

RESPONSE TO DRAFT REPORT ON THE UNIVERSAL SERVICE OBLIGATION IN JAPAN

EUROPEAN BUSINESS COUNCIL TELECOMS CARRIER COMMITTEE

August 2005

1. EXECUTIVE SUMMARY

The EBC Telecoms Carrier Committee (**the EBC**) welcomes the opportunity to comment on the draft report on the Universal Service Obligation (**USO**) in Japan (**the Draft Report**) released by the Ministry of Internal Affairs and Communications (**Soumusho**) on 25 July 2005.

While the EBC supports the concept of universal access for all citizens in Japan, the EBC is concerned that the Draft Report adopts an approach to the definition of the USO that is out of step with the advanced state of Japanese communications and does not reflect international best practice.

The Draft Report recommends the activation of a Universal Service Fund (**USF**) despite the absence of any real or compelling evidence that the obligations that have been defined would represent an undue burden on NTT East & West (**NTT E/W**). International experience has shown that the activation of a USF is plagued with controversy, complexity and legal challenges. The United States, for example, has recently launched an inquiry into the management and oversight of its USF as a result of the soaring levels of the fund and the concerns about waste, fraud and abuse of the mechanism. Similarly there have been numerous legal challenges to the USF in France as the levels of the fund have grown dramatically.

In light of this experience, the EBC encourages Soumusho to re-examine the issue of whether a USF is either necessary or appropriate for Japan, and sets out its comments on the Draft Report below.

2. BACKGROUND TO REVIEW

The Draft Report notes that, since the USO scheme was first established in Japan, competition has grown rapidly. Not only has there been increasing substitution by customers of mobiles and voice over IP for fixed services, but there is also increasing competition in fixed services with the rollout of dry copper offering customers a choice of access operators

The Draft Report also notes that Non Traffic Sensitive (**NTS**) costs, which have previously been recovered through the interconnection charge, are to be phased into subscriber line charges over the next five years, potentially increasing NTT E/W subscriber line costs by 300 billion yen annually at the end of the five year period.

If the key reason for review of the USO and activation of a USF is actually the exclusion of the NTS costs from the interconnection charge, this approach would be at odds with the experience in other countries. In other jurisdictions, the exclusion of NTS costs has been followed not by an activation of a USF, but by a process of rebalancing of line rental tariffs and cost cutting by the incumbent.

Activating a USF primarily to deal with NTS costs effectively undoes the competitive progress that was made by excluding these costs from interconnection charges. Allowing for recovery of these costs in a USF effectively reinstates the tax on competitors and ultimately consumers that was previously recovered through the interconnection charge.

The EBC believes that, prior to making an assessment as to whether a USF was necessary, NTT E/W should have been required to undertake a rebalancing and cost cutting exercise. In particular, the first step should be to address the disparity between rural and urban line rental tariffs by bringing rural tariffs into line with urban line rentals.

Offering geographically averaged line rental tariffs and then subsidising those who cannot afford service is the approach taken in other countries. This, rather than a blanket reduction in all rural tariffs, ensures more accurate targeting towards areas of need.

3. SCOPE OF UNIVERSAL SERVICE OBLIGATION

The Draft Report includes the following services within the scope of the USO:

- Fixed line access;
- Type 1 public payphones; and
- Emergency calls.

The Draft Report's focus on traditional technology as a means of providing the USO is out of step with the advanced state of Japanese communications and the extensive levels of competition that exists in the fixed and mobile markets. While the EBC agrees that it is not appropriate to have a universal service obligation that extends beyond basic telephone service to include broadband and

mobile, it is concerned that the incumbent has been locked in as the universal service provider (USP) and at the failure to ensure technological neutrality and contestability in service provision.

The EBC considers that the first step is to consider whether a USO is necessary at all or whether any unmet need for basic services might be met by competition. If a USO is required, then adoption of a technology neutral approach to meeting the requirement for basic service removes the potential for competitive distortion and satisfies customers' requirements for service. Adoption of a competitively neutral approach can be facilitated through a contestable USO so that operators can bid to provide services in particular regions or areas. This encourages competition and ensures the most efficient way of providing services for any particular region is chosen.

