Accounting Separation and Publication of Financial Information for Telecommunications Operators

Consultative Paper

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1 Introduction

Maltese legislation recognises that, in the interests of developing and sustaining competition in the telecommunications industry, new entrants to the market must have the facility to interconnect to the network of an incumbent operator. Accordingly a telecommunications industry operator providing public telephone networks and designated as having Dominant Market Power ("DMP”), is required to publish a Reference Interconnection Offer (“RIO”). The RIO must include a statement of the rates at which other licensed operators may interconnect to the DMP operator’s network.

The subject is addressed by the Telecommunications (Regulation) Act and subsidiary legislation enacted under this Act. Relevant EU Directives which the MCA intends to adopt (irrespective of EU membership or not) include the following:

- Directive 97/33/EC of the European Parliament and Council establishing the legal and regulatory framework for the interconnection of telecommunications networks within the EU - a framework that includes a requirement for accounting separation.

- EU Commission Recommendation of 8 April 1998 providing detailed guidelines to National Regulatory Authorities (“NRA”) on accounting separation.

To assist in ensuring that these rates fairly reflect the associated costs, Maltese legislation also requires such organisations to have transparent cost accounting systems. This transparency mandate includes "accounting separation", that is, the drawing up by the DMP operator of accounts separated for its different business units and, specifically, separated between interconnection and other activities. This involves the separate identification of all elements of cost and revenue related to the various activities of the organisation, so helping to ensure transparency of internal cost transfers and discouraging cross-subsidisation between activities.

The MCA will, in conjunction to this document, address the implementation of cost-based accounting systems for the telecommunications sector in another consultative paper. The paper reviews the options, outlines a strategy and establishes a timetable for the implementation of appropriate cost accounting systems by the four existing network operators in the Maltese telecommunications sector.

The MCA is now engaged in the development of accounting separation arrangements in the Maltese telecommunications sector. To assist in this work, the MCA invites submissions from interested parties on the matters referred to in this document concerning accounting separation and the publication of financial information for telecommunications operators.

This document is without prejudice to the legal position or the rights and duties of the MCA to regulate the market generally. This is not a legal document; the MCA is not bound by this document and may amend it from time to time.

2 Legislative Background

2.1 Telecommunications Services (General) Regulations, 2000 [1]

Regulation 10 of the Telecommunications Services (General) Regulations imposes the obligation on all operators to negotiate interconnection agreements with other operators of public telecommunications services. An operator with a DMP is also obliged to ensure that interconnection is accomplished at charges which are based on principles of transparency and cost orientation. Furthermore, an operator with a DMP must publish a RIO and have cost-orientated and sufficiently unbundled charges supported by transparent cost accounting systems. Regulation 12 further imposes that the RIO must include the service tariffs relating to interconnection services.

Regulation 13 requires that operators with a DMP develop an accounting system to calculate charges for interconnection based on Long Run Incremental Costs (LRIC) for network elements used to provide the interconnection, excluding overheads such as marketing, personnel or headquarter maintenance. However, pending an operator's calculation of such charges based on LRIC and their approval by the MCA, interconnection charges are to be based on one of two alternative methods as decided by the MCA. The MCA may decide on the basis of "best current practice" charges for call terminations published in European Union countries. If these are not available the MCA may decide on the basis of other benchmarks, as it deems appropriate.

Regulation 30[2] also requires that an operator providing telephony services having a DMP, other than an operator of public mobile telecommunications systems and services, shall use cost oriented tariffs and shall not, without the MCA's approval, bundle a number of services into a single tariff without also offering each of the constituent services under separate tariffs. Regulation 31 further establishes that when such an operator submits a proposal for changes in tariffs, that operator must provide support based on costs and other factors for its proposed tariffs.

Regulation 32 additionally states that the MCA may require an operator of public mobile telecommunications services to provide support based on costs

[1] L.N. 151 of 2000 as amended by L.N. 70 of 2001, hereafter "the Telecommunications Services (General) Regulations".

