SUMMARY OF THE FCC'S *THIRD REPORT AND ORDER* LIMITING CABLE FRANCHISE FEE PAYMENTS AND PREEMPTING LOCAL AUTHORITY OVER NON-CABLE SERVICES

August 9, 2019

On August 2, 2019, the FCC released a *Third Report and Order* in its 2005 docket interpreting provisions of the federal Cable Act. As summarized below, the *Third Report and Order* ***allows cable operators to deduct from franchise fees the fair market value of cable franchise requirements***, with limited exceptions, and ***largely preempts states and local governments*** from regulating the non-cable services and equipment of franchised cable operators, including their Wi-Fi and small cells equipment.

The *Third Report and Order* ***will take effect 30 days after publication in the Federal Register***. We do not have a date certain for Federal Register publication, but it could be as early as mid-August, leading to a mid-September effective date.

REVISED DEFINITION OF "FRANCHISE FEE" AND DEDUCTIONS FROM FRANCHISE FEES

The federal Cable Act caps the cable franchise fees that franchising authorities may charge cable operators at 5% of their gross revenues derived from the operation of the cable system to provide cable services. The Act further defines a "franchise fee" to include "any tax, fee, or assessment of any kind imposed by a franchising authority or other governmental entity on a cable operator or cable subscriber, or both, solely because of their status as such," subject to certain exemptions. In the *Third Report and Order*, the Commission has determined that a "franchise fee" includes non-monetary franchise obligations, which it calls "in-kind, cable-related contributions." The result of this determination is that ***cable operators will quantify many cable franchise obligations at "fair market value" and, where the franchise provides for a franchise fee at the maximum 5% cap, deduct that amount from the monetary franchise fee payment*** in order to stay within the cap.

The following is a summary of additional details on this portion of the *Third Report and Order*:

- Defines "in-kind, cable-related contributions" to include "any non-monetary contributions related to the provision of cable services provided by cable operators as a condition or requirement of a local franchise, including but not limited to free or discounted cable service to public buildings, costs in support of PEG access other than capital costs, and costs attributable to the construction of I-Nets. It does not include the costs of complying with build-out and customer service requirements."

- The Commission concludes that "most cable-related, in-kind contributions are encompassed within this definition and thus must be included for purposes of calculating the statutory five percent cap on such fees."
- The *Third Report and Order* discusses application of this definition to a few specific franchise provisions (as outlined below), however, the definition is not limited to provisions expressly addressed in the *Order*. It is not clear what other cable franchise provisions may fall into the definition and thus it is difficult to determine the full financial impact of the *Order*.

- Exclusions from "in-kind, cable-related contributions"—***franchise provisions that cannot be deducted from franchise fees***—are:
  - ***Capital costs for PEG access facilities.***
    - The *Third Report and Order* includes a new definition of "capital costs" that is more inclusive than the Commission's prior definition: "[T]he term 'capital cost' in section 622(g)(2)(C) should be given its ordinary meaning, which is a cost incurred in acquiring or improving a capital asset. … [T]he exclusion for capital costs under section 622(g)(2)(C) could include equipment that satisfies this definition, regardless of whether such equipment is purchased in connection with the construction of a PEG access facility."
    - See below for a discussion of how this definition applies to certain PEG facilities.
  - ***Build-out requirements*** (*i.e.*, franchise provisions requiring cable operators to be capable of providing cable service to all households in the franchise area within a reasonable period of time as provided in 47 U.S.C. § 541(a)(4)(A)).
  - ***Customer service obligations***.

- Application to specific franchise provisions:
  - <u>PEG Channel Capacity:</u> Though the *Third Report and Order* finds that non-capital PEG-related franchise provisions are franchise fees, the Commission ***does not allow the offset of PEG channel capacity <u>at this time</u>.***
    - The Commission found that "the record is insufficiently developed" for it to determine whether or not PEG channel capacity is a "capital cost" that is excluded from the definition of "franchise fee."
    - The *Order* "encourage[s] parties to ***supplement the record*** on the channel capacity issue. To the extent that we are provided sufficient information to answer the complex questions raised by channel capacity, ***we intend to resolve them in the next twelve months.***"
  - <u>PEG Transport Facilities:</u> The *Third Report and Order* finds the installation of "PEG transport facilities" are capital costs that are exempt from the 5% franchise fee cap. However, ***maintenance and use of PEG transport facilities are operating costs that count toward the cap***.

        - "PEG transport facilities" are "facilities dedicated for long-term use by a PEG provider for the transmittal of recurring programming to a cable headend or other point in the cable system."
        - "Episodic" or "short term" PEG transport connections are considered non-capital costs and thus are counted toward the 5% cap.
    - I-Nets: The *Third Report and Order* finds that ***the construction, maintenance and service of I-Nets are included in the 5% franchise fee cap***. Note that this is different from the determination with respect to PEG transport facilities, for which installation costs are capital costs excluded from the cap.

- Calculation of franchise fee deduction:
    - Franchise obligations considered "franchise fees" under the *Third Report and Order* are to be ***valued at fair market value***.
        - "[W]here there is a product in the market, [fair market value] is the most reasonable valuation for in-kind contributions because it is easy to ascertain—cable operators have rate cards to set the rates that they charge customers for the services that they offer."
        - In a footnote, the *Third Report and Order* suggests that "certain business or enterprise services may be comparable to I-Nets."

