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# Texas Telecommunications:

## *The Road Ahead*

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## Introduction

Texas recently became the national leader in telecommunications reform when the 79th Texas Legislature passed Senate Bill 5. This legislation restructured Texas telecommunication laws in order to foster increased competition throughout the industry, bringing substantial benefits to Texas consumers, businesses, and the economy.

The most significant aspect of SB 5 is its provision for a statewide video franchise. Texas is now the only state that allows new entrants to receive a state franchise in order to provide video service that competes with existing cable providers. Companies will no longer will be required to endure the slow, expensive and anti-competitive process of receiving franchises from local governments. And once existing local franchise agreements expire, current cable providers will be able to switch to the statewide franchise as well.

As discussed later in the paper, Texans have already benefited from this provision through increased investment, more jobs, new technology and lower prices. The effects of this reform will be felt nationwide—the timing and extent of the impact will depend on whether Congress or other states follow Texas' lead.

Despite the many positive aspects of SB 5, significant challenges still lie ahead. Many of the provisions of SB 5 are left for future legislatures to fully implement, while others could be significantly improved. The resolution of these issues over the next two years will likely determine the robustness of competition in the Texas telecommunications industry for years to come.

This paper examines competition in the telecommunications industry, looks at specific aspects of the regulatory system in Texas, analyzes the provisions and impact of SB 5, and looks at the road ahead for telecommunications in Texas. It concludes with the following recommendations to assist policymakers in the implementation of SB 5 and in their preparation for continued debate on this issue in the 80th Texas Legislature.

**Regulation**

- The relics of monopoly regulation—such as price caps and price floors[i]—should be removed from the current system.

- Firm timelines should be set for deregulation of all telecommunications markets.

[i] Price caps are the maximum prices that companies are allowed to charge which are set by government regulation. Price floors are minimum prices on goods or services set by government regulation that limit price competition in a particular market.

**Subsidies**

- Significant reductions in telecommunications subsidies should be the focus of relevant interim and legislatively-mandated studies.

- Reductions in subsidies should be paired with pricing flexibility.

**Taxes**

- The high telecommunications tax burden on Texas businesses and consumers should be reduced.

# A Brief History Of Telecommunications Competition

For most of the last century, cheap and universally available local residential phone service was the primary telecommunications goal of policymakers across the country. The resulting regulatory regime kept competition at bay in order to maintain an elaborate web of subsidies that supported artificially low local service prices.

In the 1970s, when it became clear to everyone that consumers were demanding services that the regulated system couldn't deliver, the country began to move into the new era of telecommunications deregulation.

## Telecommunications Equipment

Telecommunications equipment was the first sector of the industry to see significant deregulation. Though phone companies argued that a consumer who plugged in a phone system produced by a third party could compromise the integrity of the telephone system, federal regulators opened up the equipment market to competition.[1] The result was a sharp decline in equipment prices, with prices for phone handsets, key telephones, and private branch exchanges declining at a real rate of between six and seven percent per year between 1972 and 1987.[2]

## Long Distance

In the area of long-distance service, MCI had begun to compete against AT&T as early as 1969. But competition was slow in spreading because of the government-authorized local phone monopolies. The negotiated breakup of AT&T in 1984 allowed competition to flourish which again brought about significant declines in long-distance prices. Interstate rates fell 68 percent from 1984 to 2003, while intrastate rates fell 56 percent.[3] The slower decline of intrastate rates is due largely to state regulators who have kept intrastate access charges artificially high in order to maintain subsidies of local phone rates.