[2] Regulations 30, 31 and 32 will come into force on a date yet to be determined.

and other factors for its proposed tariffs, and the MCA may also offer an opportunity for comment upon the proposed tariffs by other operators and by customers.

2.2 Cable Systems (General) Regulations, 2001 [3]

Regulation 11 of the Cable Systems (General) Regulations establishes that an operator providing cable television and radio services having a DMP shall use cost oriented tariffs and shall not, without the MCA's approval, bundle a number of services into a single tariff without also offering each of the constituent services under separate tariffs. Regulation 12 further states that when such an operator submits a proposal for changes in tariffs, that operator must provide support based on costs and other factors for its proposed tariffs.

Regulation 25 also states that an operator shall furnish the MCA with accounts which show separately the annual turnover per service category, and with accounts which show annual costs using cost accounting methods to be defined by the MCA, for system services provided to other operators and for services provided under the universal service obligations.

[3] L.N. 167 of 2001, hereafter "the Cable Systems (General) Regulations".

3 Purpose of Accounting Separation and Publication of Financial Information

The purpose of accounting separation is to provide an analysis of information derived from financial records to reflect as closely as possible the performance of parts of a business as if they were operating as separate businesses. The MCA recognises that it is necessary for competing operators to have confidence that a DMP operator is not unduly discriminating between itself and competing operators or between one competitor and another when providing similar services.

This consultative document considers the level of accounting separation information that is necessary for publication purposes.

3.1 Promotion of a Competitive Environment

The aim of accounting separation is to assist in ensuring that charges are cost based, transparent and non-discriminatory. This in turn promotes a competitive environment in a number of ways, including:

- the publication of accounts which are transparent, thereby allowing other operators to understand how the DMP operator's revenues relate to costs;

- the availability of information, thereby giving other operators the confidence that the interconnection arrangements are equitable, in that it demonstrates that there is no over or under recovery of the DMP operator’s network costs ;

- the publication of detailed cost statements showing the average cost build of products and services provided by a DMP operator, thereby increasing and raising the confidence of competitors that there are no anti-competitive cross subsidisations.

4 Level of Accounting Separation

This section discusses the level of disaggregation that is required for the published separated accounts ("Accounts") of DMP operators**.** The MCA believes that the publication of sufficiently detailed financial information would increase transparency and clearly show that there is no cross subsidisation between the activities of a DMP operator. Balanced against the requirement to promote increased transparency and a competitive environment is the need to consider concerns over the commercial confidentiality of the information.

Consideration of the applicable Maltese and EU legislation, in addition to the EU Commission's Recommendation of 8th April 1998[4], would imply that it is appropriate to publish separate accounting information for the following main business areas: -

- Core Network;
- Local Access Network;
- Retail;
- Other Activities;

A definition for each of the above business areas is set out in Appendix 1[5].

The Accounts of the main business areas should be consolidated into a summarised set of Accounts. The Recommendation suggests that the publication of Accounts for the disaggregated activities of the above main business areas would further increase transparency and assure other operators that there is no discrimination in the provision of services to the DMP operator's own retail arm and other operators. The recommendation also suggests that reconciliations between the Accounts and the statutory accounts should take place.

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[4] EU Commission Recommendation of 8th April 1998 on interconnection in a liberalised telecommunications market Part 2 – Accounting separation and cost accounting, hereafter "the Recommendation".

[5] These definitions are as set out in the Recommendation.

In the light of this Recommendation, it is the MCA's view that a proposed framework for the disaggregation of activities could take the following format:

1) Consolidated Accounts
   a) Core Network
   b) Local Access Network (PSTN / Cable)
      i. Local Access Network - Business
      ii. Local Access Network - Residential
   c) Retail
      A. PSTN
         i. Retail - Local Calls
         ii. Retail - International Calls
         iii. Retail - Directory Enquiry Services
         iv. Retail - Public Payphones
         v. Retail - Leased Lines
         vi. Retail - Calls To Mobile
         vii. Retail - Internet
         viii. Retail - Supplementary Services Business
         ix. Retail - Remaining activities
      B. Mobile
         i. Retail - Voice Calls
         ii. Retail - SMS / Data
         iii. Retail - Roaming
         iv. Retail - Directory Enquiry Services
         v. Retail - Remaining activities
      C. Cable
         i. Retail - Broadcast Services
         ii. Retail - Leased Lines
         iii. Retail - Internet
         iv. Retail - Telephony
   d) Other Activities
      i. Other - Apparatus Supply
      ii. Other - Remaining activities

Set out in Appendix II are definitions for the above proposed disaggregated activities of "Retail" and "Other".

