



ERGP (12) 28 – draft Common Position on cost allocation rules

DRAFT ERGP COMMON POSITION ON COST ALLOCATION RULES

FOR PUBLIC CONSULTATION

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Preliminary comments on the public consultation

The draft ERGP common position draft on cost allocation rules is submitted to public consultation between the 28 November 2012 and the 23 January 2013. The ERGP will welcome any contribution from stakeholders of the postal sector, and invites the respondents to structure their answers based on the following questions:

Question 1: please provide comments on the ERGP draft common position on the scope of regulatory accounting

Question 2: please provide comments on the ERGP draft common position on the allocation rules

Question 3: please provide comments on the ERGP draft common position on the auditing procedure



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Executive summary

Based on issues identified during the elaboration of the 2012 report on common cost allocation¹, the European Regulators Group for Postal Services (ERGP) has now reached a common position as regards the scope of regulatory accounting, the classification of costs on allocation rules and the verification of the accuracy and reliability of the regulatory accounts, to obtain a satisfactory cost allocation, in particular as regards common costs.

The common position starts with some definitions of the different types of cost accounting and their respective goals. It also stresses that cost accounting is a set of rules used to calculate costs that can be used for different goals (pricing, competition law analysis, net cost calculation, etc.). This distinguishes regulatory accounts from statutory accounts or costs accounts.

As regards the scope of regulatory accounting, one of the main issues faced by regulators is to prevent inappropriate cross-subsidisation between universal service and non-universal service products and services. In this respect, the report emphasises the importance of the totality principle and recommends that the regulatory accounts should encompass any activity that is used by both universal service and non-universal products and services.

Furthermore, given the impact of cost allocation on the different issues regulators deal with – transfer prices between the universal service provider (USP)² and its fellow subsidiaries or divisions or segments, net cost calculation of a public service mission, price regulation, etc. – appropriate standards should be used to ensure that the prices are not anti-competitive, and that no cross-subsidisation is taking place.

The issue of cross-subsidisation also raises the question of transfer prices. The ERGP considers that, in principle, transfer prices between different units or subsidiaries within the USP should be set at cost. Transfer prices between the USP and other related entities should be based on market prices, where a marketplace for the related services showing effective competition exists. In the absence of market prices, transfer prices should be cost-oriented.

As regards the different types of cost, the ERGP considers that the principles used to establish regulatory accounts should include, inter alia, the principles of cost causality, objectivity, transparency and consistency. Subject to national legal provisions, the preferred

¹ http://ec.europa.eu/internal_market/ergp/docs/documentation/ergp-11-16-rev-1_en.pdf

² For countries where there is no designated universal service provider, the term USP stands for the incumbent operator



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solution is that the national regulatory authority (NRA) sets methodological principles which specify the high-level accounting and costing rules.

The report recalls the classification between direct costs, joint costs and common costs, as set by the 2012 ERGP report. Due to the organisation of the postal process, joint costs are significant in the postal sector. If the accounting system is refined enough, then the share of common cost should eventually be rather small. To reach this goal, the principle of cost causality must apply and cost drivers should cover technical relationships between products and activities. In this regard, the ERGP considers that the USO should not be regarded as a cost driver per se, but must be clearly evidenced as such by operators and formally acknowledged by the NRA. In some cases, specific allocation rules might be used to reduce the share of common costs, as long as they do not come into conflict with the cost causality principle. When a specific allocation rules is used by the USP, the NRA should have access to sufficient information to assess the impact of the rule, and, if the NRA is not able to set the allocation rules, it should have access to a sufficient level of information to implement different allocations rules. This principle also applies for the modelling of stand-alone and incremental costs.

Finally, as regards the accuracy and the verification of the accounts, the ERGP emphasises the importance of adherence to the broad principles of the regulatory audit: completeness, accuracy, objectivity, causality, equivalence, consistency, and materiality. Independent verification of the accounts should cover revenue and cost scope, allocation rules, in particular the correct documentation and appropriate updates of any parameters or measures used for cost allocation.

The main principles of this common position are emphasised below

SCOPE

1. Regulatory accounts are neither statutory accounts nor cost accounts; however, NRAs should have access to the necessary information to verify the correct reconciliation between them.
2. Cost accounting is a set of rules used to calculate cost that can be used for different goals (pricing, competition law analysis, net cost calculation, etc.). The presented principles should allow regulators (NRA, Government, Competition Authority...) to apply the relevant standards in a consistent way for those different tasks.



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3. According to the totality principle, the regulatory accounts should encompass any activity that is used by both universal service and non-universal products and services.
4. In principle, transfer prices between different units or subsidiaries within the USP should be set at cost. Transfer prices between the USP and other related entities should be based on market prices, where a marketplace for the related services showing effective competition exists. In the absence of market prices, transfer prices should be cost-oriented.

ALLOCATION RULES

5. The principles used to establish regulatory accounts should include, inter alia, the principles of cost causality, objectivity, transparency and consistency. Subject to national legal provisions, the preferred solution is that the NRA sets methodological principles which specify the high-level accounting and costing rules.
6. Typology of costs should be in line with the main concepts of direct cost, joint cost and common cost. A distinction between pipeline overheads and general overheads can be made.
7. Common costs should tend to be minimized. The level of common costs should be known by the regulator.
8. The principle of cost causality applies. Cost drivers should cover technical relationships between products and activities. In this regard, the USO should not be regarded as a cost driver per se, but must be clearly evidenced as such by the USP and formally acknowledged by the NRA.
9. Specific allocation rule: In some cases, specific cost allocation rules could be considered to reduce common costs (allocation based on stand alone cost, peak-load pricing, etc.). In these cases, the regulatory accounting should give details on them and the NRA should have sufficient information to challenge them if necessary.
10. Regulatory accounting should provide elements that would enable the modelisation of stand-alone and incremental costs,
11. The regulatory accounting methodologies should be explicit, after being submitted to and approved (subject to national domestic provisions) by the NRA. The NRA should have either the power to change the regulatory accounting rules or access to sufficient information to implement alternative allocation rules.



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AUDITING PROCEDURE

12. Audit is subject to broad principles, including: completeness, accuracy, objectivity, causality, equivalence, consistency, and materiality.
13. Scope of audit should extend beyond universal service, as requested by the totality principle;
14. Auditing procedure should cover the following subjects:
 - Consolidation and reconciliation with statutory accounts or other source of costing information;
 - Profit and Loss Statements;
 - Correctness of figures, including operational data like volumes;
 - Allocation of revenues
 - Allocation of costs
 - Resources used, in particular capital employed statement (namely, detailing form of calculating and value of parameters used);
 - Other supplementary schedules as required, e.g. reconciliation of top-down and bottom-up revenue data from traffic estimates.
15. A description of the methodologies used to prepare costs should be available, including:
 - Reference to cost base and standards, allocation and valuation methodologies,
 - Identification and treatment of joint and common costs,
 - The frequency of updates for indices used for cost allocation purpose,
 - Methodologies used regarding amortization, cost capitalization, allocation and for the evaluation of the assets;
 - Non-discrimination notes (namely, detailing transfer charges);
16. Auditor should be independent from the USP: the following statements should be made
 - Audit opinion in line with legal and regulatory obligations (if required by the national regulatory authority);
 - Compliance with EC and national regulations statement.



0. – Introduction

The ERGP common position is building on the 2012 ERGP report on cost allocation³. It intends to present some shared principles on cost allocation, in order to fulfil the aims set by the postal directive⁴, in particular in article 14.

