2005-2006

REVENUE LAWS STUDY COMMITTEE

MINUTES

2005-2006 Revenue Laws Study Committee

Committee Membership & Staff Contact Information Listing

House Appointments

Representative Paul Luebke, Co-Chair
1507 Oakland Avenue
Durham, North Carolina 27705
Paull@ncleg.net
(919) 286-0269

Representative Harold J. Brubaker
138 Scarboro Street
Asheboro, North Carolina 27203
Brub@ncleg.net
(336) 629-5128 629-2603 (F)

Representative Becky Carney
P. O. Box 32873
Charlotte, North Carolina 28232
Beckyc@ncleg.net
(704) 332-1893 (H) 905-2449 (C)

Representative Walter G. Church, Sr.
P.O. Box 760
Valdese, North Carolina 28690
Waltc@ncleg.net
(828) 879-3761 (H) 879-2356 (F)
(828) 874-2141 (O)

Representative Dewey L. Hill
P.O. Box 723
Whiteville, North Carolina 28472
Deweyh@ncleg.net
(910) 646-4297 (H) 640-7085 (C)
(910) 642-6044 (O) 642-7004 (F)

Representative Daniel F. McComas
P.O. Box 2274
Wilmington, North Carolina 28402
Dannym@ncleg.net
(910) 392-3011 (H) 612-9393 (C)
(910) 343-8372 (O) 343-8003 (F)

Representative William Wainwright
P.O. Box 33
Havelock, North Carolina 28532
Williamw@ncleg.net
(252) 447-7379 (H) 670-4469 (C)
(252) 633-2422 (O) 672-4075 (F)

Representative W.A. (Winkie) Wilkins
210 Fair Oaks Drive
Roxboro, North Carolina 27574
winkiew@ncleg.net
(336) 599-7336

Senate Appointments

Senator John H. Kerr, III, Co-Chair
P.O. Box 1616
Goldsboro, North Carolina 27533-1616
Johnk@ncleg.net
(919) 734-2910 (H) 734-4215 (F)
(919) 734-1841 (O)

Senator Daniel G. Clodfelter
100 N. Tryon St., 47th Fl.
Charlotte, North Carolina 28202-4003
Danielc@ncleg.net or clodfleterd@mvalaw.com
(704) 334-3684 (H) 378-2041 (F)
(704) 331-1041 (O)

Senator Walter H. Dalton
560 North Main Street
Rutherfordton, North Carolina 28139
Walterd@ncleg.net or wdalton@ndmlaw.com
(828) 287-2908 (H) 286-8229 (F)
(828) 286-8222 (O)

Senator Fletcher L. Hartsell, Jr.
P.O. Box 368
Concord, North Carolina 28026-0368
Fletcherh@ncleg.net
(704) 786-8508 (H) 788-8058 (F)
(704) 786-5161 (O)

Senator David W. Hoyle
P.O. Box 2567
Gastonia, North Carolina 28053
Davidh@ncleg.net
(704) 922-4969 (H) 864-7468 (F)
(704) 867-0822 (O)

Senator Hugh Webster
1419 Legislative Building
Raleigh, North Carolina 27601-1096
Hughw@ncleg.net
(919) 658-6170 658-3637 (F)

Mr. Leonard W. Jones
300 North 35th Street
Morehead City, North Carolina 28577

Mr. J. Micah Pate, III
615 Oberlin Road
Raleigh, North Carolina 27605

Last Updated: 11-16-2005 at 7:06 pm

2005-2006 Revenue Laws Study Committee

Committee Membership & Staff Contact Information Listing

Staff Members

Ms. Cindy Avrette, Research Division
Room 545, Legislative Office Building
Cindya@ncleg.net
(919) 733-2578 715-5460 (F)

Ms. Martha Walston, Fiscal Research Division
Room 643, Legislative Office Building
Marthaw@ncleg.net
(919) 733-4910 (F)

Committee Clerk

Ms. DeAnne Mangum
Room 329, Legislative Office Building
Deannem@ncleg.net
(919) 733-2405

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Marthaw@ncleg.net
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Committee Clerk

Ms. DeAnne Mangum
Room 329, Legislative Office Building
Deannem@ncleg.net
(919) 733-2405

Article 12L.

Revenue Laws Study Committee.

§ 120-70.105. Creation and membership of the Revenue Laws Study Committee.

(a) Membership. – The Revenue Laws Study Committee is established. The Committee consists of 16 members as follows:

(1) Eight members appointed by the President Pro Tempore of the Senate; the persons appointed may be members of the Senate or public members.

(2) Eight members appointed by the Speaker of the House of Representatives; the persons appointed may be members of the House of Representatives or public members.

(b) Terms. – Terms on the Committee are for two years and begin on January 15 of each odd-numbered year, except the terms of the initial members, which begin on appointment. Legislative members may complete a term of service on the Committee even if they do not seek reelection or are not reelected to the General Assembly, but resignation or removal from service in the General Assembly constitutes resignation or removal from service on the Committee.

A member continues to serve until a successor is appointed. A vacancy shall be filled within 30 days by the officer who made the original appointment. (1997-483, s. 14.1; 1998-98, s. 39.)

§ 120-70.106. Purpose and powers of Committee.

(a) The Revenue Laws Study Committee may:

(1) Study the revenue laws of North Carolina and the administration of those laws.

(2) Review the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable.

(3) Call upon the Department of Revenue to cooperate with it in the study of the revenue laws.

(4) Report to the General Assembly at the beginning of each regular session concerning its determinations of needed changes in the State's revenue laws.

These powers, which are enumerated by way of illustration, shall be liberally construed to provide for the maximum review by the Committee of all revenue law matters in this State.

(b) The Committee may make interim reports to the General Assembly on matters for which it may report to a regular session of the General Assembly. A report to the General Assembly may contain any legislation needed to implement a recommendation of the Committee. When a recommendation of the Committee, if enacted, would result in

an increase or decrease in State revenues, the report of the Committee must include an estimate of the amount of the increase or decrease. (1997-483, s. 14.1.)

§ 120-70.107. Organization of Committee.

(a) The President Pro Tempore of the Senate and the Speaker of the House of Representatives shall each designate a cochair of the Revenue Laws Study Committee. The Committee shall meet upon the joint call of the cochairs.

(b) A quorum of the Committee is nine members. No action may be taken except by a majority vote at a meeting at which a quorum is present. While in the discharge of its official duties, the Committee has the powers of a joint committee under G.S. 120-19 and G.S. 120-19.1 through G.S. 120-19.4.

(c) The Committee shall be funded by the Legislative Services Commission from appropriations made to the General Assembly for that purpose. Members of the Committee receive subsistence and travel expenses as provided in G.S. 120-3.1 and G.S. 138-5. The Committee may contract for consultants or hire employees in accordance with G.S. 120-32.02. Upon approval of the Legislative Services Commission, the Legislative Services Officer shall assign professional staff to assist the Committee in its work. Upon the direction of the Legislative Services Commission, the Supervisors of Clerks of the Senate and of the House of Representatives shall assign clerical staff to the Committee. The expenses for clerical employees shall be borne by the Committee. (1997-483, s. 14.1.)

§ 120-70.108. Property Tax Subcommittee.

(a) The Revenue Laws Study Committee shall establish a Property Tax Subcommittee consisting of six members. The Senate cochair of the Committee shall designate three members appointed by the President Pro Tempore of the Senate to serve on the Subcommittee and shall name one of those members a cochair of the Subcommittee. The House cochair of the Committee shall designate three members appointed by the Speaker of the House of Representatives to serve on the Subcommittee and shall name one of those members a cochair of the Subcommittee. The Subcommittee shall meet upon the call of the Subcommittee cochairs.

(b) The Property Tax Subcommittee shall study, examine, and, if necessary, recommend changes to the property tax system. The Subcommittee shall include in its study an examination of all classes of property, including exemptions and exclusions of property from the property tax base. The Subcommittee shall also study the present-use value system, including the following:

(1) Examine the implementation and application of the current present-use value statutes.

(2) Evaluate other tax credits, including adjustments to and credits for ad valorem taxes, to encourage agricultural, forestry, horticultural, and conservation use of land.

(3) Evaluate the treatment of undeveloped land in ad valorem tax.

(4) Evaluate the possibility of amending the present-use value system and developing other tax incentives to encourage conservation and environmental protection of land. The study shall include the feasibility of allowing lands managed for conservation and the preservation of water quality, wildlife habitats, and other conservation purposes to be taxed at their present-use value.

(5) Evaluate the possibility of adding more specific land and resource management criteria to the sound management programs required for all lands enrolled in the present-use value system.

(6) Review other issues related to the taxation of agricultural land, horticultural land, and forestland, including reducing the acreage requirement for land to qualify as forestland.

(c) The Subcommittee shall report any recommendations to the Revenue Laws Study Committee. (2002-184, s. 8.)

REVENUE LAWS STUDY COMMITTEE
Monday, December 12, 2005 at 1:00 PM
Room 544, Legislative Office Building

MINUTES

The Revenue Laws Study Committee met at 1:00 PM on December 12, 2005, in Room 544 of the Legislative Office Building. Eleven members of the committee were present. Senator Kerr and Representative Luebke presided.

2005 Finance Law Changes

Cindy Avrette, a staff attorney with the Research Division, was recognized to briefly explain the 2005 Finance Law Changes. A copy of the explanation is attached.

Taxation of Communication Services.

Cindy Avrette was recognized for a power point presentation of "Past and Current North Carolina Tax Treatment". A copy of the presentation is attached. Brenna Erford, a research assistant with the Fiscal Research Division, was recognized for a power point presentation of "Convergence of the Industries". A copy of the presentation is attached.

Expansion of the Sales Tax Base – Maintenance Agreements.

Linda Millsaps, a fiscal analyst with the Fiscal Research Division, was recognized for a power point presentation of "Expansion of the Sales Tax Base – Maintenance Agreements". A copy of the presentation is attached.

The meeting adjourned at 3:10 PM.

Senator John H. Kerr, III, Co-Chair
Revenue Laws Study Committee

Representative Paul Luebke, Co-Chair
Revenue Laws Study Committee

DeAnne Mangum, Committee Clerk

REVENUE LAWS STUDY COMMITTEE
State Legislative Building
Raleigh, North Carolina 27603

Senator John H. Kerr, III, Co-Chair *Representative Paul Luebke, Co-Chair*

November 22, 2005

NOTICE

TO: Members, Revenue Laws Study Committee

FROM: Senator John Kerr, Co-Chair
Representative Paul Luebke, Co-Chair

SUBJECT: Revenue Laws Study Committee Meeting

There will be a meeting of the **Revenue Laws Study Committee** as follows:

DAY:	**Monday**
DATE:	**December 12, 2005**
TIME:	**1:00 pm**
LOCATION:	**Room 544, Legislative Office Building**

Please advise Jason Cannon, Committee Clerk, at (919) 715-1812 or e-mail jasonc@ncleg.net if you will be unable to attend.

JK/PL/jac

Posted: 22-Nov-05

cc: Committee Record X
Interested Parties X

REVENUE LAWS STUDY COMMITTEE

Rep. Paul Luebke Sen. John Kerr

Monday, December 12, 2005
Room 544, Legislative Office Building
1:00 p.m.

I. **Welcome and Introductions**

II. **2005 Finance Law Changes**
Cindy Avrette, Research Division

III. **Taxation of Communication Services**

- **Past and Current North Carolina Tax Treatment**
  Cindy Avrette, Research Division
- **Convergence of the Industries**
  Brenna Erford, Fiscal Research Division

IV. **Expansion of the Sales Tax Base – Maintenance Agreements**
Linda Millsaps, Fiscal Research Division

V. **Adjournment**
Next Meeting: Wednesday, January 11, 1:00 pm

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — December 12, 2005

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Lynne Wilson	SS
John Adams	MOD / F&LTC
Amy Fullbright	Hunton & Williams
John McAlister	Duke Energy

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — December 12, 2005

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Ed Turlington	Brooks Pierce
Randy Fraser	Time Warner Cable
Lucius Pullen	Attorney
Steve Woodson	NC Farm Bureau
David Barnes	Poyner & Spruill
Rebecca Troutman	NCACC
John Maffei	[illegible]
Michelle Bank	State Govt Radio
Jeff VanDyke	Time Warner Cable
Ken [illegible]	N.C. D.O.R.
Lee Mandell	NCLM

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — December 12, 2005

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Jon Carr	Jordan Price Law Firm
Doug Howey	NCPMA
Gary Harris	NCPMA
Leslie Bevacqua Cone	Capstrat
Don Beason	Beason Dr. Affairs
FRANK BODREAU	NCAOA
S.T. Pace	Verizon
[illegible]	[illegible]
Butch Gunnells	NCSA
Jon Mann	[illegible]
John Bowdish	AstraZeneca

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — December 12, 2005

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Fred Baker	Baker & Assoc.
[illegible]	[illegible]
[illegible]	[illegible]
DON HOBART	DOC
[illegible]	[illegible]
Dana Sipes	Smith Anderson
Don McCorquodale	SAS
Jonathon Smith	SAS
Karl Knapp	DOR
[illegible]	OSBM
[illegible]	JD, AL, PA

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — December 12, 2005

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Jim Ahler	NCACPA
Paul Stock	NC BANKERS
[illegible]	[illegible]
Elizabeth Dalton	NCCBI
James Bennett	NCCAC
Debra Dew	Bell South
Diana Jaskell	League of Women Voters
Drew Morot	Raleigh Chamber
Paul Meyer	NCACC
Andy Sisol	NC DOR
Anna Mitchell	NC DOR

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — December 12, 2005

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Michael Houser	NCAE
Mary Klenz	League of Women Voters NC
Andy Romanet	NCLM
Jh Patton	[illegible]
Shawn Miller	CUCA
Keir Lassman	Progress & Freedom Fund
Stephanie Simpson	NCAR
Joe Coletti	John Locke Fdn
Paul Matthews	Progress Energy
Nancy Rendleman	Maupin Taylor
Colleen Kochanek	Smith Moore

2005

FINANCE LAW CHANGES

PREPARED BY FINANCE TEAM LEGAL STAFF:
Cindy Avrette
Trina Griffin
Canaan Huie
Martha Walston

2005 Finance Law Changes

Hurricane Recovery Act of 2005.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-1	SB 7	Senator Nesbitt

AN ACT TO ENACT THE HURRICANE RECOVERY ACT OF 2005, MAKING FINDINGS AS TO DAMAGE CAUSED BY THE HURRICANES THAT STRUCK NORTH CAROLINA IN 2004, CONCERNING ESTABLISHMENT OF THE DISASTER RELIEF RESERVE FUND, MAKING APPROPRIATIONS TO THE DISASTER RELIEF RESERVE FUND, DIRECTING THE REESTABLISHMENT AND MODIFICATION OF HURRICANE FLOYD RECOVERY PROGRAMS, AUTHORIZING ESTABLISHMENT OF NEW PROGRAMS, EXPANSION OF EXISTING PROGRAMS, AND MODIFICATION OF EXISTING PROGRAMS TO IMPLEMENT THIS ACT, AUTHORIZING TRANSFER OF FUNDS TO FEDERAL AGENCIES AND LOCAL GOVERNMENTS, AUTHORIZING TIME-LIMITED POSITIONS TO IMPLEMENT THIS ACT, PROVIDING FOR SUBROGATION BY THE STATE OF CERTAIN INSURANCE CLAIMS, AUTHORIZING ADVISORY COUNCILS TO ADVISE STATE AGENCIES ON RECOVERY EFFORTS, PROVIDING FOR TAX EXEMPTION OF BENEFITS, DIRECTING THE MAPPING OF FLOOD PLAINS AND THE IDENTIFICATION OF POTENTIAL LANDSLIDE AREAS AND STREAM BANK EROSION, DIRECTING THE DEPARTMENT OF ENVIRONMENT AND NATURAL RESOURCES TO STUDY THE CAUSES OF FLOODING IN CERTAIN AREAS AND DETERMINE MEASURES TO PREVENT OR MITIGATE FUTURE FLOODING, DIRECTING THE GOVERNOR TO MAINTAIN THE REDEVELOPMENT OFFICE IN WESTERN NORTH CAROLINA, APPROPRIATING FUNDS TO RESTORE AND REPAIR CERTAIN PUBLIC BUILDINGS IN HYDE COUNTY DAMAGED BY HURRICANE ISABEL AND ESTABLISHING REPORTING REQUIREMENTS.

OVERVIEW: This act provides disaster assistance to individuals, businesses, and public agencies that sustained damage from one or more of the six hurricanes that struck North Carolina during the late summer and early fall of 2004. The Governor has established the Disaster Relief Reserve Fund in the Office of State Budget and Management, and this act

makes appropriations to this Fund. It also provides greater income tax relief for recipients of disbursements from the Disaster Relief Reserve Fund than current law allows.

FISCAL IMPACT: The act appropriates $247,541,447 to the Disaster Relief Reserve Fund. The State income tax deduction is expected to result in a one-time loss of General Fund revenues of $1,575,000.

(For a more complete fiscal analysis, see Overview Fiscal and Budgetary Actions, 2005 Session. Available in the Legislative Library.)

EFFECTIVE DATE: The tax deduction became effective for taxable years beginning on or after January 1, 2004; the remainder of the act became effective when it became law, February 25, 2005.

ANALYSIS: North Carolina was struck by six hurricanes in 2004. Hurricanes Alex, Bonnie, Charlie, and Jeanne brought flooding and wind damage to the Eastern Region of the State. Hurricanes Frances and Ivan dumped heavy rains in the Western Region of the State resulting in landslides, flooding, and the death of at least 11 people. Forty-five counties in western North Carolina were included in federal disaster declarations as a result of Hurricanes Frances and Ivan. Nineteen of those counties were designated by FEMA as eligible for individual assistance and public assistance. Another twenty-six counties were designated as eligible for individual assistance. The damage in the Eastern Region resulted in State disaster declarations.

This act is known as the 'Hurricane Recovery Act of 2005'. It sets forth detailed findings regarding the impacts of the many hurricanes on individuals, businesses, and local governments in the affected areas. One of the findings states that further deterioration of the economy, environment, public health and safety, and quality of life in the State is likely to occur unless significant additional State assistance is allocated to the areas affected.

The act establishes the following 47 counties as eligible to receive assistance under the Act:

- The 19 counties that were designated as eligible for federal individual assistance and public assistance: Alleghany, Ashe, Avery, Buncombe, Burke, Caldwell, Haywood, Henderson, Jackson, Macon, Madison, McDowell, Mitchell, Polk, Rutherford, Swain, Transylvania, Watauga, and Yancey.
- The 26 counties that were eligible for federal public assistance: Alamance, Alexander, Bladen, Cabarrus, Caswell, Catawba, Cleveland, Columbus, Cumberland, Davidson, Forsyth, Gaston, Graham, Guilford, Hoke, Iredell, Lincoln, Mecklenburg, Randolph, Robeson, Rockingham, Rutherford, Scotland, Stokes, Union and Wilkes.
- The two counties that were not included in a federal disaster declaration but were included in a State disaster declaration as a result of the damages sustained by one of the hurricanes that occurred in 2004: Hyde and Dare.

The act notes that the Governor has established the Disaster Relief Reserve Fund for the purpose of providing necessary and appropriate assistance and relief needed as a result of natural disasters. Funds in the Disaster Relief Reserve Fund may be used for a variety of purposes such as housing buyout and relocation assistance, loans, infrastructure repair, studies, and federal matches. The Governor must report periodically to the Appropriations Committees and to the Joint Legislative Commission on Governmental Operations on the

use of the money in the Fund. The act appropriates $247,541,447 to the Fund. This amount comes from the following sources:

- $91 million from unexpended General Fund appropriations for fiscal year 2004-2005.
- $153,541,447 million from the Savings Reserve Account. Of this amount, $30,000,000 must be used to implement the recommendations of the study on flood prevention and mitigation.
- $3 million in reversions from the NC Community Development Initiative for Hurricane Floyd recovery programs. (These are unused Hurricane Floyd Recovery funds)

The act also provides a State income tax deduction equal to the amount paid to the taxpayer, either individual or business, during the taxable year from the Disaster Relief Recovery Fund. The deduction does not apply to amounts received as payments for goods and services provided by the taxpayer. Under current State and federal law, payments received to replace property lost in a federally declared disaster are exempt from tax. However, payments received to replace income are not exempt. Payments to farmers for crop losses would be an example of a taxable payment, as the crops are assumed to be converted into income. The General Assembly provided similar tax relief to Hurricane Floyd victims in 1999. The deduction is effective for taxable years beginning on or after January 1, 2004.

NASCAR Hall of Fame Financing.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-68	SB 525	Senator Clodfelter

AN ACT RELATING TO NASCAR HALL OF FAME FINANCING.

OVERVIEW: This act authorizes the Mecklenburg County Board of Commissioners to levy an additional 2% occupancy tax upon receiving written confirmation from NASCAR that it will locate the NASCAR Hall of Fame Museum facility in Charlotte. The net proceeds of the additional 2% occupancy tax can be used only for the acquisition, construction, repair, maintenance, and financing of the NASCAR Hall of Fame Museum facility and an adjacent NASCAR convention center ballroom facility. The additional 2% tax would bring the occupancy tax rate to 8% in Mecklenburg. No other county or city in North Carolina currently has an occupancy tax rate in excess of 6%.

FISCAL IMPACT: The act does not impact State revenues. The additional 2% occupancy tax rate will generate an additional $5.8 million in 2005-06 fiscal year for Mecklenburg County; the amount is projected to increase to $7 million by fiscal year 2009 - 2010.

(For a more complete fiscal analysis, see Overview Fiscal and Budgetary Actions, 2005 Session Available in the Legislative Library.)

EFFECTIVE DATE: The act became effective when it became law, May 26, 2005.

ANALYSIS: NASCAR plans to locate a NASCAR Hall of Fame Museum in one of five cities. The City of Charlotte is one of the five locations being considered.[1] To finance the capital costs of building the facility, the City of Charlotte and Mecklenburg County requested, and the General Assembly enacted, authorization for Mecklenburg County to levy an additional 2% occupancy tax. Mecklenburg County currently has the authority to levy a 6% occupancy tax. Of the more than 74 counties and 65 cities authorized to levy a room occupancy tax, no locality has the authority to levy an occupancy tax in excess of 6%.[2]

In authorizing Mecklenburg County to levy an 8% occupancy tax, the General Assembly set strict parameters around the levy, use, and repeal of the tax. The act authorizes Mecklenburg County to levy an additional 2% room occupancy tax upon receiving written confirmation from NASCAR that it will locate the NASCAR Hall of Fame Museum facility in Charlotte. The proceeds of the additional 2% occupancy tax must be distributed to the City of Charlotte and used only for the acquisition, construction, repair, maintenance, and financing of a NASCAR Hall of Fame Museum facility and an ancillary and adjacent NASCAR convention center ballroom facility. By using the term 'proceeds' instead of the defined term 'net proceeds', the bill ensures that all of the proceeds of the additional 2% tax will be used for the stated purposes and that none of the proceeds will be used for administrative expenses associated with collecting and administering the additional 2% tax. Lastly, the act provides that the Mecklenburg County Board of Commissioners must repeal the tax effective the earlier of July 1, 2038, or July 1 following the date of final satisfaction of all debt instruments or obligations issued by the City of Charlotte (or a related special purpose entity) in connection with the financing or refinancing of the NASCAR Hall of Fame Museum facility.

Allow Payment of Tax by Offset.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-134	SB 537	Senator Clodfelter

AN ACT TO ALLOW THE PAYMENT OF TAXES IN LIMITED CIRCUMSTANCES BY OFFSET OF AN OBLIGATION OWED TO THE TAXPAYER BY THE TAXING UNIT.

OVERVIEW: This act provides that a taxing unit may, under limited circumstances, collect taxes through offset of an obligation owed to the taxpayer by the taxing unit.

FISCAL IMPACT: No fiscal impact.

EFFECTIVE DATE: This act became effective when signed into law by the Governor on June 29, 2005.

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[1] The other cities are Daytona Beach, FL; Atlanta, GA; Richmond, VA; and Kansas City, KS.

[2] In 1993, a House Finance Subcommittee on Occupancy Tax established uniform guidelines for the occupancy tax legislation it considered. As a general rule, the House Finance Committee continues to follow these guidelines. One of those guidelines is that the combined city and county tax rate cannot exceed 6%.

ANALYSIS: G.S. 105-357 provides that taxes owed to local taxing authorities are payable in existing national currency. A taxing unit is specifically prohibited from accepting the following as payment of taxes: deeds to real property; notes of the taxpayer; bonds or notes of the taxing unit; or payments in kind.[3] Prior to the enactment of this act, G.S. 105-357 also specifically prohibited a taxing unit from permitting the payment of taxes by offset of any bill, claim, judgment, or other obligation owed to the taxpayer by the taxing unit. This act provides that the prohibition against payment of taxes by offset does not apply to an offset of an obligation that arose under a lease or another contract entered into before July 1 of the fiscal year for which the taxes are levied.

This change was intended to facilitate the collection of taxes when a taxpayer has declared bankruptcy. When a taxpayer declares bankruptcy, the bankruptcy laws generally operate as a stay for all actions to collect pre-petition debts.[4] However, a creditor's right of setoff under non-bankruptcy law is preserved when the right of setoff arose before the commencement of the bankruptcy case.[5] To affect a setoff, a 'party in interest' must seek court approval from the automatic stay. The court will generally allow the setoff if the debt is a pre-petition debt and if the right of offset existed under applicable non-bankruptcy law. Prior to the enactment of this act, G.S. 105-357 prevented local taxing authorities from utilizing this form of collection in bankruptcy cases because, as applicable non-bankruptcy law, it forbid such an offset.

2005 Continuing Budget Authority/Revenue.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-144	HB 1630	Representative Luebke

AN ACT AUTHORIZING THE DIRECTOR OF THE BUDGET TO CONTINUE EXPENDITURES FOR THE OPERATION OF GOVERNMENT AT THE LEVEL IN EFFECT ON JUNE 30, 2005; EXTENDING THE FINAL MATURITY OF CERTAIN GLOBAL TRANSPARK DEBT FROM JULY 1, 2005, UNTIL JULY 31, 2005; EXTENDING THE SUNSET ON RETIRED TEACHERS RETURNING TO THE CLASSROOM UNTIL JULY 31, 2007; CONFORMING THE STATE ESTATE TAX TO THE FEDERAL ESTATE TAX SUNSET; AND EXTENDING THE SUNSET ON THE ADDITIONAL ONE-HALF CENT STATE SALES AND USE TAX FROM JULY 1, 2005, UNTIL THE 2005 APPROPRIATIONS ACT BECOMES LAW.

OVERVIEW: Part VIII of the act conforms the repeal of the North Carolina estate tax to the repeal of the federal estate tax. Part IX of the act extends the sunset of the additional

[3] G.S. 105-241 provides that taxes owed to the State are payable in national currency. However, the statute does not specifically prohibit the right of setoff.
[4] 11 U.S.C. § 362.
[5] 11 U.S.C. § 553.

one-half cent State sales and use tax until the date that the Current Operations and Capital Improvements Appropriations Act of 2005 (hereinafter 2005 Appropriations Act) becomes law, but in no event is the tax extended beyond December 31, 2005.[6]

The remaining parts of the act set out temporary year-end transitional provisions that were in effect until the passage of the 2005 Appropriations Act, extended the maturity date of certain debt of the Global Transpark Authority, and extended the sunset on retired teachers returning to the classroom.[7]

FISCAL IMPACT: The extension of the estate tax sunset is estimated to generate gains to the General Fund of $30.6 million in FY 2005-06 and $121.6 million in FY 2006-07. See the summary of S.L. 2005—276 (2005 Appropriations Act) for the fiscal impact of the extension of the one-half cent state sales tax.

(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2005 Session. Available in the Legislative Library.)

EFFECTIVE DATE: Parts VIII and IX of the Act became effective when signed into law by the Governor on June 30, 2005.

ANALYSIS: Part VIII of the act conforms the repeal of the State estate tax to the repeal of the federal estate tax, which is scheduled to become effective for deaths occurring on or after January 1, 2010. The State continues to conform to the increasing federal exemption amounts.[8] The amount of the State estate tax remains at the amount of the State death tax credit allowed under the Internal Revenue Code in 2001. The Governor and the Senate, in Senate Bill 622, also recommended continuing the State estate tax.

North Carolina repealed its inheritance tax in 1998, effective for deaths occurring on or after January 1, 1999. It replaced the inheritance tax with an estate tax that was equivalent to the federal state death tax credit allowed on a federal estate tax return. This type of state estate tax was known as a "pick-up" tax because it picked up for the state the amount of federal estate tax that would otherwise be paid to the federal government. In 2001, Congress increased the exclusion amount for the federal estate tax and phased out the state death tax credit over four years by reducing it 25% in 2002, 50% in 2003, and 75% in 2004%, and by repealing it entirely in 2005.

In 2002, the General Assembly enacted legislation not to conform to the phase-out of the state death tax credit. In other words, North Carolina began tying the amount of the State estate tax owed to the federal credit as it existed in 2001 rather than as it currently exists. The 2002 legislation was set to sunset for estates of decedents dying on or after January 1, 2004. S.L. 2003-2004 extended the sunset to July 1, 2005, meaning that the estate tax would continue to be based on the federal credit as it existed in 2001. This act removes the sunset. The result of the removal of the sunset is that so long as there is a federal estate tax, there will be a North Carolina estate tax. The amount of the State estate tax will be equal to the amount of the federal state death tax credit as it existed in 2001.

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[6] The 2005 Appropriations Act became law on August 13, 2005, and extended the sunset on the additional one-half cent State sales and use tax to July 1, 2007. (See Section 33.1 of S.L. 2005-276).

[7] S.L. 2005-201 extended the maturity date of certain Global Transpark debt to August 31, 2005.

[8] North Carolina conforms to the following federal exemption amounts: 100% exemption for property passing to a surviving spouse; $1.5 million exemption for other estates. Under current federal law, this exemption amount rises to $2 million in 2006, $3.5 million by 2009, and the tax is fully repealed in 2010.

Part IX of the act extends the sunset on the additional one-half percent State sales and use tax rate to the date that the 2005 Appropriatons Act became law. The General Assembly increased the State sales and use tax rate in S.L. 2001-424 from 4% to 4.5%. This increase was to sunset July 1, 2003. S.L. 2003-284 extended the sunset for two years to July 1, 2005. The 2005 Appropriations Act extends the additional one-half per cent rate to July 1, 2007.

Before 2001, the State sales and use tax rate had last been increased in 1991 from 3% to 4%. The Governor's 2005 budget (House Bill 719) recommended removal of the sunset on the ½% additional State sales and use tax, and the Senate passed his recommendation in Senate Bill 622.

Computer Manufacturing Tax Incentives.

Session Law	*Bill #*	*Sponsor*
S.L. 2004-204	S 2 Extra Session	Sen. Hoyle

AN ACT TO PROVIDE A TAX CREDIT FOR CERTAIN MAJOR COMPUTER MANUFACTURING FACILITIES AND TO ENHANCE CERTAIN EXISTING TAX INCENTIVES FOR THOSE FACILITIES.

OVERVIEW: The act provides the following income, franchise, and sales tax incentives for a computer manufacturing facility that, along with related parties and strategic partners, is expected to invest at least $100 million of private funds in a facility in the State over a five-year period and employ at least 1,200 people within five years after the facility is used as a computer manufacturing and distribution facility:

- A new tax credit based upon the unit output and increased employment level of a major computer manufacturing and distribution facility. This credit may be used to eliminate 100% of a taxpayer's income and franchise tax liability. Any unused portion of the credit may be carried forward for the next succeeding 25 years.
- Enhanced Bill Lee Act tax credits that entitle a taxpayer to claim the credit amounts allowed for facilities located in a development zone regardless of the county in which the facility is located. The act also provides that the wage standard does not apply to the activities of a taxpayer at a major computer facility.
- An expansion of the sales tax refund, enacted by the 2003 General Assembly[9] for building materials purchased to build a computer manufacturing facility.

FISCAL IMPACT:

Description	*General Fund Impact*
Computer Manufacturing Credit	$10 million loss for 2005-2006 $10 million loss for 2006-2007 $20 million loss for 2007-2008

[9] S.L. 2003-435

	$20 million loss for 2008-2009 $20 million loss for 2009-2010
Bill Lee Act Changes Jobs Credit	$600,000 loss for 2008-2009 $1 million loss for 2009-2010
Machinery/Equipment Credit	$300,000 loss for 2007-2008 $500,000 loss for 2008-2009 $900,000 loss for 2009-2010
Worker training Credit	$500,000 loss for 2007-2008 $400,000 loss for 2008-2009 $600,000 loss for 2009-2010
Real property Credit	$1.3 million loss for 2006-2007 $1.3 million loss for 2007-2008 $2.6 million loss for 2008-2009 $2.6 million loss for 2009-2010
Sales Tax Refund Expansion	No fiscal impact anticipated
Grand Total of losses	$11.3 million loss for 2006-2007 $22.1 million loss for 2007-2008 $24.1 million loss for 2008-2009 $25.1 million loss for 2009-2010

The amount of the computer manufacturing credit expected to be taken between 2005 and 2020 is $450 million. The amount of the Bill Lee Act credits expected to be taken between 2005 and 2020 is $42.8 million.

(For a more complete fiscal analysis, see Overview Fiscal and Budgetary Actions, 2004 Session Available in the Legislative Library)

EFFECTIVE DATE: See Analysis for effective dates.

ANALYSIS: The Governor convened the Extra Session of the 2004 General Assembly to consider new and enhanced incentives for an eligible computer manufacturing and distribution facility. The following incentives were enacted by the General Assembly to persuade Dell Computer Corporation to locate a manufacturing facility in North Carolina:

Tax Credit based upon Unit Output of a Computer Manufacturing and Distribution Facility

Section 1 of the act creates a new tax credit for an eligible computer manufacturing and distribution facility.[10] The amount of the credit is based upon the facility's unit output and increased employment level. The credit is effective for business activities occurring on or after November 1, 2004, and for taxable years beginning on or after January 1, 2005. The credit expires for business activities occurring in taxable years beginning on or after January 1, 2020.

[10] "Computer manufacturing" is defined in G.S. 105-164.14, as amended by this act. "Facility" is also defined in the act.

The tax credit may be taken against the taxpayer's franchise tax or income tax. The taxpayer must elect the percentage of the credit to be applied against the franchise tax with any remaining percentage to be applied against the taxpayer's income tax liability. Unlike other incentive tax credits, the election is NOT binding for either the year in which it is taken or for any carryforwards of the credit. A taxpayer may elect a different allocation for each year the taxpayer qualifies for a credit. A taxpayer may not claim a credit that exceeds 100% of the taxpayer's tax liability. Most other tax incentives allow the taxpayer to offset no more than 50% of its tax liability. Any unused portion of a credit may be carried forward for the next succeeding 25 years.

Credit Eligibility - To be eligible for this credit, the taxpayer must meet the following employment conditions:

- The Department of Commerce must make a written determination that the taxpayer has or is expected to have an increased employment level of at least 1,200 new full time jobs OR new permanent part-time jobs converted into full-time equivalences within five years after the facility is operational.
- The taxpayer may meet this employment threshold either directly or indirectly through one or more related entities and strategic partners.[11] In order for a taxpayer to include jobs created by related entities and strategic partners in its increased employment level, the taxpayer must obtain their written consent to do so. Once granted, this consent is irrevocable. A job may not be included in the increased employment level of more than one entity. This credit is the first one the State has enacted that allows a taxpayer to meet an employment threshold indirectly through related entities and strategic partners.
- The taxpayer and the taxpayer's related entities and strategic partners must provide health insurance[12] for all of the full-time jobs each year it claims a credit or carryforward of a credit. The taxpayer does not have to provide health insurance for its part-time jobs. This condition is the same as the health insurance condition under the Bill Lee Act.

To be eligible for this credit, the taxpayer must meet the following investment condition:

The Secretary of Commerce must make a written determination that the taxpayer has invested or is expected to invest at least $100 million of private funds in a computer manufacturing and distribution facility over a five-year period. The investments may be made either directly or indirectly through related entities and strategic partners.

To be eligible for the credit, the taxpayer must also meet the following conditions that are typically required under other State tax incentives:

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[11] The act defines a "related entity" as an entity for which the taxpayer possesses directly or indirectly at least 80% of the control and value. The act defines "strategic partner" as a business that is engaged in activities at the facility that directly contribute to the manufacture and distribution of computers and computer peripherals and with whom the taxpayer has contracted to provide those activities at the facility in direct support of its manufacturing and distribution activities.

[12] An entity provides health insurance if it pays at least 50% of the premiums for health care coverage that equals or exceeds the minimum provisions of the basic health care plan of coverage recommended by the Small Employer Carrier Committee pursuant to G.S. 58-50-125. This provision is the same as the insurance provisions of the Bill Lee Act.

- The taxpayer and the taxpayer's related entities and strategic partners have no pending administrative, civil, or criminal enforcement actions based on alleged significant environmental violations, nor have they had a final determination of responsibility for any significant environmental violation within the past five years.
- The taxpayer and the taxpayer's related entities and strategic partners have no citations under the Occupational Safety and Health Act that have become a final order within the past three years for willful serious violations or for failing to abate serious violations.
- The taxpayer and the taxpayer's related entities and strategic partners have no overdue tax debts that have not been satisfied or otherwise resolved.

The taxpayer must apply to the Secretary of Commerce for the required eligibility determinations. The application must be made under oath. The determination is a question of fact and must be made whenever a taxpayer can demonstrate performance or provide a credible plan for performance. If the taxpayer does not perform as promised, the taxpayer does not forfeit any of the credits already taken, unless the assertions of the taxpayer can be proven to have been false when made.[13]

Credit Amount - The credit amount and conditions vary from year to year based on complicated formulas. The actual amount of the credit is computed in two steps. First, one must determine the lesser of the cap and an amount determined by multiplying the number of units produced at the facility by a dollar amount. In some cases, this amount would be adjusted downward based on how much the actual increased employment level is below certain targets. In other situations, no downward adjustment is made for reductions in increased employment level.

If the amount of the credit computed in the first step is less than the cap, then the amount can be brought up to the cap by using amounts in a make up account. The make up account includes amounts by which prior year formula calculations exceeded the applicable caps. These amounts must be used within seven years. This credit is the first one the State has enacted that allows a taxpayer to carry forward credit amounts that could not be used because they exceeded the caps. It is also the first time the State has allowed a taxpayer to meet a cap by using prior year excesses.

In 2005, the taxpayer may claim a credit equal to $10 million if the taxpayer has invested at least $25 million by the end of the taxable year to construct a computer manufacturing and distribution facility. The investment may be made either directly by the taxpayer or indirectly through related entities.

For taxable years 2006 - 2009, the maximum credit allowed is $10 million. The actual amount of the credit is determined by the increased employment level of the taxpayer at the

[13] One could argue that there is the potential for a court to find that allowing a credit for nothing more than a finding by the Secretary of Commerce violates the constitutional provision prohibiting the General Assembly from delegating the taxing authority because it potentially gives the executive branch the authority to pick and choose which taxpayers will receive credits. Under current law, when a taxpayer receives a tax benefit based on a determination by the Secretary regarding expected future activity, the tax benefits are subject to forfeiture if the taxpayer does not perform as expected. Because there is no forfeiture under the credit created in this act, if the taxpayer does not produce the expected jobs or make the expected investment, one could argue that the General Assembly has delegated its taxing authority to the Secretary.

facility and the number of consumer-ready computers and computer peripherals produced, assembled, or manufactured by the facility during that taxable year, hereinafter referred to as 'unit output of facility'. The formula is as follows:

Credit amount = (Employment level adjustment factor)(Production factor)(Unit output of facility)

The employment level adjustment factor is the lesser of 1 or the increased employment level for the year divided by the applicable target increased employment level. Assuming the taxpayer meets the increased employment levels stated in the act, the adjustment factor would be 1. If the taxpayer fails to meet the targeted increased employment levels, then the factor would be a percentage less than 1, thereby reducing the amount of credit available to the taxpayer for that taxable year. The target increased employment level and the production factor vary for tax years 2006-2009 as follows:

Year	Increased employment level	Production factor
2006	600	$15
2007	1,000	$6.25
2008	1,100	$6.25
2009	1,500	$6.25

For taxable years 2010-2014, the maximum credit amount depends upon the increased employment level attained by the taxpayer at the facility for which the credit is claimed.

- If the taxpayer has EVER attained an increased employment level of at least 1,500 at the facility for which the credit is claimed, then the credit amount for taxable years 2010-2014 is the unit output of the facility multiplied by $6.25 or $15 million, whichever is less. The credit amount would be reduced if the taxpayer's increased employment level decreased by more than 40% from that of the previous year. The reduction would be a percentage reduction equal to the increased employment level for the taxable year divided by 1,500.

- If the taxpayer never attained an increased employment level of at least 1,500, then the maximum credit amount remains at $10 million and the amount of the credit is reduced for any year the taxpayer does not reach an increased employment level of 1,500. The formula for determining the credit amount is:

  Credit = (Employment level adjustment factor)(Unit output of facility)($6.25)

  The employment level adjustment factor is the lesser of one and the number derived by dividing the taxpayer's increased employment level for the taxable year by 1,500.

For taxable years 2015-2019, the maximum credit amount may be increased to $20 million if the taxpayer has in ANY year attained an increased employment level of 2,500 at the facility for which the credit is claimed. The credit amount continues to vary depending upon the maximum increased employment level EVER attained and the current increased employment level.

- If the taxpayer has EVER attained an increased employment level of 2,500 AND the taxpayer's increased employment level for the current year is at least 1,500, then the

credit amount is the unit output of the facility multiplied by $6.25 or $20 million, whichever is less.

- If the taxpayer has EVER attained an increased employment level of 2,500 BUT the taxpayer's increased employment level for the current year is less than 1,500, then the credit amount is the unit output of the facility multiplied by $6.25 or $15 million, whichever is less. The credit amount would be reduced if the taxpayer's increased employment level decreased by more than 40% from that of the previous year AND the increased employment level of the previous year was 1,500 or less or the increased employment level for the current year is 900 or less.
- If the taxpayer has EVER attained an increased employment level of 1,500, but has never attained an increased employment level of 2,500, then the credit amount is the unit output of the facility multiplied by $6.25 or $15 million, whichever is less. The credit amount would be reduced if the taxpayer's increased employment level decreased by more than 40% from that of the previous year AND the increased employment level of the previous year was 1,500 or less or the increased employment level for the current year is 900 or less.
- If the taxpayer has never attained an increased employment level of at least 1,500, then the maximum credit amount remains at $10 million and the amount of the credit is reduced for any year the taxpayer does not reach an increased employment level of 1,500.

Constitutional Concerns - The credit set out in Section 1 of the act would be vulnerable to attack under the reasoning of the *Cuno* decision because it evinces a clear preference for in-State economic activity at the expense of out-of-state development. On September 2, 2004, the Sixth Circuit Court of Appeals issued its decision in *Cuno v DaimlerChrysler*, 386 F.3d 738, (2004, 6th Cir. (Ohio)). In that decision, the Court found that Ohio's investment tax credit violated the Commerce Clause of the United States Constitution because it (a) encouraged in-state economic development at the expense of out-of-state economic development and (b) allowed the taxpayer to reduce pre-existing income tax liability by investing in-state but not by investing out-of-state.

Although the Sixth Circuit's decision is not binding in North Carolina[14] and is subject to further review[15] a similar case could be brought in this jurisdiction. If a decision applicable in this jurisdiction followed the reasoning of the Sixth Circuit opinion, the credit set out in Section 1 of the act would be ruled unconstitutional. If that happened, it is uncertain what the remedy would be. Possible remedies could include ordering the State to provide retroactive credits to otherwise similarly situated taxpayers who had made similar investments in other states.

The credit could also be vulnerable to attack on equal protection grounds because the amount of the credit is based, in part, on the maximum increased employment level ever attained by the taxpayer and not just on the current increased employment level of the taxpayer. Under this proposal, two companies that have identical output and increased

[14] The decision is binding only in the states that compose the Sixth Circuit: Kentucky, Michigan, Ohio, and Tennessee.

[15] The United States Supreme Court will hear this case during the 2005-2006 Term..

employment levels in the current year could be eligible for substantially different credits based on the increased employment level attained in an earlier year.

For example, consider two companies - CorpA and CorpB. In 2010, CorpA has an increased employment level of 1,500 and CorpB has an increased employment level of 1,200. In that year, CorpA is eligible for a maximum credit of $15 million and CorpB is eligible for a maximum credit of $8 million. Further assume that in 2011, CorpA reduces its increased employment level to 1,200 and CorpB maintains its increased employment level at 1,200. CorpA remains eligible for a maximum credit of $15 million while CorpB remains eligible for a maximum credit of $8 million. Under this example, in 2011, two corporations with identical output and increased employment levels would be eligible for vastly different credits. A court could find that there is no rational basis for awarding CorpA almost double the amount of credit just because it once had an increased employment level of 1,500. In fact, one could argue that the distinction is irrational because the company that has laid off employees is the one that qualifies for the larger credit.

This problem is exacerbated in certain situations. Once a taxpayer has attained an increased employment level of 1,500, it can reduce its labor force by up to 40% a year without a reduction in the maximum amount of credit for which it is eligible. Continuing the example cited above, CorpA could reduce its increased employment to 900 in 2011 and still be eligible for a maximum credit of $15 million. In that case, CorpA would have less of a positive impact (i.e. 900 new jobs as opposed to 1,200 new jobs) in 2011 than CorpB, but be eligible for a much larger credit.

Other Considerations - The credit, as enacted raises the following additional issues:

- The method for calculating the amount of a credit for which a taxpayer is eligible is extremely complicated. This may result in additional compliance and auditing burdens.

- There is no provision regarding expiration of a credit if the increased employment level is not maintained. Generally under prior law, when a taxpayer was allowed a credit for a certain activity, the credit expired if the activity was not maintained. For example, in order for a taxpayer to take full advantage of the credit for creating jobs under the Bill Lee Act, those jobs must be maintained for a number of years.

  The credit in this act is designed in a way that allows the taxpayer, under certain circumstances, to take the full benefit of a credit even if increased employment levels are not maintained. Once a taxpayer has attained an increased employment level of at least 1,500, the taxpayer may reduce its increased employment level by up to 40% each year without being subject to a reduction in the maximum amount of the credit for which it is eligible. For example, if a taxpayer has an increased employment level of 1,500 in 2010, the taxpayer would be eligible for a maximum credit of $15 million per year. In 2011, the taxpayer could reduce its increased employment level to 900 while maintaining eligibility for up to $15 million per year in tax credits. Then, in 2012, the taxpayer could reduce its increased employment level to 540 while still maintaining eligibility for a maximum credit of $15 million.

  Taken to the mathematical extreme, it is theoretically possible for a taxpayer to reduce its increased employment level by almost 99% over nine years while maintaining eligibility for the maximum amount of the credit. Continuing the

example cited above, a taxpayer that had an increased employment level of 1,500 in 2010 that took the 40% reduction each year would have an increased employment level of just 16 by 2019 and would still be eligible for a maximum credit of $15 million.[16]

- There is no wage standard associated with this credit. The Bill Lee Act generally requires that jobs at the relevant facility satisfy a wage standard in order for the taxpayer to be eligible for a credit under that Act. A wage standard does not apply in tiers one and two or in development zones. Although there was no wage standard requirement for the alternative credit for cigarette exportation enacted in 2003, it was understood at the time that those jobs would easily satisfy the Bill Lee wage standard.

- The 25-year carryforward period for credits under this act is extremely long, although not unprecedented.

- This credit is the first one the State has enacted that would give one entity a credit for activity undertaken by another. North Carolina has struggled for years with companies using related entities as a tax avoidance mechanism. Companies create related Delaware holding companies and use accounting tricks to eliminate their North Carolina taxable income. Companies create complex chains of related companies to shift property into LLCs and avoid franchise tax. Shifting income and expenses between and among various related entities is the essence of tax avoidance. North Carolina is a separate entity filing state; therefore the Department of Revenue cannot view the entire web of inter-related entities to determine the real economic effect of the actions of related entities.

Bill Lee Incentive Enhancements

Section 2 of the act provides that a taxpayer who is otherwise eligible for one of the tax credits under the Bill Lee Act and who qualifies for the tax credit for major computer manufacturing facilities is eligible for the following major computer facility enhancements under the Bill Lee Act, regardless of the enterprise tier designation of the county in which it is located. The taxpayer may include employees of or investments made by related entities or strategic partners to meet its Bill Lee eligibility requirements. The Bill Lee Act expires for computer manufacturing facilities in 2009.

- Wage Standard. – The wage standard does not apply to the activities of the taxpayer at the major computer facility. Under prior law, the wage standard was inapplicable only in tiers one and two or in development zones.

- Credit for Creating Jobs. – The amount of the credit for creating jobs is increased by $4,000 per job for jobs at the major computer facility. For jobs created at other facilities, the amount of the credit remains at $500 per job in a tier five county; $1000 in tier four; $3,000 in tier three; $4,000 in tier two; and $12,500 in tier one.

- Credit for Investing in Machinery and Equipment. – The threshold investment a taxpayer must meet to qualify for the credit and the amount of credit the taxpayer is

[16] The amount of the credit is also based on output at the facility. It is likely that a taxpayer that greatly decreased its employment level at a facility would also decrease output, so the taxpayer may not be able to take advantage of the maximum amount of the credit.

allowed under the Bill Lee Act is the same as allowed under current law for a tier one county: a threshold amount of zero and a credit amount equal to 7% of the eligible investment. Under current law, the threshold for a tier five county is $2 million and the applicable credit percentage is 4%.

