June 30, 2005

Policy Brief

Texas Public Policy Foundation

Testimony on Telecommunications Regulatory Reform

Presented Before the House Regulated Industries Committee

By Bill Peacock, Economic Freedom Policy Analyst

Mr. Chairman, Members. My name is Bill Peacock, economic freedom policy analyst with the Texas Public Policy Foundation. Thank you for allowing me to testify before you today.

The Foundation has conducted several studies in telecommunications over the last two years, including two studies released in January. I'd like to share with you some of our findings and how they relate to the telecom debate going on in Texas today.

The reform of telecommunications regulations in Texas could bring significant benefits to consumers and businesses throughout the state. Of course, the type of reforms are important. The Foundation believes that reforms which incorporate some of our core principles of limited government, free markets and private property rights would best serve the people of Texas.

Before I offer the Foundation's specific recommendations for reform and how these might benefit the state, let me offer a brief analysis of the state of regulation of the Texas telecommunications industry.

Background

An examination of the regulatory scheme in Texas reveals three basic areas in need of improvement.

First, our regulatory system is falling behind the rapid advances in technology. This may be a surprise to some because it was only ten years ago that Texas became a national leader in reforming its telecommunications laws – even ahead of the federal government.

Our regulatory system was designed to take advantage of technological advances allowing us to begin the transition away from a conglomeration of near monopolies.

And while the system did a good job of fostering that transition, it has gone as far as it can. The current system of state-managed competition is slowing the introduction of new technologies that would provide Texas consumers with better products and services at lower cost and higher quality.

Second, our system contains cross-subsidies and price distortions. This is not unrelated to the first area, but goes beyond it because of the two state policies: the policy of the state to guarantee "affordable" telephone rates for certain classes of individuals and the policy of protecting certain businesses from competition from other businesses, in the belief that this would ultimately protect the customers of those protected businesses.

There are four types of traditional subsidies under this regulatory scheme: long-distance to local, urban to rural, business to residential and vertical to basic.

We cannot accurately estimate the full costs of these subsidies without access to companies' proprietary earnings and cost information. But based on the publicly available information we have estimated, in a study by Robert Crandall and Jerry Ellig, that the cost of the long distance and urban subsidies is about $785 million a year. Additionally, we have estimated that in 2002 the local basic rates charged by large incumbent telephone companies ran about $600 million short of covering the long-run incremental cost of all residential lines.

CONTINUED on PAGE 2

CONTINUED from PAGE 1

The price distortions are caused by two different price regulations – price caps and price floors.

The subsidies and price distortions adversely impact consumer choice, business decisions and new investments. With the information we have, Crandall and Ellig estimated that this regulatory scheme leads to a reduction in consumer welfare of between $206 and $266 million per year. The total would likely to be significantly higher if the full amount of the subsidies were known.

Third, Texas telecommunications services are highly taxes. Texans pay a total of 28.56 percent in state and local telecom taxes, versus the national average of 17.9 percent. This includes sales taxes, right-of-way fees and charges for the Texas Universal Service and Texas Infrastructure funds. The high level of taxes adds to the reduction in consumer welfare and distorts the economic decisions of consumers and businesses.

Framework for Reform

When determining how to reform the Texas telecommunications system, policymakers should consider these problems with the current system as well as the context in which reform is being undertaken.

The big picture, if you will, is that ultimately the nature of telecommunications regulation will be decided at the federal level.

This principle is well established in law, having been affirmed just last week by the Supreme Court's Brand X decision. This is not to say that state and local governments will not have any regulatory authority in the future, but the extent of that authority will be determined by federal law.

This makes today's situation reminiscent of 1995. As I mentioned, Texas took the lead in reforming its laws that year in advance of the federal government. And many of the reforms of the federal government followed the trail blazed by Texas, providing significant benefits to Texas consumers and businesses.

The federal government seems poised to adopt significant regulatory reforms designed to reduce regulations and open up competition. If Texas policymakers adopt regulatory reforms of this nature during a special session, Texas will have the opportunity to once again lead Washington and the rest of the country in implementing practical free market reforms. However, if we do nothing or maintain significant market regulations, we will likely have little impact on federal reforms and may be forced in a couple of years to change our regulations to comply with federal law whether it seems best for Texas or not.

