

# VIEWS AND NEWS

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### Verizon Communications to spin off its consumer wireline business?

Earlier this month, *Bloomberg BusinessWeek* described a recent Goldman Sachs research report in which the investment banking firm had suggested that Verizon should divest its fixed-line consumer operations so as to clear the way for the company to merge its wireless and enterprise units with UK partner Vodafone. In 2000, Vodafone and then-Bell Atlantic both contributed their US wireless operations and assets to a joint venture to be called Cellco Partnership d/b/a Verizon Wireless. For its contributions to the venture, Vodafone received 45% of Cellco, but Verizon Wireless and Vodafone's UK networks have remained separate.

Verizon has yet to comment on the Goldman recommendation, but there are a number of reasons why the company may well be considering such an initiative.

First, Verizon has already off-loaded a large chunk of its wireline operations. In 2008, it sold its Maine, New Hampshire and Vermont operations to Fairpoint Communications, Inc. and in 2005 sold its former-GTE Hawaiian Telecom to the Carlyle Group, a private equity firm. In 2010, Verizon sold a large portion of the wireline business it had acquired in its 2000 merger with GTE, along with the former Bell Atlantic's West Virginia operation, to Frontier Communications, Inc., retaining the three largest former-GTE markets in Florida, Texas and California. Immediately following the Bell Atlantic/GTE merger, Verizon was providing wireline service in some 28 state jurisdictions; that number is now down to only 12.

Verizon had been scaling back its investments in its traditional fixed line voice telephone business for some time, particularly in non-metropolitan markets. But in 2004 and with considerable fanfare, the Company announced an ambitious "fiber-to-the-home" (FTTH) broadband deployment branded as *FiOS*. *FiOS* investment was concentrated in Verizon's major east coast metropolitan markets; by 2010, the company had spent some \$23-billion on the undertaking and had built out *FiOS* to some 18-million homes. *FiOS* penetration has remained relatively low, however. Verizon's 2010 10-K Report put the number of *FiOS* Internet subscribers at only 4-million and video subscribers at 3.5-million as of the end of that year, representing a per-subscriber investment of some \$5,750 (\$23-billion spread across 4-million subscribers).

The major cable multisystem operators (MSOs) like Comcast, TimeWarner Cable and Cox did not sit idly by while Verizon was in pursuit of the consumer broadband (and video) market. The MSOs were upgrading their systems by extending fiber deeper into residential neighborhoods and were implementing new transmission

protocols like DOCSIS-3 that supported data rates on the MSOs' hybrid fiber/coax networks that rivaled what Verizon's FTTH architecture could achieve. In 2010, Verizon announced that it would call off all further expansion of *FiOS* beyond the 18-million homes that were to be passed as of the end of that year.

And Verizon's core wireline phone business was continuing to shrink. By the end of 2010, Verizon residential/small business access lines had dropped by 58%, from its 2000 peak of 63-million to 26-million.

#### *The impact of wireless on wireline demand*

Of course, a good deal of the drop-off in wireline demand was being offset by the immense growth of the wireless subscriber base. A large portion of that migration is likely attributable to Verizon's own marketing strategies. For much of the past decade, Verizon Wireless and most other US wireless carriers have eliminated the distinction between "local" and "long distance" calling. They offer "free" or nearly-free evening, night and weekend airtime, as well as "free" calling between mobile phones on their own networks and, more recently, between any US mobile phones. At the same time, wireline customers who had not subscribed for a long distance calling plan were being hit with ever increasing per-minute charges. It is no surprise that consumers got into the habit of placing long distance calls on their wireless phones and, in so doing, felt sufficiently comfortable with wireless that a good number (31% by the latest count) have "cut the cord" and eliminated their fixed wireline service altogether.

