

SB 980 and SB 986

**Testimony of Joseph Gillan
On Behalf of
Texas Cable Association
and
tw telecom of Texas**

**SENATE BUSINESS & COMMERCE COMMITTEE
March 15, 2011**

Good Morning Chairman Carona and members of the Committee,

Introduction

My name is Joseph Gillan and I am a consulting economist specializing in regulatory and policy issues in the telecommunications industry. Over the past 30 years, I have been actively involved in virtually every aspect of the industry's transformation from monopoly to competition, having testified over 300 times before state commissions (including the Public Utility Commission of Texas), state legislatures, and the FCC. In addition, in 2008 I was appointed by the Chairman of the Federal Communications Commission to serve on the Board of Directors of the Universal Service Administrative Company, the corporation formed to administer the federal universal service subsidy program on behalf of the Federal Communications Commission (FCC).

I am testifying today on behalf of the Texas Cable Association and tw telecom of Texas and will address the competitive implications of Senate Bills 980 and 986. The purpose of Senate Bill 980 is to further streamline the Texas regulatory environment by making clear that the Texas Public Utility Commission has limited oversight over

services provided using Voice over Internet Protocol technology, commonly known as VoIP. Senate Bill 986 adopts a substantially reduced “market test” that would be used to streamline the regulation of incumbent local telephone companies (at least those no longer subject to traditional rate-of-return regulation), irrespective of the technology they may use to provide service.

My testimony addresses these bills from the perspective of identifying those other elements of the statute that either should be – or, importantly, should *not* be – changed to complement the streamlining envisioned by the proposed bills. The TCA and tw telecom, as well as other stakeholders, have been working with AT&T and Verizon to resolve their differences regarding these bills and will continue to do so. There are, however, three areas that must be addressed for the competitive environment so desired for Texas to succeed, specifically:

- * Affirmation of the Commission’s continued authority over the incumbents’ wholesale obligations;
- * Reform of the Texas USF that provides subsidies to large carriers like AT&T and Verizon to ensure there are no subsidies for deregulated areas; and
- * The retention of the LRIC price floor that prevents the abuse of whatever subsidies remain.

The Commission Authority over Wholesale Offerings Must Not Be Diminished

To begin, it is important that the emergence of new technologies – in particular, Voice over Internet Protocol (VoIP) – not be confused with a lessening need for wholesale, carrier-to-carrier, regulatory oversight. Without getting mired in the technical

details, what we commonly think of as the telephone network – that is, the ability for one phone/device to call another, using the familiar convention of a telephone number – is not going to disappear. It is merely (although importantly) going to be provided by a different technology, in this case packet-technology similar to that used by the Internet.

There is nothing particularly remarkable about technological change occurring in the phone network. Just a few decades (or so) ago, the telephone network transitioned from analog circuitry to digital technology, with few consumers noticing the difference (other than an improvement in quality and a decrease in cost). By itself, technological change is no reason for a change in regulatory policy. The regulatory policy most important to retain here and now is Commission oversight of interconnection agreements and wholesale tariffs so that these arrangements can be updated for new technology.

Interconnection agreements are the contracts that exist between companies that allow a customer on one network to call a customer served by a different carrier. Today, calls are exchanged between carriers like AT&T and Verizon with their competitors using traditional telephone technology. The future will be dominated by packet networks (using the Internet Protocol) that operate differently than traditional “switched” phone networks operated in the past. This fact has an important implication. It means, as a practical matter, that all the interconnection and traffic exchange arrangements that today exist between incumbents and competitors are *also* becoming obsolete because they are based on the legacy architecture of the past.

Importantly, the carrier with the largest market share enjoys significant leverage when it comes to interconnection negotiations. Recognizing this leverage, the federal Telecommunications Act empowered state commissions to arbitrate disputes and to ensure that basic principles of fair-dealing – non-discrimination, reciprocity and transparency – apply to interconnection negotiations. As packet networks replace the traditional network, the Texas PUC will again be called upon to arbitrate new interconnection agreements to allow calls to pass between new, modern, packet networks. It is vital that SB 980 not preclude the Commission’s authority to perform this critical role.

