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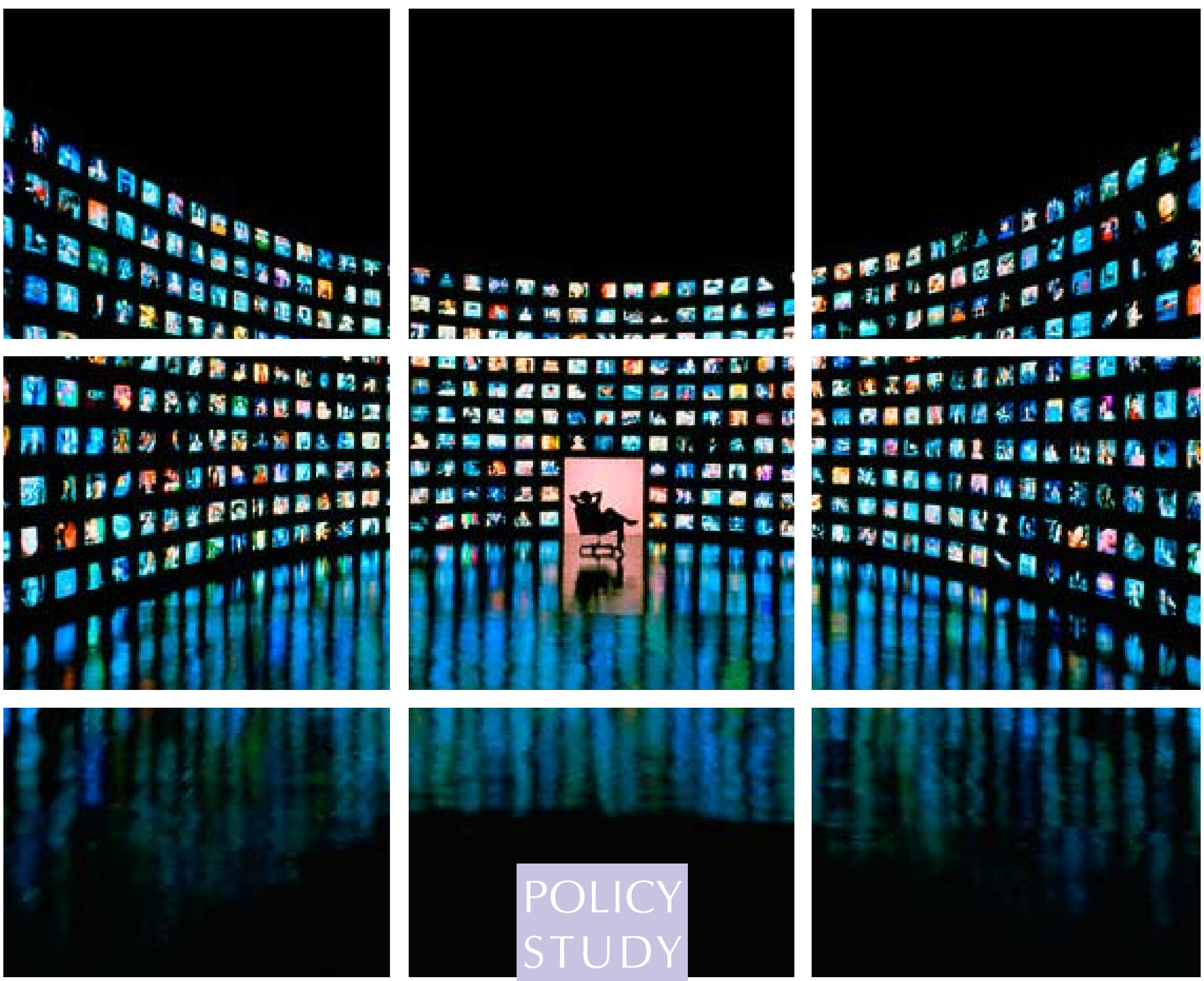

POLICY STUDY 352

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Part 1

Introduction

Video franchises are the revenue-sharing agreements that cable TV companies sign with local governments in return for the right to offer video services to customers. Historically, in return for the revenue the company gives the municipality (a portion of gross video revenues), cable TV companies get exclusive use of the city's right of way and monopoly use of the market. As the country's largest telephone companies begin to deploy broadband networks that can support cable TV-like services, they have been pressing for changes in the process. They are pushing legislation that would not only open franchises to competition, but also let them apply for a statewide franchise in one fell swoop, eliminating the need to go from municipality to municipality to negotiate individual agreements, as cable companies were forced to do in the past.

For the phone companies, these national or statewide franchises offer expedited but not exclusive market entry, faster revenues and a more predictable procurement and deployment schedule. For incumbent cable TV companies that already enjoy exclusive franchises for municipalities, it removes their monopoly, allowing competitors to serve the needs of the market and to do so on a statewide or even nationwide basis. For customers, this reform allows them to choose their services from several competitors, driving prices down and service up. Predictably, cable TV companies are resisting this reform movement.

In August 2005, Texas became the first state to pass legislation to create statewide franchising. Since the beginning of 2006, seven more states, California, Indiana, Kansas, New Jersey, North Carolina, South Carolina, and Michigan, have enacted similar legislation. Virginia and Arizona enacted franchise reform, but stopped short of authorizing statewide authority. The Louisiana legislature also passed video franchise reform legislation, but it was vetoed by Gov. Kathleen Blanco.

Statewide franchising initiatives were in the pipeline in at least four other states as of September 2006. In six others, legislation was proposed but died in committee or did not make it to the floor before the spring 2006 legislative session adjourned.

National franchising is a provision of the Communications Opportunity, Promotion and Enhancement (COPE) Act of 2006 (H.R. 5252), sponsored by Reps. Joe Barton (D., Tex.) and Bobby Rush (D., Ill.). In the Senate, the Communications, Consumer Choice, and Broadband

Deployment Act (S. 2686), sponsored by Sens. Ted Stevens (R., Alaska) and Daniel Inouye (D., Hawaii), calls on the Federal Communications Commission (FCC) to standardize the franchise process, but preserves a degree of authority to municipalities. COPE passed the House in early June. The Senate bill, more sweeping in its approach to telecom deregulation, has been bogged down in a partisan fight over network neutrality, a doctrine that would prohibit carriers from offering large web sites, such as Google, Amazon.com, eBay and others, as well as their own partners, higher speed and quality guarantees for a higher fee. The Senate bill did not pass, but both bills are expected to be reintroduced in 2007.[1]

Historically, in return for the revenue the company gives the municipality, cable TV companies get exclusive use of the city's right of way and monopoly use of the market.