Cost allocation is a task that can be used for multiple goals, in particular:

- (i) ensuring universal service provision,
- (ii) preventing the abuse of market power by postal market operators, either directly or indirectly.

Eventually, the allocation rules are under the responsibility of the USP, but the elaboration of the accounts should follow a specific process involving the NRA, subject to the domestic legal provisions. Three steps are reviewed in this common position. The outline is the following:

- First section is about the scope of the regulatory accounts
- Second section is about the types of costs and the allocation rules
- Third section is about ensuring that the figures provided in regulatory accounting statements are valid and accurate. Some principles to ensure that this aim is met are provided for.

This introduction is starting with some preliminary reflections on the different types of accounting that are produced by a company and how the regulatory accounting fits in. It moves then to a description of different costs standards and their relevance according to the situation.

0.1. – Comparison between financial accounting and cost accounting

Financial accounting and cost accounting are the two types of accounting systems most used by companies; the first is an information tool and plays a legal role, while the second is an analysis tool enabling managers to make the right decisions.

³ Report published in August 2012. It is available on the ERGP website:
http://ec.europa.eu/internal_market/ergp/docs/documentation/ergp-11-16-rev-1_en.pdf

⁴ Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service, as amended by the Directive 2002/39/EC of 10 July 2002 and by the Directive 2008/6/EC of 20 February 2008.



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Regulatory accounting, discussed in this document, is based on cost accounting and not on financial accounting – nevertheless there must be reconciliation between regulatory accounts and statutory financial accounts.

It seems useful to clarify the difference between the two in the following sections.

0.I.a – Financial accounting (or statutory financial accounting)

The financial accounting is the field of accounting concerned with the preparation of financial statements for decision makers, such as stockholders, suppliers, banks, employees, government agencies, owners, and other stakeholders. The fundamental need for financial accounting is to reduce principal-agent problem by measuring and monitoring agents' performance and reporting the results to interested users.

Financial accounting is used to prepare accounting information for people outside the organization or not involved in the day-to-day running of the company.

In short, financial accounting is the process of summarizing financial data taken from an organization's accounting records and publishing in the form of annual (or more frequent) reports for the benefit of people outside the organization. Financial accounting is governed by both local and international accounting standards.

0.I.b – Cost accounting

Cost accounting is not mandatory within the framework of accounting regulations that apply to companies in general. However, in order to manage a company on a daily basis, financial accounting is not enough.

It is necessary to know various elements such as the cost price of a product, as well as the main variations of the company's key indicators.

Cost accounting is a system of accounts, tuned to financial accounting, allowing to identify and value the components of the result of the financial year and allowing those components to be interpreted and used by the management. It divides the results according to decision centre allowing a better management, or consolidates them according to line of activity, in order to better judge its situation. Sometimes it is associated with other managerial techniques, such as budget management or goal management, for which it provides elements of comparison as management accounting.

While it was reserved for a long time to large industrial companies, because of its complexity and implementing costs, cost accounting became more widespread with the appearance of information technology (IT) and management tools, which have strongly lowered the cost of collecting and processing detailed information. It now relates to all forms and sizes of companies, where it constitutes one of the key elements in the information system.



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Unlike financial accounting, which is highly standardised (IFRS, GAAP), intensively regulated, and common to all companies, cost accounting is based on a wide variety of methods and international standards are rudimentary.

One method, most widely used in the postal sector as mentioned in the ERGP 2011 report on cost allocation, is the Activity Based Costing (ABC) method. Its key principle is the following: cost objects (products, customers...) consume activities which in turn consume resources.

0.II. – Cost standards

Even when one method for cost allocation is chosen, there are still different choices as regards the cost standard that is eventually produced. On this question, the ITU has emphasized the following list of cost standard relevant for regulatory issues⁵.

a) Fully Distributed Costs (FDC)

This standard consists in allocating categories of costs, which can be directly or indirectly attributed to services. These categories of costs are: direct volume-sensitive costs, or direct variable costs, direct fixed costs, and a share of the joint and common costs.

b) Stand Alone Costs (SAC)

SAC is a cost standard that measures the cost of providing a service by the operator in isolation to other services of the company. SAC comprises all directly attributable costs and all shared cost categories related to production of the service, thus it includes direct variable costs, direct fixed costs, common and joint costs. Under this allocation method, the shared costs are totally supported by the service that is to be provided in isolation.

c) Marginal Costs (MC)

This standard calculates the costs of increasing output by one additional unit. Therefore, the marginal costs include only the direct variable costs excluding any other cost category, such as common and/or joint costs which should be recovered by means of specific mark-ups. In contrast to SAC, MC provides the lower limit in the wholesale price regulation.

d) Long-Run Average Incremental Costs (LRAIC)

⁵ “Regulatory accounting guide” Telecommunication Development Bureau March 2009, ITU (p. 21-23)



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LRAIC associates a long-term horizon with incremental costs. Incremental cost measures the cost variance when the production output increases or decreases in a discrete increment. In the particular case where the increment considered is a single unit, incremental costs equal marginal costs.

Depending on the circumstances, different cost standards might be relevant. This common position is not about defining one relevant cost standard, it is rather about ensuring that the appropriate cost standard can be evaluated consistently by the NRA or any other third party if appropriate (competition authority, etc.), according to the circumstances, with a sufficient level of confidence. The issues at stake are emphasized in the following section.

0.III. – A tool for different issues

Cost allocation is a fundamental issue for regulatory policies governing postal market. Its importance cannot be properly understood without a prior discussion of the impact of cost-allocation on different issues: tariffs in the context of “cross-subsidies”, price regulation, net cost calculation.

The applied methodology of cost allocation has immediate impact on the universal service and on the conditions of competition in the postal sector. Actually the letter market for residential customers is not competitive in most member States, so that the pressure for the incumbent to charge prices at a level which merely covers the costs will be weak. As long as the incumbent largely dominates this letter segment, there is a risk that a significant part of joint and common costs will tend to be allocated to the universal services⁶. Accordingly there is indeed the risk that revenues generated within the universal service segment cross-subsidize competitive non-universal services. By allocating an excessive part of common and joint costs to the universal sector there is the risk that cross-subsidisation could turn the incumbent artificially competitive in non-universal services leading to efficient suppliers

⁶ As it was mentioned in Cigno *et al.* (*), “where incumbent operators do not face competition, there is little incentive to correctly allocate costs to products. They will have an incentive to increase the costs of products sold to customers with inelastic demand patterns, and to offer lower prices to customers with elastic demand patterns. In addition, where some postal products are subject to active competition, the incumbent operators will have the incentive to minimise the cost allocated to those products, in order to compete with other providers of the postal products”.

(*) *Allocating the cost of delivery to postal products – principles and Practice, of 18th Conference on Postal and Delivery Economics*: Cigno, Margaret PRC (USA); Forslund, Lars PTS (Sweden); Grazell, Jos University of Tilburg (the Netherlands); Hearn, John ComReg (Ireland); Knott, Gavin Postal Services Commission UK; Penris, Wino OPTA (the Netherlands); Waller, John PRC (USA)



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being excluded from the market. A permissive approach to cross-subsidisation could thus jeopardise the beneficial effects of liberalisation by allowing incumbents to use revenues generated in the activities where they are dominant to forestall the entry of new operators on the markets on which they face competition.

In order to be able to assess such anti-competitive welfare damaging practices legal provisions may impose the incumbent to establish a strict cost-accounting separation between universal and non-universal services. Detailed guidelines and specifications with regard to the allocation rules should allow the NRA to analyse cost-data and prices, in order to assess whether and to what extent cross-subsidisation occurs.

