COMMISSION RECOMMENDATION

of 19 September 2005

on accounting separation and cost accounting systems under the regulatory framework for electronic communications

(Text with EEA relevance)

(2005/698/EC)

THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to 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) [1], and in particular to Article 19(1) thereof,

After consulting the Communications Committee,

Whereas:

(1) Certain provisions of the regulatory framework for electronic communications networks and services require necessary and appropriate cost accounting mechanisms to be implemented, namely Articles 9, 11, 13 and 6(1) in connection with Annex I, of 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) [2]; Articles 17 and 18(1) of and Annex VII(2) to 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) [3]; and Article 13 of Directive 2002/21/EC.

(2) Operators designated as having significant market power (SMP) on a relevant market (hereinafter referred to as notified operators), as a result of a market analysis carried out in accordance with Article 16 of Directive 2002/21/EC, may be subject, *inter alia*, to obligations concerning the preparation of separated accounts and/or implementation of a cost accounting system. The purpose of imposing such obligations is to make transactions between operators more transparent and/or to determine the actual cost of services provided. Furthermore, accounting separation and the implementation of cost accounting systems may be used by national regulatory authorities to complement the application of other regulatory measures (e.g. transparency, non discrimination, cost orientation) on notified operators.

(3) This Recommendation updates Commission Recommendation 98/322/EC of 8 April 1998 on interconnection in a liberalised telecommunications market (Part 2 — Accounting separation and cost accounting) [4], following the application of the regulatory framework for electronic communications (25 July 2003). This revision is necessary since the regulatory framework of 2002 brought about some important changes to the regulatory package of 1998 such as the enlarged scope of application of the framework; a different approach to the imposition of *ex ante* obligations; a different scope of application of the specific provisions concerning cost accounting and accounting separation; and the application of the principle of technology neutrality.

(4) The overall objectives of this Recommendation are to foster the application of consistent accounting principles and methodologies at EU level, taking into account the experience gained by the national regulatory authorities in the domain of cost accounting and accounting separation; improve the transparency of the accounting systems, the methodologies, the data elaborated, the auditing and reporting process to the benefit of all involved parties.

(5) Operators may operate in markets in which they have been designated as having significant market power, as well as in competitive markets where they are not so designated. In order to carry out its regulatory tasks, a national regulatory authority may need information about markets where operators do not have SMP. When an obligation for accounting separation is imposed on a notified operator with SMP on one or more markets, the imposition of accounting separation may cover markets where the operator does not have SMP, e.g. to ensure the coherence of data.

(6) Any mandated cost accounting or accounting separation methodology used in particular as a basis for price control decisions should be specified in a way that encourages efficient investment, identifies potential anti-competitive behaviour, notably margin squeezes, and should be in accordance with the national regulatory authority's policy objectives as set out in Article 8 of Directive 2002/21/EC.

[1] OJ L 108, 24.4.2002, p. 33.
[2] OJ L 108, 24.4.2002, p. 7.
[3] OJ L 108, 24.4.2002, p. 51.
[4] OJ L 141, 13.5.1998, p. 6.

(7) The implementation of a new or revised costing methodology may indicate that current levels of regulated charges and/or price mechanisms are inappropriate or misaligned in some way. If a national regulatory authority believed corrective action is required then due regard should be taken of the commercial and economic environment to minimise risk and uncertainty in the relevant markets. This action could include, for example, spreading any price adjustment over a reasonable period of time.

(8) When implementing an accounting system that uses a forward-looking approach (such as long run incremental cost) based not on historic costs but on current costs, e.g. where assets are revalued based on the cost of using a modern equivalent infrastructure built with the most efficient technology available, national regulatory authorities may need to adjust the parameters of the cost methodology in order to achieve these objectives. The coordinated use of top-down and bottom-up approaches should be envisaged, where applicable. Accounting systems should be based on the principle of cost causation, such as activity based costing.

(9) When current cost accounting (CCA) is applied to network assets, such as the local loop which is considered to be less replicable in the medium term, consistent application of costing methodologies requires parameters (such as cost of capital, depreciation profiles, mark-ups, time varying components) to be adjusted by the national regulatory authorities accordingly.

(10) When the implementation of a cost accounting system is mandated in accordance with Article 13(4) of Directive 2002/19/EC, rules used for the allocation of costs should be displayed at a level of detail that makes clear the relationship between costs and charges of networks components and services; the basis on which directly and indirectly attributable costs have been allocated between different accounts also needs to be provided.

(11) This Recommendation provides guidance on how to implement cost accounting and accounting separation under the new regulatory framework of 2002. Recommendation 98/322/EC provides guidance on the implementation of cost accounting and accounting separation under the regulatory framework of 1998. The Recommendation of 1998 continues to apply in situations where Member States have not completed the review of existing obligations concerning cost accounting and accounting separation in accordance with Article 16 of Directive 2002/21/EC.

