



## **Subject: GSME response to ERG Accounting Separation and Cost Accounting Paper**

### **1. Introduction and Summary of key points**

*These are GSME comments on the ERG opinion prepared by the IRG working group Accounting Separation and Cost Accounting – 22 March 2004 –Proposed changes to Commission Recommendation of 1998 on Accounting separation and Cost Accounting.*

- 1.1 GSME is very concerned about the implied intention to extend the same methodology of Accounting Separation and associated Cost Accounting approach used in the fixed telecommunications sector to mobile operators. The mobile sector has always operated in a more competitive environment than the fixed. Accounting separation has rarely been implemented in the mobile sector and this paper raises serious concerns for mobile operators because it seems to signal a move away from the “least intrusive” approach to mobile regulation pursued by many Member States.*
- 1.2 The Accounting Separation paper seems to be disconnected from the process defined in the Directives coming before the results of market analysis and in fact being used to anticipate them. There seems to be a presumption that these remedies are appropriate for both the fixed and mobile sectors before adequate analysis has been performed to justify the introduction of such a costly and complex system that as a general rule has not been applied to the mobile industry before.*
- 1.3 The application of Accounting Separation would be totally inappropriate to the mobile sector where only three markets (and in effect only two because Access and Origination is under most analysis competitive) are potentially subject to regulatory obligations. The application of AS to these markets would therefore be totally disproportionate with the likely cost, to both operators and NRAs, exceeding any benefit. It is clearly disproportionate to apply costly and complex remedies to the whole of a business where only a small portion is judged to require some form of regulatory remedy.*
- 1.4 . The considerable amount of work needed to set up costing and accounting separation systems and to audit and maintain them is considerable, placing a significant burden on operators. Thus according to the principle of proportionality and minimal distortion it should only be imposed on mobile*

*operators when it is fully justified on the basis of cost-benefit analysis of appropriate remedies. In practice there are many complex issues around cost allocation that end up as arbitrary judgements made in the end by NRAs which then have unintended detrimental effects on innovation within the industry.*

*1.5 According to Article 8.2 of the Framework Directive, NRAs shall promote competition by, amongst other things promoting innovation. Accounting Separation has tended to restrict innovation in companies to which it has been applied (more caution, more complex business cases, risk aversion) and its introduction into mobile at a time of high product and service evolution would be destabilising. It is essential that NRAs carefully consider the full implications of introducing these measures on the basis that they may have a significant impact.*

*1.6 GSME considers that the Recommendation should not endorse a specific methodology on cost accounting and price control as it occurs in Whereas 7). Moreover, as it is stated in the ERG Common Position on Remedies, “the freedom of the NRA to use a methodology or a particular cost model to calculate an appropriate charge is unrestricted except to comply with Art. 8 of the FD”.*

## **2 General**

These comments are made on the principles raised in the paper and do not imply any acceptance of the application Accounting Separation to the mobile sector. The consultation links Accounting Separation and Cost Accounting which is clearly not always the case. Cost Accounting principles can be applied to situations where Accounting Separation has not but the reverse is not true.

### **3 Key points – GSME welcome**

#### **3.1 Disaggregation and level of detail –**

In the first recommendation concerning disaggregation GSME are supportive of the points made concerning proportionality and transparency viz that “NRAs require from their notified operators the disaggregation of their operating costs, capital employed and revenues *to the extent justified by the objective pursued and the nature of the problem identified by the market analysis.....The level of disaggregation required should comply with the principles of proportionality, transparency and competitive requirements .....*”.

As mentioned earlier GSME believes that the application of these measures to mobile operators would be disproportionate at the outset and if it were to be applied it is essential that this is applied in accordance with statements above to avoid undue and costly disaggregation.

#### **3.2 Adequate consultation –**

There are a number of complex details that would need to be agreed before any application of these principles and this would require adequate consultation. We support the proposal where it identifies the need for extensive industry consultation by the relevant NRAs before implementing

Accounting Separation. For example, the emphasis in recommendation two regarding consultation on “the adoption of sound allocation methods, the specific treatment to be given to un-attributable costs and the methodology and criteria for the evaluation of network assets at current value...”. These are just some of the complex topics that need to be agreed through industry consultation in order that the resulting separated accounts are robust and meaningful.

### **4 Key points - GSME Disagree with...**

#### **4.1 Attribution of costs**

The assertion that 90% of costs are to be allocated on the basis of direct or indirect cost causation may be true for fixed networks but is not true for mobile networks. The cost recovery must take account of the return on investment and causality as seen in mobile businesses.

Besides, that rule is not based on any theoretical or empirical evidence. In fact, it might be anticipated that the “optimal” proportion between causally and non causally attributed costs will not be fixed, but dependent on the peculiarities of the technology and the production process in each sector and firm. Thus, if those peculiarities are such that the firm has a large proportion of common costs then it might be difficult to find pure causal drivers to allocate costs to services so that the 90-10 ratio is achieved.