Accordingly, transparency in relation to the allocation rules on the basis of consistently applied and objectively justified cost accounting principles constitutes a key element within the context of price-regulation. When a price-cap is used, determining the cost level – a crucial step for the determination of X-factor – requires that the non-direct costs should be allocated appropriately, on the basis of generally accepted allocation rules.

Furthermore cost allocation rules play an important role when calculating the net costs of the universal service. Although net cost calculation is not produced exclusively by the accounting system (since it is necessary to evaluate avoided costs and lost revenues in a counterfactual scenario) for the calculation to be well grounded, it is crucial to correctly identify the relevant costs and revenues. This requires the choice of commonly applicable allocation rules as well as knowledge of common costs attributed to the universal services. For such investigations full transparency in relation to the extent of common and joint costs is crucial. For doing this calculation, the NRA needs to be able to identify fixed and variable (or incremental) costs; therefore information on the cost structure of the incumbent broken down into direct, joint and common costs is needed.

In order to be able to fulfil those different objectives, the ERGP has identified the following principles that should be implemented as regards the cost accounting system of the USP.

I. – Scope of regulatory financial reporting

The purpose of this chapter is to provide guidance on the principles that should prevail in the elaboration of the scope of the regulatory accounting.



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I.I. – Totality principle

The scope of the regulatory financial reporting should cover the totality of all the activities which contribute to the provision of the universal service. Some of these activities may happen to contribute also to the provision of products or services outside the USO.

If some activities are shared in this way, the scope of the regulatory reporting should cover the totality of those activities, and consequently all the products or services to which they contribute, whether they are inside or outside the USO (in a manner that allows comparison between US and non-US products and services). The main rationale for this principle is to prevent inappropriate cross-subsidisation between US and non-US products and services.

The most effective way of ensuring that the US products and services are allocated a fair share of the revenues and activity costs, in comparison with non-US products and services, is to apply an integrated and consistent costing and accounting methodology to the totality of the activities which contribute to the US products and services.

Often the totality of these activities is embodied in an integrated network of activities which collects, sorts, transports and delivers various types of mail. Both US and non-US products and services flow through this common network. This common network is sometimes referred to as the 'USP network'.

Some NRAs may be subject to legal constraints on whether they can require the inclusion of non-US products and services. However, providing it is permitted by individual countries' legal requirements, the scope of regulatory financial reporting should extend to the whole of the USP network, i.e. all activities shared by US and non-US products, including non postal services.

I.II. – Regulated Business

Some USPs have a corporate structure which complicates the definition of the scope of regulatory financial reporting. The USP network may be used by more than one business unit, or more than one legal entity within the USP group (e.g. by two fellow subsidiaries).

Alternatively, the business unit or the legal entity which controls and uses the USP network may also conduct other operations, including the provision of services that are central and shared between the USP network and the other operations, such as procurement, finance, and even fleets of vehicles.

In all of these scenarios, the totality principle should be applied by defining the 'Regulated Business' which encompasses the totality of the activities contributing to the US products



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and services. The Regulated Business is a regulatory construct which may cross over the USP's official business unit boundaries, or the legal definitions of the USP group companies.

Often the main challenge of defining the Regulated Business is to exclude those activities and operations of the contributing entities, which are irrelevant to the USP network.

An example in the UK is the UK Parcels, International and Letters ('UKPIL') business unit of Royal Mail Group Limited. UKPIL includes both the USP network, i.e. the Regulated Business, and Parcelforce which does not use the USP network. Royal Mail Group Limited, itself is a legal entity which conducts other operations that do not use the USP network. It also provides central services such as procurement and finance to both the USP network and Parcelforce.

In order to define the scope of the Regulated Business, NRAs need to ensure that the USP discloses to them all of its related parties, and the nature of its relationship with those parties.

I.III. – Accounting separation

Accounting separation is often necessary to ensure robust financial data is produced for the Regulated Business. Accounting separation measures should enable the USP to generate and maintain separate financial data, and any necessary operational data for the Regulated Business.

One of the key features of accounting separation is transfer pricing. For instance, if another business unit related to the USP uses the vehicle fleet which is controlled and used primarily by the Regulated Business, then transfer charges should be considered for the hire of vehicles by that business unit.

The main principle for regulatory transfer pricing is the principle of equivalence. It requires transfer prices to be determined, as far as possible, based on market or regulated prices for comparable services. This will ensure that the Regulated Business is separated - for reporting purposes – on an arms' length basis. It prevents inappropriate cross-subsidisation between the Regulated Business and the remainder of the USP group.

If the units or entities providing and receiving the services or products are both within the Regulated Business, then, in principle, the transfer prices should be set at cost.

Where no comparable open market or regulated services or products exist, transfer prices should be set such that they are cost oriented.



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Additional control might be required in this case, comparable to the ones performed in fiscal matters.

Those general principles can be illustrated by the following example:

If the transfer price within the group is in line with the competitive price of alternative providers, then this price could be used as the cost of providing this input in the regulatory accounting systems. If the input is provided by a sister company that enjoys substantial market power (e.g. it is almost unique by the size or scope of its operations, for instance delivery at national level, large volumes sorting, etc.), then the sister company could fall within the scope of the regulatory accounts, and the allocation rules could be submitted to the NRA. This would also prevent the circumvention of regulatory requirements by the spin-off of subsidiaries by the incumbent. This discussion can be illustrated by the three following cases, depending whether the serving unit and the receiving unit are providing mainly universal services or not.

- **Case A: serving unit and receiving unit are under the scope of USO**
In principle, transfer-charges should be based on costs incurred for the provision of the relevant services as long as the business units involved in the transaction process are exclusively providing universal services. These units are obliged to keep separate accounts. Consequently detailed disaggregated cost-data of the serving and receiving unit can be generated and are available for regulatory purposes and their cost data could be basis for the calculation for transfer-charges and be submitted to the NRA.
- **Case B: serving unit is not under the scope of USO, but receiving unit is under the scope of USO**

The use of market oriented transfer-charges could be an option if the serving party does not primarily deal with universal services and there exists a marketplace showing effective competition where comparable services are offered for other customers so that prices are geared to costs. If cost data for units involved in the transaction process are not available, as this unit does not primarily provide universal services and therefore is not subject to the obligation on cost-accounting, transfer charging could alternatively be based on the market prices as a substitute for cost based transfer charges.

- **Case C: serving unit is under the scope of USO, but receiving unit is not under the scope of USO:**

If a business unit mainly engaged in the universal segment provides services for the non-US segment transfer charges should be cost-oriented in order to prevent distorting effects on competition.



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As the US segment is largely monopolized there might be an incentive for the USP to charge transfer prices which undercut the costs for providing the service. The charging of below-cost-transfer charges could lead to cross-subsidy of the activities in the receiving segment. By offering services at reduced and discounted conditions such transfer charges could raise the concern of impairing the opportunities of other operators.

I.IV. – Financial sustainability of the USO

The financial results⁷ and position⁸ of the Regulated Business are necessary for an NRA to fulfil its duties with regard to the financing of the provision of the USO, and facilitating competition. However, in some cases the NRA may feel a need to consider the financing of the USO, also with reference to a corporate entity which is different from the Regulated Business.

Often this corporate entity is a parent company of the Regulated Business or a wider business that encompasses the Regulated Business. If the financing and investment decisions are taken at the level of this entity, then it may be necessary to monitor the financing of that entity in addition to the Regulated Business.

