

P L A T F O R M

for drawing up the Rules on the application of the cost-accounting principle to a telecommunications operator designated as having significant market power

Introductory notes

The drawing up of the draft Rules on the application of the cost-accounting principle to a telecommunications operator designated as having significant market power was entrusted to the RATEL Advisory Council. To this end, at its 4th session held on 9 November 2006, the Advisory Council set up a task force.

The Task Force for drawing up the Rules was confronted with a rather complex task. This is testified to by the fact that in the relevant professional circles and literature the calculation of costs and performance in the telecommunications sector is regarded as one of the most complex cases because in technical, technological and business terms, this sector represents a particularly dynamic area, because a successful application of the cost-accounting principle always assumes that accounting solutions should be tailored to a particular operator to which it refers, and because (especially) in the first phase of the application of the cost-accounting principle in the telecommunications sector and its improvement phases, even the countries with a much advanced cost management and accounting culture invested a great deal of effort and time that, truth be told, were always justified in view of additional information-related benefit. The complexity of the task related to the drafting of the Rules by applying the cost-accounting principle to an operator designated as having significant market power increased under the influence of market circumstances and the conduct of players on the telecommunications service market, which is a very sensitive strategic issue of national interest. For this reason, it is rather logical that, according to European and domestic legislation, the role of the regulatory body, in this case RATEL, is critical in this process and that the Rules on the application of the cost-accounting principle are of highest importance for the regulatory body and operators designated as having significant market power in a relevant telecommunications service market.

The proposed Platform lays down minimal information requirements related to costs, performance and cost calculations per operator service required for exercising the competences and responsibilities of RATEL and meeting the management needs of operators. Sufficient room remains between the Platform and the final wording of the Rules for tailoring solutions to operator-specific circumstances and possibilities, to which the time frames per cost-accounting principle application phase are adjusted, with the aim of ensuring that operators designated as having significant market power be prepared, until 2012, for the implementation of the Long-Run Incremental Cost model, currently being applied in a number of EU countries. The solutions proposed under the Platform in no way imply that RATEL is interfering with the operations and finances of operators in the regular market environment, with the regulation of which RATEL desires to make its due contribution.

1. Cost-accounting principle as the subject matter of the Rules

The Serbian telecommunications market is divided into the following:

- ◆ the free (full) competition market (mobile telephony services, Internet services and the like), and
- ◆ the limited competition market i.e. the market with the significant power of one operator (fixed telephony services, cable TV network services).

Service rates on the free competition market are under market control and the management and/or the application of the cost-accounting principle to operators selling their services on such a market falls within the exclusive competence of operators' management which uses it for the purpose of optimizing its cost (price) and other (product range-related, quality, etc.) competitiveness. If by way of merger, acquisition or business alliances on this market, an operator designated as having significant market power emerges, such an operator or several of them are subject to the application of the cost-accounting principle hereunder from the date of acquiring such a market status and/or adoption of the relevant decision thereon by RATEL.

Service rates in the limited competition market and/or market with the significant market power of one operator (or one operator in association with others) are mandatorily controlled by the national regulatory body for the purpose of preserving the competitive character of the country's telecommunications market. The prices of such services are formed as follows:

- ◆ primarily by applying the cost-accounting principle, that is, the „costs plus“ method, which does not imply any costs, but prospective normal and standard costs through the employment and management use of applied cost-accounting principle data,
- ◆ by applying an additional method of benchmarking with countries in the immediate environment. If one or more operators appear in the limited competition market and this results in the termination of the significant market power of an operator with such a market status, either in terms of some services or in general, then such services or the operator itself are fully exempted from the use of the cost-accounting principle hereunder from the date of cessation of free market competition and/or adoption of the relevant decision thereon by RATEL.

With respect to multi-service providers, in terms of placing one or more services on the free competition market, and some other service or services on the limited competition market (the market where it has significant market power), the need to adopt an integral approach to the application of the cost-accounting principle is evident. Such an approach implies:

- ◆ reliable and verifiable cost-accounting for the company as a whole, per cost responsibility centre, per internal transfer performance (internal re-allocation of costs) and per final performance (service) of the company for both of the abovementioned markets;
- ◆ reliable and verifiable analytical calculation of revenues from the sale of services, expenses of sold services and service profit;
- ◆ reliable and verifiable identification of relevant operating funds per type of service;
- ◆ a relevant periodical financial reporting system related to the operating and financial results of the company and its parts for the needs of the regulatory body and the operator's management.

