

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

Management Summary:

There are many specific issues around cost allocation that may end up as judgements set by NRAs which can have substantial impacts on the profitability of business segments and unintended detrimental effects on investment in the telecommunication industry.

The telecommunication industry has recently gone through a period of market liberalisation accompanied by dramatic changes for incumbent operators. At the same time new infrastructure (broadband) has been rolled out, and in the near future another generation of network technology (NGN) will replace the existing equipment. Therefore it is essential that NRAs carefully consider the full implications of changing guidelines on cost accounting and accounting separation.

Telekom Austria would highlight the following issues to be considered in the final version of the recommendation:

- Modifications of recently implemented cost accounting methods in the member states can be extremely cumbersome to implement and may cause disproportionate additional costs for both regulatory authorities and the industry. Therefore such **changes should be limited to a minimum**.
- Telekom Austria **does not agree** with the recommendation that **accounting information** should be **available** on request **to interested parties**. Accounting information includes highly sensitive information and could therefore not be made available at all to such a broad, unrestricted audience as "interested parties". In addition to that, Telekom Austria as listed company at Vienna Stock Exchange and New York Stock Exchange is subject to strict confidentiality compliance programs which might contradict broad transparency requirements of the regulator. In the light of the directives' framework we do not see any imperatives to go this far.
- Telekom Austria would prefer to continue the practise of providing **accounting separation** based on the **historic cost accounting approach** (HCA).
- The current cost approach adopted in the recommendation does not correctly measure the investment cost that a new entrant operator would have, if in a top down model, equipment with a book value equal zero, which is still in use, is **re-valuated with net replacement costs equal to zero**. For each period under consideration, the number and type of necessary network elements, their current value and their expected lifetime have to be evaluated anew, independent from their treatment in the financial accounting system.
- If the **WACC** is used to determine the cost of capital in an FL-LRAIC calculation we would recommend to use **forward looking values for certain input parameters** (e.g.: target capital structure, forward looking tax rate, etc.) instead of current ratios/values.

- A **drilldown** of the WACC **along business lines** and calculation of separate costs of capital for such sub-entities seems neither accurately viable nor economically sensible.
- Telekom Austria does not agree with the recommendation to oblige the notified operator 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.

Detailed comments to the submitted questions could be found below:

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

The replacement of existing cost accounting mechanisms, implemented at national level in a proper way, is, however, unnecessary and not appropriate as long as the existing cost accounting mechanisms are adequate and proportionate tools to achieve the objectives of the regulatory framework. It is therefore important to limit any new requirements for regulators and regulated operators to the extend, the NRAs need in order to to ensure a proper and consistent application of the provisions of the relevant directives.

Modifications of currently implemented cost accounting methods in the member states can be extremely cumbersome to implement and may cause disproportionate additional costs for both regulatory authorities and the industry. Therefore such changes should be limited to a minimum. In this context we want to draw the attention to the necessity of proportional regulatory measures deriving from Framework Directive (COM(2000) 393 final), article 7 (1)."

By implementing obligations for cost accounting and accounting separation it should be taken into account that cost based price regulation is – from the regulated operator's view - a remedy with high transactions costs. Therefore regulatory costing obligations should only be implemented, if a cost based price control cannot be avoided in order to guarantee competitive prices.

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

Telekom Austria does not agree in respect of two proposed changes:

- Telekom Austria does not agree with the recommendation that accounting information should be available on request to interested parties. Accounting information includes highly sensitive data and could therefore not be made available to such a broad

audience as comprises the term “interested parties”. Even though “interested parties” is an imprecise term, it is clear that at least competitors of the regulated company would qualify as interested parties. Sensitive information such as accounting information should therefore only be accessible by the NRA, which should be the body in charge of guaranteeing that the notified operator has properly implemented the cost accounting system.

Furthermore, Telekom Austria as listed company on the Vienna Stock Exchange and the New York Stock Exchange is subject to strict confidentiality compliance programs which might contradict broad transparency requirements of the regulator. In the light of the directives’ framework we do not see any imperatives to go this far.

- Telekom Austria does not agree with the recommendation that methodology and criteria for the evaluation of network assets should be fixed by the NRA after a public consultation. As mentioned above the specification of details regarding the re-evaluation of assets (CCA) could only be seen as a task performed between the notified operator and the NRA.

B: Cost Accounting:

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

Telekom Austria does not agree with the statement on p. 9 of the Annex, that a costing system should allocate at least 90% of the cost on the basis of direct or indirect cost-causation.