This approach has two advantages. Firstly, this approach will ensure that the NRA can monitor decisions and events which may not fall into the scope of the operations of the Regulated Business, but can potentially affect the Regulated Business, and the financing of the USO. An example is USP's other non-USO business activities which may have a higher risk associated with them.

Secondly, the accounting separation of the Regulated Business (and in particular the associated transfer pricing) may result in creation of theoretical cash flows which do not correspond to real cash flows. Considering the real cash flows of a higher level entity would ensure that the cash flows of the Regulated Business are put in a real-world context.

⁷ Profit and Loss, cash flow

⁸ Balance sheet information: net assets/debt, net capital employed



I.V. – Specification of regulatory accounting methodology

Most USPs are required to provide the NRA with regulatory financial reports, including annual regulatory accounts. However, there is considerable variation in the extent to which the NRAs specify regulatory accounting methodology.

In some countries, there are legal constraints on the extent of specification by the NRA. However, subject to such legal constraints, the preferred solution is that the NRA sets methodological principles which specify the high-level accounting and costing rules.

USPs have more detailed knowledge about their business, and given the fact that the regulatory accounting obligation is set for a number of years and many USPs already prepare statutory and internal management accounts, they should have taken appropriate actions in order to be better positioned to devise the most appropriate and practicable regulatory accounting methodology. However, there is a risk, if the NRA is not able to intervene at a certain level of details of the allocation rules, that the USP may favour methodologies that suit its interests e.g. risk of inappropriate cross subsidisation by setting cost allocation rules that allocate more costs to regulated USO products and away from competitive non-regulated products.

A set of broad principles should define a framework by which compliance can be assessed. These broad principles may be the fundamental principles which are expected to be complied with in any regulatory reporting context. They may include principles of completeness, accuracy, objectivity, causality, equivalence, consistency, and materiality.

The text defining these principles may not be more than a page or two. An example is the Guiding Principles set by Ofcom in the Accounting Condition for Royal Mail, which came to force in April 2012⁹.

Depending on the circumstances, the NRA can vary in its specification from certain specific issues, to the whole spectrum of accounting and costing rules. The level of detail in the rules represents another dimension in the range of specification. Ofcom's Regulatory Accounting Guidelines¹⁰ that came into force in April 2012 is an example.

This solution gives the NRA significant control over how the figures in the regulatory reports are produced. However, the more detailed and granular the prescribed rules are, the more

⁹ <http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/annex10.pdf> see USPAC 1.7.2

¹⁰ <http://stakeholders.ofcom.org.uk/binaries/consultations/review-of-regulatory-conditions/statement/annex11.pdf>



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important it is for the NRA to ensure that the level of control is appropriate and proportionate.

Nevertheless, this ability of the NRA to define rules should not absolve the USP from the responsibility of implementing coherent and accurate cost allocation rules. On the contrary, it shall have to demonstrate thoroughly the relevance of the chosen rules.

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II. – Classification of costs and allocation rules

This section purpose is to underline the necessity for the regulatory accounting to make a clear description of the different costs types used, that shall be, in any case, in line with the broad concepts of costs on which the ERGP agrees on a common position (see below).

The clarity of this description would rely on the identification, as detailed and thorough as possible, of the different items that constitute each cost type.

Cost allocation rules would then be based on that typology and also on the concept of cost causality whenever possible or, if not, on any other concept detailed by the regulatory accounting that could be examined by the NRA.

II.I. – Broad typology of costs

Research undertaken so far suggests two main types of costs depending on the causality link between a resource and a product:

- either a reciprocal direct link between both. In this view, the cost of a resource can be *directly* allocated to a product.

- or no direct link can be identified, thus leading to an indirect link for products which use a same resource. The measurement of the consumption of the resource by each product cannot be directly measured.

Article 14 of the Directive refers to the concepts of “direct” and “common” costs. The typology below relies on distinction between “joint” and “common” costs, where the sum of “joint” and “common” costs equals what in Article 14 is referred (solely) to as “common” costs.

According to Article 14 of the postal directive, those costs shall be allocated in the following way:

“(i) whenever possible, common costs shall be allocated on the basis of direct analysis of the origin of the costs themselves;

(ii) when direct analysis is not possible, common cost categories shall be allocated on the basis of an indirect linkage to another cost category or group of cost categories for which a direct assignment or allocation is possible; the indirect linkage shall be based on comparable cost structures;

(iii) when neither direct nor indirect measures of cost allocation can be found, the cost category shall be allocated on the basis of a general allocator computed by using the ratio of



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all expenses directly or indirectly assigned or allocated, on the one hand, to each of the universal services and, on the other hand, to the other services”

II.1.1. – Direct costs

These costs (fixed or variable) concern all resources that are attributable to one and only one kind of product, such as advertisement for bulk letter, specific envelope/forms for a specific products or services, terminal dues for cross-border mail, etc.

Since these costs can be directly attributed to only one particular product or service, they would end up as a unit cost for this product or service. No allocation is actually involved in this case (no cost driver is applied). Proper costing relies on the correct evaluation of the relevant volume¹¹.

II.1.2. – Joint costs

Joint costs concern costs of a resource shared by a group of products at the same time, such as postal services office workers, other postal services office costs (rent, depreciation, electricity, communications, etc.), mail street boxes. They are responsive to the degree of economies of scale and scope – and may include a fixed component¹². They should be allocated to each product of the group, by using a technical cost driver. A technical cost driver is an engineering based method through which it is possible to measure the consumption of the joint resource by each product. The consumption of the shared resource by each product represents the measure to allocate joint costs.

The ERGP considers that their allocation must rely on two main parameters as far as possible: (i) the quantity/volume/traffic of each product treated by the resource and (ii) the relative consumption of the resource by each product according to the flow of allocation in an ABC system.

If no cost driver is available, then such cost should be considered as common cost and allocated accordingly.

II.1.3. – Common costs

Common costs, also referred to as “overheads”, concern all resources related to general support and management in postal services. Examples of such costs are key personnel

¹¹ See the ERGP report on common cost allocation, p. 13-15

¹² See the ERGP report on common cost allocation, p. 13-18



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(board members, marketing director, human resources director, financial director), headquarters costs (rent, depreciation, electricity, maintenance). Differently from joint costs, common costs cannot be allocated by using a technical cost driver as there is no cost driver to measure the consumption of the common resource by each product. It is a cost “*which cannot be directly assigned to a particular service or product*” in the terms of the postal directive.

The allocation of common costs must should take into account, in the most appropriate way, the nature of the resource¹³, be in line with cost causality, and be coherent with the treatment of a similar resource in different occasions. The allocation must remain coherent with the incentive of efficient production.

When no measure of cost allocation can be found, the postal directive prescribes the use a general allocator, corresponding to an equi-proportionate mark-up over already attributed cost (EPMU).

It is possible to make a distinction between overheads; as a matter of fact, a better representation of the operational reality of postal services requires recognition of the role of some management/support resources in support of some specific production process, while some other management/support resources are not.

In the first case, the ERGP considers that the use of these resources creates “pipeline overheads”.

In the second case, the ERGP considers that the use of these resources creates “general overheads” that are used indistinctly by all products offered by the firm and which can be allocated to all products using EPMU.

II.II. – Allocation rules

II.II.1. – Cost accounting methodologies

a) Regulatory accounting methodologies

Previous work of the ERGP stressed on the widespread use of Activity Based Costing (ABC) methodology in regulatory accounts and the use of Historical Cost Accounting System (HCA) approach to calculate regulated charges. If the low level of capital investment and the

¹³ In this view, staff joint costs would, for instance, be allocated, if possible, according to an EPMU based on direct staff costs.