- Credit for Worker Training. - The maximum amount of the credit is $1,000 per worker. This is the same credit amount allowed to other taxpayers for jobs in a tier one area. If the jobs are not in a tier one area, then other taxpayers are allowed a $500 credit for worker training..
- Credit for Substantial Investment in Other Property. - Under prior law, this 30% credit was available only for property located in a tier one or two area. The credit in the act is available to a taxpayer who qualifies as a major computer manufacturing facility regardless of the enterprise tier area in which the property is located.

Sales Tax Incentives

In 2003, the General Assembly provided that the owner of an eligible facility that invests at least $100,000,000 of private funds to acquire, construct, and equip a facility in North Carolina was allowed an annual refund of sales and use taxes paid by it on building materials, building supplies, fixtures, and equipment that become a part of the real property of the eligible facility. An eligible facility includes computer manufacturing. If the owner of an eligible facility does not make the required minimum investment within five years after the first refund is allowed, the facility loses its eligibility and the owner forfeits all refunds already received. Upon forfeiture, the owner is liable for tax equal to the amount of all past taxes refunded plus interest. The tax and interest are due 30 days after the date of the forfeiture.

Section 3 of the act makes several changes to the sales tax refund statute as it applies to computer manufacturing. These changes are effective January 1, 2005, and apply to sales made on or after that date:

- It provides that the investment may be made directly by the taxpayer or indirectly through a related entity.
- It clarifies that a 'computer facility' may include multiple buildings on a single campus.
- It provides that the term 'computer manufacturing' includes peripheral equipment if the manufacture or assembly of this peripheral equipment occurs at the facility or campus at which the taxpayer also manufactures or assembles electronic computers.

Section 4 of the act adds an exemption to the confidentiality of tax information statute so that the State may verify information received by a taxpayer claiming the credit under the act with a related entity or strategic partner.

Public Finance Changes.

Session Law	Bill #	Sponsor
S.L. 2005-238	HB 1117	Representative Ross

AN ACT TO MAKE CHANGES TO STATE AND LOCAL GOVERNMENT FINANCE LAWS AND TO AUTHORIZE PUBLIC HOSPITAL AUTHORITIES TO GRANT MORTGAGES TO FINANCE OR REFINANCE HOSPITAL FACILITIES AND EQUIPMENT.

OVERVIEW: This act makes various amendments to statutes dealing with public finance. The act contains a severability clause so that if any provision of the act is found invalid, the invalidity will not affect other provisions of the act.

FISCAL IMPACT: No impact.

(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2005 Session Available in the Legislative Library.)

EFFECTIVE DATE: The act became effective August 1, 2005.

ANALYSIS: This act makes various changes to State and local government finance laws.

Project Development Financing – In 2003, the General Assembly passed an act authorizing the voters of the State to vote in the November 2004 statewide general election on an amendment to the North Carolina Constitution that would allow local governments to finance development within defined districts by issuing tax increment financing bonds without a local referendum. The ballot measure passed. This development tool, known as 'project development financing', allows local governments to set aside the additional property taxes that are generated by a new investment to pay for public facilities that support that new investment. Under current law, the total land area of the defined district, known as the 'development financing district', may not exceed 5% of the total land area of the unit creating the district. The district also must be comprised of property that is one or more of the following:

- Blighted, deteriorated, deteriorating, undeveloped, or inappropriately developed from the standpoint of sound community development and growth.
- Appropriate for rehabilitation or conservation activities.
- Appropriate for the economic development of the community.

The act provides that land in a district created by a county that subsequently becomes part of a municipality does not count against the five-percent (5%) limit for the municipality unless the municipality has entered into an agreement with the county under which the city taxes on the incremental valuation of the property in the district will secure the bonds issued by the county.[17]

[17] Sections 1, 5, and 12 of the act.

The act makes one other change to the project development financing statutes. Under prior law, units of local government could issue project development financing debt instruments, and agree to repay the debt with any available revenues of the unit, provided the agreement did not constitute a pledge of the unit's taxing power. The act expands the sources of revenue that may be pledged as security for the bond to include revenues to be raised from any special assessment, provided it did not constitute a pledge of the unit's taxing power, and the encumbrance of any real or personal property being financed or improved by the project. Any property so encumbered could be sold in accordance with the encumbering document and would not fall under any disposition of governmental property statutes. The act also allows cities and towns to pledge local sales tax revenues. Those revenues do not constitute a pledge of the taxing power of a city or town because local sales tax is a county tax that is shared with the municipalities, not a tax levied by a city or town.[18]

Revenue Bonds. – The State and units of local government are authorized to issue revenue bonds, but prior law specifically prohibited them from encumbering the related real property. This act allows the State and units of local government, including hospital facilities, to pledge, mortgage, or grant a security interest in real and personal property, whether owned or leased, comprising the utility or public enterprise project affected by the bond issuance. Any property so encumbered could be sold in accordance with the encumbering document and would not fall under any disposition of governmental property statutes. The act authorizes the same encumbrance of property in connection with the issuance of revenue bonds made through the Medical Care Commission that could occur through the Revenue Bond Act. The act also makes a similar change in the NC Clean Water Revolving Loan and Grant Act by permitting an applicant for clean water revolving grants and loans to grant a mortgage on the assets being financed.[19] Local government units and certain non-profit water corporations may apply for clean water revolving grants and loans.

General Changes. – The act makes the following general changes to the State and local finance laws:

- Local governments are required to appoint a finance officer to carry out certain statutorily required duties.[20] Under prior law, the finance officer was required to have a performance bond of at least $10,000 and no more than $250,000, payable to the local government. The act increased the minimum bond amount to $50,000 and removed the cap.[21]

- Under prior law, the public notification and hearing requirements for refunding bonds were the same as for the original issuance. The act provides that if refunding bonds do not extend the maturity of, or increase the aggregate debt service on, the debt being refunded, then a new public hearing is not required, the bond order may be introduced and adopted in one day, and various restrictions about installments, issues, series, and redemption do not apply.[22]

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[18] Section 6 of the act.
[19] Sections 4, 11, 13, and 14 of the act.
[20] G.S. 159-24 and G.S. 159-25.
[21] Section 2 of the act.
[22] Section 3 of the act.

- The act removes the requirement that all bonds of a particular maturity must bear interest at the same rate and clarifies that the interest rate restrictions do not apply to private negotiated sales.[23]
- The act eliminates the 2% deposit on the bids for general obligation bonds and in its place permits the Local Government Commission to set an appropriate bid deposit or to determine no bid deposit is required.[24]
- Bonds sold at public sale must be awarded to the bidder offering to purchase the bonds at the lowest interest cost. The act replaces the current statutory language used to determine the lowest interest cost for bond bid purposes with Local Government Commission authority to establish the appropriate calculation method in the notice of sale.[25]
- The act replaces the antiquated system for destroying cancelled bonds. It permits cancelled bonds to be destroyed by being marked cancelled in the manner determined by the finance officer with an entry of the destruction or cancellation entered in the government's official records. Under the prior law, the cancelled debt instrument had to be burned or shredded and the appropriate entry made in a 'substantially bound book'.[26]
- Lastly, the act expands the purposes for which the North Carolina Capital Facilities Financing Agency and local industrial development authorities may issue bonds to include museums and orphanages and similar housing facilities for children or disadvantaged or disabled persons.[27]

Extend JDIG and Bill Lee Act.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-241	HB 1004	Rep. Gibson, Grady

AN ACT TO EXTEND THE WILLIAM S. LEE QUALITY JOBS AND BUSINESS EXPANSION ACT AND THE JOB DEVELOPMENT INVESTMENT GRANT PROGRAM; TO ALTER THE MANNER IN WHICH ENTERPRISE TIERS ARE DESIGNATED; TO AMEND THE HEALTH INSURANCE REQUIREMENTS FOR THE JOB DEVELOPMENT INVESTMENT GRANT PROGRAM; AND TO CREATE AN ECONOMIC DEVELOPMENT OVERSIGHT

[23] Section 7 of the act.
[24] Section 7 of the act.
[25] Section 8 of the act.
[26] Section 9 of the act.
[27] Section 10 of the act.

COMMITTEE TO PERFORM A COMPREHENSIVE STUDY OF THE ECONOMIC DEVELOPMENT INCENTIVES.

OVERVIEW: This act makes the following changes to the William S. Lee Quality Jobs and Business Expansion Act (hereinafter the Bill Lee Act) and the Job Development Investment Grant Program (hereinafter the JDIG Program):

- Extends the sunset for the Bill Lee Act and the JDIG Program until January 1, 2008. For certain projects located in development zones, the sunset of the Bill Lee Act is extended until January 1, 2010.
- Amends and adds exceptions to the tier designation formula under the Bill Lee Act as follows:
  - Adds an exception to designate a county as a tier one area if the county's rate of unemployment was one of the ten highest in the State for the most recent 12-month period preceding the designation.
  - Amends the exception for certain small counties that have a population of less than 12,000 and that meet a certain poverty level, by requiring that the counties only meet the population requirement to be designated a tier one area.
- Amends the JDIG Program so that an eligible business no longer is required to provide health insurance for **all** full-time employees. The eligible business must provide health insurance only to a full-time employee who earns less than $150,000 in taxable compensation annually or three and one-half times the annualized average wage for all private insured employers in the State employing between 250 and 1,000 people.
- Creates an Economic Development Oversight Committee

FISCAL IMPACT: Changes to the Bill Lee Act are estimated to reduce General Fund revenues by $2.03 million in FY 2006-07, $7.22 million in FY 2007-08, $5.47 million in FY 2008-09, and $5.64 million in FY 2009-10. The extension of the JDIG sunset is estimated to reduce General Fund revenues by $4.50 million in FY 2006-07, $9 million in FY 2007-08, $9 million in FY 2008-09, and $6 million in FY 2009-10.

(For a more complete fiscal analysis, see Overview Fiscal and Budgetary Actions, 2005 Session Available in the Legislative Library.)

EFFECTIVE DATE: This act became effective when signed into law by the Governor on July 29, 2005. The sections of the act amending and adding exceptions to the tier designation formula of the Bill Lee Act apply to designations made on or after July 29, 2005.

ANALYSIS:

Extension of Sunsets for Bill Lee Act and JDIG Program

This act extends the sunsets on both the Bill Lee Act and the JDIG Program generally from January 1, 2006 to January 1, 2008.[28] In addition, the act extends the Bill Lee Act until

[28] There are several exceptions to the 2006 sunset date: Interstate air couriers are eligible to claim the credits for business activity that occurs on or before January 1, 2010, provided that the interstate air courier entered

January 1, 2010, for projects located in development zones if all of the following conditions[29] are met:

- Before January 1, 2006, the taxpayer must sign a letter of commitment with the Department of Commerce describing the proposed new or expanding project.
- Before January 1, 2006, the Secretary of Commerce must make a written determination that the taxpayer is expected to place in service at least $10 million of new machinery and equipment in a development zone over a three-year period and that the taxpayer will create at least 300 new jobs at the location over a three-year period.
- Before January 1, 2006, the taxpayer must place in service at least $4 million of real property and machinery and equipment in service at the location and must create at least 20 new jobs.

In 1998, the General Assembly amended the Bill Lee Act to provide additional incentives for businesses that locate or expand in development zones, which are economically distressed areas located within cities. In order to be designated as a development zone by the Department of Commerce, the area must satisfy all of the following conditions: (1) every census tract or block group in the zone is located at least partially in a city with a population of at least 5,000, (2) the zone has a population of at least 1,000, (3) more than 20% of the population of the zone is below the poverty level, (4) every census tract and census block group in the zone has more than 10% of its population below the poverty level, or is immediately adjacent to a tract or group that has more than 20% of its population below the poverty level, and (5) no census tract or block group in the zone is located in another development zone. Designation as a development zone is effective for two years.

Location in a development zone leads to enhanced tax incentives. For example, if a business locates in a development zone, its maximum worker training credit is $1,000 rather than $500, it receives an additional $4,000 per job on its jobs tax credit, and the credit for investing in machinery and equipment is calculated as if the zone were a tier one county. Finally, a business located in a development zone does not have to meet a wage standard to be eligible for the credits.

Exceptions to Tier Formula in Bill Lee Act[30]

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into a real estate lease on or before January 1, 2006, with an airport authority that provides for the lease of at least 100 acres of land for a term of at least 15 years. Taxpayers that qualify as "eligible major industries" before January 1, 2006, are also allowed to claim credits for business activity that occurs on or before January 1, 2010. A taxpayer is an eligible major industry if it will invest at least $100 million in acquiring, constructing, and equipping a facility and it is engaged in bioprocessing, the manufacture or distribution of pharmaceuticals or medicines, aircraft manufacturing, computer manufacturing, motor vehicle manufacturing, or semiconductor manufacturing. Also the credit for research and development under the Bill Lee Act would still expire effective January 1, 2006. During the 2004 Regular Session, the research and development credit under the Bill Lee Act was replaced with a stand-alone credit for research and development under Article 3F of Chapter 105. (See Part 32D of S.L. 2004-124) This stand-alone credit sunsets January 1, 2009.

[29] Only two projects qualified for this extension at the time this act was enacted: The Cheesecake Factory in Nash County and the Dole plant in Gaston County.

[30] S.L. 2005-406 also amends the tier designation formula by allowing certain industrial parks located in higher-tiered counties to be treated as if they were located in an enterprise tier one area if the parks meet conditions related to government ownership, size, population of the counties, and Medicaid eligibility within the counties.

Under the Bill Lee Act, counties are divided into five enterprise tiers based on the unemployment rate, per capita income, and population growth of the county. For many of the credits, the lower the tier of a county, the more favorable the incentive. By December 31 of each year, the Department of Commerce is required to assign a tier designation to each of the 100 counties in the State. In order to make these assignments, the Department of Commerce must rank all 100 counties based on the following factors: the rank of the county in a ranking of counties by average rate of unemployment over the preceding 12 months from lowest to highest, the rank of the county in a ranking of counties by average per capita income over the preceding 12 months from highest to lowest, and the rank of the county in a ranking of counties by percentage growth in population over the preceding 12 months from highest to lowest. Each of these factors is given equal weight. The Secretary of Commerce is required to use the latest data available in making these calculations. Counties with one of the 10 highest rankings are designated enterprise tier one, the next 15 counties are enterprise tier two, the next 25 counties are enterprise tier three, the next 25 counties are enterprise tier four, and the remaining counties are enterprise tier five.

There are several exceptions to the tier formula. Once exception provides that any county that has a population of less than 12,000 and more than 16% of its population living below the federal poverty level is automatically a tier one county. This act eliminates the requirement related to the percent living below the poverty level. If this provision had been in effect for the 2005 designations, two counties would have been affected: Camden and Clay Counties would have been designated as enterprise tier one areas rather than enterprise tier three areas.

This act also creates a new exception for counties with particularly high rates of unemployment. Any county whose rate of unemployment was one of the ten highest in the State for the most recent 12-month period preceding the designation is automatically designated an enterprise tier one area. If this new exception had been in effect for the 2005 designation, five counties would have been affected: Anson, Cleveland, Rockingham, and Rutherford Counties would have fallen from tier two to tier one; Wilson County would have fallen from tier three to tier one

Health Insurance Requirement for JDIG Program

In 2002, the General Assembly created a new economic development tool for new and expanding businesses in North Carolina, the Job Development Investment Grant (JDIG) Program. The JDIG Program is used to attract businesses to the State by allowing a five-member committee to award grants to businesses. The grants may be awarded over as many as 12 years and the amounts of the grants are based on income tax withholdings from new jobs created by the businesses. The committee may enter into no more than 25 agreements per calendar year and may commit no more than $15 million in any fiscal year under all agreements entered into during a single calendar year. In order to be eligible for a grant under the JDIG Program, a business must provide health insurance for all full-time jobs associated with the project. The test is the same as under the Bill Lee Act – the business must, for all full-time employees of the project, pay at least 50% of the premiums for health insurance that meets at least the minimum provisions of the basic health care plan of coverage recommended by the Small Employer Carrier Committee.

This act eliminates the requirement that the business provide health insurance for any individual whose taxable compensation from the business exceeds the greater of $150,000

on an annualized basis or 3.5 times the average wage for all private insured employers in the State employing between 250 and 1,000 people.

Creation of Economic Development Oversight Committee

This act creates an Economic Development Oversight Committee.[31] This standing committee consists of twelve members: six appointed by the Speaker of the House of Representatives and six appointed by the President Pro Tempore of the Senate. The act directs the Committee to study the budgets, programs, and policies of various State, regional, and local entities involved with economic development; to analyze legislation from other states regarding economic development; and to analyze proposals of the Economic Development Board. Before the 2006 Regular Session, the Committee must complete a comprehensive study of the Bill Lee Act and JDIG Program. The Committee is also required to hold at least one joint meeting with the Revenue Laws Study Committee before issuing a report on the comprehensive study. The act states that it is the intent of the General Assembly to replace the Bill Lee Act and to revamp the JDIG Program based on the recommendations of the Committee.

2005 Appropriations Act.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-276	SB 622	Senator Garrou

AN ACT TO MAKE BASE BUDGET APPROPRIATIONS FOR CURRENT OPERATIONS OF STATE DEPARTMENTS, INSTITUTIONS, AND AGENCIES, AND FOR OTHER PURPOSES.

OVERVIEW, EFFECTIVE DATES, AND FISCAL IMPACT:

Part	Description and Effective Dates	Fiscal Impact
7	**LEA Sales Tax Refund Reporting & Redirect Refundable Sales to State Public School Fund** Section 7.27 authorizes the Department of Revenue to release sales tax refund data for individual LEAs. Section 7.51 redirects sales and use tax refunds payable to LEAs to the State Public School Fund.	No Impact. $33,300,000 recurring General Fund Revenue, beginning with the 2006-07 fiscal year.
8	**Extend the Sunset on Training & Reemployment Contributions made by Employers**	

[31] House Bill 1365, introduced by Rep. Daughtridge, also established an Economic Development Oversight Committee. This bill was in the House Rules Committee at the end of the Session.

	Section 8.8 extends for an additional five years the expiration of a tax, known as a "training and reemployment contribution" paid by employers in lieu of part of the unemployment taxes they would otherwise owe.	No impact.
11	**Increase Funds for North Carolina Grape Growers Council** Section 11.4 expands the quarterly distribution of a portion of the excise tax on wine to the North Carolina Grape Growers Council by raising the annual cap from $350,000 to $500,000, effective October 1, 2005.	
22	**Department of Revenue Debt Fee for Taxpayer Locater Services and Collection and Property Tax Commission Per Diem** Section 22.1 adds three more purposes to the list of purposes for which the collection assistance fee may be used. Section 22.5 authorizes the Property Tax Commission to set the salary for its members, effective September 1, 2005.	
33	**Sales Tax Changes** This part makes the following changes to the State sales and use tax laws:	
	• Section 33.1 extends the one-half cent State sales tax to July 1, 2007, effective August 13, 2005.	FY 2005-06 $417.1 million gain FY 2006-07 $462.7 million gain FY 2007-08 $ 31.6 million gain
	• Section 33.11 taxes railway cars and locomotives at the general rate (was 3% State rate with cap of $1,500 per item), effective January 1, 2006. Section 33.12 provides interstate carriers a refund of a portion of the taxes paid.	Minimal fiscal impact expected
	• Section 33.4 taxes telecommunications at the combined general rate (was 6%), effective October 1, 2005	FY 2005-06 $32.1 million gain. The gain is estimated at $51.7 million for a full fiscal year.
	• Section 33.6 includes voicemail as part	Minimal fiscal impact

[32] Prior to 2003, candy was subject to State and local sales tax unless it was purchased for home consumption. S.L. 2003-284 exempted candy from sales tax. The taxation of candy brings it in line with the taxation of soft drinks.

	of the gross receipts of telecommunications service, effective October 1, 2005.	
	• Section 33.4 taxes direct-to-home satellite service at combined general rate (was 5%), effective October 1, 2005.	FY 2005-06 $6.5 million gain The gain is estimated at $10.5 million for a full fiscal year.
	• Sections 33.4 and 33.14 tax cable service at combined general rate, and allow a cable service provider a credit for the local franchise taxes paid on cable service (was no sales tax), effective January 1, 2006.	FY 2005-06 $10.9 gain FY 2006-07 $26.1 gain
	• Section 33.4 taxes satellite digital audio radio service at general rate (was no sales tax), effective January 1, 2006.	No fiscal information available, but a revenue gain is expected in future years.
	• Section 33.4 taxes spirituous liquor at combined general rate (was 6%), effective October 1, 2005.	FY 2005-06 $2.9 million gain
	• Section 33.10 taxes candy at general rate (was exempt), effective October 1, 2005.[32]	FY 2005-06 $9.8 million gain FY 2006-07 $15.8 million gain
	• Section 33.4 taxes mobile classrooms and mobile offices at the general rate (was taxed at 3% State rate with cap of $1,500 per item), effective January 1, 2006.	FY 2005-06 $0.1 million gain FY 2006-07 $0.3 million gain
	• Section 33.9 exempts the following items currently taxed at special 1% State rate, effective January 1, 2006: o Horses or mules sold to farmers o Animal semen o Fuel, other than electricity, sold to farmers for farm purposes, to manufacturers, and to laundries and dry cleaners o Wrapping paper, cartons, and supplies sold to freezer locker plants	The exemption of items taxed at 1% is expected to reduce the General Fund by $0.95 million in FY 2005-06 and thereafter by $2.0 million annually.
	• Section 33.9 exempts the following items currently taxed at the special State rate of 1%, with an $80 cap per item,	The exemption of sales to farmers of machinery and containers and of sales of storage facilities and tobacco

	effective January 1, 2006: o Sales to farmers of machinery, attachments and repair parts for the machinery, and lubricants applied to the machinery. o Sales to farmers of containers for use in planting, harvesting, marketing, packaging, or transporting farm products. o Bulk tobacco barns or racks, parts, and accessories attached to the barns. o Grain, feed, or soybean storage facilities. o Sales to laundries and dry cleaners of machinery, parts, and accessories attached to the machinery. o Sales to an interstate passenger air carrier of aircraft simulators for flight crew training. o Sales to an interstate air courier of materials handling equipment and racking systems used at an airport or in a warehouse or distribution facility. o Central office equipment, switchboard equipment, private branch exchange equipment, and terminal equipment sold to telephone companies. o Towers and broadcasting equipment sold to a radio or television company licensed by the FCC; and broadcasting equipment (excluding cable) sold to a cable service provider. • Section 33.9 exempts sales of potting soil to farmers, effective January 1, 2006 • Section 33.9 exempts funeral services, but taxes tangible property such as caskets and monuments at the general rate, effective January 1, 2006. Current	barns is estimated to reduce the General Fund by $1.5 million for FY 2005-06 and thereafter, by $3.1 million annually The exemption of sales of equipment to laundries, telephone companies, radio and television companies, and air couriers is estimated to reduce the General Fund by $0.9 million for FY 2005-06 and thereafter, by $2.0 million annually. Minimal fiscal impact FY 2005-06 $1.7 million gain FY 2006-07 $2.7 million gain

	law exempts funeral expenses, including coffins and caskets, not to exceed $1,500. • Sections 33.8 and 33.24 make the use tax applicable to taxable services sourced to the State, effective October 1, 2005, and extend the sunset on the use tax line item on the individual income tax return from January 1, 2005 to January 1, 2010. • Section 33.3 adds new definitions to the sales tax laws in order to conform to the Streamlined Sales and Use Tax Agreement, effective October 1, 2005. <u>Revenue Laws Study Committee</u> Section 33.32 directs the Revenue Laws Study Committee to study the following issues and make a final report to the 2007 General Assembly: o Equity of taxation on video, cable, satellite, and data service providers o Impact of taxing maintenance agreements. (It is the intent of the General Assembly to apply the sales and use tax to maintenance agreements beginning July 1, 2006.) Section 33.33 reenacts and limits S.L. 2004-123 so that it applies to Dare County only. The 2004 legislation authorized counties to levy an additional 1% sales and use tax for beach nourishment. The legislation, as the title indicates, was meant to apply to Dare County only.	
34	**Tobacco Tax Rate Changes** Effective September 1, 2005, increased the tax on cigarettes from 5 cents a pack to 30 cents a pack. Effective July 1, 2006, increases the tax on cigarettes to 35 cents a pack. Effective September 1, 2005, increased the tax on other tobacco products from 2% to 3%.	FY 2005-06 $117.2 million gain FY 2006-07 $187.3 million gain FY 2007-08 $184.0 million gain FY 2008-09 $179.1 million gain FY 2009-10 $173.7 million gain FY 2005-06 $1.6 million gain FY 2006-07 $2.1 million gain FY 2007-08 $2.2 million gain

	Effective August 13, 2005, authorized a tobacco product manufacturer that elects to place funds into a qualified escrow fund in lieu of participating in the Master Settlement Agreement to assign its interest in the funds to the benefit of the State.	FY 2008-09 $2.3 million gain FY 2009-10 $2.4 million gain
35	**IRC Update** Effective August 13, 2005, changed the State tax law reference to the Internal Revenue Code from May 1, 2004, to January 1, 2005. However, any amendments to the Internal Revenue Code enacted after May 1, 2004, that would have increased North Carolina taxable income for the 2004 taxable year are effective beginning with the 2005 taxable year.	The partial conformance to the Code results in a loss to the General Fund of $8 million for FY 2005-06 and $10.7 million for FY 2006-07.
36	**Individual Income Tax Changes** Extends the 8.25% upper-income individual income tax rate for two more taxable years: 2006 and 2007.	FY 2005-06 $39.8 million gain FY 2006-07 $89.7 million gain FY 2007-08 $50.18 million gain
38	**Corporate, Excise, and Insurance Tax Changes** <u>Equalize Gross Premiums Tax</u> Effective for taxable years beginning on or after January 1, 2007, taxes health maintenance organizations (HMOs) at the general gross premiums tax rate of 1.9% and repeals the special 1% rate for HMOs.	FY 2005-06 no impact FY 2006-07 $13.4 million gain FY 2007-08 $ 3.94 million gain FY 2008-09 $13.4 million gain FY 2008-09 $13.4 million gain FY 2009-10 $13.4 million gain
39	**Tax Incentives/Film Industry Jobs Incentives** <u>Film Industry Jobs Incentives</u> Effective for taxable years beginning on or after January 1, 2005, provides a refundable income tax credit equal to 15% of the production expenses for film and television production companies that spend at least $250,000 in North Carolina in connection with certain productions.	FY 2005-06 $3.5 million loss FY 2006-07 $3.5 million loss FY 2007-08 $3.5 million loss FY 2008-09 $3.5 million loss FY 2009-10 $3.5 million loss

(For a more complete fiscal analysis, see <u>Overview Fiscal and Budgetary Actions, 2005 Session</u> Available in the Legislative Library.)

ANALYSIS: This act is known as the 'Current Operations and Capital Improvements Appropriations Act of 2005.' The act contains several tax provisions that are summarized below.

Part 7: Public Schools

Part VII of the act contains two provisions related to the sales and use tax refund allowed to local school administrative units. LEAs are among the list of entities that may apply to the Secretary of Revenue for an annual refund of State and local sales and use taxes paid by it on direct purchases of tangible personal property and services, other than electricity and telecommunications service. A request must be in writing and is due within six months after the end of the LEA's fiscal year.

The first provision can be found in Section 7.27. It allows the Department of Revenue to release sales tax refund information on a per LEA basis and it makes a corresponding change in the tax secrecy statute. This information will be useful in providing complete budget oversight. Since the refund is received outside of the appropriations and budgetary process, the LEA could spend the money in whatever manner it chose. The act requires the Department to make an annual report to the Department of Public Instruction and to the Fiscal Research Division of the General Assembly by March 1 of the amount of refunds claimed by taxpayer. The act directs the Department to also provide this information for the past three fiscal years: 2002-03, 2003-04, and 2004-05.

The second provision can be found in Section 7.51. It redirects estimated State sales tax revenues refundable to LEAs to the State Public School Fund for allotment through State position, dollar, and categorical allotments. The effect of this provision is to funnel all State monies for public education through the budgetary process by eliminating the State monies going directly to LEAs through the refund process.

The provision accomplishes this redirection in three steps:

- It repeals the ability of individual LEAs to obtain an annual refund of the State and local sales and use tax monies paid, effective July 1, 2005, and applicable to sales made on or after that date.[33] LEAs have had the ability to request an annual refund of State and local sales and use taxes paid since July 1, 1998.[34] The provision also repeals the ability of school board cooperatives to obtain a refund; they have had the ability to request annual refunds since July 1, 2003.[35] The LEAs will be able to obtain a refund for sales and use taxes paid by them during the fiscal year 2004-05. The request for the refund must be made on or before December 31, 2005, and the amount will be refunded during fiscal year 2005-06.

- For fiscal year 2006-07, the provision directs the Secretary of Revenue to transfer quarterly a calculated amount from the State sales and use tax net collections to the State Public School Fund. The quarterly amount will be equal to one-fourth of the amount refunded to LEAs and school board cooperatives[36] during the 2005-06 fiscal

[33] The intent of the legislation, as reflected by the Committee Report, was to repeal the ability of school boards to obtain a refund of State sales and use taxes paid, not State and local. It is anticipated that a provision will be introduced in the 2006 legislative session to reinstate the refund of local sales and use taxes.
[34] S.L. 1998-212.
[35] S.L. 2003-431.
[36] S.L. 2003-345 corrected a statutory reference made in this provision of the act.

year plus or minus the percentage of that amount by which the total collection of State sales and use tax increased or decreased during the preceding fiscal year. The Fiscal Research Division estimates that the total amount of this annual earmarking will be $33,000,000.[37]

- For subsequent fiscal years, the provision directs the Secretary to transfer quarterly an amount equal to one-fourth of the amount refunded to LEAs and school board cooperatives during the preceding fiscal year plus or minus the percentage of that amount by which the total collection of State sales and use taxes increased or decreased during the preceding fiscal year.

Part 8: Community Colleges

In 1999, the General Assembly temporarily reduced unemployment insurance taxes for most employers by 20% and levied a corresponding contribution to be used for enhanced reemployment services and worker training programs, effective January 1, 2000.[38] While the unemployment insurance taxes fund the unemployment insurance fund, the training and reemployment contribution is credited to a special account in the State Treasury to be appropriated annually by the General Assembly to the Department of Community Colleges for various worker-training programs. Thus, the training and reemployment contribution program has the effect of redirecting payments from the unemployment insurance fund to appropriations for State worker training programs The training and reemployment contribution program was originally set to expire in 2002. S.L. 2001-424 extended the expiration date to 2006. Section 8.8 of this act extends the sunset date to 2011.

The law, as written in 1999, automatically suspends the training and reemployment contribution any time the unemployment insurance fund falls to $900 million or less or any time the State unemployment rate rises above 4.3%.[39] The training and reemployment contribution was suspended shortly after it was enacted because the unemployment insurance fund balance fell below $900 million. The unemployment insurance fund currently has a balance of roughly $20 million and the State unemployment rate is 5.1%.

Part 11: Department of Agriculture and Consumer Services

The first $350,000 of the net proceeds of the excise tax on fortified and unfortified wine is credited to the Department of Agriculture and Consumer Services.[40] The funds credited to the Department from this tax must be allocated to the North Carolina Grape Growers Council and used to promote the North Carolina grape and wine industry and to contract for research and development services to improve viticultural and enological practices in North Carolina. If any of the earmarked funds are not expended during the fiscal year, they do not revert to the General Fund but remain available to the Grape Growers Council.

Section 11.4 of the act expands the quarterly distribution of a portion of the excise tax on wine to the North Carolina Grape Growers Council by raising the annual cap from $350,000 to $500,000. Prior to 2001, the Council received 94% of the net tax proceeds from the excise

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[37] This dollar amount reflects the amount of State sales and use taxes paid by LEAs, not the local sales and use taxes paid by them.

[38] S.L. 1999-321.

[39] G.S. 96-6.1.

[40] S.L. 2005-380 transferred the North Carolina Grape Growers Council from the Department of Agriculture and Consumer Services to the Department of Commerce.

tax on unfortified wine and 95% of the tax collected on fortified wine, up to $175,000 a year. In 2001, the General Assembly allocated 100% of the net tax revenues from unfortified and fortified wine to the Council and increased the cap from $175,000 to $350,000 in 2001.[41] The amount distributed to the Council reached the $350,000 cap in fiscal year 2002-03. The net proceeds from the tax in fiscal year 2004-05, and the amount the Council would have received but for the cap, totaled $473,343.

Part 22: Department of Revenue

In 2001, the General Assembly established a system under which the cost of collecting overdue tax debts is to be borne by the delinquent taxpayers, not by the taxpayers who pay their taxes on time. The collection assistance fee is 20% of the overdue tax debt and is a receipt of the Department.[42] The proceeds of the fee are credited to a special, non-reverting account to be used only for collecting overdue tax debts. The Department of Revenue may apply the fee proceeds to pay contractors for collecting tax debts and to pay the fee charged by the federal government for collecting tax debts by offset. The remaining proceeds of the fee may be spent for collecting overdue tax debts only pursuant to appropriation by the General Assembly. In 2004, the General Assembly enacted legislation stating that the proceeds of the fee could not be used for any purpose that is not directly and primarily related to collecting overdue tax debts. In addition to the two expenditures specifically authorized in 2001, the General Assembly added 'taxpayer locater services' to the list of purposes directly and primarily related to collecting overdue tax debts.

Section 22.1 of this act adds three more purposes to which the fee proceeds may be applied:

- Postage or other delivery charges for correspondence relating to collecting overdue tax debts.
- Operating expenses for Project Collection Tax and the Taxpayer Assistance Call Center.
- Expenses of the Examination and Collection Division relating to collecting overdue tax debts.

The provision also requires the Department to account for all expenditures using accounting procedures that clearly distinguish costs allocable to collecting overdue tax debts from costs allocable to other purposes and it must demonstrate that none of the fee proceeds are used for any purpose other than collecting overdue tax debts. This section became effective July 1, 2005.

Section 22.5 authorizes the Property Tax Commission to set the salary for its members, effective September 1, 2005. Under prior law, the Commission members were compensated

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[41] S.L. 2001-475.

[42] Section 22.6 of S.L. 2005-276 amended the law to provide that the amount of the collection assistance fee would be the actual cost of collection, not to exceed 20% of the amount of the overdue tax debt. However, section 37 of S.L. 2005-345 subsequently repealed this section, leaving the amount of the collection assistance fee at 20% of the amount of the overdue tax debt.

$200 a day for their work on the Commission.[43] In the fourth edition of Senate Bill 622, this provision changed the salary of the Commission members from $200 a day to $400 a day and it also set the salary for the chair of the Commission at $450 a day. Although the final budget act did not set the salaries at this amount, S.L. 2005-345, 'Modify 2005 Budget Appropriations Act', amended this act to appropriate additional funds to the Department of Revenue to be used to pay the increased salaries of the Commission members at that amount.

The Property Tax Commission is the five-member State board of equalization and review that hears and decides taxpayers' administrative appeals from decisions concerning the listing, appraisal, or assessment of property made by county boards of equalization and review and boards of county commissioners. It consists of five members, three of whom are appointed by the Governor, one of whom is appointed by the General Assembly upon the recommendation of the Speaker of the House of Representatives, and one of whom is appointed by the General Assembly upon the recommendation of the President Pro Tempore of the Senate. The members serve staggered, four-year terms.

The expenses of the Property Tax Commission do not come from the General Fund but are paid by local governments. The Department of Revenue collects local sales taxes on behalf of local governments and distributes the proceeds quarterly. In making these distributions, the Department is required under G.S. 105-501 to deduct the State's costs relating to local property tax administration, the Property Tax Commission, the School of Government's property tax training program, and the Local Government Commission.

Part 33: Sales Tax Changes

Part 33 makes a number of changes to the sales tax laws that are necessary to conform to the Streamlined Sales and Use Tax Agreement. The Streamlined Sales Tax Project is an effort by states, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The Project began in March 2000, and has the goal of achieving sufficient simplification and uniformity to encourage sellers without nexus in states to voluntarily collect use tax in participating states. In November 2002, the implementing states approved the Streamlined Sales and Use Tax Agreement. The Agreement contains the uniformity and simplification provisions developed by the Project. On July 1, 2005, eleven states, including North Carolina, were determined to be in substantial compliance with terms of the Agreement. The Agreement becomes effective when at least 10 states representing 20% of the population of all states with a sales tax are in compliance with the provisions of the Agreement. As of October 2005, these requirements were met and the Agreement became effective.

Over the past several years, the Revenue Laws Study Committee has recommended, and the General Assembly has enacted, changes to North Carolina sales tax laws to bring it into compliance with the Agreement. As set out in the OVERVIEW, the act makes the following changes to the sales and use tax laws:

- Section 33.3 defines a number of terms. "Combined general rate" is defined as the State's general rate of tax plus the sum of the rates of the local sales and use taxes.

[43] S.L. 2000-67 provided that members of the Commission would receive travel, subsistence, and salary while being trained and clarified those members should receive salary and reimbursement while deciding, as well as hearing, cases.

The act defines "Streamlined Agreement" and conforms the definition of "food" to the Agreement by removing "alcoholic beverage" from the definition of food. The act also defines the terms "cable service" and "satellite digital audio radio service".

- Amends the sales tax holiday statute to include definitions for "computer supplies" and "school supplies". A State has the option of allowing a sales tax holiday, but the items included in the holiday must be defined terms under the Agreement. The act includes computer supplies in the sales tax holiday. Computer supplies include computer storage media, printers, printer supplies, hand-held electronic schedulers, and personal digital assistants. Prior to August 2004, the State's sales tax holiday included most of these items. The General Assembly changed the law in 2003 to except these items from the holiday in 2004, in conformity with the Streamlined Agreement. Section 33.11, based upon amendments to the Agreement in November 2004, expands the sales tax holiday to include these items once again so long as the sales price does not exceed $250.

- Sections 33.4 and 33.9 amend the taxation of a number of items as set out in the OVERVIEW by either exempting the item from the sales tax or taxing the item at the combined general rate. These changes satisfy the requirement of the Streamlined Agreement that states must have one tax rate with no caps or thresholds.

- Sections 33.20 and 33.21 expand Article 5F of Chapter 105 to provide that the privilege tax will apply to manufacturing fuel and certain machinery and equipment, effective January 1, 2006. The 2001 General Assembly enacted Article 5F in response to the requirement of the Streamlined Agreement that states must simplify their sales tax rates. The 2001 legislation, which becomes effective January 1, 2006, repealed the 1% sales tax rate and $80 cap imposed on mill machinery and replaced it with a privilege tax having the same rate. Sections 33.20 and 33.21 of the act continue the sales tax rate simplification requirement by imposing a 1% privilege tax on a manufacturing industry or plant that purchases fuel, other than electricity or piped natural gas, to operate the industry or plant. The act also imposes a 1% privilege tax with a cap of $80 per article on a major recycling facility that purchases certain personal property used at the facility. The privilege tax becomes effective January 1, 2006, and replaces the current sales tax imposed on these taxpayers. There will be no fiscal impact because the privilege tax rates will be the same as the current sales and use tax rates. The change from a sales tax to a privilege tax means that retailers are not responsible for collecting and remitting the tax.

- Section 33.13 clarifies the effective dates for sales tax rate increases and decreases on services, effective October 1, 2005. For a rate increase, the new rate applies to the billing period that starts on or after the effective date. For a rate decrease, the new rate applies to bills rendered on or after the effective date. For prepayments of telecommunications and direct-to-home satellite services, the billing period starts on or after November 1, 2005. For prepayments of satellite digital audio radio services, the first billing period starts on or after February 1, 2006.

- Section 33.15 conforms the statutory language in G.S. 105-164.28 to the information actually requested on a certificate of resale, effective October 1, 2005.

- Section 33.17 provides an amnesty provision as required by the Streamlined Sales Tax Agreement for sellers who register with the State within 12 months after the State becomes a member of the Agreement, effective October 1, 2005.

- Section 33.18 clarifies that a seller who relies on the Secretary of Revenue for information concerning the boundaries of taxing jurisdictions and the tax rates applicable to those jurisdictions is not liable for any underpayments of tax attributable to erroneous information provided by the Secretary, effective October 1, 2005.

- Sections 33.8 and 33.24 provide that the use tax applies to taxable services sourced to the State, effective October 1, 2005, and extend the sunset on the use tax line item on the individual income tax return from January 1, 2005 to January 1, 2010. The use tax is owed by the consumer, and unlike sales tax, the consumer must remit it to the State. To simplify use tax collection, the General Assembly established an annual filing period in 1997 for the payment of use taxes owed by consumers on mail order and other out-of-state purchases. In 1999, it simplified use tax collection by providing that the use tax will be paid on taxpayers' income tax returns. In 2000, the General Assembly sunset this provision in anticipation that use tax collection would be handled by retailers by 2003, as a result of the Streamlined Sales Tax Agreement. The 2003 sunset was overly optimistic. The General Assembly extended the sunset to 2005 in S.L. 2003-284. The act extends it for five more years.

Part 34: Tobacco Tax Changes

Part 34 makes the following three changes to the tobacco tax:

- Effective September 1, 2005, it increased the tax on cigarettes from five cents a pack to 30 cents a pack. Effective July 1, 2006, it increases the tax on cigarettes an additional five cents to 35 cents a pack. The General Assembly last increased the cigarette tax in 1991 from two cents a pack to five cents a pack. The Governor, in his 2005 budget, recommended increasing the tax on cigarettes from five cents a pack to 40 cents a pack from the period between September 1, 2005, and June 30, 2006, and then to 50 cents a pack.

- Effective August 13, 2005, it increased the tax on other tobacco products, such as cigars and snuff, from 2% of the cost price of the product to 3%. The General Assembly first imposed a tax on other tobacco products in 1991 at the rate of 2%. The Governor, in his 2005 budget, recommended increasing the tax from 2% to 15% for the period between September 1, 2005 and June 30, 2006, and then to 18%.

- Effective August 13, 2005, it authorized a tobacco product manufacturer that elected to place funds into a qualified escrow fund in lieu of participating in the Master Settlement Agreement, to assign its interest in the funds to the benefit of the State. Under G.S. 66-291, a tobacco product manufacturer that places funds in escrow is allowed to receive the interest or other appreciation on such funds as earned. This act would allow the manufacturer to assign its interest in the funds, including any earning and appreciation in the escrow account, to the benefit of the State. The assignment is irrevocable and must be in writing. The benefit of this legislation is

that a nonparticipating manufacturer that makes an assignment can claim an income tax deduction. The act provides that this legislative authorization is repealed and any assignment of the funds is void if (1) a court finds the new legislation invalid or unenforceable, or (2) a court finds that the new legislation would subject participating manufacturers under the Master Settlement Agreement to a nonparticipating manufacturer adjustment under the Agreement.

Part 35: IRC Update

North Carolina's tax law tracks many provisions of the federal Internal Revenue Code, by reference to the Code.[44] The General Assembly determines each year whether to update its reference to the Internal Revenue Code.[45] Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State law tracks federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made.

Part 35 of this act changed the reference date from May 1, 2004 to January 1, 2005. Changing the reference date to January 1, 2005, incorporates federal changes made in the Working Families Tax Relief Act of 2004 (P.L. 108-311) and the American Jobs Creation Act of 2004 (P.L. 108-357). In addition, in early 2005 Congress enacted an act to enhance the tax benefit for certain charitable contributions made in January 2005 for tsunami relief (P.L. 109-1). That act did not amend the Code, but rather used uncodified language to bring about that result. The 2005 Appropriations Act conforms to that legislation as well. A detailed summary of these federal tax law changes is set out below:

Working Families Tax Relief Act (WFTRA) of 2004 (P.L. 108-311)

The Working Families Tax Relief Act of 2004 was signed into law by President Bush on October 4, 2004. Despite its title, the act provides tax benefits for businesses as well as individuals and families. The following features of the act are important for State tax purposes:

- *Creation of a more uniform definition of "child" throughout the Code starting with the 2005 taxable year.* At the federal level, the definition of "child" is important in five areas: the dependency exemption, the child credit, the earned income credit, the dependent care credit, and head of household filing status. The WFTRA creates a more uniform definition of "child" that applies to each of these areas. Under the new definition, a child is a qualifying child if the child satisfies three separate conditions. First, the child must have the same principal place of abode as the taxpayer for more than one

[44] North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

[45] The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power."

half the tax year (residency test). Temporary absences due to special circumstances are not included. Second, the child must be the child, stepchild, sibling, stepsibling, or a descendant of any of these relations of the taxpayer (relationship test). Third, the child must satisfy an age condition to be deemed a qualifying child. In general, a child must be under age 19, or under age 24 if a full-time student, to be a qualifying child. However, lower age limits were retained for the dependent care credit (under 13 years of age unless disabled) and the child tax credit (under 17 years of age). For State tax purposes, the changes are important in so far as they relate to the dependency exemption, the child tax credit, and head of household filing status. The new definition of qualifying child for the dependency exemption may result in a change of status of some children – where the new law has a residency test, the old law had a support test (the taxpayer claiming the child as a dependent had to provide at least 50% of the child's support). For the federal child tax credit, some taxpayers may become eligible to claim the credit due to the elimination of some restrictions related to foster children. This is important because eligibility for the State child tax credit is dependent on the taxpayer's eligibility for the federal credit. In general, the uniform definition should not affect head of household filing status.

- *Extension of the above-the-line deduction for educators.* Under previous law, an eligible educator was allowed an above-the-line deduction of up to $250 for amounts paid by the teacher for books or supplies used in the classroom. This provision was set to expire with the 2003 taxable year. The WFTRA extended this provision for the 2004 and 2005 taxable years.

- *Extension of elective expensing of qualified environmental remediation expenditures.* Under previous law, a taxpayer could elect to treat qualified environmental remediation expenditures that would normally be charged to a capital account and depreciated over time as deductible in the current year. To be deductible currently, the expenditure must be paid or incurred with the abatement or control of hazardous substances at a qualified contaminated site. This provision would have expired with the 2003 tax year. The WFTRA extended this provision for the 2004 and 2005 taxable years.

- *Extension of enhanced deduction for qualified computer contributions.* Under previous law, corporations were allowed an enhanced charitable contribution deduction for contributions of computer technology or equipment to schools or public libraries that would use the computer equipment for educational purposes. This provision would have expired with the 2003 tax year. The WFTRA extended this provision for the 2004 and 2005 taxable years.

- *Elimination of the phase down of the deduction for qualified clean fuel property.* Under previous law, a taxpayer was allowed a specified deduction for clean fuel vehicles or refueling property placed into service before January 1, 2007. The amount of that deduction was to be reduced by 25% in 2004, 50% in 2005, and 75% in 2006, and was to be completely phased out in 2007. The WFTRA eliminated the phase down in the 2004 and 2005 taxable years. Without further action, the phase down will resume at 75% in 2006.

- *Extension of Archer Medical Savings Accounts (MSAs).* Archer MSAs were designed to give small employers, their employees, and self-employed individuals a way of

creating tax-deferred savings to offset qualifying medical expenses. The program was designed to be limited in scope: no new Archer MSAs could be set up after a certain threshold had been met or after the end of 2003. The WFTRA extends the period in which new Archer MSAs may be created until the end of 2005.

American Jobs Creation Act (AJCA) of 2004 (P.L. 108-357)

The American Jobs Creation Act of 2004 was signed into law by President Bush on October 22, 2004. The bill makes many substantial changes in many different areas of tax law. The act conforms to all but the following three federal tax law changes:

- It does not create a tonnage tax in lieu of an income tax on qualifying shipping activities.
- It does not create a deduction for income attributable to domestic production activities.
- It does not allow a deduction of state and local sales taxes in lieu of a deduction for state income taxes for the 2004 taxable year. The act conforms to this change beginning with the 2005 taxable year, but requires an add back of the amount of sales taxes deducted.

The act does conform to the following changes for State tax purposes listed below:

- *Repeal of the exclusion for extraterritorial income (ETI).* Under previous law, U.S. exporters were eligible for an exclusion from gross income for qualifying extraterritorial income. In 2000, the World Trade Organization declared this exclusion an illegal trade subsidy. Congress did not take action regarding this finding until the European Union (EU) began placing sanctions on U.S. exports. At the time Congress acted, those sanctions were at 12% and were rising by one percentage point per month. This exclusion will be phased out over several years. The ETI exclusion will be reduced by 20% in 2005 and by 40% in 2006. The ETI exclusion will be eliminated altogether beginning in 2007. Based on Congress's enactment of this law, the EU has indicated it will drop sanctions on U.S. imports beginning January 1, 2005.

  In part to replace the ETI exclusion, Congress created a new deduction for domestic production activities.[46] "Domestic production activities" is defined fairly broadly and includes the following:

  - sale, lease, or license of property manufactured or produced by the taxpayer in significant part in the United States,
  - sale, lease, or license of United States produced motion pictures and video tapes,
  - sale of electricity, natural gas, or potable water within the United States,
  - construction activities performed in the United States, and
  - engineering or architectural services performed in the United States for construction projects occurring in the United States.

[46] As previously noted, the act does not create a deduction for income attributable to domestic production activities.