Such an approach to the application of the cost-accounting principle to operators

designated as having significant market power is described in more detail hereinafter and will be used for drafting the Rules on the application of the cost-accounting principle to a telecommunications operator designated as having significant market power.

2. The basis for and objectives of the adoption of the Rules

2.1. Basis

The basis for the adoption of the Rules on the application of the cost-accounting principle to an operator designated as having significant market power (hereinafter referred to as: Rules) lies in the following documents:

- ◆ The regulatory framework of the EU 2002, Directive on a common regulatory framework (2002/21/EC), in view of Serbia's strategic commitment to accession to and membership of the EU, which stipulates the application of Acquis Communautaire, including the said Directive on a common regulatory framework and Special Directives for the telecommunications sector;
- ◆ The Commission Recommendation on relevant product and service markets within the electronic communication sector susceptible to ex ante regulation in accordance with Directive 2002/21/EC (2003/311/EC), given that it provides for the recognition of types of market telecommunications services as a framework for the analysis of market structures in this country;
- ◆ The Telecommunications Law („Off. Gazette of RS", No. 44/2003 and 36/2006), in view of the fact that it regulates, in more detail, the competences and responsibilities of RATEL and a telecommunications operator designated as having significant market power with respect to the interrelated issues of preserving and promoting free competition on the telecommunications market and/or preventing and eliminating monopoly behaviour, and the issues of formulating and pursuing the tariff policy for the exclusively awarded services, comprehensive application of the cost-accounting principle, control of RATEL's role, financial reporting and other cognate activities;
- ◆ The Commission Recommendation on accounting separation and cost-accounting systems under the regulatory framework for electronic communications (2005/698/EC), in view of binding stands and guidelines for the installation of a cost-accounting system and a reporting system per segment by an operator designated as having significant market power;
- ◆ Cost Concepts and Applications for Telecom Regulation, Presentation to RATEL, Belgrade, 2006, in view of the fact that it includes the accepted principles, goals, models and basic procedures of the cost-accounting principle, based on international experience in the telecommunications sector;
- ◆ The Accounting and Auditing Act („Off. Gazette of RS", No. 46/2006), in view of the fact that it imposes on large legal entities financial reporting in compliance with the International Standards of Financial Reporting/ International Accounting Standards

(ISFS/IAS), including IAS 14 – Segment Reporting, which sets out financial reporting on revenue, expenses, results, assets and obligations by line of business (products and services) and geographical area (countries or other areas) of its overall business portfolio;

- ◆ The Rules on the organization and/or organizational, management, financial and reporting structure of an operator designated as having significant market power, in view of adjusting the applicable cost-accounting model and procedures to the technical, technological and business activities of the operator and the intention to harmonize, to the greatest extent possible, its financial and reporting obligations towards RATEL, with the management information-related needs of the operator, provided they do not contradict the said superior documents;
- ◆ other derivative international and domestic documents which may be relevant for the adoption of the Rules.

2.2. Objectives

For RATEL, as the national regulatory body in the field of telecommunications, and a telecommunications operator with significant market power, to be able to perform their competences and obligations stipulated in the aforementioned documents, the Rules on the application of the cost-accounting principle to the telecommunications operator with significant market power should accomplish the following objectives, while recognizing the integral concept of the cost-accounting principle, i.e. regulate principles, models and key procedures to ensure:

- business and financial information bases for planning and control of activities aimed at creation and maintenance of regulatory competitive relations on the telecommunications service market (Regulatory framework 2002, Article 5, Article 8, paragraphs 2b, 3c and 4d, the Telecommunications Law, Article 9, paragraph 1, Article 10, paragraph 1, paragraph 2, items 1, 2 and 3, Articles 56 and 57);
- historical (actual) and projected cost, revenue, profit and asset (capital) information bases per type or group of services provided by the operators with significant market power, for the needs of establishing a special pricing policy for the services under exclusive business authority of such operators on a "cost plus" basis, i.e. unit costs of such services increased by adequate return on equity employed in the production and sales of services, while recognizing the operators' legitimate business interests, protection of their customers' interests and the prevention of cost or price-based subsidies provided by the operator between its services with significant market power and those designated for free competitive market (the Telecommunications Law, Article 9, item 10, Article 10, paragraph 2, items 1, 2, 3 and 4, Articles 43, 44, 109 and 110; Commission Recommendation on accounting separation and cost-accounting systems under the regulatory framework for electronic communications (2005/698/EC); Cost Concepts and Applications for Telecom Regulation: Rate of Return Regulatory Approach);
- relevant structures and contents of internal accounting system for the operator with significant market power, i.e. maintaining of separate accounts of costs, revenue, profits (or losses) and relevant property (assets) to the extent required by an assumption that the same is