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predictable asset lives and residual values in the postal sector, these approaches seem the most appropriate for regulatory accounting purposes.

Given the specific attributes of each postal operator depending on the specificities of each country, the ERGP can only acknowledge these approaches as a general relevant rule; in the case where other accounting methodologies are used, the ERGP regards as prerequisite:

- that the methodologies are explicit in the regulatory accounting system,
- that the methodologies should be subject to a mechanism of review by the NRA

b) Top-down and Bottom-up approaches

Previous work of the ERGP stressed on the widespread use of a Top-down approach¹⁴ for cost allocation. There are a few exceptions for certain postal process and/or activities¹⁵. If the Top-down approach seems appropriate to grasp and reflect the complexity of the postal process, its relevance is limited regarding the allocation of common costs and, eventually, the total level of costs.

This assessment is based on the link between a Top-down approach and the financial information provided by the operator that feed the regulatory accounting; the accuracy and level of the Top-down allocation depend on these information.

In that view, the specification of the financial information provided by the operator to the NRA is a first step to guarantee the relevance of a Top-down allocation. Part 3 of the present document explores this issue and presents the ERGP position.

In the case where a Top-down allocation is not able to provide an accurate analysis of joint and/or common costs, the use of an alternative methodology such as a Bottom-up allocation might be considered in a second step. For that purpose, the ERGP considers that NRAs should be able to verify and check those systems when they are used by USPs, and, if

¹⁴ A Top-Down approach means that cost accounting data (from the general ledger) are identified at a global level, and then successively refined to (main) activities, sub-activities and finally to elementary activities / tasks (see definition below) using appropriate allocation keys. This approach is different from a Bottom-Up approach where an explicit description of elementary activities is used and then combined with activity measures and unit costs for the different resources in an elementary cost function. These costs are then aggregated successively to sub-activities and finally to the (main) activities to recover the total cost. In principle, the two approaches should be reconcilable at some intermediary cost level.

¹⁵ In some cases, the result of a Top-down allocation might need to be adjusted, e.g. to eliminate inefficiencies or correction for wrongly allocated common costs that may create potential for cross-subsidization.



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required, set the conditions and principles to develop such models. Since the legitimacy of a Bottom-up model compared to a Top-down' relies on the capacity of the first to provide with a better description of the operational reality, it is essential that any information or data that would ensure the accuracy of this model be also provided by the operator at the NRA request.

II.II.2. – Cost causality

Causality in the context of the postal network which can be characterized as a multiple service environment with large fixed cost (joint and common cost) is a controversial multi-dimensional concept with diverging outcomes where interests of operators and regulators collide.

As a general allocation rule, the principle of cost causality must apply.

The principle of cost causality consists in identifying the source of the cost endured for the production of a product/service. One of the issues raised by this concept in the postal sector is the consideration of the USO as cost driver or not.

On this subject, the ERGP considers that the USO cannot be regarded as a cost driver until proven otherwise by operators and formally acknowledged by the NRA.

The attention of the ERGP has been drawn on two examples where research on the USO as cost driver would be needed:

- if the USO comprises obligations related to the network of post office, the corresponding additional cost compared with a commercial network must be identified and measured when a USO net cost calculation is done. Since the accounting parameters used in such calculation depend on the cost allocation rules and the cost drivers, a discussion on the USO as a cost driver would be needed.

To assess whether this treatment is appropriate or not, it is essential that the relevant information is provided to the NRA. Furthermore, it should take into account, in any case, the potential existence of non-USO products sold in post offices that should bear an appropriate part of costs.

- the value added tax exemption that concerns the “*postal public services*” according to Article 132 of the 2006/112/CE directive of 26 November 2006 on the common system of value added tax.



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If there is no full harmonization, for the time being, in the respective national legislation on the signification of the “*postal public services*” – despite the interpretation of the Court of Justice of the European Communities in its judgment of 23 April 2009¹⁶ –, USO products and services are, for the majority of members, the ones effectively VAT exempted.

A proper treatment from a causality perspective of the VAT exemption requires taking into account the fiscal legislation that prevails for each operator. In this case, it is the tax status of the different products or services which should be a cost driver. The USO is only of secondary importance, as the tax exemption is linked to domestic tax rules which do not necessarily match the scope of the USO.

II.II.3. – Specific allocation rules

Some process or activity may require certain specific rules due to the concentration of joint and/or common costs. Typical examples of where such concentrations of joint and/or common costs are found are in the delivery process (network) and the network of post offices (or postal contact points).

For a given set of fixed and common cost categories to be recovered from services within the universal and non-universal sector (including parcel and non-postal services of the incumbent) different approaches can be followed, such as a fully distributed costs approach resulting in allocation according to proportionality reflecting the actual (and in some cases expected) utilization of the postal equipment and facilities. The costs of shared infrastructure are therefore equally allocated on the basis of resource consumption.

¹⁶ “The concept of ‘public postal services’ in Article 13A(1)(a) of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, must be interpreted to cover operators, whether they are public or private, who undertake to provide, in a Member State, all or part of the universal postal service, as defined in Article 3 of Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service, as amended by Directive 2002/39/EC of the European Parliament and of the Council of 10 June 2002.”

Judgment of the Court (Second Chamber) of 23 April 2009.

The Queen, on the application of TNT Post UK Ltd v The Commissioners for Her Majesty’s Revenue and Customs.

Reference for a preliminary ruling: High Court of Justice (England & Wales), Queen’s Bench Division (Administrative Court) - United Kingdom.

Sixth VAT Directive - Exemptions - Article 13, A, (1), (a) - Services supplied by the public postal services. Case C-357/07.



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A specific allocation rule can apply either to only the fixed part of a joint cost, or to the entire joint (or common) cost of a process. However, for a specific allocation rule to be appropriate, it is necessary that it is based on a thorough analysis relying on the principle of cost causality and also consistent with the hierarchy of rules put forward in the Directive's Article 14, paragraph 3, b (i) – (iv).

A fairly widespread basis for specific allocation rules is the use of the stand alone costing (SAC) methodology. Practical implementations of such SAC based allocation rules exist in (e.g.) Sweden and France (in both cases relating to joint costs of the delivery process).

SAC is based on modelling of separate stand alone networks/processes for each of the products that utilize a common resource/network/process. The model must therefore ensure that the stand alone network of a particular product can handle the real world product in a realistic way (e.g., in terms of quality and reliability). Since the sum of the costs of the stand alone process is larger than the (real world) joint cost of the joint process, SAC implies that this difference must be reallocated back to each product. To ensure consistency in the allocation, the reallocation of these implied synergies of joint operation should be done in relation to the stand alone cost of each product.¹⁷

Peak-Load pricing is another approach sometimes used by USP for the allocation of network costs and calculation of letter prices. In general, USPs offer different prices for letters whereas urgency in terms of average delivery times (first, second, third class services when applicable) is considered as a cost driver. Such a pricing strategy is based on an allocation rule which reflects the different usage of network facilities. The marginal costs depend on the period under consideration or for which quality requirements postal facilities are built up to serve peak demand. According to this concept the incumbent set up a postal infrastructure with a capacity to meet the requirements for priority services in terms of delivery times. As priority mail shall be delivered within one day the capacity for the delivery network should be dimensioned as to allow a processing during the peak-time. Non priority mail, however, will be generally processed within the off-peak-times. For these services there are no capacity limitations. As a result of this capacity utilization and restrictions, network costs are caused by the peak demand and not by the demand during off-peak-times. Based on this presumption the majority part of the common costs will be caused and consequently allocated to the first-mail-letters while the prices for second class letters only reflect incremental costs for the off-peak-usage. This allocation method yields the risk of marginalizing the costs attributed to the competitive non-universal segments.