For taxable years beginning in 2009, the amount of the deduction is equal to nine percent (9%) of the lesser of the domestic production activities income of the taxpayer or taxable income without regard to the deduction. This deduction will be phased in over several years beginning in 2005. For the 2005 and 2006 taxable years the deduction will be limited to three percent (3%). This amount will grow to six percent (6%) for the 2007 and 2008 taxable years.

- *Extension of 179 expensing limit increase/revisions regarding SUVs.* Section 179 of the Code allows a taxpayer to treat the cost of certain property as an expense which is not chargeable to a capital account. This allows the taxpayer to take a deduction for the property in the year in which it is placed into service rather than depreciating the property over a number of years. In 2003, Congress increased the amount that could be expensed under Section 179 of the Code from $25,000 to $100,000.[47] The federal change was originally set to expire after the 2005 taxable year. The AJCA extends this provision through the 2007 taxable year.

  One frequent complaint about the federal provision was that it allowed expensing of costs associated with the purchase of a sports utility vehicle (SUV) by a small business. General rules relating to the depreciation of motor vehicles did not apply to many large SUVs because those rules applied only to vehicles weighing 6,000 pounds or less. The effect of this provision was to allow an immediate write-off for the purchase price of a large SUV, but to require more gradual depreciation for the purchase of most other passenger vehicles. Taxpayers thus had a greater incentive to purchase a large SUV. The AJCA limits the amount of the purchase price that may be expensed under Section 179 with respect to a vehicle weighing less than 14,000 pounds to $25,000[48] The federal legislation made this change effective when it became law, October 22, 2004.

- *Establishment of 15-year straight line cost recovery for qualified leasehold improvements and qualified restaurant property.* The AJCA provides for 15-year straight-line depreciation for qualified leasehold improvements to nonresidential real property placed into service after the date of enactment (October 22, 2004) and prior to January 1, 2006. A qualified leasehold improvement is an improvement made to the interior of a building by either the lessor or lessee and placed in service more than three years after the building is placed in service. Under prior law, a qualified leasehold improvement was depreciated using straight-line depreciation over a 39-year period – the same period as for depreciation of nonresidential property in general.

  A similar depreciation schedule is put into place for qualified restaurant property placed into service after the date of enactment (October 22, 2004) and prior to January 1, 2006. In order to qualify as "qualified restaurant property", the property must be a building improvement placed in service more than three years after the building is placed in service and the restaurant must use more than half of the square footage of the building.

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[47] The General Assembly conformed to this federal change as part of the 2003 Budget Act (S.L. 2003-284).

[48] There are some exceptions to this rule for certain vehicles. These exceptions were put in place to ensure that the legislation would apply only to SUVs and not other types of heavy motor vehicles (such as delivery trucks) that have a weight greater than 6,000 pounds but less than 14,000 pounds.

If the leasehold improvement or restaurant property contains tangible personal property that may be segregated from the cost of other improvements and that tangible personal property has a shorter depreciation period, then the taxpayer may depreciate that property separately using the shorter period.

- *Modification of deduction for charitable contribution of used motor vehicles.* The AJCA limits the amount of the deduction for contributions of motor vehicles to charity. Vehicle donation programs have become popular in recent years. Generally, the taxpayer who has donated the motor vehicle has claimed a deduction for the full "blue book" value of the vehicle. The new law will limit the amount of the deduction based on how the donee organization uses the vehicle. If the charitable organization sells the vehicle without using it in any significant way, the amount of the deduction cannot exceed the gross proceeds of the sale. If the charity retains the vehicle for its own use, the taxpayer must receive an acknowledgment from the charity as to the value of the vehicle. The deduction may not exceed the acknowledged value of the vehicle to the charity. These changes become effective with the 2005 taxable year.

- *Establishment of an above-the-line deduction for certain attorney fees and court costs.* The AJCA allows an individual taxpayer an above-the-line deduction (i.e. from gross income) for attorney fees and court costs associated with certain civil rights actions, claims against the government, and Medicare fraud claims. Under previous law, these costs were deductible only as an itemized deduction, meaning that they were deductible only if the taxpayer itemized deductions and only to the extent aggregate itemized deductions exceeded 2% of the taxpayer's adjusted gross income. This provision became effective when the legislation became law, October 22, 2004.

- *Modification of deduction for automobile expenses of United States Postal Service employees.* The AJCA allows United States Postal Service employees who deliver and collect mail on rural routes and receive qualified reimbursements of automobile expenses involving these duties to deduct their actual automobile expenses that exceed the reimbursement amount. This is an itemized deduction and therefore may be claimed only to the extent aggregate deductions exceed 2% of the taxpayer's adjusted gross income. Under previous law, the deduction could not exceed the amount of the qualified reimbursements, regardless of actual expenditures. As under previous law, reimbursements in excess of the amount of actual expenditures do not have to be included in gross income.

- *Exclusion of National Health Service Corps Loan Program repayments from gross income and from employment taxes.* The National Health Service Corps is an agency housed within the U.S. Department of Health and Human Services and has as its mission improving the health of the nation's underserved populations. Under the National Health Service Corps Loan Repayment Program, participants in the program may receive up to $25,000 per year for two years to pay off qualified educational loans. The loan repayment is in addition to any salary the participant receives from the employing community site. Under previous law, the amount of loan repayment was included in taxable income and was also subject to employment taxes (i.e. FICA). Under the AJCA, these loan repayments are to be excluded from both gross income and from employment taxes. This provision became effective with the 2004 taxable year.

- *Creation of a deduction for start-up costs and amendments to the expensing schedule for such costs.* Under the AJCA, a taxpayer may take a deduction of up to $5,000 for start-up and organization expenses of the taxpayer's trade or business. However, the amount of the deduction is reduced by the amount by which those expenses exceed $50,000. Any expenses in excess of $5,000 must be amortized over a 15-year period. Under previous law, no current expensing was allowed, the full amount of the start-up and organizational expenses would be amortized over 5 years. This provision is effective for expenses that occur on or after the date the legislation became effective, October 22, 2004.

- *Modification regarding the treatment of gain on the sale of a principal residence when the residence was acquired in a like-kind exchange.* Under current law, a taxpayer is allowed to exclude up to $250,000 of gain from the sale of a residence ($500,000 if a married couple filing jointly) if the taxpayer owned and used the residence as a principal residence for at least two of the last five years. The AJCA makes a change to this provision when the home was acquired as part of a like-kind exchange.[49] Under the AJCA, a residence received in a like-kind exchange must be owned by the taxpayer for at least five years and must be used as a principal residence of the taxpayer for at least two of the last five years in order to qualify for the exclusion from gross income of the gain on the sale of the residence. This provision became effective for residences sold on or after the date the legislation was enacted, October 22, 2004.

As previously noted, the act does not conform to three aspects of the federal tax law changes in the AJCA:

- It does not create a tonnage tax in lieu of an income tax on qualifying shipping activities. - The AJCA provides that a corporation can elect to be subject to a tonnage tax rather than an income tax on its qualified shipping activities. The tonnage tax is based on the taxpayer's "notional shipping income." Notional shipping income is determined by reference to a monetary rate per ton shipped. The rate is 40 cents per 100 tons per day for the first 25,000 tons shipped per vessel and 20 cents per 100 tons per day for the amount shipped in excess of 25,000 tons per vessel. Once notional shipping income has been determined, tax is computed on that amount at the rate of 35%. In exchange for electing to be subject to the tonnage tax, the taxpayer may exclude from its gross income any amount resulting from its qualifying shipping activities. Conforming to this exclusion would result in income from shipping activities being excluded from taxation in North Carolina. In effect, it would result in a loss of tax revenues at the State level without a corresponding loss at the federal level. In order to maintain this revenue source, this act requires the taxpayer to add back the amounts deducted from gross income because of this new provision.

- It does not create a deduction for income attributable to domestic production activities. The AJCA phases out the exclusion for extraterritorial income: 20% in 2005, 40% in 2006; eliminated in 2007. Congress created a new deduction for domestic production activities to replace the ETI. "Domestic production activities"

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49 A like-kind exchange is an exchange of property held for productive use in a trade or business or for investment for similar property. Unless cash is received as part of the trade, the exchange is not a taxable event.

is defined fairly broadly. For taxable years beginning in 2009, the amount of the deduction is equal to 9% of the lesser of the domestic production activities income of the taxpayer or taxable income without regard to the deduction. This deduction will be phased in over several years beginning in 2005. For the 2005 and 2006 taxable years the deduction will be limited to 3%: this amount will grow to 6% for the 2007 and 2008 taxable years. In order to maintain this revenue source, this act requires the taxpayer to add back the amounts deducted from gross income because of this new provision.

- It does not allow a deduction of state and local sales taxes in lieu of a deduction for state income taxes for the 2004 taxable year. The act does conform to this change beginning with the 2005 taxable year, but requires an add back of the amount of sales taxes deducted. The AJCA allows taxpayers to deduct state and local sales taxes in lieu of deducting state and local income taxes. This provision became effective with the 2004 taxable year and is set to expire for taxes beginning in 2006 and thereafter. Taxpayers that elect to deduct state and local sales taxes instead of state and local income taxes will have two options for determining the deductible amount: a) they may accumulate receipts for the actual amount of sales and use tax paid, or b) they may refer to tables prepared by the Secretary of the Treasury which estimate the amount of taxes paid based on average consumption and other factors.

  This federal provision is of particular benefit to taxpayers who reside in states that do not impose a personal income tax. For most North Carolina taxpayers, the greater benefit would come from deducting state income taxes rather than from deducting state and local sales taxes. Some exceptions to this general statement would include the following:

  - Nonresidents or part-year residents who reside in a state that does not impose an income tax and who have relatively low income tax liability in North Carolina or other states.
  - Taxpayers who may have a low tax liability due to eligibility for a significant amount of tax credits.
  - North Carolina residents for whom a large portion of income is not subject to taxation. This class of taxpayers would include many government retirees whose government pensions are not subject to State income tax under the decisions in *Bailey* and the related cases and whose Social Security payments are not subject to State income tax under G.S. 105-134.6.

  North Carolina law currently requires taxpayers to add back the amount of the deduction allowed under the Code for state, local, and foreign income taxes. In order to treat the deduction for state and local sales taxes equivalent to the deduction for state, local, and foreign income taxes, the General Assembly would have to have required the add back of the deduction for state and local sales taxes if it had decided to conform to the federal change. This conformance would have been problematic, however, given that the federal legislation is effective for the 2004 taxable year and the General Assembly could not conform to the federal legislation and require the add back unless it acted before the end of the year. Although the practical effect of conforming to the change and requiring the add back is the same as not conforming to the change at all, a court could find that requiring an add back would in effect be a

retroactive tax increase. Therefore, the act does not conform to the change allowing a deduction of state and local sales taxes in the 2004 taxable year, but does conform to that change and require an add back beginning with the 2005 taxable year.

An Act to accelerate the income tax benefits for charitable cash contributions for the relief of victims of the Indian Ocean tsunami (P.L. 109-1).

On December 26, 2004, a large earthquake centered in the Indian Ocean unleashed a catastrophic tsunami that resulted in widespread devastation in 11 countries in South Asia, Southeast Asia, and Africa. The disaster is estimated to have caused billions of dollars in damages and produced a death toll in excess of 270,000.

On January 6, 2005, the first act of the 109th Congress was to approve accelerated tax benefits for charitable cash contributions for the relief of victims of the Indian Ocean tsunami. President Bush signed the act into law the following day. The act allows a taxpayer to treat a cash contribution for tsunami relief efforts made in January 2005, as if it were made on December 31, 2004. Thus, the taxpayer would be able to take a deduction in the 2004 taxable year rather than the 2005 taxable year. In order to qualify for the accelerated benefit, the contribution must be cash. Donations of property or cash substitutes, such as marketable securities, are not eligible for the accelerated benefits. In addition, the contribution must be specifically designated to be for tsunami relief. A contribution that is made to a charitable organization that is assisting in relief efforts but that is not specifically designated to relief efforts is not eligible for the accelerated benefits. For example, a donation to the Red Cross would be eligible for the accelerated benefit only if the donation were specifically designated for tsunami relief efforts; a general donation to the Red Cross would not be eligible for the accelerated benefit.

Part 36: Individual Income Tax Changes

Part 36 of the act extends the 8.25% upper-income individual income tax rate for tax years 2006 and 2007. The Governor's budget recommended a phase down of the upper income tax rate to 8% in 2006, and the elimination of the bracket in 2007.

In 2001, the General Assembly added a new tax bracket that imposed an additional one-half percent income tax (a total rate of 8.25%) on certain North Carolina taxable income for three years. The change was estimated to affect approximately 2% of North Carolina taxpayers. In 2003, the General Assembly extended the tax rate for two more years. This act retains the upper bracket for two additional years.

Under prior North Carolina law, tax was imposed at the following rates on individuals' North Carolina taxable income:

Tax Rate	Married filing jointly	Heads of household	Single filers	Married filing separately
6.0%	Up to $21,250	Up to $17,000	Up to $12,750	Up to $10,625
7.0%	Over $21,250 and up to $100,000	Over $17,000 and up to $80,000	Over $12,750 and up to $60,000	Over $10,625 and up to $50,000

7.75%	Over $100,000	Over $80,000	Over $60,000	Over $50,000

The 2001 law created a fourth tax bracket for North Carolina taxable income as follows.

Tax Rate	Married filing jointly	Heads of household	Single filers	Married filing separately
8.25%	Over $200,000	Over $160,000	Over $120,000	Over $100,000

This part of the act was later amended in section 46 of S.L. 2005-345 (Modify 2005 Appropriations Act) to add a new section increasing from $1 to $3 the amount that an individual income taxpayer may designate on the taxpayer's return to be allocated to the North Carolina Political Parties Financing Fund. The amount is for use by the political party designated by the taxpayer.

Part 38: Corporate, Excise, and Insurance Tax Changes[50]

This part equalizes the gross premiums tax on insurance companies by taxing health maintenance organizations (HMOs) at the same rate as other insurers. HMOs are currently taxed at 1%. This part repeals the special 1% rate for HMOs and taxes HMOs at 1.9%, effective for taxable years beginning on or after January 1, 2007. Prior to 2001, HMOs did not pay a gross premiums tax.[51]

In 2001, the General Assembly enacted legislation subjecting all insurance carriers to the gross premiums tax in lieu of the State's corporate income and franchise tax. However, the rate continued to vary depending upon the type of insurer. The 2001 legislation taxed HMOs and Article 65 corporations, such as Blue Cross/Blue Shield and Delta Dental Corporation, at the rate of 1%. Effective January 1, 2004, the General Assembly increased the gross premiums tax on Article 65 corporations from 1% to 1.9%. This act increases the rate on HMOs to 1.9%, effective for taxable years beginning January 1, 2007. For the 2007 tax year only, HMOs are directed to make the following estimated payments of the tax: 50% on April 15 and 50% on June 15, with true-up the following March 15. For subsequent tax years, the general law on installment payments of gross premiums tax applies. This change accelerates the timing of the tax payment to move the revenue gain to an earlier fiscal year.

Part 39: Tax Incentives/Film Industry Jobs Incentives

This part replaces the current film industry development grant program[52] with a refundable income tax credit equal to 15% of the qualifying expenses spent by a production company in connection with a production. However, the amount of the credit with respect to a feature film production is capped at $7.5 million. The credit is effective for taxable years beginning on or after January 1, 2005, and applies to qualifying expenses occurring on or after July 1,

[50] The Senate version of Senate Bill 622 would have reduced the corporate income tax rate from 6.9% to 6.4% and repealed the earmarking of a percentage of the corporate income tax collections to the Public School Building Capital Fund. The House version would have equalized the privilege tax on entertainment by taxing all forms of entertainment at a rate equal to the combined State and local sales tax rate, and would have provided an income tax credit to a small business that provides health insurance to its full-time employees.

[51] Prior to 2001, HMOs were subject to corporate income and franchise taxes. Companies that pay a gross premiums tax are exempt from State corporate income and franchise taxes.

[52] Section 39.1(d) of this part repeals G.S. 143B-434.4. The General Assembly has not appropriated money to this account for the past couple of years.

2005. The credit expires for qualifying expenses occurring on or after January 1, 2010. The incentive is targeted at feature films, episodic television series, and commercial advertising. The Governor's budget exempted from sales and use tax, sales to a production company of film or video production equipment.

Under G.S. 105-164.3, a production company is defined as a person engaged in the business of making original motion picture, television, or radio images for theatrical, commercial, advertising, or educational purposes. However, for the purposes of the new credit, the production may not be any of the following: political advertising, television production of a news program or live [53] sporting event, a radio production, or a production containing obscene material.[54] In the case of an episodic television series, an entire season of episodes is considered one production.

In order to obtain the credit, the taxpayer must have qualifying expenses in excess of $250,000 with respect to a production and provide on its return a detailed accounting of qualifying expenses. Qualifying expenses are the total amount spent in North Carolina for the following:

- Goods and services purchased by a production company in connection with a production. For goods with a purchase price of $25,000 or more, the amount included in qualifying expenses is the purchase price less the fair market value of the goods at the time the production is completed.
- Compensation and wages paid by a production company on which it remitted withholding payments to the Department of Revenue. Any amounts paid to an individual who receives in excess of $1 million with respect to a single production cannot be included in a qualifying expense.

The taxpayer must maintain and make available for inspection any information or records required by the Secretary of Revenue or the regional film commissions. The taxpayer has the burden of proving eligibility for the credit and the amount of the credit. The Secretary of Revenue may consult with the North Carolina Film Office of the Department of Commerce and the regional film commissions in order to determine the amount of qualifying expenses.

The credit may be claimed for the taxable year in which the production activities are completed. The credit is computed based on all of the taxpayer's qualifying expenses incurred with respect to the production, not just the qualifying expenses incurred during the taxable year. If the credit exceeds the amount of tax imposed for the taxable year reduced by the sum of all credits allowable, the Secretary must refund the excess to the taxpayer. A pass-through entity is considered a taxpayer for purposes of claiming this credit; therefore, it does not distribute the credit among its owners. The taxpayer may not claim the credit for qualifying expenses for which it claimed a deduction under the Internal Revenue Code.

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[53] Section 47 of S.L. 2005-345 amended this part to clarify that the sporting event ineligible for the credit is a "live" sporting event and to define the term "live sporting event".

[54] G.S. 14-190.1 defines "obscene" material as material that meets all of the following conditions: the material depicts or describes in a patently offensive way sexual conduct; the average person applying contemporary community standards relating to the depiction or description of sexual matters would find that the material taken as a whole appeals to the prurient interest in sex; the material lacks serious literary, artistic, political, or scientific value; and the material as used is not protected or privileged under the Constitution of the United State or the Constitution of North Carolina.

The Department of Revenue must publish by May 1 of each year the following information, itemized by taxpayer for the 12-month period ending the preceding December 31:

- The location of the sites used in a production for which a credit was claimed.
- The qualifying expenses for which a credit was claimed, classified by whether the expenses were for goods, services, or compensation.
- The number of people employed in the State with respect to the credits claimed.
- The total cost to the General Fund of the credits claimed.

Finally, this part amends the tax secrecy statutes to allow the exchange of information concerning the credit with the North Carolina Film Office of the Department of Commerce and the regional film commissions.

Present-Use Value Buyout Credits.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-293	HB 705	Representative Hill

OVERVIEW: This act allows payments received under the tobacco quota buyout program to be counted towards the $1,000 income requirement which must be met before agricultural land can be assessed at present-use value for property tax purposes.

FISCAL IMPACT: The Department of Revenue does not expect that this act will result in any significant amount of additional acreage being assessed at present-use value.

(For a more complete fiscal analysis, see Overview Fiscal and Budgetary Actions, 2005 Session Available in the Legislative Library.)

EFFECTIVE DATE: This act is effective for taxes imposed for taxable years beginning on or after July 1, 2005.

ANALYSIS: Agricultural land, horticultural land and forestland have been designated as a special class of property and are appraised and assessed at present-use value, instead of market value, for property tax purposes if the land meets certain statutory requirements. Agricultural land must be part of a farm unit, under a sound management program, individually owned, consist of one or more tracts (one of which must consist of at least 10 acres that are in actual production) and for the three years preceding January 1 of the year for which the present-use value benefit is claimed, have produced an average gross income of at least $1,000. Counted income includes the following:

- Income from the sale of agricultural products produced from the land, and
- Payments received under a governmental soil conservation or land retirement program

This act allows payments received under the Fair and Equitable Tobacco Reform Act of 2004 to be included as income when determining the present-use value eligibility of agricultural land. The agricultural land must continue to meet the ownership and actual production requirements.

Congress passed the Fair and Equitable Tobacco Reform Act of 2004 in October, 2004. That act repeals the federal tobacco price support and quota programs, provides compensation payments to tobacco quota owners and growers, and provides an assessment mechanism for tobacco manufacturers and importers to pay for the buyout. An eligible quota owner is the owner of a farm on the date the federal legislation was enacted, October 22, 2004, for which a basic tobacco quota/allotment was established for the 2004 marketing year. An eligible quota grower is an owner, operator, landlord, tenant or sharecropper who shared in the risk of producing tobacco in the 2002, 2003, or 2004 marketing year. Quota owners will be paid $7 per pound for the basic quota they owned in 2002. Growers will be paid $3 per pound for their 2002 effective quota.[55] These payments will be distributed equally over 10 years, beginning with the 2005 fiscal year and ending in 2014. The initial payment was made by the beginning of October 2005. The buyout is funded by quarterly assessments on tobacco manufacturers and importers. Because the buyout is funded by manufacturer and importer assessments, future Phase II payments will be terminated. For federal tax purposes, quota owner payments are treated as capital gains and grower payments are expected to be treated as ordinary income. As of October 2005, the I. R. S. had not ruled on the tax status of these payments.

Property Tax Paid With Vehicle Registration.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-294	HB 1779	Rep. Folwell, Insko, Justice, Walker

AN ACT TO CREATE A COMBINED MOTOR VEHICLE REGISTRATION RENEWAL AND PROPERTY TAX COLLECTION SYSTEM.

OVERVIEW: This act creates a combined system for motor vehicle registration renewal and property tax collection. Currently, the two systems, though interrelated, are run separately and administered by different entities.

FISCAL IMPACT: The NC Association of Tax Assessors estimates that this act will result in collection of approximately $72 million annually in additional motor vehicle property taxes that currently go uncollected. Counties will also likely experience savings from the elimination of resources devoted to collection of property taxes on motor vehicles, including staff time and mailings for delinquent notices. An administrative fee equal to the cost of preparing and mailing notices will be retained by the Department of Revenue. A second fee for the cost of collection of taxes and fees will be retained by the Division of

[55] The payment is $2 per pound if the grower participated in two of the three marketing years, and $1 per pound if the grower participated in only one of the three marketing years.

Motor Vehicles and tag agents. The bill will require significant changes in DMV operations and significant costs for changing DMV computer systems. The full extent of these changes and costs is not currently known.

(For a more complete fiscal analysis, see Overview Fiscal and Budgetary Actions, 2005 Session Available in the Legislative Library.)

EFFECTIVE DATE: Different portions of the act have different effective dates as specified in the analysis. Most of the act becomes effective on the earlier of January 1, 2009, or the date when the Department of Revenue and the Division of Motor Vehicles have certified that an integrated computer system is in operation. The act became law when signed by the Governor on August 22, 2005.

ANALYSIS: Since 1993, all motor vehicles, except public service company vehicles appraised by the Department of Revenue and manufactured homes, are classified for listing, assessment, and taxation separately from other classes of property. The classified motor vehicles consist of two groups; those that are registered with the Department of Transportation's Division of Motor Vehicles (DMV) and those that are not registered with the DMV.[56]

The county in which the motor vehicle is registered assesses the vehicle for property taxes on a revolving, year-round basis. To accomplish this, DMV gives each county a monthly list of all the motor vehicles in the county for which the registration was renewed or obtained two months earlier. The county then lists and appraises each vehicle and sends the owner of the vehicle a bill for the county, municipal, and special district property taxes due. The result is that a motor vehicle owner receives a tax bill for the vehicle approximately three months after the vehicle is registered or the registration is renewed. Each month, the county tax collector collects taxes on approximately one-twelfth of the motor vehicles having a tax situs in the county. If the taxes on the registered motor vehicle are not paid within one month after they become due, then the motor vehicle owner is liable for interest at the rate of 2% a month for the first month following the date the taxes were due and ¾ % for each month thereafter. In addition, if the taxes are not paid, the county includes the motor vehicle on a list that is sent to the DMV. The DMV then refuses to renew the vehicle's registration the following year unless the taxpayer obtains a receipt showing that the previous year's taxes have been paid.[57] Unpaid taxes may also be collected by levying on the motor vehicle or other personal property of the owner, but the unpaid taxes do not become a lien on the owner's real property.

The DMV requires motor vehicles to be registered annually. Under G.S. 20-66, the registration of a vehicle that is renewed by means of a registration renewal sticker expires at midnight on the last day of the month designated on the sticker. It is lawful, however, to operate the vehicle on a highway until midnight on the fifteenth day of the month following the month in which the sticker expired. The DMV varies the expiration dates of registration renewal stickers for a type of vehicle so that an approximately equal number expires at the

[56] A vehicle is not registered with the DMV either because it is a tractor, an earthmover, or some other type of vehicle that cannot be registered with the DMV or it is a car or truck and could be, but for some reason is not, registered with the DMV.

[57] Vehicle owners may get around this block by buying a new tag on the vehicle.

end of each month, quarter, or other period consisting of one or more months. The $28 fee[58] is paid to the DMV and credited to the Highway Fund.

This act combines the motor vehicle registration and property tax billing and collection into a combined process. The goals of the combined process are to reduce the number of taxpayer interactions with government, save money, increase the overall efficiency of both functions, and improve the property tax collection rate on motor vehicles.

Beginning January 1, 2006, the interest rate on unpaid taxes on classified motor vehicles will increase from 2% for the first month to 5% for the first month following the date the taxes were due. Instead of going to the taxing unit that is the situs of the motor vehicle, 60% of the interest collected on unpaid taxes on registered vehicles will be transferred on a monthly basis to a special account created within the Treasurer's Office. The North Carolina Association of County Commissioners will direct the Treasurer to distribute funds from the account for the purpose of developing and implementing an integrated computer system within the DMV. The system will allow for the combined assessment, billing, and collection of property taxes on motor vehicles and the issuance of registration plates.

Beginning July 1, 2009, or when the Division of Motor Vehicles and the Department of Revenue certify that the integrated computer system for registration renewal and property tax collection for motor vehicles is in operation, whichever occurs first, the following changes will occur:

- Property tax on registered motor vehicles will be due on the date that a new registration is applied for or the fifteenth day of the month following the month in which the registration renewal sticker expired pursuant to G.S. 20-66(g).
- The Property Tax Division of the Department of Revenue shall prepare and mail a combined tax and registration notice for each registered vehicle. The notice will contain the date of the notice, the appraised value of the vehicle, the tax rate of the taxing units, a statement that the appraised value of the motor vehicle may be appealed to the assessor before the taxes and fees become delinquent, and the registration fee imposed by the DMV.
- The Department of Revenue may receive a fee for each combined notice generated for a registered vehicle. The fee must be equal to the actual cost of printing and sending the combined notice and will be subtracted from the taxes and fees remitted to the county or municipal corporation in which the vehicle is registered.
- The property taxes and registration fees must be paid either to the DMV or an agent contracting with the DMV. The taxes and fees do NOT have to be paid in the county that is the situs of the vehicle.
- The DMV or its agent may retain a fee for collecting the county and municipal taxes and fees. This fee must be an amount equal to at least 1/3 of the compensation paid for registration renewals conducted by contract agents under Chapter 20 of the General Statutes. This fee is in addition to the $1.43 that is currently paid to contract agents for each registration renewal.

[58] This fee was raised from $20 to $28 in the 2005 Appropriations Act, S.L. 2005-276.

- The DMV or its agent must provide a weekly financial report containing information required by the Property Tax Division to the taxing units and the DMV to enable them to account for payments received.
- G.S. 105-330.7 is repealed. It will no longer be necessary for the tax collector to send a monthly list to the DMV of classified vehicles on which taxes remain unpaid, because the taxes and registration fees will be paid to the same entity at the same time.
- Interest at the rate of 5% for the remainder of the month following the month in which the registration renewal sticker expired will also accrue on unpaid registration fees on classified motor vehicles. Interest collected on unpaid registration fees will be transferred on a monthly basis to the North Carolina Highway Fund for technology improvements within the DMV. The interest collected on unpaid property taxes will no longer go into the special account in the Treasurer's office but will remain with the taxing units.
- G.S. 20-50.3 is repealed. Once the computer system is in operation, the DMV will no longer need to furnish county tax assessors a list of registered vehicles.

Effective when the act became law, August 22, 2005, the Property Tax Division within the Department of Revenue and the DMV shall jointly study and develop a plan for determining the method of valuation of vehicles to be taxed and for implementing an integrated computer system needed to combine the registration renewal and property tax collection for motor vehicles in the State. The Divisions shall consult with representatives from the following organizations: the North Carolina Association of County Commissioners, the North Carolina League of Municipalities, the North Carolina Association of Assessing Officers, the North Carolina Automobile Dealers Association, the North Carolina Independent Automobile Dealers Association, and the North Carolina Tax Collectors Association.

The Treasurer must report to the Revenue Laws Study Committee semi-annually, with the first report due by April 30, 2006. The report must contain a detailed description of the moneys transferred and distributed from the special account.

The Property Tax Division within the Department of Revenue and the DMV must report findings and recommendations of its joint study to the Revenue Laws Study Committee, the Joint Legislative Transportation Oversight Committee, and the Fiscal Research Division by April 30, 2006.

Property Tax % Value of Motor Vehicles.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-303	HB 988	Rep. Blackwood, Church

AN ACT TO EXCLUDE HIGHWAY USE TAXES AS A FACTOR IN DETERMINING THE TRUE VALUE IN MONEY OF MOTOR VEHICLES FOR PROPERTY TAX PURPOSES.

OVERVIEW: This act provides that when a tax assessor considers the sales price of a motor vehicle in determining the true value of the vehicle for property tax purposes, the assessor may not consider the highway use tax as part of the sales price.

FISCAL IMPACT: According to the North Carolina Department of Revenue, there are no counties currently using the sales price to determine the value of motor vehicles. Most counties use pricing guides developed by Tax Equity Consultants (TEC) or the National Automobile Dealers Association to determine the average retail prices paid for motor vehicles. In some instances in which the assessed value of a vehicle is appealed by the taxpayer, assessors may use the bill of sale that includes highway use tax as documentation for changing the assessed value. To the extent that this occurs, this act will result in lower revenue for local governments. It is expected that the revenue impact would be small; however, the exact amount is not known.

(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2005 Session. Available in the Legislative Library.)

EFFECTIVE DATE: This act is effective for taxes imposed for taxable years beginning on or after July 1, 2005. The act became law when signed by the Governor on August 22, 2005.

ANALYSIS: By statute, a county must appraise motor vehicles at their true value in money for property tax purposes. True value is defined as the price at which property would change hands between a willing and financially able buyer and a willing seller. In practice, assessors use a pricing guide developed by TEC Data Systems to determine the value of vehicles for property tax purposes. The pricing guide reflects the average retail price paid for motor vehicles. In determining retail prices, all costs that are necessary to acquire and operate a motor vehicle are considered. If an assessor believes the values developed in the guide are too low or too high, the assessor may consult with TEC Data Systems about the values and have a different set of values computed for use in that assessor's county. If a taxpayer disagrees with the appraised value, the taxpayer has 30 days after the date the tax notice was prepared to appeal the value. Counties will adjust an appraised value for reasons such as the vehicle's condition or excessive mileage.

Counties typically do not begin their appraisal of a new motor vehicle based on the vehicle's bill of sale. However, there are instances where a taxpayer may bring in a bill of sale to show that he or she paid less than the value at which the vehicle is assessed. A vehicle's bill of sale includes the 3% highway use tax paid on the vehicle. This act provides that when an assessor considers the sales price of a motor vehicle in determining its true value, the assessor must not consider the highway use tax paid on the vehicle.

Property Tax Changes.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-313	HB 116	Representative Brubaker

AN ACT TO CLARIFY PRESENT-USE VALUE ELIGIBILITY, TO AMEND THE PERIOD FOR APPEAL OF A PRESENT-USE VALUE DETERMINATION OR APPRAISAL, TO MODIFY THE TAX YEAR FOR MOTOR VEHICLES THAT ARE TO BE SWITCHED FROM AN ANNUAL SYSTEM OF REGISTRATION TO A STAGGERED SYSTEM EFFECTIVE JANUARY 1, 2006, AND TO APPLY THE SAME PENALTY THAT CURRENTLY APPLIES TO PAYMENTS BY CHECK TO PROPERTY TAX PAYMENTS MADE BY ELECTRONIC PAYMENTS.

OVERVIEW: This act makes clarifying and technical changes to the present-use value statutes, clarifies the tax year for motor vehicles that are to be switched from an annual system of registration to a staggered system, and imposes a penalty for nonpayment of property taxes on an electronic funds transfer that cannot be completed because of insufficient funds.

FISCAL IMPACT: This act would only impact local revenues and no fiscal impact is expected.

(For a more complete fiscal analysis, see Overview Fiscal and Budgetary Actions, 2005 Session. Available in the Legislative Library.)

EFFECTIVE DATE: The changes made by the act to the motor vehicle property tax statutes become effective January 1, 2006. The other provisions are effective for taxes imposed for taxable years beginning on or after July 1, 2005. The act itself became law when the Governor signed it into law on August 25, 2005.

ANALYSIS: This act makes changes in three different parts of the property tax statutes.

Present-Use Value - Since 1973, the General Assembly has provided that farmland may be appraised, assessed, and taxed at its present-use value, as opposed to its fair market value. The present-use value classification helps preserve farmland by insulating it from the rising property tax values cause by competing market pressures to develop farmland for commercial and residential purposes. In 2002, the General Assembly provided an updated method for calculating the value of farmland in its present use. In 2004, the Department of Revenue indicated to the Property Tax Subcommittee of the Revenue Laws Study Committee that the present-use value statutes needed to be clarified to help the counties and the Department with their administration of the classification. Sections 1 through 7 of this act make those changes. These changes codify existing practices among county assessors.

The act provides that certain land defined as horticultural land may be treated as agricultural land when there is no significant difference in the cash rental rates for the land.[59] This provision applies to land used to grow horticultural and agricultural crops on a rotating basis and to land used to grow a horticultural crop that is set out or planted and harvested within one growing season.

Under the present-use value system, farmland must be part of a unit engaged in commercial production. A 'unit' is one or more tracts of farmland. Under this act, multiple units must be under the same ownership and be of the same type of classification. If the multiple tracts are located within different counties, then the tracts must be within 50 miles of a qualifying tract. Prior to this act, multiple tracts in different counties could be considered part of the same unit if they either shared the same classification or shared the same equipment or labor force. This act removes the latter condition and requires that multiple tracts in different counties must share the same classification to qualify as a unit.

For property to qualify for present-use value classification, it must meet certain ownership requirements in addition to use and income requirements. Generally speaking, a qualifying owner must own the property for four years or the property must be the home of the qualifying owner. Prior to 2002, there existed an exception to the ownership requirement that allowed an owner to immediately qualify newly acquired property for use value classification if the property was appraised at its present use value at the time title to the land passed to the new owner or the property *was eligible for appraisal* at its present use value so long as the new owner continued to use the property for farm purposes. In 2002, the General Assembly amended this exception to require the new owner to file a timely application for the newly acquired property and to agree to accept liability for the deferred taxes. The new condition of accepting liability for the deferred taxes conflicts with the old condition that the property *be eligible for* use value classification since there would be no deferred taxes to assume unless the property was currently appraised at its present-use value when the property was transferred. This act removes this ambiguity by setting forth two different exceptions to the ownership requirements:

- It removes the phrase 'or was eligible for appraisal at its present use value' from the first exception.
- It creates a new exception for property for which there are no deferred taxes. It will allow property *eligible for* use value classification to immediately qualify in the hands of a new owner if the new owner has other property classified at present use and files a timely application for use-value classification.

Lastly, the act establishes 60 days as the time within which a taxpayer (1) must appeal an assessor's decision regarding the qualification or appraisal of the taxpayer's property as use value property and (2) may submit additional information to reverse a disqualification of property for present-use value classification or for exemption or exclusion because of failure to submit additional information. Current law provides no time limit for presenting additional information after the assessor has disqualified the property. The 60-day time limit

[59] Effective with the 2003 property tax year, the value of agricultural and horticultural land is determined by the estimated cash rental rates for the land. Prior to 2003, the value of agricultural land was determined by the income of corn and soybean yields and the value of horticultural land was determined by horticultural product yields.

corresponds to the current timeframe a new owner has to file an application for use value treatment after acquiring the property.[60]

Motor Vehicles. – Sections 8 and 9 of the act clarify how the motor vehicle property tax year will be accomplished for commercial vehicles that are converting from an annual registration system to a staggered registration system. Most vehicles registered with the Division of Motor Vehicles are taxed for property tax purposes on a revolving, year-round basis that corresponds with their vehicle registration and renewal. Commercial trucks are registered under the annual system. However, in 2004 the General Assembly enacted legislation that provides for the staggered issuance of commercial vehicle and dealer license plates, effective January 1, 2006. The Department of Revenue estimates this change will affect approximately 500,000 annually registered motor vehicles. To accomplish this transition, this act provides for a motor vehicle tax year greater than 12 months during the period that the vehicles are converting from annual registration to staggered registration. This change will allow the Division to issue one-time 7- to 18-month registrations for these vehicles, resulting in an approximate equal number of expiring registrations throughout a 12-month period. Upon renewal of these one-time registrations, the subsequent registrations will be 12-month registrations. The act specifies how the tax calculation is made for tax bills when the registration cycle is not 12 months.

Electronic Funds Transfer. – Section 10 of the act provides that the same penalty and penalty waiver provisions that apply to payments of property taxes by check also apply to payment of property taxes by electronic funds transfer. If a worthless check is given for payment of property taxes, the penalty is $25 or 10% of the amount of the check, whichever is greater, subject to a maximum of $1,000. The penalty does not apply if the tax collector finds that the taxpayer inadvertently failed to draw the check on the taxpayer's account that had sufficient funds.

Add Agencies to Set-Off Debt Collect.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-326	SB 682	Senator Holloman

AN ACT TO EXTEND TO PUBLIC HEALTH AUTHORITIES, SANITARY DISTRICTS, AND METROPOLITAN SEWERAGE DISTRICTS THE SET-OFF DEBT COLLECTION PROCEDURES CURRENTLY AVAILABLE TO COUNTIES AND CITIES.

OVERVIEW: This act adds public health authorities, metropolitan sewerage districts, and sanitary districts to the list of agencies authorized under the Setoff Debt Collection Act to collect debts owed to them by obtaining a setoff against a debtor's North Carolina income tax refund.

FISCAL IMPACT: No fiscal impact.

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[60] G.S. 105-277.4(a). The General Assembly enacted the provision requiring a new owner to submit an application for use-value classification for newly acquired property within 60 days after its purchase in 2002.

EFFECTIVE DATE: This act becomes effective January 1, 2006, and applies to income tax refunds determined on or after that date.

ANALYSIS: The Setoff Debt Collection Act authorizes State and local agencies to collect debts by diverting part or all of an individual's income tax refund to pay a debt the individual owes to a particular agency. Thus, the debt the individual owes the agency is set off against the individual's income tax refund. Before January 1, 2000, the setoff program was open only to State agencies. Since 2000, authorized local agencies[61] participate through a clearinghouse. Because there are so many local agencies, funneling their claims through a clearinghouse avoids an undue administrative burden on the Department of Revenue. A $15.00 collection assistance fee is added to each local agency debt submitted for setoff, which is remitted to the clearinghouse that submitted the debt. In addition, a $5.00 collection fee is added to each debt, State or local, that is submitted for setoff, which is retained by the Department of Revenue. The fees do not, however, apply to child support debts. While the use of debt setoff for State agencies is mandatory, usage by local agencies is optional. The Act only applies to debts that are at least $50 and to a refund that is at least this same amount.

This act allows public health authorities,[62] metropolitan sewerage districts,[63] and sanitary districts[64] to participate under the Setoff Debt Collection Act in the same manner as other authorized local agencies. Like other authorized local agencies, these agencies would be authorized to submit their debts for collection by setoff through a local clearinghouse only after providing the debtor with notice, an opportunity to be heard before the authority, and an appeal process pursuant to the Administrative Procedure Act.

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[61] In 1997, the General Assembly extended the Setoff Debt collection act to counties and municipalities, effective in 2000. In 2003, the General Assembly added water and sewer authorities to the list of entities eligible to participate in debt setoff. In 2004, regional joint agencies created by interlocal agreement were added.

[62] Although a public health authority functions similarly to a county agency, it is a separate legal entity created under G.S. 130A-45.02. A public health authority is created by joint resolution of a county board of commissioners and the local board of health. It functions as a policy-making, rule-making, and adjudicatory body designed to protect and promote the public health. Among its powers, a public health authority may establish a fee schedule for services received from public health facilities. Currently, there is only one public health authority, created under this authorizing legislation, and it is the Hertford County Public Health Authority.

[63] Any two or more political subdivisions in one or more counties, or any political subdivision and any unincorporated area within one or more counties, may petition for the creation of a metropolitan sewerage district by filing a resolution with the boards of county commissioners of the county or counties within which the proposed district will lie. A public hearing is then held where the Environmental Commission and board of county commissioners determine whether the creation of the metropolitan sewerage district would preserve and promote the public health and welfare of the area. A sewerage district board has the authority to levy taxes on property within the district and impose charges for the services furnished. The district board may provide methods for collection of charges and measures for enforcement of collection, including penalties and the denial or discontinuance of service.

[64] The Commission for Health Services may create sanitary districts for the purpose of preserving and promoting the public health and welfare. A sanitary district is incorporated if 51% of the freeholders in the proposed district petition the county board of commissioners of the county in which all or the largest portion of the land of the proposed district is located. A sanitary district board has the authority to levy property taxes within the district and apply service charges and rates based on the benefits provided. Sanitary districts that maintain and operate a sewage system may bring suit for overdue sewer charges and disconnect the sewer lines. This remedy is not sufficient when the customer moves out of the district. The charges also become a lien on the property served and the property may be sold.

Fuel Tax Refund for Pumpers and Sweepers.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-377	SB 356	Senator Hoyle

AN ACT TO ALLOW A FUEL TAX REFUND FOR OFF-ROAD FUEL USE BY PUMPER TRUCKS AND SWEEPERS.

OVERVIEW: This act adds the following two vehicles to the list of vehicles that are allowed an annual refund of the motor fuel taxes paid on fuel consumed by the vehicles:

- A commercial vehicle that uses a power takeoff to remove and dispose of septage and for which an annual fee is paid to the North Carolina Department of Environment and Natural Resources under the septage management program.
- A sweeper.

FISCAL IMPACT: The fiscal impact for allowing a fuel tax refund for off-road fuel used by pumper trucks is estimated to result in the following gains to the General Fund and Local Governments and the following losses to the Highway Fund and Highway Trust Fund. There is no estimate available for sweepers.

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
GF	$124,461	$122,369	$118,142	$113,016	$111,109
HF	($458,067)	($460,701)	($461,680)	($461,084)	($464,837)
HTF	($152,689)	($153,567)	($153,893)	($153,695)	(154,946)
LG	$77,788	$76,481	$73,839	$70,635	$69,443

(For a more complete fiscal analysis, see Overview Fiscal and Budgetary Actions, 2005 Session Available in the Legislative Library.)

EFFECTIVE DATE: This act became effective when it was signed into law by the Governor on September 8, 2005, and applies to motor fuel and alternative fuel consumed on or after January 1, 2006.

ANALYSIS: Certain vehicles that use motor fuel to conduct their work, as distinguished from propelling them on the highway, are allowed an annual refund of a portion of the motor fuel taxes paid. The amount of the refund is equal to 33 1/3% of the sum of the flat cents-per-gallon rate in effect during the year for which the refund is claimed and the average of the two variable cents-per-gallon rates in effect during the year. The amount of sales tax due on the fuel is deducted from the refund.

The act adds the following two types of vehicles to the list of vehicles that are eligible for this fuel tax refund:

- A commercial vehicle that uses a power takeoff to remove and dispose of septage and for which an annual fee is required to be paid to the Department of Environment and Natural Resources (DENR) under its septage management

program.[65] In order to issue the refund, the Department of Revenue is not required to verify the payment of the permit fee as required by G.S. 130A-291.1.[66] If the Department, however, discovers through its auditing or investigatory procedures that those permit fees have not been paid, it may refuse to issue a refund or seek a return of the refund.

- Sweeper. A sweeper is a vehicle that vacuums up and hauls away litter in parking lots. A sweeper vehicle has an auxiliary engine that runs only when the vehicle is performing its sweeping function. A factory-installed meter gauges how much fuel is being used for that function.

The other vehicles eligible for this refund include concrete mixing vehicles; solid waste compacting vehicles; bulk feed vehicles that deliver feed to poultry or livestock and use power takeoffs to unload the feed; vehicles that deliver lime or fertilizer in bulk to farms and use power takeoffs to unload the lime or fertilizer; tank wagons that deliver alternative fuel, motor fuel, or another type of liquid fuel into storage tanks and use power takeoffs to make the deliveries; and commercial vehicles that deliver and spread mulch, soils, compost, sand, sawdust, and similar materials and that use power takeoffs to unload, blow, and spread these materials.

GARVEE Bond Issuance.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-403	HB 254	Representative Crawford

AN ACT TO AUTHORIZE THE STATE TREASURER TO ISSUE "GARVEE" GRANT ANTICIPATION REVENUE VEHICLE BONDS ON BEHALF OF THE DEPARTMENT OF TRANSPORTATION, TO REQUIRE "GARVEE" FUNDS TO BE DISTRIBUTED IN ACCORDANCE WITH THE EQUITY DISTRIBUTION FORMULA, AND TO DIRECT THE SECRETARY OF THE DEPARTMENT OF TRANSPORTATION AND THE STATE TREASURER TO DEVELOP AN IMPLEMENTATION PLAN FOR ISSUANCE OF THE BONDS, AS RECOMMENDED BY THE JOINT LEGISLATIVE TRANSPORTATION OVERSIGHT COMMITTEE, AND TO CLARIFY THE DEFINITION OF GOVERNMENTAL UNIT FOR PURPOSES OF INTEREST RATE SWAP AGREEMENTS.

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[65] Under G.S. 130A-291.4, DENR is responsible for administering a septage management program which includes establishing standards for transportation, storage, treatment, and disposal of septage; operator registration and training; the issuance, suspension, and revocation of permits; and procedures for the payment of annual fees.

[66] An earlier version of Senate Bill 356 allowed a refund to a vehicle for which an annual fee is "paid" to DENR, wile the ratified version allows a refund to a vehicle for which an annual fee is "required to be paid" to DENR.

OVERVIEW: This act does two things:

- It authorizes the use of GARVEE bonds to finance projects in the Intrastate Highway System and the Transportation Improvement Program.
- It modifies the definition of 'governmental unit' for purposes of interest rate swap agreements to mirror the language in the statute authorizing swap agreements.

FISCAL IMPACT: This act is not projected to impact State revenues since the debt service for the bonds will be paid by federal funds.

(For a more complete fiscal analysis, see Overview Fiscal and Budgetary Actions, 2005 Session Available in the Legislative Library.)

EFFECTIVE DATE: The authority to issue GARVEE bonds becomes effective February 1, 2006. The remainder of the act became effective when the Governor signed it into law on September 20, 2005.

ANALYSIS: GARVEEs, Grant Anticipation Revenue Vehicles, represent one of the tools Congress provides to the states to facilitate the development and acceleration of highway projects. With GARVEEs, states may issue bonds secured by future federal highway funds. The debt itself is a state responsibility; a GARVEE does not carry with it any guarantee for repayment from the federal government. However, the federal aid highway program represents a long-standing source of transportation revenue and many investors appear willing to accept the risk that Congress will continue to authorize highway funds for the full term of the bonds.

This act authorizes the Department of Transportation to issue GARVEE bonds to finance federal-aid highway projects. A state may elect to pledge their obligations of future federal-aid funds as the only security backing the federal share of the obligation to investors (non-recourse GARVEES) or to pledge other sources of revenue as a back-stop for the future federal-aid funds (back-stopped GARVEES). The GARVEE bonds issued under this act's authority must be non-recourse GARVEES. The notes issued under this authority are not supported by a pledge of the taxing power of the State and they must contain on their face a statement to the effect that the State of North Carolina is not obligated to pay the principal or the interest on the notes, except from the federal transportation fund revenues. The act also specifies that the bond revenues must be distributed in accordance with the equity distribution formula under G.S. 136-17.2A.[67] This part of the act becomes effective February 1, 2006; DOT may not issue GARVEE bonds before that date.

The act directs the Department of Transportation and the State Treasurer to form a committee to develop a plan to address the issues involved in issuing GARVEE bonds. The plan must be submitted to the Board of Transportation for review and comment. The final plan must be submitted by December 1, 2005, to the cochairs of the Transportation Appropriations Subcommittee and the Joint Legislative Transportation Oversight Committee.

The act limits the amount of GARVEE bonds that may be issued by requiring the State Treasurer to determine one of the following before the bonds are issued:

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[67] The 100 counties in the State are divided into seven distribution regions. G.S. 136-17.2A seeks to ensure that all the regions of the State have a percentage share of the transportation funds as determined by the formula set forth in this statute.