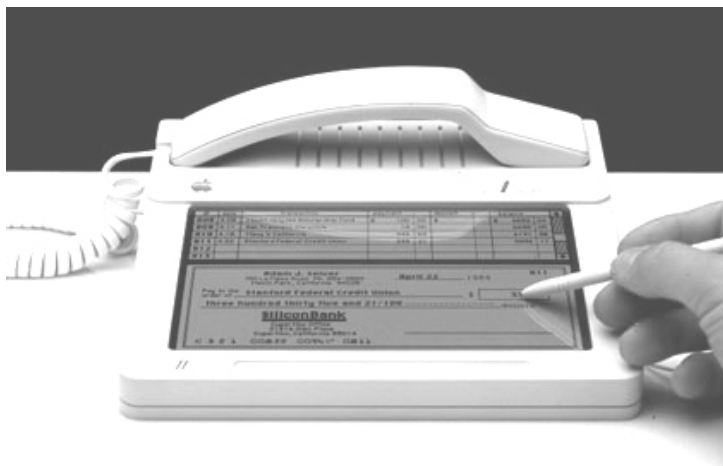
By virtue of its ownership and/or control of both consumer wireline and wireless services, Verizon was in a position to manage the "intermodal" rivalry between the two and to pursue a business strategy aimed at maximizing joint profits across the two platforms. The notion that Verizon's wireless service was somehow "competing" with its own wireline service is, to put it mildly, something of an overstatement.

#### *A wireline divestiture*

In principle, separating wireline and wireless into separate – and truly *competing* – companies could produce considerable competitive benefit. As a provider of both, Verizon has done little to enhance the attractiveness of its wireline services. It has retained the pricing distinction between "local" and "long distance" calling and has maintained what are by current standards absurdly small "local calling areas" of 20 miles or less despite the offering of what amounts to nationwide local calling by its own wireless affiliate. It persists in imposing additional charges for wireline "optional"

features like call waiting, call forwarding, three-way calling, voice mail, call screening, and caller ID – features that cost it little or nothing to provide – while bundling these and others into its wireless pricing without any additional charge. On the other side, Verizon has worked to protect its *FiOS* investment by not upgrading its wireless network to offer comparable broadband and video services that could cannibalize the *FiOS* customer base (the latest LTE network upgrades offer download speeds that range from 1/5th of the slowest *FiOS* package, to 1/15th of the fastest).

The prospect of the separation of Verizon's wireline and wireless operations offers the possibility that the two (then independent) companies would aggressively compete with each other for consumer business. There are, of course, limits to the direct substitution between the two services. Wireline phones are, by definition, tethered to a fixed location, whereas wireless phones are not. Hence, wireless is more of a substitute for wireline than vice versa. Nevertheless, for calls placed from the customer's home or other fixed location, wireline and wireless *are* substitutes. A wireline provider seeking to retain customers who might otherwise go wireless-only could certainly take measures to make the wireline service more attractive, such as by eliminating the local/long distance distinction and by bundling features with the service. It could offer more flexible call forwarding services, and speech-to-email voice mail, and could emphasize the far better voice quality and reliability of fixed line services in its marketing and advertising. Up to now, "smartphones" have largely been confined to mobile services, but fixed-line smartphones that could include easier-to-use keyboards, larger video displays, and that could support such features as multi-party video conferencing could well operate to stem the hemorrhaging of the wireline customer base. (Check out Apple's first smart telephone – a landline – from 1983, with integrated screen and computer.)



On the broadband side, a wireless provider that is not also in the wireline business could offer a serious challenge to fixed line broadband services like DSL and cable – particularly in those areas where higher-speed services like *FiOS* are not available.

#### ***Is increased wireline/wireless competition a realistic expectation?***

How likely are any of these to occur? A lot will depend upon what specific wireline assets Verizon actually divests, and the financial and technical strengths of the entity(ies) to whom the assets are sold.

Goldman Sachs is urging that Verizon divest its *consumer* wireline assets, thus retaining those wireline assets it uses to serve large enterprise customers, along with all of its wireless assets. But it may not be that simple. A good deal of the network facilities that Verizon uses to serve large enterprise customers were acquired from MCI when the two firms merged in 2006. Those former-MCI assets form the core of what is known as the *Verizon Business* subsidiary of Verizon Communications. These assets are, in general, separate and distinct from, and not integrated with, the legacy Verizon local service network – subscriber loops, remote terminals, central office switches, wire centers, and interoffice transport plant. However, services furnished to larger enterprise customers are not confined solely to the former MCI assets. If the purchaser of Verizon's consumer wireline business becomes the owner of all of these legacy local network facilities, then the remaining Verizon wireline business service unit will be required to purchase local access and transport from the divestee entity.

