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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 19 September 2005

COMMISSION STAFF WORKING DOCUMENT

Explanatory Memorandum of the Commission Recommendation

**ON ACCOUNTING SEPARATION AND COST ACCOUNTING SYSTEMS UNDER
THE REGULATORY FRAMEWORK FOR ELECTRONIC COMMUNICATIONS**

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ON ACCOUNTING SEPARATION AND COST ACCOUNTING SYSTEMS UNDER THE REGULATORY FRAMEWORK FOR ELECTRONIC COMMUNICATIONS

1. CONTEXT: OBJECTIVES OF THE RECOMMENDATION

- 1.1. This Recommendation updates the Recommendation of 8 April 1998 on Interconnection in a liberalised telecommunications market (Part 2 - Accounting separation and cost accounting)¹ following the application of the new regulatory framework for electronic communications networks and services (25 July 2003)².

This revision is necessary since the new regulatory framework brought about some important changes to the regulatory package of 1998 which require the adoption of a new Recommendation. In this respect, in order to be aligned to the new regulatory framework, the following aspects need to be taken into account:

- The enlarged scope of application of the new regulatory framework (this includes a wider range of networks and services since it covers all electronic communications networks and services in a technologically neutral manner);
- A different approach to the imposition of *ex ante* obligations (the imposition of *ex ante* regulation is generally possible only after a market analysis and in the event the market is not effectively competitive; the definition of significant market power is equivalent to the concept of dominance as defined in case law);
- A different scope of application of the specific provisions concerning cost accounting and accounting separation (which, under the new rules, may cover both access and interconnection).

In addition, in 2002 the Commission contracted a study on the implementation of cost accounting and accounting separation³. This study proposed certain regulatory enhancements with a view of reviewing the Recommendation of 1998, which have been taken into account in this new Recommendation.

- 1.2. The overall objectives of the Recommendation are to:

- Set out common principles and methodologies for data to be analysed and, at the same time, provide guidance on how to implement them;

¹ OJ L 141, 13.5.98, p.6.

² This Recommendation included a review clause (point 9); the deadline for reviewing the Recommendation of 1998 (31 July 1999) was implicitly linked to the review of the regulatory package of 1998.

³ Study on the implementation of cost accounting methodologies and accounting separation by telecommunications operators with significant market power, prepared for the European Commission, DG Information Society by Andersen Business Consulting, June 2002.

- Ensure a consistent application of principles, systems and methodologies at EU level taking into account the experience gained at national level in the implementation of the regulatory framework of 1998;
- Improve the transparency of the methodologies used, of data elaborated, and of the reporting and auditing process to the benefit of all involved parties; and
- Adjust the Recommendation of 1998 to the new regulatory framework for electronic communications networks and services.

2. THE LEGAL ELEMENTS OF THE RECOMMENDATION

2.1 The legal basis of the Recommendation is Article 19 of the Framework Directive 2002/21/EC for electronic communications networks and services⁴, which enables the Commission to issue Recommendations on the harmonised application of the regulatory framework.

This Article requires that the Commission submit proposals for any such Recommendations to the Communications Committee for Opinion. It also provides that Member States ensure that NRAs take the utmost account of such Recommendation and give reasoning to the Commission if the Recommendation is not followed.

2.2 The Recommendation concerns the implementation of accounting separation and cost accounting systems by operators designated by the National Regulatory Authorities (NRAs) as having significant market power on relevant markets as a result of a market analysis carried out in accordance with Article 16 of the Framework Directive⁵.

The use of these two obligations by notified operators makes transactions between operators of e-communications more transparent and is necessary to determine the actual cost of the provision of services; moreover, their implementation supports the application of other regulatory obligations (non-discrimination, cost orientation and price controls, transparency, etc.) included in the regulatory framework.

In detail, the provisions of the regulatory framework concerning the possible imposition of accounting systems and accounting separation to providers of electronic communications networks and services are the following:

- Access Directive⁶: Article 11 (obligation of accounting separation), Article 13 (price controls and cost accounting obligations) and Article 6(1) in connection with Annex I, part 1.b) (conditional access systems);

⁴ Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services (Framework Directive), OJ L 108, 24.4.2002, p.33.

⁵ See footnote 4.

⁶ Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (Access Directive), OJ L 108, 24.4.2002, p.7.

- Universal Service Directive⁷: Article 17 (regulatory controls on retail tariffs) and Annex VII.2 (cost orientation) concerning the conditions for the minimum set of leased lines referred to in Article 18.1 of the same Directive;
- Framework Directive: Article 13 (accounting separation and financial reports).

2.3 The Recommendation does not concern statutory financial accounts and their reporting that may be required under national or Community law.

2.4 The Recommendation of 1998 will remain applicable to those Member States that have not yet completed the transition from the old to the new regulatory framework, i.e. have not reviewed existing obligations in accordance with the market analysis procedure.