- That the total outstanding principal of the debt does not exceed the total amount of federal transportation funds authorized to the State in the prior federal fiscal year.
- That the maximum annual principal and interest payment of the debt does not exceed 15% of the expected average annual federal revenue for the 7-year period in the most recently adopted Transportation Improvement Program.

In federal fiscal year 2004, the amount of federal transportation funds authorized for the State was $950 million.[68] Therefore, this act would allow the State to borrow roughly $950 million. The fiscal note assumes that DOT would issue $475 million of debt in February 2006, and $475 million of debt in the spring of 2007. It also assumes that the interest rate would be 4.5% on each of the bond issues and that each bond issue would be paid off over 12 years. Based upon these assumptions, the payments on this debt would be about $1.25 billion.[69] These debt service payments would be funded from federal aid available to the State, and would displace the use of this federal aid for other projects or purposes.

Candidate projects for GARVEE financing are typically larger projects that have the following characteristics:

- They are large enough to merit borrowing rather than pay-as-you-go grant funding, with the costs of delay outweighing the cost of financing.
- They do not have access to a revenue stream (such as local taxes or tolls) and other forms of repayment (such as state appropriations) are not feasible.
- The sponsors (generally state DOTs) are willing to reserve a portion of future year federal-aid highway funds to satisfy debt service requirements.

Unrelated to the GARVEE bond authorization, the act clarifies that the State Treasurer can enter into interest rate swap agreements between bond issues. Under G.S. 159-194, the State Treasurer can enter into swap agreements; however, the language in the definitional part of the article does not mirror the language in the authorizing statute itself. Section 4 of this act modifies the definition of 'governmental unit' to mirror the language in the statute authorizing swap agreements. The State's bond counsel requested this change.

Bill Lee / Excise Tax Refund.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-406	SB 868	Senator Berger of Franklin

AN ACT TO AMEND THE ENTERPRISE TIER STRUCTURE UNDER THE WILLIAM S. LEE QUALITY JOBS AND BUSINESS EXPANSION ACT AND TO ALLOW FOR A REFUND OF EXCISE TAX ON UNSALABLE CIGARS.

[68] The actual federal aid received by the State usually amounts to less than the federal aid authorized. For federal fiscal year 2004, the State received roughly $830 million in federal highway funds.

[69] Based upon an interest rate of 4.5%, roughly $300 million of this amount would be for interest expenses.

OVERVIEW: The act provides an exception to the tier designation formula under the William S. Lee Quality Jobs and Business Expansion Act, by allowing certain industrial parks located in higher-tiered counties to be treated as if they were located in an enterprise tier one area if the parks meet conditions related to government ownership, size, population of the counties, and Medicaid eligibility within the counties.

The act also gives tobacco products dealers a refund of the excise tax paid on stale or otherwise unsalable cigars returned to the manufacturer.

FISCAL IMPACT: No estimate available.

EFFECTIVE DATE: Changes to the Bill Lee Act are effective for taxable years beginning on or after January 1, 2005. The refund for unsalable cigars became effective September 1, 2005.

ANALYSIS:

The William S. Lee Quality Jobs and Business Expansion Act (hereinafter Bill Lee Act) was enacted in 1996, effective beginning with the 1996 tax year with a 2002 sunset.[70] The Bill Lee Act is a package of State tax incentives and has been modified in each subsequent year. The incentives are primarily in the form of tax credits for investment in machinery and equipment and real property, for job creation, for worker training, and for research and development. Counties are divided into five economic distress tiers based on the unemployment rate, per capita income, and population growth of the county. For many of the credits, the lower the tier of a county, the more favorable the incentive. The Bill Lee Act requires the Department of Commerce and the Department of Revenue to report periodically on the credits allowed by the Act.

By December 31 of each year, the Department of Commerce is required to assign a tier designation to each of the 100 counties in the State. In order to make these assignments, the Department of Commerce must rank all 100 counties based on the following three factors: the rank of the county in a ranking of counties by average rate of unemployment over the preceding 12 months from lowest to highest, the rank of the county in a ranking of counties by average per capita income over the proceeding 12 months from highest to lowest, and the rank of the county in a ranking of counties by percentage growth in population over the preceding 12 months from highest to lowest. [71] Each of these factors is given equal weight. The Secretary of Commerce is required to use the latest data available in making these calculations. Counties with one of the 10 highest rankings are designated enterprise tier one, the next 15 counties are designated enterprise tier two, the next 25 counties are enterprise tier 3, the next 25 counties are enterprise tier 4, and the remaining counties are enterprise tier 5. There are numerous exceptions to this formula.[72] A county designated as enterprise tier

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[70] See summary of S.L. 2005-241, Extend JDIG and Bill Lee Act, for discussion of the extension of the Act's sunset.

[71] Prior to the designations for the 2005 calendar year, these ranking were based on longer time periods. Unemployment and per capita income were averaged over three years rather than 12 months. There was no time period specified for measuring population growth, but it was the practice of the Department of Commerce to measure population growth by comparing the most recent estimates of population in the county with the figures derived from the last decennial federal census. See S.L. 2004-202.

[72] S.L. 2005-241 creates an exception for counties with particularly high rates of unemployment and amends the current exception for counties with small populations and high rates of poverty by eliminating the requirement related to the percent of the population living below the poverty level.

one or two may not be designated a higher tier until it has been at its current tier for at least two consecutive years. Certain lower-population counties also enjoy exceptions that could result in those counties receiving a lower tier designation. Finally, certain industrial parks that are located at one site in two or more counties receive the tier designation of the lower-ranked county. This last exception was added in 1998 (S.L. 1998-55) to promote regional cooperation in industrial development and to avoid an industrial park that is split into two tier designations.

Exception to Tier Structure under Bill Lee Act

Section 1 of this act creates a new exception to the Bill Lee Act tier designation formula. Under this act, sites within certain industrial parks will be able to qualify for enterprise tier one status. In order to take advantage of this exception, all of the following conditions must be satisfied:

- The site is located in an industrial park created by interlocal agreement pursuant to G.S. 158-7.4.
- The industrial park is located, at one or more sites, in at least four contiguous counties.
- At least two of the counties in which the industrial park is located are designated as enterprise tier one areas.
- Four or more units of local government, or a nonprofit corporation owned and controlled by four or more units of local government, own the industrial park.
- In each county in which the industrial park is located, the park has at least 300 developable acres. The term "developable acres" includes acreage that is owned directly by the industrial park or its owners or that is the subject of a development agreement between the industrial park or its owners and a third-part owner.
- The total population of all the counties in which the industrial park is located is less than 200,000.
- In each county in which the industrial park is located, at least 16.8% of the population was Medicaid eligible for the 2003-2004 fiscal year based on 2003 population estimates.

As of the time the bill was signed into law by the Governor on September 20, 2005, the industrial park in the Kerr-Tar region is the only industrial park that was known to meet the above criteria. It is possible that other counties could enter into similar agreements in order to take advantage of the exception in the future, but the restrictions are so stringent as to make it unlikely that a significant number of high-tiered counties could qualify under this act. The four counties involved in the Kerr-Tar industrial park project are Franklin, Granville, Vance, and Warren. In 2005, Franklin County was an enterprise tier five area; Granville County was an enterprise tier three area; and Vance and Warren Counties were enterprise tier one areas.

Refund of Excise Tax on Unsalable Cigars

Section 2 of this act allows a wholesale dealer or retail dealer who has paid the 2% excise tax on cigars to apply for a refund of the excise tax if the cigars are stale or otherwise unsalable. To obtain the refund, the dealer must return the cigars to the manufacturer and send an application to the Secretary of Revenue accompanied by an affidavit from the manufacturer stating the number of cigars returned to the manufacturer. The amount of the refund is the excise tax paid less the 2% discount.[73] Similar treatment is allowed to a distributor of cigarettes. If the distributor of cigarettes is in possession of stale or otherwise unsalable cigarettes, the distributor may apply for a refund of the tax paid, less the discount allowed on the unsalable cigarettes. This act gives the same refund to dealers in possession of unsalable cigars, but not to other tobacco products.

Before August 1, 2003, distributors and wholesalers who timely paid the excise taxes on cigarettes, other tobacco products, wine, beer, and liquor were eligible for a discount equal to 4% of the tax due. In 2003, the General Assembly eliminated these discounts. (S.L. 2003-284). In 2004, the General Assembly reinstated the discounts, but at a rate of 2% of the tax due. (S.L. 2004-84)

Tax Increment Financing Changes.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-407	SB 528	Senator Clodfelter

AN ACT TO ALLOW A MUNICIPALITY TO USE PROJECT DEVELOPMENT FINANCING FOR TOURISM-RELATED DEVELOPMENT PROJECTS LOCATED IN AN ENTERPRISE TIER ONE AREA.

OVERVIEW: This act allows a municipality to use project development financing for a tourism-related development project located outside its central business district if the project is located in an enterprise tier one area.

FISCAL IMPACT: The act does not affect General Fund revenues.

EFFECTIVE DATE: The act became effective when it was signed into law by the Governor on September 20, 2005.

ANALYSIS: In November 2004, the voters approved a constitutional amendment that has enabled counties, cities, and towns to use project development financing for the public portion of certain economic development projects within a defined territorial area. Project development financing, also known as tax increment financing, allows a local government to issue bonds secured by the incremental property tax increase generated by the development financed. This financing mechanism can be used for airports, auditoriums and arenas, hospitals, museums, parking facilities, sewer systems, storm sewers and flood control facilities, water systems, street improvements, public transportation facilities, railroads,

[73] Under current law, a wholesale dealer or retail dealer of tobacco products who timely pays the excise tax on tobacco products at the rate of 2% of the cost price is eligible for a discount equal to 2% of the tax due. This discount is intended to cover expenses incurred in preparing tax reports and the expense of furnishing a bond.

affordable housing, land development for industrial or commercial purposes, utilities, and redevelopment. The prior law restricted the amount of retail development that could be considered as a 'development project' if the project was located outside a municipality's central business district. Under that restriction, no more than 20% of a project's square footage may be proposed for use in retail sales, hotels, and other commercial uses other than office space.

The act enables municipalities to use project development financing for tourism related development in an enterprise tier one area by eliminating the 20% limitation on commercial uses for tourism-related economic development, such as developments that would feature facilities for exhibitions, athletic and cultural events, show and public gatherings, racing facilities, parks and recreation facilities, art galleries, museums, and art cents.

The act was enacted to give the City of Roanoke Rapids the opportunity to develop a music theater and entertainment district that could become a nationally recognized travel destination in North Carolina. The proposed district will encompass over 700 acres, represents an investment of an estimated $129 million, and should create over 2,595 new jobs. The district will consist of music theaters, shopping, hotels, motels, restaurants, and family recreational activities. The City of Roanoke Rapids has agreed to provide certain improvements in the proposed district and believes project development financing will be a desirable vehicle for it to use to finance these improvements. However, because the project will be located on I-95, outside the City's central business district, the 20% limitation on commercial development prevented the City from using this financing tool. The act alleviates this problem by eliminating the 20% limitation.

Energy Credit Banking/Selling Program/Fund.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-413	SB 1149	Senator Jenkins

AN ACT TO ESTABLISH A BANKING AND SELLING PROGRAM FOR CREDITS ISSUED UNDER THE FEDERAL ENERGY POLICY ACT IN ORDER TO GENERATE FUNDS FOR THE USE OF ALTERNATIVE FUELS AND ALTERNATIVE FUELED VEHICLES BY STATE DEPARTMENTS, INSTITUTIONS, AND AGENCIES AND TO EXTEND AND EXPAND THE CREDIT FOR INVESTMENT IN RENEWABLE ENERGY PROPERTY.

OVERVIEW: This act[74] extends and expands the tax credit for investing in renewable energy property as follows:

- Expands the definition of renewable energy property in G.S. 105-129.15(7) to include any biomass equipment that uses renewable biomass resources for commercial thermal or electrical generation.

[74] Changes to the tax credit for investing in renewable energy property are set out in sections 4 and 5 of the act.

- Expands the definition of renewable biomass resources in G.S. 105-129.15(6) to include spent pulping liquor.
- Increases the ceiling on the tax credit for placing renewable energy property in service for nonresidential property from $250,000 to $2.5 million.
- Includes pool heating in the residential property ceiling for solar energy equipment.
- Extends the sunset on the tax credit for investing in renewable energy property from January 1, 2006, to January 1, 2011.

FISCAL IMPACT: The following General Fund loss is estimated as a result of the extension and expansion of the renewable energy tax credit:

Fiscal Year	Business	Individuals	Total
2005-06	$0.00	$0.00	$0.00
2006-07	$0.02 million	$0.08 million	$0.10 million
2007-08	$0.92 million	$0.13 million	$1.05 million
2008-09	$1.95 million	$0.18 million	$2.13 million
2009-10	$3.53 million	$0.27 million	$3.80 million
2010-11	$5.36 million	$0.29 million	$5.65 million

The category "business" includes non-profit organizations with participating private entities. The above revenue losses reflect current usage of the credit. The loss is expected to be higher in the future if energy costs continue to rise.

(For a more complete fiscal analysis, see Overview Fiscal and Budgetary Actions, 2005 Session. Available in the Legislative Library.)

EFFECTIVE DATE: Sections 4 and 5 of the act are effective for taxable years beginning on or after January 1, 2006.

ANALYSIS: In 1977, the General Assembly enacted legislation to provide tax credits for the construction or installation of a solar energy system to a building in North Carolina. In subsequent years tax credits encouraging the installation and use of equipment that takes advantage of other renewable energy resources were enacted. Renewable energy property is equipment that uses the renewable energy sources such as solar radiation, vegetation, organic wastes, moving water, or wind for the following purposes: to heat or cool buildings; to produce hot water, thermal, or process heat; or to generate electricity.

Under current law, the credit for investing in renewable energy property applies to any of the following machinery and equipment or real property:

- Biomass equipment that uses renewable biomass resources for biofuel production of ethanol, methanol, and biodiesel; anaerobic biogas production of methane utilizing agricultural and animal waste or garbage; or commercial thermal or electrical generation from renewable energy crops or wood waste materials. Renewable biomass resources are organic matters produced by terrestrial and aquatic plants and animals, such as standing vegetation, forestry and agricultural residues, landfill wastes, and animal wastes.

- Hydroelectric generators
- Solar energy equipment
- Wind equipment

The act adds spent pulping liquor to the definition of renewable biomass resources. Spent pulping liquor is a byproduct of pulp and paper processing. To accommodate this addition to the definition of renewable biomass resources, the act also expands the definition of renewable energy property to include any biomass equipment that uses renewable biomass resources (not just renewable energy crops or wood waste materials) for commercial thermal or electrical generation.

The amount of the credit for investing in renewable energy property is 35% of the cost of the property placed in service. In the case of renewable energy property that services a single-family dwelling, the credit must be taken for the taxable year in which the property is placed in service. For all other renewable energy property, the credit must be taken in five equal installments, beginning with the taxable year in which the property is placed in service. The credit may not exceed the following amounts:

TYPE OF PROPERTY	MAXIMUM CREDIT
Non residential property	The act increases the credit from $250,000 per installation to $2,500,000 per installation
Residential property - Solar energy equipment for domestic water heating. The act clarifies that the credit also applies to solar energy equipment for pool heating.	$1,400 per dwelling unit
Residential property - Solar energy equipment for active space heating, combined active space and domestic hot water systems, and passive space heating.	$3,500 per dwelling unit
Residential property - All other renewable energy property for residential purposes	$10,500 per installation

The renewable energy tax credit has the following limitations and conditions:

- The renewable energy tax credit may not exceed 50% of the tax against which it is claimed for the taxable year. Any unused portion of the credit may be carried forward for the succeeding five years.
- A taxpayer that claims any other credit allowed with respect to renewable energy property may not take the renewable energy tax credit with respect to the same property.
- A taxpayer may not take the renewable energy tax credit if the taxpayer leases the property from another person, unless the taxpayer obtains the lessor's written certification that the lessor will not claim a credit with respect to this property.
- The Department of Revenue must report each year on the number of taxpayers claiming the credits, the cost of the property for which the credits were claimed, and the total cost

to the General Fund of the credits claimed.

The act extends the sunset on the renewable energy tax credit from January 1, 2006 to January 1, 2011, and maintains the existing sunsets on the other credits in Article 3B (Business and Energy Tax Credits) of Chapter 105 of the General Statutes.

Economic Development - Public Records.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-429	SB 393	Senator Hoyle

AN ACT TO CLARIFY THE PUBLIC RECORDS LAWS WITH RESPECT TO ECONOMIC DEVELOPMENT AND TO REQUIRE THE DEPARTMENT OF REVENUE TO PUBLISH ANNUAL REPORTS REGARDING USE OF ECONOMIC DEVELOPMENT TAX INCENTIVES.

OVERVIEW: This act requires the Department of Revenue to annually publish a list, itemized by taxpayer, disclosing information about certain tax incentives. In addition, the act clarifies that public records created with respect to a proposed location or expansion of a specific business or industrial project must be released once the project has been announced, that certain types of information are public records, and that an agency must notify applicants for and recipients of economic development incentives about public records requirements.

FISCAL IMPACT: No impact.

EFFECTIVE DATE: The annual reporting required by the Department of Revenue becomes effective January 1, 2007; the remainder of the act became effective when the Governor signed it into law on September 22, 2005.

ANALYSIS: Generally, documents prepared or received by State agencies in the transaction of public business are public records and must be made available to the public for inspection. There are several important exceptions to the public records law that allow for withholding certain public records from disclosure. One of these exemptions is for tax information, which may be disclosed only as specifically authorized by law. Another of these exceptions relates to the location or expansion of business or industrial projects. Prior to this act, public records relating to the location or expansion of specific business or industrial projects could be withheld from disclosure so long as that disclosure would frustrate the purpose for which the public records were created. Arguably, the release of public records related to a specific project could "frustrate the purpose for which they were created" long after the project was announced.

This act clarifies that public records created with respect to the location or expansion of a specific business or industrial project may not be withheld once the project location or expansion has been announced. The act provides for a 25-business-day period for the State agency to gather and review the records before making them public. The act also specifies

that when an agency is required to perform a cost-benefit analysis or similar assessment with respect to economic development incentives offered to a specific business, the assumptions and methodologies used in completing that analysis are public records and must be disclosed in the same fashion as other public records. The act requires an agency to notify the applicant or recipient of economic development incentives about these public records law requirements.

In addition to clarifying the public records law as it pertains to economic development incentives, the act creates and expands reporting requirements surrounding economic development incentives. Under the act, the Department of Commerce must make an annual report on all grant programs administered by the Department; it must specifically disclose the amount transferred to the Utility Account of the Industrial Development Fund under the JDIG Program[75] each year; and it must report employment levels for businesses receiving grants under the JDIG Program.

The Department of Revenue currently publishes an annual report, itemized by taxpayer, on credits claimed under the Bill Lee Act. It also makes annual reports on other credits to either the Revenue Laws Study Committee or the Fiscal Research Division. This act requires the Department to annually publish a report on economic development tax incentives authorized by the State. The act modifies the Department's current reporting requirements so that all reports prepared by it on credits and refunds have identical reporting dates and data periods. It amends the existing reporting requirements for the following credits to require that they be itemized by taxpayer:

- Tax incentives for recycling facilities under Article 3C of Chapter 105.
- Research and development under Article 3F of Chapter 105.

It creates new reporting requirements for the following tax incentives:

- Historic rehabilitation tax credits under Article 3D of Chapter 105.
- Tax incentives for major computer manufacturing facilities under Article 3G of Chapter 105.
- Credit for North Carolina State Ports Authority wharfage, handling, and throughput charges.
- Credit for manufacturing cigarettes for exportation.
- Sales tax refunds for building materials of certain industrial facilities.

Lastly, the act directs the newly formed Economic Development Oversight Committee[76] to study the issue of public disclosure as it relates to economic development efforts. Specifically, the Committee shall study ways of providing the public information about employment levels at businesses that receive economic development incentives.

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[75] Job Development Investment Grant Program. Part 2G of Article 10 of Chapter 143B of the North Carolina General Statutes.

[76] Created by S.L. 2005-241.

Motor Fuel Tax Chgs & Rev Laws Technical Chgs.

Session Law	*Bill #*	*Sponsor*
S.L. 2005-435	HB 105	Representative Luebke

AN ACT TO MODIFY THE TAXATION OF MOTOR FUELS, TO MAKE TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES TO THE REVENUE LAWS AND RELATED STATUTES, AND TO ALLOW INTERSTATE PASSENGER AIR CARRIERS A REFUND OF SALES AND USE TAXES ON FUEL.

OVERVIEW: This act makes numerous changes to the motor fuels tax laws as recommended by the Revenue Laws Study Committee, makes technical and clarifying changes to the revenue laws[77] and allows for a refund of sales and use taxes paid on certain aviation fuel.

FISCAL IMPACT:

Provision	*Fiscal Impact*
Part I. Motor Fuel Tax Changes	
Penalty provisions.	Generally, no estimate is available of the fiscal impact of the various penalties authorized or increased in this Part, but the effect is expected to be minimal.
Red Cross exemption from motor fuels tax.	Since this section conforms statute to department policy, no fiscal impact is expected.
Refund conformity.	No fiscal impact is expected.
IRP audit responsibility.	No additional funding required for the positions with auditing responsibility. Additionally, there is no increase in receipts needed for the department to administer the new or revised statutory requirements resulting from this legislation. The remaining sections deal with record keeping requirements and have no fiscal impact.
Part II. Revenue Laws Technical Changes	A review of the language of the changes to the tax law indicates that they are purely technical in nature. In many cases the new language conforms to the current administrative interpretation. No fiscal impact is expected.
Part III. Refund of Sales and Use Taxes on Fuel	
Interstate air passenger	Based on historic fuel refund data and projected fuel costs,

[77] The Revenue Laws Study Committee recommended numerous technical corrections on S 159 that were incorporated into this bill.

carriers.	Tax Research and Fiscal Research agree that the provision is likely to cost the State between $3.0 and $5.0 million each year the program is in effect. The change is expected to impact a fairly limited number of air carriers.
Motorsports racing teams and sanctioning bodies.	Based on data provided by some of the motorsports teams, and information gleaned from recent industry impact studies by UNC Charlotte, Fiscal Research estimates the annual State cost of this portion of the bill as approximately $1.1 million for each of the two years. The local cost is expected to be $0.6 million.

(For a more complete fiscal analysis, see Overview: Fiscal and Budgetary Actions, 2005 Session Available in the Legislative Library.)

EFFECTIVE DATE: Except as otherwise specified, this act became effective when signed into law by the Governor on September 27, 2005.

ANALYSIS:

Part I: Motor Fuel Tax Changes.

Section	Explanation
1	Penalty for failure to obtain a license. - Allows the Secretary to impose a $1,000 penalty for failure to obtain a license under G.S. 105-449.65 or G.S. 105-449.131[78] Under existing law, the Secretary has general authority to impose a penalty for failure to obtain a license. Under that general authority, the amount of the penalty imposed is equal to 5% of the amount prescribed for the license for each month the taxpayer fails to obtain the license, with a maximum penalty of 25% of the amount prescribed for the license. Because this general authority limits the penalty to a percentage of the amount prescribed for the license, it effectively bars assessing a penalty when there is no charge to obtain a license. There is no charge for the licenses issued pursuant to G.S. 105-449.65 or G.S. 105-449.131. This provision becomes effective January 1, 2006.
2	Electronic funds transfer. - Enables the Motor Fuels Division to move towards a paperless return by requiring those taxpayers who file electronically to also pay electronically. By statute the Secretary can require motor fuels taxpayers to file returns electronically. The Division plans to require motor fuel taxpayers that have schedule data information to file their returns electronically. "Schedule data information" is a separate schedule that lists all bills of lading for the fuel being reported. The information enables the

[78] G.S. 105-449.65 is contained in the Article dealing with gasoline, diesel fuel, and blended fuel, and requires the following to have a license: refiners, suppliers, terminal operators, importers, exporters, blenders, motor fuel transporters, and distributors who purchase motor fuel from an elective or permissive supplier at an out-of-state terminal for import into this State. G.S. 105-449.131 is contained in the Article dealing with alternative fuels and requires the following to have a license: providers of alternative fuel, bulk-end users, and retailers.

	Department to track fuel on a load-by-load basis. The Secretary will not require electronic filing from taxpayers who make a written request for relief from this requirement.
3	Conform refund provisions. - Conforms the refund statute applicable to motor carriers to the general rule applicable to tax refunds of overpaid taxes. Under the general administrative provisions of G.S. 105-266(a)(3), the Secretary does not have to refund a tax overpayment of less than $3.00 unless the taxpayer makes a written request for the refund. A motor carrier is entitled to a credit on its quarterly report for tax paid by the carrier on fuel purchased in this State. If the credit exceeds the amount of tax owed, the statute provides that the Secretary must refund the excess to the carrier. The statute does not set a minimum amount. This statute appears to conflict with the general administrative provision. This section clarifies that the general administrative law applicable to refunds applies to refunds payable to motor carriers.
4	Technical change. - Removes obsolete language to conform to current administrative practice. G.S. 105-449.44 establishes the calculation by which a motor carrier determines the amount of fuel used in North Carolina. The formula under previous law had not been used since 1991. In 1992, North Carolina became a participant in the International Fuel Tax Agreement. The method specified by this section conforms to the IFTA agreement and is the method motor carriers have been using to determine the amount of fuel used in this State since 1992.
5 and 22	Conforming change. - Transfers audit functions related to the International Registration Plan from the Department of Transportation, Division of Motor Vehicles to the Department of Revenue, Motor Fuels Tax Division. The International Registration Plan is the mechanism through which interstate motor carriers are licensed. It helps to ensure that the proper amount of motor fuels tax is credited to each jurisdiction in which the motor carrier travels. It has been suggested that the Department of Revenue has more expertise in auditing taxpayers and would be a more appropriate home for these audit functions. The positions associated with these audit functions were transferred July 1, 2004, through an administrative transfer.
6	Technical change. - Removes language that is no longer applicable. G.S. 105-449.47 provides that the Secretary must issue identification markers to motor carriers. Under previous law, the statute provided that the Secretary could withhold an identification marker if a motor carrier failed to comply with former Article 36 or 36A. The General Assembly repealed those articles in 1996. The authority of the Department to issue an assessment under one of those articles has expired and any uncollectible assessments issued under those articles has been written off. Therefore, the language repealed by this section is obsolete.
7	Reasons to refuse to register and issue identification marker to motor carrier. - Sets forth the reasons the Secretary could refuse to register and issue an identification marker to a motor carrier. The Department requested this

	change to enable it to register only applicants that are in good standing with North Carolina and other taxing jurisdictions. The statute created in this section is very similar to G.S. 105-449.73, which sets forth the reasons the Secretary may refuse to issue a license to an applicant under the motor fuel statutes. This provision becomes effective January 1, 2006.
8	Simplify criminal penalty. - Simplifies the criminal penalty imposed on persons who operate as a motor carrier in this State without obtaining the necessary registration and identification markers. A violation of the motor carrier requirements is a Class 3 misdemeanor. Under previous law it was punishable by a fine that was no less than $10 nor more than $200. This section sets the amount of the fine at $200. The civil penalty for this offense is $100. This provision becomes effective January 1, 2006.
9	Clarification of licensing requirements for multiple activities. - Clarifies the current licensing requirements by conforming them to the current Department policy and practice. This provision becomes effective January 1, 2006.
10	Technical change. - Removes obsolete language. In 1999, the General Assembly removed the licensing requirements for bulk-end users and retailers of undyed diesel fuel. The legislation did not include a conforming change to G.S. 105-449.69(b).
11	Clarifying change. - Changes the defined term "overdue tax debt" to the appropriate defined term "tax debt". Under the general administrative provisions in G.S. 105-243.1, a tax debt is defined as the total amount of tax, penalty, and interest due for which a notice of final assessment has been mailed to the taxpayer after the taxpayer no longer has the right to contest the debt. An "overdue tax debt" is any part of a tax debt that remains unpaid 90 days or more after the notice of final assessment was mailed to the taxpayer. A collection assistance fee is imposed on an overdue tax debt that remains unpaid 30 days or more after the appropriate fee notice is mailed to the taxpayer. G.S. 105-449.73 sets forth the reasons the Secretary can deny a license to an applicant. One of the reasons is failure to remit taxes that remain due after a taxpayer no longer has the right to contest the tax debt. Since G.S. 105-449.73 has nothing to do with the imposition of the collection assistance fee, the term "overdue tax debt" is not the appropriate term to use.
12	Conforming change. - Exempts motor fuel acquired to operate a highway vehicle owned by or leased to the American Red Cross from the motor fuel excise tax. In Department of Employment v. United States, 385 U.S. 355, 87 S.Ct. 464 (1966), the United States Supreme Court ruled that the Red Cross is an instrumentality of the United States for state tax immunity purposes. This provision codifies the current administrative practice of the Department of Revenue. This section makes another conforming change by recognizing that federal law no longer allows dyed diesel fuel to be used in intercity buses. Dyed diesel fuel indicates that the fuel is used for a nontaxable purpose under

	federal law. Because dyed diesel fuel may no longer be used in intercity buses under federal law, there is no need to specifically apply the State tax to dyed diesel fuel used in intercity buses. This amendment does not change the taxation of the fuel used in intercity buses: the State tax continues to apply.
13	Repeal obsolete payment procedure. – Removes the ability of a person exporting motor fuel to another state to pay the tax directly to the Department if the person is not licensed in the destination state of the motor fuel. The provision is repealed because it is no longer necessary. This provision was included in the statutes in 1996 when North Carolina first adopted "tax at the rack" to accommodate persons exporting products to a state that was not a "tax at the rack" state. Today, with the exception of Georgia, all of the surrounding states have adopted "tax at the rack". The Georgia border in the western part of the State would not be affected by this repeal because the closest terminal to the Georgia line is in Charlotte.
14	Conforming change. – Provides that a supplier must list on its return to the Secretary the number of gallons of motor fuel the supplier exchanged with another licensed supplier pursuant to a two-party exchange agreement. The Secretary currently requires this information on the supplier return.
15	Technical change. – Removes obsolete language from the catch line of G.S. 105-449.106. In 2003, the General Assembly exempted motor fuel sold to a county or city for its use from the motor fuel tax. Although the legislation authorizing the exemption made the appropriate conforming change to the refund statute, it failed to amend the catch line. This provision becomes effective when it becomes law.
16	Shipping document. – Allows the Secretary of Revenue to assess a penalty of $5,000 on a terminal operator who intentionally fails to issue a shipping document that satisfies the requirements for the shipping document. Under G.S. 105-449.115, shipping documents issued by a terminal operator must contain the following information: 1) identification of the terminal or bulk plant from which the fuel was received, 2) the date the fuel was loaded, 3) the gross gallons loaded, 4) the destination state of the motor fuel, 5) the net gallons loaded, and 6) a tax responsibility statement indicating the name of the supplier that is responsible for the tax. The Motor Fuels Tax Division has noticed a problem with some terminal operators failing to issue proper shipping documents. Without an accurate shipping document, it is difficult, if not impossible, for the Department to ensure that the proper amount of tax is being paid. This provision becomes effective January 1, 2006. This section also adds a defense to imposition of a penalty for failure to obtain a diversion number for motor fuel delivered to a state other than the destination state printed on the shipping document. In order for this defense to be applicable, the person must notify the Secretary of the diversion within 7 days after the diversion occurred and must have timely paid the tax on the diverted fuel. This part of the section becomes effective when it becomes law and applies to penalties imposed on or after January 1, 2005. Finally, this section also specifies that a civil penalty assessed against a

	transporter is to be paid to the Department of Crime Control and Public Safety or the Department of Revenue. Previously, the penalty could be paid to the Division of Motor Vehicles of the Department of Transportation rather than the Department of Crime Control and Public Safety. This change reflects a recent realignment of enforcement responsibilities.
17	Documentation for tank wagon. -Requires the same documentation requirements for a person who operates a tank wagon into which motor fuel is loaded at the terminal as for a person who operates a transport truck into which motor fuel is loaded at the terminal. It would also require that a copy of the invoice be kept at a centralized place of business for at least three years from the date of delivery.
18	Penalty for failing to properly mark storage facility. - Imposes a civil penalty on a person who intentionally does not properly mark the storage facility of motor fuel. Undyed fuel is subject to the motor fuel tax; dyed fuel is not. This section also specifies that a civil penalty assessed against the person failing to properly mark a storage facility is to be paid to the Department of Crime Control and Public Safety or the Department of Revenue. Previously, the penalty could be paid to the Division of Motor Vehicles of the Department of Transportation rather than the Department of Crime Control and Public Safety. This change reflects a recent realignment of enforcement responsibilities. This section becomes effective January 1, 2006
19 and 20	Conforming change. - Makes changes to Chapter 119 necessitated by legislation enacted in 2003. In 2003, the General Assembly voted to apply the inspection tax to dyed diesel fuels. The inspection tax is imposed on all fuel types at the rate of ¼¢ per gallon. Proceeds of the tax are used to offset the expenses of administering the motor fuels taxes. The changes in these two sections are needed to apply the tax to distributors who purchase only dyed diesel fuel.
21	Technical change. - The law provides that an applicant for a license as a kerosene supplier, kerosene distributor, or a kerosene terminal operation may file either a bond with the Secretary of Revenue or an irrevocable letter of credit. Section 21 inserts the phrase "irrevocable letter of credit" in a sentence in which it was inadvertently omitted.
23	Effective date section for this part.

Part II. Revenue Laws Technical Changes.

Section	Explanation
24	Technical change. - Adds language regarding a federal determination of gross estate tax that changes the amount of tax payable to the State. The current statute refers only to a federal correction or determination made with regard to the maximum state death tax credit allowed. As of January 1, 2005, there is no state death tax credit allowed under federal law so language needs to be added regarding gross estate tax changes.

25	Technical change. - Section 25(a) conforms the definition of "unfortified wine" in Chapter 18B to the definition in G.S. 105-113.68. The General Assembly changed the definition of "unfortified wine" in S.L. 2004-135. The definition in Chapter 18B inadvertently included an unnecessary word. Section 25(b) cross-references the applicable definitions in the Alcoholic Beverage License and Excise Tax Article to the definitions in Chapter 18B and makes stylistic changes. In addition, the change made to "wholesaler or importer" conforms to a change made in Chapter 18B in the 2003 Regular Session.
26	Clarifying change. - Clarifies that the excise tax on wine shippers is imposed only on wine shipped to North Carolina consumers.
27	Clarifying change. - Clarifies the scope of authorized disclosure of information obtained by the Secretary of Revenue under Article 2D, Unauthorized Substance Taxes. Under previous law, information obtained under article 2D was confidential and could not be disclosed, unless the disclosure was made to exchange information with certain law enforcement agencies concerning a tax imposed by the Article. The information could also not be used in a criminal prosecution, other than for a prosecution for a violation of the Article or unless the information was independently obtained. However, the law was somewhat ambiguous about when this disclosure between the Division and law enforcement could take place. Since the Division needs to be able to exchange information with law enforcement in order to assist with the collection of the tax and the intent of the statute was to allow such communication, this section clarifies when this information may be disclosed while preserving a person's Fifth Amendment and double jeopardy protections.
28	Clarifying change. - Clarifies that the jobs tax credit installments end if the number of jobs in this State fall below the number the taxpayer had in this State when the taxpayer claimed the credit.
29	Technical change. - Substitutes the appropriate reference to "Article, " as opposed to "section."
30	Technical change. - Repeals the sales tax exemption for sales to the North Carolina Museum of Art of paintings and other objects or works of art for public display, the purchases of which are financed in whole or in part by gifts or donations. Effective July 1, 2004, the sales tax refund for State agencies was replaced with a sales tax exemption for all State agencies. Since the NC Museum of Art is a State agency under G.S. 140-5.12, the specific exemption in Chapter 105 is unnecessary. Those sales will be covered by the broader exemption for all State agencies.
31	Clarifying change. - Clarifies that the sales and use tax exemption for free distribution periodicals, which became effective July 1, 2005, is limited to a publication that is continuously published on a periodic basis monthly or more frequently. The exemption does not apply to publications that are published monthly part of the year and less than monthly the rest of the year.

32	Administrative change. – Section 32(a) authorizes cities to receive the same information available to counties regarding claims for sales tax refunds filed under G.S. 105-164.14, which authorizes refunds for various types of entities, including interstate carriers, nonprofit organizations, certain governmental entities, State agencies, major recycling facilities, nonprofit insurance companies, and certain industrial facilities. These changes were recommendations of a joint county and city task force organized to improve the administration of local sales tax. Section 32(b) excludes from the definition of otherwise confidential tax information, information concerning sales tax refunds paid to governmental entities. It also deletes a reference to information submitted on a master application for a business license since this master application system has been eliminated now that the Business License Information Office has been moved from the Secretary of State to the Department of Commerce.
33	Administrative change. – Section 33(a) provides a sales tax refund for certain building materials used by an air courier. This section allows Fed Ex, which plans to construct a facility in North Carolina, to apply for a sales tax refund on its purchases of building materials. The airport authority was going to construct the facility, and it would have been entitled to a refund. However, Fed Ex now plans to construct the facility. This section entitles Fed Ex to the same exemption to which the airport authority would have been entitled. This section became effective August 1, 2005, and applies to sales made on or after that date. Section 33(b) extends the sunset date by six months from July 1, 2009, to January 1, 2010. Section 33(c) removes the sunset language from the effective date part of the 2004 law. Placing the sunset date in the statute reduces the possibility of errors and confusion when and if the relevant subdivisions are amended. This section became effective August 1, 2005.
34	Technical change. – Corrects a grammatical mistake in G.S. 105-113.82(h), 105-116.1(e), and 105-164.44F(e).
35	Technical change. – Deletes the definition of "chlorofluorocarbon refrigerant" from the White Goods Disposal Tax Article because the white goods disposal tax is no longer based on the presence of these materials.
36	Technical change. – Inserts a statutory reference due to a previous recodification. Effective January 1, 1999, the General Assembly repealed the inheritance tax (Article 1, G.S. 105-2 through G.S. 105-32) and replaced it with the current State estate tax system (Article 1A, G.S. 105-32.1 through G.S. 105-32.8.) The new G.S. 105-32.8 preserved the provisions on federal determinations, which had previously been in G.S. 105-29. However, G.S. 105-241.1(e), which sets out the statute of limitations for the Secretary to propose an assessment of tax due, was not updated to include a reference to G.S. 105-32.8.

37	Administrative change. – Makes two changes to G.S. 105-259(b). G.S. 105-259(b) prohibits State employees with access to tax information from disclosing that information to any other person unless the disclosure is for one of the reasons enumerated in that subsection. First, it corrects an agency reference in the tax information confidentiality statute to reflect that the Business License Information Office was moved from the Secretary of State to the Department of Commerce. Second, it adds a new subdivision to allow the Department of Revenue to share with a taxpayer claiming a tax credit under Article 3G (Tax Incentives for Major Computer Manufacturing Facilities), tax information about its related entities and strategic partners.
38	Technical change. – Corrects a statutory reference due to a recodification.
39	Technical change. – Corrects two statutory references due to recodifications.
40	Technical change. – Corrects a statutory reference.
41	Administrative change. – Changes the way in which local sales tax revenues are reported to more accurately account for how the proceeds are distributed. This is a reporting change only and does not change the distribution amounts. Under existing law prior to this act, the first 2% of the local sales taxes on food were considered Article 39 distributions. This section clarifies that the taxes distributed on a per capita basis are to be allocated as distributions under Articles 40 and 42, and that the taxes distributed on a point of delivery basis are to be allocated under Article 39. This administrative change makes it easier for local governments to track local sales tax proceeds.
42	Technical change. – Corrects a subsection reference.
43	Technical change. – Deletes an obsolete reference.
44	Clarifying change. – Clarifies reimbursement language with regard to the requirement that State and local agencies that acquire land for wetlands mitigation reimburse the county in which the land is located for its lost taxes due to the acquisition.
45	Administrative change. – Corrects the dates an occupancy tax return is due and the taxes are due.
46	Administrative change. – Increases the fees for obtaining paper and electronic certificates provided by the Secretary of State's Office for certifying a copy of any filed document relating to a domestic or foreign limited partnership. Prior to the enactment of this act, the fee was $5.00. This section increases the fee to $15.00 for a paper certificate and $10.00 for an electronic certificate. In 2002, the General Assembly increased several fees assessed by the Corporations Division of the Secretary of State's Office, including the fee for obtaining certificates and certified copies of records. In part, the new fee

	schedule was designed to encourage customers to use the online ordering system. Although the fee change was made for corporations and limited partnerships, a corresponding fee change was not made in the Partnership Act, which has resulted in an inconsistency. This fee increase resolves that inconsistency and makes the fees for corporations and partnerships the same.
47	Clarifying change. - Section 47(a) clarifies that the authorization for the additional local sales tax enacted in S.L. 2004-123 applies only to Dare County. Section 47(b) provides that the original bill, as amended by this act, is effective when it becomes law.
48	Technical change. - Provides that the exception in the tax secrecy statute created to correspond with a change in the law sunsets at the same time as that tax law change.
49	Technical change. - Corrects a session law reference.
50	Technical change. - Corrects the proper name for the National Association for Stock Car Auto Racing, Inc. by substituting "for" for "of."
51	Administrative change. - Repeals the conditional sunset on the gross premiums tax rate on medical service corporations. In 2003, the General Assembly increased the gross premiums tax rate on medical service corporations from 1% to 1.9%, effective January 1, 2004. The legislation also provided a conditional sunset on the increased tax rate once there were no longer any medical service corporations offering anything other than dental service plans. There are only two Article 65 medical service corporations in North Carolina - Blue Cross/Blue Shield and Delta Dental. At the time, Blue Cross/Blue Shield was contemplating converting to for-profit status. In doing so, it would have been subject to the 1.9% rate as well. The conditional sunset would have reduced the rate on medical service corporations back to 1%, thus reducing the rate for Delta Dental. In July 2003, Blue Cross/Blue Shield announced its intention not to pursue conversion at this time. Therefore, the conditional sunset language, which was intended to address that issue, is no longer necessary.
52	Technical change. - Reenacts S.L. 2005-120 (House Bill 1056). This bill extended the period of time allowed for the Carteret Board of County Commissioners to develop a plan and sign a contract for the construction of a convention center. It also extends by one year the date for the Board to levy the one percent (1%) room occupancy tax to the year 2008. This bill passed both the House and Senate and was enacted on June 28, 2005. However, the bill was not read on three separate days in the House. The session law is being reenacted in this bill, which is also a roll-call bill, to assure that the bill meets the constitutional roll-call requirement.
53	Technical change. - Corrects a typographical error by replacing the word "of" with the word "or."
54	Technical change. - Corrects a reference in S.L. 2005-233 to "tourism promotion" by changing it to "promote travel and tourism," which is a

	defined term in the statute.
55	Technical change. – Corrects incorrect statutory reference.
56	Technical change. – Inserts a sentence inadvertently omitted. This section becomes effective January 1, 2006.
57	Clarifying change. – Clarifies that HMOs are taxed at the rate of 1.9%. This section becomes effective January 1, 2007.
58	Clarifying change. – Provides that for prepayments of cable services, the first billing period is considered to start on or after February 1, 2006.
59	Clarifying change. – Clarifies the drama portion of the literary purpose for the property tax exemptions. This change was made in order to clarify the tax status of institutions such as the Carolina Theater in Guilford County.
59.1	Technical change. – Corrects incorrect statutory reference. This section becomes effective January 1, 2006.
59.2	Clarifying change. – Clarifies the application of the franchise tax to a corporation who must include in its franchise tax base the assets of a LLC that pays a franchise tax as an electric power company. Under previous law, G.S. 105-114 provided that a corporation subject to the general franchise tax was liable for the tax only to the extent that the tax exceeded the amount of tax paid by the corporation under any other section of the Article. This limitation did not apply when the taxes were paid indirectly by the corporation through a LLC whose assets were required to be included in the corporation's franchise tax base. This provision allows those taxes paid by the LLC to be treated in the same manner as taxes paid directly by the corporation. This change was made at the request of Duke Power in order to main the current tax treatment of the company once it has completed a corporate merger and restructuring. This section is effective for taxable years beginning on or after January 1, 2006.
60	Effective date section for this part.

Part III: Aviation Fuel Sales Tax Refund

61	Interstate Passenger Air Carriers. – Under current law, interstate carriers are allowed a refund of a portion of the sales and use taxes paid by the carrier on fuel, lubricants, repair parts, and accessories purchased in this State. The refund is equal to a proportion of the sales and use taxes paid by the carrier in this State. The proportion is equal to the proportion of the miles traveled by the carrier in this State to the total miles traveled by the carrier. This act allows for an additional refund for interstate passenger air carriers.[79] The act allows for a refund of any amount of sales and use taxes paid by the

[79] An interstate passenger air carrier is defined as "a person whose primary business is scheduled passenger air transportation, as defined in the North American Industry Classification system adopted by the United States Office of Management and Budget, in interstate commerce."

	taxpayer on fuel that exceeds $2.5 million, after taking into consideration the other refund allowed to the interstate passenger air carrier. The refund allowed by this section must be claimed on an annual basis on a form developed by the Secretary of Revenue. The change was made to encourage US Airways to maintain a hub at Charlotte Douglas International Airport. It is unknown if other airlines will benefit from this refund as well. The refund applies to purchases of fuel made on or after January 1, 2005, but before January 1, 2007.
61.1	Motorsports. - This section allows for a refund of sales and use taxes on aviation fuel paid by a motorsports racing team or motorsports sanctioning body. In order to qualify for the refund, the fuel must have been used to travel to or from a motorsports event in this State, from this State to a motorsports event in another State, or to this State from a motorsports event in another State. For the purposes of the refund, a "motorsports event" includes a motorsports race, a motorsports sponsor event, and motorsports testing. The refund allowed by this section must be claimed on an annual basis on a form developed by the Secretary of Revenue. The refund applies to purchases of fuel made on or after January 1, 2005, but before January 1, 2007.
62	Effective date section for this part.

Service Contracts and Warranties

Prepared by
Linda Struyk Millsaps
Fiscal Research

For
Revenue Laws Study Committee
December 12, 2005

Outline

- Background
- Current Tax Treatment in NC
- Treatment in Other States
  - Overall
  - Computer Software
  - Computer Hardware
  - Automobiles
  - Machinery
  - Surrounding States
- Next Steps/Decision Nodes



Background



- During the 2005 Session the Senate Budget (SB 622) included a provision to extend the sales tax to service contracts and warranties. At that time the term "maintanence agreement" was used.

•The language in the bill refers to maintenance agreements for services performed on tangible personal property at a future time.

•Later the legislation was altered to direct Revenue Laws to study the issue, with legislative intent to levy a tax on this category July 1, 2006.

Current Tax Treatment in NC



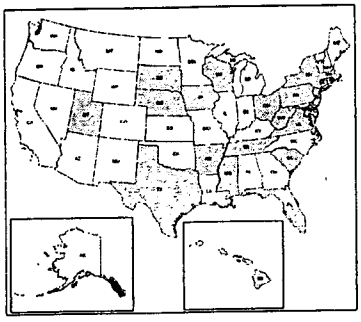
- Generally Service Contracts and Warranties are Exempt from Tax. However, there are exceptions:
  - If the service agreement is mandatory, it is considered part of the sale of tangible personal property and is taxed.
  - If the agreement is optional, the service is not taxed, but the goods used to fulfill the contract are subject to tax.

Treatment in Other States



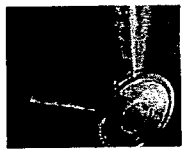
- Overall 45 States levy a sales tax, 5 do not.
- Of the 45 sales tax states:
  - 21 apply the sales tax to warranty agreements.
  - 18 of those exclude the purchase of parts by the service provider from tax.
  - 27 tax software maintenance contracts.
  - 25+ tax computer hardware maintenance agreements.
  - 8 tax annual "help line" fees applied to customers.

Treatment in Other States

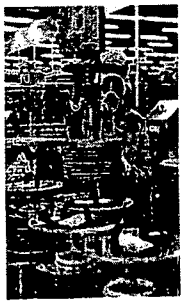


Computer Software Maintenance Agreements

- Two Types:
  - Maintain proper functioning.
  - Software updates to improve performance or usefulness.
- Maintenance agreements are often taxed but only if mandatory (like NC).
  - Other distinctions are linked to the taxability of the software, if the service was performed in the state, and if the contract was linked to the initial software sale.



Computer Software Maintenance Agreements



- More states apply their sales tax to software maintenance contracts if they include updates.
  - Rationale: Likely includes some type of property transfer component.
  - Some states exempt the sale if the transfers/updates are via download or internet (not discs or tapes).

Hardware Maintenance Agreements

- These contracts typically provide for inspection and maintenance of the hardware, and are generally billed annually.
- Often linked to the state's tax treatment of repair and maintenance of tangible personal property.
- In some states it depends on when the contract was purchased (SC).
- All of our surrounding states tax hardware maintenance agreements.



Automobiles



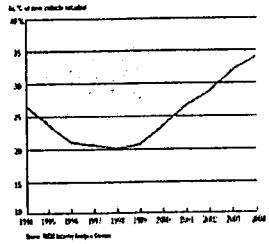
•Currently autos are not subject to the sales tax (7.0%), but are subject to the highway use tax (3.0%). Associated contracts are not taxed.