Consumers have proved generally supportive of franchise reform, which promises to deliver a new competitive alternative to local cable companies, which dominate local markets, even where direct broadcast satellite (DBS) services are an option. After the bill failed during the Texas legislature's regular session in the spring of 2005, constituent pressure put it back on the docket in the special session that summer, when it passed.

In line with this, bi-partisan support for franchise reform has also been increasing. Republicans led the first franchise reform efforts in Texas and Indiana. When the issue reached the Democrat-controlled state assembly in California, legislators there voted 77-0 on a statewide initiative. In the vote on COPE in the House, Democrat members voted 106-92 in favor of the measure.

While federal and state franchise reform proposals differ in their specific details, they broadly address and codify five areas.

- They set the maximum percentage of "gross video revenues" that local franchise authorities can collect from a video services provider. This defines the revenue stream municipalities can collect from a provider.
- They address specific rights local agencies have in terms of regulating service provider use of public rights-of-way.
- They specifically define income that counts "gross video revenues."
- They detail service provider requirements as to the provision of public, educational and government (PEG) channels in local communities.
- Finally, in one of the more controversial aspects, they change or eliminate "build-out" requirements for new entrants, permitting competitors to launch service to portions of the community ahead of others.

Aside from the cable companies, which have lobbied heavily against franchise reform, resistance has been strongest from municipalities and local franchise agencies, which fear loss of a key revenue stream as well as a point of political leverage. The National Cable and Telecommunications Association reports that the cable industry pays $2.6 billion per year in franchise fees.[2] The National Association of Telecommunications Officers and Advisors (NATOA) has been particularly vocal in its opposition.[3]

Curiously, some of the most visible consumer advocate organizations, including the Consumers Union, the Consumer Federation of America, the U.S. Public Interest Research Group and FreePress, urge preservation of local franchise schemes, even if it means placing monopoly regimes and putting higher service rates ahead of accelerated competition and consumer choice. They fear statewide franchises will close down revenue flow to local governments. From a social perspective, they fear that without mandated build out requirements, new entrants will bypass middle and low-income households and build out only to the rich.[4]

Yet none of the franchise reform legislation that has thus far been proposed stops the flow of money to local franchise authorities. Some bills, however, place limits on how the funds may be used; others narrow the definition of “gross video revenues” to reduce the scope of the revenue pool that falls under a percentage formula.

Even so, there have been calls for more radical reform of the franchise process. Anaheim Mayor Curt Pringle views franchise fees as nothing more than an additional tax levied on broadband—a service with numerous economic and social benefits to individuals and communities. In Pringle’s opinion, franchise fee assessments are unnecessary government intrusions into what is now a competitive market. They discourage sound investment in infrastructure and Internet services. In letters and testimony, Pringle has recommended that cities wean themselves from franchise fee revenues.[5]

Meanwhile, two other states already have ruled that telephone companies do not require a new franchise to offer TV or video services to their customers.

In Oklahoma, Attorney General Drew Edmondson issued an official opinion stating that a telephone company with existing statewide authority to place its phone lines in the public rights-of-way doesn't need to obtain separate municipal franchises if it plans to provide additional services—including video—over its phone lines. “A ‘telephone line’ does not cease to be a telephone line because it is used for transmitting video service in addition to voice service,” Edmondson wrote in his opinion. “Although we can find no Oklahoma cases on this point, cases in other jurisdictions that grant telephone companies statewide access to rights-of-way have decided this issue.”[6]

In Connecticut, the state’s utility regulatory commission, the Department of Utility Control (DPUC) ruled that telephone companies that use Internet Protocol television (IPTV) platforms are not subject to franchise fees. Internet-protocol television is “merely another form of data stream,” the DPUC ruled.[7]

Oklahoma and Connecticut are the first states to draw a distinction between video services based on the delivery platform they use. These rulings could have an impact on what types of video service revenues are “eligible” for franchise fees in states where telephone companies are required to pay them.

Cable TV systems, as well as Verizon’s new FiOS fiber optic video service, receive satellite signals at a local downlink point—called a head-end—and retransmit them to homes via their own facilities. The viewer selects from the hundreds of channels piped down the cable using a set-top box, which replaces the old TV channel knob some may remember from their youth.

AT&T has always maintained that its U-Verse IP video service is not cable TV in the classic sense. Indeed, the case can be made that the U-Verse set-top box works much more like a browser than a tuner. With U-Verse, the viewer downloads video the same way he or she might do so from a Web site, although AT&T’s content is streamed and optimized for viewing on a large-screen TV. As a result, AT&T’s content is not passively delivered like cable. The user must “command” his set-top box to go out to the Internet and retrieve it. AT&T is a service provider in Oklahoma and Connecticut, although in Oklahoma, at least one small phone company, Pioneer Telephone Cooperative, has been delivering video over DSL lines for at least a year.[8] But despite these differences, some legislation, including the Stevens-Inouye bill in the Senate, includes IP video platforms in the definition of video services.

With passage of national video franchise reform still in question, and more and more states taking up the issue, there is an opportunity to study questions of video competition and the effectiveness of franchise fees as a policy, not only for cable TV, but broadband Internet services. The remainder of this report will show how streamlining the franchising process speeds competition and holds down prices. The report will discuss federal and state legislation that has passed or is pending. It will also examine whether video franchising is a sound policy as the service providers become part of the larger supply chain for broadband services. Finally, it will explore the changing ways entertainment and information are being delivered to the home and whether cities and towns can rely on franchise fees as a source of revenue for the long term.

Part 2

The Benefits of Franchise Reform

Franchise fees are largely a product of the cable monopoly era. In addition to right-of-way, cities felt justified in charging a franchise fee for the right to exclusivity. In return, cable companies were required to build out infrastructure to all parts of the franchise area.

The notion of cable "exclusivity" was undermined by the entrance of direct broadcast satellite (DBS) companies into the home entertainment market. The two principal DBS companies, DirecTV and Dish Network, have garnered 27.7 percent of the multichannel video programming market as of 2005, according the FCC.[9]

DBS does not fall under local jurisdiction. Providers are not subject to franchise fees or build-out requirements. The rationale has been that they use public airwaves regulated by the FCC, not local right-of-way.