## Cellular Service

Wireless phone service had only just begun at the time of AT&T's breakup, largely due to regulatory delays in licensing equipment. And even then, federal restrictions on use of the radio spectrum by cellular service significantly limited the number of competitors in local markets. From 1984 to 1995, when there were just two cellular providers per market, inflation-adjusted rates fell by an average of only three to four percent annually. However, in 1993 the government allowed up to six competitors in each market, resulting in declines in wireless rates averaging 17 percent annually from 1995 to 1999.[4] A cellular phone call which averaged 50 cents per minute in 1984 has declined to 8 cents per minute today.[5]

## The Internet

The explosive growth of the Internet, which has outpaced the growth rate of most other technology services, can be largely attributed to the lack of regulation. Beginning in 1966, the Federal Communications Commission decided that data processing, and later Internet services, should be free from price controls, entry regulations, and other restrictions imposed on telephone service.[6] In addition, Congress has significantly limited the taxation of Internet access and transactions. As a result, competition in both Internet access and services has been intense, and is reflected in the rapid growth in high-speed Internet access and the simultaneous decline in prices.

Nationally, high-speed connections have increased from 2.7 million in 1999 to 37.8 million in 2004.[7] Texas has followed the national trend, and even outpaced it recently: high-speed connections in Texas increased 35 percent over the last year to 2.6 million.[8] In a report issued by the Texas Public Policy Foundation earlier this year, Robert Crandall and Jerry Ellig calculate almost a 15 percent drop in broadband prices from 1997 to 2003,[9] and anecdotal evidence suggests even greater decreases recently—broadband today is available for as little as $14.95 a month, far less than SBC's standard rate of $49.99 in 2000.[10]

### Local Phone Service

Local telephone service has had a difficult time shedding its 100 year history of regulation. State regulators still control significant aspects of local service, including pricing. Thus regulatory controls combined with subsidies are often used to maintain low prices for local phone service. The success of this policy can be called into question, however, when the stable prices for basic service are compared with the declines in prices of other technology services.

### Cable and Video

Video is perhaps the last telecommunications service to be opened up to competition. For years, cable companies had virtual monopolies through their local franchise agreements. Though these agreements did not prohibit additional providers from entering a market, high franchise fees to cities and requirements that service be offered city-wide made the economics highly questionable for additional entrants. However, technology is beginning to change this, and satellite providers are being joined by facilities-based providers as true competitors to the cable industry. The biggest remaining hurdle to robust competition in video services are local franchises, which require new providers to negotiate entry into each city with the local city government. Texas dealt effectively with this issue in SB 5 through the statewide video franchise. However, it remains an issue for the rest of the country.

## The Texas Experience

Ten years ago, Texas became the national leader in telecommunications reform when the legislature allowed incumbent phone companies to opt for an alternative regulatory framework that capped basic network service at current level, gave them immunity from rate-of-return regulation,[i] and allowed rate flexibility for other services. The changes preceded, and in some ways led the way for, Congress' overhaul of telecommunications law in 1996.

Unfortunately, the state's once leading-edge regulatory system had fallen behind the rapid advances in technology. While the system did a good job of fostering the transition away from legally sanctioned monopolies, it had gone as far as it could go. The primary reason for this is that the system relied heavily on cross-subsidies, price regulation, and taxes to achieve the state's policy goal of providing low-cost, universal residential basic phone service. The following is a brief look at the Texas telecommunications system prior to the passage of SB 5.

### Subsidies

Telecom subsidies in Texas are essentially schemes to redistribute income from one set of consumers to another. There are four basic types of subsidies under this regulatory scheme: long-distance to local, urban to rural, business to residential, and vertical to basic. The main mechanisms for achieving these subsidies are the Universal Service Fund, long-distance access charges, price caps, and Private Network Service for public institutions.

It is difficult to accurately estimate the full costs of these subsidies without access to companies' proprietary earnings and cost information. But based on the publicly available information, Crandall and Ellig estimated that the minimum cost of these subsidies is $711 million a year.[11] In addition, they estimated that these subsidies caused market distortions, i.e., increased costs or reduced usage, that cause harm to Texas consumers of at least $206 million per year.

### Pricing Regulation

Price regulations in Texas telecommunications come in three forms—price caps, price floors, and tariffed rates. Companies that have chosen alternative regulation under Chapters 58 or 59 of the Public Utility Code are generally subject to price caps or floors on many of their services.

