

The independent auditor will have to examine all the evidences supporting the amounts and the disclosures on financial statements, as well to assess the appropriateness of the accounting principles applied and the reasonableness of the estimates made by the management. The auditor will also take into account the *code of ethics* recommended by the Professional Accountants Association such as the 16th accounting principle.

According to this accounting principle, fixed assets are written down when there is a permanent impairment to below their net book value, till the underlying assumptions are no longer correct. The accounting principle stresses also that assets' devaluation must be supported and motivated adequately by the company.

**Thus, this accounting principle aligns historical cost value with the current cost value.**

Formattato: Tipo di carattere:Grassetto

The accounting principle also states that fixed assets include only inflation adjustments made on the basis of the law, and can not include other kind of adjustments until they are effectively carried out.

**As a consequence, Historical Cost Accounting can not provide higher results than the Current Cost one.**

Formattato: Tipo di carattere:Grassetto

**Proposed changes (new wording- introduction of new text):**

Economic value ('EV') is a measure of the value of an asset based on the net present value of future cash flows. Moreover, the economic value will also reflect the value of the quoted company as it is in its present operating conditions.

**References on the ERG draft document:**

**Section:** Annex 3 - Current cost Accounting: guidelines for implementation

**Page of ERG document:** 27

**Paragraph:** 3.2 Modern Equivalent asset valuation

**Original text:**

The new technologies are usually far superior to the old technologies in terms of functionality and efficiency. However, since MEA values are required to reflect assets of equivalent capacity and **functionality**, it is necessary to make adjustments to the current purchase price and also the related operating costs - for example, the **new asset may require less maintenance, less energy and may need less space.**

**Comments/reasons to change (introduce new) text:**

New technologies can be far superior in terms of functionality and efficiency than the old ones due to **new or different network architectures** (i.e. a new technology may need a total re-engineering of the network, using also other assets).

However the Current cost accounting is an accounting methodology, so it cannot be required to accommodate also for technical modifications of the existing network.

Network re-engineering can be applied only in a LRIC approach. Extensively applying network re-engineering concepts to a CCA approach would create relevant problems to the audit activities.

Therefore, MEA values are better required to reflect assets of equivalent capacity and functionality related to the **existing network**.

A reasonable solution is the following:

given the existing network, differences between the operating costs of the asset and the ones of the MEA should be considered only if significant. Operators should adjust their costs only if the difference does exist and is higher than 10% of the annual costs of each category.

**Proposed changes (new wording- introduction of new text):**

The new technologies are usually far superior to the old technologies in terms of functionality and efficiency. However, since MEA values are required to reflect assets of equivalent capacity and functionality related to the existing network, it is necessary to make adjustments to the current purchase price and also the related operating costs - for example, the new asset may require less maintenance, less energy and may need less space - when the difference between the operating costs of the asset and the ones of the MEA is significant and higher than 10% of the annual costs of each category.

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page of ERG document:** 33

**Paragraph:** 4.1 Cost of Capital

**Original text:**

The Capital Asset Pricing Model, when adopted<sup>(9)</sup>, provides the formula for the cost of equity  $R_E$ .

**Comments/reasons to change (introduce new) text:**

The CAPM model is largely used and considered to be the best practice for the purpose of estimating Cost of Equity. We suggest that only CAPM model should be recommended in order to ensure homogeneity across the European Union.

The adoption of models other than CAPM should be avoided for undertakings listed in the stock market and carefully assessed for those which are not. The BETA factor of undertakings non listed in the stock market could be estimated via benchmark of listed similar ones in the same market.

**Proposed changes (new wording- introduction of new text):**

The Capital Asset Pricing Model provides the formula for the cost of equity  $R_E$ .

Eliminato: , when adopted (9),

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page of ERG document:** 34

**Paragraph:** 4.1 Cost of Capital - Equity/Debt ratio

**Original text:**

Equity/Debt ratio: it can be calculated using the current ratio or an **optimal** ratio, provided that they reflect reasonable consistency in the period of time considered for the analysis.

**Comments/reasons to change (introduce new) text:**

We suggest the substitution of the term “optimal” with “target”. The reason is that the definition of an optimal capital structure would be arbitrary both from a theoretical and practical point of view (different theories, application to the undertaking uncertain). Otherwise, especially for big, listed companies, the calculation of the target capital structure is quite straightforward, it can be derived from public announcements to the financial community.

**Proposed changes (new wording- introduction of new text):**

Equity/Debt ratio: it can be calculated using the current ratio or an **target** ratio, provided that they reflect reasonable consistency in the period of time considered for the analysis.