- Auto service contracts, extended warranty contracts, and roadside assistance plans are sold both by the dealer and independent organizations.
- NC automobile dealers association estimates that the average contract costs $1,400.

Automobiles

Service contract penetration rates



- Over times service contracts have become a significant profit center for auto dealers.
- Some dealers and manufacturers hold their own paper, while many others use third parties or resell.

Machinery Maintenance Agreements

- A purchaser of **production machinery** maintenance contracts typically pay an annual fee for inspection, regular maintenance, and emergency service.
  - Most states do not impose a sales tax on these contracts.
  - Often because the machinery being serviced is exempt.
- **Non-production machinery** contracts are more likely to be taxable, as the machine is more likely to be taxable.
- In **both cases**, contracts are generally for labor, parts, or parts and labor.
- All linked to tax treatment of repair, less dependence on service contract statutes.



Surrounding States



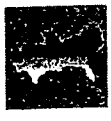
- Virginia:
  - Extended warranties (generally) are taxed.
  - Tax applied to all cases examined in CCH survey.
  - Recent Revenue Ruling: "When the contract provides in whole or in part for the provision of tangible personal property in order to maintain or repair another item of tangible personal property, the tax applies under the regulation".
  - Several Rulings specifically state that automobile extended warranties are taxable.

Surrounding States



- South Carolina:
  - Charges for sales or renewals of warranty, maintenance, or similar service contracts (whether optional or mandatory) for tangible personal property are subject to the sales and use tax (SC Revenue Ruling #05-12)
  - Charges for motor vehicle extended service contracts and motor vehicle extended warranty contracts are exempt (SC Code 12-36-2120(53)).
  - Software and Hardware agreements are subject to tax if sold in conjunction with the product.

Surrounding States



- Tennessee:
  - Taxes Software and Hardware maintenance contracts.
  - Taxes Production and Non-production maintenance contracts.
  - Taxes maintenance contracts with third party providers, initial warranty contracts, and extended warranty contracts.
  - Parts and materials used to fulfill the contract are exempt.

Policy Decisions/Next Steps



- Should we tax service contracts and warranties?
- Should the tax apply only when tangible personal property is transferred, or be linked only to a specific product no matter when it is sold?
- Should certain types of service contracts and warranties be included/excluded?
- Should the sale of tangible personal property used to fulfill a taxable service contract be exempt?
- Additional data will be needed to determine the revenue impact of various proposals.

Communications

Convergence, Technology, and National Outlook

NCGA Revenue Laws Study Committee
December 12, 2005

Overview

- Part I: Communications
  - Convergence
  - New Technologies & Internet-based Services
- Part II: Federal Legislation
  - Proposed changes to Telecommunications Act of 1996
- Part III: Conclusion
  - Implications for state & local government revenues

Part I, Communications:

- What does "communications" include?
  - Voice services (telecommunications)
  - Video services (television)
  - Data services (Internet)

Convergence

- ***Technological convergence***
  - Modern presence of an array of different types of technology to perform very similar tasks
- ***Industry convergence***
  - Consolidation of all communications (voice, data, and video) onto a single network infrastructure

Industry Convergence

- Easier to combine services by "packaging" communications into all-digital format
- Providers of single communications service now able to offer broader array of services delivered via Internet-based technology

Broadband Services

- Two major types used by majority of residential & business consumers
  - DSL (Direct Service Line)
  - Cable Internet Access (Cable modem)
- Typically, both provide an average Internet connection speed many times faster than dial-up

Broadband Services

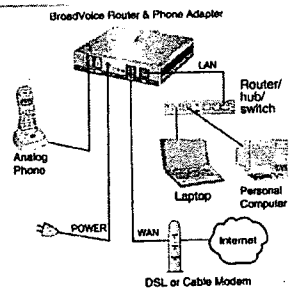
- In general ...
  - Both telephone and cable providers have necessary infrastructure to offer broadband services
- However ...
  - Technological differences in the physical infrastructure used by cable & telephone providers can affect their capacity to deliver packaged broadband services

Communication Services Are Going Digital

- Dominant forms of service delivery for voice & video services are now Internet-based
- The following services are either digital version of existing services, or new services delivered via Internet-based technology

VoIP (Voice over Internet Protocol)

- Routing of voice conversations over the Internet or any other internet protocol-based network
- Cost is generally lower than POTS (Plain Old Telephone Service)

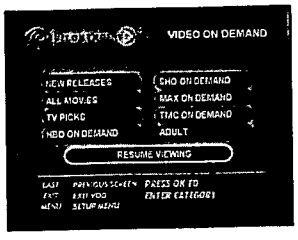


VoIP has become significant

- Growing in popularity
  - Time Warner reported 1 million VoIP customers as of December 8, 2005
  - Skype (based in Netherlands) has 10 million U.S. subscribers and 40 million worldwide
- North Carolina General Assembly recently installed VoIP system

Video: Video on Demand (VOD)

- Allows users to select and watch video content over a network as part of an interactive television system.
- Either "streaming" or "download"



Video: IPTV (Internet Protocol TV)

- System where a digital television service is delivered to subscribing consumers using internet protocol over a broadband connection.
  - Often provided with Video on Demand
  - May also include web service & VoIP
- Supplied by broadband operators

Video: The "next generation" of IPTV

- Apple has partnered with NBC Universal to offer downloadable TV shows via iTunes (including "Lost" and "Desperate Housewives") at $1.99 each
- Shows can be watched on a computer or on an iPod
- Other networks offer or plan to offer downloadable content a la carte

Video: Alternative Service Providers

- 20.8% of households receiving subscription television now get it from alternate sources
  - Direct Broadcast Satellite companies hold 20.2% of the alternative subscription TV market
- In 42 markets nationwide, 30% of consumers are reached via alternative distribution methods, primarily satellite

Triple Play *(Internet, Telephone, & Television)*

- Marketing term for provision of all three services via the same service provider
- Focus on business model, not common standards or method of delivery
- Offered by both telecommunications & cable providers
- Relies on assumption of increased opportunity costs for customers

Triple Play
(Internet, Telephone, & Television)

- Telephone companies:
  - Delivered via combination of fiber optic and digital subscriber line (DSL)
  - Verizon rolled out Triple Play in Keller, TX, in September, and Herndon, VA, in early December
- Cable companies
  - Delivered via switched-IP technology over hybrid fiber coax (HFC) architecture

Triple Play
(Internet, Telephone, & Television)

- Rapid growth in sales of this packaged service
- Time Warner (Reuters, December 8): 75% of new digital phone subscribers also choose triple play service
  - Added 240,000 new subscribers in Q3
  - Approximately 180,000 new triple play subscribers in Q3

Coming Soon: "Quadruple Play"

- Same as Triple Play, but utilizes ***wireless*** technology to deliver Internet, telephone, and television services
- Advances in technology are making Quadruple Play an option for competitors looking to gain competitive advantage over other Triple Play providers

What are people paying for cable and broadband service?

- The average monthly cable bill in the United States this year (Kagan):
  - $39.63 for basic service
  - Up to $63.88 for digital cable (VOD)
  - $80.33 for additional high-speed Internet package
- In areas where there is a wire-based competitor, prices for cable TV service are 15 percent lower (GAO, 2005)

And The Winner Is ...?

- Despite the influx of new technologies & services in communications, no clear industry "winner" has emerged

Part II, Federal Legislation

- Several draft and introduced bills that would significantly change the Telecommunications Act of 1996
  - S. 1504, Broadband Investment & Consumer Choice Act (Ensign/McCain)
  - H. 3146, Video Choice Act of 2005 (Blackburn/Wynn)
  - Draft legislation from House Energy & Commerce Committee

Broadband Investment & Consumer Choice Act

S. 1504 (Ensign/McCain)

- Would immediately allow telecoms to ***enter*** video services market without obtaining local or state franchises
- Cable would no longer be required to meet franchise obligations of "multiple localities"
  - Up to 5% franchise fee to municipalities from new entrants (same as current pay-TV providers), but applied differently

Broadband Investment & Consumer Choice Act

S. 1504 (Ensign/McCain)

- Would not require "build out" of services within a particular community
- Requires new entrants to comply with same rules on copyright, privacy, & public access as cable providers
- Radio & TV broadcast industries unaffected
- Bill would preempt state law governing cellular phone providers
- Does not address Universal Service Fund

Video Choice Act of 2005

H. 3146 (Blackburn/Wynn)

- Defines "competitive video service provider" (CVSP) as any provider of video programming, interactive on-demand service or other programming service that has a right, permission or authority to use PROW independent of a cable franchise.
- Removes franchise requirement for CVSPs

Video Choice Act of 2005

H. 3146 (Blackburn/Wynn)

- CVSP may be required to pay a fee (up to 5% limit) to local franchising authority based on gross revenue in that area
- Prohibits economic redlining, but removes build-out requirement
- Removes local enforcement authority
  - S. 1349 (Senate version) exempts existing cable franchise agreements from the act for the term of the franchise agreement; H. 3146 does not

Draft legislation from House Energy & Commerce Committee

- Not yet introduced
- Major issues addressed in Nov. 9 hearing: "Net neutrality" and franchising
  - "Net neutrality" means that subscribers to broadband services are not limited in what legal content they may access over their internet connection
  - Limitations on net neutrality could affect consumer choice regarding broadband service

Draft legislation from House Energy & Commerce Committee

- Franchising
  - Allows local franchise authorities to charge up to 5% fee on gross revenues annually
  - Gross revenue defined to include cash, credits, property, & in-kind; does not include bad debt and refunds, rebates, or discounts to subscribers of any kind
- Sets forth nationwide franchise concept that would supplant existing franchise structure
  - Broadband internet & video providers would have to file with FCC, not local governments

Part III, Conclusions

- Price wars between new entrants (telecoms) and cable could erode sales tax base for telephone/video/broadband internet service in the short run
- Unregulated VoIP providers like Skype will most likely continue to cut into both POTS and regulated VoIP provider sales, but to an unknown extent

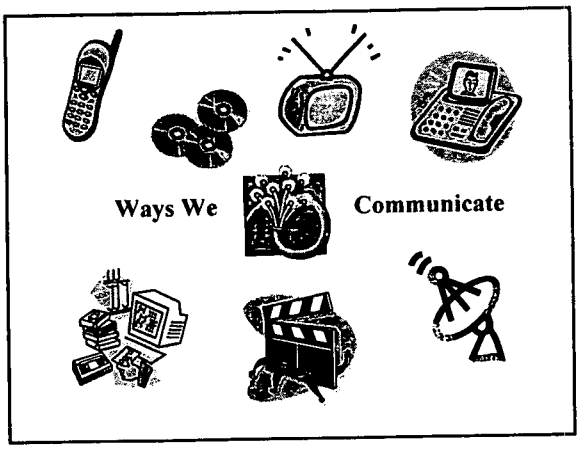
Conclusions

- Local governments will likely lose some, if not all, control over video franchising process due to federal legislation in 2006
  - May retain ability to assess franchise fees, but not necessarily at current levels
- Language of current North Carolina communications tax law does not address or include new services & modes of delivery

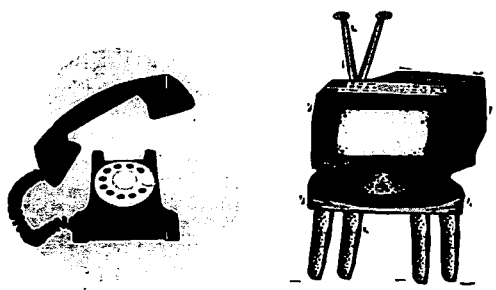
Conclusions

- Continuing convergence and competition will lead to erosion of communications tax revenues under current law

Questions?

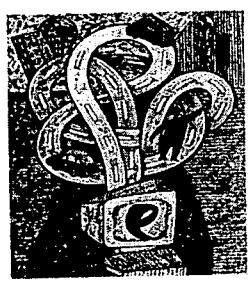


Communication Industries



Communication Service Industries

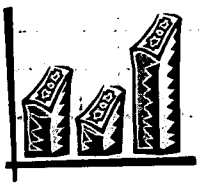
- Telecommunication
- Television
  - Cable
  - Satellite
- Internet and wireless technology



Purpose of Taxation

- To provide revenue to meet the State's budgetary needs





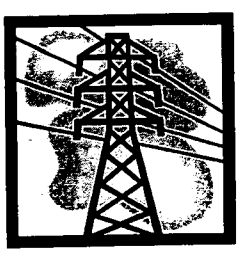
- NOT to give one industry a competitive advantage over another

Telecommunications

- Prior to 1985
  - 6% gross receipts franchise tax
- 1987 - 2002
  - 3.22% gross receipts franchise tax on land lines
  - Complicated local sourcing of franchise receipts
  - Varying sales tax rates
  - Advent of prepaid calling cards and cell phones
- Major revisions in 2001
  - One State tax at one rate applies to all – 6.5%
  - Separate county and city taxes prohibited
  - Local revenue stream maintained by earmarking a percentage of State sales tax revenue
- Rate increased to 7% in 2005

Cable Television

- Local taxes
  - Subject to local regulation since 1973 b/c cable lines use local rights-of-way
  - Subject to local franchise tax of up to 5%
  - Local franchise tax bases may differ from city to city and county to county b/c they are the result of negotiated contracts



Cable Television

- Sales tax
  - Cable boxes rented to customers subject to State and local sales tax
  - Prior to 2006
    - Equipment and transmission lines taxed at 1% as part of broadcasting equipment
    - Cable services not subject to sales tax
  - Effective January 1, 2006, cable services subject to State sales tax

Satellite Television



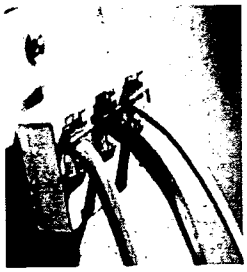
- No local franchise tax b/c no local right-of-way issues
- Federal law prohibits local tax
- SL 2001-424 imposed State sales tax on satellite services at the rate of 5%, which is the maximum local franchise tax rate allowed on cable companies

SL 2005-276
Taxation of Cable & Satellite

- Satellite – State sales tax rate on satellite increased to 7% to comply with SSTA
- Cable – Imposed 7% State sales tax on cable services with a credit for local franchise tax paid
- ISSUE REMAINS – Is this equal taxation?

SL 2005-276
Telecommunications & Cable

- Sales tax on pre-written software – was 1% for telephone companies
- Sales tax on transmission lines – was 1% for cable
- Equipment exempt from sales tax



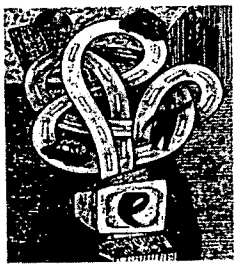
Developments in Cable & Telecommunications



- Telecommunication companies capable of offering video services
- Cable companies capable of offering phone services

Convergence of Industries: Issues

- Tax all data transmissions equally
- Current law taxes by industry, not by service
- Establish role of local regulation
- Federal limitations
- Nature of tax and distribution of revenue between State and locals



REVENUE LAWS STUDY COMMITTEE
State Legislative Building
Raleigh, North Carolina 27603

Senator John H. Kerr, III, Co-Chair *Representative Paul Luebke, Co-Chair*

December 14, 2005

NOTICE

TO: Members, Revenue Laws Study Committee

FROM: Senator John Kerr, Co-Chair
Representative Paul Luebke, Co-Chair

SUBJECT: Revenue Laws Study Committee Meeting

There will be a meeting of the **Revenue Laws Study Committee** as follows:

DAY:	**Wednesday**
DATE:	**January 11, 2006**
TIME:	**1:00 pm**
LOCATION:	**Room 544, Legislative Office Building**

Please advise DeAnne Mangum, Committee Clerk, at (919) 733-2405 or e-mail DeAnneM@ncleg.net if you will be unable to attend.

Posted: 12/14/05

cc: Committee Record X
Interested Parties X

REVENUE LAWS STUDY COMMITTEE
Wednesday January 11, 2006 at 1:00 PM
Room 544, Legislative Office Building

MINUTES

The Revenue Laws Study Committee met at 1:00 PM on January 11, 2006, in Room 544 of the Legislative Office Building. Ten members of the committee were present. Representative Luebke and Senator Kerr presided.

Representative Hill moved to approve the minutes of the December 12, 2005 meeting and the motion carried.

Review of Current State Tax Treatment

Cindy Avrette, a staff attorney with the Research Division, was recognized to summarize the current State taxation of communication services.

Comments from Interested Parties.

Bruce Yancey, Director of State and Local Taxes, BellSouth, was recognized. A copy of his presentation is attached.

Alan Ciamporcero, President, Southeastern Region Public Affairs, Policy & Communications, Verizon, was recognized. A copy of his presentation is attached.

Robert Wells, Executive Director, The Alliance of North Carolina Independent Telephone Companies, was recognized. A copy of his presentation is attached.

Randy Fraser, Vice President Government Affairs – NC, Time Warner Cable, was recognized. A copy of his presentation is attached.

Tom Adams, President of the NC Cable Telecommunications Association and President, Raleigh Division, Time Warner Cable was recognized. A copy of his presentation is attached.

David Miner, Echo-Star representative, was recognized. A copy of his presentation is attached.

Dr. Lee Mandell, Director of Information Technology and Research, NC League of Municipalities, was recognized. A copy of his presentation is attached.

Paul Meyer, Assistant General Counsel, NC Association of County Commissioners, was recognized. A copy of his presentation is attached.

The meeting adjourned at 2:50 PM.

Senator John H. Kerr, III, Co-Chair
Revenue Laws Study Committee

Representative Paul Luebke, Co-Chair
Revenue Laws Study Committee

DeAnne Mangum, Committee Clerk

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — January 11, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
John Goodman	Allen Associates
Mia Bailey	Electricities of NC
John Bowdish	AstraZeneca
Kira Peeples	Capstrat
A. White	Capstrat
G. Sessoms	Commerce
Mark Prak	Brooks Pierce
Ed Turlington	Brooks Pierce
Jennie New	Kennedy Covington
Maran Trathen	Brooks Pierce
Thomas Adams	Time Warner Cable

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — January 11, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Martin Bocock	Sprint
Dana Simpson	Smith Anderson
Kathy Harris	Progress Energy
[illegible]	TWC
[illegible]	Bode & Assoc.
Lee Mandell	NCLM
Michael Williams	City of Raleigh
Doris J. Boles	City of Charlotte
Gary Harris	NCPMA
[illegible]	Sprint Nextel
[illegible]	Kaylor Law Firm

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — January 11, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Debra Deer	Bell South
Paul Matthews	Progress Energy
Bruce Yancey	Bell South
Wayne Mabry	BellSouth
Mary Klenz	League of Women Voters NC
W. Trinity Thomas	Dept. of Revenue
Karl Knapp	NCDOR
Amelia Bryan	NCDOR
Bob Wells	N.C. TC/Co Alliance
Don Hathcock	BellSouth
Dwight Allen	NC Telephone Coops

House Pages

Name Of Committee: Revenue Laws Study Date: 1-11-05

1. Name: _____

   County: _____

   Sponsor: _____

2. Name: _____

   County: _____

   Sponsor: _____

3. Name: _____

   County: _____

   Sponsor: _____

4. Name: _____

   County: _____

   Sponsor: _____

5. Name: _____

   County: _____

   Sponsor: _____

House Sgt-At-Arms

1. Name: Martha Gadison
2. Name: Towssaint Avent
3. Name: Dusty Rhodes
4. Name: Frank Prevo
5. Name: _____

SENATE

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — January 11, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Patricia A. Glenn	NCAGSC / LLPP
Jon Edwards Jr	

REVENUE LAWS STUDY COMMITTEE

Sen. John Kerr Rep. Paul Luebke

Wednesday, January 11, 2006
Room 544, Legislative Office Building
1:00 p.m.

I. **Approval of the Minutes from the December 12, 2005, Meeting**

II. **Taxation of Communication Services**

- **Review of Current State Tax Treatment**
  Cindy Avrette, Legal Analyst, Research Division
- **Comments from Interested Parties**
  - *Bruce Yancey, Director of State and Local Taxes, BellSouth*
  - *Alan Ciamporcero, President, Southeast Region Public Affairs, Policy, & Communications, Verizon*
  - *Robert Wells, Executive Director, The Alliance of North Carolina Independent Telephone Companies*
  - *Randy Fraser, Vice President Government Affairs – NC, Time Warner Cable*
  - *Tom Adams, President of the NC Cable Telecommunications Association and President, Raleigh Division, Time Warner Cable*
  - *Ross Lieberman, Director of Government Relations, Echo-Star*
  - *Lee Mandell, Director of Information Technology and Research, NC League of Municipalities*
  - *Paul Meyer, Assistant General Counsel, NC Association of County Commissioners*

III. **Adjournment**

Next Meeting: February 8, 2006 at 1:00 pm

REVENUE LAWS STUDY COMMITTEE
Monday, December 12, 2005 at 1:00 PM
Room 544, Legislative Office Building

MINUTES

The Revenue Laws Study Committee met at 1:00 PM on December 12, 2005, in Room 544 of the Legislative Office Building. Eleven members of the committee were present. Senator Kerr and Representative Luebke presided.

2005 Finance Law Changes

Cindy Avrette, a staff attorney with the Research Division, was recognized to briefly explain the 2005 Finance Law Changes. A copy of the explanation is attached.

Taxation of Communication Services.

Cindy Avrette was recognized for a power point presentation of "Past and Current North Carolina Tax Treatment". A copy of the presentation is attached. Brenna Erford, a research assistant with the Fiscal Research Division, was recognized for a power point presentation of "Convergence of the Industries". A copy of the presentation is attached.

Expansion of the Sales Tax Base – Maintenance Agreements.

Linda Millsaps, a fiscal analyst with the Fiscal Research Division, was recognized for a power point presentation of "Expansion of the Sales Tax Base – Maintenance Agreements". A copy of the presentation is attached.

The meeting adjourned at 3:10 PM.

Senator John H. Kerr, III, Co-Chair
Revenue Laws Study Committee

Representative Paul Luebke, Co-Chair
Revenue Laws Study Committee

DeAnne Mangum, Committee Clerk

Overview of December 12th Meeting
RE: Communication Services

- Communication services
  - Voice – telephone
  - Video – cable and satellite
  - Data – Internet

- 'Old days'
  - Communication services used to be provided with distinct and separate technology.
  - Taxation of these services based upon the company that provided the service rather than the service itself.
  - NC
    - 7% State sales tax on the gross receipts derived from telecommunication services with a portion of the revenue allocated to local governments.
    - Local franchise tax of up to 5% on cable companies and a 7% State sales tax with a credit for any local franchise tax paid. Cable companies subject to local regulation.
    - 7% State sales tax on direct-to-home satellite service. Federal law prohibits local tax.

- Today
  - Experiencing both a technological and industry convergence
    - Consolidation of all communications onto a single network infrastructure ... Internet
    - Both telephone and cable providers have the necessary infrastructure to offer these services via Internet
    - Providers of single communications service in the past now able to package and offer a broader array of services
  - Purpose of the tax system is to provide revenue to meet the State's budgetary needs, not to give one industry a competitive advantage over another
  - However, while the industry has experienced a convergence, the tax system has not.
  - NC has made efforts to neutralize the tax differences:
    - 2001 – Tax satellite at 5%
    - 2005-276 – Tax satellite and cable at 7% with credit
    - 2005-276 – Equalize the sales tax treatment of equipment used by telecommunications companies and cable companies

- Goal of this Committee is equity of taxation between providers of cable service, satellite service, digital audio service, video programming service, and data service
  - Current law taxes by industry, not by service
  - Recognize the nature of tax and distribution of revenue between State and local governments
  - Establish the goal and role of local regulation
  - Recognize federal limitations
    - Several draft and introduced bills that would significantly change the Telecommunications Act of 1996
    - Telecoms enter video services without obtaining local or state franchises?
    - Existing local franchises?
    - Nationwide franchising?
    - "Build out" of services within a particular community? Economic redlining?
    - Public access?
    - Access to public rights-of-ways?
    - Wireless providers?
  - Continuing convergence and competition will lead to erosion of communications tax revenues under current law.

Revenue Laws Committee, January 11, 2006

Testimony of Bruce D. Yancey, Director – State & Local Taxes, BellSouth Corporation

Mr. Chairman and Honorable Members of the Committee:

I am Bruce Yancey, Director of State and Local Taxes for BellSouth. BellSouth employs more than 6,000 people in North Carolina and is privileged to serve over 2 million customers in the State.

First of all, I would like to thank the honorable committee members for the leadership they have provided in achieving great strides towards fair, equitable tax policy on communications services. In the Southeast, North Carolina was one of the first states to adopt simplification and uniform taxation with the Telecommunications Simplification Act of 2001 which was sponsored by Representatives Hackney, Luebke and Wainwright and by Senators Kerr and Hoyle. With the passage of that Act all telecommunications services were taxed the same whether it was local exchange services or long distance services.

The Telecommunications Simplification Act of 2001 was landmark legislation taxing telecommunications more like any other general business. It is now time to expand this tax policy to recognize the convergence of our industry.

Since 2001, BellSouth has evolved to more of a broadband company rather than a telecommunications company. Broadband is one of the fastest growing sectors of our company. Due to competition from wireless, competitive local companies and Cable TV (VoIP), the demand for older technology is shrinking. The investment needed to continue our push into the broadband market will be fueled by enhanced utilization of the network. An exciting

area BellSouth is currently testing is the entrance into the Cable TV market. The Cable TV market has proven to be challenging economically. The level of investment needed with no guarantee of adequate return since we are the third entrant into a competitive market behind well established competitors as cable television and satellite television. Another challenge we are examining is the technology and the interaction of the technology with our extensive network. Everywhere you go, you do not have to look far to see some component of our network whether it is telephone lines or central offices. The larger the system, the more challenges there are in enhancing the system. However, that is what we do best. Lastly, there is the local franchise challenge. All of which are barriers of entry into the market.

Today, I come before you to discuss tax policy. Alan Ciamporcero from Verizon is our next speaker and he has much more experience in negotiating local franchises. For that reason, I will limit my comments to taxes.

I suspect our Cable competition will come before you and state they are OK with keeping the franchise structure as it is. This is very much understandable as they know the local franchises are a barrier of entry. What other valid business reason would Cable have to <u>want</u> to file thousands of tax returns with local jurisdictions other than to protect their market? We are all good citizens in this room and I doubt there is anyone of us that would like to file more tax returns and undergo more audits.

I also suspect local governments will also want to continue on with the current tax policy of filing local cable franchise tax returns. However, leaving the current franchise barriers in place will curtail investments in their communities, reduce the likelihood of competition, and keeps local cable rates high. We have an opportunity to keep local governments whole and still increase investments and retain jobs in this state.

This can all be accomplished by expanding the simplification effort undertaken in 2001 by:

1. Creating a single statewide cable franchise.
2. Take the last step in simplification.
    a. Eliminate franchise fees and credits altogether;
    b. Continue imposing sales tax on voice and Cable TV services at 7%; and
    c. Distribute a share of the Cable TV sales tax revenue to local governments.

The Revenue Laws Committee doesn't have to look far to find the most efficient tax policy. You only have to expand your existing sales tax/franchise fee funding statutes provided for in telecommunications to include Cable TV services. As such, the following goals will be accomplished:

1. Local governments will be kept whole.
2. Taxes will be collected in the most efficient manner.
3. You will create an incentive to spur investments and employment opportunities in the state.
4. You will promote competition in the cable industry to give the consumers of the state more choices and lower rates.

Mr. Chairman and honorable members of the committee, thank you for the opportunity to speak before you and I welcome any questions you may have.

Testimony of Alan F. Ciamporcero, President, Verizon S.E. Region

Before the Revenue Laws Committee, January 11, 2006

Mr. Chairman and Honorable Members of the Committee:

I am Alan Ciamporcero, regional president for Verizon. My territory includes the Southeast, but particularly North and South Carolina and Florida where we have wireline networks. We serve approximately 300,000 wireline customer in North Carolina, primarily in the Durham/RTP area and in far Western North Carolina.

The traditional telephone business is changing rapidly. The wired telephone on your desk or kitchen wall now performs only part of your communications functions. You only need to watch young people to appreciate this. They are always communicating, and doing it in new ways--instant messaging, cell phones, VOIP, blackberry, cable television, DVDs, and I-Pods, among others.

To meet these changing consumer demands, we are transforming our business. We are evolving from a phone company to a data company by vastly expanding the capacity of our network. For the large investments in the new high-speed technologies to make business sense, however, we need to be able to offer the full suite of services, everything from plain old phone service to video entertainment.

Cable companies can do this now with ease – there are no regulatory barriers to them adding telephone and data services to their basic video business. In fact, federal and state law make it very easy for anyone to get into the phone business – just file a simple form and get a certificate.

Entry into the video business by a phone company, on the contrary, is very difficult. Even though it already has a franchise to provide communications services, a telephone company must get another franchise from the local government to provide video service.

And this franchise is not easy to get. We've learned hard lessons in Florida and other states over the past year. Franchises are often more than 100 pages of legalese, specifying everything from insurance, to bond requirements, to liquidated damages in the event we can't build out an entire municipality. Further, local governments use this process as a way to indirectly tax companies – by requiring in-kind benefits and direct monetary grants.

For example, one city that I'm intimately familiar with said that we could offer consumers video only if we gave the city more than $10 million in benefits upfront – everything from free channels to money to buy equipment to program those channels. Because of these unreasonable demands, the consumers are not yet receiving the benefits of investment and competition. Similarly, other cities want us to donate data networks, hook together traffic lights, and provide free video entertainment to city buildings – all before getting in the business.

But the biggest problem with the local cable franchise process is the time it takes to get these negotiations finished and get a new product to market. Cities typically retain Washington lawyers to help extract the most from the applicant – and these consultants don't move quickly. In the end, it takes about 12 to 18 months to get a local franchise. That's 12 to 18 months each for the hundreds of local franchising authorities in each state. For a national company like Verizon, that means about 10,000 franchises – after about a year of effort, we don't yet have fifty.

So far, Texas is the only state to rationalize this difficult process. There, the legislature took advantage of a provision of federal law that permits the state – instead of localities -- to grant video franchises. The process is simple. A company files a registration statement with the state indicating where it intends to provide video service and provides an affidavit that it will comply with all laws – for example, FCC registration, applicable fed and state regulations, and municipal regulations regarding use and occupation of right of way. If everything is in order, the company is free to begin offering service after seventeen days.

The Texas law has been great for investment and great for consumers. Several new companies have entered the video business and some incumbent providers have also taken advantage of it. One municipality, West Lake, even decided to move to the state franchise rather than continue with its local Verizon franchise. Verizon substantially increased its building program in Texas as a result of the new law, filing to provide video service in 21 additional markets.

And citizens have been the winners. Price competition and better quality service are spreading quickly throughout Texas. We recommend that same solution to you. It is simple and easy to do, it substantially increased investment in the state, and it should even prove efficient and beneficial for local governments, getting them out of a regulatory role for which they are not well suited.

Mr. Chairman, Members of the Committee

I am Bob Wells, Executive director of the Alliance of N.C. Independent Telephone Companies.

The independent Telephone companies are the native born and bred telephone companies in North Carolina. Most are a hundred years old – also as old as the telephone itself. They are located in the smaller towns and rural areas in seventeen counties. Some of you on the committee represent them. There are Mebtel (used to be Mebane Telephone Co., North State Telephone co. in High Point, Thomasville and surrounding counties. Lexcon, (Lexington Telephone Co.) Concord Telephone Co., Randolph Telephone Co., Ellerbe Telephone Co., and citizens Telephone Co. in Brevard. They are mostly family owned. There used to be more of them. They are now down to seven. They are strong, reliable, state of the art providers of telecommunication services to their customers, and rarely are there ever complaints about their service.

I am here today to speak on their behalf.
I really have only two points to make today.
One is that we support the simplified and equally applied tax approach the state has adopted over the last several years as it applies to our business. We want you to continue to apply those principles as you move forward in adopting any new tax policies. Everyone in the business should pay the same tax. Do what you can to provide the proverbial level playing field.

Two. We support the concept of statewide franchising that the gentleman from Verizon spoke of earlier. It will simplify and speed up telephone companies getting into the business of providing video services. It will bring competition to the cable industry and lower prices for the consumer.

I want to give you a first hand example of what it can mean. In Lexington N.C., Lexcom Telephone (one of the members of my association) went into the cable business in competition with Time Warner. Today cable rates in Lexington are $10.00 cheaper than in any other city in the Triad and maybe in North Carolina.

If phone companies can get into this business without having to plow their way through all the city and county bureaucracies in the state. It will greatly benefit your constituents, the citizens of this state.

Thank you for this opportunity to speak this afternoon.

Treating Like Services Alike:

Cable Tax and Regulatory Policy



North Carolina Cable Telecommunications Association

TIME WARNER CABLE

Randy Fraser

Vice President, Government Affairs-North Carolina, Time Warner Cable

Cable Investment and Innovation

- $100 billion investment by cable industry nationwide
- Cable is leader in North Carolina:
  - Video service: 1.8 million subscribers
  - High-speed data (broadband): >600,000 broadband customers
  - Voice-over-Internet phone service: >150,000 customers

Competitive Environment

- Minimum of 3 existing multichannel providers in nearly all markets – cable, DirecTV and DishNetwork
- Satellite 27% market share
- DirecTV and DishNetwork are 2nd and 4th largest video providers
- 10% receive free, over-the-air television

Recent Tax Increases

- New 7% state tax on gross receipts (credit given for local franchise taxes paid)
- 7% tax on purchase of "cable" (old tax was 1%)

Taxation of Cable Video Service

- 7% state tax
- 5% local franchise tax on gross receipts (credit given against new 7% state tax)
- 12% tax on rental of converters & remotes (7% state sales tax plus up to 5% local franchise tax)
- 7% tax on purchase of cable
- Corporate income and franchise taxes
- Local property taxes

Statement of Randall O. Fraser
Revenue Laws Study Committee
January 11, 2006

Good afternoon. My name is Randy Fraser. I am currently the Vice President for Government Affairs for Time Warner Cable in North Carolina and have served two terms as the President of the North Carolina Cable Telecommunications Association. I've worked in the cable industry for 32 years, and I've had the pleasure of working with many of you over the past years. It is a privilege to speak with you again today on behalf of Time Warner Cable.

You have asked for our views on tax and regulatory policy affecting our industry. Our position is simple: Like services should be treated alike. Whether it is called "tax equity," "regulatory parity," or "leveling the playing field" the fundamental goal is the same. The State should not pick winners and losers among competitors.

You have, in recent years, successfully achieved sales tax parity for North Carolina citizens receiving television services from cable and satellite companies. You reinforced that parity last year when you brought the State's sales tax into compliance with the Streamlined Sales Tax Initiative. You may well have a similar opportunity in the coming session to ensure regulatory parity if you consider legislation to help define the rules for the telephone companies' entry into the cable television business.

My colleague Tom Adams will speak more about these issues on behalf of the cable association. But first, I thought it would be helpful to give you a brief snapshot of the origins of cable television, the competitive environment in which cable currently operates, and the current tax structure applicable to cable service.

Cable Investment and Innovation

Cable television is a testament to free enterprise. It traces its roots to Community Antenna Television (or "CATV") systems that were built in rural areas where reception of television broadcast signals was spotty or totally unavailable because of mountains or other obstructions in the terrain.

Consumer demand for television service in these areas led to the birth of cable television. Private individuals and entities, using risk capital, without any guaranteed rate of return, constructed facilities beginning in the 1960s to serve these rural consumers. Soon, the demand for cable television grew beyond rural areas to cities and towns throughout the nation.

Over the past ten years, cable service has been transformed by advances in technology. Just ten years ago, cable was a one-way analog video service. Today, cable provides an interactive broadband platform that offers a variety of voice, video, and data services.

The cable industry has spent approximately $100 billion nationwide -- yes, $100 billion -- to upgrade its facilities so that it can offer these services. We didn't come to the government seeking hand-outs or subsidies for this upgrade, and we didn't ask for special regulatory favors to support this effort. We did it because that's how the free enterprise system works—you make an investment with the hope of earning a return.

With the additional capacity and digital capability provided by this investment, cable operators now offer tiers of digital programming, along with video-on-demand and digital video recording capability. Cable also increased the quality and diversity of its programming and pioneered commercial high-speed Internet service as well as Voice-Over-Internet Protocol (or "Digital Phone") telephone service.

The result of this investment has been that cable has driven much of the technical innovation in video and digital services that consumers enjoy today. Cable is the leader in broadband deployment; it is leading in facilities-based digital phone deployment; and it will, in the years to come, continue to bring new and innovative services and products to its customers.

To give you a snapshot of the extent of this service in North Carolina, cable has over 1.8 million video subscribers in this State. It also has over 600,000 broadband customers, and more than 150,000 Digital Phone customers. And we don't just serve high population metropolitan areas, we also serve rural communities in the state—communities like Pikeville (population 714) and Fremont (population 1,400) in Wayne County and Boiling Springs (population 3,800) in Cleveland County.

Competitive Environment

While cable has been a leader in bringing technical innovation and new communications services to its customers, it does face stiff competition for all its products.

Today, cable faces vigorous competition from two satellite companies—DishNetwork and DirecTV—as well as free, over-the-air broadcasting companies. The satellite companies, who also include local broadcast signals in their service packages, now enjoy a share of the video market that is approximately 27%. Nationwide, DirecTV and DishNetwork are the 2nd and 4th largest providers of video services in terms of total subscribers. The practical effect of this is that in every location that my company, Time Warner, provides service, it faces at least two competitors that typically take more than 1 out of every 4 customers.

Of course this is in addition to competition from other sources of video programming like over-the-air television—which has about 10% of the market—other competitors like Internet video, the sale and rental of DVDs and videotapes, and movies.

Also, new competition in the multichannel video industry is increasingly coming from the telephone companies. All the major telephone companies like BellSouth and Verizon have announced that they intend to provide video services and have, in fact, begun offering services in other states.

I would also point out that other competitors are emerging on an almost daily basis. Recent competitive announcements include Apple's statement that it is providing video downloads of television programming to its iPods; and Google has stated that it is launching an Internet-based service ("Google Video Store") to allow consumers to pay to download shows and movies. As these new services take root and duplicate standard video services, the legislature may well need to consider how these new services should be treated, from a tax and regulatory perspective, consistent with the treatment of other similar services.

But the bottom line is undeniable—today cable faces vigorous and increasing competition in the market for video subscribers.

Recent Tax Increases

Cable pays its fair share of taxes. And this share just went up in the last legislative session.

As this next slide shows, by virtue of tax increases in the last legislative session, cable operators are now subject to a 7% gross receipts tax imposed by the State. This tax was imposed on cable service in the last legislative session and was effective

January 1, 2006. However, to preserve overall tax equity between cable and satellite subscribers, the legislature allowed cable operators to take a credit against this new tax in an amount equal to local franchise taxes paid. As Tom Adams will talk about in more detail, local governments are authorized by the State to impose a franchise tax on cable operators in an amount up to 5% of gross receipts. This money goes directly to the bottom line of local government operations and is used for general welfare purposes. The vast majority of local governments do impose this tax at the maximum rate of 5%. In any event, the effect of this credit is that, regardless of what rate of tax is imposed by local governments, cable customers pay a total rate of 7% in combined tax to state and local government.

In addition to the new state gross receipts tax, in the last legislative session the tax on the purchase of the "cable" we put in the ground and on poles was raised from 1% to 7%. This is obviously a significant tax increase on essential cable facilities.

Current Taxation of Cable Video Service

This next slide summarizes the current taxes paid by cable operators in North Carolina.

* As mentioned, cable is subject to the new 7% state gross receipts tax as well as a local franchise tax—typically in the amount of 5%—with a credit given against the state tax for local taxes paid.
* In addition to these gross receipts taxes, cable pays up to a 12% tax on rental of cable boxes or converters and remote control devices. This includes the 7% state tax plus an up to 5% local franchise tax.

* Cable operators also pay a 7% tax on its purchase of fiber and other cable used in its network.

* Of course, cable operators are also subject to general state business taxes like corporate income and franchise taxes.

* Cable operators also pay property tax at the local level.

Speaking just for my company, Time Warner, we pay more than $63 million a year in state and local taxes. With the new 7% state gross receipts tax, obviously this number will go up in 2006.

* * * *

I hope this brief overview has helped to put cable in its appropriate context. As the cable industry has been built entirely through the use of private, risk capital, I hope you can appreciate how important it is to preserve a level-playing field where competitors can fairly compete without the government picking winners and losers based on technology or other factors.

Again, I appreciate the opportunity to speak to you today.

Let me now turn the podium over to my colleague, Tom Adams.

Tom Adams

President, Time Warner Cable-Raleigh Division

President, North Carolina Cable Telecommunications Association

Current: Cable vs. Satellite Tax

Tax on Cable Subscribers	Tax on Satellite Subscribers
7% state tax (w/ up to 5% credit for local tax paid)	7% state tax
5% local franchise tax	0% local tax
Total: 7%	**Total: 7%**

Satellite's Proposal

Tax on Cable Subscribers	Tax on Satellite Subscribers
7% state tax (w/ no credit for local tax paid)	7% state tax
5% local franchise tax	0% local tax
Total: 12%	**Total: 7%**

Tax and Regulatory Policy

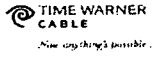
- Tax and regulate like services alike
- Don't discriminate against television viewers who subscribe to cable
- Don't bend or relax the rules for any particular competitor!

Treating Like Services Alike:

Cable Tax and Regulatory Policy



North Carolina Cable Telecommunications Association



Statement of Tom Adams
Revenue Laws Study Committee
January 11, 2005

My name is Tom Adams. I am President of the Raleigh Division of Time Warner Cable. I'm also currently the President of the North Carolina Cable Telecommunications Association and, in that capacity, I am speaking today.

As my colleague, Randy Fraser, explained, our goal with respect to tax and regulatory treatment is simple. Treat like services alike. We don't mind competition—in fact our industry has benefited in a number of respects from competition—but we strongly believe that in a competitive environment there must be a level playing field.

I'd like to spend the time that I have today by digging a little deeper into the issue of treating like services alike and explain what it means in terms of two critical issues currently facing the cable industry.

The first is the treatment of cable and satellite service taxes. The second is the issue of increased competition—in particular competition from the telephone companies.

Satellite Tax Issue

As to the tax issue, I want to applaud your work over the years to equalize the sales tax treatment between satellite and cable. You have had the challenging task of closing tax loopholes, plus the issue of bringing North Carolina's sales tax system into compliance with the Streamlined Sales Tax Initiative. You took the time to study the issues, hear from all parties, and make sure that cable and satellite service providers, and their customers, were treated fairly.

As you are aware, cable companies have historically paid up to five percent of their gross receipts in franchise taxes to local governments, in addition to the other state and local taxes identified by Randy.

By contrast, you may be surprised to know that, until 2001, satellite providers paid no gross receipts tax to the State or to local governments. The reason that the satellite companies have not been subject to local tax is that Federal law prohibits it. However, Congress did not prevent states from imposing taxes on satellite. To the contrary, Congress envisioned that states could, and would, impose taxes on satellite service at the state level. So, in North Carolina, prior to 2001, satellite enjoyed a classic tax loophole.

In 2001, acting upon the recommendation of the Governor's Tax Loophole Closing Commission, North Carolina closed this loophole by approving a five percent state sales tax on satellite providers. With the enactment of this tax, the overall tax burden on cable and satellite subscribers was equalized. Subscribers of both services were subject to a five percent gross receipts tax—cable at the local level and satellite at the state level.

Last year, in response to the Streamlined Sales Tax Initiative—which requires the equalization of gross receipts taxes—the General Assembly adopted a seven percent state gross receipts tax applicable to both satellite and cable companies. To preserve tax equity, the legislature allowed cable companies to take a credit against this state tax for the franchise taxes paid to local governments. As is shown on the slide before you, the credit has the effect of equalizing the overall tax burden on cable and satellite

subscribers. Under this provision, cable subscribers pay an overall tax of seven percent and satellite subscribers pay the same. Like services are treated alike.

Regrettably, the satellite companies have gone to federal court to try and overturn the General Assembly's fair-minded decision to treat satellite and cable customers alike. They claim the General Assembly's tax treatment of cable and satellite violates the Constitution because it treats the state and local taxes on gross receipts equally. The satellite companies actually lost this very same argument in the state courts last year when they challenged the old law. They have now brought this same challenge against the new tax, this time in federal court. We certainly believe that the federal court will come to the same conclusion that the state court did—that the tax is an entirely rational and permissible measure well within the legislature's prerogative.

In their arguments for change, you will probably hear from the satellite companies about state sales tax and local franchise taxes serving different purposes. Satellite companies will argue that the tax paid by cable companies is actually a "fee" for use of the rights-of-way. This simply is not so. It's a tax, pure and simple.

In fact, the statutes authorizing this tax call it just that—a "tax." If the General Assembly had intended for it to be a "fee," it would have called it that.

And the tax has, in substance, all the characteristics of a tax. Unlike a "fee" which is used to recover specific costs, the proceeds of the five percent franchise tax are used by local governments for general welfare purposes. If the tax was just a "fee" for use of the rights-of-way—then North Carolina counties would not be permitted to impose the five percent levy because counties do not own rights-of-way in North Carolina.

Finally, it is telling that other companies using rights-of-way do not pay a five percent tax to the local governments. Telephone, electric, and gas companies all use rights-of-way, yet they are not subject to a five percent franchise tax. If the tax was merely a "fee" for use of the rights-of-way, these other companies would also pay the fee.

All these arguments aside, all you really need to do is look at the effect of the taxes in question on the consumers of the services. The slide in front of you shows what the satellite companies are proposing—what you have already rejected twice. If you were to accept the satellite companies' argument that the local franchise tax should not be treated as a tax, the effect would be to put an additional five percent tax on the 1.8 million North Carolina households that elect to receive their television by cable rather than satellite. Cable customers would then be taxed at the rate of 12 percent—paying five percent at the local level and seven percent at the state level. Yet satellite customers would pay only the seven percent state sales tax. That is unfair by any measure. Cable subscribers should not be penalized for choosing to receive their television service by cable.

At the end of the day, what the satellite companies really want is their loophole back. I can't say I blame them. But I do want to applaud you for the decisions you have already made to adopt a tax-neutral policy for competition between cable and satellite providers, and I would urge you to reject any further efforts by the satellite industry to tilt this level playing field in their direction.

Video Franchise Issue

The second issue that I want to address today, is the issue of telephone companies entering the video marketplace and the potential impact this will have on consumers and on state tax and regulatory issues.

In other states across the country, telephone companies are seeking authority to enter the video service market, but under a different set of rules. We anticipate the same attempts will occur in North Carolina. As we have indicated previously, we welcome competition, as long as everyone is playing by the same rules.

In North Carolina, some telephone companies are already providing video under local franchise agreements, the same rules that apply to cable companies. There are at least five telephone companies that currently offer video services under local franchises and have been doing so for quite some time. In other states, Verizon has been actively obtaining cable franchises from local governments in states like Virginia. BellSouth currently has at least 20 cable franchises in other states serving some 1.4 million subscribers in areas like Atlanta and Miami.

Nonetheless, some of the phone companies have said that they want to bend the rules in their favor. They advocate a change in the local franchise process to give them a competitive advantage. Many of you are aware that during the final hours of last year's legislative session, attempts were made to add a provision to the technical corrections bill that would have exempted telephone companies—but not cable companies—from the local franchise process completely. We are grateful for the successful efforts of leadership in the General Assembly, including many of you in this room, to block this effort.

The cable industry is not opposed to a re-examination of the manner in which franchises are awarded. Again, we only ask that you regulate like services alike. That's why we will strenuously oppose any effort to carve out special regulatory treatment for telephone companies that would free them from regulatory requirements to which the cable industry is subject.

There are few points here that I want to bring to your particular attention.

First, the debate over how telephone and cable companies should be regulated is not occurring in a vacuum. It is occurring in many states across the nation. It is also being debated in Congress, and at the Federal Communications Commission. There are several bills pending in Congress that would overhaul the manner in which video franchises are awarded, and the FCC itself has opened a rulemaking proceeding to consider adopting new rules to more tightly regulate the local franchise process. Any regulation by North Carolina must, of course, be consistent with these federal laws and rules as they presently exist and as they may change in the near future.

Second, one of the principles that is particularly important under federal law is that local governments should be permitted to ensure that their citizens are not left behind as new services are made available. This is referred to as "build-out." Cable operators have traditionally been required to build out their networks. Sound public policy should not require one competitor—in this instance, cable—to construct facilities throughout a community and then allow another competitor—the phone companies—to pick and choose where they want to build and which customers they want to serve. Such "cream-skimming" would artificially increase the cost of cable service and, by regulatory fiat, effectively subsidize the telephone companies' networks.

More fundamentally, the public policy of this State has been that all citizens should have access to the latest technologies and services. Such technologies are an engine of economic growth in North Carolina, and are an essential part of community development and opportunity in today's economy. It is the policy of the State to promote broadband deployment in rural and underdeveloped areas. This is what the "digital divide" is all about. And as we all know, it is something that is still prevalent in our rural areas. Ensuring that the phone companies build-out like cable companies have done—and not be permitted to serve only affluent customers or only customers in densely populated areas—will be consistent with this policy and will help ensure high-speed broadband facilities are widely available.

In summary, as shown on the slide in front of you, the basic policy position of the cable association on these important tax and regulatory issues is straightforward:

* Tax and regulate like services alike;
* Don't discriminate against television viewers who subscribe to cable; and
* Don't bend or change the rules for any particular competitor.