It would be necessary to publish reconciliation statements in conjunction with the Accounts. These reconciliations would be:

- between the statutory accounts of the organisation and the Consolidated Accounts of the main business areas;
- between the Consolidated Accounts of the main business areas and the Accounts of the main business areas (e.g. Retail);
- between the Accounts of the main business areas (e.g. Retail) and their disaggregated activities (e.g. Local Calls, National Calls).

5 Format of the Accounting Separation Financial Statements

This section of the consultation document considers the format of the financial information to be disclosed in the Accounts. The preparation of the Accounts should follow a set of guiding principles. Examples of such principles are as follows:

a) The separated accounts shall be based on a transparent cost apportionment methodology based on a Fully Allocated Costing (FAC) Historic system.

b) The separated accounts shall include transfer charges between the main business areas and the disaggregated activities for services the organisation provides to itself. They shall also disclose the equivalent transactions with competing operators.

c) The separated accounts shall be prepared in accordance with accepted accounting standards insofar as they are relevant.

d) The separated accounts shall be prepared in accordance with the Regulatory Accounting Principles, which set out the general rules by which the Accounts are prepared. Proposed principles are set out in Appendix IV.

e) Details of significant changes that impact on the financial statements and prior year restatements shall be given.

f) Separated accounts shall be published annually and contain comparative information. Where there are material changes to Regulatory Accounting Principles, cost allocation methodology, attribution methods, or to accounting policies that have a material effect on the information reported in the separated accounts of a main business area or a disaggregated activity, the parts of the previous year's separated accounts affected by the changes shall be restated.

g) The separated accounts shall make explicit any differences between costs allocated to different activities by the operator, and the costs that the MCA allows for the purpose of determining charges.

h) The separated accounts shall be subject to an audit in accordance with the relevant rules of Maltese legislation.

Suggested formats for the separated accounts of the Local Access Network, Core Network, etc are included in Appendix III.

The Profit and Loss formats disclose Turnover (split between internal and external provision of services for the Network businesses, and connection fees, rentals and call charges for the Retail businesses), Operating Costs and Transfer Charges. Access Deficit and Universal Service contributions (if any) are also shown. The return [profit/(loss)] is calculated on the same basis as the cost of capital i.e. if a pre-tax and pre-interest weighted average cost of capital is used, the return in the accounts would be before interest and tax.

The Balance Sheet format includes a breakdown of Fixed and Current assets, as well as totals for Creditors and Provision for Liabilities and Charges. The Balance Sheet figures are the average values for the period to which the Balance Sheet relates. This average should ideally be a weighted average value, although a simple average value of opening and closing balances could initially be used.

5.1 Publication of Other Financial Information

The Recommendation recommends that "relevant accounting information" from DMP operators is made available to interested parties "at a sufficient level of detail to ensure that there has been no undue discrimination between the provision of services internally and those provided externally, and to enable the average costs of unbundled interconnection services to be identified."

The Recommendation recommends that the following items of information should also be prepared as part of the accounting separation process: -

a) a statement of accounting policies used in the preparation of the accounts;

b) a matrix summarising the total transfer charges between the different Accounts;

c) a statement describing the basis on which unattributable costs have been allocated between different accounts;

d) information about the cost allocation methodologies employed in order to prepare separate accounts. This should be at a level of detail that makes clear the relationship between costs and interconnection charges;

e) a statement showing the average cost of network components.