Eliminato: optimal

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page of ERG document:** 34

**Paragraph:** 4.1 Cost of Capital - Debt

**Original text:**

Debt: Gross debt (or debt less cash if the unlevered Beta of comparable companies is then used), it can be calculated using economic (market) values **or book values**

**Comments/reasons to change (introduce new) text:**

As underlined above, best practice suggests making reference to **market values** rather than book values.

Moreover, Net Debt should be considered rather than Gross Debt, since the capital structure of an operator should take into account the actual financing needs of the company.

**Proposed changes (new wording- introduction of new text):**

Debt: Gross debt (or debt less cash if the unlevered Beta of comparable companies is then used), it can be calculated using economic (market) values \_\_\_\_\_

**Eliminato:** or book values

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page of ERG document:** 34

**Paragraph:** 4.1 Cost of Capital - Equity/Debt ratio

**Original text:**

Equity/Debt ratio: it can be calculated using the current ratio or an **optimal** ratio, provided that they reflect reasonable consistency in the period of time considered for the analysis.

**Comments/reasons to change (introduce new) text:**

We suggest the substitution of the term “optimal” with “target”.

The reason is that the definition of an optimal capital structure would be arbitrary both from a theoretical and practical point of view (different theories, application to the undertaking uncertain).

Otherwise, especially for big, listed companies, the calculation of the target capital structure is quite straightforward, it can be derived from public announcements to the financial community.

**Proposed changes (new wording- introduction of new text):**

Equity/Debt ratio: it can be calculated using the current ratio or a target ratio, provided that they reflect reasonable consistency in the period of time considered for the analysis.

**Eliminato:** optimal

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page of ERG document:** 34

**Paragraph:** 4.1 Cost of Capital - Cost of debt

**Original text:**

Cost of debt: it should result from a weighted average of the various costs of debt outstanding, or, alternatively, from the sum of risk free activities and a default spread based on long term credit rating

**Comments/reasons to change (introduce new) text:**

The average costs of debt outstanding is a good proxy of the actual cost of debt of a company only in the case of a steady credit worthiness. The appropriate cost of debt should be the marginal one and not the one that rewards "old" debt. Only the marginal cost, in fact, shows the actual risk of the marginal investor, as estimated by the market. This is the risk the company should bear under the assumption of complete re-financing of its own debt, at market conditions and considering its own financial risk profile.

Therefore the second approach (Risk Free + Spread) should be preferred for the estimate of the cost of debt, with the use of average or median values for both Risk Free rate and Spread.

**Proposed changes (new wording- introduction of new text):**

Cost of debt: it should result from the sum of risk free activities and a default spread based on credit rating.

**Eliminato:** a weighted average of the various costs of debt outstanding, or, alternatively, from

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page of ERG document:** 34

**Paragraph:** 4.1 Cost of Capital - Equity risk premium

**Original text:**

Equity risk premium: the premium (i.e. the premium that the marginal investor expects for choosing to invest in equity and not in risk free investments) is in principle a forward-looking measure of investor expectations, but can be derived from historic actual differences between stocks and bonds using the relevant stock market of the company as a reference. The use of long historical series is generally recommended as well, unless such series refer predominantly to a very different risk profile (es before/after liberalization) of the market (or of the operator)

**Comments/reasons to change (introduce new) text:**

because of the very high level of uncertainty and subjectiveness in the use of forward-looking projections, we fully agree that long historical series is recommended (best practice suggests the use of the longest time series available). The inaccuracy of estimates based on shorter time series is usually proved by higher standard deviations. If the ERP estimate is based on long time series, it should be less influenced by short term market fluctuations. It is our opinion that the part of the sentence: "unless such series refer predominantly to a very different risk profile (es before/after liberalization) of the market (or of the operator)" should be deleted. As a matter of fact ERP for long periods of time is measurable regardless of liberalization process of the market and is not related to the liberalization of a single operator. Moreover, the liberalization processes of the Nineties are too recent to use a material time series. As far as the choice of the benchmark equity market is concerned, the most representative index should be the one of the national financial market. In the case of an insufficient number of observations, or of a poor liquidity of the equity market, the US financial index (the best proxy for the global market) could be used as well, provided that it is corrected to consider the country default spread

**Proposed changes (new wording- introduction of new text):**

Equity risk premium: the premium (ie the premium that the marginal investor expects for choosing to invest in equity and not in risk free investments) is in principle a forward-looking measure of investor expectations, but can be derived from historic actual differences between stocks and bonds using the relevant stock market of the company as a reference. The use of long historical series is recommended as well,

**Eliminato:** , unless such series refer predominantly to a very different risk profile (es before/after liberalization) of the market (or of the operator)

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page:** 34

**Paragraph:** 4.1 Cost of Capital - Risk free rate

**Original text:**

Risk free rate: normally treasury bonds with a long duration (10-30 years) are used. Typically, regulators may adopt several alternatives in determining the appropriate maturity of government bonds.

