Testimony of Joseph Gillan
on behalf of
Sprint Communications
Texas Cable Association
tw telecom of Texas

SENATE BUSINESS & COMMERCE COMMITTEE

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Introduction

Good Morning Chairman Carona and members of the Committee. 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 a diverse coalition concerned with the distorting effects of unjustified subsidies in a competitive market: Sprint Communications, L.P. (a long distance and competitive local exchange carrier affiliated with Sprint the wireless

provider), the Texas Cable Association (representing cable companies principally focused on providing residential and business telephone services using interconnected VoIP technology), and tw telecom of Texas, LLC (a CLEC specializing in the business market).

In the testimony below, I explain that:

* Over the past four years, the Public Utility Commission of Texas ("Commission"), and importantly its Staff, has made substantial progress facilitating two settlement agreements that have greatly reduced the subsidies provided the State's largest local exchange companies, particularly AT&T and Verizon, which will receive **<u>no further public subsidies</u>** after January 1, 2017.

* Despite this progress – and in the absence of further reform – the Large Carrier Subsidy Fund will still be transferring approximately **<u>$100 million per year</u>** from the pockets of Texas consumers and businesses to incumbent and competitive telephone companies, **<u>without</u>** any demonstration that the subsidies are needed to ensure affordable telephone service.

The Commission plans to continue its USF reform efforts in 2013, with the goal of adopting a rule that will require all large ILECs to demonstrate need in order to receive

high cost subsidies.[1] In our view, large incumbent local exchange carriers (*i.e.*, the ILECs owned by CenturyLink, Windstream and Consolidated, regardless of whether they receive support from the large or small carrier funds) should be required to demonstrate need in any area that is served by a competitor that receives no subsidy.[2] The presence of an unsubsidized competitor is compelling market evidence that a private-sector business plan exists and that public subsidy is unnecessary. Fiscal responsibility demands that the many millions of dollars in subsidies received by these large, national companies not be considered entitlements. We strongly support the Commission's plan to adopt a needs requirement for these ILECs in 2013.[3]

So that the Commission has the flexibility to reform the Texas Universal Service Fund, however, there are three statutory issues that should be addressed:

* The provisions of HB 2603 (82nd R.S.), which has increased subsidies to companies in the Small Carrier Fund by $37.8 million in just two years, should be allowed to expire in September 2013.

* The "make whole" guarantees of the Tex. Util. Code § 56.025 that obligate the Texas Commission to offset any reduction in revenues

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[1] *See* Staff Memo, September 6, 2012, Item 3 of September 13, 2012 agenda of the Public Utility Commission of Texas.

[2] AT&T-Texas and Verizon Southwest would not be subject to a competitive needs test because they will lose their subsidies entirely by January 1, 2017.

[3] The Commission initiated Project No. 40342 in April 2012 and Staff requested comment on a draft rule providing that an ILEC who serves an area that is also served by an unsubsidized competitor would lose its TUSF subsidy unless it is able to demonstrate that it needs ongoing TUSF in order to meet its Provider of Last Resort obligations. In September, Staff informed the Commission that it expects this rulemaking project to be completed in first quarter 2013.

for small ILECs that result from a governmental decision, should be eliminated or modified. In effect, § 56.025 immunizes companies from the decisions of other agencies – including decisions by the FCC reforming the federal universal service system – because it guarantees that Texas consumers will always provide replacement subsidy, even when another agency has determined that the subsidy is no longer justified.

* Some ILECs claim that current law absolves them of having to demonstrate their "need" for subsidy, relying on language in § 56.026 that a full "revenue requirement showing" is not necessary for a disbursement from the universal service fund. So that the Commission has the unambiguous flexibility in 2013 to consider the full-range of analyses that might demonstrate need, this provision should be eliminated.

None of my recommendations above should be construed as opposition to the core universal service objective that Texas consumers, irrespective of where they live, should be able to connect and communicate with neighbors, family and the world at reasonably affordable rates. Subsidy, however, should be the exception and not the rule, particularly in a market where affordable competitive alternatives (such as wireless service and VoIP service) are available to ensure that customers remain connected, even if they no longer choose the local telephone company.