¹⁷ Such reallocation of implied synergies is prescribed in ARCEP's Decision n°2008-0165. Also, this view is supported by PTS in an injunction to Sweden Post (PTS Dnr: 10-9595). (However, the PTS injunction is still under judicial proceedings.)



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Concluding from the different approaches the NRA shall give priority to the proportionality principle consistently applied between the products sharing joint and common costs. This principle reflects the actual use of network and minimizes the risk of anti-competitive cross-subsidisation. In case of dissent between NRA and USP in relation to the applied allocation method the USP shall prepare its cost records in such a way that enables the NRA to reallocate the common and joint costs to the USO and non-USO products.

Each country and operator specificities can lead to different allocation rules for process/activities with a high concentration of joint/common costs.

However, in these cases, since the significant impact of these rules on the level of costs can be significant, it is essential that the regulatory accounting gives details on them and that the NRA has sufficient information to challenge them if necessary.

II.II.4. – Transparency and updates of cost drivers

The cost causality principles, when and if correctly applied, requires that the main principles and the specific rules of the cost allocation are described in the regulatory accounting and audited by the NRA or an organisation commissioned by the NRA.

One aspect of these verifications must include the frequency of updates of indices that reflect the relative consumption of a resource by a product and that are used for cost allocation purposes.

As certain allocation rules can remain implicit in the regulatory accounting, it is essential for the NRA to have the power to request the USP to change the regulatory accounting when and if some implicit rules with significant impact on costs level are identified by the auditor and/or the NRA.

II.III. – Conclusion

Based on these assessments, and in order to achieve a detailed knowledge of the costs allocation of products and services of an operator, it is essential that:

- any regulatory accounting presents a typology of costs, and that this typology is in line with the main concepts of costs above,
- any regulatory accounting details as much as possible the different resources used in the different postal process,



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- the traffic data used for cost allocation purpose is measured in a transparent and accessible way to the NRA, and audited periodically by an independent and competent organisation,
- the relative consumption of a resource by a product is measured in a transparent, frequent and accessible way to the NRA and challenged if necessary by the latter,
- in case of an EPMU allocation, the typology of costs determines the order of allocation of the costs,
- any regulatory accounting provides, as much as possible, elements that would enable the modelisation of stand-alone and incremental costs,
- any cost allocation relies on a cost causality principle,
- the regulatory accounting methodologies are explicit in the regulatory accounting after being submitted to and approved by the NRA,
- relevant, detailed and accurate financial information is transmitted to the NRA (see chapter 3),
- the universal service shall not be regarded as a cost driver *per se*,
- the NRA should have either the power to change the regulatory accounting rules or should have access to sufficient information to implement alternative allocation rules,
- the level of common costs should be known by the regulator with sufficient detail to ensure regulatory needs.

III. – Accuracy and verification of accounts

III.I. – Accuracy and reliability of accounts

The purpose of this section is to provide guidance on the qualitative characteristics that a National Regulatory Authority would expect from the information prepared and presented by postal operators under any cost accounting or accounting separation obligations. It is essential and should be also in the interest of the USP that information is accurate and reliable and free of errors, misstatements and unexpected changes.

On this issue, the directive makes provision for an audit of the financial accounts of the USP conducted by an independent auditor. This provision is complementary to the obligation to



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submit financial accounts to audit by an independent auditor.¹⁸ According to Article 14-5 of the postal directive:

“National regulatory authorities shall ensure that compliance with one of the cost accounting systems described in paragraphs 3 or 4 is verified by a competent body which is independent of the universal service provider. Member States shall ensure that a statement concerning compliance is published periodically.”

III.I.1. – Basis of preparation

On the whole, accounting principles that apply to the preparation of general purpose financial statements under national or international accounting standards should be the basis of regulatory reporting.

Nevertheless, regulatory accounting information should be prepared in accordance with a set of principles, policies and procedures set out by National Regulatory Authority, either when initially defining the system or as a result of an audit process, reviews and investigations and a subsequent decision. These principles and procedures could include the following:

a) Accounting policies

These policies follow the form used for the preparation of standard statutory accounts and will include, for example, details of fixed asset depreciation (asset lives and depreciation methods).

b) Regulatory accounting principles

These principles establish the key doctrines to be applied in the preparation of regulatory accounting information. They should include, inter alia, the principles of cost causality, objectivity, transparency and consistency.

c) Costing methodologies

A description of the methodologies used to prepare costs, including reference to cost base and standards, allocation and valuation methodologies, identification and treatment of joint and common costs as described in chapter 2

¹⁸ In the postal sector, the article 15 of the directive states that: *“The financial accounts of all universal service providers shall be drawn up, submitted to audit by an independent auditor and published in accordance with the relevant Community and national legislation to commercial undertakings.”*



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d) Methods for identification of revenues and allocation of costs

A description of the attribution methodologies used to fully allocated revenues, costs, assets, liabilities and capital employed.

These bases for preparation need to be sufficiently detailed and comprehensive so as to ensure that the operator and the independent auditor can apply them consistently and thoroughly.

In addition to this, for a National Regulatory Authority to meet its objectives, regulatory financial information should be relevant, reliable, comparable, and substantial.

III.I.2. – Relevance and Materiality

Information is relevant if it has the ability to influence the economic decisions and inform about their impact. A National Regulatory Authority therefore should ensure that qualitative characteristic of relevance is applied as a selection criteria at all stages of the regulatory financial reporting process. In practice this may mean closely defining the basis of preparation, the form and content of the statements and verification processes.

Materiality is a term used to express the relevant significance and importance of a particular matter in the context of the preparation, presentation and audit of financial information.

A matter is material if its omission or misstatement would reasonably influence the economic decisions or interpretations of users. It is therefore, not always capable of general mathematical definition but is reliant of qualitative judgements and estimations. An item can be deemed material in the context of the accounts as a whole or at a more detailed level depending on the purpose of the information.

In the regulatory context, it is very important that materiality thresholds are taken into account when a National Regulatory Authority uses the information for compliance purposes. A transfer charge showing non-discrimination may, for example, need to be calculated in a very precise and accurate way but a general cost-orientation obligation could be examined with broader materiality thresholds.



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III.I.3. – Reliability

There are a number of criteria that can be applied to test if information is reliable, such as:

- it can depend upon users to represent faithfully what it purports to represent;
- is it free from deliberate or systematic bias;
- is it free from material error;
- is it complete (subject to materiality tests);
- its basis preparation is carried out in an objective way;
- has a degree of caution (i.e. prudence) been applied in exercising judgement and making the necessary estimates.

III.I.4. – Comparability

Information in a financial statement gains greatly in usefulness if it can be compared with similar information for other reporting periods in order to identify trends and differences. This aspect is particularly valuable to National Regulatory Authority where comparable information is used to assess the impact of competition or establish cost trends.

Comparability is usually achieved through a combination of consistency and disclosure of accounting policies. In a regulatory environment this would include regulatory accounting treatments such as cost attribution methodologies. Full transparency of these policies and other methodologies used to prepare regulatory financial statements is therefore important.