- 1) To base the maturity on the lifetime of the most relevant assets used in providing the regulated service. This reflects the planning horizon of investors in those assets;
- 2) To base the maturity on the duration of the regulatory determination.
- 3) To use the same bond term used to measure the market risk premium;

**Comments/reasons to change (introduce new) text:**

It is our opinion that alternative 1) should not be taken into consideration: the estimate of the Risk Free according to the duration of assets assume complete absence of financial risk for the company. The Risk Free rate should be consistent with the duration of interest-bearing debts of the company. It is our opinion that alternative 2) should not be taken into consideration as well: the duration of regulatory determinations is very short, whereas best practice and rating agencies recommend to use government bonds with a long duration (10-30 years), as it is also written in the Opinion (page 34). Besides, we believe that alternative 3) should refer to the risk free for the determination of the Cost of Equity only, being the market risk premium considered for the purpose of calculating the Cost of Equity.

**Proposed changes (new wording- introduction of new text):**

Risk free rate: normally treasury bonds with a long duration (10-30 years) are used. Typically, regulators may adopt several alternatives in determining the appropriate maturity of government bonds.

- 1) To use the same bond term used to measure the Risk Free Rate adopted to estimate the Cost of Equity;
- 2) To base the maturity on the lifetime of the most relevant assets used in providing the regulated service. This reflects the planning horizon of investors in those assets;

**Eliminato:** the market risk premium

**Eliminato:** 2) To base the maturity on the duration of the regulatory determination.¶

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page of ERG document:** 34

**Paragraph:** 4.1 Cost of Capital - Relevered Beta

**Original text:**

Relevered Beta (a measure of Beta which considers taxation effects and use an optimal debt/equity ratio)

**Comments/reasons to change (introduce new) text:**

See comments on Equity/Debt ratio. It is our opinion that the term “optimal” should be changed into “target”. This particularly fits with large TLC companies who regularly communicate to the financial community their financial plans; the consideration of the target capital structure results in a better estimate of the cost of capital through a more realistic estimate of the relative weight of debt and equity.

**Proposed changes (new wording- introduction of new text):**

Relevered Beta (a measure of Beta which considers taxation effects and use an target debt/equity ratio)

Eliminato: optimal

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page of ERG document:** 35

**Paragraph:** 4.1 Cost of Capital - Taxation

**Original text:**

Taxation: it should be the level of taxation incurred by the company applied for the year(s) of application

**Comments/reasons to change (introduce new) text:**

The global tax rate of a company can vary also according to its extraordinary and financial activities; such tax rate would be incoherent with the application of the resulting pre-tax wacc (cost of capital) to the network components of the Wholesale Aggregate. The Wholesale aggregate, by definitions, excludes the Other Activities of the undertaking. In Italy the estimate of future taxation level would be very difficult and arbitrary, so we suggest to adopt the operating tax rate applied for the year in which the estimate of cost of capital is made.

**Proposed changes (new wording- introduction of new text):**

Taxation: it should be the level of taxation applied to operating activities incurred by the company applied for the year(s) of application

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page of ERG document:** 35

**Paragraph:** 4.1 Cost of Capital

**Original text:**

Otherwise, NRAs may take into account that different risks premiums normally apply to different activities, which could be reflected in different costs of equity ' $r_e$ '<sup>10</sup>, even if the financial structure is the same. If so, there could be a different WACC for each business line or disaggregated activity such as core/access network, mobile, conditional access or cable TV or international services.

**Comments/reasons to change (introduce new) text:**

it should be remarked that **industry-specific market parameters can be identified only for activities whose companies are quoted in financial markets.**

Risk premiums for a specific undertaking are measured by the beta factor. Beta factors of listed companies are publicly available: **these data refer only to the company as a whole** (the listed share) while the derivation of different Beta may result arbitrary. Furthermore the **financing process is a unitary one** and the derivation of different costs of capital for different activities may become inconsistent with the actual data ( if different wacc are applied to different activities, the compounded average of the different WACC applied should be equal to the WACC for the activity of an operator considered as a whole).

Therefore it seems to have little sense try get a separate estimate of the WACC of specific regulated activities; the exercise- if done- could be highly contestable in the Courts; ERG should give adequate evidence of such approaches if already used by NRAs, In any case ERG should also give, in the Recommendation, specific and well detailed guidelines, to be given to a public consultation.