The Reform of USF Must Continue

In 2008, the first step towards reform of the Texas Universal Service Fund was taken, reducing – but not eliminating – millions of dollars of subsidy annually provided to large carriers such as AT&T and Verizon. In 2007, these carriers received nearly \$260 million in annual subsidy; the partial reforms that have been implemented thus far reduced these payments to \$135 million in 2010. Clearly more must be done.

There is a fundamental inconsistency between competition, deregulation and public subsidy. Competition and deregulation assume that markets work; public subsidy assumes that markets fail. And when the two are combined – that is, when public subsidy is provided to one competitor in a deregulated market – then market outcomes *will be* distorted and consumers will be asked to foot the bill.

Let me be clear that I do not oppose the additional retail deregulation contemplated by Senate Bills 980 and 986. But a rational policy must have balance. As competition replaces regulation, then private capital and risk must too replace public subsidy. This is particularly true here in Texas where the Texas USF provides millions of dollars of subsidy annually to large carriers like AT&T and Verizon, without any mechanism to ensure that those subsidies are used only in high cost rural areas for the purpose of assuring reasonable rates.

Moreover, the need for reform is particularly acute now, because if the Texas USF is not reduced, it is clear that the Texas Commission will soon have to increase the USF tax rate to collect these subsidies for AT&T and Verizon.

There is an unmistakable trend, in Texas and nationally, that the assessment base for USF (telecommunications revenues) is declining. Although there is little transparency to the USF tax calculation in Texas (that is, there are no routine public filings that allow the public to review how the tax rate is calculated), the FCC publishes data on intrastate revenue information that demonstrates the concern. Between 2006 and 2007 (the most current data available from the FCC) shows that “taxable” intrastate revenues in Texas declined by 7%. A similar trend is observed in data filed by the highly-transparent federal universal service fund, which quarterly discloses its contribution rate calculation. This data indicates that the taxable base for the federal USF (interstate and international revenues) declined by nearly 10% since 2007 (through the 2nd Quarter of 2011).

The effect of declining revenues available to both the federal and state universal service funds means that the necessary tax rate to collect the same level of subsidy must increase. The Texas Commission estimates that the Texas USF will hand out nearly \$100 million more in subsidy in 2011 than it will collect, and that the surplus in the fund that has *delayed* an increase in the Texas USF tax rate will be completely exhausted in 2012.

The bottom line: Either the Texas USF must be reformed or the Texas USF tax rate to collect the subsidy must increase.

In my view, the correct response is simple. Providing subsidies to companies like AT&T and Verizon in a competitive environment is inappropriate and a burden on Texas consumers. These companies are clearly strong enough to stand on their own without consumers and businesses in Texas providing unaccountable subsidies and the practice must stop.

Senate Bill 980 should be amended to add language that directs the PUC to begin a review of the Texas subsidy fund on January 1, 2012. The Commission should be directed to implement the reforms it believes are in the public interest, including consideration of the overall profitability of the company seeking such support. SB 986 should also include a statutory prohibition on the receipt of subsidy in deregulated areas, which is a reform so basic to fair competition that the incumbents agreed to the policy in

the 2008 settlement. It is now time for this aspect of the settlement to become part of Texas statute and policy.

Subsidy and the Price Floor

Texas law currently prohibits pricing competitive services below cost and includes provisions that hold competitive services to a LRIC (long run incremental cost) price floor to prevent this market abuse. So long as companies receive tens of millions of dollars of subsidy through a system that has no mechanism to account for how such subsidies are used, the LRIC price floor is the *only* competitive protection against these subsidies being used to price competitive services below cost.

I note that Senate Bill 980 does not propose to eliminate the price floor provisions in the statute. That sound decision should remain as the bill is considered by the Committee and moved to the floor.

Thank you.