(12) Where a compensation mechanism which involves financial transfers is implemented by Member States, Annex IV, part B to the Universal Service Directive requires that these transfers are undertaken in an objective, transparent, non-discriminatory and proportionate manner. In order to meet these purposes, any compensation received for the provision of universal service obligations should be duly reported in the systems for accounting separation.

(13) As regards the funding of universal service obligations, the Recommendation does not prejudice Commission Directive 80/723/EEC of 25 June 1980 on transparency of financial relations between Member States and public undertakings as well as on financial transparency within certain undertakings [1].

(14) The application of the principles of this Recommendation is without prejudice to the duty of the Member States and of undertakings to comply fully with the Community competition rules.

(15) Commission Recommendation 2002/590/EC of 16 May 2002 on 'Statutory Auditor's Independence in the EU: A Set of Fundamental Principles' [2], establishes a sound framework against which the auditor's independence can be tested, where relevant.

(16) The European Regulators Group (ERG) [3] has provided an opinion on the revision of Commission Recommendation on accounting separation and cost accounting of 1998 which includes a detailed annex on aspects of cost accounting and accounting separation,

HEREBY RECOMMENDS:

1. This Recommendation concerns the implementation of accounting separation and cost accounting systems by operators designated by their national regulatory authority as having significant market power on relevant markets as a result of a market analysis carried out in accordance with Article 16 of Directive 2002/21/EC. Operators with such obligations are hereinafter referred to as 'notified operators'.

   The purpose of imposing an obligation to implement a cost accounting system is to ensure that fair, objective and transparent criteria are followed by notified operators in allocating their costs to services in situations where they are subject to obligations for price controls or cost-oriented prices.

(1) OJ L 195, 29.7.1980, p. 35. Directive as last amended by Directive 2000/52/EC (OJ L 193, 29.7.2000, p. 75).
(2) OJ L 191, 19.7.2002, p. 22.
(3) The ERG was established by Commission Decision 2002/627/EC (OJ L 200, 30.7.2002, p. 38) as amended by Decision 2004/641/EC (OJ L 293, 16.9.2004, p. 30).

The purpose of imposing an obligation regarding accounting separation is to provide a higher level of detail of information than that derived from the statutory financial statements of the notified operator, to reflect as closely as possible the performance of parts of the notified operator's business as if they had operated as separate businesses, and in the case of vertically integrated undertakings, to prevent discrimination in favour of their own activities and to prevent unfair cross-subsidy.

2. It is recommended that national regulatory authorities require from the notified operators the disaggregation of their operating costs, capital employed and revenues to the level required to be consistent with the principles of proportionality, transparency and regulatory objectives mandated by national or Community law.

It is recommended that the allocation of costs, capital employed and revenue be undertaken in accordance with the principle of cost causation (such as activity-based costing, 'ABC').

The cost accounting and accounting separation systems of the notified operators need to be capable of reporting regulatory financial information to demonstrate full compliance with regulatory obligations. It is recommended that this capability be measured against the qualitative criteria of relevance, reliability, comparability and materiality.

It is recommended that national regulatory authorities satisfy themselves as to the adequacy and effectiveness of the cost accounting and accounting separation systems; such systems may be subject to public consultation.

3. It is recommended that a national regulatory authority, when assessing the features and specification of the cost accounting system, reviews the capability of the notified operator's cost accounting system to analyse and present cost data in a way that supports regulatory objectives. In particular, the cost accounting system of the notified operator should be capable of differentiating between direct costs ([1]), and indirect costs ([2]).

It is recommended that national regulatory authorities, having adopted a decision on a cost accounting system based on current costs set clear deadlines and a base year for their notified operators' implementation of new cost accounting systems based on current costs.

Evaluation of network assets at forward-looking or current value of an efficient operator, that is, estimating the costs faced by equivalent operators if the market were vigorously competitive, is a key element of the 'current cost accounting' (CCA) methodology. This requires that the depreciation charges included in the operating costs be calculated on the basis of current valuations of modern equivalent assets. Consequently, reporting on the capital employed also needs to be on a current cost basis. Other cost adjustments may be required to reflect the current purchase cost of an asset and its operating cost base. Evaluation of network assets at forward-looking or current value may be complemented by the use of a cost accounting methodology such as long run incremental costs (LRIC), where appropriate.

It is recommended that national regulatory authorities have due regard to price and competition issues that might be raised when implementing CCA, such as in the case of local loop unbundling.

It is recommended that national regulatory authorities take due regard to further adjustments to financial information in respect of efficiency factors, particularly when using cost data to inform pricing decisions since the use of cost accounting systems (even applying CCA) may not fully reflect efficiently incurred or relevant costs ([3]). Efficiency factors may consist of evaluations of different network topology and architecture, of depreciation techniques, of technology used or planned for use in the network.