**Proposed changes (new wording- introduction of new text):**

Eliminate

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page of ERG document:** 35

**Paragraph:** 4.1 Cost of Capital

**Original text:**

Add at the end of the paragraph 4.1

**Comments/reasons to change (introduce new) text:**

Cost of capital is a key issue in regulatory costing/pricing, particularly in the TLC sector where innovative investments are a matter of vital importance. It should also be noted that regulation does not reduce the business risk; obligation to make network available to other operators (besides prices can be set not at the historic cost but on the basis of LRIC models) involves the risk that costs may not be recovered since other operators enjoy a wide flexibility in the decision to make or buy. Therefore, in assessing the cost of capital, NRA'S should consider investments made by operators and allow a return on capital employed congruent not only with risks involved but also with investments for the development of innovative networks and services.

**Proposed changes (new wording- introduction of new text):**

In assessing the cost of capital, NRA'S should consider investments made by operators and allow a return on capital employed congruent not only with risks involved but also with investments for the development of innovative networks and services.

**References on the ERG draft document:**

**Section:** Annex 4 - The Cost of capital and Capital Employed

**Page of ERG document:** 36

**Paragraph:** 4.3 Capital Employed

**Original text:**

For price-setting purposes, NRAs and operators will be concerned with average capital employed during any period rather than with capital employed at a single point in time such as the end of the financial year. This is because a “snap-shot” at any one point in time may not be representative of the average level of capital employed by operators. Specifically, working capital balances at a single point in time may not be representative of average working capital requirements over an extended period. The separate accounts of operators should therefore show average capital employed, rather than year-end balances, calculated using a geometric average between the beginning and the end of the fiscal year.

**Comments/reasons to change (introduce new) text:**

It is our opinion that, in order to determine average capital employed for the fiscal year, arithmetic average should be used rather than geometric average.

**Proposed changes (new wording- introduction of new text):**

For price-setting purposes, NRAs and operators will be concerned with average capital employed during any period rather than with capital employed at a single point in time such as the end of the financial year. This is because a “snap-shot” at any one point in time may not be representative of the average level of capital employed by operators. Specifically, working capital balances at a single point in time may not be representative of average working capital requirements over an extended period. The separate accounts of operators should therefore show average capital employed, rather than year-end balances, calculated using an arithmetic average between the beginning and the end of the fiscal year.

Eliminato: geometric

**References on the ERG draft document:**

**Section:** Annex 5 – Qualitative Characteristic of accounting information

**Page of ERG document:** 37

**Paragraph:** 5.1 Basis of preparation

**Original text:**

On the whole, accounting principles that apply to the preparation of general purpose financial statements under national or international accounting standards can form the basis of regulatory reporting. It is important that the preparer of any set of financial statements fully understands these principles and that these are comprehensive. One way for an NRA to ensure this happens is to explicitly require International Accounting Standards (IAS, see Commission Regulation No 1725/200312) to apply in the absence of regulatory accounting guidelines.

**Comments/reasons to change (introduce new) text:**

Ti disagrees with the recommendation that the notified operator should be obliged to apply IAS for regulatory financial statement assessment. It must be the sole decision of the notified operator on which accounting standards the regulatory cost accounting framework is based on. It would mean a disproportional effort to provide accounting information for regulatory purposes based on different standards, and then the statutory accounting system is based on. Moreover the reconciliation between the regulatory financial statements and the statutory one would be critical and/or impossible.

**Proposed changes (new wording- introduction of new text):**

On the whole, accounting principles that apply to the preparation of general purpose financial statements under national or international accounting standards can form the basis of regulatory reporting. It is important that the preparer of any set of financial statements fully understands these principles and that these are comprehensive. One way for an NRA to ensure this happens is to explicitly require national ~~International~~ Accounting Standards (i.e. adopted in the company statutory accounts) to apply in the absence of regulatory accounting guidelines. The NRAs have to approve a set of principles, policies and procedures before the preparation of financial statements. After the NRA approval any further modification have to be applied for the future financial statements.

**References on the ERG draft document:**

**Section:** Annex 6 – Transparency, confidentiality, market-related limitations and publication of accounting data and methodologies

**Page of ERG document:** 42

**Paragraph:** 6.2 Publication of accounting data and methodologies

**Original text:**

None

**Comments/reasons to change (introduce new) text:**

See Recommendation 5 ERG opinion prepared by the IRG working group on cost accounting – 22 March 2004

**Proposed changes (new wording- introduction of new text):**

**References on the ERG draft document:**

**Section:** Annex 6 – Transparency, confidentiality, market-related limitations and publication of accounting data and methodologies

**Page of ERG document:** 42

**Paragraph:** 6.2 Publication of accounting data and methodologies

**Original text:**

According to Article 11.2 of the Access Directive, accounting records may be published for the general audience as would contribute to an open and competitive market, rather than solely making financial information publicly available (which might imply that only interested parties are entitled to get access to the information under specific conditions).

