Testimony of Joseph Gillan
On Behalf of
Michigan Internet and Telecommunications Alliance

STANDING SENATE COMMITTEE
on ENERGY AND TECHNOLOGY
March 8, 2011

Mr. Chairman and members of the Committee,

Introduction

My name is Joseph Gillan and I am a consulting economist specializing in the evaluation of 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 Michigan Public Service Commission), state legislatures, and the FCC. In addition to my consulting practice, I am an instructor at the Annual Regulatory Studies Program at Michigan State University and serve on the Board of Directors of the Universal Service Administrative Company, a corporation formed to administer the federal universal service subsidy program on behalf of the Federal Communications Commission (FCC).

I have been asked by the Michigan Internet and Telecommunications Alliance (MITA) to address those aspects of state regulatory authority that are most important to the continued development of competition in Michigan. The members of MITA (which include competitive carriers, Internet service providers, Web hosting facilities, software programmers and engineers) have a common interest in maintaining and developing

viable access to a robust communications infrastructure in Michigan to offer competitive services to the Michigan marketplace in general and their customers in particular.

As I explain below, as the Committee considers changes to the Michigan Telecommunications Act (MTA), it is just as important to retain those elements of regulation that are needed for markets to work as it is to jettison any regulation that is no longer appropriate. In my view, it is frequently acceptable to reduce (or eliminate) the last vestiges of regulation over *retail* services, so long as the Michigan Commission retains strong authority to address conditions in the underlying *wholesale* market. In particular, the Commission must retain its authority to fully address wholesale carrier-to-carrier issues involving interconnection between competing networks and access to the facilities needed to extend competitive services to retail customers. These are the wholesale tools that *make possible* the competitive retail environment that enables further retail deregulation, particularly in the market of business customers.

Competition in the Small Business Market is Critical to Michigan's Economic Recovery

As noted earlier, the central goal of the Michigan Internet and Telecommunications Alliance is to maintain viable access to a robust Michigan network infrastructure to serve their customers. MITA members are themselves small businesses and the primary market segment that they serve is the small business marketplace. In a real sense, the concerns expressed by MITA are the concerns of the small business market, which is central to Michigan's economic health. As the Small Business Administration itself explains, "Michigan's small businesses are key to the state's well-

being."[1] In 2008, small firms made up over 98% of Michigan's employers and provided more than 50% of its jobs.[2]

The importance of the small business sector is not limited to Michigan. Small businesses provide nearly 60% of the jobs in our economy. Moreover, the smaller the firm, the greater is its contribution to innovation and economic growth. Although 97% of the firms in the nation employ fewer than 20 people, these firms cumulatively account for half of the non-farm gross domestic product and have generated more than 60% of the net new jobs in the last decade.[3]

The simple fact is that if Michigan is interested in its economy growing – with more jobs, better wages, and greater productivity – its focus should be on establishing an attractive environment for small business formation and growth. Critically, MITA and its members focus precisely on this market segment. Consequently, the more successful MITA's members are in meeting the needs of their small business customers, the more rapid will be Michigan's economic recovery and ongoing prosperity.

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1 Small Business Administration, Small Business Profile – Michigan, available at: http://www.sba.gov/sites/default/files/files/mi10.pdf

2 *Ibid.*

3 *The Small Business Economy: A Report to the President*, Small Business Administration, December 2006, page v.

A Tale of Two Markets: Michigan is a Leader in Residential Competition, but Trails in the Development of Competition in the Business Market

There are material differences between competitive conditions in the residential and business communications markets that are critical to developing sound public policy. We all aware that the cable-based providers of phone services and wireless carriers have been successful in attracting residential consumers. But their success in the residential market should not be confused with competitive conditions overall.

The most recent statistics from the Federal Communications Commission reveal a significant disparity in competitive conditions in the residential and business market segments in Michigan. Although Michigan is a both a national and regional leader in residential competition, the opposite conclusion applies to competition in the business market.

Table 1: Comparing the Progress of Competition in Michigan[4]

Measure	Residential Market	Business Market
Competitive Share	36%	21%
Midwest Rank (out of 5 states)[5]	1st	4th
National Rank	8th	44th

As shown above, Michigan enjoys the highest level of competitive penetration for residential customers in the Midwest. Moreover, on a national scale, Michigan is solidly

[4] Source: *Local Telephone Competition*: Status as of December 31, 2009, Industry Analysis and Technology Division, Wireline Competition Bureau, Released January 11, 2011 ("*FCC 2011 Local Competition Report*").

[5] The Midwest is defined here as the five states formerly served by Ameritech prior to its acquisition by SBC (now AT&T): Illinois, Indiana, Ohio, Michigan and Wisconsin.

in the top 10 states for residential competition.[6] The only states with higher levels of competitive residential activity are Rhode Island, New York, New Hampshire, Arizona, New Jersey, Massachusetts and South Dakota (which is likely a consequence of its relatively small population base).

In contrast, Michigan ranks near the bottom of all states in competition for business customers.[7] In the Midwest, only Indiana ranks lower than Michigan (with a competitive business share of 18%), and the only other states with less competition for business customers than Michigan are Mississippi, Kentucky, the District of Columbia, Wyoming, Hawaii and Alaska.

It is not the purpose of my testimony to suggest that the Committee consider retaining regulation of AT&T's (or another incumbent's) *retail* business services in response to the statistics above. As I explain below, however, the disparity in residential and business competition does underscore the key point of my testimony that the legislature must ensure that the Michigan Public Service Commission retains full authority to oversee wholesale services which are fundamental to retail competition, as well as maintain its authority to review the transfer of any facilities out of the incumbent to an affiliate with fewer (or no) wholesale obligations.