- There is no empirical evidence, that a “good” costing system – especially in this area of network industries - is defined by a relationship of 90 % direct/ indirect costs to 10% common costs.
- There is no fixed relationship between direct/ indirect attributable and common costs over the time. Especially with increasing technical progress and hence decreasing network prices for a given service the relative part of common costs could increase.

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

We don't agree with step (iii) of the proposed allocation process (last § of chapter e) on page 3 of the annex). We do agree that transparent and non-discriminatory drivers to allocate common costs have to be found, but the fact that the recommendation explicitly pre-defines that the cost should be allocated, using the ratio of all expenses directly assigned (cost based driver), is not coherent with the scope of such a recommendation. It must be the choice of the notified operator to choose a fair and objective method of cost allocation based on his professional judgement.

5. Do you agree with the given definition of transfer charges?

The terms “supportable” and “satisfactory” mentioned at the end of p.3 and the top of page 4 of the annex are unclear regarding its meaning and should be removed to avoid a barren discussion on their interpretation.

Regarding the definition of transfer charges 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”*, Telekom Austria would like to mention, that very often the provided

internal and external product or service is not exactly the same. Therefore this fact has to be considered carefully when setting transfer charges for specific services.

C: Accounting separation:

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

As described above, the position of Telekom Austria is: We demand that detailed information provided throughout the separated accounts per business segment. should only be made available to the national regulator and not at the disposal of other industry members, customers or other stakeholders.

We see it as an obligation to the NRA. to ensure that the companies obliged to provide detailed accounting separation, are not placed at a competitive disadvantage throughout the availability of sensitive information in the industry. Based on this information (accounting separation) the NRA can monitor the development in the market and set based on this measures their regulatory actions and decisions.

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

Telekom Austria does not see the need for a publication of detailed cost statements showing the average cost of network components. It has to be ensured that this sensitive type of information is not accessible by our competitors but is only accessible throughout the NRA.

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

Telekom Austria prefers to continue the practise of calculating accounting separation based on the historic cost accounting approach (HCA). The obligation, to develop in addition separated accounts based on current cost accounting information (CCA), would lead to an additional, disproportional effort for the notified operator.

Keeping in mind the objective of the provision of accounting separation, from our point of view, accounting separation could only be developed based on historic cost accounting information:

- Reconciliation to statutory accounts is only feasible based on HCA
- The majority of transfer charges between business units is based on HCA
- Retail prices are based on HCA
- Profitability of business segments can only be determined based on HCA

D: Principles for cost causality, driver definition and attribution methodologies:

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

The problem of setting an absolute border (90/10) regarding the allocation of direct and indirect costs has been already mentioned under question 3. In addition, we remind that the degree of direct or indirect attributable costs depends highly on the type of business and the degree of vertical and/or horizontal integration. Therefore the degree of arbitrary allocated cost in relation to total costs alone could not be a measure for the quality of the cost accounting system.

Table 2.3 shows some categories of operating costs and methods of allocating them. Similarly to the arguments mentioned under Question 11 we don't see much value add by such a table, as part of a legal document. Even if we would follow the majority of the possible methods of allocation mentioned in the table for specific categories of operating costs, we would not see the value of restricting allocation methods to the listed ones without a need to do so.

The same arguments are valid for the allocation of assets and liabilities (see Table 2.4 Methods of allocating capital employed).

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

In Austria a long tradition is established regarding the joint coordination between the NRA and Telekom Austria as notified operator, comprising the principles of cost accounting methods and the main corner stones of Telekom Austria's cost accounting models, used for tariff applications and/or the deduction of interconnection rates.

This approach gives both sides a high degree of predictability and ensures for the notified operator an efficient implementation process and for the NRA an efficient audit procedure.

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

We don't really see much value added, regarding the sample allocation process illustrated in Figure 1, especially as part of a legal document such as the Annex of the Recommendation on Accounting Separation and Cost Accounting. On the one hand it is too generic to be really of help for someone who has to implement a cost accounting system. On the other hand it is not sufficiently elaborated on a theoretical level in order to serve as a general guideline. At least we would recommend naming Figure 1 an example cost allocation process, instead of typical cost allocation process.

E: Guidelines for CCA implementation:

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

The operator should identify the network assets subject to valuation in the application of current cost accounting.