**Comments/reasons to change (introduce new) text:**

It seems sufficient and clearer the only reference to the Article 11.2 of the Access Directive.

**Proposed changes (new wording- introduction of new text): Art 5**

According to Article 11.2 of the Access Directive, accounting records may be published for the general audience as would contribute to an open and competitive market.

**Eliminato:** rather than solely making financial information publicly available (which might imply that only interested parties are entitled to get access to the information under specific conditions)

**References on the ERG draft document:**

**Section:** Annex 6 – Transparency, confidentiality, market-related limitations and publication of accounting data and methodologies

**Page of ERG document:** 43

**Paragraph:** 6.3 Relevant market related limitations

**Original text:**

In compliance with the accounting separation requirements previously illustrated in this Annex (Section 1), NRAs may consider that, to assist in monitoring compliance with non-discrimination and transparency principles and to investigate potential anti-competitive behaviours, more disaggregated sets of accounts, or with accounts with more granularity, or further clarification should be prepared, on request, by the operator.

**Comments/reasons to change (introduce new) text:**

Accounting separation structure/granularity is already defined in the specific section of the proposed Recommendation and should not be redefined elsewhere (particularly if the redefinition implies a different structure or granularity of required information . that might result in invalidating the main definition).

**Proposed changes (new wording- introduction of new text): Art 5**

NRAs may consider that, to assist in monitoring compliance with non-discrimination and transparency principles and to investigate potential anti-competitive behaviours, more detailed information or further clarification should be prepared, on request, by the operator.

**Eliminato:** In compliance with the accounting separation requirements previously illustrated in this Annex (Section 1),

**Eliminato:** more disaggregated sets of accounts, or with accounts with more granularity

**References on the ERG draft document:**

**Section:** Annex 6 – Transparency, confidentiality, market-related limitations and publication of accounting data and methodologies

**Page of ERG document:** 44

**Paragraph:** 6.4 Principles

**Original text:**

**Detailed** financial information relating to markets not having SMP designation is of relevance to NRAs in so far as it demonstrates the non discriminatory allocation of costs.

**Comments/reasons to change (introduce new) text:**

Remedies apply to those markets where the operator is notified as having a SMP Financial information related to non SMP markets should not be systematic nor detailed.

**Proposed changes (new wording- introduction of new text): Art 5**

~~financial information relating to markets not having SMP designation is of relevance to NRAs in so far as it demonstrates the non discriminatory allocation of costs.~~

**Eliminato:** Detailed

**References on the ERG draft document:**

**Section:** Annex 7 – Reporting requirements and verification

**Page of ERG document:** 48

**Paragraph:** 7.2 Audit scope and verification

**Original text:**

iv) the controlling entity When the verification of the compliance with a cost accounting system is mandated in order to support price controls or retail controls, the compliance should be ensured by a qualified body, independent from the operator concerned. The NRAs may itself undertake the annual control provided it has the necessary qualified staff. The Commission Recommendation on statutory auditors' independence, establish a sound framework against which independence could be tested, where relevant.

**Comments/reasons to change (introduce new) text:**

Regulator and auditor have different roles and duties; In general, since they imply different qualifications, they should be different entities.

It seems advisable that the qualifications required to the NRA to perform the verification are better defined (for example with reference to the register of professional accountant)

**Proposed changes (new wording- introduction of new text): Art 5**

iv) the controlling entity When the verification of the compliance with a cost accounting system is mandated in order to support price controls or retail controls, the compliance should be ensured by a qualified body, independent from the operator concerned. The NRAs may itself undertake the annual control provided it has the necessary qualified staff, at same level of a qualification like an auditing company. The Commission Recommendation on statutory auditors' independence, establish a sound framework against which independence could be tested, where relevant.

**References on the ERG draft document:**

**Section:** Annex 8 – Long Run Incremental Cost

**Page of ERG document:** 50

**Paragraph:** 8.1.2 Economic rationale

**Original text:**

In economic theory, the optimal method of setting tariffs is the method that causes the least distortion in the market. Using marginal cost as a basis for determining tariff levels is generally considered as providing the economically (welfare) optimal incentives. **In the case of access services**, new entrants deciding on whether or not to replicate (part of) the notified operator's network get the right incentives: they will only replicate and operate (part of) the network if they can do this more efficiently than the notified operator. This is because a new entrant will only decide to replicate and operate itself if the entrant can do this at a cost lower than the tariff to be paid to the notified operator.

**Comments/reasons to change (introduce new) text:**

See Issue: Differences between LRIC and CCA methodology

The words access services are ambiguous. In fact, access depends on the contest where it is applied (e.g. fixed network, mobile network, digital TV, etc). Moreover the concept reported in the box is not specific only to the access service, rather than is a concept on network replicability.