Telephone companies, however, do require right-of-way. With dial tone revenues shrinking, phone companies are anxious to move ahead with video and broadband services in order to create new revenue streams. Hence, as phone companies expand into video services, local franchise agencies demand the same franchise agreements that have been standard with cable TV players, in effect paying municipalities for a guaranteed customer base.

The chief objection phone companies have is the length of time it takes to negotiate local franchise agreements. "A franchise can take anywhere between six to 18 months to negotiate. The network itself only takes about 18 months to build," Bill Kula, a spokesman for Verizon, told CNET's News.com last year.[10]

Separately, citing Verizon sources, the Heartland Institute reported that the company had been able to negotiate only 20 agreements in two years for its new video service. Without statewide franchising, AT&T faces the prospect of negotiating 2,000 to 2,500 separate agreements in its 13-state service area. "At that pace it would take decades for innovative video services to reach consumers," wrote Joseph Bast, president of the Heartland Institute.[11] This delay not only confounds business plans, but keeps consumers from accessing a market that may better serve their desires.

Local franchise authorities—and the cities and towns they represent—however, fear loss of revenues and regulatory control. Some appear willing to hold up competitive entry to sort it out. For example, the village of Roselle, Ill., in March passed an ordinance halting AT&T's broadband and video upgrades for 180 days while the village determines if the network additions require a separate video franchise.[12]

The vote coincides with a coordinated push by the DuPage County, Ill. Mayors and Managers Conference to halt phone network upgrades in cities, villages and towns within in this suburban Chicago county of some 1 million residents.

In a memo to DuPage officials, Mark Baloga, executive director of the DuPage Mayors and Management Conference, recommended towns immediately pass ordinances similar to Roselle's that outright halt local network upgrades. He further advised communities to stop granting right-of-way permits to AT&T and urged cities to adopt new ordinances that specifically create franchise regimes that cover the services AT&T is proposing.[13]

Towns that follow this advice may do so at risk of consumer backlash. As noted, franchise reform has popular support. And with franchise reform moving forward in some states, the promised benefits indeed have begun to materialize.

As phone companies expand into video services, local franchise agencies demand the same franchise agreements that have been standard with cable TV players, in effect paying municipalities for a guaranteed customer base.

A. Video franchise reform is good for consumers.

Video franchise reform allows competition to enter the market faster. Competition drives down prices. This has been demonstrated in Texas, which enacted statewide franchising in August.

With a statewide video franchise in hand, Verizon in January rolled out its FiOS fiber-optic video service in Keller, Plano and Lewisville, three communities near Dallas. The Pacific Research Institute tracked the results.

> *[Verizon] offered 180 video and music channels for $43.95 a month, or a 35-channel plan for $12.95 a month. It also offered three tiers of fast Internet access over fiber for $34.95 to $199.95. In response, the local cable company, Charter Communications, dropped its prices, offering a package of 240 channels and fast Internet service for $50 a month. That amounts to big savings for the people of Keller, compared to the hefty $68.99 Charter once charged for a TV package alone.*[14]

Both the FCC and Government Accountability Office have found that *when* cable markets are competitive, prices are 15 percent or more lower for customers.[15]

B. More studies link franchise reform and cable savings.

Franchise reform could net an annual economic payoff of $9 billion for U.S. consumers, according to an extensive new report from George Mason University. "Were head-to-head wireline video rivalry, now offered to just under five percent of U.S. households, to extend nationwide, annual benefits to consumers are estimated to approximate $9 billion, with overall economic welfare increasing about $3 billion per year."[16]

The 81-page GMU report addresses the financial stakes of the battle over franchising and why both incumbent cable companies and local franchising authorities tend to fight it. While reform offers consumers $9 billion in economic benefits, author Thomas W. Hazlett writes, cable companies stand to lose as much as $6 billion per year in profits if direct competition were to break out nationwide. At the same time, Hazlett says, "an open, predictable franchising process that restricted the discretion of local regulators would also cause a reduction in the rent extraction and redistribution opportunities available to local government leaders and interest groups influential at City Hall."[17]

But many of these concerns are trumped by the savings consumers inevitably see when competition enters the market. Hazlett cites FCC measurements of competitive and non-competitive cable markets that found subscription prices for basic and expanded basic services were on average 16 percent lower in the competitive group.

Hazlett recognizes that cities do incur costs when they need to accommodate cable construction and municipalities are entitled to compensation for use of right-of-way (ROW). These costs, he asserts, can be divorced from the "raw horse trading" of franchise payments over and above true liability. This reduces, if not eliminates the problem of regulatory favoritism, unlevel playing fields and general competition through rent-seeking.

"The optimal policy approach…opens entry into cable TV markets while maintaining rules that impose liability on operators for the costs they may impose," Hazlett writes. "Without barriers to entry, there is no artificial scarcity and the franchise 'auction' is eliminated, as general rules are enforced for use of public [rights-of-way] and the number of competitors is determined by the marketplace. Thus ends the rent seeking competition for special privilege."[18]

Elsewhere, in another new report, Yale M. Braunstein, a professor at the School of Information at the University of California at Berkeley, predicts cable competition franchise reform will save California consumers between $690 million to $1 billion annually. Braustein calls on the same FCC data that Hazlett uses, but takes a closer look at several markets in California.[19]

C. The phone companies have begun rollout.

It is true that telephone companies have talked about competing in video for years and even seasoned industry veterans have taken an “I’ll-believe-it-when-I-see-it” attitude. Today, the effort can be seen. Verizon has deployed FiOS TV in more than 100 communities across its service territory, and it plans to reach a total of 3 million homes by the end of this year. AT&T’s Project Lightspeed is a plan to invest $4 billion to $5 billion and install 40,000 miles of new fiber optic lines to 18 million homes in the next three years.

The telephone companies have signed multi-million-dollar contracts with manufacturers of cable TV equipment such as Scientific-Atlanta and Motorola. In its annual report to shareowners, Motorola says it expects sales to phone companies to account for major near-term revenue growth.

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D. Rollout has not been limited to wealthier neighborhoods.

While new entrants were expected to target well-to-do households first, there is evidence that phone companies are seeking opportunities wherever they can find them and that fears of “red-lining”—that phone companies would ignore low-income areas—are misplaced.