Despite an absence of meaningful analysis in relation to their usage, the Draft Report proposes the inclusion of Type I public payphones on a nationwide basis within the USO. This is on the basis that Type I public payphones are still seen as an essential means of communication outside of the house. The Draft Report notes that, while the use of payphones is diminishing because of growing mobile penetration, some 25% of people over the age of six do not own a mobile phone and therefore have no alternative means of communication outside the house. The Draft Report however, does not include any survey or demographic evidence which would assist in identifying what payphone services (if any) this proportion of the population require or how they are geographically located. The Draft Report also justifies inclusion of all Type I public payphones on the basis that, in an emergency, all Type I public payphones are classed as a priority phone

The EBC is concerned that the application of a blanket obligation to provide Type I public payphones fails to identify with sufficient granularity whether there may be particular geographic pockets of need for Type I public payphones or particular requirements for particular types of calls that may be able to be met in other ways.

The EBC would therefore encourage Soumusho to conduct a more extensive analysis of the current and expected usage of Type I public payphones and their distribution to identify whether there are other ways of meeting unmet calling needs. In addition the EBC would encourage Soumusho to consider whether the need for emergency calls may be able to be met by other options, such as emergency contact points which could be funded by municipalities.

4. METHODOLOGY FOR CALCULATING COSTS OF USO PROVISION

The approach to calculating the costs of the USO adopted in the Draft Report is one of benchmarking. Those areas where the costs of access lines exceed by two standard deviations the average access line costs and where there is no fixed line competitive entry will be considered as high cost areas. Assessment of these areas on the basis of historical cost data of NTT E/W means that historical inefficiencies are likely to have been built into the benchmarking process.

In addition, there needs to be greater transparency about these historical costs than has been provided in the Draft Report.

The Draft Report proposes that NTT E/W will be compensated for the difference between the average cost of an access line and the cost of access lines in high cost areas. Costs will be calculated on a LRIC basis. The benchmarking method however, does not take any account of revenues.

The EBC would encourage Soumusho to consider revenues in order to assess whether meeting the USO will really be an undue burden on NTT E/W. Merely because a line is located in a high cost area does not mean that the operator may not be profitable in respect of that area. Given that the areas that are eligible for subsidy in this case will be areas where there is no competing fixed line operator, NTT E/W is likely to be capturing all relevant revenues for all fixed services in that area.

Before concluding that the USO is an undue burden, it is necessary to examine therefore the overall position with regard to revenues including revenues from non USO services, and also to have regard to incoming revenues for those high costs lines. This reflects the position of an operator who will consider not only the provision of the USO services but also revenues from non USO services and the incoming revenues that high costs areas generate.

Intangible benefits should also be included in any calculation. This is particularly so in this case where the intangible benefits that accrue are not only likely to be to NTT E/W but to the NTT Group as a whole.

In calculating the costs of the provision of the USO, the LRIC methodology that is used must be extremely robust. In particular, the methodology must assume that the best technology available to deliver the service is used so for example if wireless service would be more efficient, than this must be factored into the methodology.

5. FUNDING OF THE USO

The Draft Report proposes that funding of the USO will be on the basis of allocated telephone numbers. The key reasons for adopting such an approach are said to be simplicity and transparency.

The EBC notes that the details of how the number allocation methodology will work in practice have yet to be outlined and that current assumptions about simplicity may therefore be misplaced or overstated. The details of any such approach must ensure that the scheme is non

discriminatory and that it is transparent for operators and end users (who are the ultimate contributors to the fund).

The EBC would also encourage Japan to consider funding any USF through general taxation. Using general taxation as a revenue mechanism would recognise that the provision of universal service is a social good which delivers externalities that benefit all citizens. In addition, funding the USO through direct taxation would provide incentives to ensure the USO is appropriately defined and that there are ongoing incentives for reduction in the size of the fund.

If not, there must be direct pass-through to customers and express obligations on operators to recover contributions through USO line items in bills. If not, NTT Group companies will simply absorb these costs in order to create pressure for competitors to do the same. This will mean that the size of the fund and the subsidy that is ultimately being directed to NTT E/W from Japanese telecommunications subscribers will remain invisible to these subscribers.

6. CONCLUSIONS

For the reasons set out above the EBC encourages Soumusho to:

- Require NTT E/W to undertake a rebalancing and cost cutting exercise before activating a USF;
- Re-examine whether USO services can be provided in a technologically neutral way;
- Examine whether making the USO contestable might provide more efficient solutions for particular regions than a single nationwide USP;
- Conduct detailed analysis of geographic and consumer need for Type I public payphones and consider alternatives to a nationwide obligation;
- Make a full assessment of all relevant revenues (including intangible benefits) in order to assess whether there is really an undue burden on the USP;
- Consider funding through general taxation;
- Alternatively ensure that there is transparency of USO contributions by requiring operators to pass through to customers as a USO line item in order to create incentives for cost reduction.