A note on bad policy

David Havyatt 17 December 2009

Background

Buried away on page 34 of the Government's discussion paper *National Broadband Network: Regulatory Reform for 21st Century Broadband* lurked the innocuous question:

> *If industry funding is preferred for universal access, should smaller carriers be required to contribute? If not, what should be the threshold revenue for exempting such carriers?*[1]

The Government received extensive submissions in response to the discussion paper. There was no evidence from these submissions that the impost of the USO levy on smaller providers was a major issue. Further the question was specifically only asked in relation to USO funding.

The current regulatory structure imposes three hypothecated taxes on telecommunications providers. These are the carrier licence fee, the USO levy and the NRS levy. The determination of a carrier's liability for each is determined by a carrier's share of industry revenue. The process of determining a carrier's eligible revenue is established by ACMA under section 20 of the Telecommunications (Consumer Protection and Service Standards) Act 1999. Section 20D of that Act requires the return to be accompanied by an audit report.

In simple terms eligible revenue is a carrier's "value added" revenue from telecommunications carriage. Total revenue has deducted from it revenue from non-telecommunications activity, for content services and CPE. To avoid "double counting" carriers also get to deduct any payment they make to other carriers for network services – as this amount will be part of the revenue of the other carrier.

The total of carrier licence fees is limited to the costs incurred by the ACCC and the ACMA in performing their telecommunications functions, the Government's ITU membership and grants to consumer groups and research. The USO levy is set by the amount determined by the Minister as the USO cost and the National Relay Service levy is set to recover the cost of operating the service.

In general economists and policy makers usually oppose hypothecated taxes. There are two fundamental reasons for this. The first is that it can reduce the incentives for the cost incurring agency to only incur costs efficiently, as they know their costs are automatically recovered. The second is that industry specific taxes are an inefficient way of raising taxes because they distort market price signals.

The attraction of the hypothecated taxes in the case of telecommunications case is the argument that the schemes are merely replacing programs that were previously undertaken internally by the monopoly provider. This ignores the fact that the decision to

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[1] Department of Broadband, Communications and the Digital Economy *National Broadband Network: Regulatory Reform for 21st Century Broadband Discussion Paper* April 2009

cross-subsidize internally was accompanied by other captured benefits, some of which are still captured by the largest firm.

Decision

With the introduction of the *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009* the Government announced as part of the package that;

> *The government has decided that as part of these regulatory reforms it will implement a number of red-tape removal measures.*
>
> - *It will exempt carriers with annual revenues of less than $25 million from having to pay an annual carrier licence charge, or having to contribute to the universal service levy or the national relay service.*[2]

It is interesting to note that this decision was bundled with a group of red tape reduction measures which is not where in the discussion paper it arose. It is also interesting to note that the decision went far further than the decision to merely change the USO fee component, but became an exemption from paying all three charges (taxes).

In the Explanatory Memorandum accompanying the Bill there was a *Regulation Impact Statement: Telecommunications Consumer Safeguards And USO And Other Levy Deregulation Until The National Broadband Network Is Rolled Out.* Part B of this statement provided the detail of the consideration that resulted in the announcement made in the second reading speech.[3]

The statement outlined that;

> *The telecommunications industry is highly concentrated. Of approximately 180 carriers in the telecommunications industry around 150 carriers lodged eligible revenue in 2007-08 of less than $10 million and around 40 carriers lodged returns with eligible revenue of zero. This compares with around 10 carriers with eligible revenue of greater than $100 million.*
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> *Preparation of the eligible revenue returns is a considerable expense for smaller carriers. It is estimated that it costs at least $7000 just for auditing the returns. Given that there are around 30 carriers with eligible revenue of zero, and around 70 carriers with eligible revenue of less than $100 000, this is a significant impost on them. Audit costs alone would amount to over $1 million per annum but preparation of the returns could add significantly to this.*

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[2] Minister for Infrastructure, Transport, Regional Development and Local Government, the Hon. Anthony Norman Albanese MP *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009 Second Reading Speech* Delivered Tuesday, 15 September 2009