In today's competitive environment, the large telephone companies should be required to **prove** that they need support in order to maintain reasonably affordable local service before the government steps in to impose on customers throughout Texas what is no different than a tax to provide subsidy.[4] As I explain in the final section of my testimony, Texas should continue its reform of the Provider-of-Last-Resort obligation (POLR) to ensure that new investment is not required by regulatory rule and, equally importantly, the POLR obligation can no longer be used as an excuse to receive public subsidies without a demonstration of need.

The Commission Has Made Substantial Progress Reforming the Large Carrier Fund

Beginning with a settlement agreement in 2008, and continuing with another agreement guided by the Commission Staff just last month,[5] the Commission has made substantial progress reforming the Large Carrier Fund. These agreements principally rely upon "rate rebalancing" to permit measured increases in basic local rates to reduce subsidy payments to local telephone companies. Figure 1 (below) illustrates the actual and projected subsidy payments made from the Large Carrier Fund since the Legislature directed the Commission to study the Texas USF in 2005.

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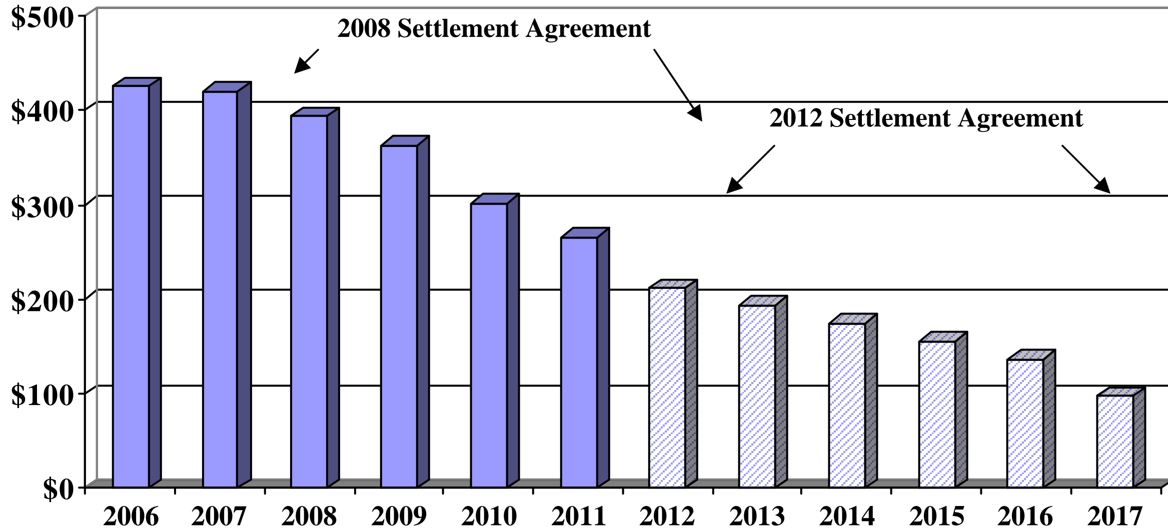
[4] When the Large Carrier Fund was first implemented, the Commission used cost models to estimate carrier's need for support. Today, not only are such cost models hopelessly outdated, the 2008 and 2012 settlements eliminated the relationship to the amount of support provided and the cost model results.

[5] PUC Docket No. 40521. The Commission approved the Settlement Agreement on September 28, 2012.

Figure 1: Texas Large Carrier Fund ($ millions)[6]
(2006-2011 actual disbursements; 2012-2017 estimated[7])



Looking inside the reductions produced by the first settlement agreement, however, reveals that the vast majority of the reductions in the fund are attributable to rate rebalancing primarily implemented by two carriers: AT&T-Texas and Verizon Southwest. The other two large incumbents that receive subsidies from the Large Carrier Fund, CenturyLink and Windstream, have seen their subsidies reduced more modestly, while a third category – competitive local exchange carriers that provide service in competition with these incumbents – have actually seen their subsidies increase.