The Recommendation does not set out the information to be disclosed in the statement of the average cost of network components. The MCA is proposing that the breakdown of information to be disclosed in this statement be as follows:-

- average per minute cost of each conveyance network component;
- average per minute cost of each non-conveyance network component. For example, Directory enquiries, Operator assistance, etc;
- other costs split into appropriate categories (split into an average per minute cost where applicable);
- Routing factors for traffic;
- Time of Day Gradients ;
- Final charges;
- International Out payments.

Sufficient explanatory information would also be required to accompany the separated accounts, to assist interested parties in fully understanding the information contained within. This information would include: -

- A statement of the Regulatory Accounting Principles followed when preparing the Accounts;
- complete definitions of the main business areas and their disaggregated activities;
- a description of the transfer charging system that is operated for accounting separation;
- details of significant changes which impact on the financial statements and on comparative figures.

5.2 Publication of Confidential Financial Information

The MCA may request detailed financial information at any time from a relevant operator. This information may be published, if the MCA considers it would contribute to an open and competitive market subject to the consideration of its commercial confidentiality.

The process of determining an appropriate balance between contributing to an open and competitive market, and the commercial confidentiality of the information is not a straightforward matter. The publication of financial information at a sufficiently detailed level would increase the confidence of operators that there is no undue discrimination between the internal and external provision of services by the DMP operator, and would make transparent the relationship between interconnection charges and costs. However, balanced against assisting market development is the commercial confidentiality of the information being published. It is possible that a DMP operator would regard some of the detailed information in section 5.1 as being commercially confidential.

The MCA would welcome comments from interested parties on the additional financial information that would contribute to an open and competitive market and the basis for the publication of this information.

5.3 Timeframe for Publication of the Separate Accounting Information

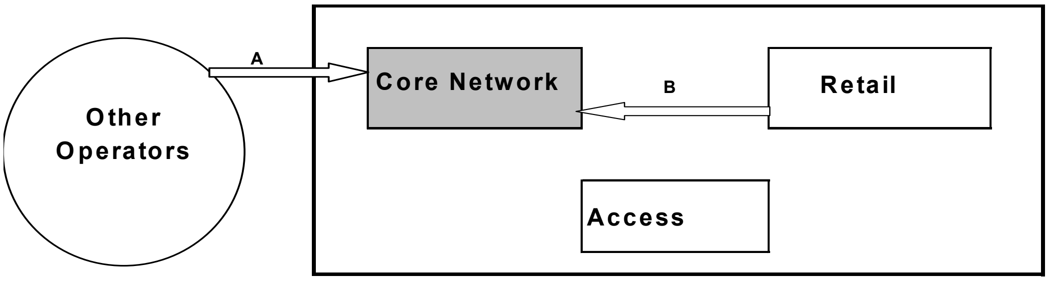
In order for accounting separation to be effective, the information published should be timely. Unnecessary delay in the publication of the accounts and the additional financial information would reduce the positive effects of accounting separation.

A proposed timeframe for the preparation and publication of the Separate Accounting information is within two months after the date on which the DMP operator's annual statutory financial statements are published and, in any event, not later than five months after the end of the period to which they relate.

This timeframe would come into force following the transition period described in Section 7.

6 Transfer Charging Principles

A system of transfer charges would apply to services and products provided between the main business areas and disaggregated activities. For example, the following diagram shows the interaction of the Core Network and the Retail business of the DMP operator.



The Core Network sells a range of services to meet the differing needs of other operators (if any) and Retail respectively. The price of each service is based on the fully allocated cost of the network components or parts ("component"), including a reasonable return on capital, used to provide the service. A network component is a unit of network plant or activity which can be separately costed but, in most cases, cannot be separately supplied, e.g. a minute of local exchange switching. All services sold by the Core Network, either to the other operators (if any) or to Retail is built up from combinations of one or more network components using routing factors.

The payments identified at point A in the above diagram are based on the interconnection charges in the DMP operator's RIO. The payments at point B are the internal transfer charges.