performed by independent companies, as well as submission of periodical financial statements to the national regulatory body, based on such an approach and including attachments to the operator's annual financial statements both for the needs of the regulatory body and for external release of financial statements, their audit and disclosure, recognizing at the same time information needs of the operator's management, i.e. its existing and prospective organization, management and accounting and information structure (Regulatory framework EU 2002, Article 13, the Telecommunications Law, Article 9, items 1, 2, 10, 13, 14 and 17, Articles 56 and 57, IAS 14 – Segment Reporting, Accounting and Auditing Act, Articles 2 and 25 and the Rules on Chart of Accounts based thereunder – "Official Gazette of RS", no. 114/2006, the Rules on the Organization of Operators);

- a comprehensive system of confidential and transparent calculations of partial performance (internal services) of the cost centres and final performance (market services) of the profit centres and the company as a whole; confidential in terms of its reliance on the accounting information system, especially the Cost and Performance Accounting; transparency in terms of classifying cost elements according to the requirements of the initial and prospective cost-accounting principles.

3. Cost-Accounting Principles and Application Models

3.1. Principles

Cost-accounting principle is a rather elaborate business principle. To produce expected effects, its application by a multi-service operator should be based on the following principles:

- **completeness principle**, in terms of introducing and applying methodological solutions to cover all value-based operators' inputs and outputs, with respect to all its organizational units (centres of management competencies and responsibilities), with respect to its overall business portfolio (by lines of business, i.e. types of services, and geographical areas);
- **correlation principle**, in terms of comparing (associating) the revenues from certain period with the relevant costs and their reporting, on separate accounts;
- **causation principle**, in terms of attributing costs to ultimate performance (sales services) of the operators incurring the same, which also implies a causal primary allocation of the company's costs per business organizational unit, cost origin or activity (subject to the level of development of the cost principle application), as well as secondary reallocation of costs (values of internal transfer services) between the said cost units;
- **consistency principle**, in terms of consistent application of carefully selected methodological cost-accounting solutions in time, in order to ensure an inter-periodic information comparability and a reliable inference with respect to the development of the operator's business performance, which does not exclude the system's openness for feasible innovations harmonized by and between the national regulatory body and the operator;
- **transparency principle**, in terms of periodic and annual reporting to the regulatory body by a multi-service operator regarding its performance, facilitating the regulatory body to prevent potential non-competitive behaviour in the pricing policy, as well as to familiarize itself with the business operations and boost the development of an operator with significant market power along with the entire telecommunications sector;
- **verifiability principle**, in terms of reliance of periodical and annual, analytical

and synthetic reports of an operator for the needs of the regulatory body on the applied accounting system of an operator, including authentic documentation and protected software solutions;

- **feasibility principle**, in terms of a gradual introduction of possible models and procedures of integral cost-accounting principle in the accounting information system of an operator, given the comprehensiveness and complexity of the venture and underdeveloped Accounting of costs and performance applied to domestic operators;
- **multi-purpose principle**, in terms of defining models and procedures of the cost principle implementation as a solution designed for providing information to both RATEL and the operator's management;
- **confidentiality principle**, in terms that RATEL may not use the obtained information concerning the operator's performance to the detriment of the supervised company save in case of non-competitive behaviour;
- **co-operation principle**, in terms of complete trust, openness and cooperation between the operator and RATEL in the joint venture of cost-accounting principle implementation.

3.2. Models

In drafting the Rules, three fundamental cost-accounting principles should be taken into account. These are:

- Historical Cost Accounting – HCA,
- Current Cost Accounting – CCA and
- Long Run Incremental Cost – LRIC.

Usually, these are development phases in the application of the cost-accounting principle to an operator with a significant market power.

When selecting and planning the application and development of a cost-accounting principle, it is necessary to start from the experience and the capacity of an operator in cost accounting. The actual cost-accounting position, applied to an operator with significant market power, is, as a rule, characterized only by the following:

- accounting of historical (actual) costs by nature, for the company as a whole and
- readiness to associate only direct costs per organizational unit, usually only the ones of the first level of the organizational chart of the company,
- therefore, non-application of an analytical Cost and performance accounting (as specified in the Rules on Charts of accounts, as the applicable by-law), which, in addition to the above, should also include allocation of primary overhead costs, at least per organizational unit of the first level of the Organizational chart, reallocation of costs by virtue of internal transfer of services between such units, periodical (monthly, as a rule) cost accounting by cost objects (type of services), calculation (calculation of unit cost) of services and revenue and profit accounting, per service type and geographic segments of company's activities.