The situation is even more complex in the case of wireless. The true "wireless" portion of what are commonly referred to as "wireless services" is limited to just the "air segment" between the handheld wireless device and the nearest cell site. The connection between the cell site and the wireless switching office, and beyond that office to the rest of the public switched (local and long distance) network, consist almost entirely of *wireline* facilities. One category of those facilities – the so-called "backhaul" links between each cell site and the wireless switching office – are provided mainly by local exchange carriers. And where the wireless carrier is an affiliate of the local wireline incumbent local exchange carrier (ILEC), most – or even all – of those backhaul facilities are provided by the ILEC at all of the wireless affiliate's cell sites that lie within the ILEC's operating footprint. The interdependence of the wireless and wireline networks within a given geographic area cannot be overstated: There would be no wireless service without ILEC-provided wireline backhaul.

Wireless carriers obtain the use of the ILEC's backhaul facilities as "special access services" purchased from the ILEC pursuant to interstate special access tariffs or (if de-tariffed, as is the case in many areas) price lists. Non-ILEC-affiliated wireless carriers such as Sprint and T-Mobile obtain their backhaul facilities from the ILEC on the same basis as the ILEC-affiliated wireless carrier. Sprint (and T-Mobile as well, up until it announced plans to merge with AT&T) had been vociferous in their complaints about the excessive special access rates that they were being forced to pay to satisfy their backhaul needs. But as long as the affiliated wireless carriers like Verizon Wireless and AT&T Mobility were required to pay the same prices for these special access services as Sprint, the ILECs' rates were at least slightly constrained by their own affiliates' interests. Once Verizon Wireless's affiliation with (what would then be the former Verizon) ILEC is severed, backhaul rates could escalate even further. If Verizon and its Vodaphone partner are about to bet the farm on wireless, it seems difficult to imagine that they would willingly forgo control of these strategic backhaul assets.

#### ***Finding a weak divestee would be the likely solution***

Can Verizon have its cake and eat it too? Perhaps. If history is any guide, Verizon has actually perfected a business model aimed at protecting its own strategic interests while still off-loading assets

that no longer fit into its business plans. And Verizon has accomplished this with reasonable assurance that the buyer of these wireline assets will never pose a serious competitive challenge.

- Verizon sold its three northern New England states to FairPoint, a small North Carolina-based independent telco whose pre-acquisition size (in terms of number of customers) was less than one-fifth that of the three-state operation it was acquiring. FairPoint ran into difficulty almost immediately. For some time prior to its sale, Verizon had paid little attention to its northern New England network. Upon taking over, FairPoint found itself with deteriorated plant badly in need of major capital infusions. Service quality deteriorated to the point where regulators in all three states convened a joint hearing with FairPoint management to demand solutions to the billing, service quality, and 911 issues plaguing consumers. FairPoint itself went into Chapter 11 in October 2009 and did not emerge from bankruptcy until January 2011. Customer complaints escalated, and the company experienced some of the largest line losses of any ILEC in the US.
- Verizon sold its Hawaii ILEC to the Carlyle Group, a private equity firm that had made other telecom acquisitions but had never actually operated a large-scale ILEC entity. The Carlyle Group never successfully transitioned Hawaiian Tel over to its own operating platform, resulting in billing issues and extremely long hold times to reach customer service representatives. The company fired its CEO to bring in a turnaround specialist, only to end up filing for bankruptcy protection in 2008.
- Verizon divested the majority of its former GTE ILEC operations along with the former Bell Atlantic West Virginia operation to Frontier Communications, a mid-sized independent rural telco that started out life as the ILEC serving Rochester, New York. Prior to the acquisition, Frontier served some 1.7-million subscriber lines; post-acquisition, that number mushroomed to 5.7-million. Verizon had done little to upgrade the former-GTE operations prior to the transaction, leaving the now-abandoned customers largely without broadband or anything more than the barest minimum DSL capability. How successful Frontier will be in accomplishing what Verizon had failed to do remains to be seen.