* * * * *

As always, we appreciate, very much, the opportunity to work with you on these and other issues impacting our industry.

Again, thank you for the opportunity to speak with you today.

Mr. Lieberman unable to attend.
David Miner read Mr. Lieberman's testimony

Testimony of Ross Lieberman,
Governmental Relations,
EchoStar Communications Corporation,
Before the North Carolina Revenue Laws Study Committee

January 11, 2006

Chairman Kerr, Chairman Luebke, and other distinguished members of this committee, I appreciate the opportunity to address you today on behalf of EchoStar Communications Corporation, one of the two principal providers of satellite television services in North Carolina — and in the interest of the over 900,000 North Carolina television customers that are collectively served by the satellite television industry.

The way consumers receive voice, video, and data is changing. As technologies converge and companies expand their traditional service offerings, the approach to taxing these services must also change. For that reason, EchoStar is concerned that inconsistencies between the manner in which cable television and satellite are taxed create bad, and inequitable, public policy. Currently, the cable industry receives a sales tax credit against the franchise fees they pay to the localities where they do business. There is no reason to compensate cable companies for paying franchise fees. Cable companies pay franchise fees to local governments in exchange for valuable privileges—privileges that satellite television providers like EchoStar do not receive. For example, under the franchise agreements they enter into with local governments, cable companies receive the right to serve the "franchised" cable area, as well as the right to use streets, highways, and other public rights-of-way to lay down their cable networks. In their filings with the federal government, the major cable companies value these privileges in the *billions* of dollars.

Thus, giving cable companies a state tax break worth over $60 million does nothing more than bestow a financial windfall to one kind of company in the television services industry based on of their costs of doing business. We find this grossly inequitable. Satellite providers do not pay local franchise fees, because our service is not dependent upon the use of local rights of way. Instead, in order to obtain comparable operating rights, satellite companies pay substantial amounts to the federal government for use of the airways and satellite orbital positions. As a result, the tax credit for cable creates a competitive disadvantage for satellite providers—in contravention of federal law that encourages competition between cable and satellite, and at the expense of the citizens of North Carolina.

In short, a tax credit for cable means the public suffers, because cable companies do not bear their fair share of state sales taxes. Most directly harmed are the more than 900,000 North Carolina consumers of satellite television service who are forced to pay a tax for their television service that their neighbors who subscribe to cable are not required to pay. Cable customers also suffer by giving cable companies in North Carolina a state-supplied tax cushion protecting them from competition, cable will be able to charge rates above what would be set in a truly competitive market. And the effects do not end there.

Because the substantially higher sales tax on satellite television companies acts like a tariff, it is a barrier lasting into the future for North Carolina residents who wish to purchase television service provided by innovative technologies such as satellite.

The cable industry disagrees with our assessment. They would have you believe that their tax credit creates "a level playing field" and achieve "tax parity" between competitive providers of pay television service. The reality is clear though: the cable sales tax credit is a form of market discrimination that places a tax burden on satellite providers, which would result in higher costs for North Carolina's satellite TV consumers who have made the switch from cable.

My company understands that this issue is complex. We understand that it is politically difficult. We also know though that the status quo cannot stand. A special tax break for one specific component of our industry is little more than an unfair subsidy to a multi-billion dollar industry that harms North Carolina consumers. I appreciate the opportunity to present our perspective, and hope you will not hesitate to address any issues to our representative, David Miner who will speak to the committee about the consideration of a broad television communications tax in place of the sales tax.

NCLM Local Cable and Video Programming Franchising Goals

NC municipalities welcome fair competition in the provision of video programming in their communities from all competitive providers as long as all providers operate under the same set of currently established franchising rules, procedures and standards. NC municipalities do not see that requirement as *unreasonable*.

It is the policy of the NC League of Municipalities to support the authority of our members to grant franchises to all companies providing video programming (cable service) to their municipalities and have all providers of video programming services to cities and towns pay the same level of franchise fees. Specific goals include:

1. Ensure and maintain authority for municipalities to grant franchises to all companies to provide cable-type video programming services in a municipality (local governments use franchises to manage streets and sidewalks, provide for public safety, enhance competition, and to collect compensation for private use of public land).
2. Ensure and maintain local regulation of rates, charges, customer service rules, and other terms or conditions for entry regarding the provision of video programming services in a municipality within the restrictions of current law.
3. Ensure and maintain local franchise fees for video programming services from all companies providing the service.
4. Preserve adequate cable and video programming franchise fees by not excluding advertising and other non-subscriber revenues from franchise fees.
5. Ensure and maintain requirements for all franchised companies to provide video programming services throughout a municipality (build out to all citizens regardless of race, age, income or location within a reasonable timeframe).
6. Ensure and maintain the appropriate number of public, educational, and local government (PEG) channels, institutional networks, and the use by municipalities of cable systems for local emergency alerts.
7. Ensure and maintain funding or in-kind support (facilities/equipment) from all video programming companies for PEG channels shown on the video programming system.
8. Ensure and maintain municipal control of video programming companies' use of rights of way within the restrictions of current law.
9. Ensure and maintain all other local regulation of cable or video programming companies within the restrictions of current law.

Our thanks to Dave Harris, Regional Cable Administrator Piedmont Triad Council of Governments, for his contributions to this listing.

Revenue Laws Study Commission - Telecom Taxation Comments
January 11, 2006
North Carolina Association of County Commissioners – Paul Meyer, Asst. General Counsel

A. NCACC supports legislative position of NCLM, although counties not identical to cities
B. Primary county concerns: Maintenance of revenue; Potential loss of important regulatory purposes of local cable franchise agreements
C. Revenue
    a. But for satellite radio, counties do not receive any portion of the state sales tax on telecom/cable services – unlike cities, no revenue sharing with state.
    b. However, counties are authorized to negotiate cable franchise agreements with "cable television system" (wired video services) providers (authority 153A-137), including local cable franchise tax, up to 5% gross revenues (per federal law).
    c. Not all counties have cable franchise agreements; county cable franchise tax rates range from 1-5% of gross revenues
    d. Change last year allows "cable service providers" a credit for local cable franchise taxes paid, against 7% state sales tax.
    e. NCACC supports the authority of counties to negotiate and grant local cable franchises to all "cable service" providers, including telecoms entering into video service market.
    f. No pressing public policy purpose is served if cable TV and telecom providers were to operate under differing tax models for the same service.
    g. If county cable franchise agreements were eliminated (and the tax with it), counties would lose approx $15 million. Cities would continue to receive revenue sharing with state on 7% sales tax related to voice and data.
D. Primary regulatory purposes of local cable franchise agreements
    a. **Build out requirements** to ensure access to services for all citizens, irrespective of income, location, or race – i.e. no cherry picking of the most profitable areas.
        i. This is particularly important in the unincorporated portions of a county, where population densities can be minimal – video service providers are less apt to run wires to serve these customers due to lack of profitability.
    b. Require ongoing **availability of government access channels**, in order help citizens understand, follow and participate in the local government decision making process.
        i. Empirical studies have found that people are getting their news more from video than written sources
    c. **Local regulation of rates, fees, and charges** to ensure consumer protections, and meet local needs as to service quality and quantity.

REVENUE LAWS STUDY COMMITTEE
State Legislative Building
Raleigh, North Carolina 27603

Senator John H. Kerr, III, Co-Chair *Representative Paul Luebke, Co-Chair*

January 23, 2006

NOTICE

TO: Members, Revenue Laws Study Committee

FROM: Senator John Kerr, Co-Chair
Representative Paul Luebke, Co-Chair

SUBJECT: Revenue Laws Study Committee Meeting

There will be a meeting of the **Revenue Laws Study Committee** as follows:

DAY:	**Wednesday**
DATE:	**February 8, 2006**
TIME:	**1:00 pm**
LOCATION:	**Room 544, Legislative Office Building**

Please advise DeAnne Mangum, Committee Clerk, at (919) 733-2405 or e-mail deannem@ncleg.net if you will be unable to attend.

Posted: 01/23/06

cc: Committee Record X
Interested Parties X

REVENUE LAWS STUDY COMMITTEE

Sen. John Kerr Rep. Paul Luebke

Wednesday, February 8, 2006
Room 544, Legislative Office Building
1:00 p.m.

I. **Approval of the Minutes from the January 11, 2005, Meeting**

II. **Synopsis of the Institute of Emerging Issues Forum on 'Financing the Future'**

Sabra Faires, Senate Tax Counsel and member of IEI workgroup on 'Bridging the Gap'

III. **Streamlined Sales Tax Update**

Andy Sabol, Director of the Sales & Use Tax Division, Department of Revenue

IV. **Additional Personal Income Tax Filing Option: Draft Proposal, Summary, and Fiscal Memorandum**

Martha Walston, Fiscal Research Division
Linda Millsaps, Fiscal Research Division

V. **IRC Update: Draft Proposal, Summary**
Canaan Huie, Bill Drafting Division
Linda Millsaps, Fiscal Research Division

VI. **Property Tax Changes: Draft Proposal, Summary, and Fiscal Memorandum**

Martha Walston, Fiscal Research Division
Rodney Bizzell, Fiscal Research Division

VII. **Revenue Laws Technical Changes: Draft Proposal and Summary**

Trina Griffin, Research Division

VIII. **2005 Biennial Tax Expenditure Report**

Karl Knapp, Director of the Tax Research Division, Department of Revenue

IX. **Adjournment**

Next Meeting: March 1, 2006, in Room 544 LOB at 1:00 pm

REVENUE LAWS STUDY COMMITTEE
Wednesday, February 8, 2006 at 1:00 PM
Room 544, Legislative Office Building

MINUTES

The Revenue Laws Study Committee met at 1:00 PM on February 8, 2006, in Room 544 of the Legislative Office Building. Fourteen members of the committee were present. Senator Kerr and Representative Luebke presided.

Approval of the Minutes.

Sen. Clodfelter motioned for the approval of the January 11, 2005 minutes and the motion carried. A copy of the minutes is attached.

Synopsis of the Institute of Emerging Issues Forum on 'Financing the Future'.

Sabra Faires, Senate Tax Counsel, was recognized for a description of the 2006 Emerging Issues Forum on 'Financing the Future". A copy of the presentation is attached.

Streamlined Sales Tax Update.

Andy Sabol, Director of the Sales & Use Tax Division, Department of Revenue, was recognized for an update on the Streamlined Sales Tax. A copy of the presentation is attached.

Additional Personal Income Tax Filing Option.

Martha Walston, a staff attorney with the Fiscal Research Division, was recognized to explain the 'Additional Personal Income Tax Filing Option' draft proposal and fiscal memo. Rep. Luebke made a motion for consideration of the draft proposal and the motion carried. A copy of the draft proposal, summary and fiscal memo are attached.

IRC Update.

Canaan Huie, a staff attorney with the Bill Drafting Division, was recognized to explain the 'IRC Update' draft proposal and fiscal memo. Greg Radford, Director of the Corporate, Excise, and Insurance Tax Division, NC Department of Revenue, was available to answer questions. In addition to updating the reference to the Internal Revenue Code, the bill would shorten the time span in which a taxpayer must report a federal change from two years to six months. Rep. Brubaker made a motion that this part of the bill be amended to provide a taxpayer with the right to request a six-month extension of time to report the federal change. The motion carried. A copy of the draft proposal and summary are attached.

Property Tax Changes.

Martha Walston, a staff attorney with the Fiscal Research Division, was recognized to explain the 'Property Tax Changes' draft proposal and fiscal memo. Pete Rodda, Forsyth County Tax Administrator, and Paul Meyer, Assistant Counsel for NC Association of County Commissioners, were available to answer questions. A copy of the draft proposal, summary and fiscal memo are attached.

Revenue Laws Technical Changes.

Trina Griffin, a staff attorney with the Research Division, was recognized to explain the 'Revenue Laws Technical Changes' draft proposal. Greg Radford, Director of the Corporate, Excise, and Insurance Tax Division, NC Department of Revenue, was available to answer questions. A copy of the draft proposal and summary are attached.

2005 Biennial Tax Expenditure Report.

Karl Knapp, Director of the Tax Research Division, Department of Revenue, presented the 2005 Biennial Tax Expenditure report as required by G.S. 105-256(a)(2). A copy of the report is attached.

Rep. Wainwright made a motion to adjourn the meeting and the motion carried. The meeting adjourned at 3:37 PM.

Senator John H. Kerr, III, Co-Chair
Revenue Laws Study Committee

Representative Paul Luebke, Co-Chair
Revenue Laws Study Committee

DeAnne Mangum, Committee Clerk

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — February 8, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Carol Rist	League of Women Voters
[illegible]	MT.
[illegible]	LWVNC
Hilda B. Kruse	LWV
Thelma B. Cousin	LWV
[illegible]	LWVNC
Bill Spencer	NCDOR
Linda Tableman	LWV Moore County
Jo Nicholas	LWV Moore County
Angie Harris	Maupin Taylor
DAVID BARNES	Poyner Spruill

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — February 8, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Jennie New	Kennedy Covington
Jim Ahler	NC Assn. of CPAs
Shea Denning	Institute of Government
Mia Bailey	Electricities of NC
Becki Gray	Civitas Institute
Fred Baron	Baron Assoc.
Cam Crue	BPMHL
Andy Ellen	NCBMA
Lucius Pullen	Attorney
Sharon Miller	CUCA
David Baker	NCDOR

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — February 8, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Bill Wilkes	DOR
Nancy Pomeranz	DOR
Karl Knapp	DOR
Andy Sasol	DOR
Anna Mitchell	DOR
John McAlister	Duke Energy
Janice W. Davidson	Motor Fuels - DOR
Dana Alderman	Motor Fuels - DOR
John D Panza	Motor Fuels DOR
Jeff VAN Dyke	BELLSOUTH
John Pollard	NC APA

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — February 8, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
	TWC
Lee Mandell	NCLM
	DOR
Stan Pace	Verizon
	JD, AL, TA
	NCPMA
Doug Howey	NCPMA
	[illegible]
	NCFA
Ken Melton	N.C. Dep't of Revenue
	LWV-NC

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — February 8, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Ann Tadlock	LWV - Moore County
Paul Meyer	NC ACC
Carol Shroud	LWV - ODC
Beverly Hawley	LWV-ODC
JUDIE BURKE	LWV NC
Brenda Rogers	LWV-NC
MARTY BOCOCK	SPRINT
Tom Moore	retired
Ed TURLINGTON	Brooks Pierce
Louise Romanow	LWV - Wake Co.
DIANA HASKELL	LWV - WAKE

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — February 8, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Rita Harris	NCSPA
Elizabeth Dalton	NCCBI
Connie Wilson	SSI
Jan Carr	Jordan Price
Johnny Tilley	Bone/Atkins.
Robert W. Wilson	S.O.J.
[illegible]	DJNLC

REVENUE LAWS STUDY COMMITTEE

Sen. John Kerr Rep. Paul Luebke

Wednesday, February 8, 2006
Room 544, Legislative Office Building
1:00 p.m.

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VIII. **2005 Biennial Tax Expenditure Report**

Karl Knapp, Director of the Tax Research Division, Department of Revenue

IX. **Adjournment**

Next Meeting: March 1, 2006, in Room 544 LOB at 1:00 pm

REVENUE LAWS STUDY COMMITTEE
Wednesday January 11, 2006 at 1:00 PM
Room 544, Legislative Office Building

MINUTES

The Revenue Laws Study Committee met at 1:00 PM on January 11, 2006, in Room 544 of the Legislative Office Building. Ten members of the committee were present. Representative Luebke and Senator Kerr presided.

Representative Hill moved to approve the minutes of the December 12, 2005 meeting and the motion carried.

Review of Current State Tax Treatment

Cindy Avrette, a staff attorney with the Research Division, was recognized to summarize the current State taxation of communication services.

Comments from Interested Parties.

Bruce Yancey, Director of State and Local Taxes, BellSouth, was recognized. A copy of his presentation is attached.

Alan Ciamporcero, President, Southeastern Region Public Affairs, Policy & Communications, Verizon, was recognized. A copy of his presentation is attached.

Robert Wells, Executive Director, The Alliance of North Carolina Independent Telephone Companies, was recognized. A copy of his presentation is attached.

Randy Fraser, Vice President Government Affairs – NC, Time Warner Cable, was recognized. A copy of his presentation is attached.

Tom Adams, President of the NC Cable Telecommunications Association and President, Raleigh Division, Time Warner Cable was recognized. A copy of his presentation is attached.

David Miner, Echo-Star representative, was recognized. A copy of his presentation is attached.

Dr. Lee Mandell, Director of Information Technology and Research, NC League of Municipalities, was recognized. A copy of his presentation is attached.

Paul Meyer, Assistant General Counsel, NC Association of County Commissioners, was recognized. A copy of his presentation is attached.

The meeting adjourned at 2:50 PM.

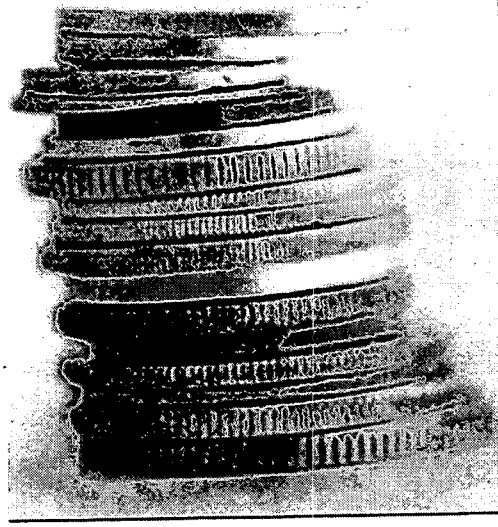
Senator John H. Kerr, III, Co-Chair
Revenue Laws Study Committee

Representative Paul Luebke, Co-Chair
Revenue Laws Study Committee

DeAnne Mangum, Committee Clerk

FINANCING THE FUTURE

21st Annual Emerging Issues Forum
February 6-7, 2006



AGENDA
FINANCING THE FUTURE
February 6 & 7, 2006
McKimmon Center -- NCSU
Raleigh, NC

Registration for the Emerging Issues Forum begins at 7:00 a.m. on February 6 and 7.

Monday
Feb. 6

8:00 am **Welcome**
JAMES B. HUNT, JR.
Former Governor, North Carolina

JAMES OBLINGER
Chancellor, North Carolina State University

LUKE BIERMAN
Director, Institute for Emerging Issues

8:20 am **Short Film: "Financing Our Future"**

8:30 am **Financing the Future: A World View**
PAUL H. O'NEILL
Former Secretary of the U.S. Treasury

9:15 am **Paying for What North Carolina Needs in 2030**
Brought to you by Wachovia Corporation
G. KENNEDY THOMPSON
Chairman, President and CEO, Wachovia Corporation

9:45 am **Break**

10:00 am **Success Out West?**
BILL RICHARDSON
Governor of New Mexico

10:40 am **Panel: Options for the Future**
TOM ROSS - moderator
Executive Director, Z. Smith Reynolds Foundation

JOHN CONNAUGHTON
TIAA-CREF Professor of Economics, University of North Carolina, Charlotte

MIKE WALDEN
William Neal Reynolds Distinguished Professor and Extension Economist, NC State University

MICHAEL HANNAH
Director, Multistate Tax Services, PricewaterhouseCoopers, LLP

BILL FOX
Director, Center for Business and Economic Research University, University of

Tennessee

11:40 am	Financing Opportunity WILLIAM BYNUM CEO and President, Enterprise Corporation of the Delta
12:10 pm	Lunch PAUL KRUGMAN Op-Ed Columnist, *The New York Times* Professor of Economics, Princeton University
1:45 pm	What Would Steve Forbes Do? STEVE FORBES President and CEO, Forbes Inc.
2:25 pm	Short Film: Show Me the Money
2:40 pm	Working Group Sessions Sufficiency Efficiency Equity
3:50 pm	Getting Down to Business HENRI MEIER Chairman, Board of Directors, HBM Partners AG and HBM BioVentures AG KIP THOMPSON Vice President of Global Facilities, Dell Corporation
4:35 pm	Across the States: Tales from the Trenches RODNEY ELLIS Texas State Senator NORMA ANDERSON Former Colorado State Senator
5:15 pm	Closing
Tuesday Feb. 7	
8:00 am	Welcome
8:15 am	Russia's Economic Revolution YEGOR TIMUROVICH GAIDAR Former Prime Minister, Russia Director, The Institute for Economy in Transition
8:55 am	Singapore's Story: Big Ideas In Action VIVIAN BALAKRISHNAN Minister for Community Development, Youth and Sports; Second Minister for Trade and Industry, Singapore
9:30 am	Paying for Education: Case in Point *Brought to you by Duke Energy* JUNE ATKINSON North Carolina State Superintendent of Public Instruction MARTIN LANCASTER

President, North Carolina Community College System

KAREN PONDER
President, North Carolina Partnership for Children

SHAYNA SIMPSON HALL
Executive Director, North Carolina Individual Development Account and Asset Building Collaborative

BRAD WILSON
Chair, UNC Board of Governors
Senior Vice President, Blue Cross and Blue Shield of North Carolina

10:30 am Break

10:45 am Bringing it Home
JERRY E. ABRAMSON
Mayor, City of Louisville, Kentucky

11:20 am Financing North Carolina: A Roundtable Discussion
Brought to you by Blue Cross and Blue Shield of North Carolina
JAMES B. HUNT, JR. (Moderator)
Governor of North Carolina: 1977-1985, 1993-2001

DAN GERLACH
Senior Policy Advisor, Fiscal Affairs, Office of the Governor

BEVERLY EARLE
Representative, State of North Carolina

BARRY W. EVELAND
Interim President & CEO, North Carolina Citizens for Business and Industry

A. EVERETTE CLARK
Mayor, City of Marion, North Carolina

KITTY BARNES
President, North Carolina Association of County Commissioners

12:35 pm Lunch
MARK WARNER
Former Governor, Commonwealth of Virginia

2:05 pm Closing: Next Steps for North Carolina
JAMES B. HUNT, JR.
Former Governor, North Carolina

** Please note: The 2006 Emerging Issues Forum agenda is subject to change and will be updated frequently. Please check this website often.

Institute for Emerging Issues

Financing the Future: Options for Consideration

Summary of Working Group Deliberations

Over the past 20 years state and local governments have seen their share of overall government spending in the United States grow from 38 percent to over 50 percent. At the same time, state and local governments have seen their share of revenue remain constant. On top of everything else, the costs to both state and local governments for public education and healthcare are set to rise rapidly. This means that state and local governments depend increasingly on the federal government—an unreliable financial partner—and on filling budget gaps with ad hoc, band-aid type solutions.

These tensions, combined with economic weakness, left the states in crisis during the recession of 2000-2001. Although the states in general, and North Carolina in particular, are now emerging from that crisis, fundamental tensions remain. The future liabilities of state and local governments are rapidly increasing while revenue growth remains slow. Ensuring sustainable revenues will be an emerging issue for state and local governments in the years to come.

To that end, the Institute for Emerging Issues has begun a multiyear program of work that will lay the groundwork for change in the state's system of tax and finance. This program is grounded in research that yields ideas for improvement. These ideas are subject to a model public policy process in which new combinations of leaders debate and refine them, and champion necessary action.

Specifically, the Institute convened three working groups to develop initial ideas to guide the program of work. The groups included members from business, government and higher education, as well as advocates from across the political spectrum. The groups were tasked with searching for innovative solutions for the whole revenue picture at both the state and the local level.

The groups developed a wide range of options, to be presented at the 2006 Emerging Issues Forum, "Financing the Future." At the Forum, stakeholders from across the state and experts from around the world will have an opportunity to debate and refine them.

From there, the Institute will move these ideas into action by working in a variety of ways. Regional forums and roundtables will be convened to inform and mobilize business and government leaders across the state. The Institute will work with faculty and other partners to perform the studies and research necessary to make the document an effective tool for public policy debate. The Institute will partner with leaders to implement reform. These options constitute a living document, evolving though interaction with partners, stakeholders and experts.

In creating these options, few ideas met with unanimous consent from the group. However, most group members recognized that all ideas had potential if considered as part of an entire package. As such, all the options noted below merit further investigation.

Three themes remained constant during the working group process: restructuring the state's revenue system in a way that promotes growth with equity; ensuring sufficient revenues to meet the future needs of counties, cities and the state; and developing a transparent budget and management process for both state and local governments.

Four goals were established for this set of options: 1) to increase the stability of revenues; 2) to enhance the equity of the tax system; 3) to promote economic growth and competitiveness; and 4) to encourage innovative thinking by governments at all levels.

State Revenue

Making changes to a tax system in a revenue-neutral way requires that the system as a whole be considered. Revenue changes in one area necessitate offsetting revenue changes in another. Therefore this document seeks to do two things. First, it outlines the specific options the group considered for improving the revenue system. Second, it offers two broad formulas for approaching the tax structure.

The Personal Income Tax

The largest single source of state revenue is the personal income tax. Currently, North Carolina has a bottom rate of 6 percent and a top rate of 8.25 percent.

Possible Concerns

- The high marginal rate may be driving away high net worth individuals, small business owners and corporate headquarters from the state.
- Reliance on the federal tax code exposes North Carolina's revenue collection to changes in national tax policy.
- For most working group members, the income tax is the primary vehicle for ensuring equity in the tax system as a whole.

Possible Options

- Expand the tax base to increase revenue and allow for adjustments elsewhere.
    - Expand the tax base by moving to Federal Adjusted Gross Income minus a personal exemption. This would result in a large expansion of income tax revenue and could further increase progressivity.
    - Selectively eliminate deductions in the income tax code.
- Lower the top marginal rates to encourage businesses and individuals to set up residence in North Carolina.

- Expand the personal exemption to eliminate lower income households from the tax rolls.
- Institute some form of a negative income tax that would give increased support to lower income families.

Possible Constraints

- Using Federal Adjusted Gross Income will mean taxing social security in some cases and the elimination of the mortgage interest deduction. This is politically challenging.
- A lowered top rate and an increased personal exemption may place a greater burden on the middle class.

The Sales Tax

The sales tax is the second largest source of revenue for the state. Currently the state imposes a 4.5 percent sales tax on non-food tangible goods, while counties impose an additional 2.5 percent (3 percent in Mecklenburg County).

Possible Concerns

- In recent years, sales tax revenue has grown more slowly than income tax revenue. There are two major factors at play.
  - Out-of-state sales and Internet sales are increasing in volume.
  - An increasing portion of economic activity is in the service sector, which is largely exempt.
- At least for a snapshot in time, the sales tax is regressive. Some in the group felt that regressivity is reduced when one considered lifetime income and spending patterns.

Possible Options

- Continue efforts to conform to the Streamline Sales and Use Tax Agreement. This interstate compact aims to increase tax payments by out-of-state vendors.
- Continue to eliminate special exemptions from the sales and use tax.
- Pay out-of-state vendors to collect sales tax on the state's behalf.
- Expand the sales tax base to include more services. Expansion to services has the potential to dramatically increase sales tax revenue. Several paths include:
  - Expand the tax to include admissions to events and to services that are a substitute for tangible goods (lawn care services vs. lawnmowers).
  - Expand the tax to services in general with specific exemptions such as medical care.
  - Expand the tax to all services and currently exempt goods with no exemptions.
- Lower the sales tax rate.

Possible Constraints

- There may be administrative difficulties in extending the sales tax to all personal services.
- There will be significant political problems, leading to taxes only on the politically weak (barbers).

The Corporate Income Tax

The corporate income tax represents about 5 percent of state revenue collection. A portion of the corporate income tax is dedicated to school construction and school capital needs, and many counties have pledged this revenue stream to support ongoing school projects and debt service for new schools.

Possible Concerns

- The corporate income tax code contains numerous targeted credits, exemptions and other loopholes. Currently the official rate is 6.9 percent, but the effective rate may be only approximately 3.5 percent.
- Some corporations use shell subsidiaries and other affiliates to avoid income tax liability.
- In general, small businesses are at a disadvantage in the current system.
- Some in the group felt that the cost to corporations and the state of administering this tax might exceed total tax revenues.
- The corporate income tax is highly volatile.

Possible Options

- Review all targeted exemptions and credits within the corporate income tax code for effectiveness and efficiency (including a review of exemptions and credits that claim a specific economic impact).
- Lower the corporate income tax rate to 3 percent – 4 percent.
- Replace the corporate tax with an expanded and modernized franchise tax. The franchise tax may be less variable than the corporate income tax.
- Study the merits of mandatory combined reporting of corporate income.
- Completely eliminate the corporate income tax.
- Ensure that funding from the corporate income tax now dedicated to school capital needs would continue at its current level with state funds.

Holistic Paths

All members agreed that the state revenue system is best examined as a whole. Two paths seemed to emerge during group discussions. However, the range of possible paths is not limited to those listed below.

Reduce Inefficiencies While Retaining Progressivity

The personal and corporate income tax codes contain many exemptions and marginal personal income tax rates may be driving away a significant number of high net worth individuals.

However, the income tax is useful in promoting progressivity in the tax structure. At the same time, the sales tax exempts services that compete directly with tangible goods. The expansion of the sales tax base would probably make it less regressive as a whole. One holistic path might be to:

Consider

- Reducing the top marginal personal income tax rates.
- Reducing the corporate income tax rate, but protect school capital funding.
- Eliminating all exemptions, credits, and loopholes in the corporate income tax code.
- Reducing the number of itemized deductions in the personal income tax code.
- Increasing the personal exemption to eliminate lower income families from the tax rolls.
- Expanding the franchise tax to all business.

Study

- The extent to which a reduction in the highest marginal rates may be self-financing.
- The impact of moving to combined reporting of corporate income.

The extent to which a reduction in the top marginal rate is self-financing will determine the relationship between reducing the deductions and increasing the personal exemption. If combined reporting is found to be advantageous to the state, it could be included in an attempt to increase the efficiency of the corporate income tax.

Shift Towards Consumption Taxation

Some members of the group felt that consumption taxes promote economic growth by reducing the double taxation on investment and encouraging savings. One path towards taxing consumption would be to:

Consider

- Expanding the sales tax to include all services.
- Exempting all business-to-business sales from the sales tax.
- Reducing or eliminating the corporate income tax.
- Creating a refundable credit or (negative income tax) within the personal income tax code to provide support to lower income families.

Study

- The revenue returns from a destination based value added tax (VAT).
- The feasibility of a consumption tax administered through the income tax system.
- Replace the corporate income tax with a commercial activity tax, as is now the case in Ohio.

Local Government Structure & Revenue

To support and manage North Carolina's economic and demographic change, local governments in the state must have greater flexibility in both revenue authority and service provision.

While all local governments are experiencing increased pressure in the new millennium, the source of the pressure varies widely. Some localities will see their population double in the next 20 years while others will see it decline. Some localities will grow much older while some will see a new boom in school age children.

To meet these challenges, local governments need the autonomy and flexibility to respond individually, while at the same time continuing to receive state level support and oversight. The local government structure and tax reform strategies discussed below should be considered in the light of a comprehensive understanding of the way revenues and responsibilities are shared between state and local authorities. This relationship has not been reviewed in a comprehensive way by the working groups. Subsequent consideration of the options below should be conducted in the light of such a review.

Local Government Structure

Local governments in North Carolina have the responsibility of providing many services to their residents. However, in many localities, service responsibilities and available resources have become misaligned as greater state and federal mandates are being pushed down without attendant revenue authority.

State and local leaders should assess state-local relations and identify gaps inherent in the current allocation of state and local responsibilities and revenues. This effort could entail several options, including the following:

- Consider redesigning the state and local government structure, including such elements as the allocation of service responsibilities between the state and its localities (e.g., education, health care and transportation).
- Reallocate the sharing of state and local revenue sources as needed to support the overall delivery of services.
- Provide local governments with greater autonomy and capacity to promote regional or statewide economic competition and growth.
- Promote viable regionalization ventures (e.g., sewage and water systems), perhaps through grants and other fiscal incentives.
- Encourage with incentives local governments to regionalize or consolidate services (e.g., joint county initiatives).
- Reassess the modified Dillon's rule and consider offering local governments expanded home rule powers.
- Consider offering appropriate oversight (e.g., expand scope of local government commission) as a condition prerequisite to expanded local government powers.

Local Government Taxes

Counties and cities in North Carolina are largely dependent on the property tax and local sales tax to support an increasing array of services. Economic conditions result in local governments having widely differing revenue-raising powers. Each locality generally must request the right to use a new revenue method from the General Assembly individually. Even user fees to support direct service costs are often dictated by statutory limitations. This process is inequitable and has resulted in an unbalanced distribution of revenue raising options.

Consistent with inextricably linked efforts to reform the state tax structure and modify state-local structures, the state should consider incremental refinements to the local government tax structure in order to even the playing field among local governments and eliminate unfair and unnecessary barriers to the effective financing of local governments.

However, the group was split over whether this should be done by increasing the revenue options available or decreasing the revenue options available. Some felt that revenue was best raised centrally by the state to support statewide services such as Medicaid and public education. These members felt that the burden on the localities could best be eased by one of the following:

- Expanding the sales tax base and ensuring all goods and services subject to the state's sales tax be included in the local sales tax base.
- Having the state take over responsibility for Medicaid and an increasing share of education.

Others in the group felt strongly that local government leaders are in the best position to decide what revenues sources are best suited for their jurisdiction, and a level playing field might be achieved by offering a standardized menu of revenue options from which local governments could choose, subject to local voter approval. The following revenue options are now in place for one or more local governments and could be made available to all:

- Local option occupancy tax.
- Local option admissions tax.
- Local option vehicle tag tax.
- Local option impact tax.
- Local option prepared food and beverage tax.
- Local option land transfer tax.

State & Local Government Efficiency

Reforming the state and local revenue systems, without restructuring the way in which governments deliver services and instituting rigorous processes for ensuring the responsible management of public resources, may not attain our objectives. North Carolina has more counties and cities

with AAA bond ratings than in any other state. All counties have adopted the council/manager form of government, thereby promoting professional local management while ensuring citizen participation and representation. While North Carolina has long enjoyed a reputation for good government and public stewardship, the global economy demands continual improvement. Ideas proposed within the group included:

Improved state budgeting process

The state could establish a long-term planning and policy formulation process to guide incremental policy changes. It could seek a public-private partnership for designing and maintaining a rigorous, dynamic forecasting model for state and local government. The state should design a new budget process that is more transparent and seamlessly linked with its long-term planning process (North Carolina could serve as a model in the area, as no state at present has state-of-the-art budgeting and planning practices). It also should consider designing the new budget process to increase budgetary flexibility, encourage agency savings and incorporate performance-based budgeting characteristics.

Improve state contingency planning

Consistent with a more comprehensive and rigorous planning process, the state should improve its ability to prepare for financial contingencies. To that end, the state should prepare accurate forecasts of long-term capital needs, incorporate the annual portion of the capital budget in the operating budget and fully report long-term financing obligations, including the present value of projected receipts and costs. The state also should consider measures for strengthening its capacity to manage debt (e.g., debt limits). Most importantly, the state should consider new policies for funding and maintaining reserves on a continual basis, establishing a minimum fund balance for unforeseen emergencies, as is the case for all local governments. For example, the state could consider specific increases to the state rainy day fund and measures for preventing the under-funding of such reserves.

Revamp infrastructure funding

The state should establish a statewide capital improvement and management plan. State and local governments need new ways to ensure the reliable and cost-effective financing of long-term capital improvements and other required investments. Consistent with sound capital planning principles, state and local governments should have the best available financing tools to maximize investments in sound capital projects that will accelerate economic growth or reduce public costs. The state should increase local access to appropriate funding sources for infrastructure needs and reduce unnecessary funding barriers for local governments with demonstrated capital needs. The state also should explore incentives for spurring the private financing of public improvements.

State government accountability

The state could establish rigorous and durable systems for enhancing the efficiency and accountability of state agencies. It should consider creating an independent review process (e.g., Texas and Florida) to reassess spending priorities and conduct zero-based

(sunset) reviews of discrete programs. The state could accelerate efforts to pursue feasi ble privatization opportunities (e.g., ABC system) and consider incentives for encouraging state entrepreneurship. It should develop a coherent accounting framework for aligning costs with revenues (e.g., entitlement and business services).

Setting the Framework: Financing the Future

John E. Silvia
Chief Economist, Wachovia Corporation

Dr. Silvia and the Economics Group at Wachovia Corporation provide a detailed summary of issues facing North Carolina's economy and the state's ability to raise revenue. The state's population has been increasing faster than the national average and can be expected to do so into the foreseeable future. In addition, our state is becoming more diverse as the traditional White and Black populations are giving way to a larger proportion of Asians and Hispanics.

Economically, the trend has been toward services and specialized manufacturing. Traditional agricultural and manufacturing industries have declined dramatically, giving way to service sector industries such as finance, health, education and tourism.

Comparing North Carolina's economic growth to its nearest neighbors shows that the economy is growing at a healthy pace. Gross state product is second in growth only to Virginia, and personal income is second in growth only to Georgia. However, the good fortune is not shared evenly across the state. In particular, the metropolitan centers of Charlotte and Raleigh-Durham have per-capita incomes significantly higher than the national average, while much of the state falls well below the national average.

In terms of spending needs, there has been a shift toward higher education and medical services as an increasing proportion of the population goes on to college and as the cost of healthcare rises. However, the traditional costs of roads and primary and secondary education have not subsided. These factors combined have accelerated the growth in the state's spending needs over the last decades.

Lastly, we must consider how to distribute the responsibilities of government between the various levels. In general, local revenue and spending decisions should be kept local. However, that must be balanced against the desire to provide assistance to localities that cannot afford to support their own services. In either case it is vital that the state maintain accountability over which projects are funded and how projects are funded.

To read the full version of this paper, please go to:
www.ncsu.edu/iei/projects/financing.html

Institute for Emerging Issues

State Tax Reform: Evidence, Logic, and Lessons from the Trenches

Benjamin Russo
Professor of Economics, University of North Carolina, Charlotte

Dr. Russo presents evidence that tax reform is crucial for the state of North Carolina. Recent trends in sales tax revenue indicate that North Carolina's tax system may be insufficient to meet the demands of the 21st century economy. Over the last 40 years, the national sales tax base has fallen from roughly 63 percent of the economy to just 44 percent of the economy. North Carolina has followed a similar pattern. In addition, North Carolina has found it increasingly difficult to levy taxes on corporations. In an open market, governments have to compete for corporate facilities. That competition drives down tax rates.

Given these factors, Dr. Russo concludes that tax reform is inevitable. However, the question remains whether that reform is going to be comprehensive or partial. The advantage of comprehensive reform is that it brings all stakeholders to the table. The effect is sweeping and all citizens are likely to be interested and involved. This prevents the process from being overtaken by special interest groups that may be concerned with only parts of the tax code. This unifying effect explains in part the success of federal tax reform in 1986.

Yet the possibility also exists for special interests to unite against a tax. This was the case in 1987 when Florida attempted to expand the sales tax to services. In this case the service industries proved a powerful lobbying agent and prevented tax reform from happening.

By contrast, partial reform has the advantage of reaping much of the rewards while allowing the legislature to pick off the lowest hanging fruit first. In particular, while it may be difficult to tax media and medical services it might be easier to tax other services and still gain much of the benefits of a broader based tax.

However, whichever direction the state decides to choose, tax reform is a critical issue going into the next century.

To read the full version of this paper, please go to:
www.ncsu.edu/iei/projects/financing.html

Institute for Emerging Issues

Change in State and Local Taxes in North Carolina

Roby B. Sawyers
GlaxoSmithKline Faculty Fellow, Institute for Emerging Issues and Professor of Accounting, North Carolina State University

Dr. Sawyers outlines the evolution of taxes in North Carolina from the 1930's through the present. North Carolina underwent significant reform in the 1930's. The state introduced a personal income tax, a corporate income tax and a motor fuels tax, while reserving the property tax strictly for local use. At the same time, the state took over much of the responsibility for the schools, roads and prisons.

Since that time, the structure of North Carolina's tax system has changed very little. However, the importance of each revenue source has changed dramatically. In 1942, North Carolina received nearly 90 percent of its own source revenue from taxes, while the other 10 percent came from a variety of fees, charges and miscellaneous revenues. By 2002, taxes accounted for only about 66 percent of the state's own-source general revenue.

At the same time, the income tax has increased dramatically in terms of relative importance. The individual income tax increased from 10 percent of total local and state combined revenues in 1957 to 32 percent in 2002. In contrast, revenue from the corporate income tax fell from 9 percent to roughly 3 percent, and sales tax revenue slipped from 41 percent to 35 percent.

The burden associated with different taxes has changed over time. The tax burden from most taxes has remained relatively constant. However, the burden from the income tax has steadily risen, along with the burden from fees and charges. As a result, the total tax burden has also risen.

These changes are important to recognize as they may impact the distribution of the tax burden and the equity of the overall tax system in North Carolina. While the individual income tax is progressive, fees and charges are typically regressive resulting in a greater burden on low-income taxpayers in the state. In addition, a state's tax burden can be an important factor in business location decisions. Increases in the overall burden and the tax burden may adversely impact the ability of the state to compete with other states for new businesses.

To read the full version of this paper, please go to:
www.ncsu.edu/iei/projects/financing.html

Institute for Emerging Issues

Financing Government: Revenue Variability and the Role of Rainy Day Funds

Gary A. Wagner
Associate Professor of Economics, School of Government, University of North Carolina, Chapel Hill

Dr. Wagner describes the patterns of revenue growth faced by state governments in general and specifically North Carolina. Unsteady revenue streams create the need for rainy day funds to support the operation of government during economic downturns. The fiscal benefits for states with properly structured rainy day funds are sizable when compared to states without rainy day funds or improperly structured funds.

For example, states with properly structured rainy day funds saved more, faced significantly lower long-term borrowing costs, and experienced fewer expenditure reductions and tax increases during the 1990-1991 recession. In addition, government expenditures are approximately 20 percent less volatile over the business cycle in states with properly structured rainy day funds.

Although the use of a properly structured rainy day fund may ease the fiscal crunch of recessions, there is an opportunity cost associated with the practice of saving. If the state does not save, then the funds that would have been saved may be used to provide additional services, retire debt or reduce tax burdens. The relevant trade-off in the decision to save comes in weighing the "cost" of saving (fewer services) against the "benefit" of being better prepared for downturns (fewer spending cuts/tax increases).

Changes in economic activity create difficult problems for state governments since the demand for public sector services tends to be countercyclical, while revenue growth is procyclical. While it is challenging to reduce the variability in revenue streams that results from swings in the business cycle, there are a number of potential strategies that have been identified by previous research:

- Broadening tax bases will tend to have minimal effects on the long-term sustainability of a given revenue source but may result in smaller year-to-year swings.
- Since more progressive individual income tax systems produce more volatile revenue streams in the short-run, but more rapid revenue growth in the long-run, there appears to be a trade-off between long-run growth and short-term variability.
- Since it is not possible to completely eliminate business cycle swings from revenue streams, there is evidence that properly structured rainy day funds can significantly reduce the need for expenditure reductions and tax increases during downturns.

To read the full version of this paper, please go to:
www.ncsu.edu/iei/projects/financing.html

STREAMLINED SALES TAX UPDATE

February 2006

The Streamlined Sales Tax Project began in March 2000 as an effort by states, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The goal of the representatives working on this Project is to achieve sufficient uniformity and simplification so as to encourage sellers without nexus in states to voluntarily collect sales or use tax in participating states. Currently, forty-three states and the District of Columbia have by legislative or executive action authorized participation in Project.

In November 2002, the Streamlined Sales and Use Tax Agreement was approved by the states. The Agreement contains the uniformity and simplification provisions developed by the Project. The Agreement has been amended several times over the last three years to adopt items that the Project participants continued to address. The Agreement itself was to become effective when at least ten (10) states representing twenty percent (20%) of the population of all states that impose a sales tax were determined to be in compliance with the provisions of the Agreement.

Over the last few years, states, including North Carolina, have enacted provisions to bring themselves into compliance with the Agreement. 2005 was a significant year in that in July 2005, eighteen states representing over twenty-eight percent (28%) of the population of states imposing sales tax were determined to be in substantial compliance with the Streamlined Agreement and became either full or associate member states. Full member states are states that were determined presently to be in substantial compliance with the provisions of the Streamlined Agreement. Associate member states are states that have taken action to amend their laws to come into compliance but have future effective dates. On October 1, 2005, the Streamlined Sales Tax Governing Board, Inc., consisting of representatives of the member states, came into existence. The Governing Board will oversee administration of the Agreement including matters such as interpretations of the Agreement, admittance of new members, and oversight of contracts and technology.

Since 2001, legislation has been enacted in each session to bring North Carolina laws into compliance with the provisions of the Streamlined Agreement and North Carolina was admitted as a full member state. There are currently thirteen full member states and six associate member states as Nevada was admitted as a member state as of January 1, 2006. As the states continue to address matters brought before them, there will be future amendments to the Agreement that will require amendments to our law. With most amendments states are being given at least two legislative sessions to address the issues and our Department has been working with General Assembly staff on changes to the Agreement made in April 2005 that will need to be enacted by January 1, 2008 in order for our State to remain in compliance. We look forward to continuing to work with members and staff and want to express our appreciation for all that has been accomplished to date.

The Governing Board is overseeing the implementation of several technology initiatives that will ease the burden of sellers for collection and remittance of sales and use tax. On October 1, 2005, a central registration system was activated on the Governing Board's website. This allows a multistate seller to complete a single electronic registration form and become registered to collect sales and use tax in all the member states. The member states download the registration information and incorporate the data into their own registration systems. To date, 479 sellers have registered through the central site with 27 of these being new sellers signifying that they will collect tax in North Carolina and with 67 being sellers already registered and collecting tax. Over $110,000 has been collected from the new sellers since activation of the system. In addition to these new sellers, we have estimated that we are collecting over $1.5 million annually from several sellers that came forward prior to the formation of the Governing Board who indicated that the reason for beginning to voluntarily collect tax was the progress that the states had made through the Streamlined Project efforts.

Another major initiative is the finalizing of contracts with third party service providers that will perform the administrative sales tax collection and remittance functions for sellers. Under this model, states have agreed to compensate the service providers for the services that they provide to sellers thus significantly easing the burden of collecting tax in states in which a seller is not located. The member states have been working for months on reviewing the tax computation software developed by the service providers and other functions necessary for the proper collection and remittance of tax. Four firms are currently being evaluated and it is hoped that the Governing Board will enter into contracts with at least two of the firms over the next few months. Once a service provider is available, it is anticipated the number of voluntary sellers will significantly increase.

All forty-three participating states and the District of Columbia, along with local government representatives, continue to work on remaining issues undertaken by the Streamlined Project through a State and Local Advisory Council. Private industry representatives have also formed an advisory body as recognized in the Streamlined Agreement. These bodies will be consulted and assigned projects by the Governing Board as new issues are brought forward, as deemed appropriate. Only the states that compose the Governing Board have the authority to vote on amendments to the Streamlined Agreement and entry of new members. It is anticipated that at least two more states, Vermont and Washington, will petition for membership in 2006 and that more states will choose to give serious consideration to making law changes necessary to become members now that the Agreement is effective and sellers are coming forward.

Members of our Department continue to represent the State and are delegates to the State and Local Advisory Council and the Governing Board. Our staff will continue to work with the appropriate parties to explain any new measures that come forth and to help formulate any legislation necessary to keep North Carolina in compliance. Federal legislation has once again been introduced in Congress that would require remote sellers to collect tax in those states that have adopted the uniformity and simplification provisions of the Streamlined Agreement. If this legislation is eventually enacted, our State should find itself in position to benefit accordingly.

Thank you for the opportunity to present this update. My staff and I will be glad to provide any additional information. 2005 was an important year in this process although there continues to be important work ahead. Once again, the support members of the General Assembly and their staff have given is appreciated and we look forward to future discussions.

Submitted by: Andy Sabol, Director
Sales and Use Tax Division
North Carolina Department of Revenue

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-LAz-20 [v.3] (1/31)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/6/2006 11:26:08 AM

Short Title: Additional Personal Income Tax Filing Option.	(Public)
Sponsors: Unknown.	
Referred to:	

A BILL TO BE ENTITLED

AN ACT TO ALLOW AN ADDITIONAL JOINT FILING OPTION FOR INDIVIDUAL INCOME TAXES.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-162(e) reads as rewritten:

"(e) Joint Returns. – A husband and wife ~~shall file a single income tax return jointly if (i) their~~whose federal taxable income is determined on a joint federal return ~~and (ii) both spouses are residents of this State or both spouses have~~shall file a single income tax return jointly if each spouse either is a resident of this State or has North Carolina taxable ~~income.~~income, and may file a single income tax return jointly if one spouse is not a resident and has no North Carolina taxable income. Except as otherwise provided in this Part, a wife and husband filing jointly are treated as one taxpayer for the purpose of determining the tax imposed by this Part. A husband and wife filing jointly are jointly and severally liable for the tax imposed by this Part reduced by the sum of all credits allowable including tax payments made by or on behalf of the husband and wife. However, if a spouse has been relieved of liability for federal tax attributable to a substantial understatement by the other spouse pursuant to section 6015 of the Code, that spouse is not liable for the corresponding tax imposed by this Part attributable to the same substantial understatement by the other spouse. A wife and husband filing jointly have expressly agreed that if the amount of the payments made by them with respect to the taxes for which they are liable, including withheld and estimated taxes, exceeds the total of the taxes due, refund of the excess may be made payable to both spouses jointly or, if either is deceased, to the survivor alone."