Price caps are used by policymakers attempting to hold down the cost of basic phone service. However, the benefits of price caps to consumers are questionable. While real local rates in Texas have remained essentially the same since the passage of the 1996

[i] Rate of return regulation allows a company to set its prices so that it will earn a margin of profit agreed upon by the company and regulators.

Federal Telecommunications Acts, if the federal subscriber line charge[i] is added in, Texans generally pay more for their local service today than they did ten years ago.[12] This is in contrast to the declining prices of virtually every other technology service.

Texas also has price floors in law designed to prohibit companies from engaging in so-called "predatory pricing," i.e., offering certain telecommunications services at prices below their long-run incremental costs.[ii] While alleged to protect consumer welfare, price floors in fact do the opposite; they protect businesses from competition and maintain artificially high prices by altering consumer buying preferences and denying them the ability to choose one product over another on the basis of price.[13]

### Telecom Taxes

Taxes are the third major element of the telecommunications regulatory structure in Texas. Texans are highly taxed on their telecommunications services, paying an average of 25.29 percent in state and local telecom taxes—third highest in the nation, versus the national average of 14.17 percent.[14] This includes sales taxes, right-of-way fees, and charges for the Texas Universal Service and Texas Infrastructure funds. Adding federal taxes of almost four percent means that the average total tax bill is almost 30 percent.

Though cable and telephone service are merging together in practice, from a regulatory standpoint they are still treated separately. Texas cable consumers pay a total tax rate of approximately 14 percent.[15]

These high levels of taxation add to the reduction in consumer welfare by adding costs and making the economic decisions of consumers and businesses less efficient. It is worthwhile noting that a state which seeks to preserve low cost telecommunications services for its citizens has one of the highest tax rates in the country.

## Senate Bill 5

By the beginning of 2005, Texas policymakers recognized many of the challenges faced under the aging regulatory structure, and telecommunications promised to be high on the priority list of legislative action. While that proved to be the case, politics, telecommunications industry in-fighting, and school finance caused the legislative session to come to an end without the passage of telecommunications reform.

However, the special sessions on school finance offered legislators another opportunity to address the issue. When Governor Perry added the topic of telecommunications to the legislative call, the legislature responded by passing Senate Bill 5 by Sen. Troy Fraser and Rep. Phil King. It was signed by the governor and took effect September 7, 2005.

Senate Bill 5 addressed each of the regulatory issues described above—subsidies, pricing, and taxes. In addition, SB 5 authorized a state-wide franchise for video and cable providers. Each of these will be discussed below. But in order to understand the legislation's impact in these areas, it is first necessary to examine its overall regulatory framework.

### Regulatory Framework

Senate Bill 5 establishes three different categories of incumbent local exchange companies (ILECs): deregulated, transitioning, and regulated. The status of each company is determined by 1) the size of the markets it serves, 2) the determination of the Public Utility Commission (PUC) as to whether a market served by a company is sufficiently competitive to allow competition, and 3) whether companies choose to be regulated or deregulated—SB 5 allows an ILEC to elect to have all of its markets remain regulated, and thus remain a regulated company regardless of the first two factors.

All markets[iii] which cover an area with a population of at least 100,000 will be deregulated as of January

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[i] The Federal Subscriber Line Charge was instituted after the break-up of AT&T in 1984 to cover the costs of the local phone network. The FCC caps the maximum price that a company may charge for this.

[ii] Long-run incremental cost means the change in the total costs of a company caused by producing a particular product or service.

[iii] A market is a geographic area, which usually embraces a city or town and its environs, in which an incumbent local exchange company provides residential local exchange telephone service.

1, 2006. For markets with populations between 30,000 and 100,000, the PUC must apply a market test defined in SB 5[i] to determine whether there is sufficient competition in a market to deregulate it by the same date. For markets under 30,000, the PUC must determine by rule a market test to be applied in making its determination in whether to deregulate a market. Smaller markets determined to be competitive will be deregulated on January 1, 2007. As noted above, the exception to these designations is the ability of an ILEC to elect to have all of its markets remain regulated.