None of these divestitures involved any of the *wireless* assets owned or acquired from GTE that served these same geographic areas, belying the oft-stated claims of wireline/wireless synergy.

#### **Regulators need to pay close attention to any proposed spin-off**

When then-Bell Atlantic was in the process of taking over GTE back in 2000, it advanced claims of strong consumer benefits based upon the efficiencies of scale and scope that would result from the integration of the two companies' operations. Whatever the merits of such claims may have been at the time, it's difficult to imagine that state regulators in particular would have sanctioned the merger if they knew that what would become Verizon would balkanize its network into operating units smaller and financially weaker than had characterized the pre-merger Bell Atlantic and GTE. This situation is magnified by Verizon's strategic interest in retaining the lucrative special access portion of its networks across any divested geography, allowing the company to continue to serve high-profit enterprise customers and to protect Verizon Wireless backhaul, all while maintaining the excessive special access prices paid by its competitors.

## **Tax Revenues Suffer Unintended Collateral Damage from Regulatory/Marketplace Changes**

*Should five percent appear too small  
Be thankful I don't take it all  
'Cause I'm the taxman, yeah I'm the taxman*

*If you drive a car, I'll tax the street,  
If you try to sit, I'll tax your seat.  
If you get too cold I'll tax the heat,  
If you take a walk, I'll tax your feet.*

The Beatles, *Taxman*

Although state and local taxing authorities rarely become involved in telecommunications policy matters, they have often been blindsided by regulatory or legislative initiatives that, whether intentionally or otherwise, have resulted in a net – and sometimes a large – reduction in tax revenues.

This is hardly a new phenomenon. Prior to the FCC's 1980 *Computer II* decision initiating the process of deregulating customer premises equipment (CPE) and the 1984 break-up of the former Bell System, the full range of ILEC CPE – from consumer handsets to PBXs – were carried as capital assets in an ILEC's rate base, and represented as much as 15% to 20% of a typical ILEC's assets. Local *ad valorem* property taxes, local and state franchise taxes, and various other taxation systems were often based upon the value of a utility's capital investment. When CPE was deregulated and transferred to a nonregulated affiliate and/or ultimately sold in-place to individual customers, aggregate ILEC asset values decreased substantially, and tax revenues based thereon experienced a commensurate reduction.

Tax revenues may also be unintentionally reduced even when regulatory policy and law are held constant in the face of major marketplace changes. For example, the introduction and development of competition by nonregulated entities across a broad range of telecommunications industry segments had a similar effect upon state and local tax revenues. In many instances, taxes applicable to "telecommunications" services were explicitly or implicitly linked to the service provider's status as a regulated telecommunications utility or "telephone company" under a specific legal definition. Rather than the tax being applied to the product or service irrespective of who produced it, many telecommunications taxes were specifically applied only where the service at issue was furnished by an entity subject to state public utility regulation. When nonregulated competitors captured some portion of the market for such services, the tax payments by the regulated utility would decrease, but would not be replaced by the nonregulated rival that was not itself subject to an equivalent tax.

Sometimes tax collections may be impacted by technological developments rather than through any specific policy initiative. A case in point is the Federal Excise Tax (FET) on long distance telephone calls. Section 4252(b)(1) of the Internet Revenue Code provides that toll telephone service is subject to the Federal Excise Tax where the charge for such calls varies with both the distance and elapsed transmission time of each individual call. This two-element long distance call pricing scheme – based on distance and duration – had been in effect since the introduction of long distance service

nearly a century ago, and was certainly operative when the FET was adopted. But with the arrival in the 1990s of ultra high capacity fiber optics and digital switching, distance dropped out as a material cost driver, and long distance prices became "postalized" – i.e., subject to the same price irrespective of distance. The problem, from the perspective of the IRS, was that the FET was explicitly applicable only where both the distance and the duration element were present – take one away, and the legal basis for the FET disappeared. After a series of federal court challenges that the IRS had consistently lost, the IRS caved, and in 2006 issued Notice 2006-50 effectively eliminating the FET on long distance calls.