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6 *FCC 2011 Local Competition Report*, at Table 9.

7 *FCC 2011 Local Competition Report*, at Table 10.

Competition for Business Customers in Michigan Remains Critically Dependent Upon AT&T's Wholesale Offerings

The above statistics demonstrated that retail competitive conditions differ between the retail residential and business markets; here I explain that *how* carriers compete in these markets also differ. The central conclusion of my testimony is that business competition in Michigan would be seriously jeopardized if AT&T (or other incumbents) were able to evade their wholesale duties, either by the Commission losing regulatory authority over their wholesale offerings, or (more subtly) by transferring assets to an affiliate that is subject to fewer (or no) wholesale obligations.

In the residential market, the primary sources of competition are cable-based providers and wireless carriers. Neither of these competitors requires last-mile facilities from AT&T to reach their customers. (Significantly, as I explain in the final section of my testimony, even wireless and cable-based competitors are dependent upon the Michigan Public Service Commission retaining authority to address other wholesale carrier-to-carrier issues such as interconnection).

Unlike residential competition, competition for business customers is critically dependent upon wholesale offerings overseen by the Michigan Public Service Commission. Nearly 75% (at a minimum)[8] of the competition in the business market is

[8] Table 2 assumes that all VoIP customers are served by cable-based entrants. However, it is likely that some VoIP is provided by competitors using facilities leased from the incumbent phone company, but the FCC does not separately identify that data. As a result, the percentages in Table 2 may *understate* the competitive reliance on incumbent facilities, further underscoring the importance of the Michigan Commission retaining clear authority over wholesale services.

directly dependent upon facilities acquired from incumbents (principally AT&T) under contracts that are regulated by the Michigan Public Service Commission.

Table 2: Comparing the Type of Competition in the Residential and Business Markets[9]

Method of Connecting to the Customer	Residential Market	Business Market
Cable Telephone	**85%**	18%
Other Competitor-Provided Facilities	1%	8%
Wholesale Facilities Acquired from Incumbent Pursuant to Contracts Regulated by the Michigan Commission	13%	**74%**

Again, it is not the purpose of these statistics to justify the continued regulation of the incumbent's *retail* business services. But the statistics clearly demonstrate that the Commission's authority over *wholesale* arrangements cannot be diluted. It is only because of the Commission's wholesale oversight that Michigan businesses enjoy the level of competitive choice that they do. To the extent that any statutory change provides AT&T (or other incumbents) with additional flexibility over retail services, these businesses will only be able to choose alternatives if the Commission's wholesale authority is retained.

Moreover, it is equally important that the Commission retains its authority over asset transfers to ensure that no competitively significant facilities are transferred to an affiliate that does not share the incumbent's wholesale obligations. Allowing the incumbent to transfer facilities without review and approval between affiliates subject to

[9] Source: *FCC 2011 Local Competition Report*, Tables 9, 10 and 14.

different rules is a form of self-deregulation (of its remaining wholesale obligations) that is unacceptable.

The Development of VoIP (and Wireless) Makes the Commission's Authority over Wholesale Arrangements Even More Critical

The largest single policy failure that can occur at this point in the development of telecommunications competition is if the emergence of new technologies – in particular, wireless and Voice over Internet Protocol (VoIP) – is confused with a lessening need for wholesale, carrier-to-carrier, oversight. In fact, it is quite the opposite.

First, a comment on wireless competition. There is an unmistakable explosion of innovation in the wireless industry, as new smart phones and other appliances (such as the iPad and Kindle) change how people perceive wireless service. What is less appreciated, however, is that wireless service is dependent upon wireline facilities to connect towers and provide the underlying service. It is only at the tail end(s) of a service (between the tower and the wireless device) that the service is wireless; the vast majority of the service is dependent upon wireline facilities, typically leased from the incumbent. As a consequence, wireless competition is critically dependent upon wholesale arrangements; specifically, transport facilities to connect towers and interconnection to enable wireless customers to make/receive calls with the incumbent phone company.

Second, the significance of Voice over Internet Protocol (commonly known as VoIP). 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 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 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. In this instance, it will be important to maintain existing regulatory policy with respect to Commission oversight of interconnection agreements, so that such 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 AT&T and its competitors using traditional telephone technology. State commissions – including the Michigan Public Service Commission – played an important role arbitrating agreements between incumbents and competitors to make sure that quality was not sacrificed when calls cross the networks of rival companies. But these agreements are all grounded in technologies that are rapidly becoming obsolete.

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. What is critically important is that modern replacement agreements maintain the quality that consumers have come to expect.

Quality-of-service provides a useful example for the key message of my testimony that retail deregulation can be appropriate, so long as wholesale oversight remains. In this example, if competitors are able to incorporate quality standards into their carrier-to-carrier contracts with incumbents, then retail quality standards are unnecessary. This is because competitors will be able to maintain end-to-end quality of their services (including when those calls are partially carried over the incumbents' network) and provide customers with choice, should the incumbent's retail quality decline. But this is only possible if the interconnection agreement contains the necessary metrics and protections. As a result, it may be appropriate to eliminate retail quality-of-service rules, but only if the Commission can adopt and enforce quality-of-service requirements governing wholesale arrangements.

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 <u>state commissions</u> 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, state commissions (including, the Michigan Public Service Commission) will again be called upon to arbitrate new interconnection agreements to allow calls to pass between new, modern, packet networks. It is vital that the Commission the authority to perform this critical role and to ensure that quality services remain available to Michigan consumers and business.

In summary, additional deregulation of retail services may be appropriate. But as the Committee considers that deregulation, it must make sure that the Michigan Commission retains strong authority to address the wholesale issues upon which retail competition depends.

Thank you.