Policy Brief
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Texas Telecom Deregulation: Seeking a Level Playing Field

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Introduction

Telecommunications technology has been rapidly changing since the breakup of AT&T in 1984, producing products and services unforeseen by the courts. One of the major advances has been the convergence of voice, video and data services across all types of telecommunications media.

The regulation and taxation of telecommunications services has not kept pace with the technological changes, resulting in regulatory inconsistency between various products and service providers.

As regulators try to address these inconsistencies, they have moved in the direction of uniform rules that remove the technological and economic disparities found in the old regulations. Yet the regulation and taxation of different services are markedly different.

Senate Bill 5

Texas became the first major state to address the disparate treatment of different technologies and services when it passed SB 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.

Statewide Video Franchise

The most significant aspect of SB 5 is its provision for a statewide video franchise. Texas was the first major state to allow new entrants to receive a state franchise in order to provide video service that competes with existing cable providers. Companies will no longer be required to endure the slow, expensive and anti-competitive process of receiving franchises from local governments.

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. SB 5 moved Texas regulation of cable and video substantially in this direction.

Specifically, SB 5 allows new entrants to file an application for a state-issued certificate of franchise authority with the Texas Public Utility Commission. The application must include 1) an affirmation that the applicant will comply with all applicable federal, state and local regulations, 2) a description of the service area footprint, and 3) the location of the applicant's principle place of business and the names of the applicant's principal executive offices. The commission has 17 business days from the receipt of a completed application to issue a certificate.

With one exception, incumbent providers cannot utilize the statewide franchise until their existing local franchise agreements with cities have expired.

Holders of a state-issued certificate must pay each municipality in which it provides cable or video service a franchise fee of five percent of gross revenue. Certificate holders must also pay to a municipality the same cash payments on a per subscriber basis as required of the incumbent cable provider. Once the in-

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cumbent's local franchise agreement has expired, the holder must then pay an additional one percent of gross revenue. The certificate holder is also required to provide access to public, education and governmental channels, but is not required to provide any additional in-kind services.

Taxes and Fees
Texans pay an average of 25.29 percent in state and local telecom taxes and fees—third highest in the nation. This includes state and local sales taxes, municipal franchise fees, and charges for the Texas Universal Service and Texas Infrastructure funds.

The average Texas local telecom tax rate is 11.32 percent and the average state tax rate is 13.97 percent. Adding federal taxes to the mix means that the average Texan's total telecom tax bill is just under 30 percent, almost one third of the cost of telecommunications services. In comparison, the general business tax rate in Texas is 8.25 percent.

It is important to note that these average tax rates are representative of the tax burden on traditional local phone service. Not all services are taxed the same. Cellular service in Texas is taxed less because it is not subject to the municipal franchise fee. Cable service has an average rate in Texas of about 14 percent, though cable companies offering traditional phone service generally face a similar level of taxes and fees on that service as phone companies. Satellite service faces an even lower burden, having to pay only state and local sales taxes. And though the status of Voice Over Internet Protocol (VoIP) service is uncertain, it could likely face a lower tax burden than traditional phone service.

The PUC has published a proposed rule in order to implement provisions of SB 5 that define voice services. Many Texas cities want to have franchise fees apply to any provider of voice services—like VoIP—regardless of their physical presence in the right-of-way. The PUC seems to agree with this in its proposed rule and may have gone beyond what is necessary to implement SB 5.

Deregulation
Local telephone service for more than 15 million Texans was deregulated as of January 1, 2006. Thanks to SB 5, this was a major step forward in reducing costs and bringing new technologies and services to million of Texas.

But there is still room for improvement. Even though more than 15 million Texans live in areas where telephone service has been deregulated, only three incumbent phone companies serve those people. The vast majority of phone companies will continue to operate in regulated markets serving over 7 million Texans located mostly in rural Texas.

The PUC should be commended for its work in implementing the deregulatory provisions in SB 5. It has done a good job in both the application of the statutory market test for mid-markets and the development of a market test for small markets.

Impact of SB 5

This legislation has already had a significant positive impact on Texas consumers and its economy.

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. For instance, SBC Texas announced it would invest $800 million in video and high-speed Internet access technology for the state.

Verizon had 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.

The statewide franchise has accelerated Verizon's efforts to offer broadband and video to consumers. The company estimated it would reach three million homes by the end of last year, and that the deployment effort will create 3,000 to 5,000 new jobs with the company.

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 and display Caller ID on the television screen. New technology in the works will allow cable companies to increase their bandwidth and offer more channels to subscribers.

Perhaps the clearest signal of the benefits of the state-wide 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.

Recommendations

The Texas legislation provides an excellent model for other states to follow in reforming the local franchise. However, both the statute and the implementation of statute could be improved as follows:

Deregulate Telephone Rates in Texas
Both the Legislature and the PUC in their respective roles should be aggressive in leveling the regulatory playing field by deregulating pricing for all providers in all geographic areas of the state.

Provide a (Lower) Level Playing Field for Telecom Taxes
The Texas tax system should be changed to provide a technologically neutral application of taxes across the spectrum of providers at a lower level than today's high rates. There is no reason—other than to maintain or increase state and municipal revenues—that traditional phone service should be taxed more than VoIP, cable or satellite services.

Allow Incumbent Providers to Opt Out of Existing Municipal Franchise Agreements
Incumbent cable companies should be allowed to opt out of their existing local franchise agreements with cities. While SB 5 attempted to level the playing field between the new entrant and existing franchise holders, the best way to accomplish this is to provide the incumbents the ability to opt out.

Carefully Monitor the Cost and Application of Franchise Fees
Municipal franchise fees have become divorced from paying for the cost of managing the right-of-way. This is true for both the amount of the fees and the applicability of the fees to varying services. Ultimately, the burden of these fees on consumers should be reduced.

Reduce the Size of the Universal Service Fund
In order to ensure that the fund serves as a "competitively neutral mechanism" for "providing basic local telecommunications service at reasonable rates in high cost rural areas," the primary focus should be on reducing its size. This could be accomplished by:

- Allowing the price of basic local service to rise to better reflect actual costs
- Use all savings from lower costs identified in an updated cost study should go toward reducing the size of the fund
- Provide more careful targeting of fund programs to those who truly need them
- Eliminate mandated provision of Private Network Service

Conclusion

Technological change is often disruptive, but new technologies have introduced tremendous efficiencies into the market. New entrants, incumbent providers and consumers should be able to profit from these efficiencies.

The way to do this is to provide a level playing field for all market participants. But this has to be implemented properly by lowering taxes and reducing regulatory burdens. Attempts to level the playing field by increasing taxes or regulations on those less heavily regulated in order to guarantee stable state or municipal revenues in an ever changing market will limit the benefits of these efficiencies to consumers and the economy and stifle future technological innovation.

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