### MAJOR TELECOM MARKETPLACE CHANGES WITH TAX IMPLICATIONS

Category	Taxable Format	Marketplace change resulting in taxation "gray area"
Music	CDs	iTunes Downloads
TV/Videos	Cable TV; DVD rentals	Netflix-type Streaming Videos
Retail Merchandise Purchases	Brick-and-Mortar retail stores	Amazon, other e-Commerce/ Online Stores
Voice telephone access lines	Wireline ILECs, CLECs	"Over-the-top" VoIP via consumer Internet access service
Mobile voice service	As provided by wireless carriers	"Over-the-top" VoIP via wireless 3G, 4G, LTE broadband data services
Computers, software	In-house PCs, LANs, storage, software	Cloud computing, remote storage accessed via the Internet

And now, another technological development that has emerged over the past year or so portends a further erosion of state and local tax revenue. Cable television services are typically subject to state sales tax as well as other locally-imposed franchise or similar fees. However, under the 1998 federal *Internet Tax Freedom Act* (ITFA), Internet services are specifically exempt from state and local sales, franchise, gross receipts, and other taxes that would ordinarily apply to most other businesses and services. The ITFA was initially adopted as a temporary measure, slated to expire in 2001, intended to encourage the development of the then-nascent commercial Internet while sidestepping the problem of identifying the appropriate tax jurisdiction ("tax nexus") where services may have had unknown and multiple geographic points of origin. This "temporary" tax exemption has been extended several times, and there is pending legislation that would make it permanent.

The ITFA has been a source of considerable controversy, since it creates a competitive disparity with respect to otherwise comparable services and business activities based upon whether they are furnished over the Internet or via some more traditional means. Although the ITFA does not preclude the imposition of local sales tax on purchases made over the Internet, its existence has been cited as

a rationale for continued state-level sales tax exemption for such transactions. Amazon has been particularly aggressive in fending off state sales tax collection requirements even to the point of dropping so-called "affiliates" who offer merchandise via the Amazon website that are based in states that had sought to utilize their physical presence as a basis for establishing a broader tax nexus applicable to all of Amazon's sales in their jurisdiction. This conflict came to a head in 2011 when California attempted to force Amazon to collect state sales tax on sales to California customers.

The growth of streaming video services – from Netflix, Hulu, Roku, Apple, Google, and even from Amazon – creates yet another challenge for state taxing authorities. As more Internet-based sources of video become available, customers are eliminating their cable TV service ("cutting the cord") or downgrading their service to a lower-priced premium tier or all the way to basic cable only. They are also replacing taxable DVD rentals from stores like Blockbuster with non-taxable streaming downloads from Netflix and others. The downgrades and discontinuations of taxable cable services are being replaced by *non-taxable* Internet-based streaming services. Of course, in many cases the Internet access service is being furnished by the same entity that had been providing the cable TV (or equivalent) video service. From the provider's perspective, the loss of cable revenue is offset, at least to some extent, by increased demand for higher-bandwidth Internet access. But from the perspective of state and municipal governments, the migration from a legacy taxable service to a competing non-taxable service can have serious revenue impact.

ETI has long believed that the ITFA has outlived its original purpose and needs to be repealed (see *Views and News*, November, 2010). The Internet is no longer a nascent industry that needs to be nurtured by special tax breaks. Moreover, the disparity between the taxation of traditional businesses and services vis-a-vis those sold over the Internet has contributed to a demise of many otherwise sustainable brick-and-mortar firms. The negative impact upon local communities, local economies and jobs cannot be overstated. The challenges confronting state and local governments during the current economic downturn are exacerbated by the continued erosion of the tax base. Expansion of broadband is a central focus of national telecommunications policy, yet if Internet-based services continue to escape state and local taxation, the unintended consequence of more broadband could well be a further erosion of state and local governments' ability to run their schools and to provide other essential public services.

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**About ETI.** Founded in 1972, Economics and Technology, Inc. is a leading research and consulting firm specializing in telecommunications regulation and policy, litigation support, taxation, service procurement, and negotiation. ETI serves a wide range of telecom industry stakeholders in the US and abroad, including telecommunications carriers, attorneys and their clients, consumer advocates, state and local governments, regulatory agencies, and large corporate, institutional and government purchasers of telecom services.