Benefiting from franchise reform in Indiana, Verizon chose to begin deployment of its FiOS service in Ft. Wayne, not in the city’s tony Sycamore Hills neighborhood, which is surrounded by a Jack Nicklaus-designed golf course, but in the low-income Hanna-Creighton neighborhood. “Hanna-Creighton…beset by vacant lots and decaying homes—is on track to be among the first areas in the Midwest to have Internet service that at its slowest download is 89 times faster than a traditional dial-up modem. At its fastest, the fiber-optic network is 536 times faster,” according to the *Ft. Wayne Journal-Gazette*.[20]

AT&T, meanwhile, perhaps with an eye toward offering future connectivity, has announced a $100 million grant program aimed at providing low-income households with PCs and Internet access. The national program, administered by the AT&T Foundation, aims to offer two years of free high-speed Internet access and affordable computers to qualifying households as early as the end of this year.[21]

E. Franchise fees constitute a discriminatory tax.

While local agencies may have become dependent on revenues from franchise fees, they remain at heart, a special tax. Taxes, by nature, are a barrier to entry. In the past, it might have been easier to justify a cable franchise fee on the basis that the service was largely TV entertainment. Today, video service providers also offer broadband Internet services, which have greater social value in terms of education, commerce and communications. The broadband dimension raises the question if special taxes on these services are desirable.

F. Good legislation can address local concerns.

Concerns of local communities need to be taken seriously. Franchise reform can be accomplished while addressing local concerns. The babies of revenue, local control and service to the poor do not have to be thrown out with the bathwater of franchise fees. When applied judiciously, a fair system can serve everyone's needs—the municipality, the customer and poor communities—without closing the market to competitors.

Part 3

A Competition-Friendly Approach to Franchises

The free-market perspective calls for a light hand in all these provisions. Franchise fees are both a form of discriminatory taxation and intrusive regulation, both of which, from a free-market angle, should be resisted. On the other hand, phone and cable companies do require the use of public thoroughfares as a matter of course, so from this perspective, the local government, as steward of these public "commons" on behalf of taxpaying residents, is entitled to seek compensation for their use, just as any property owner is entitled to seek rent from a tenant.

Likewise, when phone and cable companies do construction and maintenance on their networks, it often requires closing or obstructing public streets and sidewalks, and sometimes follow-up repair. Again, municipalities, acting on behalf of their citizens, are within their rights to seek compensation or remuneration for the inconvenience this work causes.

In the most just of environments, service providers would only be responsible for paying rents for right-of-way, pole use and other resources (just as they would pay a private owner), and any cost they impose on the owner. The services they offer through that infrastructure, be it cable TV, Internet or phone, would be inconsequential.

Telephone and cable companies would pay these fees because their physical infrastructure uses public right-of-way. This is a legitimate differentiation from satellite companies, video rental stores and Internet-based video aggregators—all of whom provide video services but through different delivery methods.

Ideally, the municipality would set market-based rents for right-of-way. To run a cable conduit down Main Street would cost X dollars. Revenue percentages would not enter into the formula, creating the most level playing field.

Such a regime could not even be called "franchise fees." A franchise agreement implies protection or restriction or exclusivity of service, which cities can no longer guarantee because of so many competitive video alternatives that now exist beyond the reach of regulators.

Even so, it will be difficult in practice to wrest away the use of revenue percentage formulas from the municipal agenda. That said, franchise reform initiatives should require the bulk of franchise fees to pay for right-of-way and related costs. This at least directs service provider payments to the areas where they extract the most costs. The best bills prohibit the assessment of additional right-of-way fees and surcharges on service providers. Some, such as the vetoed Louisiana bill, did just that.

The definition of video revenues should be limited to the income for provision of retail cable TV services. This would include the monthly fees for basic and expanded basic service, set-top box rental, premium channels and pay-per-view. It should not include revenue from local advertising—as that is not a video service. Nor should it tax commissions received from home shopping networks on sales made to the company's cable customers. These revenues do not derive from use of right of way or public property. The service provider's income from both derives from its success in marketing service to the homes its cable passes, not from laying the cable itself. If a cable company can deliver viewers, its appeal to advertisers goes up. Likewise, home shopping commissions also relates to the number of subscribers a cable company has. They are a marketing incentive, not a matter of right-of-way.

Franchise fees are both a form of discriminatory taxation and intrusive regulation, both of which, from a free-market angle, should be resisted.

Carriers should make space for PEG channels, but they should not have to fund or furnish PEG equipment and facilities. If a town wishes to create its own TV programming, its government can vote to allocate the resources. Many cities and towns now operate their own Web sites, some very sophisticated. Yet they do not demand their ISPs to fund or furnish their Web server, programming, design or administrative services. Many franchise reform bills, including the federal bills, call for a 1 percent fee over and above a principal franchise fee. These assessments are both unnecessary and unfair.

Franchise reform should contain no build-out requirements. Although controversial, such a provision recognizes that competition functions better than regulatory mandates. Time and again, free market mechanisms prove themselves far better at delivering desired services to the greatest number at the lowest price. There is no reason to expect any different in cable and video services.

Opponents fear that new entrants will focus only on the high-end of the market unless forced to extend infrastructure to all parts of the community. But there is no evidence to support this, only supposition. Thus far, phone companies have priced video services below cable price points and targeted users of all incomes. This makes sense. It is easier—and more cost-effective in terms of marketing dollars—to cultivate new users than lure away a captured clientele. Phone companies are aiming to do both, to be sure, but it would make no sense for them to exclusively target the high-end.

Another criticism, heard mostly from cable companies, is that build-out provisions have long been part of their franchise agreements. True, but when these agreements were made, as far back as 30 years ago, cable was still a regulated monopoly and cities were able to enforce franchise protections. Even then, build-out requirements were not always honored and franchise deals became rife with corruption and scandal. New York City was one of the worst examples. Although parts of the city had been wired for cable since the mid-1960s, it wasn't until 1987, following a federal criminal investigation, that build-out began in large areas of Brooklyn and the Bronx.[22]

Finally, cable companies should be able to "opt-in" to a statewide franchise agreement once a competitor enters a local market they serve. This further levels the playing field by relieving incumbent cable companies of obligations imposed by virtue of their one-time monopoly status. As discussed, these obligations take the form of constructing playgrounds, parking lots or paying special fees and surcharges. These unnecessary cost impositions, in a competitive environment, can't simply be passed on to consumers. On principle, they should not even be required, as they constitute a discriminatory taxation.

