Oaseirys Çhellinsh
Communications Commission

Information Notice

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COST ORIENTATION ASSESSMENTS

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Cost orientation Assessments

Background and Overarching Principles

1. Manx Telecom (MT) notifies the Communications Commission (the Commission) of proposed new wholesale products and changes to wholesale pricing. The Commission expects wholesale prices to be moving towards cost orientation, as per obligations set out in Decision Notice 2012/02[1]. The Commission also expects MT to clearly demonstrate how its prices are cost oriented, in line with the obligation set out in Decision Notice 2012/02. This document aims to set out the Commission's expectations in this regard.

2. The decision notices issued as part of the 2012 market reviews provide the formal basis for the accounting separation and cost orientation obligations.

> ***Obligation of accounting separation***
>
> *xxii. In accordance with Condition 43.2.7 of its Licence, MT is hereby directed to produce separated accounts. The format, timing and reporting requirements of these accounts will be subject to agreement with the Commission.*
>
> ***Obligations relating to price controls and cost accounting***
>
> *xxiii. A price control obligation is proposed in accordance with Condition 44.2.1 such that MT is directed not to cause a margin/price squeeze. This is a proportionate measure designed to address the objectives outlined in Condition 44.3. In accordance with Condition 44.2.2 of its Licence, MT is directed to comply with rules which the Commission may make in relation to the measures imposed under Condition 44.2.1, regarding the recovery of costs and cost orientation.*
>
> *xxiv. In accordance with Condition 44.2.3 of its Licence, MT is hereby directed to maintain appropriate cost accounting systems in respect of the price controls imposed in accordance with Condition 44.2.1 regarding products, services or facilities in the wholesale fixed markets. In accordance with Condition 44.2.3 (a) and (b), MT is required to make publicly available a description of the cost accounting system, including details of (i) the main categories under which costs are brought into account for the purposes of that system; and (ii) the rules applied for the purposes of that system with respect to the allocation of costs.*

3. The cost orientation remedy was imposed with the intention of providing clarity around the cost involved in supplying a wholesale input. Naturally, this has had implications for the accounting and reporting practices of Manx Telecom. The major output has been creation of the separated accounts. Further information is available on the Commission's[2] and Manx Telecom's[3] websites.

[1] https://www.iomcc.im/media/1144/notification-of-market-power-and-decision-notice-2012-02.pdf
[2] https://www.iomcc.im/telecoms/manx-telecom-separated-accounts/
[3] https://www.manxtelecom.com/about/corporate-responsibility/regu-atory-responsibility

4. The view in 2012 was that cost orientation could not be imposed until the separated accounts had been imposed and other remedies leading out of the 2012 market reviews, such as transparency, had been implemented[4]. In the interim, Manx Telecom was required not to cause a margin squeeze.

5. The Commission and Manx Telecom have now reached a point where the aforementioned remedies are being applied and have been well developed. As a result, the Commission has devised this document as a means to begin formal implementation of the cost orientation remedy. This document sets out how cost orientation can be demonstrated and assessed.

Definitions

6. **Cost Orientation:** The ability of Manx Telecom to demonstrate its wholesale prices are set at a level that is appropriate of costs incurred (linked back where appropriate to the Cost Model), including a reasonable proportion of common costs, plus a reasonable rate of return. The expectation is that costs should be efficiently incurred and that this can be demonstrated.

7. **Wholesale Prices:** The wholesale price is assessed at the product portfolio level. This ensures that the approach adopted is consistent with the margin squeeze process. Implicit in this approach is that individual products or circuits within a portfolio do not necessarily need to be cost oriented. This is subject to a reasonableness test; specifically the Commission expects that deviations are not material and that Manx Telecom would be able to justify pricing in such a way. The portfolio overall should be cost oriented.

8. **Costs Incurred:** The Commission recognises that not all costs will link back to the bottom up models, particularly where investments are made, or costs are incurred after the bottom up models were updated or produced. In these cases, the Commission expects information on the investment made and an explanation of why the costs incurred have been included.

9. **Common Costs:** A reasonable proportion of common costs should be allocated to the portfolio or product as part of the cost orientation assessment. A common cost is one that is shared between multiple markets, portfolios or products. The Commission expects Manx Telecom to demonstrate its rationale for the proportion of common costs applied. The common costs should link back to the bottom up models or separated accounts. In addition, any variation in common cost allocation from the same product or portfolio which was assessed previously, should be noted by Manx Telecom and justified. The Commission recognises that not all costs will link back to the bottom up models, particularly where investments are made, or costs are incurred after the bottom up models were updated or produced. In these cases, the Commission expects information

[4] https://www.iomcc.im/media/1146/wholesale-fixed-consultation-paper-and-notification-of-proposed-determinations.pdf See page 33

on the investment made and an explanation of why the proportion of common costs has been included

10. **Reasonable Rate of Return:** The weighted average cost of capital that has been agreed between the Communications Commission and Manx Telecom as the appropriate rate. Currently this rate is 8.9%.

11. **Product Portfolio:** For the purposes of this note a Product Portfolio is all of the optional products that fall within a given market offering – for example, within the market for wholesale on-Island leased lines there are, at present, three market offerings – Wavelength, Megaline, and Ethernet. The various Ethernet offerings could be seen as a portfolio of products.