In principle where a subscriber cost is common to all services it should be allocated to common costs so it can be recovered appropriately across all services using a driver that cannot be 100% causal in all cases.

An example of this is customer acquisition costs are incurred by the MNO in order to create calling opportunities from which revenues and profits may be

derived. These calling opportunities comprise both outbound calls from the customer and inbound calls to the customer and affect both retail and wholesale services. In other words, by incurring customer acquisition costs, a mobile operator usually contributes to the development of the market, including the interconnection market. Customer acquisition costs are therefore common to all services and should be allocated accordingly.

In addition, customer servicing costs, which might appear at first sight to be exclusively attributable to the retail level, should in part be allocated to network costs (e.g. complaint desks may handle complaints about problems receiving inbound calls).

#### **4.2 Publication of Information**

Proportionality is essential when the NRA specifies the information that must be published and the information which will be of a confidential nature. In this respect, GSME does not agree with the statement on page 8 of the annex. It indicates that the publication of certain information on the average costs of network components of the required operator will increase the transparency and confidence of its competitors where cross subsidies do not exist.

As stated in Recital 13 and Article 5 of the framework Directive, while the NRAs need to compile information about the market players to efficiently carry out their assignment, requests for information should be proportionate and not involve any excessive burden on companies. Furthermore, according to art. 5.4, the information gathered by the NRA may be available to the public, unless it is of a confidential nature (... subject to Community and national rules on business confidentiality),

*The legislation recognises two equal rights, i.e., the right of third party operators to know the relevant accounting details of the competitor declared as dominant, and the latter's right that the NRA declare and maintain the confidentiality of any data that is covered by commercial and industrial secrecy.*

*There is no doubt that information provided that refers to costs, price structure and other related data involves commercial and industrial secrecy. This could not be otherwise, as the declaration of confidentiality is an activity that is directly linked to the NRA's role of safeguarding the conditions for effective competition in the market. The operators' knowledge of the competition, of any information that could affect the commercial strategy a company intends to pursue, could have an impact on the market by not promoting but restricting the level of competition in the market.*

*Indeed, the revealing of data covered by commercial secrecy can bring about a distortion in the market, given the fact that by possessing strategic information, third-party competitors obtain a definite competitive advantage.*

*Therefore, the availability of the results of cost accounting systems to interested parties should meet two conditions:*

*1.- indispensable minimum level of disaggregation that allows the relationship between the interconnection prices offered and their associate costs to be known and*

2.- *guaranteeing at any moment the compatibility of availability of information with the confidentiality of the dominant operator's commercial strategy*

#### **4.3 Provision of Information**

The Consultation document states that:-

“the provisions of the framework provide a basis for an NRA to gather accounting separation information in respect of non-SMP markets only insofar as an NRA can justify that the provision of such information is necessary for the NRA to carry out its responsibilities under other provisions of the framework”.

It is then stated that “the not regulated business segments can be subject to different granularity levels, according to the proportionality principle”...and that “activities not subject to regulation may be aggregated in a common account (Other Activities)”.

GSME believes that transactions not pertaining to regulated operations should not be subject to regulatory obligations and further, that to attempt to do so is without legal basis.

#### **4.4 Appropriate and Proportionate Use**

NRAs should not leverage specific issues by grouping them together with for example call termination, in an attempt to facilitate wider regulation by requiring detailed financial information on non SMP markets. To do so would be massively disproportionate and contrary to the new Framework.

Using accounting separation as an adjunct to a remedy runs the risk of being disproportionate. Accounting Separation is a potentially heavy handed regulatory approach that was for example rejected by Ofcom (UK) as disproportionate when recently applying call termination remedies. NRAs should be cautioned not to misuse separated accounts in this way.

Accounting Separation should not be used to limit pricing discretion by mobile operators as this would negatively impact on consumer welfare. Flexibility of mobile operators in pricing is proven to promote market expansion and thus consumer benefits; for example pre-paid mobile was an innovation in pricing, rather than technology.

GSME is very concerned by the ERGs generic presentation of suggested accounting separation formats for the various industry sectors i.e. Fixed and Mobile. It is not acceptable that blanket separate accounting formats are imposed on the various telecommunications sectors. GSME believes that NRA's have to demonstrate that competition is ineffective before imposing such regulatory obligations on firms; specifically any obligations have to be clearly justified by the nature of the problem identified in the individual markets analysed.