The definition of video revenues should be limited to the income for provision of retail cable TV services.

The American Legislative Exchange Council (ALEC) has created model legislation that reflects some, but not all, of these principles. Specifically, the ALEC model bill sets franchise fees at a 5 percent or the percentage assessed the local incumbent, whichever is lower. It does not include advertising, commissions from shopping channels or promotional payments as part of gross video revenues. It calls on the statewide franchisee to provide PEG channels in numbers "comparable" to the incumbent. It does not impose any build-out requirements.[23]

Only in its treatment of incumbent cable providers is the ALEC model legislation questionable. For one, at a time when phone, video and Internet services are converging, it draws not two, but *three* specific distinctions between providers of video service: 1) the incumbent cable service provider, 2) the competitive cable service provider, and 3) the competitive video service provider.[24]

The bill, moreover, subjects the members of different categories to different rules. For example, the incumbent cable provider is not permitted to apply for a statewide franchise until its current local franchise expires, even if a competitor enters the market.[25]

Further, on build-out requirements, the bill specifically exempts only competitive cable and video service providers, inferring that incumbents remain bound by build-out rules.[26] At first blush, this may seem moot—most incumbent cable companies have been operating long enough to have wired entire areas. However, such a clause may put cable companies at a disadvantage should they wish to make network upgrades or other technological improvements. It may not permit them the benefit new entrants will enjoy: Phased deployment of capital-intensive infrastructure. Giving incumbent cable companies and video services the same leeway as new entrants ensures a level playing field and gives all players equal opportunity to harness technology to serve consumers to the best of their ability.

One of the primary goals of telecommunications deregulation has been the recognition that services once separate and distinct, i.e., phone and cable TV, today can be offered to consumers by one company over a single network. Deregulation has attempted to dismantle the regulatory regime that treats these services as if they were still isolated into service silos, rather than converged and integrated. This regime perversely gave service providers greater incentive to “stay in their corners,” rather than aggressively expand into the market for converged, integrated services—and deliver those benefits to consumers.

From this perspective, the ALEC model falls short because it insists that distinctions between cable and phone companies be maintained. In the interest of competition and innovation in consumer video and broadband services, policy should be directed at dismantling these regulatory silos and creating a level playing field. Fortunately, most of video franchise reform legislation has been written in this spirit. The one troublesome aspect is that some lawmakers aim to level the playing field by extending the current regulatory burden to new entrants, when it would be more beneficial to consumers and local communities if these burdens were instead removed all around.

Part 4

Current Legislation

Putting aside for a moment the question of whether the franchise process should continue at all in the competitive broadband era, how should franchise reform look? Although bills vary in length, by and large most contain a number of common provisions that carry over from existing franchise rules and have not been subject to controversy.

In all cases, local franchising authorities receive payments directly. To date, no franchise reform bill that has passed or is pending creates a new structure for collection and dispersal of franchise fees. With the exception of Virginia, the state and federal laws only place the administrative process for the application of granting video franchising with a state agency, usually the public utilities commission. Federal legislation places administrative authority with the FCC. Local authorities also retain their right to audit franchisee accounting data.

All legislation calls for statewide franchisees to provide public, educational and government (PEG) channels, usually a minimum of three, often more based on population. At the same time, all legislation requires local franchise authorities to provide at least eight hours of programming per day on each channel (limited repeat broadcasts are allowed to fulfill this requirement). Franchisees must provide a means of connection from PEG studio facilities to the head-end.

All legislation prohibits cities from discriminating against some service providers by denying access to rights of way or charging higher prices for access than to other providers.

All legislation prohibits local franchising authorities from assessing additional franchise fees or requirements, or demanding other services, payments or use of property, unless specifically mentioned in the new legislation.

Most legislation calls for free connectivity and cable and Internet service to city buildings, including firehouses, police stations, libraries and schools.

All legislation specifically prohibits franchisees from using the average income of residents of an area or neighborhood as a reason not to provide service to that area. All legislation provides a means of redress to residents who feel they were discriminated against for these reasons.

These provisions answer many of the criticisms against statewide franchising reform. However, there are specific areas that have proved contentious as legislation has moved through the process.

These are reflected in the differences that can be seen when the various bills are laid out side by side (see table).

Table 1: Recent Video Franchise Reform Legislation

Legislation	Bill No(s).	Name	Status	Key Provisions			
				Franchise Fee Formula	Ad sales and shopping channel commissions included in "gross revenues"	Build-out Requirements	Incumbent transition upon competitive entry
U.S. Senate	S. 2686	Communications, Consumer Choice, and Broadband Deployment Act	Passed Committee; Session ended without floor vote	5%+1% for PEG	Yes[1]	No	Yes
U.S. House	H.R. 5252	Communications Opportunity, Promotion and Enhancement (COPE) Act of 2006	Passed House	5%+ 1% for PEG	Yes[2]	No	Yes
Texas	SB 5	None	Passed; Signed into Law	5%	Yes	No	No
Indiana	SB 245/ HB 1279	None	Passed; Signed into Law	5% max	No	Allows "reasonable time" for full build-out, but sets no deadline.	Yes
Virginia	HR 1404	None	Passed; Signed into Law	5% max	No	Yes, but heavily qualified	Not applicable
Kansas	SB 449	Video Competition Act	Passed; Signed into Law	5% max	No	No	Yes[3]
North Carolina	SB 1559 HB 2047	Video Service Competition Act	Passed; Signed into Law	7%	No	No	Yes
South Carolina	H 4428 S 1053	Cable Competitive Services Act	Passed; Signed into law	5% max	Yes	No	
Iowa	HF 2647 SF2362	None	Referred to Committee	5% max	Yes[4]	No[5]	No[6]
New Jersey	S. 2912 A. 4430	None	Passed; Signed into law	4%[7]	No	Yes for incumbent Verizon, no for other	Yes
Louisiana	H. 699/S. 386	Competitive Cable and Video Services Act	Passed; Vetoed by governor	5% max	Yes	No	No
California	AB 2987 SB 850	Digital Infrastructure & Video Competition Act of 2006	Passed; Signed into law	5% + 1% for PEG	Yes	No	Yes
Arizona	HB 2812 SB 1421	None	Passed; Signed into law	5% max	No	No	No
Michigan	S 1157 HB 5895	Cable and Video Competition Act	Passed; Signed into law	5% max + ~1% for PEG	No	No	No
Tennessee	SB 3210 HB 3636	Competitive Cable Services Act	Referred to Committee	5% max	No	No	No
Pennsylvania	SB 1247	Cable Choice and Competition Act	Referred to Committee	5% max	Yes	No	No

1 Bill excludes sales commissions from home shopping networks in definition of gross revenues.

2 Bill neither includes nor excludes sales commissions from home shopping networks.

3 Upon entry of a competitor, an incumbent may request the local franchise agency change the terms of the local franchise to match statewide franchise provisions. Incumbent cannot directly apply for a statewide franchise until its local franchise agreement expires.

