

TELECOMMUNICATIONS REFORM IN JAPAN

EUROPEAN BUSINESS COUNCIL POSITION PAPER

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1. INTRODUCTION

The European Business Council (**EBC**) remains concerned about the persistent lack of progress towards effective liberalisation of the Japanese telecommunications market. There remains a substantial and widening gap between Japan and the rest of the world in terms of best practice regulation. NTT's dominance continues to inhibit competition in most fixed-line markets¹ and regulation is increasingly damaging high levels of competition in mobile markets. There have also been alarming signs of escalating protectionism of NTT DoCoMo in the mobile market. This, together with the recent exit of Cable & Wireless from the market, is substantially undermining the confidence of international investors. 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 Internal Affairs and Communications (**Soumusho**) to pull back from intrusive micro-management and move towards a less interventionist and more competition driven approach to regulation.

¹ Broadband has been the major exception, as a result of strong regulatory controls on NTT's dominance, but current proposals to de-regulate are likely to result in the rapid re-monopolisation of this market by NTT.

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** – Soumusho 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 Soumusho 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 decisions on fixed-line interconnection charges, Universal Service and spectrum (see below) are clear indications 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

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 and Universal Service

Current Japanese fixed line interconnection charges are unjustifiably high by international standards and substantially distort the process of competition.

The inclusion of Non-Traffic Sensitive (**NTS**) costs in the interconnection charge has been the major cause of this problem. All international regulators prohibit the recovery of NTS costs from competitors. Soumusho's refusal to apply this rule to NTT, which has delivered to NTT years of monopoly profits, constitutes compelling evidence of the failure of independent regulation in Japan.

The recent decision to require NTT to exclude NTS costs therefore appears to be a welcome development but it has three serious drawbacks:

- NTT is being given five years in which to rebalance its tariffs. International evidence demonstrates that this is excessive and that rebalancing should take no more than three years. A longer period unnecessarily prolongs high interconnection charges and delays the benefits of more competitive rates to consumers.
- NTS costs are being taken out of the interconnection charge and shifted into the Universal Service Fund (**USF**). Recovering NTS costs through either the interconnection charge or the Universal Service Fund is economically unjustified and violates international best practice. The requirement in all other jurisdictions has been for the incumbent to absorb NTS costs or eliminate them by way of efficiency improvements.
- Without the addition of NTS costs, there would be no net loss to NTT in the provision of Universal Services, and there would be no justification for activating a USF. Costs are being manipulated, in a fundamentally anti-competitive manner, for overtly political purposes.²

² Funding obligations are being created in telecommunications simply to justify the creation of similar funding obligations (a Postal Services Fund) in the postal services area in order to advance the Government's postal privatisation agenda. Such a

The overall effect of Soumusho's decision is to shift the same tax on competition from one part of the regulatory regime to another, call it by a different name, and continue transferring the same monopoly profits to NTT. This is a seriously retrogressive and highly protectionist development with WTO implications.

(2) 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

politically-driven distortion of the regulatory regime would not be possible in a jurisdiction with a truly independent regulatory system.

- 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** - Soumusho 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 may also reflect an unwillingness to take action that would affect the value of the Government's shareholding in NTT. However, the interests of competition and consumers require decisive action against any abuse of NTT's dominant position, and proper 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 continue unchecked.

(3) **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 remaining 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 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.

(4) Spectrum

There are serious problems with current spectrum allocations and Soumusho's proposals for the allocation of new spectrum in Japan. 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** - The foreign mobile operator in Japan has less than half of the globally aligned 3G spectrum than its Japanese competitors. This inequality causes serious cost and other disadvantages for the affected operator. The EBC, and other

international observers, have repeatedly called for this problem to be addressed. Soumusho has not only refused to acknowledge or remedy this situation, but is about to make it worse, by licensing up to three new mobile entrants. Allocating spectrum to new entrants, before correcting the imbalance affecting the foreign operator, will simply magnify existing competitive distortions and impede the foreign operator's ability to compete effectively. This constitutes discrimination of the worst kind and the EBC repeats its call for the existing spectrum imbalance to be corrected before spectrum is allocated to new entrants.

- **Discriminatory criteria for allocation of new spectrum** - There will only be a limited amount of new spectrum left after initial grants of new spectrum have been made to new entrants. Soumusho plans to award the remaining new spectrum to operators using threshold criteria based on the number of subscribers per Megahertz. This will simply result in the concentration of the remaining spectrum in the hands of the dominant incumbent which, by definition, will always have the greatest number of subscribers per Megahertz and will always cross the threshold first. This constitutes blatant discrimination in favour of the Government-owned incumbent and is likely to significantly distort the development of the market. The only way to prevent such a distortion is to limit the concentration of spectrum by way of a spectrum cap. As a general rule, no operator should be permitted to hold more than 35% of the total spectrum available for commercial use on a cumulative basis, judged by reference to general international experience. The EBC considers that a spectrum cap, or similar competitive safeguard, should be imposed to ensure non-dominant operators have access to sufficient growth spectrum.
- **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. The spectrum usage fee formula needs to be revised to ensure spectrum users pay fees relative to the volume of spectrum they use in order to remove existing inequalities. Soumusho's administration of the system is also grossly inefficient and should be overhauled or outsourced to maximise efficiency and reduce costs to a minimum.
- **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	
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

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	<p>consultation process.</p> <ul style="list-style-type: none"> • A statement is issued setting out the results of the consultation, responding to points made, and giving full reasons for the decision.
Independent Regulator	<p>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.</p>
REGULATORY	
Fixed Line Interconnection/ Universal Service Obligation	<p>NTS costs should be excluded from the fixed line interconnection charge within a maximum of three years without allowing NTS cost recovery under the USO.</p> <p>USO funding obligations should not be triggered.</p>
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.

ISSUE	RECOMMENDATION
	<ul style="list-style-type: none"> • 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. • Preventing concentration of spectrum in the dominant operator by imposing a spectrum cap on NTT DoCoMo. • 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.