A company, then, would be deregulated if it serves only deregulated markets. Deregulated companies are generally subject only to market conduct regulations, and retain their obligations of providers of last resort. Pricing regulations also continue in limited fashion.

Regulated companies serve only regulated markets, and are subject to all of the provisions that applied to them on September 1, 2005.

Transitioning companies would be those that serve both regulated and deregulated markets. They are given some flexibility in regulated markets that regulated companies do not have, but lack some of the flexibility in deregulated markets that deregulated companies have.

The regulatory status of companies also affects their long-distance intrastate access rates. The specifics on both pricing and access rates for each of the categories of companies will be discussed below.

There are exceptions to how a company is categorized: as already mentioned, a company may elect to have all of its markets remain regulated by filing an affidavit with the PUC by December 1, 2005, and thus remain a regulated company. Companies may also petition the PUC to deregulate markets they serve after July 1, 2007 in order to change their designation. Additionally, the PUC may re-regulate a market of less than 100,000 that it had previously deregulated.

## Statewide Video Franchise

The statewide video franchise, which began as almost an afterthought in the telecommunications debate, became the centerpiece of SB 5, and will have the most immediate beneficial impact on consumers and the telecommunications industry.

Over the last three decades, cable companies have had to go city by city to secure cable franchises, an expensive and time-consuming process. Local governments used their monopoly status to extract significant concessions from the cable companies, who had little choice but to pay the cities' asking price if they wanted to do business.

Cable companies, understandably, wanted new entrants to face the same hurdle, in order to provide a "level playing field." The solution to the problem of the local franchise, though, was not to subject new entrants to the same onerous regulations, but to create new laws which facilitate entry and lower regulatory costs for all competitors.

Senate Bill 5 accomplished this by making Texas the only state that allows new entrants to receive a state franchise in order to provide video or cable service that competes with existing cable providers. Companies no longer will be required to obtain franchises from local governments. And once current franchise agreements expire, current cable providers will be able to switch to the statewide franchise as well. The impact of this change is already being seen.

SBC had previously announced plans to invest $4 billion dollars to build a fiber-optic network that will provide voice, video, and high-speed internet to 18 million households in its 13 state territory. But now that the legislature has acted, SBC has made it clear that it will be even more aggressive in building out its network in Texas.[16]

Verizon has spent $1 billion to reach a million homes with fiber in its multi-state service region, which includes Texas. But the rollout of new services had been slowed because it was taking Verizon six to 18 months to obtain a single local franchise.

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[i] The market test requires that there be at least three competitors in a market in addition to the ILEC.

The statewide franchise will accelerate Verizon's efforts to offer broadband and video to consumers. The company estimates it will now reach three million homes by the end of this year, and that the deployment effort will create 3,000 to 5,000 new jobs with the company.[17]

And while the cable industry opposed the statewide franchise, it responded to it very quickly. Time Warner Cable recently rolled out new services allowing people to track their eBay bids via their cable TV[18] and display Caller ID on the television screen.[19] New technology in the works will allow cable companies to increase their bandwidth and offer more channels to subscribers.

Perhaps the most clear signal of the benefits of the statewide franchise is that Charter Communication, the first cable-television company to face competition from Verizon's FiOs TV service, has already lowered its cable prices in Keller, Texas in response.

## Subsidies

Approximately 95 percent of all basic residential service in Texas is subsidized.[20] This does not mean, though, that 95 percent of all residential consumers are subsidized. Many consumers buy additional services, such as Caller ID and voice mail, that make up for the low price of their basic service so the telephone company makes a profit. But the fact remains that while charges for basic service run from $13.82 per month in rural areas to $16.72 in urban areas, long-run incremental costs for service range from $11.84 per month in the most densely-populated areas to more than $250 per month in rural areas. Telephone subsidies are a way of life in Texas.