- Process for implementing the franchise fee provisions of the *Third Report and Order*:
    - The *Third Report and Order* is ***prospective only***; cable operators cannot recoup past franchise fee payments.
    - However, the *Third Report and Order* ***applies to existing franchise agreements, including state franchises,*** and contemplates cable operators and franchising authorities will agree to franchise fee deductions and/or franchise modifications to address the *Order* without waiting for the franchise renewal process.
        - The Commission "encourage[s] the parties to negotiate franchise modifications within a reasonable time and find[s] that 120 days should be, in most cases, a reasonable time for the adoption of franchise modifications."
        - If an agreement to modify the franchise is not reached, any provision of a franchise agreement that is inconsistent with the *Third Report and Order* "is subject to preemption under section 636(c)."
    - The Commission contemplates a process in which franchising authorities will be able to decide whether to (1) continue to receive the "in-kind cable-related contributions" and thus accept a reduced monetary franchise fee payment; (2) "discontinue" that contribution and receive the full monetary franchise fee payment of 5% of gross revenues; or (3) reduce the contribution (*e.g.*, continue free cable service to some public buildings but not others) and accept a reduced franchise fee payment based on the adjusted contribution.

- Franchising authorities ***may not ask a cable operator to voluntarily waive or forego the franchise fee deductions allowed by the*** **Third Report and Order.** The Commission stated, "Complying with the terms of the statute is not optional."

MIXED-USE RULE AND PREEMPTION

The "mixed-use rule" is the Commission's rule to address regulation of and authority over the non-cable services cable operators provide over their cable systems. In the earlier *Orders* in this docket, the Commission found that local governments could not use their cable franchising authority under the Cable Act to regulate some cable operators' non-cable services. The Commission previously acknowledged that this original version of the mixed-use rule "does not affect the authority of local authorities to regulate non-cable services under other applicable regulatory regimes." In other words, the rule did not preempt local authority over non-cable services that may exist outside the context of the Cable Act. The *Third Report and Order* ***extends the mixed-use rule to all cable operators and includes a significant new preemption of state and local authority over cable operators' non-cable services.***

- The mixed-use rule "***prohibit[s] [franchising authorities] from using their cable franchising authority to regulate any services other than cable services provided over the cable systems" of any cable operator, with the exception of channel capacity on I-Nets.***
  - Note that even though franchising authorities can require I-Nets as provided in the Cable Act, as described above, the *Third Report and Order* states that I-Nets are "franchise fees" and thus the value of the construction, maintenance and service of I-Nets are subject to the franchise fee cap.
- The *Third Report and Order* "***expressly preempt[s] any state or local requirement, whether or not imposed by a franchising authority, that would impose obligations on franchised cable operators beyond what Title VI allows.***" The preemption includes:
  - "[A]ny imposition of fees on a franchised cable operator or any affiliate using the same facilities franchised to the cable operator that exceeds" the Commission's new definition of "franchise fee" discussed above, "whether styled as a 'franchise' fee, 'right-of-access' fee, or a fee on non-cable (e.g., telecommunications or broadband) services."
    - The *Third Report and Order* states that "installation of Wi-Fi and small cell antennas attached to the cable system" are part of the cable system and thus ***states and local governments cannot impose separate rights of way fees on cable operators' Wi-Fi and small cell attachments.***"

- "[A]ny requirement that a cable operator with a Title VI [cable] franchise secure an additional franchise or other authorization to provide non-cable services via its cable system."
    - The Commission found that ***the cable franchise "bestows the right to place facilities and equipment in rights-of-way" to provide "cable and non-cable services, such as wireless broadband and Wi-Fi services***."
- States and local governments may impose requirements on non-cable facilities and equipment designed to protect public safety, so long as such requirements otherwise are consistent with the provisions of Title VI. The scope of this authority is not clear from the *Third Report and Order*:
    - "Our decision today ***still leaves meaningful room for states to exercise their traditional police powers*** under section 636(a). While we do not have occasion today to delineate all the categories of state and local rules saved by that provision, we note that states and localities under section 636(a) may lawfully engage in rights-of-way management (e.g., road closures necessitated by cable plant installation, enforcement of building and electrical codes***) so long as such regulation otherwise is consistent with Title VI.***"

APPLICATION TO STATES

The *Third Report and Order* finds that the new rules will apply to states as well as local governments. Note that this is not limited to circumstances in which the state is the franchising authority. The rules apply to "franchising actions taken at the state level and state regulations that impose requirements on local franchising."

Not only will the rules set out in the Third Report and Order apply to both states and local governments, so, too, will the findings of the First Report and Order[1] and Second Report and Order[2] in this docket. Some of the applicable provisions from the *First Report and Order* and the *Second Report and Order* now applicable to states (which continue to apply to local governments) include:

- Shot clocks for granting or denying competitive franchise applications; and
- Guidelines and limitations on the build-out, PEG and Institutional Network ("I-Net") requirements that may be included in franchises for new entrants to the cable market.

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[1] *Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as Amended by the Cable Television Consumer Protection and Competition Act of 1992*, Report and Order and Further Notice of Proposed Rulemaking, 22 FCC Rcd 5101 (2007) ("*First Report and Order*").

[2] *Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as Amended by the Cable Television Consumer Protection and Competition Act of 1992*, Second Report and Order, 22 FCC Rcd 19633 (2007) ("*Second Report and Order*").