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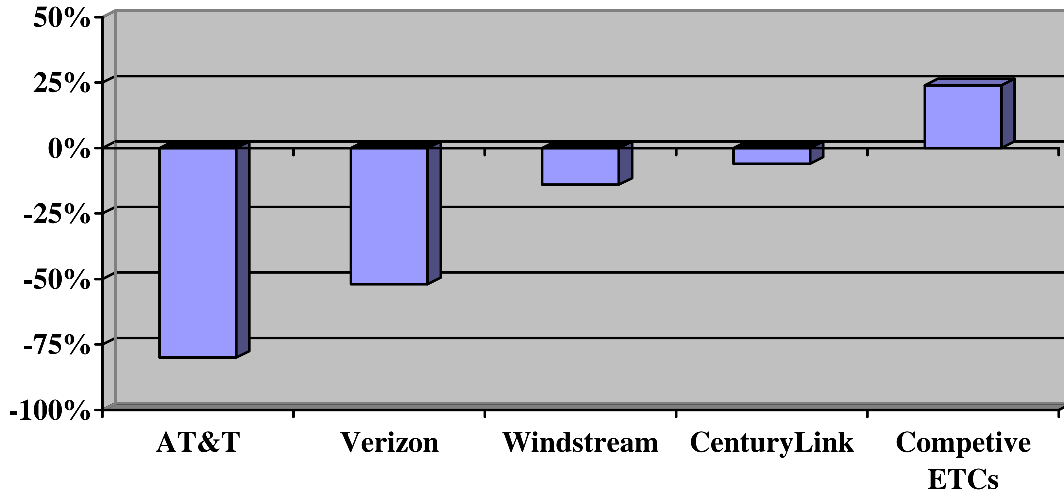
[6] Sources: 2006-2011 Actual Disbursements, Project No. 21208, Texas Universal Service Fund Administration, Staff Memo, October 20, 2011 (Agenda Item 1, Open Meeting October 27, 2011); 2012-2017 Projections based on 2Q2012 (annualized) carrier-specific quarterly filings in Project No. 36163 and projected reductions contained in Staff Testimony in support of the 2012 Settlement Agreement in Docket No. 40521.

[7] Figure 1 illustrates the expected reductions in the Texas Large Carrier fund resulting from the rate rebalancing adopted by the 2012 Settlement agreement. Additional reductions may occur if consumers continue to move to providers offering unsubsidized competitive alternatives and incumbent local telephone companies report fewer lines, and thus receive fewer subsidies. Figure 1 does not include any reduction from potential line-loss by incumbents.

Figure 2: Percent Change in USF Support From Large Carrier Fund (2008-2012)[8]



Significantly, under the Commission's new rule governing the Large Carrier Fund, AT&T and Verizon have agreed to completely phase-out the subsidies they draw from the fund. However, even after subsidy is no longer provided in the areas served by these two carriers, I estimate that the Large Carrier Fund will continue to provide approximately $100 million per year to the incumbent local telephone companies – and the competitors that have entered the market, partially in response to the enticement of public subsidy – in the areas served by CenturyLink and Windstream.

It is not my purpose here to criticize the existing policy that provides subsidy to both a competitor and an incumbent. Rather, the goal should be **<u>no subsidy</u>** in any area that is sufficiently attractive for competition to emerge. Subsidy should be isolated to

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8 Developed from carrier-specific quarterly filings in Project No. 36163 (annualized disbursements from 2Q2012 in comparison to annualized 2Q2008 second quarter reported disbursements). Estimating the total payments received by CLECs is particularly challenging given inconsistencies in reporting and revisions filed by some carriers.

only those areas where no private-sector business case exists to provide service. The largest single flaw of the current system is the absence of any market-check, or fact-based determination, as to whether subsidy is actually needed in a particular area.

The Large Carrier TUSF Must Be Reformed to Require Proof of Need

French philosopher René Descartes once famously said: “I think, therefore I am.” Unfortunately, a similar philosophy underlies the justification most often offered for Texas USF support: “I exist, therefore I must be needed.”

Nothing could be further from the truth.

Today, Texas law *permits* any incumbent to seek deregulation wherever there are two competitors offering service.[9] And, where there is deregulation, SB 980 appropriately terminated state USF subsidies. The problem is that the incumbent can **choose** to forgo deregulation so that it may continue to receive subsidy, all without having to show any proof that the subsidy is actually required or in the public interest.