Comparability implies consistency over time in the way in which a regulated undertaking prepares and reports financial information. For instance, changes to the regulatory aggregates and sub-aggregates, changed accounting methodology, restatements, should only take place after National Regulatory Authority approval. As indicated above, disclosure of the basis of preparation together with any changes and of the effect of such changes enhances the usefulness of the data.

III.I.5. – Accuracy, Data integrity and Maintenance

Data in regulatory accounts have to be free of mistakes. It is up to the USP to ensure that data used for and in the regulatory accounts meet high quality standards.



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Furthermore it is with the responsibility of the USP that the data originally presented in the information system are the data submitted to the auditor and the National Regulatory Authority. Data integrity must also result by the availability of electronic support (or exceptional on paper) that enables the auditor to perform tests and verifications and allows it to begin the audit with confidence on the audited data. In the case of data processed and derived from an electronic system, the USP must also ensure a satisfying level of confidence in the security and stability of the system used.

Bearing in mind National Regulatory Authority duties and tasks, financial and regulatory information can be required and should be made available by operators on a periodic basis (at least annually), in order to monitor the compliance with regulatory obligations, and on request, for investigation and analysis of specific situations regarding non-compliance of regulatory obligations and possible anti-competitive behaviours. Additionally, financial information should be kept for a period in line with national legislation (e.g. statute of limitations), allowing to trace significant evolutions of costs, revenues and outputs and evaluate the effects on costs of applying possible different criteria and methods.

If the relevant data is put offline after a reasonable period of time (that is, data is removed from dedicated information systems in use by the operator), it should at least be possible to submit to the auditor documents (printouts or other material) certified by a high-ranking manager, which would at least allow the auditor to perform some test on data relevant at some time for the year of verification, although it would be impossible to test the system with the original data.

III.I.6. – Access to Information for not regulated services

Most Postal Operators are also characterised by being vertically integrated, with large service/products portfolios, with significant joint and common cost and can avail of significant economies of scale and scope. Postal operators of this type may operate in markets where they are subject to regulatory obligations as well as competitive markets. Thus, the division of services and products, and the corresponding costs, capital employed and revenues, between the different markets should be reflected in costing systems and coherence and integrity of information should be assured.

National Regulatory Authorities need to be able to ascertain to what extent services in regulated markets may impact on services supplied in non regulated markets. In order to determine the information required for regulatory purposes, it is necessary to explore the nature of the costs incurred by activities undertaken in the course of supplying a service (or combination of services).



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Detailed financial information relating to non regulated markets is of relevance to National Regulatory Authorities in so far as it demonstrates the non-discriminatory allocation of costs. To this end, controls related to services supplied in regulated markets must demonstrate that the internal transfer charges are similar to those paid by the competitors present in the same downstream market. Such controls may include the use of ‘control totals’ or a separate set of information for non regulated reconciled back to the statutory accounts for the aggregate of services supplied to non regulated markets if some suspect of unfair cross—subsidization exists or the transparency of attribution methods is not clear. Failure to do this could result in costs which should be charged to a competitive market being charged to a regulated market with appropriate increases in prices and loss in welfare for consumers or in reverse could result in predatory prices or cross subsidies.

III.II. – Reporting requirements and verification

This section outlines the periodic reporting framework and publication issues concerning the auditor’s control and the statement of compliance.

Pursuant to the guidelines further defined in the present document, cost accounting systems must produce financial information with the degree of detail taken as necessary to demonstrate compliance with the principle of non-discrimination and transparency, adequately identifying and attributing revenues, costs and volumes for the several activities performed by the operator.

The regulatory accounting and reporting arrangements of the postal operator must ensure that it can demonstrate that:

- the resulting costs for a given service have been properly and appropriately derived from the entirety of financial information relating to all services; and the separation for accounting purposes of the regulated market, its services and any individually identified activities has been properly and appropriately carried out;
- the completeness of the financial data relating to services supplied in regulated and non regulated markets is verifiable;
- in order to provide assurance as to the reliability of financial information, such information should be traceable, i.e. enough evidence exists that is sufficient to enable the auditor to follow the path leading to original information in the general ledger.



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Such accounting information should be made available in a prompt manner to the National Regulatory Authority.

Good presentation of regulatory accounts ensures that the essential messages of the financial statements are communicated clearly and effectively and in as simple and straightforward a manner as possible. The presentation of information in financial statements involves some degree of abstraction and aggregation. If this process is carried out in an orderly manner, greater knowledge will result because such a presentation will satisfy the various regulatory objectives such as demonstrating that charges are cost-orientated or the absence of undue discrimination.

Accounting reports comprise supporting notes and supplementary schedules that amplify and explain the financial statements. Both the financial statements and the supporting notes form an integrated whole.

The following financial information should be prepared for the relevant market/service

- Consolidation and reconciliation with statutory accounts or other source of costing information;
- Allocation of revenues
- Allocation of costs
- Profit and Loss Statements;
- Resources used, in particular capital employed statement (namely, detailing form of calculating and value of parameters used);
- A description of the methodologies used to prepare costs, including reference to cost base and standards, allocation and valuation methodologies, identification and treatment of shared and common costs.
- Non-discrimination notes (namely, detailing transfer charges);
- Audit opinion in line with legal and regulatory obligations (if required by the National Regulatory Authority);
- Compliance with EC and national regulations statement;
- Other supplementary schedules as required, e.g. reconciliation of top-down and bottom-up revenue data from traffic estimates.



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Reporting formats, which may follow standard statutory accounting design, should be defined in advance by National Regulatory Authorities.

III.II.1. – Reporting period

Reporting of some information regarding regulatory accounting should take place at least on an annual basis, and as soon as possible after the end of the accounting (reporting) year. It would be desirable to establish that no later than a few months, as decided by the regulator, after the completion of the statutory audit or no later than the current practice as specified by regulatory obligations, the publication of the statement takes place.

Operators should be capable of reporting on-demand or within a stricter timeframe, when required by National Regulatory Authorities or National Competition Authorities for specific circumstances, in particular for investigations on alleged anti-competitive practices.

III.II.2. – Audit scope and verification

The audit should be understood as the review of compliance of regulatory requirements as set by the NRA.

The questions of the audit scope, given its regulatory purposes the main of which is to provide confidence and transparency, must be relatively wide and in general go beyond the traditional audit scopes performed on the statutory financial statements. To this end, some guidance is provided here to the:

- scope of the audit, timing, powers and obligations of the controlling entity;
- elements to be covered in the audit;
- ensure that elements of the mandate of the auditor are clearly established;
- the auditing entity: guidance on the elements above apply regardless of the entity that carries out the annual audit, which can be both the National Regulatory Authority itself (provided it has the necessary qualified staff) or another qualified body, independent of the operator concerned and designated according to national provisions.

- a) Scope and definition of audit



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To audit means a process of examining and verifying an undertaking's separate accounting reports and supporting documents. This includes a systematic method of checking and verifying the accounting information (and ensuring the rules set out by regulatory framework including the NRA are correctly applied).

If an external verification is required (in the form of a “fairly presents” or equivalent statement), in some cases an “agreed-upon procedure” (or similar procedure) engagement is a possible alternative option, particularly given the possibly qualitative nature of some National Regulatory Authority's requirements.

b) Elements to be covered in the audit

The main elements to be covered in the audit are the following:

- the scope of costs included in the regulatory accounts and the scope of costs allocated to individual regulated products (where appropriate);
- the reconciliation between regulatory accounts and statutory accounts;
- correctness of figures, including operational data like volumes;
- methodologies used regarding amortization, cost capitalization, allocation and for the evaluation of the assets;
- transfer charges in separated accounts (entities and/or products);
- appropriateness of usage of the drivers;
- the frequency of index updates used for cost allocation purpose;
- appropriateness of possible important changes in the methodology.