Format and Scope of the Accounts

Overall Approach

12. Long run incremental costs (LRIC) models allocate network costs to services, which in turn can provide a key source of cost allocation criteria.

13. The accounts structure being developed by MT includes both a "Charges-Historical Cost Accounting (HCA)" view and a "Charges-Current Cost Accounting (CCA)" view. The former is based on the HCA costs in MT's statutory accounting systems including its Fixed Asset Register. The operating expenditure in both cases is based on the historic operating expenditure although the Charges-Bottom-Up (BU) view may incorporate efficiency adjustments where appropriate.

14. Where cost oriented wholesale tariffs are derived in the BU cost models and are agreed by the Commission and employed in the wholesale market, they are then used for transfer pricing purposes. For other wholesale transfer pricing the retail-minus values will be used in the meantime to reflect the non-discrimination of transfer pricing between MT wholesale to its own retail business and to these of other operators in the market.

15. The transfer charges will, to the maximum extent possible, be consistent with the wholesale charges that would be faced by an alternative operator seeking to purchase the same input service. Therefore in order to facilitate compliance with obligations of transparency and non-discrimination, the transfer charges are, where possible, to be based on the wholesale charges that applied in the market during the year that the accounts relate to.

Relationship with the Bottom-Up Cost Model

16. While the primary aim of the cost model is to systematically analyse MT's costs in order to derive regulated tariffs which are oriented towards costs, the analysis underpinning the models also provides a key source of data for allocating costs to services/markets within the regulatory accounts. There is therefore an interrelationship between the

information collected for accounting separation, cost accounting and cost orientation, and the common theme is the provision of a coherent and consistent understanding of the ways in which costs and revenues are allocated and apportioned.

Market Categories

17. Although the SMP obligation to prepare separated accounts applies only to the fixed markets in which MT has been designated with Significant Market Power (SMP), it is the Commission's view that MT should provide additional information on non-regulated markets and other business areas where this supports the demonstration of compliance with SMP obligations in regulated markets. For example, issues between regulated and non-regulated markets could involve potential margin squeeze, cross-subsidy, or discriminatory common cost allocations.

18. There is also a risk that certain costs could be double-counted or excluded and the inclusion of information on the non-regulated markets facilitates reconciliation between the separated accounts and the statutory accounts to help verify that costs are fully and correctly attributed. The Commission expects that any information on non-regulated markets and business areas would be provided on a confidential basis; as MT has not been designated with SMP in those markets and the markets are deemed to be effectively competitive.

19. In addition to the 4 retail and 6 wholesale fixed markets identified through the market review process (that is, all of the markets, not just those where MT was designated with SMP), MT has identified further retail fixed markets and mobile markets which together make up its overall business. Finally, two additional categories have been identified. These are "common costs" which gathers costs common to all other markets and then allocates using the Equi-Proportional Mark Up (EPMU) approach, and an "out of scope" category which groups all miscellaneous revenues and costs which are irrelevant to all other markets.

20. In effect, a full scope of financial information will be prepared and submitted to the Commission, and this will be the context for the preparation of separated accounts for the regulated markets.

Cost Allocation Principles

21. Each item of revenue and costs, and of assets and liabilities, and capital employed, must be attributed to the products and services provided by MT. In the case of revenues it should be relatively straightforward to allocate a substantial proportion directly, based on revenue accounting and/or billing systems. However, some degree of revenue analysis may be required to allocate the revenues from bundled offerings to the relevant markets.

22. The allocation of costs tends to be more complicated than revenues as a significantly greater proportion of operators' costs are shared between different products and services. This means that MT has to identify different types of costs and attribute them to individual elements of networks and services within the structure of the identified markets and categories.

23. In general, attribution should be based on the principles of:

    a. cost causality;
    b. objectivity;
    c. consistency; and
    d. transparency.

Cost Causality

24. The principle of causality implies that costs are allocated, directly or indirectly, to the services that "cause" the costs to arise. In practice, this requires that costs should be allocated to services on the basis of how those services causes the costs to be consumed, the assets to be acquired or liabilities to be incurred.

Objectivity

25. The principle of objectivity means that the attribution of costs and revenues should be carried out in a manner which is not designed to benefit any particular operator, or any product or service.

Consistency

26. There must be consistency over time in the approach to the preparation of the separated accounts. Where there are material changes to the basis and method of revenue and/or cost attributions year on year, MT should fully restate the previous year's separated accounts affected by the changes, to the extent that prior period financial and non-financial data is available.

Transparency

27. The attribution methods used must be transparent. This requires that the allocation of resources, assets and liabilities and their associated costs must be traceable back to their source in the MT's accounting records.

The Cost Orientation Test

28. The preliminary test for cost orientation will be:

Wholesale price = Costs incurred + reasonable allocation of common costs + 8.9% WACC

a. If the wholesale price is too low to allow a return of 8.9% the price would be deemed "not cost oriented" as it is below cost.

b. If the wholesale price is allowing for a return higher than 8.9% and it cannot be justified on the grounds of longer term investment incentives, the price would be deemed "not cost oriented".