SECTION 2. This act is effective for taxable years beginning on or after January 1, 2006.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: February 6, 2006

TO: Revenue Laws

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: Additional Personal Income Tax Filing Option

FISCAL IMPACT

Yes (X)	No ( )	No Estimate Available ( )		
FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:		Potential Minimal loss		
EXPENDITURES:				

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: For taxable years beginning on or after January 1, 2006.

BILL SUMMARY: Under North Carolina law, a married couple that files a joint federal return must file a joint state return if both are residents or have North Carolina income. However, if one spouse is a non-resident and has no North Carolina income, the other spouse must file a separate return with the State. The proposed legislation would allow such a couple the option of filing a joint North Carolina return. This is a recommendation of the North Carolina Department of Revenue.

ASSUMPTIONS AND METHODOLOGY: Currently no data is available about the number of returns this change would impact or the likely amount of revenue affected. However, the

Department believes the number of taxpayers involved would be small. Because this legislation gives the couple the option of choosing to file joint or separate returns, it would be reasonable to assume there are some circumstances were the taxpayer may benefit financially from a specific filing status, and would select that status. As such, there is a potential revenue loss.

SOURCES OF DATA: North Carolina Department of Revenue.

TECHNICAL CONSIDERATIONS: None

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-LYxz-284 [v.3] (1/20)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/6/2006 3:42:25 PM

Short Title: IRC Update. (Public)

Sponsors:

Referred to:

A BILL TO BE ENTITLED

AN ACT TO UPDATE THE REFERENCE TO THE INTERNAL REVENUE CODE USED IN DEFINING AND DETERMINING CERTAIN STATE TAX PROVISIONS AND TO MAKE OTHER CHANGES TO MORE CLOSELY CONFORM TO FEDERAL TAX LAW.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-228.90(b)(1b) reads as rewritten:

"(b) Definitions. – The following definitions apply in this Article:

...

(1b) Code. – The Internal Revenue Code as enacted as of January 1, ~~2005,~~2006, including any provisions enacted as of that date which become effective either before or after that date."

SECTION 2. Notwithstanding Section 1 of this act, any amendments to the Internal Revenue Code enacted after January 1, 2005, that increase North Carolina taxable income for the 2005 taxable year become effective for taxable years beginning on or after January 1, 2006.

SECTION 3. G.S. 105-32.8 reads as rewritten:

"**§ 105-32.8. Federal determination that changes the amount of tax payable to the State.**

If the federal government corrects or otherwise determines the gross estate tax imposed under section 2001 of the Code or the amount of the maximum state death tax credit allowed an estate under section 2011 of the Code, the personal representative must, within ~~two years~~ six months after being notified of the correction or final determination by the federal government, file an estate tax return with the Secretary reflecting the correct amount of tax payable under this Article. If the federal government corrects or otherwise determines the amount of the maximum state generation-skipping transfer tax credit allowed under section 2604 of the Code, the person who made the

transfer must, within ~~two years~~six months after being notified of the correction or final determination by the federal government, file a tax return with the Secretary reflecting the correct amount of tax payable under this Article.

The Secretary must assess and collect any additional tax due as provided in Article 9 of this Chapter and must refund any overpayment of tax as provided in Article 9 of this Chapter. A person who fails to report a federal correction or determination in accordance with this section forfeits the right to any refund due by reason of the determination."

SECTION 4. G.S. 105-130.20 reads as rewritten:

"**§ 105-130.20. Federal corrections.**

If a taxpayer's federal taxable income is corrected or otherwise determined by the federal government, the taxpayer must, within ~~two years~~six months after being notified of the correction or final determination by the federal government, file an income tax return with the Secretary reflecting the corrected or determined taxable income. The Secretary shall determine from all available evidence the taxpayer's correct tax liability for the income year. As used in this section, the term 'all available evidence' means evidence of any kind that becomes available to the Secretary from any source, whether or not the evidence was considered in the federal correction or determination.

The Secretary shall assess and collect any additional tax due from the taxpayer as provided in Article 9 of this Chapter. The Secretary shall refund any overpayment of tax as provided in Article 9 of this Chapter. A taxpayer that fails to comply with this section is subject to the penalties in G.S. 105-236 and forfeits its rights to any refund due by reason of the determination."

SECTION 5. G.S. 105-159 reads as rewritten:

"**§ 105-159. Federal corrections.**

If a taxpayer's federal taxable income is corrected or otherwise determined by the federal government, the taxpayer must, within ~~two years~~ six months after being notified of the correction or final determination by the federal government, file an income tax return with the Secretary reflecting the corrected or determined taxable income. The Secretary shall determine from all available evidence the taxpayer's correct tax liability for the taxable year. As used in this section, the term 'all available evidence' means evidence of any kind that becomes available to the Secretary from any source, whether or not the evidence was considered in the federal correction or determination.

The Secretary shall assess and collect any additional tax due from the taxpayer as provided in Article 9 of this Chapter. The Secretary shall refund any overpayment of tax as provided in Article 9 of this Chapter. A taxpayer who fails to comply with this section is subject to the penalties in G.S. 105-236 and forfeits the right to any refund due by reason of the determination."

SECTION 6. G.S. 105-197.1 reads as rewritten:

"**§ 105-197.1. Federal corrections.**

If the amount of a taxpayer's net gifts is corrected or otherwise determined by the federal government, the taxpayer must, within ~~two years~~ six months after being notified of the correction or final determination by the federal government, file a gift tax return with the Secretary of Revenue reflecting the corrected or determined net gifts. The

Secretary of Revenue shall determine from all available evidence the taxpayer's correct tax liability for the taxable year. As used in this section, the term 'all available evidence' means evidence of any kind that becomes available to the Secretary from any source, whether or not the evidence was considered in the federal correction or determination.

The Secretary shall assess and collect any additional tax due from the taxpayer as provided in Article 9 of this Chapter. The Secretary shall refund any overpayment of tax as provided in Article 9 of this Chapter. A taxpayer who fails to comply with this section is subject to the penalties in G.S. 105-236 and forfeits the right to any refund due by reason of the determination."

SECTION 7. G.S. 105-130.17 is amended by adding a new subsection to read:

"(g) Any corporation that files a federal return pursuant to section 6072(c) of the Code shall file its return on or before the fifteenth day of the sixth month following the close of its income year"

SECTION 8. G.S. 105-155(a) reads as rewritten:

"(a) Where and When to File. – An income tax return shall be filed as prescribed by the Secretary at the place prescribed by the Secretary. The income tax return of every taxpayer reporting on a calendar year basis other than a taxpayer filing a federal return pursuant section 6072(c) of the Code shall be filed on or before the fifteenth day of April in each year, and the income tax return of every taxpayer reporting on a fiscal year basis other than a taxpayer filing a federal return pursuant to section 6072(c) of the Code shall be filed on or before the fifteenth day of the fourth month following the close of the fiscal year. The income tax return of every taxpayer filing a federal return pursuant to section 6072 of the Code shall be filed on or before the fifteenth day of the sixth month following the close of the taxable year. An information return shall be filed at the times prescribed by the Secretary. A taxpayer may ask the Secretary for an extension of time to file a return under G.S. 105-263."

SECTION 9. G.S. 105-151.11(b) reads as rewritten:

"(b) Employment Related Expenses. – The amount of employment-related expenses for which a credit may be claimed may not exceed ~~two thousand four hundred dollars ($2,400)~~three thousand dollars ($3,000) if the taxpayer's household includes one qualifying individual, as defined in section 21(b)(1) of the Code, and may not exceed ~~four thousand eight hundred dollars ($4,800)~~ six thousand dollars ($6,000) if the taxpayer's household includes more than one qualifying individual. The amount of employment-related expenses for which a credit may be claimed is reduced by the amount of employer-provided dependent care assistance excluded from gross income."

SECTION 10. Sections 1, 2, and 10 of this act are effective when they become law. Sections 3 through 6 of this act become effective July 1, 2006, and apply to federal determinations made on or after that date. Sections 7 through 9 of this act are effective for taxable years beginning on or after January 1, 2006.

DRAFT 2005-LYxz-284: IRC Update

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	February 8, 2006
Introduced by:		**Summary by:**	Y. Canaan Huie Committee Counsel
Version:	Draft 2005-LYxz-284		

SUMMARY: This bill would update the reference to the Internal Revenue Code used in defining and determining certain State tax provisions. In addition the bill would shorten the time span in which a taxpayer would have to file an amended estate, income, or gift tax return when the federal government corrects or otherwise determines the amount on which the tax is based. The bill also conforms the filing date for income tax returns for a nonresident alien to the federal dates. Finally, the bill would conform the amounts for the credit for child care and certain employment-related expenses to the amounts allowed for the corresponding federal credit.

CURRENT LAW: Currently the reference date for the Internal Revenue Code is January 1, 2005.

When the federal government corrects or otherwise determines the amount on which an estate, income, or gift tax is based, the taxpayer must file a State return within 2 years that reflects that change.

Nonresidents aliens are currently required to file State income tax returns before their federal returns are due.

Currently, the credit for child care and certain employment-related expenses may not be based on expenses in excess of $2,400 if the household includes one qualifying individual or $4,800 if the household includes more than one qualifying individual.

BILL ANALYSIS:

IRC Update

North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.[1] The General Assembly determines each year whether to update its reference to the Internal Revenue Code.[2] Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State law tracks federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. This bill would change the reference date from January 1, 2005, to January 1, 2006, effective when the bill become law.

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[1] North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

[2] The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power."

Between January 1, 2005, and January 1, 2006, there were four major pieces of federal legislation that made changes to the Internal Revenue Code. This federal legislation includes the Energy Tax Incentive Act of 2005 (P.L. 109-58) signed into law on August 8, 2005, the SAFE Transportation Equity Act of 2005 (P.L. 109-59) signed into law on August 10, 2005, the Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) signed into law on September 23, 2005, and the Gulf Opportunity Zone Act of 2005 (P.L. 109-135) signed into law on December 21, 2005.

Energy Tax Incentive Act of 2005 (P.L. 109-58) (hereinafter Energy Act)

Many of the changes made in this act involve tax credits for various activities. Because they are tax credits, these provisions do not have a direct impact at the State level. There are, however, several provisions that could have an impact at the State level, most of which involve the depreciation, amortization, or expensing of certain items.

- *Elimination of deduction for clean-fuel vehicles.* Under previous law, a taxpayer was allowed a deduction for the purchase of a qualified clean-fuel vehicle. A "qualified clean-fuel vehicle" is any motor vehicle that may be propelled by a clean-burning fuel such as natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity, or any other fuel at least 85% of which is methanol, ethanol, or other alcohol or ether. The maximum amount of the deduction varied depending on the type of vehicle purchased. The deduction began to be phased out in 2004, and was set to be eliminated after the 2006 taxable year. This act moves up the phase-out so that the deduction is eliminated after the 2005 taxable year. In place of the deduction, this act creates a new federal credit for alternative fuel motor vehicles.

- *Tax deferral for gains on electric transmission assets.* Under current law, a taxpayer may elect to recognize qualified gain from a qualifying electric transmission transaction over an eight-year period. In order for a transaction to be a "qualifying electric transmission transaction" numerous conditions must be satisfied, one of which is that the transaction must be completed before January 1, 2007. This act extends that date by one year to January 1, 2008.

- *Deduction for nuclear decommissioning costs.* Utilities that own or operate a nuclear power plant are required by law to decommission the plant at the end of its useful life. A utility may elect to deduct contributions it makes to a nuclear decommissioning reserve fund established to help pay the costs associated with the eventual decommissioning. For previous tax years, contributions to such a reserve fund were limited to the lesser of the amount of nuclear decommission costs allocable to the fund that is included in the taxpayer's cost of services for ratemaking purposes for the taxable year and the ruling amount. The "ruling amount" is a schedule obtained from the IRS that specifies the annual payments that must be made into the fund to cover of the amount of the decommission costs allocable to the fund over its existence. This act eliminates the "lesser of" test for taxable years beginning on or after January 1, 2006, and instead limits the deduction to the ruling amount.

- *Energy efficient commercial buildings property deduction.* Despite the fact that large commercial buildings use approximately one-fourth of the electrical energy consumed in the nation, there is currently no federal tax incentive to encourage the use of energy-efficient property in the construction or renovation of commercial buildings. This act allows taxpayers to claim a deduction (as opposed to depreciation or amortization) with respect to costs associated with energy-efficient commercial building property placed into service

between January 1, 2006, and January 1, 2008. The maximum amount that may be deducted is $1.80 per square foot of the building, less any amount deducted under this provision with respect to the same building in previous tax years. In order to qualify for the deduction, the following conditions must be satisfied: 1) The costs must be associated with depreciable or amortizable property that is installed in a commercial building that meets certain standards for energy efficiency; 2) The property is installed as part of the interior lighting, heating, cooling, ventilation, or hot water systems or the building envelope; and 3) The property is installed as part of a plan to reduce the total annual energy costs of the building with respect to the interior lighting, heating, cooling, ventilation, and hot water systems by at least 50% as compared to a similar building that meets certain minimum standards for energy efficiency. The IRS is required to issue regulations relating to eligibility for a partial deduction and to the transfer of a deduction from a public entity (like the State) to the person responsible for designing the property.

- *Recapture of section 197 amortization.* Generally, property subject to amortization under section 197 of the Code is intangible property that is purchased and held by a taxpayer in the course of a business. Section 197 property includes goodwill, covenants not to compete, patents, copyrights, trademarks and certain licenses. The cost of section 197 property is recoverable over fifteen years using straight-line depreciation. Under general rules, gain on the sale of depreciable property must be recaptured as ordinary income to the extent of depreciation deductions previously claimed. Under general rules, the recapture amount is computed separately for each piece of property. This act provides that if multiple pieces of section 197 property are sold or disposed of in a single transaction or series of transactions, then the taxpayer must compute the recapture as if all of the property were a single asset. The effect of this change is to maximize the amount of income treated as recapture, and thus as ordinary income, and the lessen the amount treated as a capital gain, which is taxed at a lower rate.

- *Depreciation of electric transmission property.* Generally, under the modified accelerated cost recovery system (MACRS) assets used in the transmission and distribution of electricity for sale have a 20-year recovery period. This act allows the costs of certain electric transmission property placed into service after April 11, 2005, to be recovered over 15 years instead of 20.

- *Expensing liquid fuel refineries.* Under previous law, petroleum refining assets were depreciated over a 10-year recovery period using the double declining balance method. Petroleum refining assets are assets used for distillation, fractionation, and catalytic cracking of crude petroleum into gasoline and other petroleum products. This acts allows a taxpayer to make an election to expense 50% of the cost of qualified refinery property in the year in which the property is placed into service. "Qualified refinery property" includes any portion of a qualified refinery that satisfies the following conditions: 1) The original use of the property commences with the taxpayer; 2) The property is placed in service between August 8, 2005, and January 1, 2012; 3) The property satisfies certain production capacity requirements; 4) The property satisfies all applicable environmental laws in effect when it is placed into service; 5) No written binding contract for the construction of the property was in effect on or before June 14, 2005; and 6) The construction of the property is subject to a written binding contract entered into before January 1, 2008. A "qualified refinery" is one that is located in the United States and that is designed to serve the primary purpose of processing liquid fuel from crude oil or qualified fuels (including shale and tar sands and coal

seams). The expensing election is not available with respect to a refinery that is used primarily as a topping plant, asphalt plant, lube oil facility, crude or product terminal, or blending facility.

- *Depreciation of natural gas distribution lines.* Under previous law, natural gas distribution lines installed by a gas company were depreciated over a 20-year period. This act allows natural gas depreciation lines placed in service between April 11, 2005, and January 1, 2011, to be depreciated over a 15-year period.
- *Depreciation of natural gas gathering pipelines.* Prior to the enactment of this act, there was a disagreement among the courts as to what asset class natural gas gathering pipelines owned by a nonproducer belonged. The IRS maintained, and this position was supported by the Tax Court, that these pipelines belonged to an asset class subject to depreciation over 15 years. The Courts of Appeals in the Sixth, Eighth, and Tenth Circuits, however, held that these pipelines belonged to an asset class subject to depreciation over 7 years. There was agreement that natural gas gathering pipelines owned by a producer were part of the asset class subject to depreciation over 7 years. This act clarifies that all natural gas gathering pipelines, regardless of ownership, are subject to depreciation over 7 years. This provision applies to natural gas gathering pipelines placed in service after April 11, 2005.
- *Geological and geophysical costs amortized over two years.* Geological and geophysical costs are those incurred for the purpose of accumulating data that serves as the basis for the decision about acquisition or retention of mineral rights by taxpayers in the business of exploring for minerals (including gas and oil). Courts have held these costs to be capital in nature and allocable to the property acquired or retained. If no property was acquired or retained, the costs were treated as a capital loss. This act provides that these costs, when incurred in the United States for oil or gas exploration, shall be amortized ratably over a 24-month period beginning on the mid-point of the taxable year in which the costs were incurred. The act does not affect the treatment of costs incurred outside of the United States or with respect to exploration for minerals other than oil or gas.
- *84-month amortization of air pollution control facilities.* Current law allows taxpayers to amortize a certified pollution control facility used in connection with a plant that was in operation before January 1, 1976, over a 60-month period. For certified pollution control facilities placed in service after April 11, 2005, this act eliminates the requirement that the property be used in connection with a plant that was in operation before 1976 if the plant is an electric generation plant that is primarily coal fired. For property that satisfies this criteria, the amortization period is 84-months. The act does not lengthen the amortization period for property that was covered by previous law, it provides a favored, though not as generously favored, method of depreciation for another class of property.

Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005 (P.L. 109-59) (hereinafter SAFE Act)

Although this act makes numerous tax changes at the federal level, these changes have little to no direct impact at the State level

Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) (hereinafter Katrina Act)

2005 was a record-setting year on the meteorological front. Not only did the year see a record number of named storms (27) and a record number of hurricanes (14), the year also included the costliest Atlantic hurricane on record and one of the deadliest, Hurricane Katrina. Hurricane Katrina made

landfall along the Gulf Coast on August 29, 2005, as a Category 4 storm. Hurricane Katrina resulted in the deaths of more than 1,400 people and caused over $80 billion in property damage.

In the aftermath of Hurricane Katrina, Congress took action to assist taxpayers in the affected region. On September 21, 2005, Congress passed the Katrina Emergency Tax Relief Act of 2005, which was signed into law by President Bush on September 23, 2005. The act is collection of tax relief provisions for individuals and businesses. Below, the key provisions of this act that could have an impact on State revenues are summarized.

General Provisions. The act contains definitions of several key phrases that are used throughout the act. Under the act, "Hurricane Katrina disaster area" means an area with respect to which a major disaster has been declared by the President before September 14, 2005, with respect to Hurricane Katrina. The states of Alabama, Florida, Louisiana, and Mississippi comprise the Hurricane Katrina disaster area. The act also defines the term "core disaster area." The core disaster area is a subset of the Hurricane Katrina disaster area that has been determined by the President to warrant individual or individual and public assistance from the federal government. The core disaster area covers certain counties and parishes in Alabama, Louisiana, and Mississippi.

Retirement Funds. The act contains a number of special rules related to retirement funds for people who lived in the Hurricane Katrina disaster area or the core disaster area. Generally, these provisions allow for a more liberal use of retirement funds for emergency needs than would otherwise be allowed without subjecting the taxpayer to some sort of penalty or disincentive. These provisions include the following:

- *Tax favored withdrawals from retirement plans for relief relating to Hurricane Katrina.* Generally, a withdrawal from a qualified retirement plan, a tax-sheltered annuity, an IRA, or an eligible deferred compensation plan maintained by a state or local government is included in taxable income in the year in which it is made. In addition, a distribution that is received before death, disability, or the age of 59 ½ is generally subject to a 10% early withdrawal tax. Some distributions are known as eligible rollover distributions and are not included in taxable income or subject to the 10% penalty tax. These distributions must be rolled over into another qualified retirement account within 60 days.

  This act provides an exception to the 10% early withdrawal tax in the case of a qualified Hurricane Katrina distribution[3] from a qualified retirement plan, tax-sheltered annuity, or IRA. In addition, any amount required to be included in income as a result of a qualified Hurricane Katrina distribution is included in income in installments over the three-year period beginning with the year in which the distribution is made rather than entirely within the year that the distribution is made. Finally, any amount of a qualified Hurricane Katrina distribution that is recontributed to an eligible retirement account within the three-year period is treated as a roll-over distribution and is not included in income.

- *Recontribution of withdrawals for home purchases cancelled due to Hurricane Katrina.* There is an exception to the 10% early withdrawal tax discussed above in the case of a qualified first-time homebuyer distribution from an eligible retirement account. A qualified first-time homebuyer distribution is one that does not exceed $10,000 and that is used within 120 days of the distribution for the purchase or construction of a principal residence of a

[3] A "qualified Hurricane Katrina distribution" is a distribution made from an eligible retirement plan on or after August 25, 2005, and before January 1, 2007, to an individual whose primary place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss due to Hurricane Katrina. The total amount of qualified Hurricane Katrina distributions to a taxpayer from all accounts may not exceed $100,000.

first-time homebuyer. If the distribution is not used for the purchase of the home within 120 days or is not rolled over into an eligible retirement account within 60 days, the distribution is included in income and is subject to the 10% early withdrawal tax.

This act allows a taxpayer that received a qualified distribution from a retirement account to recontribute that amount to an eligible retirement account without penalty. For the purposes of this provision, a "qualified distribution" is a distribution that was received after February 28, 2005, and before August 29, 2005, and that was to be used to purchase or construct a principal residence in the Hurricane Katrina disaster area, but the residence is not purchased or constructed because of Hurricane Katrina. Any portion of a qualified distribution may be contributed to an eligible retirement account and treated as a roll-over if it is recontributed between August 25, 2005, and February 28, 2006. Because it is treated as a roll-over, that portion will not be included in income or subject to the 10% early withdrawal tax.

- *Loans from qualified plans for relief relating to Hurricane Katrina.* An individual is allowed to borrow from an qualified employer plan in which the individual participates provided the loan satisfies certain conditions. Generally, a loan from a qualified employer plan is treated as a taxable distribution of plan benefits. A loan is not treated as a tax distribution of benefits to the extent that the loan, when added to the outstanding balance of all other loans to the individual from all plans maintained by the employer, does not exceed the lesser of 1) $50,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or 2) the greater of $10,000 or one half the individual's accrued benefit under the plan. For this exception to apply, the loan must have a repayment period of five years or less, must be amortized in level payments, and must have payments due at least quarterly.

  This act provides special rules in the case of a loan from a qualified plan to a qualified individual. For the purposes of this provision, a "qualified individual" is one whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss because of Hurricane Katrina. Under this provision, the loan limit discussed above is increased to the lesser of 1) $100,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or 2) the greater of $10,000 or the individual's accrued benefit under the plan.

  In addition, this act provides that in the case of a qualified individual with an outstanding loan from a qualified plan on or after August 25, 2005, if the due date for any repayment with respect to the loan occurs during the period from August 25, 2005, to December 31, 2006, the due date is delayed for one year.

Charitable Giving Incentives. In the wake of Hurricane Katrina, people from around the nation rushed to the aid of people in the affected areas with unprecedented amounts of charitable giving. As part of this act, Congress further encouraged and rewarded charitable giving.

- *Temporary suspension of limitations on charitable contributions.* In general, the income tax deduction allowed for charitable contributions is subject to limitations based on the type of taxpayer, the property contributed, and the donee organization. Subject to certain limitations discussed further below, the following general rules apply: 1) Contributions of cash are

deductible in the amount contributed; 2) Contributions of capital gain property[4] to a qualified charity are deductible at fair market value; 3) Contributions of other appreciated property are deductible at the donor's basis in the property; and 4) Contributions of depreciated property are deductible at the fair market value of the property.

Most contributions are subject to percentage limitations. For individuals, the amount deductible is limited to a percentage of the taxpayer's contribution base[5]. The percentage varies depending on the type of donee organization and the type of property contributed. Contributions by an individual of property other than appreciated capital gain property to a charitable organization described in section 170(b)(1)(A) of the Code (public charities, private foundations other than private non-operating foundations, and certain governmental units) are deductible up to 50% of the contribution base. Contributions of this type of property to nonoperating private foundations and certain other organizations are deductible up to 30% of the contribution base. Contributions of appreciated capital gain property to an organization described in section 170(b)(1)(A) of the Code are generally deductible up to 30% of the contribution base. A taxpayer may elect to bring all of these contributions of appreciated capital gain property under the 50% limitation by reducing the amount of the deduction by the amount of the appreciation of the property. Contributions of appreciated capital gains property to a private nonoperating foundation are deductible up to 20% of the contribution base. For corporations, charitable contributions are deductible up to 10% of the corporations taxable income computed without regard to net operating loss or capital loss carrybacks. For both individuals and corporations, excess charitable contributions may be carried forward for up to five years.

There is also an overall limitation on most itemized deductions for individuals. The total amount of otherwise allowable itemized deductions is reduced by three percent of the amount of the taxpayer adjusted gross income in excess of a certain threshold. However, the otherwise allowed deductions may not be reduced by more than 80%. This reduction is reduced to two percent for the 2006 and 2007 taxable years and to one percent for the 2008 and 2009 taxable years, is repealed for the 2010 taxable year, and is reinstated for the 2011 taxable year.

This act provides several exceptions to the limitations on charitable contribution deductions. For individuals, the deduction for qualified contributions is allowed up to the amount by which the taxpayer's contribution base exceeds the taxpayer's deductions for other charitable contributions. In most cases, this means that an individual may deduct charitable contributions up to 100% of the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. For corporations, the deduction for a qualified contribution is allowed up to amount by which the corporation's taxable income exceeds the deduction for other charitable contributions. For the purposes of these provisions, a "qualified contribution" is a cash contribution that is made between August 28, 2005, and December 31, 2005, to an organization described in section 170(b)(1)(A) of the Code. The term does not include a contribution of noncash property or one that is for the establishment or maintenance of a segregated fund or account with respect to which the donor reasonably expects to have advisory privileges with respect to the fund or account because of his status as donor. In the

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[4] "Capital gain property" means any capital asset or property used in the taxpayer's trade or business the sale which at its fair market value, at the time of contribution, would have resulted in a gain that would have been a long-term capital gain.

[5] The "contribution base" is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback.

case of a corporation, the contribution must be for relief efforts related to Hurricane Katrina in order to be a qualified contribution.

In addition, for individuals the charitable deduction contribution, up to the amount of qualified contributions, is not treated as an itemized deduction and is not subject to the reduction for higher-income taxpayers.

- *Additional exemption for housing Hurricane Katrina displaced individuals.* In the aftermath of Hurricane Katrina, hundreds of thousands of residents of the affected areas were displaced. During this time of displacement, many individuals opened their homes to those who had been displaced. Generally, individuals are allowed personal exemptions in computing taxable income. Personal exemptions are allowed for the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. Personal exemptions are phased out for higher-income taxpayers.

  This act allowed a taxpayer an additional $500 exemption for each Hurricane Katrina displaced individual of the taxpayer, up to a maximum additional exemption of $2,000. The additional exemption is not subject to the phase out for higher-income taxpayers. For the purposes of this provision, a "Hurricane Katrina displaced individual" is a person 1) whose principal place of abode on August 28, 2005, was in the Hurricane Katrina disaster area, 2) who was displaced from the abode, 3) who is provided housing free of charge in the taxpayer's principal place residence for a period of 60 consecutive days that ends in the taxable year in which the exemption is claimed, and 4) is not the spouse or dependent of the taxpayer. For a person whose principal place of abode on August 28, 2005, was outside of the core disaster area, the person's abode must have been damaged by Hurricane Katrina or the person must have been evacuated from the abode by reason of Hurricane Katrina.

- *Increase in standard mileage rate for charitable use of vehicles.* In determining the amount of the charitable contribution deduction when a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer may either deduct actual operating expenditures or use the charitable standard mileage rate. The charitable standard mileage rate, 14 cents per mile, is significantly less than the business standard mileage rate[6]. The charitable rate is less than the business rate because it is meant to offset direct operating expenses, such as gas, only and not other expenses, such as a depreciation, insurance, or general maintenance.

  This act allows a taxpayer who uses a vehicle in providing donated service to charity for Hurricane Katrina relief only to compute the charitable mileage deduction at a rate equal to 70% of the business standard mileage rate, rounded to the next highest cent, on the date of the contribution. In the alternative, the taxpayer may continue to use actual operating expenditures to determine the amount of the deduction.

- *Mileage reimbursement to charitable volunteers excluded from gross income.* Volunteer drivers who are reimbursed for mileage expenses have taxable income to the extent that the reimbursement exceeds deductible expenses computed using either direct expenses or the charitable standard mileage rate. Under this act, reimbursement for mileage expenses by a charitable organization described in section 170(c) of the Code to a volunteer for the costs of using a passenger vehicle for Hurricane Katrina relief only are not included in income to the

[6] For expenses incurred between January 1, 2005, and September 1, 2005, the standard business mileage rate was 40.5 cents per mile. For expenses incurred between September 1, 2005, and January 1, 2006, the standard business mileage rate was 48.5 cents per mile.

extent that the reimbursement does not exceed the amount that would be allowed using the business standard mileage rate. A taxpayer may not claim a deduction or credit for amounts excluded under this provision.

- *Charitable deduction for contribution of food inventories.* A taxpayer's deduction for charitable contributions of inventory is generally limited to the lesser of the taxpayer's basis in the inventory (usually cost) or the fair market value of the inventory. For certain contributions of inventory, a C corporation may claim an enhanced deduction equal to the lesser of 1) basis plus one-half on the item's appreciation or 2) two times basis. To be eligible for the enhanced deduction, the contributed property must generally be inventory of the corporation, contributed to a charitable organization described in section 501(c)(3) of the Code, and the donee must 1) use the property consistent with the donee's exempt purpose only for the care of the ill, the needy, or infants, 2) not transfer the property in exchange for money, other property, or services, and 3) provide the taxpayer with a written statement attesting to the proper use of the property.

  This act allows the enhanced deduction to any taxpayer engaged in a trade or business that makes a donation of food inventory. For taxpayers other than C corporations, the total deduction for contributions of food inventory may not exceed 10% of the taxpayer's income from all business entities from which a contribution of food inventory is made. The enhanced deduction is available only for food that qualifies as "apparently wholesome food," – food intended for human consumption that meets all quality and labeling standards imposed by federal, state, and local laws even though the food may not be readily marketable for any number of reasons.

- *Charitable deduction for contribution of book inventories.* A taxpayer's deduction for charitable contributions of inventory is generally limited to the lesser of the taxpayer's basis in the inventory (usually cost) or the fair market value of the inventory. For certain contributions of inventory, a C corporation may claim an enhanced deduction equal to the lesser of 1) basis plus one-half on the item's appreciation or 2) two times basis. To be eligible for the enhanced deduction, the contributed property must generally be inventory of the corporation, contributed to a charitable organization described in section 501(c)(3) of the Code, and the donee must 1) use the property consistent with the donee's exempt purpose only for the care of the ill, the needy, or infants, 2) not transfer the property in exchange for money, other property, or services, and 3) provide the taxpayer with a written statement attesting to the proper use of the property.

  This act extends the enhanced deduction for C corporations to qualified book contributions. A "qualified book contribution" is a charitable contribution of books to a public school that provides elementary education or secondary education and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils in attendance at the place where its education activities are regularly carried on.

Miscellaneous Provisions.

- *Exclusion for certain cancellations of indebtedness by reason of Hurricane Katrina.* Gross income includes income that is realized by a debtor for the discharge of indebtedness, subject to certain exceptions. This act provides that the gross income of a qualified individual does not include any amount which would otherwise by includible in gross income by reason of a

discharge of nonbusiness debt if the indebtedness is discharged by an applicable entity. The relief allowed under this provision does not apply to any indebtedness to the extent that real property outside of the Hurricane Katrina disaster area serves as security for the debts. For the purposes of this provision, a "qualified individual" is any natural person whose principal place of abode on August 25, 2005, was located 1) in the core disaster area or 2) in the Hurricane Katrina disaster area and the person suffered economic loss as a result of Hurricane Katrina. An "applicable entity" includes the following: a financial institution; a credit union; a corporation that is a direct or indirect subsidiary of a financial institution or credit union and as such is subject to regulation by federal or state agencies; the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union Administration, and certain other federal executive agencies; an executive, judicial, or legislative agency; and any other organization the for whom the lending of money is a significant trade or business.

- *Suspension of certain limitations on personal casualty losses.* A taxpayer may generally claim a deduction for any loss sustained during the taxable year for which he is not compensated by insurance or otherwise. For individuals, the loss must be incurred in a trade or business or consist of property loss attributable to casualty or theft. Losses are deductible only if they exceed $100 per casualty or theft and total casualty and theft losses exceed 10% of the taxpayer's adjusted gross income. This act removes the $100 and 10% limitations on casualty and theft losses to the extent those losses are in the Hurricane Katrina disaster area on or after August 25, 2005, and are attributable to Hurricane Katrina.

- *Required exercise of IRS administrative authority.* In general, the Secretary of the Treasury may grant reasonable extensions of time to taxpayers to perform certain acts. In addition, for certain military personnel, the time period for performing certain acts (such as filing returns, paying taxes, bringing suit) is automatically suspended. In the case of a Presidentially declared disaster or terroristic or military action, the Secretary has the authority to prescribe a period of up to one year in which the time period for the same actions is suspended. This act requires the Secretary to suspend those time periods at least until February 28, 2006, for taxpayers determined to have been affected by the Presidentially declared disaster relating to Hurricane Katrina. In addition, this act adds employment and excise taxes to the list of taxes for which the Secretary may extend filing and payment time periods.

- *Special rules for mortgage revenue bonds.* A qualified mortgage bond is a type of private activity bonds for which interest is excluded from gross income. Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences and to finance qualified home improvement loans. There are several limitations on qualified mortgage bonds, including income limitations for homebuyers, purchase price limitations, and a the requirement that the mortgagor be a "first-time homebuyer" – one that did not have any ownership interest in a primary residence for the previous three years. The first-time home buyer requirement does not apply to targeted area residences – one that is located in an area of chronic economic distress or a census tract in which at least 70% of the families have an income that is 80% or less of the statewide median income. A qualified home improvement loan may not exceed $15,000.

  This act eliminates the first-time homebuyer requirement with respect to qualified Hurricane Katrina recovery residences. A "qualified Hurricane Katrina recovery residence" is one that

is financed before January 1, 2008, and is either 1) located in the core disaster area or 2) the mortgagor of which owned a principal residence in the Hurricane Katrina disaster area that was rendered uninhabitable by Hurricane Katrina and the residence financed is in the same state as the previous residence.

The act also increases the maximum amount of a qualified home improvement loan to $150,000 for residences located in the Hurricane Katrina disaster area to the extent that the loan is for repair of damage caused by Hurricane Katrina.

- *Extension of replacement period for nonrecognition of gain.* A taxpayer generally realizes gain to the extent the sales price of property exceeds the taxpayer's basis in the property. The realized gain is subject to taxation unless it is deferred or not recognized under some special provision. Gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer replaces the property within the applicable period. The applicable period begins when property is converted and ends two years after the close of the first taxable year in which the gain is realized.

  This act extends the applicable period from two years to five years for property that is located within the Hurricane Katrina disaster area that is compulsorily or involuntarily converted after August 25, 2005, by reason of Hurricane Katrina. Substantially all of the use of the replacement property must be in this area for this provision to apply.

- *Secretarial authority to make adjustments regarding taxpayer and dependency status for taxpayers affected by Hurricane Katrina.* This provision allows the Secretary of the Treasury to make adjustments to the tax laws to ensure that taxpayers do not lose eligibility for credits or deductions or experience a change in filing status due to temporary relocations caused by Hurricane Katrina. An example of such an adjustment would be allowing a parent to claim a personal exemption for a child even if the child did not satisfy the residency requirement as a result of a relocation due to Hurricane Katrina. Any adjustment must ensure that an individual is not taken into account by more than one taxpayer with respect to the same benefit.

Gulf Opportunity Zone Act of 2005 (P.L. 109-135) (GO Act)

The Gulf Opportunity Zone Act of 2005 expanded upon the relief offered in the Katrina Emergency Tax Relief Act of 2005. In some instances, this expansion meant extending the additional benefits allowed under the Katrina Act to taxpayers affected by Hurricanes Rita or Wilma. In other cases, the expansion created new tax benefits for taxpayers in one or more of the disaster areas. The act also made numerous technical corrections.

General Provisions. First, the GO Zone Act added several new definitions. First, the "Gulf Opportunity Zone" or "GO Zone" is a subset of the Hurricane Katrina disaster area that has been determined by the President to warrant individual or individual and public assistance from the federal government and is the same as the "core disaster area" under the Katrina Act. The "Hurricane Rita disaster area" means an area with respect to which the President has declared a major disaster before October 6, 2005, with respect to Hurricane Rita. The "Hurricane Wilma disaster area" means an area with respect to which the President has declared a major disaster before November 14, 2005, with respect to Hurricane Wilma. The "Rita GO Zone" and "Wilma GO Zone" are, respectively, the portions of the Hurricane Rita disaster area and Hurricane Wilma disaster area that have been determined by the President to warrant individual or individual and public assistance from the federal government.

Extensions of Hurricane Katrina benefits. The GO Zone Act extended some of the benefits of the Katrina Act to areas affected by Hurricanes Rita and Wilma. The following changes fall into this category.

- *Retirement plans.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical to those discussed under the Katrina Act with some timing differences related to the different dates of the three storms.
- *Casualty losses.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical to that discussed under the Katrina Act with some timing differences related to the different dates of the three storms.
- *Secretarial authority to make adjustments.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical to those discussed under the Katrina Act with some timing differences related to the different dates of the three storms.
- *Mortgage revenue bonds.* The first-time homebuyer requirement is eliminated for residences in the Rita GO Zone or the Wilma GO Zone. In addition, the increased maximum amount of a qualified home improvement loan is applied to residences in the Rita GO Zone and the Wilma GO Zone.

Housing relief for Hurricane Katrina. As discussed above, the Katrina Act provided some relief to individuals who provided housing for Hurricane Katrina evacuees. In this act, Congress provided further tax relief relating to housing expenditures. Employer-provided housing is generally included in income as a form of compensation. An exception to this general rule exists when an employee is required to accept the lodging on business premises as a condition of employment. This act provides that a qualified employee's gross income does not include the value of any in-kind lodging furnished to the employee, the employee's spouse, or the employee's dependents by or on behalf of the qualified employer. The exclusion applies only to lodging furnished during the six-month period beginning January 1, 2006 and may not exceed $600 for any month in which lodging is furnished. For the purposes of this provision, a "qualified employee" is an individual who on August 28, 2005, had a principal residence in the GO Zone and who performs substantially all of his or her employment services in the GO Zone for a qualified employer. For the purposes of this provision, a "qualified employer" is an employer with a trade or business located in the GO Zone.

Depreciation and expensing.

- *Bonus depreciation for Gulf Opportunity Zone property.* In 2002 and 2003, Congress acted to allow for bonus depreciation (either 30% or 50% depending on when the property was purchased) for property that was purchased after September 10, 2001. In order to qualify for the bonus depreciation, the property had to have been placed into service before January 1, 2005. For certain transportation property, noncommercial aircraft, or property with a long production period, the property must have been placed into service before January 1, 2006.

  This act allows a taxpayer to claim an additional first-year depreciation allowance equal to 50% of the adjusted basis of qualified Gulf Opportunity Zone property acquired on or after August 25, 2005, and placed into service before January 1, 2008 (the sunset date is January 1, 2009, for nonresidential real property and residential rental property). "Qualified Gulf

Opportunity Zone property must satisfy all of the following conditions: 1) It must be depreciable modified accelerated cost recovery systems (MACRS) recovery property with a recovery period of 20 years or less, MACRS water utility property, qualified leasehold improvement property, off-the-shelf computer software, residential rental property, or nonresidential real property; 2) Substantially all use of the property must be in the active conduct of a trade or business of the taxpayer in the GO Zone; 3) The original use of the property in the GO Zone must commence with the taxpayer on or after August 25, 2005; 4) The property must be purchased on or after August 25, 2005; 5) No written binding contract for the purchase of the property may be in effect before August 25, 2005; and 6) The property must be placed in service before January 1, 2008 (January 1, 2009 for nonresidential real property and residential rental property). The term does not include property that is 1) mandatory alternative depreciation system (ADS) property; 2) tax-exempt bond-financed property; 3) qualified revitalization buildings or rehabilitation expenditures for which a deduction under section 1400I of the Code is claimed; or 4) property used in connection with a private or commercial golf course, a country club, a massage parlor, a hot tub facility, a suntan facility, a liquor store, or a gambling or animal racing property.

In addition, this act allows the Secretary to extend the placed-in-service date for noncommercial aircraft and property with longer production periods for up to one year. This extension is granted on a case-by-case basis and may only be granted if the delay in placing the property into service was caused by one of the three hurricanes and the property is placed in service in the GO Zone, the Rita GO Zone, or the Wilma GO Zone.

- *Increase in limits on section 179 deductions.* Certain taxpayers may elect to claim a section 179 expense deduction on the cost of qualifying property rather than depreciating the property over time. For the 2003 through 2007 tax years, the maximum amount of the deduction is limited to $100,000, indexed for inflation.[7] This limitation is increased by $35,000 for property that is placed in service in the New York Liberty Zone, an empowerment zone, or a renewal community. The amount of the section 179 deduction is reduced to the extent that the total amount of property placed into service exceeds an investment threshold, currently set at $400,000, indexed for inflation.[8] The section 179 deduction may not exceed a taxpayer's taxable income from the active conduct of a trade or business.

  This act increases the maximum section 179 deduction for qualified GO Zone property by the lesser of $100,000 or the amount of property placed into service in the GO Zone. In addition it increases the total investment limitation by the lesser of $600,000 or the amount of property placed into service in the GO Zone. The increased amounts apply to property acquired on or after August 25, 2005, and placed into service before January 1, 2008. "Qualified GO Zone property" must satisfy all of the following conditions: 1) It must be depreciable modified accelerated cost recovery systems (MACRS) recovery property with a recovery period of 20 years or less; 2) Substantially all use of the property must be in the active conduct of a trade or business of the taxpayer in the GO Zone; 3) The original use of the property in the GO Zone must commence with the taxpayer on or after August 25, 2005; 4) The property must be purchased on or after August 25, 2005; 5) No written binding contract for the purchase of the property may be in effect before August 25, 2005; and 6) The

[7] The adjusted dollar limitation is $105,000 for 2005 and $108,000 for 2006.
[8] The adjusted investment limitation is $420,000 for 2005 and $430,000 for 2006.

property must be placed in service before January 1, 2008. The term does not include property used in connection with a private or commercial golf course, a country club, a massage parlor, a hot tub facility, a suntan facility, a liquor store, or a gambling or animal racing property.

- *Deduction for demolition and clean-up costs.* Under general law, demolition costs are capitalized and added to the basis of the land on which the demolished building was located. The tax treatment of debris removal costs depends on the nature of the costs incurred. Debris removal costs that are in the nature of replacement must be capitalized and added to the basis of the property damaged. Other times, debris removal costs may be used to show a decrease in the fair market value of property which could be used to determine the amount of a casualty loss. This act allows a taxpayer to claim a current deduction for 50% of any qualified Gulf Opportunity Zone clean-up costs paid between August 25, 2005, and January 1, 2008. For the purposes of this provision, a "qualified Gulf Opportunity Zone clean-up cost" is an amount paid for the removal of debris, or the demolition of structures, on real property located in the GO Zone if the real property is either held by the taxpayer for use in a trade or business or is inventory in the hands of the taxpayer.

- *Environmental remediation costs.* Under previous law, a taxpayer may elect to deduct, rather than capitalize, certain environmental remediation expenditures incurred in connection with property used in a trade or business for the production of income. This provision expired for expenditures incurred after December 31, 2005. This act extends the expiration date for that provision until December 31, 2007 for qualified environmental remediation expenditures incurred in connection with a qualified site in the GO Zone. In addition, expenditures incurred on or after August 25, 2005, with respect to petroleum products in the GO Zone are included in the deduction.

Federal Determinations.

This bill would reduce the period of time in which a taxpayer must report a federal change from two years to six months. When the federal government corrects or otherwise determines the amount of an estate, gift, or income that is subject to tax, the taxpayer must file a State return that reflects that change. This is so because the State estate, gift, and income taxes are, to varying degrees, based on amounts determined with respect to federal law. The Multistate Tax Commission has adopted a model uniform statute for reporting federal changes. That model uniform statute requires a taxpayer to report those changes within six months. The model statute is intended to bring uniformity to this area among the states. Currently there is a great deal of variety with some states requiring changes to be reported in as little as 90 days to as much as two years. This provision becomes effective July 1, 2006, and applies to federal determinations made on or after that date.

Filing period for nonresident aliens.

Section 6072(c) of the Code requires a nonresident alien to file an income tax return on or before the fifteenth day of the sixth month following the close of the taxable year (June 15th for taxpayer whose taxable year is the calendar year). Under current State law, nonresident alien corporate taxpayers must file a State return by the fifteenth day of the third month following the close of the taxable year (March 15th for a calendar year taxpayer) and nonresident alien individual taxpayers must file a State return by the fifteenth day of the fourth month following the close of the taxable year (April 15th for a calendar year taxpayer). Thus, under current State law a nonresident alien is required to file a State income tax return before the federal tax return is due. This provision would conform the State filing deadlines to

the federal filing deadlines for nonresident aliens and would ease compliance burdens on those taxpayers. These provisions become effective for taxable years beginning on or after January 1, 2006.

Credit for child-care and certain employment-related expenses.

Current State law allows a credit to a taxpayer who is eligible for the federal credit for child-care and employment-related expenses. The amount of the credit is based on a percentage of those expenses up to a certain amount. For the State credit, the amount of expenses that may be taken into consideration when computing the credit are capped at $2,400 when there is one qualifying individual in the household and $4,800 when there is more than one qualifying individual in the household. Until 2003, these limits were the same as those at the federal. In 2003, the federal limits increased to $3,000 and $6,000 respectively. This provision would conform the State limits to the federal limits. This provision also clarifies that the amount of expenses used in calculating the credit may not include any amount excluded from gross income. This provision becomes effective for taxable years beginning on or after January 1, 2006.

0284Draft-SMLY-LYx-284

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-LAz-18 [v.7] (1/24)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/7/2006 2:06:02 PM

Short Title: Property Tax Changes. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO MAKE CLARIFYING CHANGES TO THE PROPERTY TAX LAWS.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-304(a1) reads as rewritten:

"(a1) Electronic Listing. – The board of county commissioners may, by resolution, provide for electronic listing of ~~business~~ personal property in accordance with procedures prescribed by the board. If the board of county commissioners allows electronic listing of ~~business~~ personal property, the assessor must publish this information, including the timetable and procedures for electronic listing, in the notice required by G.S. 105-296(c)."

SECTION 2. G.S. 105-307 reads as rewritten:

"**§ 105-307. Length of listing period; extension; preliminary work.**

(a) Listing Period. – Unless extended as provided in this section, the period during which property is to be listed for taxation each year begins on the first business day of January and ends on January 31.

(b) General Extensions. – The board of county commissioners may, by resolution, extend the time during which property is to be listed for taxation as provided in this subsection. Any action by the board of county commissioners extending the listing period must be recorded in the minutes of the board, and notice of the extensions must be published as required by G.S. 105-296(c). The entire period for listing, including any extension of time granted, is considered the regular listing period for the particular year within the meaning of this Subchapter.

(1) In nonrevaluation years, the listing period may be extended for up to 30 additional days.

(2) In years of octennial appraisal of real property, the listing period may be extended for up to 60 additional days.

(3) If the county has provided for electronic listing of ~~business~~ personal property under G.S. 105-304, the period for electronic listing of business personal property may be extended up to June 1.

(c) Individual Extensions. – The board of county commissioners shall grant individual extensions of time for the listing of real and personal property upon written request and for good cause shown. The request must be filed with the assessor no later than the ending date of the regular listing period. The board may delegate the authority to grant extensions to the assessor. Extensions granted under this subsection shall not extend beyond April 15. If the county has provided for electronic listing of ~~business~~ personal property under G.S. 105-304, the period for electronic listing of business personal property is as provided in subsection (b) of this section.

(d) Preliminary Work. – The assessor may conduct preparatory work before the listing period begins, but may not make a final appraisal of property before the day as of which the value of the property is to be determined under G.S. 105-285."

SECTION 3. G.S. 105-330.10 reads as rewritten:

"**§ 105-330.10. (Effective until July 1, 2009) Disposition of interest.**

Sixty percent (60%) of the first month's interest collected on unpaid taxes pursuant to G.S. 105-330.4 shall be transferred on a monthly basis to the Combined Motor Vehicle and Registration Account created within the Treasurer's Office. The North Carolina Association of County Commissioners shall direct the Treasurer to distribute the funds in the Account to the Division of Motor Vehicles for the purpose of developing and implementing an integrated computer system within the Division of Motor Vehicles that would allow for the combined assessment, billing, and collection of property taxes on motor vehicles and the issuance of registration plates. The Treasurer shall report to the Revenue Laws Study Committee semiannually with the first report due by April 30, 2006. The report shall contain a detailed description of the amount of moneys transferred to the Account and distributed from the Account."