Three subsidies will be discussed in this section: Intrastate access charges, Texas Universal Service, and private network service.

### *Intrastate Access Charges*[i]

The average intrastate access rate in Texas is approximately 6 cents per minute, compared to about 1 cent per minute for interstate access. While information is not available for the entire state, this means that large incumbent carriers (SBC, Verizon, Central, and United) revenue from intrastate access charges may exceed the cost of providing the service by $172 million.

Though all providers rely heavily on these subsidies (along with universal service) for revenue, this excess provided significant political pressure for reducing the intrastate rate, at least in the case of SBC.

Under SB 5, deregulated companies must reduce their intrastate access rates to parity with their interstate rates. Transitioning companies must reduce their intrastate rates to parity with four equal annual reductions, beginning July 1, 2006 for companies already having that designation. The rates, however, are adjusted to reflect the mix of regulated and deregulated markets the companies serve—in effect allowing companies to continue to receive revenue as if their rates in regulated markets had not decreased.

SBC is singled out in this bill; it must decrease intrastate access rates in three equal annual reductions beginning on July 1, 2006.

The intrastate access rates of regulated companies are not affected by SB 5, so companies can avoid reducing their access rates by petitioning the PUC to remain regulated.

### *Texas Universal Service Fund*

Texas established the Universal Service Fund in 1987 to pay for a number of programs intended to enable all state residents to obtain basic telephone service at low prices. The state universal service program subsidizes phone companies that provide service in high cost or small rural areas, subsidizes Lifeline, and Linkup service for low-income customers, aids phone companies that do not opt for alternative regulation with certain costs associated with long-distance service, and pays for telecommunications relay service so that individuals who are speech- or hearing-impaired can use the phone network. The vast majority of the funding is for the high-cost and rural subsi-

[i] Access charges are the per minute fees charged by local telephone companies for providing connections for the origination or termination of intrastate and interstate long distance phone calls.

dies.[21] USF payments for FY 2004 were estimated to be $586 million.[22]

In addition to shifting costs from one set of consumers to another, the USF causes price distortions and associated reductions in consumer welfare that occur because the current percentage assessment increases the cost of every additional wireless and long distance minute. Crandall and Ellig estimate that the USF reduces the welfare of Texas consumers and providers by as much as $177 million annually.[23]

The size of the USF was not the only issue the legislature sought to address in SB 5. Since the market information used to determine USF payments is dated, there was concern among many legislators that the fund is not achieving its intended purpose. Specifically, there is a high likelihood that payments are being made to companies serving areas that were once high cost rural areas but are now lower cost suburban areas, and as such do not need the same amount of support (if any) from the USF. Likewise, their may be rural markets which have decreased in size which might justify higher payments under the current scheme.

Other legislators also questioned USF payments because in many cases they transferred wealth from poorer urban consumers to wealthier rural consumers.

Senate Bill 5 requires the PUC to study the USF and report its findings on questions such as:

- Is the USF accomplishing the purposes for which it is designed?
- Are USF funds being spent for intended purposes?
- Has the USF achieved its purposes?
- Should the USF be abolished or phased out?
- Should the USF be brought within the state treasury?
- Is the current USF funding mechanism adequate in the future?
- Should the current system prove inadequate for future needs, what are alternative USF funding mechanisms?

Senate Bill 5 also adds a new Audio Newspaper program to be supported by USF, requires steps to expand enrollment in the Lifeline Service and allows the PUC to modify USF per-line support after September 1, 2007.

***Private Network Service***

Texas ILECs are required by the Public Utility Code to offer high speed access, or private network service, to a variety of users at reduced rates. While some ILECs are reimbursed for this from the USF, others are not. Thus the full cost of this subsidy is not reflected in USF reports.

The entities eligible to receive this subsidy include public schools, institutions of higher education, public libraries, non-profit hospitals, and the Texas Education Agency.