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[9] Tex. Util. Code § 65.052(b) (2012). In making a determination under Subsection (a), the commission may not determine that a market should remain regulated if:
(1) the population in the area included in the market is at least 100,000; or
(2) the population in the area included in the market is less than 100,000 and, in addition to the incumbent local exchange company, there are at least two competitors operating in all or part of the market that :
(A) are unaffiliated with the incumbent local exchange company; and
(B) provide voice communications service without regard to the delivery technology, including through:
(i) Internet Protocol or a successor protocol;
(ii) satellite; or
(iii) a technology used by a wireless provider or a commercial mobile service provider, as that term is defined by Section 64.201.

A more fiscally responsible approach would recognize that when there are *two* unsubsidized competitors, those competitors are market evidence that a private sector business case exists and that subsidy is not needed. Indeed, a *single* unsubsidized competitor provides market evidence that subsidy is not needed, as each of the four largest incumbents advised the FCC with respect to broadband service:

> The availability of broadband service from an unsupported broadband competitor demonstrates that there is a private sector business case to offer broadband and that high-cost universal service support is not required.[10]

The exact same logic should apply here in Texas, where the presence of an unsubsidized competitor should signal that subsidy is not needed. That said, a more cautious approach would begin a phase-out of subsidy wherever **<u>two</u>** unsubsidized competitors provide service, which would match the standard used for deregulation and the elimination of the POLR obligation. (I address the POLR obligation in more detail at the conclusion of my testimony.) Under this approach, all providers would be treated equally, both as to how they are regulated and how they compete (*i.e.*, head-to-head, without subsidy favoring one over another).

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[10] ABC Plan, Attachment 1, Framework of Proposal, at 3. *See* Letter to Marlene Dortch, Secretary, Federal Communications Commission, In re: Connect America Fund, WC Docket No. 10-90; A National Broadband Plan for Our Future, GN Docket No. 09-51; Establishing Just and Reasonable Rates for Local Exchange Carriers, WC Docket No. 07-135; High-Cost Universal Service Support, WC Docket No. 05-337; Developing a Unified Intercarrier Compensation Regime, CC Docket No. 01-92; Federal-State Joint Board on Universal Service, CC Docket No. 96-45; Lifeline and Link-Up, WC Docket No. 03-109; Universal Service Contribution Methodology, WC Docket No. 06-122; Numbering Resource Optimization, CC Docket No. 99-200; Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98; Intercarrier Compensation for ISP-Bound Traffic, CC Docket No. 99-68; IP-Enabled Services, WC Docket No. 04-36, by Robert W. Quinn, Jr., AT&T, Steve Davis, CenturyLink, Michael T. Skrivan, FairPoint Communications, Kathleen Q. Abernathy, Frontier, Kathleen Grillo, Verizon, Michael D. Rhoda, Windstream, filed July 29, 2011 ("*ABC Ex Parte*").

This is not to say that the Commission should not retain a safety-net opportunity for an incumbent to demonstrate need. Today, however, some ILECs claim that they are shielded from **<u>any</u>** demonstration of need by a provision in the Texas law[11] that a full "revenue requirement showing" is not necessary for a disbursement from the universal service fund.[12] So that the Commission has the flexibility to consider the full-range of analyses that might demonstrate need, this provision should be removed. Moreover, as shown below, some local telephone companies are clearly abusing the fund (and this provision) by receiving subsidies at the same time they are reporting extremely high profits (in excess of 45%) for their Texas operations.

<u>Small ILECs Should Begin to Rebalance Rates and Reduce Subsidy</u>

The testimony above addresses reforms to the Texas Large Carrier Fund, recognizing that the competitive conditions (and regulatory options) facing the two large incumbents that intend to remain in the fund (CenturyLink and Windstream) differ from those that face the smallest, rural phone companies. There are four simple reforms that should apply to these small carriers, however, that would reduce the level of subsidy Texas consumers and small businesses are asked to provide.

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[11] Tex. Util. Code § 56.026 - Universal Service Fund Disbursements
(a) A revenue requirement showing is not required for a disbursement from the universal service fund under this subchapter.

