



TELECOMMUNICATIONS REFORM IN JAPAN

EUROPEAN BUSINESS COMMUNITY (EBC) POSITION PAPER

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1. INTRODUCTION

Recent reforms to Japan's telecommunications regulatory regime, particularly the removal of prescriptive tariff filing obligations and the simplification of the licensing process, constitute positive steps towards international best practice. However, there is still a substantial and widening gap between Japan and the rest of the world in terms of best practice regulation, with the result that reforms are not producing the expected gains for consumers and competition. Japan's success in broadband deployment should not distract from serious problems in the wider market. NTT's dominance continues to inhibit competition in most fixed-line markets and regulation is increasingly damaging high levels of competition in mobile markets. This paper identifies reforms which, by reference to European and international experience, can be expected to strengthen Japan's international competitiveness, increase investment and innovation, and maximise economic recovery and growth.

2. INSTITUTIONAL ISSUES

Deficiencies with the institutional structure of the Japanese regulatory regime continue to affect the openness, fairness and transparency of the regulatory process and undermine confidence in Japan as a destination for telecommunications-related investment:

- (1) **“Micro-management” of the market by the regulator** – Japan remains one of the most highly interventionist and highly regulated telecommunications markets in the world. In most other countries, operators are free to develop their businesses, subject only to the constraints of general competition law, and additional sector-specific rules if they are dominant. In Japan, however, competitors can do very little without first consulting and obtaining the formal or informal approval of the regulator. Regulatory supervision and control extends to almost every aspect of business. European experience demonstrates that intrusive regulatory intervention of this nature has a distortionary effect on the market and consumer welfare. There is an urgent need for the Ministry of Public Management, Home Affairs, Posts and Telecommunications (**MPHPT**) to pull back from intrusive micro-management and move towards a less interventionist and more



competition driven approach to regulation. Recent changes to the Telecommunications Business Law (TBL) do not appear to address this problem.

- (2) **Absence of clear economic foundation for regulatory intervention and decision-making** – MPHPT has wide ranging statutory powers of intervention and control. It can intervene at any time, on any issue, for any reason, and order an operator to do anything it wants. There are no clearly articulated criteria in the legislation governing the way in which these powers must be exercised. This introduces a high degree of uncertainty and unpredictability into the regulatory process. Most other countries require regulators to ensure their decisions promote the long-term interest of consumers having regard to key economic factors, including the need to promote economic efficiency, investment, innovation, and effectively competitive outcomes. A similar provision needs to be inserted into the Japanese legislation to provide certainty and ensure that decisions are economically robust.
- (3) **Inadequacies in the public consultation process** – The Government requires Ministries to consult publicly on changes in policy but the practices of MPHPT strip the consultation process of any real meaning. Most policy decisions are made in closed committee procedures, which tend to exclude foreign operators, before consultation documents are issued for comment. As a result, the consultation process is merely “window dressing”, and has little or no effect on policy decisions. Reflecting the emptiness of the procedure, consultations are forced through in unreasonably short timeframes, without regard to the problems of translation faced by foreign operators. These problems prevent meaningful participation of foreign operators in the decision-making process. Consultation should take the form of an initial period for comments on a preliminary proposal, followed by a second round of comments on the views expressed in the first round, with a minimum of six weeks allowed for responses in each case. Final decisions should only be made after the completion of this process, and a statement should be issued setting out the results of the consultation process, responding to points made in the consultation process, and giving full reasons for the decision. This would bring Japan’s consultation process more in line with international standards of regulatory best practice.
- (4) **Absence of an independent regulator** – There is a clear conflict of interest between the Government’s role as a major investor in NTT and its role as the regulator. This conflict of interest can deter investors and undermine confidence in the independence of the regulatory process. The recent decision on fixed-line interconnection charges is a clear indication of the protection NTT continues to receive from the Government. There should be clear separation of ownership and regulatory function consistent with the approach in other major economies. Responsibility for development of the industry



should also be separated from regulatory oversight functions. The Prime Minister's proposal to consider creating a combined IT and communications regulator could be used as an opportunity to introduce much needed structural reform.

3. REGULATORY ISSUES

Despite recent reforms, Japanese regulation continues to constrain the development of effective competition. There is an urgent need to create an open and fair market in which all operators can compete on a level playing field. Priority areas for reform are as follows:

(1) Fixed Line Interconnection

Current Japanese fixed line interconnection rates are unacceptably high by world standards. This distorts competition, keeps end-user prices artificially high, and imposes a substantial revenue drain on competitors.