Network asset revaluation plays a key role in the application of current cost accounting. Since network asset revaluation relies strongly on detailed network data (e.g. equipment inventories) and price information (e.g. contract prices) from the operator, the operator itself is best suited to evaluate if - for a particular asset - an accurate revaluation is possible or not. The revaluation should also include fully depreciated network assets in the statutory accounts if these assets are still in use.

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

Telekom Austria does not agree with the recommendation of illustrating and communicating the parameters and factors used for current cost accounting models to public consultation. In addition to that, we do not see an imperative legal requirement based upon the EU Directives Framework.

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

The purpose of the concept of current cost accounting (CCA) is to measure the costs of a duplicated version of the incumbent operator's existing network, providing identical functionality, but using modern assets in place of the historic assets employed by the incumbent. The recommendation of revaluating assets in a top down model, with a book value equal zero (i.e. fully depreciated assets) but still in use, with net replacement costs equal to zero, is not in line with the concept of CCA.

However a new entrant operator would need that network component when constructing an efficient, duplicated version of the incumbent's network, but it would not acquire the network component at zero costs. **Therefore the current cost approach adopted in the recommendation does not correctly measure investment cost a new entrant operator would be faced with.** For this concept, the treatment of a specific asset from an accounting point of view is irrelevant. For each current cost accounting period, the number and type of necessary network elements, their current value and their expected lifetime have to be evaluated anew, independently from their treatment in the financial accounting system.

Therefore, all network components used by the operator have to be taken into account even if they are valued in the books equal to zero.

A consequence of following the concept of net replacement costs for the termination of prices for network usage, the actual provision of the existing infrastructure would require an investment which is higher than the payment for the use of regulated operators' infrastructure. As a result no investments in alternative infrastructure will occur. The aim of encouraging efficient investment in infrastructure and promoting competition according to Framework Directive, article 7, 2. (c) is therefore not compatible with this approach.

In addition, the CCA-approach does not take into account the cost of migration from the existing to new network technology. For an incumbent operator with existing equipment it does not make any sense to rebuild infrastructure as long as the cost of migration outweighs the savings through the use of latest technology. This break-even however is reached at different points in time for different network elements.

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

The definitions of OCM and FCM are not sufficiently clear-defined for implementing them in practice.

F: Cost of capital and capital employed

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

In general Telekom Austria agrees that WACC is the appropriate basic model of calculating the average cost of capital (minimum return). Regarding the details, Telekom Austria does see the need for several adjustments/amendments (see details below).

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

The WACC is a market based model which estimates market costs of capital due to the fact that the capital market - via each individual investor - is the entity which demands and receives the cost of capital as compensation for providing capital to an enterprise. Therefore, quite naturally the input parameters should be market values.

However current market values do not completely go hand in hand with a forward looking approach because of the fact that current market prices are generally thought to reflect all public information known to the investors (*market efficiency hypothesis*¹). Therefore the internal forward looking calculations, which are the basis for investment and funding decisions within a company and other factors which influence the future cost of capital, are based upon information and know-how which is not public knowledge and therefore not (yet) priced in current market values.

One element of these internal forward looking calculations and business plan target values is the target capital structure. **For this reason we strongly feel, that an optimal capital structure – in the sense of a target capital structure - should be utilised in the calculations.**

Using a current capital structure would be a direct contradiction to the forward looking approach and would be far from optimal for the following reasons:

1. The costs of capital (which are the end result of the calculation being discussed) are to be used for accurately estimating future costs. Therefore they have to reflect the compensation which investors will demand for an investment in a specific company at a future point in time.

¹Efficient Capital Markets: a review of theory and empirical work", 1970, Journal of Finance, Volume 25, Issue 2, Papers and Proceedings of the Twenty-Eighth Annual Meeting of the American Finance Association New York, N.Y. December, 28-30, 1969 (May, 1970), 383-417

2. As the cost of capital a company faces is inherently intertwined with the capital structure of that company, the capital structure must be geared optimally if the costs of capital are to be as efficient (low) as possible. If the marginal costs of equity are lower than the marginal costs of debt, it is optimal to substitute equity for debt up to the point where the marginal costs are equal. Naturally the same logic applies – albeit in the opposite direction - if a company's marginal costs of debt are lower than those of equity.
3. If the current capital structure is used in the calculation then this calculation cannot reflect future costs of capital correctly because the company itself will aim to reach the target capital structure. And if regulators base their calculations on the current capital structure, this will inhibit a company in operating as efficiently as otherwise possible.