[3] *Telecommunications Legislation Amendment (Competition And Consumer Safeguards) Bill 2009 Explanatory Memorandum* September 2009 Pp 81-85

> *The ACMA believes that the burden of the levies and the reporting process is a factor in the high level of non-compliance in ACMA overall reporting requirements. Around 95 per cent of non-compliance is due to small carriers.*

As a consequence the statement outlined a policy objective of;

> *The objective is to reduce the administrative costs involved in preparing the 'eligible revenue' returns and to remove the USO and NRS levy burden on a large number of smaller carriers. This should encourage more competition in the industry*.

And proceeded to consider four options built around removing obligations at three alternative revenue points and no change.

It is totally unclear from the discussion that follows whether the "administrative costs" that the policy is seeking to reduce are the costs incurred by ACMA or the costs incurred by industry. The costs incurred by industry are almost totally the costs incurred in obtaining the audit report as the rest of the return is largely constructed by adding numbers from a General Ledger.

The administrative costs are greater in two circumstances. The first is where the firm may have a complex corporate structure and the return needs to associate data from a number of separate though related entities.[4] The second is where the requirement for the eligible revenue return is imposed after the accounting systems are established (as happened to all carriers extent before 1999). A sensible entity coming into being as a carrier now structures its General Ledger to facilitate the return (just as they do to facilitate tax reporting).

There is no evidence that the costs of compliance or the cost of the charges has in any way acted as a barrier to entry. The chart below shows that despite the ongoing expectations of "consolidation" in the Australian telecommunications industry each financial year has ended with a higher number of carriers than it started with. In fact, given the ongoing issues faced in terms of the quality of smaller carriers (they are over represented in complaint statistics) it could be argued there is a problem with excessive entry in the industry.

The option to exempt carriers with eligible revenue below $25 million from the requirement to submit a return and pay the charges was chosen. Intriguingly the figure is justified by noting that it is more closely aligned to the reporting threshold in the *Corporations Act 2001*. This justification is somewhat spurious as that figure would relate to total revenue not eligible revenue.

The option of no change was rejected in part on the basis that;

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[4] The author had personal experience of such a circumstance when the Australian assets of Telecom New Zealand were operating through four different companies only one of which was a licenced carrier. The requirement to report on a consolidated basis was introduced after it was realized that some overseas based telcos (in particular Primus) were operating in Australia using two entities and the licenced carrier entity was not earning the retail revenue.

> *This option would not address the complaints of industry that the existing arrangements are inequitable because small carriers are subsidising Telstra and entrenching Telstra's monopoly position in USO areas.*

It should be noted however that the consequence of the option chosen is to increase the amount by which carriers above the threshold need to subsides Telstra.

Finally the statement noted that there had only been cursory consultation on this issue;

> *The option of a $10 million exemption was raised in the NBN discussion paper although comment was not specifically sought on a particular amount, only whether smaller carriers should be exempt. Some submissions supported Telstra funding the USO itself (for example, AAPT and Optus). Of the other submitters, some supported industry funding (for example the Communications, Electrical and Plumbing Union), some government funding (for example Vodafone and Hutchison and the Australian Telecommunications Users Group) and others supported both industry and government (for example, the Australian Computer Society). None specifically raised the issue of a funding threshold.*
>
> *The ACMA has suggested a funding threshold, and favours a $25 million cut off.*

It is notable that not a single submission supported the policy option chosen. The only party supporting that option appears to have been the regulator, who, as we will note below already has the ability to remove the bulk of this regulatory burden.

Assessment of the Decision

The decision itself has received little public attention. This is in part due to the fact that, despite its inclusion in the Explanatory Memorandum and Second Reading Speech (and indeed in other speeches), the decision does not require any legislation. It is the intention to give effect to the decision via subordinate instruments.

As I understand it the current intent is to remove the requirement for preparing any return and hence also removing the requirement to pay any of the fees. As a consequence of the way the fees are calculated the ACMA cannot levy any provider until all returns are received.