These high prices result from a number of defects in the revised Long Run Incremental Cost (LRIC) model. The key defects are:

- Reliance on the incumbent's existing inefficient network and costs – rather than those of a forward-looking, efficient operator;
- Failure to optimise all elements of the model (including using lowest cost technology and structuring the model to process traffic volumes in the most efficient manner) – contrary to the principle of forward-looking efficiency;
- Failure to share common network costs over the expanding demand for broadband access, whilst instead loading these costs fully onto a declining volume of voice traffic; and
- Failure to exclude non-traffic sensitive (NTS) costs – contrary to the principle of cost causality and the accepted practice of other regulators.

Although all of these defects have a cumulative impact on price, the failure to exclude NTS costs has the single greatest impact, almost doubling the cost of interconnection. Exclusion of NTS costs would, on MPHPT's own calculations, lower prices to within acceptable benchmark levels.

Immediate steps should be taken to exclude NTS costs from the interconnection charge to bring Japan into line with international benchmarks. Concerns that excluding NTS costs would result in an automatic increase in line rental charges have been overstated. In particular:



- Overseas evidence, including from the UK, is that the incumbent is able to absorb any rebalanced costs rather than pass them onto consumers in the form of higher line rental charges.
- The incumbent has powerful commercial incentives to maintain lines at current cost because, once connected, a customer will acquire a range of voice and data services over those lines.
- The revenue incumbents generate over their access lines has grown rapidly in recent years and now includes dial-up Internet access, DSL services and calls to information and other value-added services. As a result incumbents have a much larger revenue pool out of which to meet their fixed line costs. At the same time, as a result of competition and efficiency, the incumbent's local network costs should have fallen significantly.
- Concerns about consumer "rate shock" from any increase in line rental charges can, in any event, be addressed through price caps on line rentals to enable incremental rebalancing and maintain incentives on the incumbent to absorb costs as far as possible through efficiency and other improvements.

(2) Universal Service

The revised LRIC model is being used to determine the cost to NTT of providing Universal Service in Japan. The flaws in the model have the effect of overstating any cost of universal service provision by NTT.

The revised model produces estimates of a net loss to NTT of ¥10-30 billion per annum. This would result in a substantial tax on competition if imposed on the industry, and a substantial windfall to NTT, which is locked in as the universal service provider through a lack of contestability in the current mechanism.

International best practice approaches to universal service suggest that a net loss is not likely to exist in relation to the provision of telecommunications services across Japan. There is also a question whether the current universal service scheme has been overtaken by technological developments and the deployment of competitive infrastructure across Japan.

For these reasons there is no justification for activating the current costly and inefficient scheme in Japan



(3) Inadequate Competitive Safeguards

NTT continues to enjoy all the benefits of dominance flowing from its former monopoly position. NTT's dominance is persistent, pervasive, and enables it to prevent the development of competition. Regulatory constraints have not been effective in preventing anti-competitive conduct. Competitive safeguards must therefore be strengthened as follows:

- **Reinstate obligation for NTT to notify and price on tariff** - Tariffing obligations were recently lifted from NTT. Without this obligation, there is no pricing transparency in the market, leaving NTT free to price anti-competitively at the retail level. Most overseas regimes require the dominant operator to publish and price on tariff to prevent this result. The obligation for NTT to publish and price on tariff should therefore be reinstated immediately as an essential competitive safeguard.

- **Stronger regulatory accounting and information disclosure requirements on the incumbent**
 - European experience shows that it is critical to apply strict obligations to ensure transparency of costs, ensure charges to competitors are cost-based, monitor and prevent anti-competitive behaviour in relation to the price and non-price terms of supply, and provide a means of independent audit. The current ability to monitor and respond to anti-competitive conduct by NTT is inhibited by the lack of information disclosure requirements. These should be strengthened to require NTT to:
 - Maintain regulatory accounts *horizontally* across its different businesses. This is intended to divide businesses from each other to prevent cross-subsidisation between businesses;
 - Maintain regulatory accounts *vertically* between the network and retail parts of each different horizontal business. This is intended to ensure that retail costs are not shifted into network or wholesale costs;
 - Maintain those accounts in a manner prescribed by regulation; and
 - Publish those accounts to enable competitors to monitor NTT's conduct and alert the regulator to any potential abuse of dominance by NTT.