[12] *See* PUC Project No. 40342, comments filed on May 24, 2012 by CenturyLink, p. 2 and Windstream Communications Southwest, p. 5.

* First, small companies should begin the same process of increasing local rates that the large companies are undertaking. The most recent settlement agreement acknowledges that a basic local rate of $24.00 per month is a reasonable price for the local phone service provided by ILECs and this conclusion is equally valid for rural ILECs. Indeed, it is fundamentally unfair for urban customers to pay $24 per month and be asked to subsidize other customers that pay far less. A number of small ILECs in Texas still have local rates below $10 a month. This issue is before the Texas Commission and we look forward to participating in its proceedings.

* Second, HB 2603 provided a temporary boost in subsidy (by nearly $40 million over two years) to 1999 levels for small ILECs, even where the ILEC no longer serves the line being subsidized. These provisions should be allowed to expire (as provided by HB 2603). If an ILEC needs additional subsidies, the Commission's rules already provide a mechanism to give the small ILECs (none of which have elected a form of incentive regulation available under the law) additional financial assistance from the TUSF.[13]

[13] PUC Subst. R. 26.408. Additional Financial Assistance (AFA).
(a) Purpose. Incumbent local exchange companies (ILECs) serving high cost and rural areas of the state may require financial assistance, in addition to the funds provided by § 26.403 of this title (relating to Texas High Cost Universal Service Plan (THCUSP)), by § 26.404 of this title (relating to Small and Rural

* Third, § 56.025(b),(c) and (d)[14] of the Tex. Util. Code obligates the Commission to offset any reduction in revenues that is the result of any other governmental decision by increasing the public subsidy. This provision creates the illogical result of immunizing companies from a decision by other agencies that a certain revenue stream is not appropriate. For instance, the FCC recently adopted a bipartisan reform (by a unanimous decision) of the federal universal service system that will likely reduce federal subsidies to certain rural carriers. One Texas ILEC has already filed with the Texas Commission to have Texas consumers replace all the

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Incumbent Local Exchange Company (ILEC) Universal Service Plan), or by § 26.406 of this title (relating to the Implementation of the Public Utility Regulatory Act § 56.025), so that these carriers may provide basic local exchange service at reasonable rates. This section establishes guidelines for requesting Additional Financial Assistance (AFA) from the Texas Universal Service Fund (TUSF).

(b) Application. Any ILEC that has been designated by the commission as an eligible telecommunications provider (ETP) and is not an electing company under the Public Utility Regulatory Act (PURA) Chapter 58, 59 or 65, may request AFA in a PURA §§ 53.105, 53.151, or 53.306 proceeding.

(c) Establishment of AFA need. The commission may approve an ILEC's AFA request if the commission finds:

(1) that the ILEC has fulfilled the appropriate requirements under PURA §§ 53.105, 53.151, or 53.306; and

(2) that raising the ILEC's rates for basic local telecommunications service, as defined in § 26.403 of this title, would adversely affect universal service in such ILEC's certificated service area.

[14] The applicable sections of § 56.025 are:

(b) The commission shall implement a mechanism through the universal service fund to replace the reasonably projected reduction in high cost assistance revenue caused by a commission order, rule, or policy.

(c) The commission shall implement a mechanism to replace the reasonably projected change in revenue caused by a Federal Communications Commission order, rule, or policy that changes:

(1) the federal universal service fund revenue of a local exchange company; or

(2) costs or revenue assigned to the intrastate jurisdiction.

(e) The commission shall implement a mechanism to replace the reasonably projected increase in costs or decrease in revenue of the intrastate jurisdiction caused by another governmental agency's order, rule, or policy.

(f) A mechanism implemented under Subsection (c), (d), or (e) must be through:

(1) an increase in rates, if the increase would not adversely affect universal service; or

(2) the universal service fund.

subsidy that the FCC has determined is no longer appropriate, not by proving need, but by merely showing (or claiming to show) that it expects to receive less federal support.[15] As noted above, the Commission's rules already afford small telephone companies the opportunity to prove they need additional financial assistance; the statute should not guarantee receipt of a larger Texas USF subsidy based merely on a claim of *projected* revenue loss caused by changes in cost allocation or a subsidy decrease (or elimination) by another governmental decision.