4 Advertising revenues are not included in the bill's definition of gross revenues. An amendment would add them.

5 An amendment would impose a two-year build-out requirement.

6 Language is vague. Incumbents "are not required" to apply for statewide franchises until existing municipal franchises expire, but bill does not state that incumbents can actively elect to apply for a statewide franchise before then.

7 0.5% supports local recreational services; another 0.5% subsidizes service to elderly and disabled.

The points of contention are:

> *The franchise fee percentage. Most states cap the franchise fees percentage formula—the percentage of gross video revenue that goes to local authorities—at 5 percent. New Jersey's effective rate would be 4 percent. North Carolina, proposing 7 percent, is the highest. In addition to the franchise fee, many state bills, as well as the Senate and House bills, call for an additional 1 percent of gross video revenues to fund PEG channels. All legislation, however, prohibits local franchising authorities from collecting a higher percentage of revenues from a new entrant than they do from the incumbent.*

Giving incumbent cable companies and video services the same leeway as new entrants ensures a level playing field and gives all players equal opportunity to harness technology to serve consumers to the best of their ability.

The definition of "gross video revenues." Since franchise fees are levied on a percentage of revenues, payment sums can be dramatically affected by what services states classify as video revenues. All bills consider income from service provision—billings for set-top box rental, monthly service, premium channels and pay-per-view—as video revenue. Likewise, revenue from other services—telephone, cable modem, DSL—do not qualify. More controversial has been the inclusion of cable-related income that does not come from consumers, including revenues from local advertising, commissions paid by programmers such as the Home Shopping Network and QVC on sales of merchandise to franchisee customers, and promotional fees paid to franchisees by cable programmers for including their channels on the system.

Build-out Requirements. As noted, all legislation prohibits "red-lining," which is when cable companies discriminate against the poor by building access out to wealthy areas exclusively. Bills vary in the deadlines they impose on new entrants regarding the coverage of the entire area. Most bills impose no build-out requirement, allowing new entrants to deploy service in response to market conditions and economies of scale. Some bills set specific time frames.

Incumbent transition. Some bills require the incumbent cable company to remain bound by its existing local franchise agreement until it expires. Others, including the House and Senate bills, permit incumbents to apply for a statewide (or national) franchise upon the entry of a competitor.

Part 5

The Future of Franchise Fees

The battle over franchise fees comes down to money. Municipalities fear losing not only a reliable revenue stream from local cable companies, they also do not wish to lose the leverage to demand the perks that come with local control.

That local elected officials would take advantage of their power to grant exclusive rights to service a cable area is perhaps not surprising, but it is wrong nevertheless. For instance, one city requested that, in addition to other requirements, Verizon turn over a parking lot for use as free parking for a library. Another city requested free television for every "house of worship" and a 10 percent video discount for select customers. Yet another asked for a new recreation center and pool.[27]

Perhaps local officials rationalized their demands by telling themselves that, one, the local cable system was a monopoly and, two, that even though these perks raised prices for consumers, TV entertainment was not so much an essential service that adding a dollar or two in taxes or surcharges could be considered a burden.

But today, the cable monopoly is under threat. Direct broadcast satellite has already cut into market share. And although the telephone companies want franchise reform, they are rolling out video services where they can.

But franchise reform is about much more than cable TV. The broadband dimension that comes part and parcel with these network upgrades brings a new level of urgency to policy change. And here it helps to remember that the United States ranks 19th in the world in terms of broadband penetration, according to the International Telecommunications Union's January 2006 Bandwidth Report.[28] While that status is due in part to the vast geography of the country, the relative high cost of terrestrial broadband services is a factor. And those costs are propped up in part by franchise rules that artificially insulate cable monopolies from competition.

The reason the industry, as well as enlightened state legislatures, are seeking franchise reform is not because the phone companies want to offer video for its own sake. The ultimate goal of both the phone and cable companies is to create rich broadband networks that can integrate various types of data. Today, video service is the avenue of entry—the means, not the end. Unfortunately, video services today are highly regulated at the local level. While video is the primary application associated with franchising, in the scheme of wireline broadband services, it is part of a suite of integrated services that can be delivered not only by service providers, but by third parties using those service provider networks.

This will lead to a fundamental shift in the way phone and cable companies do business. It is more complex than a matter of each segment invading the other's turf (cable companies offering phone service and phone companies offering cable). Both groups are coming to terms with their emerging, yet not-fully-defined, role in the *global* supply chain for information services and Web-driven consumer information technology. In order to complete this evolution—which will unleash the massive consumer and community benefits that all sides of the policy debate envision—local regulation of cable TV, which keeps the industry anchored to the past, must give way.

Moreover, local officials may not have much of a say. Technology and business opportunities are already changing distribution models for video entertainment. In this scheme, "cable TV" becomes just another choice consumers have for electronic video acquisition.

But franchise reform is about much more than cable TV. The broadband dimension that comes part and parcel with these network upgrades brings a new level of urgency to policy change.

"On demand" video over the Internet, in fact, may be the most significant development in delivery of home entertainment since the introduction of multichannel cable TV. Until recently, cable TV companies had exclusive control over the distribution of entertainment to the TV. True, customers could purchase or rent videocassettes and DVDs, but it still required an extra step—a visit to a video store or an on-line order through Netflix. The "impulse" decision that drives video-on-demand purchasing was the exclusive purview of the cable provider until recently.

In January, Starz, the premium pay network available only on cable systems, launched Vongo, a Web site that currently offers 1,500 titles for download. Consumers pay a monthly subscription fee. Other sites, such as Movielink, offer similar services. Apple's iTunes offer downloads of episodes of popular television shows such as *Lost* and *Desperate Housewives*. Major League Baseball and the National Basketball Association stream live video of games. Even the networks have gotten into the act, offering Web-only episodes or "uncensored" versions of their broadcast shows.