Recommendations

The Foundation supports four basic reforms:

1) *Deregulation of prices.* In those markets where companies have already opted for competition, we recommend full deregulation of pricing. This would include removing all price caps, price floors and prohibitions on promotional pricing, win back, volume discounts and other pricing differentials.

For the rest of the state, the legislature should put into place a timetable for pricing deregulation in all Texas markets. Otherwise, Texas will face in a few years a regulatory-induced digital divide between the deregulated and regulated markets.

2) *Reduced subsidies.* The Foundation recommends that there be a link between the timing and market scope of deregulating prices and reducing subsidies. While reducing subsidies is highly important, it would harm competition and companies if subsidies were reduced without giving companies the ability to make up for the lost revenue as needed. This is another reason why price deregulation in all markets is so important.

Intrastate access charges should be either deregulated or reduced to parity with interstate rates at the same pace that pricing flexibility is introduced.

If the legislature determines that it should address Universal Service Fund subsidies with a study, it should be made clear that the purpose of the study is to reduce subsidies. One way to do this would be to allow basic rates to increase for those phone lines where the revenues do not meet their long run incremental costs.
For instance, Crandall and Ellig estimated that there are about 2.7 million phone lines in Texas that fall about $3.30 a month short of covering their long-run incremental cost. Requiring these phones alone to cover their cost could reduce USF subsidies by $100 million per year.

CONTINUED on PAGE 3

CONTINUED from PAGE 2

Of course, we realize that you can only go so far at the moment in allowing the basic rates to rise in some rural areas. But as technology advances, the costs for serving these areas will come down. So it is important to make sure that the USF payments are dynamic, based on actual costs and future adjustments to basic rates.

3) *Reduced barriers to competition and market entry.* Both price regulation and subsidies serve as barriers to competition and market entry. However, another significant barrier is the management of right-of-ways and local franchises.

Both right-of-way and franchise fees are under assault, and cities have already seen reductions in revenues. Right-of-way fees, usually paid by phone companies on a per-line basis, have fallen as access lines have lessened. Cable franchise fees may soon follow suit. The Brand X decision made clear that Internet access and telephone service are information services and not cable. Therefore, as cable companies add more products to the menu, the gross revenues for cable by which the local governments calculate their franchise fees may substantially decrease.

As local governments seek to replace this lost revenue, it is important to remember that right-of-ways can be managed for significantly less than the revenues generated under these fees, and that local governments have other means for generating new revenue.

Therefore, the Foundation recommends that the state implement a statewide video franchise for new video and cable entrants and for existing companies as their current cable franchises come up for renewal. The franchise should have no cost, but a separate mechanism should be setup to provide for the proper management of right-of-ways and allow local governments to recoup actual costs for right-of-way maintenance.
The Foundation would not support the creation of any new taxes to replace the revenue for local government, nor taxing any providers that do not currently pay these fees. Replacing these declining sources of revenues with a stable or increasing revenue source would amount to a tax increase. Perhaps a transition mechanism might be put into place to allow cities time to adjust spending and replace revenues through existing revenue sources.

4) Reduced taxes. The Foundation believes than an excellent place to start in reducing telecommunications taxes would be the elimination of the TIF assessment. Failing this, we would recommend that all carriers be able to pass along this charge to their customers in the interest of parity.

Public Benefit of Free-market Reforms

Free-market reforms such as the Foundation recommends would save Texas consumers hundreds of millions of dollars a year. This includes eliminating the economic costs to all consumers of more than $266 million caused by subsidies and the much of the $600 million that some consumers are forced to pay for the benefits of others. In addition, consumers could save much more than this over the long run, as competition reduces costs, just as it has done in long distance, cellular and DSL services.

Consumers would also benefit from improved products. New technologies will move the convergence of voice, video and information from the boardroom to the family room. TV will converge with video, voice and e-mail. The possibilities are endless. And while there will certainly be plenty of technological challenges along he way, consumers will benefit greatly if these are not compounded by a 20th century regulatory scheme.

This concludes my testimony and I'd be happy to answer any questions.

Bill Peacock is the economic freedom policy analyst for the Texas Public Policy Foundation.

Texas Public Policy
FOUNDATION