* Finally, three large carriers (*i.e*., those with more than 31,000 access lines, including affiliates) draw subsidy from the Small Carrier Fund. These carriers should be made subject to the same competitive-test/needs-showing recommended above. One company that owns two ILEC affiliates in the Small Carrier Fund (Consolidated Communications of Fort Bend and Consolidated Communications of Texas), reported to the Commission returns on equity on their regulated operations in Texas of **<u>59% and 45%</u>** (respectively) in 2011.[16] Together, these companies reported receiving over $14 million in subsidy from the Texas Universal Service Fund during the year. Clearly, any system that provides

[15] Docket No. 40755, *Application of Hill Country Telephone Cooperative to Recover Funds from the Texas Universal Service Fund Pursuant to P.U.C Subst. R. 26.406*, filed September 17, 2012.

[16] Telephone Utilities Earnings Reports filed by Consolidated Communications of Fort Bend and Consolidated Communications of Texas with the Public Utility Commission of Texas for the twelve months ending December 2011.

public subsidies to companies with earnings at these levels is fundamentally broken and in need of reform.

The Exaggerated Burden of the POLR Obligation

Before it is possible to discuss eliminating or modifying the POLR obligation, it should first be understood. The provider of last resort obligation generally requires an incumbent local exchange carrier to offer basic local telecommunications service (BLTS) throughout a defined geographic area.[17] Texas law appropriately removes this obligation wherever an incumbent can show – and, importantly as discussed earlier, **chooses** to show – that sufficient competition exists that it is entitled to deregulation.

The problem is that some large incumbents would rather embrace a POLR obligation and receive subsidies, than be deregulated and compete on the same terms as their unsubsidized competitors. One reason for this preference is that the POLR obligation, in the real world, is more political argument than financial burden.

Whether the POLR obligation is a financial burden fundamentally depends upon whether a customer requesting BLTS is already connected to the network or not. For locations served by the existing network, there is virtually no additional cost caused by a customer signing up for service. From a purely financial perspective, an incumbent is

[17] Tex. Util. Code § 54.301(2) (2012). "Provider of last resort" means a certificated telecommunications utility that must offer basic local telecommunications service throughout a defined geographic area.

better off serving a customer to which it already has facilities – which is the vast majority of customers – than not.

The POLR obligation does present a different financial calculus, however, in those relatively few instances where facilities are not yet in place to serve the customer. In this case, the POLR obligation could require an incumbent to incur new costs that may not be financially justified. In this narrow circumstance, the incumbents have a valid point: Where competitive alternatives are available, it makes little sense for a regulatory rule to require the incumbent to install new facilities and incur additional costs (which it may or may not be able to recover from the customer).

It is important to remember the overall context of this issue, however. Texas law already permits an incumbent to be relieved of its POLR obligation wherever it can show there is competition that would permit deregulation. My recommendation (above) is that this same standard should be used to eliminate subsidy, unless the incumbent can show that its POLR obligation creates a need for subsidy in order to have reasonably affordable rates for local service.

But as a general rule, eliminating the POLR obligation where it actually presents a potential financial hardship should be a relatively rare circumstance because it arises only with a relatively rare condition: a customer seeking service at a location not already served by the nearly ubiquitous network of the incumbent. And, in these rare circumstances, it is likely sound policy to **not** require the incumbent to extend its network

– particularly its wireline network – to new remote locations. Texas has led the nation in allowing incumbents to use any technology to extend service to remote, unserved, locations.[18] It is time that the Texas USF subsidy system reflect the POLR reforms that have already been adopted.

Thank you.

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[18] Tex. Util. Code § 54.251(c) (2012). A certificate holder may meet the holder's provider of last resort obligations using any available technology. Notwithstanding any provision of Chapter 56, the commission may adjust disbursements from the universal service fund to companies using technologies other than traditional wireline or landline technologies to meet provider of last resort obligations. As determined by the commission, the certificate holder shall meet minimum quality of service standards, including standards for 911 service, comparable to those established for traditional wireline or landline technologies and shall offer services at a price comparable to the monthly service charge for comparable services in that exchange or the provider's nearest exchange.