These elements could be set out in a “letter of engagement” with the auditor or in the terms of reference elaborated by the USP in order to select the auditor.

c) Mandate of the auditor

The mandate of the auditor should be clearly established so to ensure that the relevant aspects of the auditing process are well defined and transparent. In this regard, the general principles should be set. The mandate should cover at least the following points:



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- the auditing entity should have access to, inter alia, all relevant data and information, supporting documents, source systems and related documentation
- the undertaking subject to verification should make appropriate resources available in order to provide explanations to questions arising during the review
- the responsibility of the auditing entity should be clearly defined regarding certification and confidentiality.

d) The auditing 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 National Regulatory Authority may itself undertake the annual control provided it has the necessary qualified staff.

In most cases the majority of data used in the regulatory accounts came from the statutory accounts, and for that reason it should be considered whether the statutory auditor should be excluded from auditing the regulatory accounts¹⁹. The possibility to exclude the statutory auditor should be examined by the NRA when it is considered that there is a risk that it should not be independent from the USP.

III.II.3. – Publication of information

The audit results should be made publicly available, respecting national and Community laws on business confidentiality restrictions.

Regulatory accounting information serves National Regulatory Authorities, but also others that may be affected by regulatory decisions based on that information, such as competitors, investors and consumers. Moreover, publication of information may contribute to an open and competitive market and also add credibility to the regulatory accounting system.

However, full disclosure may be restricted by national and Community rules regarding commercial confidentiality. It is recommended that National Regulatory Authorities, having taken the opinion of operators, define what information can be considered as confidential

¹⁹ This position is in line with the guidelines from the Sarbanes-Oxley act: http://www.sox-online.com/act_section_201.html



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and should not be made available and also what information could be useful to the public. Statement of compliance with Community and national legislation, audit opinion and description of the aspects that are relevant to accounting principles, policies methodologies and procedures used, namely the cost allocation methodologies, should not be considered confidential.

The annual statement of compliance should include an opinion on compliance with, as appropriate, an explanation of any material areas of non-compliance identified.

Publication of the statement of compliance and of the audit results should be in a form easily accessible by interested parties, such as paper form or on CD-ROM, and on the operator's or National Regulatory Authority's website.

III.II.4. – Confidentiality

The commercial sensitivity of, and any consequent confidentiality restrictions that should be applied to, any item of information /data should be considered by the National Regulatory Authorities.



Terms and abbreviations

Activity Based Costing	ABC	A cost accounting method, most widely used in the postal sector. Its key principle is the following: cost objects (products, customers...) consume activities which in turn consume resources.
Bottom-up	BU	A cost allocation approach in which an explicit description of elementary activities is used and then combined with activity measures and unit costs for the different resources in an elementary cost function. These costs are then aggregated successively to sub-activities and finally to the (main) activities to recover the total cost
Common costs		Also referred to as “overheads”, concern all resources related to support and management in postal services. Examples of such costs are key personnel (board members, marketing director, human resources director, financial director), headquarters costs (rent, depreciation, electricity, maintenance).
Cost accounting		System of accounts, tuned to financial accounting, allowing to identify and value the components of the result of the financial year and allowing those components to be interpreted and used by the management
Cost driver		A factor that has a systematic relation to a particular type of cost and which causes that cost to be incurred
Current Cost Accounting System	CCA	
Direct cost		All resources that are attributable to one and only one kind of product, such as advertisement for bulk letter, specific envelope/forms for a specific products or services, terminal dues for cross-border mail, etc.
Equiproportionate mark-up	EPM U	Allocation of cost according to a general allocator over already attributed costs
European Regulators Group for Postal Services	ERGP	
Financial accounting		Field of accounting concerned with the preparation of financial statements for decision makers, such as stockholders, suppliers, banks, employees, government agencies, owners, and other stakeholders



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Fixed cost		Costs that do not vary with the output of a firm. In practice, no cost is purely fixed in the long run, but the concept of fixed costs is used in short-term cost accounting or where otherwise relevant in the context of a shorter term horizon.
Fully Distributed Costs	FDC	A cost standard consists in allocating categories of costs, which can be directly or indirectly attributed to services, so that no costs are left unallocated. These categories of costs are: direct volume-sensitive costs, or direct variable costs, direct fixed costs, and a share of the joint and common costs
General overhead		Management/support resources that are common to all products/services of a firm. Key personnel (board members, marketing director, human resources director, financial director), headquarters costs (rent, depreciation, electricity, maintenance)
Historical Cost Accounting System	HCA	
International Telecommunication Union	ITU	
Joint costs		All resources that are common to a group of product, such as postal services office workers, other postal services office costs (rent, depreciation, electricity, communications, etc.), mail street boxes. They are responsive to the degree of economies of scale and scope – and may include a fixed component
Long-Run Average Incremental Costs	LRAIC	A cost standard that associates a long-term horizon with incremental costs. Incremental cost measures the cost variance when the production output increases or decreases in a discrete increment. In the particular case where the increment considered is a single unit, incremental costs equal marginal costs.
Marginal Costs	MC	A cost standard that calculates the costs of increasing output by one additional unit. Therefore, the marginal costs include only the direct variable costs excluding any other cost category, such as common and/or joint costs which should be recovered by means of specific mark-ups. In contrast to SAC, MC provides the lower limit in the wholesale price regulation.
National regulatory	NRA	



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authority		
Net cost calculation		Opportunity cost of providing a specific service or of responding to a specific obligation. It shall be calculated as the difference between the profit in the current situation and the profit in the counterfactual situation, where the operator is not providing the specific service or not responding to a specific obligation. Net cost is the difference between avoided cost and lost revenues. This is the method prescribed by the postal directive to assess whether the provision of the universal service is a burden or not for the USP.
Overheads		See common cost
Pipeline overhead		Management/support resources in support of some specific production process
Postal directive		Directive 97/67/EC of the European Parliament and of the Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service, amended by Directive 2002/39/EC of the European Parliament and of the Council of 10 June 2002, Regulation (EC) No 1882/2003 of the European Parliament and of the Council of 29 September 2003, and Directive 2008/6/EC of the European Parliament and of the Council of 20 February 2008
Regulated Business		Totality of the activities contributing to the US products and services. The Regulated Business is a regulatory construct which may cross over the USP's official business unit boundaries, or the legal definitions of the USP group companies
Regulatory accounting		A set of rules determining the allocation of costs to products/services for regulatory purposes
Stand Alone Costs	SAC	A cost standard that measures the cost of providing a service by the operator in isolation to other services of the company. SAC comprises all directly attributable costs and all shared cost categories related to production of the service, thus it includes direct variable costs, direct fixed costs, common and joint costs. Under this allocation method, the shared costs are totally supported by the service that is to be provided in isolation



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Top-down	TD	A cost allocation approach in which cost accounting data (from the general ledger) are identified at a global level, and then successively refined to (main) activities, sub-activities and finally to elementary activities / tasks (see definition below) using appropriate allocation keys
Totality principle		The scope of the regulatory financial reporting should cover the totality of all the activities which contribute to the provision of the universal service.
Universal service	US	
Universal service obligation	USO	
Universal service provider	USP	
USP network		An integrated network of activities which collects, sorts, transports and delivers various types of mail
Variable cost		Costs that vary with changes in the output of a firm.

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