4. It is recommended that notified operators required to report accounting separation provide a profit and loss statement and statement of capital employed for each of the regulatory reporting entities (based on the relevant markets and services). Transfer charges or purchases between markets and services need to be clearly identified in sufficient detail to justify compliance with non discrimination obligations. These accounting separation reporting obligations may require the preparation and disclosure of information for markets where an operator does not have SMP.

For consistency and data integrity, it is recommended that the financial reports of the regulatory accounts be consolidated into a profit and loss statement and a statement of capital employed for the undertaking as a whole. A reconciliation of the separate regulatory accounts to the statutory accounts of the operator is also required. These statements should be subject to an independent audit opinion or a national regulatory authority compliance audit (subject to the availability of suitably qualified staff).

([1]) Direct costs are those costs wholly and unambiguously incurred against specified activities.

([2]) Indirect costs are those costs that require apportionment using a fair and objective attribution methodology.

([3]) Some of the assets may be in excess of requirements or network architecture may be suboptimal. Implementation of a bottom-up economic/engineering model helps providing information about inefficient and unnecessary incurred costs, which should be removed.

5. It is recommended that national regulatory authorities make relevant accounting information from notified operators available to interested parties at a sufficient level of detail. The detail of information provided should serve to ensure that there has been no undue discrimination between the provision of services internally and those provided externally and allow identification of the average cost of services and the method by which costs have been calculated. In providing information for these purposes, national regulatory authorities should have due regard for commercial confidentiality.

   In this respect, the publication by the notified operator of sufficiently detailed cost statements showing, for example, the average cost of network components will increase transparency and raise confidence on the part of competitors that there are no anti-competitive cross-subsidies. This is considered to be particularly important for wholesale services. Implementing guidelines on reporting requirements and publication of information are set out in the Annex.

6. Certain undertakings may be designated as universal service providers in accordance with Article 8 of the Universal Service Directive and may be subject to regulatory control on retail tariffs in accordance with the provisions of Article 17 of the universal service Directive. For those Member States that operate schemes to finance universal service obligations, it is recommended that any contribution that designated undertaking(s) receive as part of a compensation mechanism is identified in the systems for accounting separation.

7. These accounting guidelines are concerned with regulatory reporting and they are not intended as a replacement for any statutory financial reporting that may be required in the Member State.

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

9. This Recommendation is addressed to the Member States.

Done at Brussels, 19 September 2005.

For the Commission

Viviane REDING

Member of the Commission

ANNEX

GUIDELINES ON REPORTING REQUIREMENTS AND PUBLICATION OF INFORMATION

This Annex outlines the periodic reporting framework, publication issues and the statement of compliance.

Pursuant to the principles recommended at point 2 of the Recommendation, cost accounting and accounting separation systems must produce financial information at a level of detail which demonstrates compliance with the principles of non-discrimination and transparency, adequately identifying and attributing revenues, costs, capital employed and volumes for the various activities performed by the operator. Such accounting information should be made available promptly 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 that there is no 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.

Regulatory accounting information serves national regulatory authorities and other parties that may be affected by regulatory decisions based on that information, such as competitors, investors and consumers. In this context, 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 business confidentially. Therefore, it is recommended that national regulatory authorities, having taken the opinion of operators, define what information can be considered as confidential and should not be made available.

1. **Preparation and publication of information**

The following financial information should be prepared and published (subject to confidentiality and national law obligations) for the relevant market/service:

— profit and loss statements,

— capital employed statement (detailed calculation methodology and value of parameters used),

— consolidation and reconciliation with statutory accounts or other source of costing information,

— a description of the costing methodologies including reference to cost base and standards, allocation and valuation methodologies, identification and treatment of indirect costs,

— non-discrimination notes (detailed transfer charges),

— audit opinion (if required by the national regulatory authority),

— a description of accounting policies and regulatory accounting principles,

— a statement of compliance with Community and national rules,

— other supplementary schedules as required.

Reporting formats, which may follow standard statutory accounting design, should be defined in advance by the national regulatory authority, in consultation with operators. The statement of compliance with Community and national legislation, audit opinion and description of accounting principles, policies, methodologies and procedures used, namely the cost allocation methodologies, cannot be considered confidential. Without prejudice to national and Community laws on business confidentiality, the audit results should be made publicly available.

2. **The statement of compliance**

The annual statement of compliance should at least include:

— the conclusions of the auditor,

— all identified irregularities,

— recommendations made by the auditor (with a description of the corresponding effects),

— the full description of the verification methodology followed, and

— some aggregate financial and accounting data (such as CCA adjustments, main assumptions made on attribution methodologies, level of costs allocated and the level of granularity of the model).

Publication of the statement of compliance and of the audit results should be presented in a form easily accessible by interested parties, such as a paper or electronic version, or published on the operator's or national regulatory authority's website.

3. **Reporting period**

Publication of regulatory accounts should take place annually and as soon as possible after the end of the accounting (reporting) year. Publication of the statement must take place no later than two months after the completion of the regulatory audit or no later than the current practice as specified by regulatory obligations.