**Proposed changes (new wording- introduction of new text):**

In economic theory, the optimal method of setting tariffs is the method that causes the least distortion in the market. Using marginal cost as a basis for determining tariff levels is generally considered as providing the economically (welfare) optimal incentives. **In the case of access services**, New entrants deciding on whether or not to replicate (part of) the notified operator's network get the right incentives: they will only replicate and operate (part of) the network if they can do this more efficiently than the notified operator. This is because a new entrant will only decide to replicate and operate itself if the entrant can do this at a cost lower than the tariff to be paid to the notified operator.

**References on the ERG draft document:**

**Section:** Annex 8 – Long Run Incremental Cost

**Page of ERG document:** 51

**Paragraph:** 8.1.2 Economic rationale

**Original text:**

When applying a long run perspective, all costs are assumed to be variable. This implies that long run incremental cost takes capital as a variable factor of production. That way, long run incremental cost provides decision makers with the correct cost base for making investment decisions. This is particularly important in the capital-intensive electronic communications market, which is characterized by significant investment costs and the long term nature of assets.

**Comments/reasons to change (introduce new) text:**

See Issue: Differences between LRIC and CCA methodology

In the long run perspective the services demand to be considered is the total services demand of the cost accounted services (SMP services)

**Proposed changes (new wording- introduction of new text):**

When applying a long run perspective, all costs are assumed to be variable. This implies that long run incremental cost takes capital as a variable factor of production. That way, long run incremental cost provides decision makers with the correct cost base for making investment decisions. This is particularly important in the capital-intensive electronic communications market, which is characterized by significant investment costs and the long term nature of assets. Taking into account that in a long run perspective, all costs are assumed to be variable the relevant increment to be considered is the total amount demand of the services in the markets where the Operator has been notified as having SMP.

**References on the ERG draft document:**

**Section:** Annex 8 – Long Run Incremental Cost

**Page of ERG document:** 51

**Paragraph:** 8.1.3 imposition of LRIC cost modelling

**Original text:**

In situations where replicability of infrastructure is deemed economically infeasible, the use of existing facilities of the regulated operator should be encouraged. This could be achieved by setting prices for (access) services close or equal to the efficient costs of providing the service. LRIC cost modelling could be applied to determine this efficient cost level. A national regulatory authority could use a bottom-up approach to determine the LRIC cost of an efficient operator. Another possibility is using a top-down approach, which starts with the actual costs of the regulated operator, and to adjust for inefficiencies.

**Comments/reasons to change (introduce new) text:**

See Issue: Differences between LRIC and CCA methodology

The use of LRIC modelling to determinate the efficient cost is a general concept that could be applied in general for every network segment (core and access) and for both the replicable and un-replicable and it is not specific for access services.

The bottom up and top down approach should be chosen for technical/modelling reasons. Finally the concept to use of LRIC base price control to the economically infeasible replicability is inconsistent with the whereas 7 on page 2 where the use of LRIC base price control is associated to the infrastructure with replication economically feasible.

**Proposed changes (new wording- introduction of new text):**

In situations where replicability of infrastructure is deemed economically infeasible, the use of existing facilities of the regulated operator should be encouraged. Also in this case, this could be achieved by setting prices for (access) services close or equal to the efficient costs of providing the service. LRIC cost modelling could be applied to determine this efficient cost level. A national regulatory authority could use a bottom-up approach to determine the LRIC cost of an efficient operator. Another possibility is using a top-down approach, which starts with the actual costs of the regulated operator, and to adjust for inefficiencies. [Bottom Up approach can be appropriate for the transport services \(core network\), while Top Down approach can be appropriate for the network access services where a theoretical and general model is more contentious to build up.](#)

**References on the ERG draft document:**

**Section:** Annex 8 – Long Run Incremental Cost

**Page of ERG document:** 52

**Paragraph:** 8.1.4 Relation between IC, SAC and FAC

**Original text:**

The concepts of (LR)IC, FAC and SAC are related. IC is sometimes referred to as a price floor. Setting a price below IC would mean that not even all incremental costs would be recovered. SAC is considered a price ceiling. A price above SAC would mean that an amount in excess of the IC plus all of the relevant common costs would be recovered. FAC is 'somewhere' between the IC floor and SAC ceiling, as in the case of FAC a part of the common costs is allocated to the increment. The following figure captures the relationship between the cost concepts

**Comments/reasons to change (introduce new) text:**

See Issue: Differences between LRIC and CCA methodology

LRIC is a cost base while IC, FAC and SAC are cost methodologies. In particular IC, SAC and FAC are different cost methodologies, applicable to different cost basis (HCA, CCA, LRIC), which require specific set of rules coordinated with the specific purposes (accounting separation, pricing control, etc.). This specific set of rules should be defined in the cost accounting section.