A transfer charging system should conform to the following principles: -

- Transfer charges (revenues and costs) shall be attributed to cost components, services and main business areas or disaggregated businesses in accordance with the activities, which cause the revenues to be earned, or costs to be incurred;

- The attribution shall be objective and not intended to benefit any business or disaggregated business;

- There shall be consistency of treatment of transfer charges from year to year;

- The transfer charging methods used should be transparent. There should be a clear rationale for the transfer charges used and each charge should be supportable;

- The transfer charges for internal usage should be determined as the product of usage and unit charges;

- The charge for internal usage should be equivalent to the charge that would be levied if the product or service were sold externally rather than internally. For accounting separation purposes, it should be assumed that the retail business pays the same interconnection charge for the same service as set out in the RIO;

- The separated accounts shall disclose the transfer charges between businesses and disaggregated businesses.

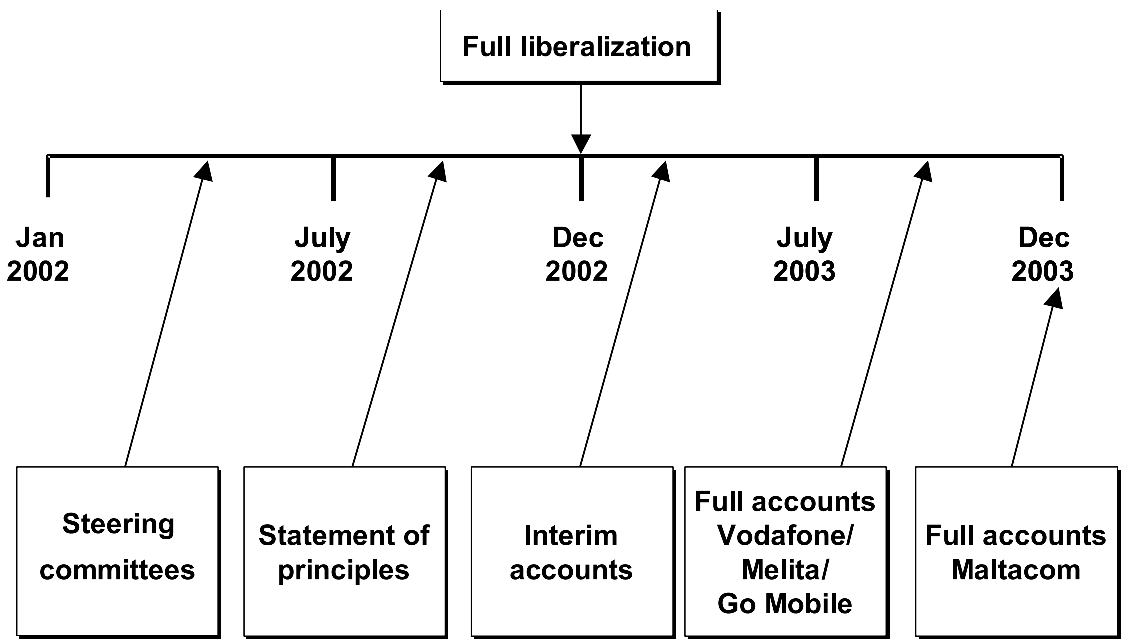
7 Organisations Affected by Accounting Separation

In accordance with the Telecommunications Services (General) Regulations and the Cable Systems (General) Regulations, all DMP operators (mobile, fixed and cable) will be obliged to prepare separated accounts.

The MCA is mindful that the imposition of regulatory obligations in relation to accounting separation and publication of financial information must allow reasonable timeframes for operators. The timeframes must be long enough to allow the operators to put all the necessary groundwork in place and then to produce the separated accounts. At the same time the timeframes must be short enough to focus minds on the tasks ahead. The MCA intends to adopt the following timeframes:

- By September 2002 a statement of allocation principles and methodology to be returned to the MCA by each operator;
- By February 2003 an interim statement of accounts with a first cut of the adopted structure and estimates of the balances involved;
- By September 2003 (December 2003 in the case of Maltacom) a full set of FAC (Historic) accounts to be produced.

