Available Costing Concepts and Their Data Demands

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General definition of cost

- Cost is the current valuation of scarce resources used up in an efficient way for a particular purpose, usually the production of a good or service
- Note emphasis on:
  - scarce resources
  - current valuation
  - used up in an efficient way
  - for a particular purpose

Fully distributed cost

- Start with this concept because it has been so important in the past
- Features:
  - Uses a backward-looking perspective
  - Little consideration given to efficiency
  - All of common cost distributed
- Data requirements:
  - Low: Uses data from firm’s cost accounting records
- Concept not consistent with definition above => therefore on its way out

Long run incremental cost (LRIC)

- Recognized as the relevant concept for a competitive environment by most regulators and observers
- Features:
  - Uses a forward-looking perspective
  - No cost not pertaining to service being looked at included
  - Only cost due to efficient operation recognized
  - Can be implemented through analytical cost models
  - For pricing purposes, common cost to be added as an extra margin, to be dependent on market conditions
- Data requirements:
  - High: Requires detailed knowledge of production process, current prices of resources used up
  - Can nevertheless be fulfilled by external analysts (as for example for analytical cost models)

Activity based costing (ABC)

- Associated with the concept of LRIC
- Features:
  - Focus on cost of activities (in contrast to cost of infrastructure)
  - Identification of cost drivers for each relevant activity
  - Identification of linkages between activities and services

  Data requirements:
  - High: Explicit studies needed to identify relevant activities, cost drivers and linkages to services
  - Due to cost of such studies, there is a limit to which ABC should be carried

Short run incremental cost

- Relevant in the short run, mostly in cases where available capacity is not fully used
- Features:
  - There are fixed cost that do not vary with short run variation in output
  - Costs that do vary are less than in case of LRIC => supply of service at lower price may be profitable
- Relevance:
  - For a regulated dominant operator, often not verifiable whether pricing with reference to lower short run cost not really motivated by operator's anticompetitive intentions
  - However, for emerging and transition economies, pricing based on short run cost relevant where demand is too weak for existing segments of the network

Other relevant cost concepts

- Marginal cost
- Opportunity cost
- Fixed cost
- Shared cost
- Indirect vs. common cost
- Sunk cost

Regulatory requirements to be met by costing procedures

- Non-discrimination
  - From it follows requirement of efficiency
- Transparency
  - Needed to evaluate fulfillment of other requirements
- Objectivity
  - Essentially a requirement of high professional standard in carrying out costing exercises
- Practicability
  - No overkill; need to observe resource constraint also affecting cost accounting

Summary

- One should be aware of proper definition of cost
- FDC's backward orientation and lack of efficiency awareness makes it a standard of the past
- LRIC the relevant standard for a competitive environment
- ABC should be judiciously used to make LRIC a complete standard
- Short run cost relevant for situations with existing network segments for which demand is weak
- Importance of procedural requirements of non-discrimination, transparency, objectivity and practicability