Under the Public Utilities Code, companies that had elected to be regulated under Chapters 58 and 59 had to provide private network service for six years at fixed rates from the date of their election. However, SB 5 extended this time period, and requires these companies to continue providing this service with no price increases until January 1, 2012, regardless of their election date.

SB 5 also requires the PUC to evaluate "a new funding mechanism to provide financial support to all telecommunications utilities that provide discounts or private network services at prescribed rates."

So not only does SB 5 extend, i.e., increase, subsidies for the eligible institutions, it also contemplates the possibility of increasing taxes or fees to pay for them.

## Pricing Regulation

As previously noted, Texas generally employs price caps, price floors, and tariffed rates to regulate telecommunications prices.

Under prior law, many companies would have been allowed to raise rates for basic service after September 1, 2005, subject to review by the PUC. However, this was put on hold by SB 5.

Now, deregulated companies cannot raise rates for basic service until September 1, 2007. In addition, they must apply rates evenly across a market, consistent with pricing flexibility that was available on August 31, 2005. They are also subject to applicable PUC rules relating to discriminatory and predatory pricing under Chapter 60 of the Public Utilities Code. However, for the most part, pricing regulations on these companies are limited, especially after August of 2007.

As with deregulated companies, transitioning companies are also prohibited from raising rates for basic service in deregulated markets until September 1, 2007. Also in deregulated markets, they are subject to price floors for all services set at the service's long run incremental cost. In regulated markets, they are generally governed by the law as it applied to them before the effective date of SB 5. However, they are given more flexibility in package pricing and in introducing new services.

Various other pricing provisions are contained in SB 5. The bill:

- deregulates residential call waiting and directory assistance;
- regulates (in regulated markets) Caller ID pricing for customers 65 and older;
- establishes a general prohibition on anticompetitive, unreasonably preferential, and predatory pricing;
- prohibits rates for pay phones which exceed the rates for regular business lines; and
- keeps current law which deregulated business access lines on September 1, 2005.

## Taxes

The already high tax burden on telecom taxes in Texas could quite possibly increase under SB 5—exactly how much can't be determined with existing data. The following examines all potential changes to telecommunications and video taxes over the next two years, even though some of these were not included in SB 5.

***Voice Over Internet Protocol***
SB 5 for the first time imposes municipal access line fees[i] on many providers of phone service using VOIP technology. At the time of the passage of the bill, the Legislative Budget Board did not determine the overall impact of this tax increase.

***Telecommunications Infrastructure Fund***
The TIF tax was originally passed to fund Internet and other communications infrastructure in public institutions such as public schools. However, since the infrastructure has been completed, the fund is no longer needed, and the tax would not have been collected any more under existing law. But the legislature kept the TIF tax alive last session at a cost to consumers of as much as $125 million per year, and diverted the funds to general revenue.[ii]

***Statewide Video Franchise Fee***
The statewide video franchise allows video and cable providers to get permission to offer services in Texas from the state instead of local governments. SB 5 imposes a five percent tax on gross revenues for any company that establishes a statewide video franchise. Eventually, there will also be an additional one percent tax in lieu of in-kind services. The six percent tax will be paid to cities where the franchisees do business. The LBB did not determine the consumer cost of this fee.

***Texas Universal Service Fund***
The direct tax consequences of SB 5 regarding the USF are small. SB 5 established a new Audio Newspaper Program to be paid out of the USF. This will increase the revenue needed from the USF only slightly.

The most significant tax impacts, positive or negative, will not begin until 2007 as the legislature and the PUC implement changes to the USF as a result of the studies mandated in SB 5.

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[i] Cities have traditionally charged telephone companies for using the cities' rights-of-way to lay telephone line. VOIP telephone service uses the Internet to reach consumers, using lines for which ROW or franchise access fees have already been paid. Providers of this service had not previously been subject to municipal access fees.

[ii] The TIF provision was in SB 1863.

***Private Network Service***
As with the USF, the most significant implications regarding the Private Network Services (PNS) will be in the coming years. Since SB 5 mandated an extension of the PNS with no increase in rates for at least seven years, consumers will have to bear the burden for this program, either through service charges for services or taxes.