These measures would bring Japan's information disclosure requirements in line with the obligations imposed on the incumbent in the UK, which are generally accepted as the best practice model used by other regulators.

- **Stronger action to prevent NTT leveraging its dominance in the local loop into new business areas** - There is evidence that NTT is actively leveraging its dominant position into new business areas, including by cross-marketing new services to its dominant customer base, in breach of current "firewalls". Aggressive action should be taken to strengthen firewalls and prevent such conduct. If this proves inadequate, the local loop business should be separated structurally from the rest of NTT's business, to remove any ability for NTT to leverage its dominance.
- **Stronger Monitoring and Prevention of Anti-competitive Conduct** - MPHPT appears to give relatively little attention to the monitoring of anti-competitive behaviour by the incumbent. This may in part reflect deficiencies in regulatory accounting and reporting obligations which prevent such conduct being detected. It is critical that decisive action be taken against any abuse of NTT's dominant position, and procedures should be put in place for the investigation of complaints. NTT appears, for example, to be cross-subsidizing its competitive services with revenues from its non-competitive services. NTT appears to be pricing its international services at levels that are below cost, and which are unsustainable, unless NTT is cross-subsidizing those services with revenues from its domestic services, where NTT enjoys a near-monopoly position. Such predatory pricing behaviour is likely to substantially damage competition, and could force the exit of competitive carriers if it is allowed to go unchecked.

(4) **Over-regulation of Competitors**

Although a number of prescriptive controls have recently been removed, non-dominant operators are still substantially over-regulated, impeding their ability to compete effectively against the incumbent. The immediate concerns are as follows:

- **Target market failure** - Regulatory intervention should be targeted specifically at market failure caused by dominance. Non-dominant operators should be free to operate and develop their businesses with a minimum of regulatory supervision and control. Non-dominant operators, by definition, lack the ability to distort the operation of the market. There is no economic justification for regulating them.



- **Do not use the TDRC for disputes between non-dominant operators** - The Telecommunications Dispute Resolution Commission procedure should be amended to apply only to disputes involving the dominant operator. The expertise and accelerated timeframes of a telecommunications-specific dispute resolution procedure are only necessary to ensure that dominant operators do not abuse their dominance by frustrating and delaying dispute resolution. When applied symmetrically to the industry as a whole, the mechanism can become clogged with disputes between non-dominant operators, leading to delays in the resolution of disputes involving the dominant incumbent. Disputes between non-dominant operators should be resolved in the same way as any other dispute in the general economy. Specialised dispute resolution procedures should be reserved for the dominant operator consistent with the principle of asymmetric regulation.
- **Increase mobile dominance threshold** - The current mobile dominance threshold (25%) risks catching operators who do not have any real ability to harm the process of competition, particularly when applied on a regional basis, and should be increased to 50%, consistent with the current European threshold and the threshold for fixed operators in Japan. Given the growing substitutability between fixed and mobile networks, it is difficult to justify the difference in dominance tests between the two networks.
- **Remove filing obligations on non-dominant operators** - The remaining regulatory reporting obligations on non-dominant operators, such as in relation to agreements with foreign carriers and remaining reporting on basic services, should be removed. They serve no useful function or purpose and result in substantial costs that impede the ability of non-dominant operators to respond to changing market conditions and compete.

(5) Spectrum

It is concerning that MPHPT is moving to consider further mobile entry before serious problems with *existing* spectrum allocations to *existing* operators have been resolved. These problems are, at least in part, a result of Japan's adherence to an administrative allocation process. A market-based allocation method, such as spectrum auctions, is unlikely to have produced such distortions, and would have enabled market-based solutions, including by way of secondary spectrum trading. The key issues are as follows:

- **Inequalities in spectrum allocations** - Current 3G spectrum allocations are unlikely to meet short term growth requirements for 3G operators. Two operators have their 2G allocations in the 800MHz band. That spectrum is technologically compatible with ITU 3G standards, and



can be redeployed for 3G purposes, including meeting growth requirements. One operator has its 2G allocation in the 1500 MHz band. That spectrum is technologically incompatible with 3G and cannot be redeployed for 3G purposes. These inequalities cause serious cost and other disadvantages for the affected operator. This must be addressed to ensure competitive neutrality and create a level playing field among competing operators.