Internet Video Goes Commercial

The integration of video and the Internet truly went commercial in 2006 and shows every sign of making a pronounced impact on video content distribution in 2007.

Internet video falls into a number of subsets, with a varying level of cost and sophistication. Here's a round-up of some of what's out there today.

Apple's iTunes (www.itunes.com) began offering short video files in the summer of 2004. By early 2005, "Podcasting" had become a phenomenon. ABC was among the first broadcasters to get involved by making individual episodes of *Lost* and *Desperate Housewives* available for purchase and download (to both PCs and Apple iPods) for $1.99 after they had aired on the TV network. In 2007, Apple will intensify efforts with the introduction of iTV (the company says the moniker is temporary), which will allow direct access to Internet downloads via TV, similar to Akimbo.

Akimbo (www.akimbo.com) and MovieLink (www.movielink.com) are two examples of content aggregators that rent and sell movies directly to consumers over the Internet. Feature films are available about the time they are released on DVD. Users of both services can watch downloaded videos on a TV. MovieLink only requires a standard video connection between PC and TV. It rents and sells movies a la carte at various prices. Akimbo requires a PC using Microsoft Windows Media Center or a special set-top box available for $200. Akimbo is subscription-based at $9.99 a month. Akimbo also offers content such as tapes of Major League Baseball telecasts and specialized programming not available elsewhere.

Vongo (www.vongo.com) also is a subscription service, but since it is owned by the Starz! cable network, Vongo subscribers also have Internet access to a live feed of the Starz! cable channel, until now a premium cable channel solely furnished by the cable provider. No other hardware is needed. Since roughly five percent of the monthly cable fee for Starz! goes to the franchise authority, Vongo, at $9.99 a month, is as plain example there is of how video over the Internet threatens revenues from local franchise fees.

AT&T Broadband TV now rolling out nationwide takes cable-over-the-Internet yet another step. Working with content aggregator MobiTV, the AT&T service offers real-time feeds of 20 TV channels, including Fox News, Fox Sports, the Weather Channel and the History Channel, to broadband users anywhere in the U.S., whether or not they are AT&T landline customers. Since it will work with WiFi or DSL connections, AT&T Broadband marks the availability of cable programming independent of local cable infrastructure. Again, local agencies face the loss of franchise fee revenue to Web-based distribution of programming.

Although less associated with cable and broadcast programming distribution, services like You Tube (www.youtube.com) and Sling Media use the Internet to change the way consumers approach video. Although not peer-to-peer, You Tube can be considered an outgrowth of the P2P phenomenon, where users shared video and music files through direct PC-to-PC connections over the Internet. You Tube is essentially a community of members who upload and download videos, many of which are home made. Movie and recording studios use You Tube to post trailers, music videos and promotional content related to bigger products. Site policies discourage piracy. There is no fee to join.

For as low as $180, Sling Media (www.slingmedia.com) sells the Slingbox, an addressable device, programmed and controlled by the owner, that connects a digital video recorder (DVR) in the home to the Internet. This allows the owner to access video content from that DVR from a PC anywhere, be it the upstairs bedroom or a hotel room in Shanghai. Less of a regulatory issue, Slingboxes threaten the traditional business model of geographical exclusivity content providers often use with distributors. They are another example of how technology is using the Internet to change the choices TV viewers have.

Viewers, by and large, must watch these videos on a PC, as opposed to a TV. But that is largely a limitation of home electronics, not service provider networks. Operating systems such as Windows XP Media Center, and the far richer Windows Vista due to be released in January 2007, turn home PCs into a hub for distribution of content to TVs, stereos and other home information appliances. These will further break down the distinction between cable TV and Internet video.

So even as phone and cable companies invade each other's turf, regulators should be wary of looking at phone, cable and Internet as distinct services, like items on a Chinese menu. PC software like Vista is designed to manipulate the interaction of all three. For example, you may be watching *Cars* on HBO, delivered via cable connection. However, at anytime while watching the movie, you may be able to go out onto the Internet, say the iTunes site, and order the soundtrack album, but conduct the entire transaction with your cable remote.

How does this factor into the franchise fee debate? The ability to create new revenue streams from the combination of Internet applications and video programming—while keeping it all invisible to the user—is the immediate challenge facing service providers, be they cable or phone. Regulatory changes that help all service providers deal with this challenge are vital to their growth and their ability to expand the availability, quality and utility of broadband services to their customer base, as well as provide an ongoing incentive for applications developers to work toward creation of more. This is why a minimally intrusive and level regulatory playing field is so important.

Of all local officials who have voiced a position on franchise reform, perhaps it is Anaheim Mayor Curt Pringle who best understands this transition.

> *City leaders do not believe that government should determine whether residents receive video content through established cable providers, growing competition from satellite television, or new concepts coming on line like internet protocol television (IPTV), or technologies on the horizon like Wi-Fi delivery of video content. Anaheim is supportive of maintaining open market competition in which any franchise fee is eliminated for consumers and a variety of service providers have an opportunity to earn customer support.*
>
> *The current franchise system inhibits additional companies who might be subject to it from entering the marketplace and investing in infrastructure when they are challenged by the expense and difficulty of attaining enough market share to recoup costs. At the same time, companies that are clearly exempt from franchising, like satellite providers, flourish.*
>
> *Franchise fees and many elements within franchise agreements, therefore, are merely an artificial intrusion by government into the consumer marketplace. Attempts to apply franchise fees and agreements to some providers, while exempting others, effectively eschews the market.*[29]

Further on, Pringle suggests that as alternate technologies flourish, revenues from video services will move beyond the reach of local franchise authorities. One way or another, time might be short for the franchise fee regime.

But, in fact, cities have created an unfair tax on cable companies and limited competition in a fast-paced, competitive marketplace. Furthermore, many cities have used these fees to fund essential municipal services unrelated to cable, although the fees simply are not a long-term stable source of revenue for cities. As an example, just look at the emergence of satellite services. This, a non-taxed cable competitor, has increasingly taken a significant share of the entertainment market. As cable companies have lost customers to other competing entities, cities have seen a corresponding drop in the revenues that come from cable franchise fees. It is a weak fiscal model that subjects core municipal services such as public safety on a dwindling source of revenue, regulated by sources out of direct control of that municipality.[30]

Pringle's suggestion that cities begin to wean themselves from franchise revenues is sound advice. Cities would do well to remember that local franchise fees are not specifically tied to video revenues, just the revenues that are collected via the cable TV model. Franchise revenues are safe as long as the service provider uses a local satellite head-end to receive hundreds of programming channels and pipe them down the cable to area homes. Should programming delivery shift to predominantly Web-based sources—say through content aggregation by Akimbo, Google, Yahoo, Netflix or the studios themselves—it would severely cut into, if not replace, today's downlink-and-transmit cable distribution model.