This timetable is illustrated below:



These timeframes are consistent with other projects which the MCA is undertaking, notably the implementation of cost based accounting systems for the telecommunications sector.

During the transition period the first interim and full Accounts will be published as follows:

Operator	**Interim Accounts**		**Full Accounts**	
	Period Reported	**By**	**Period Reported**	**By**
Maltacom	January 2002 to June 2002	February 2003	January 2002 to December 2002	December 2003
Vodafone	April 2002 to September 2002	February 2003	April 2002 to March 2003	September 2003
Go Mobile	January 2002 to June 2002	February 2003	January 2002 to December 2002	September 2003
Melita Cable	January 2002 to June 2002	February 2003	January 2002 to December 2002	September 2003

Operators will not be required to publish the Accounts prepared during the above transitional period. However these accounts will be delivered to the MCA in accordance with the above timeframe. The MCA reserves the right to make these accounts accessible to any operator at its discretion, after informing the operator to whom the accounting information relates.

Following the above transition period, the proposed timeframe for the preparation and publication of the separate accounting information as described in Section 5.3.

8 Consultation framework

8.1 Consultation Period

The consultation period will run until Monday 15th April 2002. Comments should be sent before noon on Monday 15th April 2002 to:

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8.2 Finalisation of the MCA's Position

The MCA will consider comments received in response to this consultative document before reaching a decision on accounting separation and publication of financial information.

8.3 Conclusion

In conclusion, this methodology is proposed by the MCA for comment by interested parties. The MCA recognises the subject to be a very important one for the regulation of the telecommunications market, both now and in the future.

Appendix I - Definitions of Business Areas

Core Network

The Core Network business provides a range of interconnection services internally and externally in order to allow the customer of one operator to communicate with customers of the same or another operator, or to access services provided by another operator. These services include the switching and conveyance of calls.

In addition, the Core Network business may provide other services to operators e.g. such as engineering services related to the development and maintenance of private networks.

The accounts for the Core Network business will include the costs, revenues and capital employed associated with the provision of these services. The revenues of the Core Network business will derive principally from the sale of interconnection services to the Retail business and to other operators.

Local Access Network

The Local Access Network provides connections to the Core Network. The accounts for the Local Access Network business will include the costs and capital employed associated with providing and maintaining these connections.

For accounting separation, the Local Access Network business will include all the customer-dedicated components of the network including, for example, the line cards and ports located at concentrators and/or exchanges.

The Core Network business will include all other network components. Customer line rental will be a service provided by the Retail business. The revenue from line rental provided to end-users will therefore be recorded in the Retail accounts. The cost of providing customer lines will be recorded against the Local Access Network business and there will be a transfer charge of costs to the Retail business in order to match revenues with their associated costs. The costs transferred to Retail should be net of any possible local access revenue.

Retail

The Retail business includes all those activities involving the selling of telephony services to end-users, including line rental, leased lines, calls, payphones and the provision of directory information.

The accounts for the Retail business will include the costs, revenues and capital employed associated with the provision of these services to end-users. The costs allocated to Retail will include transfer charges related to the use of network resources or services provided by Local Access Network and the Core Network businesses, and the marketing and billing costs associated with the provision of end user services.

Other Activities

Operators typically provide a wide range of other services including the rental, repair and maintenance of customer equipment. In addition, they may have interests in non-telecommunications activities (e.g. TV broadcasting, training services). For the purposes of accounting separation, the costs, revenues and capital employed associated with these activities will be separately identified.

Appendix II - Definitions of Disaggregated Activities

PSTN

Retail - Local Calls

Local dialled calls originating from ordinary, ISDN and private payphone telephone exchange lines.

Retail - International Calls

International calls originating from ordinary, ISDN and private payphone telephone exchange lines. This also includes receipts from overseas telecommunications operators and cashless calling.

Retail - Directory Enquiry

Local and international calls placed with the operator to obtain information about Maltese and overseas telephone numbers, whether made from business or residential telephone exchange lines or from public payphones and includes calls made to the Directory Enquiry database.