Furthermore, in order to avoid misunderstanding, floor and ceiling terms should be substituted with synonymous for instance lower bound and upper bound: floor (IC) and ceiling (SAC) are cost methodologies, that require the definition of a specific set of rules, for the evaluation of lower bound and upper bound costs/prices

**Proposed changes (new wording- introduction of new text):**

In a pricing control context the concepts of (LR)IC, FAC and SAC are could be related. IC is sometimes referred to as a lower bound price. Setting a price below IC would mean that not even all incremental costs would be recovered. SAC is considered an upper bound price. A price above SAC would mean that an amount in excess of the IC plus all of the relevant common costs would be recovered. FAC is 'somewhere' between the IC floor and SAC, as in the case of FAC a part of the common costs is allocated to the increment. ~~The following figure captures the relationship between the cost concepts.~~

**References on the ERG draft document:**

**Section:** Annex 8 – Long Run Incremental Cost

**Page of ERG document:** 52

**Paragraph:** 8.1.4 Relation between IC, SAC and FAC

**Original text:**

In a regulatory environment where LRIC cost allocation results in a range (LRIC to SAC) rather than in a specific LRIC price (including a specific mark-up for common costs), a first test for ensuring that prices are cost-oriented is to check whether they are between the IC floor and the SAC ceiling. However, in a situation where the prices of more products and services are based on IC (including a mark-up for common costs), this first test alone is not sufficient to demonstrate cost-orientation. For example, if all prices were set at SAC, incremental and common costs would be more than recovered. Therefore, another test might be considered necessary. This is the combinatorial test, whereby the aggregate revenue of services straddling the common costs is compared to the LRIC and SAC of these services measured as a single increment. Potentially, a large number of combinatorial tests may need to be carried out.

**Comments/reasons to change (introduce new) text:**

See Issue: Differences between LRIC and CCA methodology

“In a regulatory environment where LRIC cost allocation results in a range (LRIC to SAC) rather than in a specific LRIC price (including a specific mark-up for common costs)”: these part of the text could be misleading. Furthermore the combinatorial test terminology is specific of UK regulation. It is conceptual correct but it is preferred to use a more generic terminology.

**Proposed changes (new wording- introduction of new text):**

In a regulatory environment ~~where LRIC cost allocation results in a range (LRIC to SAC) rather than in a specific LRIC price (including a specific mark-up for common costs)~~, a first test for ensuring that prices are cost-oriented is to check whether they are between the IC floor and the SAC ceiling. However, in a situation where the prices of more products and services are based on IC (including a mark-up for common costs), this first test alone is not sufficient to demonstrate cost-orientation. For example, if all prices were set at SAC, incremental and common costs would be more than recovered. Therefore, another test might be considered necessary. This is the check test for the duplication cost avoid ability, whereby the aggregate revenue of services straddling the common costs is compared to the LRIC and SAC of these services measured as a single increment. Potentially, a large number of combinatorial tests may need to be carried out.

**References on the ERG draft document:**

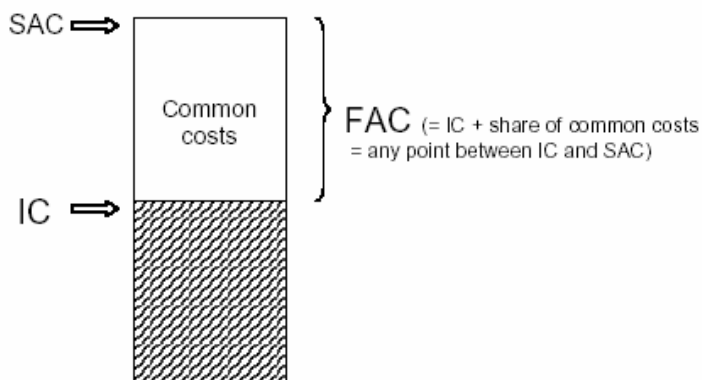
**Section:** Annex 8 – Long Run Incremental Cost

**Page of ERG document:** 53

**Paragraph:** 8.1.4 Relation between IC, SAC and FAC

**Original text:**

Figure 2



**Comments/reasons to change (introduce new) text:**

See Issue: Differences between LRIC and CCA methodology

IC, SAC and FAC are different cost methodologies applicable to different cost basis (HCA, CCA, LRIC) which require specific set of rules coordinated with the specific purposes (accounting separation, pricing control, etc.) Therefore the figure, only in a LRIC context, could be misleading

**Proposed changes (new wording- introduction of new text):**

The proposal is to delete the figure

**References on the ERG draft document:**

**Section:** Annex 8 – Long Run Incremental Cost

**Page of ERG document:** 55

**Paragraph:** 8.2.2 Long Run and Forward Looking

**Original text:**

In practice, the concept of forward-looking costs requires that assets are valued using the cost of replacement with the modern equivalent asset (MEA). The MEA is the lowest cost asset, providing at least equivalent functionality and output as the asset being valued. The MEA will generally incorporate the latest available and proven technology, and will therefore be the asset that a new entrant might be expected to employ.