Under the way franchise rules work, cities can no more collect a fee on these revenues than they can on iTunes downloads or any other on-line transaction. Should it become unprofitable at some point for broadband providers to act as "cable companies" in the sense we know now, and reorganize their businesses away from direct distribution to Web-based content aggregation, franchise fee revenues will begin to dry up. This stands to occur a lot sooner than the 10 to 15 years many local franchise agreements still have to run.

The recent news that CBS plans to launch a Web-based TV channel stokes some thinking about the future of video delivery over the Internet, and the issue of cable franchise fees. While ABC, NBC and Time Warner have been making some of their popular TV programs available for post-broadcast download, CBS's Innertube site is the first to offer original network-branded entertainment via the Web. Most programs are youth-oriented and, in CBS's terms, "edgier" than standard broadcast content.

Beyond that, pending affiliate approval, Innertube will stream network shows once they air in their usual timeslot. CBS also plans to make a library of 100,000 hours of programming available on the site, some of it on a pay-per-view basis.

Multichannel video may never go away, but a large percentage of customers will elect to download TV entertainment via the Internet. Most franchise laws do not consider Internet purchases as part "gross video revenue," although the Senate bill includes language that tries to shoehorn in video revenues from undefined "affiliates." Should major service providers initiate this type of shift, it may take either a court ruling or an FCC decision to reinforce the exclusion of Internet-derived revenues. The decisions in Oklahoma and Connecticut not to regulate IP video as a multichannel cable TV service will be critical precedents.

So in addition to confronting the trend toward franchise reform, cities and towns need to begin thinking about their fiscal sources in an era of diminished cable revenues. Franchise fee systems exist as long as the value proposition of video over broadband does. Change is coming and it favors unregulated models. For local franchise agencies the battle against franchise reform stands to be a losing one. Initiatives at the state and federal level have the momentum of constituent and legislator support. Right behind them come companies with video distribution schemes that exist outside regulatory bounds. For local authorities, the wisest course of action is to make plans for the day when the local TV distribution is no longer a cash cow.

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Titch graduated cum laude from Syracuse University with a dual degree in journalism and English.

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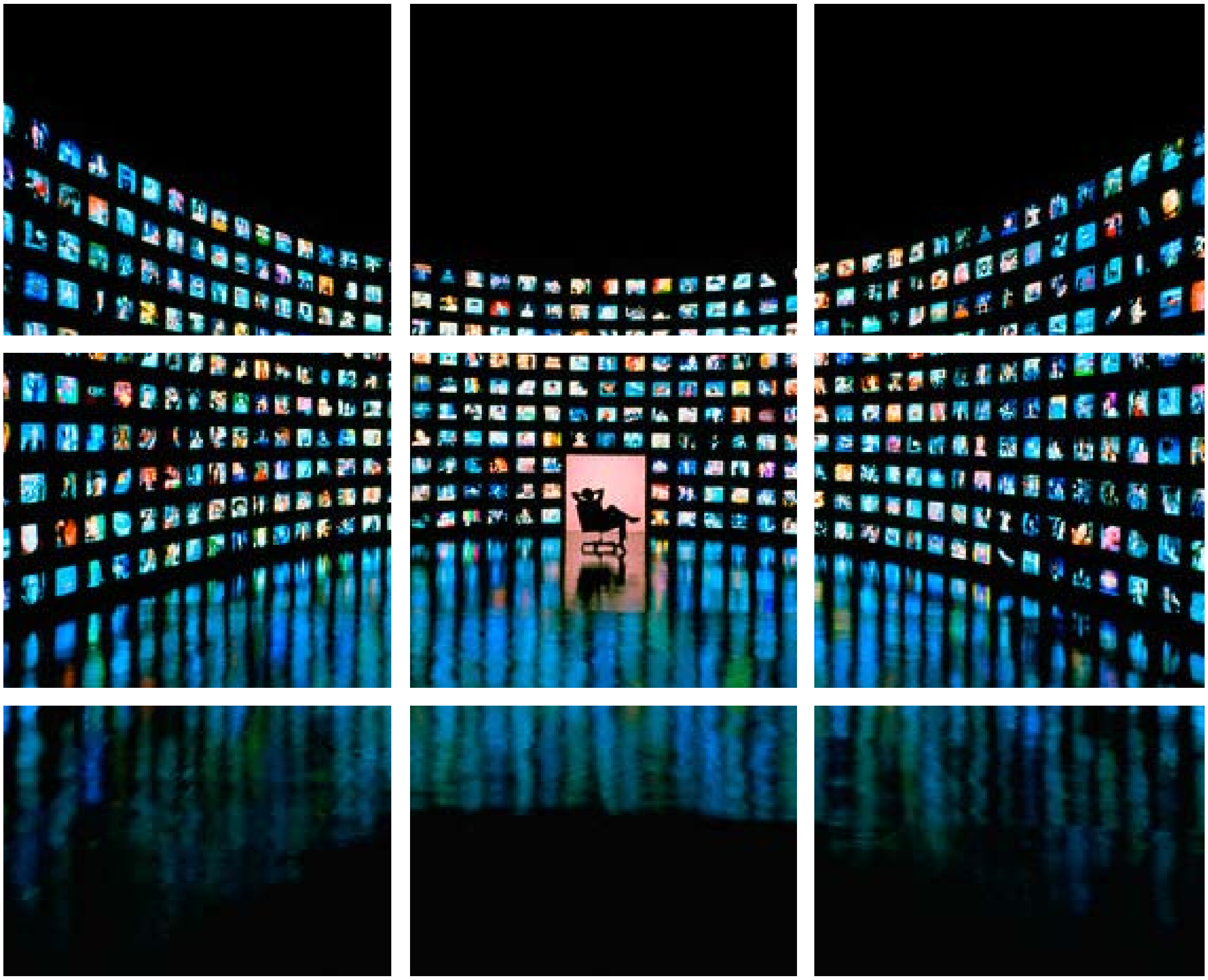

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