- **Inequalities in spectrum usage fees** - Spectrum users, including mobile operators and broadcasters, are required to pay annual spectrum usage fees. These fees are calculated using a methodology that discriminates against mobile operators and results in disproportionately high fees being paid by mobile operators in relation to the volume of spectrum used. Mobile operators pay the overwhelming majority of total fees even though the overwhelming volume of spectrum is used by broadcasters. This formula, which was created over 10 years ago, needs to be revised to ensure spectrum users pay fees relative to the volume of spectrum they use, in order to remove existing inequalities.
- **4G** - Japan has been driving research in the area of 4G and is promoting specifications and a timetable for commercial deployment in 2010. Although it is important to investigate 4G-related issues, the industry will not be in a position to judge when the market will be ready for services beyond 3G, and what shape those services should take, until 3G markets have been given sufficient time to function. Promoting commercial deployment before the market is ready risks undermining investor confidence by signalling that 3G's lifespan is limited and that a new round of investment is imminent. It is therefore important for Japan to work collaboratively with all stakeholders to ensure international harmonisation of 4G and to allow market-driven deployment.

4. RECOMMENDATIONS

Japan has the ability to significantly increase both the competitiveness of its telecommunications sector and the levels of foreign investment in that sector. However, to unlock that potential, further regulatory reform is critical, particularly in regard to institutional issues, competitive safeguards, and regulatory imbalances. The sooner these measures are introduced, the sooner the industry will grow, and the sooner the benefits of competition will flow to Japanese consumers. The EBC therefore makes the following recommendations:

ISSUE	RECOMMENDATION
INSTITUTIONAL	



ISSUE	RECOMMENDATION
Regulatory “Micro-management”	Japan should actively pull back from intrusive regulatory supervision and control of the market, particularly in respect of non-dominant operators, and move towards a light-handed competition-driven approach to regulation.
Regulatory Mandate	Japan should introduce a legislative requirement that the regulator ensure its decisions promote the long-term interests of end-users having regard to key economic factors, including the need to promote economic efficiency, innovation, investment, and effectively competitive outcomes.
Inadequate Public Consultation Process	<p>Japan should move away from its existing closed consultation procedures, which result in decisions being made before consultation takes place, in favour of a process whereby:</p> <ul style="list-style-type: none"> • An initial policy proposal is issued for a first round of public comments. • A further round of comments takes place on the views expressed in the first round. • A minimum of six weeks is allowed for public comments in each case. • A policy decision is made only after completion of this consultation process. • A statement is issued setting out the results of the consultation, responding to points made, and giving full reasons for the decision.
Independent Regulator	Japan should move to an independent regulator with a pro-competitive mandate in any future review of the regulatory structure. There should be clear separation of ownership and regulatory function, and responsibility for the development of the industry should also be separated from regulatory oversight functions. Transparency and accountability mechanisms should also be strengthened.



ISSUE	RECOMMENDATION
REGULATORY	
Fixed Line Interconnection	Japan should take immediate steps to exclude NTS costs from the interconnection charge, in order to reduce fixed-line interconnection charges to acceptable benchmark levels, and require the incumbent to absorb rebalanced costs through efficiency and other improvements.
Universal Service Obligation	Japan should not activate the existing inefficient and costly USO.
Inadequate Competitive Safeguards	<p>Japan should strengthen competitive safeguards against abuse of dominance by NTT as follows:</p> <ul style="list-style-type: none"> • Reinstating the obligation for NTT to notify and price on tariff in respect of all services in markets where it is dominant (which currently includes all fixed line local services). • Requiring NTT to publish regulatory accounts horizontally across its different businesses, and vertically between the network and retail parts of its horizontal businesses, in a form and manner similar to the accounting obligations on the incumbent in the UK. • Strengthening and rigorously enforcing firewall measures to prevent anti-competitive cross-market leverage by NTT and, if such conduct persists, separating the local loop business structurally from NTT's other business to remove NTT's ability to leverage its dominance. • More actively monitoring and prosecuting anti-competitive conduct by NTT.
Spectrum	<p>Japan should address spectrum-related issues by:</p> <ul style="list-style-type: none"> • Rectifying inequalities in existing spectrum allocations between mobile operators before considering further entry.



ISSUE	RECOMMENDATION
	<ul style="list-style-type: none">• Rectifying inequalities in the payment of spectrum usage fees by ensuring fees are relative to the volume of spectrum used.• Ensuring international harmonisation of 4G specifications and standards and allowing market-driven deployment to preserve investment incentives.