**Comments/reasons to change (introduce new) text:**

See Issue: Differences between LRIC and CCA methodology

In the LRIC methodology require, above all, the “definition” of a forward looking network topology, where possible (core network), network technology, etc: in other words require the definition of a “virtual” efficient network. Therefore the assets evaluation is base on the “quantities” of the “virtual” efficient network necessary to satisfy (for functionality, quality, etc.) the total amount of services demanded (SMP services). These assets are valued on current pricing basis and not necessary provides lowest cost but certainly provides efficient costs which could be considered in the make or buy other operator decisions. .

**Proposed changes (new wording- introduction of new text):**

In practice, the concept of forward-looking costs requires the definition of a “virtual” efficient network, based on the latest available and proven technology, necessary to satisfy (for functionality, quality, etc.) the total amount of services demanded (SMP services), These assets are valued on current price base in order to provide efficient costs which could be considered in the make or buy other operator decisions ~~using the cost of replacement with the modern equivalent asset (MEA). The MEA is the lowest cost asset, providing at least equivalent functionality and output as the asset being valued. The MEA will generally incorporate the latest available and proven technology, and will therefore be the asset that a new entrant might be expected to employ.~~

**References on the ERG draft document:**

**Section:** Annex 8 – Long Run Incremental Cost

**Page of ERG document:** 55

**Paragraph:** 8.2.3 Network Topology

**Original text:**

The network design in the LRIC model depends on what assumptions are made on network topology. One of the key decisions to be made in LRIC cost modelling is related to the question whether to adopt a 'scorched node' or a 'scorched earth' approach. In a top down modelling environment this is a decision between whether or not to allow the notified operator to base its costs on the existing network topology (scorched node) or on an ideal network topology that would meet the demands of a fully efficient operator (scorched earth). In a bottom up modelling environment this is a decision between whether or not the bottom up model should take into account the existing network topology (scorched node), or that the costs in the model should be based on an ideal topology (scorched earth).

**Comments/reasons to change (introduce new) text:**

See Issue: Differences between LRIC and CCA methodology.

The choice to adopt a "scorched node" or a "scorched earth" approach is possible in the bottom up approach only.

**Proposed changes (new wording- introduction of new text):**

The network design in the LRIC model depends on what assumptions are made on network topology. In bottom up approach. one of the key decisions to be is related to the question whether to adopt a 'scorched node' or a 'scorched earth' approach. ~~In a top down modelling environment this is a decision between whether or not to allow the notified operator to base its costs on the existing network topology (scorched node) or on an ideal network topology that would meet the demands of a fully efficient operator (scorched earth).~~ In a bottom up modelling environment this This is a decision between whether or not the bottom up model should take into account the existing network topology (scorched node), or that the costs in the model should be based on an ideal topology (scorched earth).

**References on the ERG draft document:**

**Section:** Annex 8 – Long Run Incremental Cost

**Page of ERG document:** 56

**Paragraph:** 8.2.4 Relevant Increment

**Original text:**

LRIC cost modelling includes only those costs that are caused by the provision of a defined increment of output (or, alternatively, those costs that are saved when the defined increment of output is no longer provided). This implies that in LRIC cost modelling a decision has to be made concerning this relevant increment. In principle, there are an infinite number of different sized increments that could be measured, which can be grouped into an individual or collection of products, services, components or elements.

**Comments/reasons to change (introduce new) text:**

See Issue: Differences between LRIC and CCA methodology.

The LRIC cost accounting modelling is oriented to define efficient charges for a SMP services of an operator on the base of the non discriminatory principle. In this concern the relevant increment to consider is the total amount of SMP services.

LRIC costs caused by the provision of a marginal increment of output lead necessary to a cost or pricing discrimination.

Ti strongly argues that the LRIC model, for the non discrimination principle, have to based on the total demand of the service where the operator is notified as an SMP operator

**Proposed changes (new wording- introduction of new text):**

Considering which required by the non discriminatory principle, LRIC cost modelling includes only those costs that are caused by the provision of a defined increment of output (or, alternatively, those costs that are saved when the defined increment of output is no longer provided). This implies that in LRIC cost modelling a decision has to be made concerning this relevant increment. In principle, there are an infinite number of different sized increments that could be measured, which can be grouped into an individual or collection of products, services, components or elements the total demand of the service where the operator is notified as an SMP operator.