***Right-of-Way Management***
Local government revenue from ROW management was not addressed during the legislative session. However, it is highly likely that the legislature will address this topic with an interim study. The study could include looking at the mechanisms to pay municipalities for 1) utility relocations in the public rights of way and 2) use of the public rights of way. One possible outcome of this study is that the legislature could extend the ROW use fee from traditional landline phone companies to wireless companies, which currently do not pay this fee because they do not use the public ROW.

## Other Provisions

Two other provisions of SB 5 have the potential for having significant impacts on the telecommunications market in Texas. The first is allowing electric utilities to offer Internet service—also known as broadband over power lines, or BPL. This offers the possibility of an additional Internet Service Provider in every market. The second is allowing providers of last resort to use any technology to meet their obligation. This could significantly lower future costs in providing telephone service in rural areas of the state.

# The Road Ahead

The Texas system of state-managed competition in telecommunications must continue its transition toward market-managed competition in order to speed the introduction of new technologies that would provide Texas consumers with better products and services at lower cost. SB 5 is an excellent start in this direction.

As it was 10 years ago, Texas is once again a national leader in telecommunications regulation. The statewide video franchise, BPL, and provider of last resort provisions all introduce competitive forces that will foster investment and innovation. The reduction of intrastate access charges in many markets will begin to reduce these subsidies, with the potential of even greater reductions in subsidies coming from the mandated USF study. The deregulation of basic service in larger markets in two years, along with the provisions in current law deregulating business service and allowing competitive pricing to win back old customers, will provide companies much of the flexibility they need to respond to consumer demands.

All this means that prices for video, voice, and broadband are likely to drop, just as they have in the past as competition increased. And the high tech economy in Texas and elsewhere will expand as the competition attracts new capital, spurs product innovation, and creates new jobs.

However, even with this promising future ahead, there are important issues that still need to be addressed. SB 5 leaves the resolution of significant aspects of the telecommunications market to future legislatures, and sets poor precedent in others. How these issues—regulation, subsidies, and taxes—are resolved over the next two years will likely determine the robustness of competition in Texas in the years to come.

The following discussion of these issues contains recommendations designed to assist policymakers as they implement SB 5, undertake interim studies, and prepare for the continued debate on this issue in the 80th Texas Legislature.

## Regulation

As much as it is improved in SB 5, the regulation of Texas telecom markets still contains too many relics of the monopoly era. One flaw is that the timeline for future deregulation in many markets is determined by market tests[i] (by law or by rule). While market tests can provide information to regulators about competition in a market, they are too often used by incumbents to slow down the transition to competition.

[i] Market tests are tools used by regulators to measure the amount of competition, or the potential for competition, in a particular market.

It is true that major markets with millions of consumers will likely be deregulated at the beginning of 2006—but not without limitations. Basic service in these markets is not deregulated until at least September 1, 2007, prices and services are mandated to be similarly available across a market, and prices cannot be discriminatory or predatory.

The price floors that apply to transitioning companies in deregulated markets also hinder competition. Price floors, like many antitrust provisions, are actually designed to limit competition in order to protect less efficient companies from competition, on the theory that they are needed in order to keep the market competitive. Convoluted reasoning like that can only harm consumers by keeping prices artificially high.

A significant design flaw in the bill is that it provides a disincentive for companies to choose deregulation. Companies operating in deregulated markets must reduce, or begin to reduce, their intrastate access rates more than a year before they would receive pricing flexibility on basic service. So while they face a revenue loss from access charges, they would be limited in how they could recoup the loss.

> **Recommendation:** *The relics of monopoly regulation—such as price caps and floors—should be removed from the current system.* Texas telecommunications policy should reflect the vibrant competition in many markets by immediately removing all price controls in deregulated markets, providing a positive incentive for companies to choose deregulation.