The current traditional accounting described above, but also the experience of other countries regarding the first-time adoption of the cost-accounting principle for regulatory purposes, suggest that **the historical cost accounting should be selected as a start-up cost-accounting model, based on the procedural principle of full allocation of company's total**

costs, according to the technological and business flow chart of value transformation process, to the final cost objects, revenue and profit (resulting from the rendered and sold telecommunications services). The commencement date of the application of the historical cost accounting, as the first phase in introducing the cost-accounting principle, may be scheduled for July 1st, 2008, provided that the related activities applied to the operator are significantly intensified during the second six-month period of 2007. The application of the historical cost accounting should be limited to the period 2008-2009, during which the transition to the Current cost accounting should be prepared.

The application of the Current cost accounting, as a higher development phase of the cost-accounting principle, may be scheduled for the period 2010-2011, in which preparations for Long Run Incremental Cost accounting could be also made, which could be expected to apply as of 2012.

4. Basic procedures for the application of the cost-accounting principle

Procedural regulation of the cost accounting application has a direct impact on the quality of information grounds for regulatory activities of RATEL and operator's management activities. This created a need for desirable and possible procedures to be regulated by the Rules on the cost accounting application. These procedures consist of:

- . • general aspect (basic procedures) and
- . • detailed aspect (accounting and technical procedures).

They have a common objective: as reliable as possible calculation of total and unit costs for each type of telecommunications services in the operator's business portfolio, which imposes the need for a thorough recognition of:

- direct (directly associated) costs of specific service types,
 - common costs for service groups and
 - overhead costs for all services,
- as well as the cost differentiation based on the criterion of their behavior with respect to activity volume as follows:
- . • variable costs and
 - . • fixed costs,

this, all together, implies previous actions:

- cost segmentation per operator's organizational unit and
- presentation of costs per type of elements employed, for the company as a whole.

Basic procedures for the cost accounting application to the operator are related to:

- . • selection of the basic accounting method,
- . • tailoring the selected accounting method to the operator's organizational chart and, if necessary, its adjustment to firm requirements of the selected accounting method, as well as
- . • development of the Cost and performance accounting by the operator according to

the requirements and options set out in the Rules on Charts of accounts (“Official Gazette of RS”, No. 114/2006), more precisely account class 9 – Cost and performance accounting set out in the above Rules.

The above-mentioned document Cost Concepts and Applications for Telecom Regulation offers two possibilities **when selecting a basic accounting method**:

- Top-down accounting method and
 - Bottom-up accounting method.
- Top-down accounting method includes the following accounting phases:
- presentation of primary costs by nature for the company as a whole;
 - intern cost allocation and reallocation per company unit along with a required separation of capital expenditures (expenses incurred by facilities and plants for the production of telecommunications services) and operating costs, which represents a serious accounting challenge;
 - allocation of capital and operating costs per type and unit of the services rendered.

Considering the need for accounting principle to be applied as soon as possible and the fact that operators, subject to their obligations stipulated in the Accounting and Auditing Law and Rules on Charts of Accounts, usually present primary costs by nature for the company as a whole, in a quite analytical way, **the Rules on cost accounting application suggest that the Top-down accounting method should be opted for**. The issue of including cost ineffectiveness in the cost price of services, resulting from this method, is possible to be prospectively resolved by cost standardization per each service unit, but not at initial stage. That is exactly why the section 3.2 of this Platform suggests the selection of Historical Cost Accounting as the starting cost-accounting principle applied to an operator with significant market power.

Tailoring of the selected accounting method to the operator’s organizational chart is a very delicate accounting and organizational issue, especially in cases in which operator represents a very complex technological, business, organizational and management system. Therefore, resolving this issue by virtue of this Platform may only be set as a task for drawing up the Rules on the cost accounting application, provided that the full cooperation of the operators concerned is ensured.

Development of the class-9 accounts – Cost and performance accounting, i.e. introducing basic organizational solutions in that part of the operator’ accounting activities, as an instrument for attaining the objective to have the selected basic accounting method (Top-down costing method) conform to the operator’s unmodified or partly adapted organizational chart, should also stem from the cooperation between Task group of the RATEL Advisory Council and operators' representatives, which must be ensured.

Accounting and technical procedures, as a set of specific accounting procedures with information on costs, revenue and profit (or loss), nevertheless important for the information quality of the applied cost-accounting principle, should be regulated in the above Rules only to the level of the main rules which should be consistently applied in order to ensure financial reporting outputs specified in this Platform and in the Rules on cost accounting application based thereunder.