#### 4.5 *Ramsey Pricing*

In connection with the debate over the allocation of common costs when a LRIC model is applied, the paper dismisses Ramsey pricing as “practically unfeasible” and openly favours the use of equal proportionate mark-ups (EPMU) as it is “easy to implement and use” and “may lead to price-setting that is detrimental to competition”. This approach is rhetoric and wrong in economic terms (see Laffont and Tirole, *Competition in Telecommunications*, p.132). In particular, the conclusion that EPMU “should be considered less harmful than the detrimental competitive effects that Ramsey pricing could cause” is unproven and not based on a cost-benefit analysis or any kind of sound economic analysis.

In addition the practical difficulties of collecting data to enable the use of Ramsey pricing are often exaggerated and may in fact be less than that required to build a robust alternative model. GSME believes that it is not yet possible to dismiss Ramsey pricing in the way that the paper does.

In the presence of economies of scale and scope, the socially optimal benchmark has to be determined within a Ramsey pricing framework, taking account of:

the efficient recovery of fixed and common costs across all elements of the service bundle; and

the presence of network externalities, which arise from the fact that calling parties benefit from an increase in the number of mobile subscribers, but that this benefit is not being taken into account in the decision whether to purchase a mobile subscription or a prepaid package.

The ERG, without even attempting to assess the available evidence and based on assertions, proposes to use an EPMU approach for determining regulatory benchmarks.

In GSME’s view:

It is appropriate that an allowance be made for network externalities. It is perfectly possible to calculate Ramsey prices taking account of network externalities, at least for those services for which regulatory intervention might conceivably be justified.

Despite strong growth over the last few years, the mobile market is far from saturated and network benefits from increasing penetration continue to play an important role in establishing welfare-maximising benchmark prices.

Even if Ramsey prices cannot be calculated with absolute precision, it would be wrong to dismiss the approach because:-

- The precision achieved by EPMU is to a large extent spurious, driven by attempts to allocate as many costs as possible to particular services in order to minimise the inevitable distortion resulting from the use of EPMU. In fact EPMU is based on elasticity assumption without adequate

reasoning or empirical evidence. EPMU only appears to be a more practical result because it is “force fitted” into the analysis and in the case of mobile inappropriately deals with common costs.

- The structure of Ramsey mark-ups is determined by the structure of relative elasticities (rather than their levels). Common sense suggests that mobile ownership is a precondition for making and receiving calls on a mobile. If regulation of termination charges, for example, were to be required because competition for subscribers does not constrain termination charges, this implies that the own-price elasticity of mobile-originated calls will have to exceed that of fixed-to-mobile calls, and that there is a cross-price effect from mobile originated call charges (but not from fixed-to-mobile prices) on subscription decisions. This clearly determines a structure of mark-ups that is with great certainty fundamentally different from EPMU. As Ramsey prices by definition yield maximal social welfare regulation, EPMU based regulation would necessarily result in substantial welfare loss.

In any case, the lack of sufficient data and information should not be acceptable as an argument against principles whose theoretical superiority and appropriateness in a mobile market context are generally acknowledged. In order to apply these approaches, NRA’s could where appropriate collect the data required in co-operation with the MNOs.

#### **4.6 Significant costs not discussed**

##### **4.6.1 Spectrum**

GSME is disappointed that discussion of Spectrum and Licence fees is absent from the current draft, given the significance of licence costs in particular to the mobile industry. Whereas spectrum and Licence fees are common to all services provided by the operators, they should be allocated to network components first, on the basis that they are essential to the operation of the network, and then to all services according to routing factors. This approach suits the ABC approach defended in the annex to the draft Recommendation and increases transparency in the allocation process.

##### **4.6.2 Cost of Capital -**

GSME agree in general, that the CAPM approach has attractions, in particular its simplicity and long pedigree. However, we are concerned that the “plain vanilla” CAPM approach will fail to adequately take account of the risk characteristics of the mobile operators. Rather than relying on a basic CAPM, we believe that it would be better to draw upon the range of methodologies designed to modify and improve on CAPM (not replace) for example Arbitrage Pricing Theory. By examining ways to improve the operation of CAPM, the worst shortcomings of CAPM would be addressed.

##### **4.6.3 Cost of implementation - Audit -**

In this regard we believe that auditing is not required if the NRA prepares a bottom up model for checking purposes. Any material difference in methodology or approach should be apparent when different models are

compared and differences are queried by NRAs. However, it may be that an arbitration system would be useful for resolving irreconcilable differences.

## 5 Conclusion

GSME is concerned that the document as it stands does not adequately take account of the distinctive nature of mobile communications and seems to extend the ideas applied to fixed networks and in particular historical incumbents, to mobile. It would be a major step to apply Accounting Separation to mobile and the costs and complexity would appear totally disproportionate. It would be impossible to confine the effects of Accounting Separation to the defined markets and would spread beyond that having an impact on the whole of a mobile operator's business.

The discussion on Cost Accounting again dismisses Ramsey pricing without adequate evidence and also does not discuss other relevant costs such as spectrum and cost of capital.

*GSM Europe, London 15<sup>th</sup> June 2004*