3. CONTRIBUTION OF THE EUROPEAN REGULATORS' GROUP AND CONSULTATION OF INTERESTED PARTIES

3.1 The Recommendation is based upon the Opinion of the European Regulators Group (ERG)⁸ (ERG (04) 15rev1). The ERG Opinion was published in September following a public consultation on a draft document⁹. The ERG Opinion incorporated comments of an auditor funded under a Commission contract, who was asked to verify from an accounting point of view the methodologies and the principles set out in the draft Opinion.

3.2 The ERG also published a Common Position (ERG (05) 29) which covers the following areas: i) cost accounting and accounting separation; ii) attribution methodologies and the application of the cost causality principle; iii) current cost accounting; iv) Long Run Incremental Cost; v) the cost of capital and capital employed; vi) qualitative characteristics of accounting information; vii) transparency, confidentiality, market-related limitations; viii) audit scope and verification, and represent an agreed position by the members of the ERG on these issues.

4. THE CONTENT OF THE RECOMMENDATION

4.1 The Recommendation includes the following points:

- An introductory paragraph (point 1), explaining the purpose of imposing accounting separation and cost accounting;
- Horizontal provisions which apply to both accounting separation and cost accounting. These cover the following two aspects:

⁷ Directive 2002/22/EC of the European Parliament and of the Council of 7 March 2002 on universal service and users' rights relating to electronic communications networks and services (Universal Service Directive), OJ L108, 24.4.2002, p.51.

⁸ Commission Decision of 14 September 2004 amending Decision 2002/627/EC establishing the European Regulators Group for Electronic Communications Networks and Services, OJ L293, 16.9.2004, p. 30.

⁹ <http://Erg.eu.int>

- The principles to be followed for the disaggregation and allocation of costs, etc., the criteria to test the reporting system of the notified operator (point 2);
- Provisions aimed at increasing the transparency of methodologies and data (point 5), without prejudice to commercial confidentiality. These provisions are complemented by the Annex which sets out in detail the information to be prepared and published for the purposes of accounting separation and cost accounting. In this regard, it should be borne in mind that reporting and publication requirements serve a number of important objectives including the following ones: i) they foster the consistency of data and reports prepared at Community level; ii) they establish confidence of market players in demonstrating compliance with relevant regulatory obligations; iii) by raising confidence in access/interconnection conditions provided, they facilitate negotiations between undertakings; iv) in making transparent the relationship between wholesale charges and costs, they might help identify potential anti-competitive behaviour of the access provider or deter such behaviour once relevant data are made available to interested parties.
- Provisions providing guidance on the implementation of cost accounting systems (Point 3). The key points dealt with by the Recommendation are as follows:
 - The decision of NRAs to move from an historic to a current cost basis should be planned in advance since such a move might result in a significant change of wholesale charges. A planned move over time to different level of charges/prices may send a more effective economic signal to new entrants which need information on the level and the evolution of economic conditions applied and avoid the potential destabilising effect of sudden price spikes.
 - The Recommendation provides guidance on how to evaluate network assets at current costs. In the consultation carried out by the ERG, no consensus emerged among market players and NRAs as to which costing methodology is to be applied, both in general terms and regarding specific parts of the network (e.g. the local access network and notably the local loop which is less replicable in the medium term). The approach chosen better satisfies the principles of proportionality and subsidiarity. NRAs will have the ability to select the most appropriate costing methodology consistent with the market situation in their Member State. This is to be preferred to an automatic and mechanistic choice of the accounting model independent from any national analysis. Therefore, the accounting model chosen will have to be economically justified, consistent and meaningful in relation to the specific national circumstances. In practice this implies that NRAs, in order to set the right access price (a fundamental decision given its impact on future investments of both new entrants and the notified operator) should form a view on whether network replication can be considered feasible or not, taking into account different technological and economic dimensions at national level.

- The provisions of the Recommendation take into account the difficulty of implementing some costing methodologies (e.g. the possible re-evaluation of network assets is a complex task which needs to take into account several aspects); furthermore, adjustments may be necessary to remove inefficiencies or unnecessary costs while due regard should be paid to competition issues.
- Provisions providing guidance on the financial statements to be prepared by undertakings subject to an obligation of accounting separation (point 4), and their reconciliation and consolidation with statutory financial statements. Particular care is to be given to transfer charges (i.e. transactions that flow between disaggregated regulatory entities) in order to demonstrate compliance with non-discrimination obligations.
- Provisions regarding Member States operating a universal service scheme to finance universal service obligations (point 6). In this regard, the contribution received by the designated undertaking should be separately identified in the separated account to ensure transparency of such compensation and avoid possible anti-competitive cross-subsidy.

5. CONCLUSION

- 5.1 In conclusion, the purpose of the Recommendation is to provide guidance on the application of cost accounting and accounting separation for operators designated by their NRA as having significant market power on a relevant market as a result of a market analysis.
- 5.2 The Recommendation encourages Member States to adopt harmonised methods and comparable accounting systems. In doing so, it will contribute to the development of an Internal Market by improving EU-wide consistency in application of the new regulatory framework and thereby underpin the creation of more competitive and transparent access conditions for alternative operators in the electronic communication sector. This will promote competition and deliver benefits to EU citizens.