> **Recommendation:** *Firm timelines should be set for the deregulation of all telecommunications markets.* Whatever the size or geographic location of the market, it is clear that technology will soon bring real competition in telecommunications to every part of the state. A phased-in approach to deregulation in mid- and small-sized markets would encourage competition by ensuring market participants (current and potential) understand that competition is inevitable.

## Subsidies

Senate Bill 5 definitely sent mixed signals when it comes to subsidies. On the one hand, it set firm dates for the state's largest telephone company to reduce its intrastate rates to parity with its interstate rates and ordered the PUC to determine whether the USF should be abolished or phased out. On the other hand, it added a new program to be paid for by USF, extended the subsidies for Private Network Service, asked the PUC to consider new funding sources to pay for these subsidies and allowed many companies to opt out of reducing intrastate rates to parity.

> **Recommendation:** *Significant* r*eductions in telecommunications subsidies should be the focus of relevant interim and legislatively-mandated studies*. Subsidies not only transfer hundreds of millions of dollars from one set of consumers to another, they also cause market inefficiencies that harm all consumers. The findings and recommendations of the interim and legislatively-mandated studies should not be value neutral. Instead, they should make it clear that significant reductions in subsidies are a priority—making subsidies more efficient by ensuring they are used for their intended purposes is not sufficient.

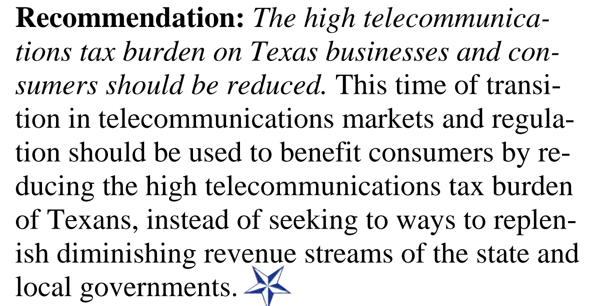
> **Recommendation:** *Reductions in subsidies should be paired with pricing flexibility.* Texas has used subsidies to meet certain policy goals, and companies have come to rely on subsidies. If Texas is going to reduce subsidies and rely more on competition and other means to achieve its goals, it should make competition more attractive to incumbent firms by giving them the pricing flexibility needed to recover lost income from subsidies.

## Taxes

Tax policy is perhaps the weakest aspect of SB 5. While it was clear that Texas telecommunication regulations were in need of an update, quite often one of the benefits of outdated regulations is that the markets have developed in a way so that the tax burden on an industry has actually reduced. This seems to have been the case in Texas.

Municipalities have claimed recent declines in revenues from their right-of-way fees on phone lines as consumers switched to wireless and VOIP services that were not subject to the fees. Video satellite service and the impending Internet Protocol Television (IPTV) threatened to bypass cities' cable franchise fees. And collection of the TIF tax had been scheduled to end.

Unfortunately, the update of the Texas telecommunications tax structure in SB 5 (and SB 1863) was largely designed to enhance diminishing revenue streams, particularly at the municipal level. VOIP providers are now subject to the telecommunications franchise tax, and telephone companies that provide IPTV via phone lines will have to pay two taxes on the same line. While the data are not yet sufficient to quantify the impact, it is clear that the telecommunications tax burden on Texans, already third highest in the nation, will not be improved and could quite possibly increase.



**Recommendation:** *The high telecommunications tax burden on Texas businesses and consumers should be reduced.* This time of transition in telecommunications markets and regulation should be used to benefit consumers by reducing the high telecommunications tax burden of Texans, instead of seeking to ways to replenish diminishing revenue streams of the state and local governments.

## References


[1] Robert W. Crandall, Jerry Ellig, *Texas Telecommunications: Everything's Dynamic Except the Pricing* (Texas Public Policy Foundation, Jan. 2005) 5.

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The Center for Economic Freedom was established by the Texas Public Policy Foundation to champion economic freedom in Texas by providing policymakers with reliable information and practical market-based alternatives to state regulation of transactions between businesses, employees, and consumers.


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