Retail - Public Payphones

Local and international dialled calls, originating from public payphones, using cash or phone cards.

Retail - Leased Lines

Business of rental, maintenance, connection and change of local and international leased lines beyond customers' premises.

Retail - Calls To Mobile

Dialled calls originating on ordinary and private payphone lines that terminates on a mobile, not fixed, network. This also includes revenue from calls originating from public payphones.

Retail - Internet

Calls to the Internet originating from ordinary and ISDN telephone exchange lines.

Retail - Supplemental Services Business

The Business relating to the supply of certain data and value added services. Examples of these services are data networks, messaging services, mobile messaging communications, fax network services, electronic information services, broadcast and visual services, internet multimedia services, managed answering services and telemarketing.

Mobile

Retail - Voice Calls

Local and International dialled calls from subscribers connected to the network for the transport of real-time speech.

Retail - SMS / Data

Transport over the network of SMS and other data signals serving for the impartation of any matter otherwise than in the form of real-time speech.

Retail - Roaming

The provision of the capability to subscribe to voice and SMS / Data services by virtue of roaming agreements concluded with other mobile network operators..

Cable

Retail - Broadcast Services

The delivery of radio or television broadcasts or other television services to a subscriber by means of a cable system.

Retail - Leased Lines

Business of rental, maintenance, connection and change of local and international leased lines beyond customers' premises.

Retail - Internet

Connections to the Internet originating from a network termination point.

Retail - Telephony

Local and International dialled calls from subscribers connected to the network for the transport of real-time speech.

<u>Others</u>

Retail - Remaining Activities

All other telecommunications services that are within the Retail Business.

Other - Apparatus Supply

The Business relating to the rental and sale of customer premises equipment.

Other - Remaining Activities

All other telecommunications activities that are within the Other Business area.

Appendix III - Suggested Formats for Separated Accounts

Network Business

PROFIT AND LOSS ACCOUNT	**2001** **Lm'000**
Turnover From other operators Transfer charges to Retail Business	
Total turnover	
Operating costs	
Return	

RETURN ON MEAN CAPITAL EMPLOYED	**2001** **Lm'000**
Return	
Mean capital employed	
% Return on mean capital employed	

Network Business

STATEMENT OF MEAN CAPITAL EMPLOYED	**2001** **Lm'000**
Fixed assets Tangible fixed assets Intangible fixed assets	
Total fixed assets	
Current assets Stocks Debtors Cash at bank and in hand	
Total current assets	
Creditors	
Provisions for liabilities and charges	
Mean capital employed	

Retail Business

PROFIT AND LOSS ACCOUNT	**2001 Lm'000**
Turnover Rental Call charges Other	
Total turnover	
Operating costs Operating costs specific to Retail Transfer charges from Core Network	
Total operating costs	
Return	

RETURN ON MEAN CAPITAL EMPLOYED	**2001 Lm'000**
Return	
Mean capital employed	
% Return on mean capital employed	

STATEMENT OF MEAN CAPITAL EMPLOYED As for Network Business

Appendix IV - Regulatory Accounting Principles

The following Regulatory Accounting Principles could be applied when preparing the Accounts.

- Cost Causality: Revenue (including transfer charges), costs (including transfer charges), assets and liabilities shall be attributed to cost components, services and businesses or disaggregated businesses in accordance with the activities which cause the revenues to be earned or costs to be incurred or the assets to be acquired or liabilities to be incurred.

- Objectivity: The attribution shall be objective and not intended to benefit the DMP operator or any other Operator, product, service, component, Business or disaggregated business.

- Consistency of treatment: There shall be consistency of treatment from year to year. Where there are material changes to the Regulatory Accounting Principles, the Attribution Methods, or the Accounting Policies that have a material effect on the information reported in the Financial Statements of the Businesses, the parts of the previous year's Financial Statements affected by the changes shall be restated.

- Transparency: The Attribution Methods used should be transparent. Costs and revenues, which are allocated to Businesses or activities, shall be separately distinguished from those that are apportioned.