Risk free rate:

We feel – in accordance with the approach in the “Draft ERG opinion” – that riskless debt instruments, such as treasury bonds, interbank rates (e.g. LIBOR, EURIBOR) or swap rates with a duration of 10 years or more should be used as a proxy for the risk free rate. Furthermore we believe that using an average of such interest rates (on riskless 10-year debt) over an economic cycle is clearly preferable to just using the interest on riskless 10-year debt on a specific point of time.

As far as the mentioned three possible approaches of defining the risk free rate are concerned:

Approach 1:

The problem this approach poses is that although a company's investment decisions go hand in hand with it's funding decisions to some degree, for one, a company cannot differentiate its sources of funding (and the corresponding costs of funding) with regard to the use of the acquired funds. Furthermore, returns on capital invested in a company are "produced" by the company as a whole - an investor in such a company does not invest in certain assets (e.g. those used to provide the regulated services) but in the entire company - and receives a total company return on his or her investment.

Approach 2:

This approach, which would constitute a firm directive by the regulatory authority, which, based upon the sentence written in the “Draft ERG opinion” does not require any reasoning or justification, seem highly questionable and we would oppose such regulations.

Approach 3:

This approach is supported by the literature on the CAPM, therefore it can be deemed appropriate.

Taxation:

We believe that the appropriate tax rate is a forecast (i.e. forward looking) tax rate.

Regarding the application of a global or disaggregated WACC for various business activities Telekom Austria wants to state the following:

A drilldown along business lines and calculation of separate costs of capital for such sub-entities seems neither accurately viable nor economically sensible.

The reasons being:

As far as the calculation of such business line costs of capital are concerned, the main problem is the lack of observable market values as sources for the input parameters, as single business lines of companies (or shares of their equity or debt) are part of the company and are not separately listed on capital markets. Therefore such calculations would either require making various assumptions, to come up with the necessary input parameters for the models under discussion (WACC & CAPM) or implementing other models which somehow find a way to deal with this lack of observable market values whilst producing valid results.

As far as an economic justification for needing or using such business line costs of capital is concerned, the main issue is that a company generally functions as a single entity – in an ideal case every element of a company has a reason for being in that company, and contributes to that company's success by enhancing its economic value. The simple rationale being that if it were more efficient or beneficial for the company as a whole, to spin off certain elements, it would strive to do so.

However the reasons for having certain elements or business lines in a company are divers and go far beyond simple financial contributions. A company might for instance keep an unprofitable business line running because the benefits of having this product in its portfolio could be attracting many customers for the entire product portfolio, thereby generating additional revenues in other business lines by keeping the unprofitable business line up and running - if an investor were to invest in this business line on its own he or she would receive "negative returns" on their investment.

On the other hand, keeping less profitable business lines in the company makes it necessary to have other business lines which are highly profitable to compensate for the financial shortcomings of other business lines.

This example illustrates the reasoning behind keeping certain assets in a portfolio, which produce below average returns. but providing diversification benefits. If this asset is looked upon as a separately and compensation is simply given in the amount of the below average return, then this compensation is too low and an investor will not invest in this asset, because then the diversification benefit – which is the reason for holding such an unprofitable asset - would not exist.

This implies. that a company is more than a sum of its parts and if a cost of capital is calculated for single business lines, even if it is calculated in a mathematically correct way, will not provide adequate compensation for the costs this business line poses for the company as a whole.

Supporting this argument we would like to point to a comprehensive study which was carried out and published on behalf of the European Commission, stating: *"The fact that substitution at both a service and a call level is taking place demonstrates that, in the mind of the customer, there is a blurring of the traditional distinction between fixed and mobile services."*². Artificially splitting up companies who provide services in both segments is therefore becoming increasingly untenable.

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

The CAPM has established itself as the standard model for calculating or estimating equity costs of capital (returns). The model is not without faults, many of which have been dealt with extensively in the academic literature on the topic, and other models (e.g. APT) have been

² Squire, Sanders & Dempsey, Analysys, 2000, Main Report, p. 22

developed. However the CAPM remains the model of choice because of its good relationship between complexity of calculations and quality of results, as it is fairly straightforward and accurate.

G: Qualitative characteristics of accounting information

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

Telekom Austria does not agree with the idea to oblige the notified operator 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. It would mean a disproportional effort to provide accounting information for regulatory purposes based on a different standard than the statutory accounting system is based (e.g. US-GAAP).