The decision pays no attention to the fact of a similar "red tape reduction" exercise performed in 2003. That exercise followed a limited review in 2002 by the Productivity Commission of the Australian Communication Authority's (ACA) cost recovery arrangements as a case study on its report on cost recovery by Government agencies.[5]

The ACA then commenced its own review. In their discussion paper the ACA noted;

> *The [Productivity Commission's] report noted that the ACA was constrained by Government policies in relation to the existing minimum annual carrier licence charge of $10,000 and the carrier licence application charge of $10,000. The*

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[5] Productivity Commission. *Cost Recovery by Government Agencies: Inquiry Report* Canberra 2002 Available at http://www.pc.gov.au/projects/inquiry/costrecovery/docs/finalreport

report also noted that these charges might favour larger carriers and discourage smaller potential carriers from entering the industry. [6]

This discussion paper noted that the minimum annual carrier licence charge based on cost recovery principles would have been $1,000 rather than $10,000. This whole discussion as I noted in a submission I drafted for AAPT at the time was absurd. The carrier licence fee itself was a cost recovery charge for the totality of the Government's telecommunications regulatory activity. The estimated cost recovery minimum charge of $1,000 was the cost of the ACA receiving and processing the return. Unfortunately, it was deemed that this piece of "red tape reduction" or regulatory efficiency would be pursued. I guess somehow it escaped the ACA's attention that the cost recovery charge could be made zero by removing the requirement for a return.

The decision to exempt providers with eligible revenue below $25M from completing a return and paying the taxes is poor policy for the following reasons;

1. The ACMA needs to know it has received all the returns before it can assess levies. It will need some correspondence from a carrier that is claiming it is exempt from the requirement to provide the return.
2. The carrier will need to do at least part of the calculation of its eligible revenue to determine if it needs to submit a return or not. How complicated this task is depends on how they establish their accounting system. If the carrier does not set up the accounting system to make the assessment easy then they will face much higher implementation costs when they do pass the $25M threshold.
3. The major cost incurred in compliance by all carriers is the cost of audit. The audit requirement is imposed by s20D of the T(CPSS)Act but the ACMA can by written instrument exempt a participating person from the requirement to provide an audit report 20D(3) and the Minister can vary the requirement under 20D(2). Further the Minister can use his powers to direct the ACMA in this matter.
4. The exemption process creates a high effective marginal tax rate at the point of whatever barrier is chosen. This will have the perverse consequence of creating pressure for ever increasing barriers to deal with the marginal cost issue. The effect will be compounded if firms face high implementation costs when they pass the barrier as noted in 2 above.
5. The policy of exempting carriers from the taxes increases the regulatory burden on the providers above the threshold.
6. There is no evidence the existing arrangements are creating a barrier to entry. Nor is there particularly any reason to believe that the current rate of entry to the industry is aiding economic efficiency.
7. There is reason to believe that there are significant costs borne by the regulators for the smaller carriers that are below the revised "minimum fee" as specified in the current arrangements.

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[6] Australian Communications Authority *Minimum Charges for Carrier Licences and Licence* October 2003

A better implementation

The objective of reducing regulatory burdens on carriers and reducing administrative costs for regulators can be met by the following process.

1. Changing the instrument under which an ERR is prepared to state that a carrier must complete the return or a statement that the ERR of the firm is below the "threshold amount". Consistent with the decision made the threshold amount can be set at $25M.
2. The return and statement be prepared by a "properly delegated officer" who shall attest on the return or statement that they have the appropriate delegation (saves finding directors and company secretaries as per current requirements).
3. The ACMA to advise any carrier who has already provided an audited return that they no longer need to get the return audited. This can be revoked on a per carrier basis if a subsequent investigation reveals errors.
4. Where a carrier does not reach the "threshold amount" the carrier will only be liable for the minimum carrier licence fee. That minimum licence fee should be returned to the original figure of$10,000.