SECTION 4. G.S. 105-277.4 is amended by adding a new subdivision to read:

"(a1) Late Application. – Upon a showing of good cause by the applicant for failure to make a timely application as required by subsection (a) of this section, an application may be approved by the board of equalization and review or, if that board is not in session, by the board of county commissioners. An untimely application approved under this subsection applies only to property taxes levied by the county or municipality in the calendar year in which the untimely application is filed. Decisions of the county board may be appealed to the Property Tax Commission."

SECTION 5. G.S. 105-321(d) is repealed.

SECTION 6. G.S. 105-378 is amended adding a new subsection to read:

"(d) Enforcement and Collection Delayed Pending Appeal. -- When the board of county commissioners or municipal governing body delivers a tax receipt to a tax collector for any assessment that has been appealed to the Property Tax Commission, the tax collector may not seek collection of taxes or enforcement of a tax lien resulting from the assessment until the appeal has been finally adjudicated. The tax collector, however, may send an initial bill or notice to the taxpayer."

SECTION 7. G.S. 105-373(a) reads as rewritten:

"(a) Annual Settlement of Tax Collector. –

(1) Preliminary Report. – After July 1 and before he is charged with taxes for the current fiscal year, the tax collector shall make a sworn report to the governing body of the taxing unit showing:

a. A list of the persons owning real property whose taxes for the preceding fiscal year remain unpaid and the principal amount owed by each person; and

b. A list of the persons not owning real property whose personal property taxes for the preceding fiscal year remain unpaid and the principal amount owed by each person. (To this list the tax collector shall append his statement under oath that he has made diligent efforts to collect the taxes due from the persons listed out of their personal property and by other means available to him for collection, and he shall report such other information concerning these taxpayers as may be of interest to or required by the governing body, including a report of his efforts to make collection outside the taxing unit under the provisions of G.S. 105-364.) The governing body of the taxing unit may publish this list in any newspaper in the taxing unit. The cost of publishing this list shall be paid by the taxing unit.

(2) Insolvents. – Upon receiving the report required by subdivision (a)(1), above the governing body of the taxing unit shall enter upon its minutes the names of persons owing taxes (but who listed no real property) whom it finds to be insolvent, and it shall by resolution designate the list entered in its minutes as the insolvent list to be credited to the tax collector in his settlement.

(3) Settlement for Current Taxes. – After July 1 and before he is charged with taxes for the current fiscal year, the tax collector shall make full settlement with the governing body of the taxing unit for all taxes in his hands for collection for the preceding fiscal year.

a. In the settlement the tax collector shall be charged with:

1. The total amount of all taxes in his hands for collection for the year, including amounts originally charged to him and all amounts subsequently charged on account of discoveries;

2. All penalties, interest, and costs collected by him in connection with taxes for the current year; and

3. All other sums collected by him.

b. The tax collector shall be credited with:

1. All sums representing taxes for the year deposited by him to the credit of the taxing unit or receipted for by a proper official of the unit;

2. Releases duly allowed by the governing body;

3. The principal amount of taxes constituting liens on real property;
4. The principal amount of taxes included in the insolvent list determined in accordance with subdivision (a)(2), above;
5. Discounts allowed by law; ~~and~~
6. Commissions (if any) lawfully payable to the tax collector as ~~compensation.~~compensation; and
7. The principal amount of taxes for any assessment appealed to the Property Tax Commission when the appeal has not been finally adjudicated.

The tax collector shall be liable on his bond for both honesty and faithful performance of duty; for any deficiencies; and, in addition, for all criminal penalties provided by law.

The settlement, together with the action of the governing body with respect thereto, shall be entered in full upon the minutes of the governing body.

(4) Disposition of Tax Receipts after Settlement. – Uncollected taxes allowed as credits in the settlement prescribed in subdivision (a)(3), above, whether represented by tax liens held by the taxing unit or included in the list of insolvents, shall, for purposes of collection, be recharged to the tax collector or charged to some other person designated by the governing body of the taxing unit under statutory authority. The person charged with uncollected taxes shall:

a. Give bond satisfactory to the governing body;
b. Receive the tax receipts and tax records representing the uncollected taxes;
c. Have and exercise all powers and duties conferred or imposed by law upon tax collectors; and
d. Receive compensation as determined by the governing body."

SECTION 8. This act is effective when it becomes law.

BILL ANALYSIS OF LEGISLATIVE PROPOSAL #: Property Tax Changes

BILL ANALYSIS

Committee:	Revenue Laws	**Sponsor:**	
Date:	February 8, 2006	**Analysis by:**	Martha Walston Committee Counsel
Version:	2005-LAz-18		

SUMMARY: This bill is a recommendation of the Department of Revenue and would make the following clarifying changes to the property tax laws:

- *Provides for the electronic filing of both business and individual personal property.*
- *Amends S.L. 2005-294 (AN ACT TO CREATE A COMBINED MOTOR VEHICLE REGISTRATION RENEWAL AND PROPERTY TAX COLLECTION SYSTEM) to clarify that the first month's interest on past due bills would be transferred to a special account. This change reflects the intent of the bill sponsors and supporters.*
- *Authorizes a county board of equalization and review to approve a late application for present-use value appraisal of property if the applicant demonstrates good cause for the delay.*
- *Authorizes a tax collector to receive tax receipts for assessments that have been appealed to the Property Tax Commission and to send the taxpayer an initial tax bill or notice; however, the tax collector may not collect on the tax or enforce a tax lien until the appeal has been finally adjudicated.*

BILL ANALYSIS:

Sections 1 and 2 of the bill provides for the electronic filing of any personal property. Current law allows the board of county commissioners, by resolution, to provide for the electronic listing of business personal property. This language excludes the electronic filing of unlisted automobiles, jet skis, mobile homes, and boats by personal taxpayers. The Department states that there is no reason to limit electronic filing to business personal property.

Current law allows the period for electronic listing of business personal property to be extended to June 1. Section 2 of the bill clarifies that this extension is provided only to business personal property.

Section 3 of the bill makes a clarifying change to legislation that was enacted during the 2005 Session. This change would clarify the intent of the bill's sponsors and supporters. Last Session, the General Assembly ratified House Bill 1779, which creates a combined system for registration and taxation of motor vehicles to become effective July 1, 2009, or upon the earlier creation of a combined registration renewal and tax collection computer system within the Division of Motor Vehicles. Under the new combined system, consumers will receive one statement per registered vehicle, containing both registration fees and the property taxes and vehicle fees due. Payment of the property taxes are a prerequisite to issuance of or renewal for

the registration. Property taxes on the vehicle become due on the date a new registration is applied for or at the end of the grace period following the expiration of a vehicle's current registration. Taxes and registration fees may be collected by the DMV or a DMV agent.

To pay for the new system, the act increased the first month's interest on delinquent registered motor vehicle taxes from 2% to 5%, effective January 1, 2006, and required that 60% of the interest collected on unpaid taxes be transferred on a monthly basis to the Combined Motor Vehicle and Registration Account in the Treasurer's Office. Funds in this Account may only be transferred to the DMV for the purpose of implementing the combined system, at the direction of the North Carolina Association of County Commissioners. The intent of the sponsors to House Bill 1779 and supporters of the bill was that 60% of only the **first month's** interest would be transferred to the Account, not the total interest collected on unpaid taxes. In December, 2005, the North Carolina Department of State Treasurer issued a memorandum directing counties to only remit 60% of the first month's interest to the Treasurer. The memorandum stated that this was the true intent of the bill and that it is anticipated that the language will be corrected during the 2006 Session. The memorandum was sent to all county managers, finance officers, tax administrators, tax assessor, tax collectors, and certified public accountants.

Section 4 of the bill would give a county board of equalization and review the authority to approve a late application for present-use value appraisal of property if the applicant demonstrates good cause for the delay. Under current law, a taxpayer seeking present-use value appraisal of farmland, must file the application within the following time periods:

- An initial application must be filed during the regular listing period of the year for which the benefit of the classification is first claimed, or within 30 days of the date shown on a notice of a change in valuation made pursuant to a county's general reappraisal or horizontal adjustment of real property.
- An application required due to transfer of the land may be submitted at any time during the calendar year but must be submitted within 60 days of the date of the property's transfer.

The bill would allow approval of a late application upon a showing of good cause by the applicant to the board of equalization and review. If the county board of equalization and review is not in session, then the late filing may be approved by the board of county commissioners. Current law allows similar approval for late applications for property tax exemptions or exclusions. (G.S. 105-282.1(a1).)

Sections 5 and 6 of the bill would allow a tax collector to receive tax receipts for assessments that have been appealed to the Property Tax Commission, but would prohibit the tax collector from collecting the tax or enforcing a tax lien resulting from the assessment until the appeal has been finally adjudicated. Pending final adjudication, the tax collector may send an initial tax bill or notice to the taxpayer.

Each year, the county board of commissioners or the municipal governing body directs the tax collector to collect taxes charged in the tax records and receipts. The tax receipt sets out the name and address of the taxpayer, the assessment of the taxpayer's property, the rate of ta

levied, and the amount of property taxes and any penalties due. Current law states that no tax receipts are to be delivered to the tax collector for any assessment appealed to the Property Tax Commission until the appeal has been finally adjudicated. In practice, boards of equalization and review often adjourn on June 30th, except to hear appeals filed prior to June 30th. By August 1, however, the tax collector has received the tax receipts. The proposal validates this practice, but clarifies that the tax collector may not seek any remedies for collection of the taxes or enforcement of the tax lien pending final adjudication of appeal from the assessment. The tax collector, however, may send an initial bill or notice to the taxpayer pending final adjudication. By providing notice pending appeal, the taxpayer may choose to avoid the amount of interest that accrues while the appeal is pending. If the taxpayer wins on appeal, the taxpayer receives a refund of any taxes paid plus interests. Finally, the proposal would put a potential buyer of the property on notice of a tax bill, if the property is transferred pending the appeal.

Section 7 of the bill makes clarifying changes to the lists of items credited to the tax collector in the collector's final settlement with the governing body for all taxes in his hands for collection for the preceding fiscal year. Current law provides that the final settlement must contain the items to be charged against the tax collector and the items to be allowed as credits for the collector.[1] The charges and credits should balance. The proposal adds to the lists of credits the principal amount of taxes for any assessment appealed to the Property Tax Commission when the appeal has not been finally adjudicated.

[1] Charges include the total amount of all taxes placed in the collector's hands for collection for the year, all late-listing penalties and costs collected by the collector, all interests on taxes collected by the collector, and any other sums collected or received by the tax collector. Credits include all sums deposited by the collector to the credit of the taxing unit, releases allowed by the governing body, discounts allowed for early payment of taxes, the principal amount of taxes constituting liens against real property, the principal amount of taxes determined to be insolvent and to be allowed as credits, and any commission the collector is entitled to deduct from amounts collected.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: January 8, 2006

TO: Revenue Laws

FROM: Rodney Bizzell
Fiscal Research Division

RE: Property Tax Changes

FISCAL IMPACT

Yes ( ) **No (X)** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:	No Significant Impact				
EXPENDITURES:					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue, North Carolina Local Governments

EFFECTIVE DATE: Becomes effective when law.

BILL SUMMARY:
Sections 1 and 2 of the bill provide for the electronic filing of personal property. Currently, counties are allowed to provide for electronic listing only for business personal property. The Department indicates no reason that this listing mechanism should not be allowed for all personal property. Current law allows the period for electronic listing of business personal property to be extended to June 1. Section 2 of this bill clarifies that this extension is provided only to business personal property.

Section 3 of the bill makes a clarifying change to House Bill 1779, which was enacted during the 2005 Session. The bill creates a combined system for registration and taxation of motor vehicles. The bill increases the first-month interest payments on unpaid vehicle property taxes from 2% to

5% and directs 60% of interest revenue to a special account within the Department of State Treasurer for the purpose of creating a registration renewal and property tax collection computer system within the Division of Motor Vehicles. The intent of the bill, and the practice put into place by the Department of State Treasurer, is to transfer 60% of only the first month of interest on unpaid taxes to the special account. This bill clarifies that the transfer applies to only the month of interest.

Section 4 of the bill would give county boards of equalization and review the authority to approve a late application for present-use value appraisal of property if the applicant demonstrates a good cause for the delay. Current law allows similar approvals for property tax exemptions or exclusions.

Sections 5 and 6 of the bill would allow tax collectors to receive tax receipts for assessments that have been appealed to the Property Tax Commission, but would not allow the collector to collect the tax or enforce a tax lien resulting from the assessment while the appeal is pending. This bill would validate the current practice in which boards of equalization provide tax receipts to collectors by August 1, but clarifies that the collector may not seek remedies for appealed assessments until the appeal is adjudicated.

Section 7 of the bill makes a clarifying change to add taxes appealed to the Property Tax Commission to the list of items credited to the tax collector in the collector's final settlement with the governing body.

ASSUMPTIONS AND METHODOLOGY: All of the proposed changes contained in the bill are administrative or clarifying in nature and would result in no significant fiscal impact.

SOURCES OF DATA: North Carolina Department of Revenue

TECHNICAL CONSIDERATIONS: None

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-SVz-10 [v.9] (01/24)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/8/2006 10:16:03 AM

Short Title: Revenue Laws Technical Changes. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO MAKE TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES TO THE REVENUE LAWS AND RELATED STATUTES.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-113.82(a) reads as rewritten:

"**§ 105-113.82. Distribution of part of beer and wine taxes.**

(a) Amount, Method. – The Secretary shall distribute annually the following percentages of the net amount of excise taxes collected on the sale of malt beverages and wine during the preceding 12-month period ending March 31, less the amount of the net proceeds credited to the Department of ~~Agriculture and Consumer Services~~ Commerce under G.S. 105-113.81A, to the counties and cities in which the retail sale of these beverages is authorized in the entire county or city:

(1) Of the tax on malt beverages levied under G.S. 105-113.80(a), twenty-three and three-fourths percent (23¾%);

(2) Of the tax on unfortified wine levied under G.S. 105-113.80(b), sixty-two percent (62%); and

(3) Of the tax on fortified wine levied under G.S. 105-113.80(b), twenty-two percent (22%).

If malt beverages, unfortified wine, or fortified wine may be licensed to be sold at retail in both a county and a city located in the county, both the county and city shall receive a portion of the amount distributed, that portion to be determined on the basis of population. If one of these beverages may be licensed to be sold at retail in a city located in a county in which the sale of the beverage is otherwise prohibited, only the city shall receive a portion of the amount distributed, that portion to be determined on the basis of population. The amounts distributed under subdivisions (1), (2), and (3) shall be computed separately."

SECTION 2. G.S. 105-122(d) reads as rewritten:

"(d) After determining the proportion of its total capital stock, surplus and undivided profits as set out in subsection (c) of this section, which amount ~~so determined~~ shall ~~in no case~~ not be less than fifty-five percent (55%) of the appraised value as determined for ad valorem taxation of all the real and tangible personal property in this State of each ~~such~~ corporation ~~plus the total appraised value of intangible property returned for taxation of intangible personal property as herein specified~~ nor less than its total actual investment in tangible property in this State, every corporation taxed under this section shall annually pay to the Secretary of Revenue, at the time the report and statement are due, a franchise or privilege ~~tax, which is hereby levied~~ tax at the rate of one dollar and fifty cents ($1.50) per one thousand dollars ($1,000) of the total amount of capital stock, surplus and undivided profits as ~~herein provided.~~ provided in this section. The tax imposed in this section shall ~~in no case~~ not be less than thirty-five dollars ($35.00) and shall be for the privilege of carrying on, doing business, and/or the continuance of articles of incorporation or domestication of each ~~such~~ corporation in this State. Appraised value of tangible property including real estate ~~shall be~~ is the ad valorem valuation for the calendar year next preceding the due date of the franchise tax return. ~~Appraised value of intangible property shall be the total gross valuation required to be reported for intangible tax purposes on April 15 coincident with or next preceding the due date of the franchise tax return.~~ The term "total actual investment in tangible property" as used in this section ~~shall be construed to mean~~ means the total original purchase price or consideration to the reporting taxpayer of its tangible properties, including real estate, in this State plus additions and improvements thereto less reserve for depreciation as permitted for income tax purposes, and also less any indebtedness incurred and existing by virtue of the purchase of any real estate and any permanent improvements made thereon. In computing "total actual investment in tangible personal property" there shall also be deducted reserves for the entire cost of any air-cleaning device or sewage or waste treatment plant, including waste lagoons, and pollution abatement equipment purchased or constructed and installed which reduces the amount of air or water pollution resulting from the emission of air contaminants or the discharge of sewage and industrial wastes or other polluting materials or substances into the outdoor atmosphere or into streams, lakes, or rivers, upon condition that the corporation claiming ~~such~~ this deduction shall furnish to the Secretary a certificate from the Department of Environment and Natural Resources or from a local air pollution control program for air-cleaning devices located in an area where the Environmental Management Commission has certified a local air pollution control program pursuant to G.S. 143-215.112 certifying that said Department or local air pollution control program has found as a fact that the air-cleaning device, waste treatment plant or pollution abatement equipment purchased or constructed and installed as above described has actually been constructed and installed and that ~~such~~ the device, plant or equipment complies with the requirements of the Environmental Management Commission or local air pollution control program with respect to ~~such~~ the devices, plants or equipment, that ~~such~~ the device, plant or equipment is being effectively operated in accordance with the terms and conditions set forth in the permit, certificate of approval, or other document of approval issued by the Environmental Management

Commission or local air pollution control program and that the primary purpose ~~thereof~~ is to reduce air or water pollution resulting from the emission of air contaminants or the discharge of sewage and waste and not merely incidental to other purposes and functions. The cost of constructing facilities of any private or public utility built for the purpose of providing sewer service to residential and outlying areas ~~shall be~~ is treated as deductible for the purposes of this section; the deductible liability allowed by this section shall apply only with respect to ~~such~~ pollution abatement plants or equipment constructed or installed on or after January 1, 1955."

SECTION 3.(a) G.S. 105-130.5(a) reads as rewritten:

"**§ 105-130.5. Adjustments to federal taxable income in determining State net income.**

(a) The following additions to federal taxable income shall be made in determining State net income:

...

(10) The total amounts allowed under this Chapter during the taxable year as a credit against the taxpayer's income tax. A corporation that apportions part of its income to this State shall make the addition required by this subdivision after it determines the amount of its income that is apportioned and allocated to this State and shall not apply to a credit taken under this Chapter the apportionment factor used by it in determining the amount of its apportioned income. The amount of a credit claimed under G.S. 105-130.47 or under G.S. 105-130.34 is not required to be added to income as otherwise required by this subdivision.

..."

SECTION 3.(b) G.S. 105-130.47(i) reads as rewritten:

"(i) No Double Benefit. – A taxpayer may not claim a credit under this section for qualifying expenses for which it claimed a deduction under the Code. A taxpayer that claims a credit provided under this section must adjust taxable income as provided in G.S. 105-130.5(a)(18). The amount of the credit claimed is not, however, required to be added to income under G.S. 105-130.5(a)(10)."

SECTION 3.(c) G.S. 105-130.47(a) reads as rewritten:

"**§ 105-130.47. Credit for qualifying expenses of a production company.**

(a) Definitions. – The following definitions apply in this section:

(1) Highly compensated ~~individual. – An individual~~ person. – A person who receives compensation in excess of one million dollars ($1,000,000) with respect to a single production.

(2) Live sporting event. – A scheduled sporting competition, game, or race that is not originated by a production company, but originated solely by an amateur, collegiate, or professional organization, institution, or association for live or tape-delayed television or satellite broadcast. A live sporting event shall not include commercial advertising, an episodic television series, a television pilot, music video, motion picture, or documentary production where any sporting events are

presented through archived historical footage or similar footage depicting earlier live sporting events that originated more than thirty days before the time of such usage.

(3) Production company. – Defined in G.S. 105-164.3.

(4) Qualifying expenses. – The sum of the total amount spent in this State for the following by a production company in connection with a production:

a. Goods and services leased or purchased by the production ~~company.~~ company, other than amounts paid to a highly compensated person. For goods with a purchase price of twenty-five thousand dollars ($25,000) or more, the amount included in qualifying expenses is the purchase price less the fair market value of the good at the time the production is completed.

b. Compensation and wages paid by the production company, other than amounts paid to a highly compensated ~~individual,~~ person, on which the production company remitted withholding payments to the Department of Revenue under Article 4A of this Chapter.

SECTION 3.(d) G.S. 105-151.29(a) reads as rewritten:

"**§ 105-151.29. Credit for qualifying expenses of a production company.**

(a) Definitions. – The following definitions apply in this section:

(1) Highly compensated ~~individual. An individual~~ person. – A person who receives compensation in excess of one million dollars ($1,000,000) with respect to a single production.

(2) Live sporting event. – A scheduled sporting competition, game, or race that is not originated by a production company, but originated solely by an amateur, collegiate, or professional organization, institution, or association for live or tape-delayed television or satellite broadcast. A live sporting event shall not include commercial advertising, an episodic television series, a television pilot, music video, motion picture, or documentary production where any sporting events are presented through archived historical footage or similar footage depicting earlier live sporting events that originated more than thirty days before the time of such usage.

(3) Production company. – Defined in G.S. 105-164.3.

(4) Qualifying expenses. – The sum of the total amount spent in this State for the following by a production company in connection with a production:

a. Goods and services leased or purchased by the production ~~company.~~ company, other than amounts paid to a highly compensated person. For goods with a purchase price of twenty-five thousand dollars ($25,000) or more, the amount included in qualifying expenses is the purchase price less the

fair market value of the good at the time the production is completed.

b. Compensation and wages paid by the production company, other than amounts paid to a highly compensated ~~individual, person,~~ on which the production company remitted withholding payments to the Department of Revenue under Article 4A of this Chapter."

SECTION 3.(e) G.S. 105-259(b) reads as rewritten:

"(b) Disclosure Prohibited. – An officer, an employee, or an agent of the State who has access to tax information in the course of service to or employment by the State may not disclose the information to any other person unless the disclosure is made for one of the following purposes:

~~(32) To provide the report required under G.S. 105-164.14(c) to the Department of Public Instruction and the Fiscal Research Division of the General Assembly.~~

...

(36) To furnish to a taxpayer claiming a credit under G.S. 105-130.47 or G.S. 105-151.29 information from a third party to the extent the information was used by the Secretary to adjust the amount of the credit claimed by the taxpayer."

SECTION 4. G.S. 105-164.6(c) reads as rewritten:

"(c) Credit. – A credit is allowed against the tax imposed by this section for the following:

(1) The amount of sales or use tax paid on the item to this State. Payment of sales or use tax to this State on an item by a retailer extinguishes the liability of a purchaser for the tax imposed under this section.

(2) The amount of sales or use tax paid on the item to another state. If the amount of tax paid to the other state is less than the amount of tax imposed by this section, the difference is payable to this State. The credit allowed by this subdivision does not apply to tax paid to a state that does not grant a similar credit for sales or use taxes paid in North Carolina."

SECTION 5. G.S. 105-164.7 reads as rewritten:

"**§ 105-164.7. Sales tax part of purchase price.**

Every retailer subject to the tax levied in G.S. 105-164.4 shall at the time of selling or delivering or taking an order for the sale or delivery of taxable tangible personal property or a taxable service, or collecting the sales price, add to the sales price the amount of tax due. The tax constitutes a part of the purchase price, is a debt from the purchaser to the retailer until paid, and is recoverable at law in the same manner as other debts. The tax must be stated and charged separately from the sales price, shown separately on the retailer's sales records, and paid by the purchaser to the retailer as trustee for and on account of the State. The retailer is liable for the collection of the tax and for its payment to the Secretary. The retailer's failure to charge the tax to or to collect the tax from the purchaser does not affect this liability. It is the intent of this Article that the tax be added to the sales price of tangible personal property and services

when sold at retail and be borne and passed on to the customer, instead of being borne by the retailer."

SECTION 6. G.S. 105-164.13 reads as rewritten:

"**§ 105-164.13. Retail sales and use tax.**

The sale at retail and the use, storage, or consumption in this State of the following tangible personal property and services are specifically exempted from the tax imposed by this Article:

. . .

(4e) Sales to a farmer of a~~A~~ grain, feed, or soybean storage facility, and parts and accessories attached to the facility. The term "farmer" has the same meaning as defined in subdivision (1) of this section."

SECTION 7. G.S. 105-164.14(k) reads as rewritten:

"(k) Reports. – The Department of Revenue shall publish by May 1 of each year the following information itemized by taxpayer for the 12-month period ending the preceding December 31:

(1) The number of taxpayers claiming a refund allowed in subsections (a1), (g), (h), (i), ~~and (j)~~(j), and (*l*) of this section.

(2) The total amount of purchases with respect to which refunds were claimed.

(3) The total cost to the General Fund of the refunds claimed."

SECTION 8.(a) G.S. 105-236 reads as rewritten:

"**§ 105-236. ~~Penalties.~~Penalties; situs of violations; penalty disposition.**

(a) Penalties. – ~~Penalties assessed by the Secretary under this Subchapter are assessed as an additional tax. The clear proceeds of any civil penalties levied pursuant to subdivisions (3), (4), (5)a., and (6) of this section shall be remitted to the Civil Penalty and Forfeiture Fund in accordance with G.S. 115C-457.2. Except as otherwise provided by law, and subject to the provisions of G.S. 105-237, the following penalties shall be applicable:~~The following civil penalties and criminal offenses apply:

(1) Penalty for Bad Checks. – When the bank upon which any uncertified check tendered to the Department of Revenue in payment of any obligation due to the Department returns the check because of insufficient funds or the nonexistence of an account of the drawer, the Secretary shall assess a penalty equal to ten percent (10%) of the check, subject to a minimum of one dollar ($1.00) and a maximum of one thousand dollars ($1,000). This penalty does not apply if the Secretary finds that, when the check was presented for payment, the drawer of the check had sufficient funds in an account at a financial institution ~~in this State~~ to pay the check and, by inadvertence, the drawer of the check failed to draw the check on the account that had sufficient funds.

. . .

~~(11) Any violation of Subchapter I, V, or VIII of this Chapter or of Article 3 of Chapter 119 of the General Statutes is considered an act committed in part at the office of the Secretary in Raleigh. The~~

~~certificate of the Secretary that a tax has not been paid, a return has not been filed, or information has not been supplied, as required by law, is prima facie evidence that the tax has not been paid, the return has not been filed, or the information has not been supplied.~~

(12) Repealed by Session Laws 1991, c. 45, s. 27.

(b) Situs. – Violation of a tax law is considered an act committed in part at the office of the Secretary in Raleigh. The certificate of the Secretary that a tax has not been paid, a return has not been filed, or information has not been supplied, as required by law, is prima facie evidence that the tax has not been paid, the return has not been filed, or the information has not been supplied.

(c) Penalty Disposition. – Civil penalties assessed by the Secretary are assessed as an additional tax. The clear proceeds of civil penalties assesses by the Secretary must be credited to the Civil Penalty and Forfeiture Fund, established in G.S. 115C-457.1."

SECTION 8.(b) G.S. 105-449.127 is repealed.

SECTION 8.(c) G.S. 105-449.48 is repealed.

SECTION 8.(d) G.S. 105-449.49 reads as rewritten:

"**§ 105-449.49. Temporary permits.**

(a) Issuance. – Upon application to the Secretary and payment of a fee of fifty dollars ($50.00), a motor carrier may obtain a temporary permit authorizing the carrier to operate a vehicle in the State for three days without registering the vehicle in accordance with G.S. ~~105-449.47 for not more than three days.~~ 105-449.47. A motor carrier to whom a temporary permit has been issued may elect not to report its operation of the vehicle during the three-day period. Fees collected under this subsection are credited to the Highway Fund.

(b) Refusal. – The Secretary may refuse to issue a temporary permit to any of the following:

(1) A motor carrier whose registration has been withheld or revoked.

(2) A motor carrier who the Secretary determines is evading payment of tax through the successive purchase of temporary permits."

SECTION 9. The caption of G.S. 105-249.2 reads as rewritten:

"**§ 105-249.2. Due date extended and penalties waived for certain military personnel or ~~individuals~~ persons affected by a presidentially declared disaster.**"

SECTION 10. The caption of G.S. 143B-437.71 reads as rewritten:

"**§ 143B-437.71. One North Carolina Fund established as a ~~nonreverting account.~~special revenue fund.**"

SECTION 11.(a) G.S. 153A-155(d) reads as rewritten:

"(d) Administration. – The taxing county shall administer a room occupancy tax it levies. A room occupancy tax is due and payable to the county finance officer in monthly installments on or before the ~~15th~~ 20th day of the month following the month in which the tax accrues. Every person, firm, corporation, or association liable for the tax shall, on or before the 20th day of each month, prepare and render a return on a form prescribed by the taxing county. The return shall state the total gross receipts derived in the preceding month from rentals upon which the tax is levied. A room occupancy tax

return filed with the county finance officer is not a public record and may not be disclosed except in accordance with G.S. 153A-148.1 or G.S. 160A-208.1."

SECTION 11.(b) G.S. 160A-215(d) reads as rewritten:

"(d) Administration. – The taxing city shall administer a room occupancy tax it levies. A room occupancy tax is due and payable to the city finance officer in monthly installments on or before the ~~15th~~20th day of the month following the month in which the tax accrues. Every person, firm, corporation, or association liable for the tax shall, on or before the 20th day of each month, prepare and render a return on a form prescribed by the taxing city. The return shall state the total gross receipts derived in the preceding month from rentals upon which the tax is levied. A room occupancy tax return filed with the city finance officer is not a public record and may not be disclosed except in accordance with G.S. 153A-148.1 or G.S. 160A-208.1."

SECTION 12. G.S. 160A-49(f2) reads as rewritten:

"(f2) Effective Date of Annexation for Certain Property. – Annexation of property subject to annexation under subsection (f1) of this section shall become effective:

(1) Upon the effective date of the annexation ordinance, the property is considered part of the city only (i) for the purpose of establishing city boundaries for additional annexations pursuant to this Article and (ii) for the exercise of city authority pursuant to Article 19 of this Chapter.

(2) For all other purposes, the annexation becomes effective as to each tract of such property or part thereof on the last day of the month in which that tract or part thereof becomes ineligible for classification pursuant to ~~G.S. 105-227.4~~ G.S. 105-277.4 or no longer meets the requirements of subdivision (f1)(2) of this section. Until annexation of a tract or a part of a tract becomes effective pursuant to this subdivision, the tract or part of a tract is not subject to taxation by the city under Article 12 of Chapter 105 of the General Statutes nor is the tract or part of a tract entitled to services provided by the city."

SECTION 13. The introductory language for Section 59.2 of S.L. 2005-435 reads as rewritten:

"**SECTION 59.2.(a)** ~~G.S. 105-114.1(a4)~~ G.S. 105-114(a4) reads as rewritten:"

SECTION 14. The introductory language of Section 4 of S.L. 2005-413 reads as rewritten:

"**SECTION 4.** ~~G.S. 105-129.15(7) reads~~ Subdivisions (6) and (7) of G.S. 105-129.15 read as rewritten:"

SECTION 15. Section 3 is effective for taxable years beginning on or after January 1, 2005. The remainder of this act is effective when it becomes law.

BILL DRAFT 2005-SVz-10: Revenue Laws Technical Changes

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	February 8, 2006
Introduced by:		**Summary by:**	Trina Griffin Committee Counsel
Version:	Draft		

SUMMARY: ***This bill draft makes several technical, clarifying, and administrative changes to the revenue laws and related statutes.***

Sections 1, 2, 5, 10, 12, 13, and 14 are technical changes. Sections 4, 6, 8, and 9 are clarifying changes. Sections 3, 7, and 11 make administrative changes.

BILL ANALYSIS: This bill draft makes the following technical, clarifying, and administrative changes:

Section	Explanation
1	Corrects a departmental reference since S.L. 2005-380 transferred the NC Grape Growers Council from the Department of Agriculture and Consumer Services to the Department of Commerce.
2	Removes obsolete language and makes other stylistic changes. This statutory subsection makes two obsolete references to including the appraised value of intangible property in the appraised value base. This language became obsolete with the repeal of the intangibles tax effective for tax years beginning on or after January 1, 1995. The Department of Revenue does not require intangible property to be included in the appraised value base.
3	Section 3 relates to the new film incentives tax credit enacted last year. Subsection (a) clarifies that the film incentives tax credit is not required to be added back to federal taxable income for purposes of determining State net income because corporations are already required to add to federal taxable income those expenses used to calculate the credit to prevent the taxpayer from receiving a double benefit. Currently, a similar provision applies to G.S. 105-130.34, the credit for certain real property donations, where the amount of the credit is not required to be added to federal taxable income, but this provision is found in G.S. 105-130.9. To be consistent, Section 3 adds G.S. 105-130.34 to G.S. 105-130.5(a) so that both exclusions from the add back requirement are both found in the add back statute. Subsection (b) makes a corresponding change in the film incentives tax credit statute. Subsections (c) and (d) change in both the corporate and individual income tax articles, the term "highly compensated individual" to "highly compensated person" with regard to the film incentives credit.[1] This change is to clarify that a production company that

[1] G.S. 105-228.90 defines "person" as "an individual, a fiduciary, a firm, an association, a partnership, a limited liability company, a corporation, a unit of government, or another group acting as a unit. The term includes an officer or employee of a corporation, a member, a manager, or an employee of an LLC, and a member or employee of a partnership who, as officer, employee, member, or manager, is under a duty to perform an act in meeting the requirements of Subchapter I, V, or VIII of

	hires an actor who receives his salary from a loan-out company is subject to the "highly compensated" limitation, regardless of whether the actor is classified as an employee of the production company or the loan-out company is considered a service provider. Subsection (e) makes two changes to the confidentiality statute, one of which is related to the film incentives tax credit. It adds a new subdivision (36), which allows the Department of Revenue to provide to a production company claiming a film production credit information from a third party to the extent the information was used by the Department to adjust the amount of the credit claimed by the production company. It also repeals subdivision (32), which allows the Department of Revenue to provide to Department of Public Instruction and the Fiscal Research Division reports regarding sales and use tax refunds received by school administrative units. This provision was enacted last year. However, Section 32(b) of S.L. 2005-435 amended the definition of tax information to exclude governmental agency refunds. Therefore, an exception is not needed in the confidentiality statute since the information is no longer confidential tax information.
4	Corrects an inadvertent omission. In last year's budget bill, there was a rewrite of this statutory section on use tax. A credit should be allowed for both sales and use tax paid to another state, but the revised statute only provides a credit for sales tax paid. There was no intent to change the application of the tax and so, this section adds the phrase "or use" back into the statute.
5	Makes a grammatical change to the statute.
6	Clarifies that the exemption from sales tax for sales of grain, feed, or soybean storage facilities and accessories only applies to sales made to farmers. This was one of the items previously subject to the 1%, $80 maximum rate of tax. The 1% rate was imposed on sales to farmers of grain, feed, or soybean storage facilities and accessories. Last year, to conform to the Streamlined Agreement, the General Assembly exempted these items from sales tax. However, the new exemption language did not limit the exemption to farmers.
7	Last year, a sales and use tax refund was authorized for the purchase of fuel by interstate passenger air carriers and by motorsports racing team or sanctioning body. Under current law, the Department of Revenue is required annually to publish the number of taxpayers claiming certain sales and use tax refunds. This section would add these categories of refunds to the reporting requirement.
8	**Subsection 8(a)** reorganizes the penalties statute and makes some technical and clarifying changes. It divides the former statutory section into three subsections: subsection (a) lists the various penalties available to the Department of Revenue for violations of the tax laws; subsection (b) is a recodification of the principle previously set out in subdivision (11), which states that a violation of a tax law is considered an act committed in part at the office of the Secretary in Raleigh; and subsection (c) restates language previously found at the beginning of the statute directing the disposition of the penalty proceeds to the Civil Penalty and Forfeiture Fund. This subsection also deletes

this Chapter, G.S. 55-16-22, of Article 12 of Chapter 113A of the General Statutes, or of Article 3 of Chapter 119 of the General Statutes."

	an obsolete requirement to avoid the penalty for a bad check, which states that a person had sufficient funds in a bank account "in this State." Since the Department does not follow this requirement, it is being deleted. **Subsection 8(b)** repeals G.S. 105-449.127, which provides that civil penalties assessed for violation of the motor fuels tax laws be credited to the Highway Fund. G.S. 105-449.48 provides that fees collected for the issuance of temporary permits for motor carriers and all civil penalties collected for violations of the motor carrier laws be credited to the Highway Fund. **Subsection 8(c)** repeals this statute and moves the fee disposition language to G.S. 105-449.49. The repeal of these two statutes redirects from the Highway Fund to the Civil Penalty and Forfeiture Fund civil penalty proceeds collected under these two articles as required by *North Carolina School Boards Assn. v. Moore*. In July of 2005, the North Carolina Supreme Court held in *North Carolina School Boards Assn. v. Moore* that the penalties assessed under Chapter 105 are imposed as a monetary payment for a taxpayer's noncompliance with a mandate of the Revenue Act, that they are punitive in nature, and, as such, they are subject to Article IX, Section 7 of the NC Constitution requiring those funds be remitted to the Civil Penalty and Forfeiture Fund for use by the schools.
9	Amends the caption of G.S. 105-249.2 by replacing the word "individuals" with the word "persons." This statute provides, in part, that no penalties may be assessed for any period in which the time for filing a federal return or for paying a federal tax is extended because of a presidentially declared disaster. The relief provided by this statute is applied by the Department of Revenue equally to all tax entities, including businesses, and not just individuals.
10	Amends the caption of the statute to reflect what the statute actually provides. G.S. 143B-437.71(a) states, "The One North Carolina Fund is established as a special revenue fund in the Department of Commerce."
11	Subsections 12(a) and (b) conform the date an occupancy tax return is due to the date that the occupancy taxes are due.
12	Corrects an incorrect statutory reference.
13	Corrects an incorrect statutory reference.
14	Corrects introductory language from a 2005 session law.

EFFECTIVE DATE: Section 3 is effective for tax years beginning on or after January 1, 2005. The remainder of the act is effective when it becomes law.

2005 Biennial Tax Expenditure Report

Presentation to the Revenue Laws Study Committee

February 8, 2006

Tax Expenditure Report

- Mandated by G.S. 105-256(a)(2)
- A "tax expenditure" is defined as an exemption, exclusion, deduction, allowance, credit, refund, preferential tax rate or other device which reduces the amount of tax revenue which otherwise would be collected.

Tax Expenditures by Type of Tax

Tax	Number of Expenditures	Value of Expenditures Over $100K ($ millions)	Number of Expenditures Estimated at <$100K	Number of Expenditures with Estimate Unavailable
Privilege	19	11.9	9	1
Tobacco Products	3	2.5	1	0
Alcoholic Beverage	2	2.4	1	0
Franchise	20	276.0	0	8
Corporation Income	47	380.5	13	5
Business Incentives	21	165.0	6	0
Individual Income	27	765.0	6	1
Sales and Use	71	1,754.1	6	18
Highway Use	10	15.3	2	3
Scrap Tire Disposal	1	0.0	0	1
White Goods	1	0.0	1	0
Piped Natural Gas	1	3.9	0	0
Gift	3	21.2	0	0
Insurance	5	127.6	0	1
Conveyances	8	8.5	2	2
Motor Fuels	14	36.4	3	1
TOTAL	259	3,750.3	50	41

Top Ten Tax Expenditures

Tax	Expenditure	$ Millions
Sales and Use	Food for Home Consumption Exemption	416.8
Individual Income	Bailey Case State Employee Retirement Income Deduction	246.0
Sales and Use	Prescription Drug and Insulin Exemption	242.0
Franchise	Holding Company Cap	200.0
Sales and Use	Refunds to Nonprofits	183.0
Individual Income	Social Security Deduction	179.4
Individual Income	Credit for Children	134.3
Sales and Use	Farming Feed, Litter, and Medication Exemption	128.0
Corporation Income	Net Economic Loss Deduction	127.4
Sales and Use	3% Preferential Rate on Residential and Commercial Electricity	107.1

North Carolina

Biennial Tax Expenditure Report

2005

Tax Research Division
October 2005

275 copies of this report were printed at a cost of $248.50, or $0.90 per copy.

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North Carolina Biennial Tax Expenditure Report

2005

Introduction

In compliance with the requirements of Section 105-256 of the General Statutes of North Carolina, the Department of Revenue has prepared this report of tax expenditures contained in the Revenue Laws of North Carolina as amended through 2005. The listing of expenditures and measurements of their respective costs will allow legislative review of their impact on the State's economy and on government revenues.

Defining Tax Expenditures for This Study

A "tax expenditure" is defined as an exemption, exclusion, deduction, allowance, credit, refund, preferential tax rate or other device which reduces the amount of tax revenue which otherwise would be collected.

Tax expenditures are created to give economic assistance to certain groups of producers or consumers in the economy or to promote other policy goals. This report does not purport to evaluate the various expenditures as to equity or desirability from a public policy standpoint.

This report concentrates on those tax expenditures that the General Assembly can alter. There are some tax expenditures that are not subject to legislative action. For instance, Constitutional restrictions forbid taxing the federal government's purchases, as well as certain transactions involving interstate trade and trade on Indian Reservations. Also, specific exemptions or exclusions that are made in order to avoid duplicate taxation of an activity are not considered to be tax expenditures. For example, S-corporations are not taxed on profits that are transferred to shareholders, who subsequently pay income taxes on these dividends. These types of tax expenditures are listed in the Appendix.

There are several other important tax breaks that are not considered tax expenditures for this report. Some exemptions and exclusions are necessary to define the appropriate base that is being taxed. For example, North Carolina's choice of Federal Taxable Income (FTI) as the starting point for income tax calculations is not considered an expenditure, even though FTI is generally lower than other measures of income.

The sales tax presents the most ambiguous cases of when exemptions should be included as tax expenditures for this report. The sales tax is generally considered to be a tax on "retail" purchases. Transactions involving the purchase of intermediate goods that will be further processed into a final good are properly exempted from the sales tax. It is arguable whether purchases of machinery, fuel or similar inputs used in production of final goods should be taxed. Since there is no consensus on this point, we include estimates of tax exemptions on machinery. Sales tax exemptions that are excluded from estimation are included in the Appendix.

The term "preferential tax rate" has been interpreted to mean any rate that is less than the basic rate that applies to the largest number of taxpayers. In some instances higher rates are used on a relatively small number of taxpayers. In such cases, the lower general rates are not listed as preferential. Nor are graduated tax rates, such as those contained in the individual income tax, the estate tax, and the gift tax. Also, no preferential status is acknowledged when distinctly different bases are taxed at different rates under the same tax schedule. For example, under the alcoholic beverage taxes, different rates and bases are used to tax beer, wine, and spirituous liquor.

Measuring the Fiscal Effects of Tax Expenditures

It should be noted at the outset of this report that the fiscal effects of tax expenditures are sometimes difficult to quantify. Several methods for estimating the costs of expenditures are used.

The most accurate source of information comes from actual tax returns that provide direct evidence of when certain expenditures are taken and the amounts of those expenditures. For example, we are able to use personal income tax and corporate income tax returns from 2002 and 2001 respectively to precisely measure the use of certain tax deductions and tax credits.

In some cases, we may not have data on tax returns for specific tax expenditures, but we do have good estimates for several expenditures combined. For example, retailers must list on their sales and use tax returns the amount of sales subject to the special 1% rate. Based on this, our estimates of several expenditures receiving this rate can be summed up and rescaled to get closer to the actual amounts.

Sometimes, needed data are more timely and extensive at the national level than at the state level. When this occurs, the state-level data are estimated by determining North Carolina's share of national activity. In these cases, several assumptions must be made to derive the final estimates. Therefore, these estimates are far less reliable than those that can be measured directly.

For most national economic data, the share of North Carolina's activities will consistently be in the range of 2½% to 3%, which also corresponds to North Carolina's share of population and gross domestic product (GDP). Therefore, national statistics are often multiplied by 2.75% to estimate North Carolina's value. However, when it is apparent that North Carolina's data are not typical of national activity, such as textile or pharmaceutical manufacturing, attempts are made to use more representative proportions.

In some cases, sufficient data were not available to allow estimation of the value of an expenditure. In these cases the expenditure estimate is designated as "unavailable."

For a small number of credits, the provision was utilized by so few taxpayers that reporting the size of the expenditure would jeopardize taxpayer confidentiality. The estimates for these items were reported as a group.

Table 1

Summary of Tax Expenditure Estimates for 2004 by Tax Category

Tax	Number of Expenditures	Sum of Estimates of $100,000 and Over (Millions of Dollars)	Number Estimated to Be Less than $100,000	Number with Unavailable Estimate
Privilege Tax	19	11.9	9	1
Tobacco Products Tax	3	2.5	1	0
Alcoholic Beverage Tax	2	2.4	1	0
Franchise Tax	20	276.0	0	8
Corporation Income Tax	47	380.5	13	5
Various Tax Incentives (Articles 3A through 3G)	21	165.0	6	0
Individual Income Tax	27	765.0	6	1
Sales and Use Tax	77	1,754.1	6	18
Highway Use Tax	10	15.3	2	3
Scrap Tire Disposal Tax	1	0.0	0	1
White Goods Disposal Tax	1	0.0	1	0
Piped Natural Gas Tax	1	3.9	0	0
Gift Taxes	3	21.2	0	0
Taxes on Insurance Companies	5	127.6	0	1
Excise Stamp Tax on Conveyances	8	8.5	2	2
Excise Taxes on Motor Fuels	14	36.4	3	1
Totals	259	3,570.3	50	41

Table 2

Forty Largest Tax Expenditures in North Carolina in 2004

Rank	Tax	Item	Citation	Short Title	2004 estimate (millions of dollars)
1	Sales and Use Tax	65	164.13B	Food Exemption	416.8
2	Individual Income Tax	5	134.6(b)(5b)	Government Retirement Income under Bailey Settlement	246.0
3	Sales and Use Tax	32	164.13(13)	Prescription Drugs and Insulin	242.0
4	Franchise Tax	19	120.2(b)(1)	Cap for Holding Companies	200.0
5	Sales and Use Tax	68	164.14(b)	Refund of Sales Taxes to Nonprofits	183.0
6	Individual Income Tax	4	134.6(b)(3)	Social Security Benefits in Excess of Federal Limit	179.4
7	Individual Income Tax	22	151.24	Credit for Children	134.3
8	Sales and Use Tax	11	164.13(2a)a	Feeds, Litter and Medications for Farming	128.0
9	Corporation Income Tax	26	130.8	Net Economic Losses	127.4
10	Sales and Use Tax	76	164.4(4a)	Electricity to Commercial Businesses and Residences	107.1
11	Corporation Income Tax	47		Tax Expenditures Combined for Confidentiality	100.1*
12	Taxes on Insurance Companies	2	228.5(c)(2)	Premiums Received from Annuities	95.0
13	Individual Income Tax	6	134.6(b)(6)	Private Retirement Plans and Government Pensions	68.8

Rank	Tax	Item	Citation	Short Title	2004 estimate (millions of dollars)
14	Sales and Use Tax	77	164.21B	Credit for Local Cable Television Franchise Taxes	65.3
15	Corporation Income Tax	11	130.5(b)(1)	US Obligation Interest	63.7
16	Sales and Use Tax	69	164.14(c)	Refund of Sales Taxes to Local Government	62.5
17	Sales and Use Tax	7	164.4C(c)(13)	Internet Access Charges	53.5
18	Sales and Use Tax	40	164.13(23)a	Packaging Items for Manufacturers, Producers and Retailers	52.8
19	Sales and Use Tax	10	164.13(1) and (1a)	Items Sold to Farmers	51.1
20	Franchise Tax	1	125(a)(1)	Charitable Nonprofits	50.2
21	Corporation Income Tax	3	130.11(a)(3)	Certain Charitable Organizations	49.3
22	Low-Income Housing Tax Credits	2	129.42	Credit for Low-Income Housing	47.1
23	Sales and Use Tax	63	164.13(51)	Water Delivered Through Main Pipes	43.5
24	Tax Incentives for New and Expanding Businesses	2	129.9	Credit for Investing in Machinery and Equipment	42.9**
25	Individual Income Tax	15	151.11	Credit for Child Care and Certain Employment-Related Expenses	41.2
26	Sales and Use Tax	52	164.13(38)	Food Stamp Purchases	33.1
27	Sales and Use Tax	31	164.13(12)	Durable Medical Equipment	30.0
28	Sales and Use Tax	64	164.13A	Tips on Meals and Beverages	29.7

Rank	Tax	Item	Citation	Short Title	2004 estimate (millions of dollars)
29	Sales and Use Tax	6	164.4C(c)(12)	Information Services	26.1
30	Taxes on Insurance Companies	3	228.5(c)(3)	Premiums Related to Funding Agreements	26.0
31	Business and Energy Tax Credit	1	129.16	Credit for Investing in Business Property	24.6**
32	Sales and Use Tax	71	164.4(a)(1a)	Manufactured Homes	23.7
33	Individual Income Tax	24	151.26	Charitable Contributions by Nonitemizers	23.1
34	Sales and Use Tax	44	164.13(27)	Food Sold in Dining Rooms Operated by Educational Institution	22.0
35	Individual Income Tax	27		Carry-Over Provisions	21.0
36	Sales and Use Tax	74	164.4(1f)	Electricity to Farmers, Manufacturers and Commercial Laundries	20.6
37	Sales and Use Tax	4	164.4C(c)(9)	Sales, Installation, Repair of Telecommunications Property	19.7
38	Sales and Use Tax	53	164.13(39)	Components of Free Distribution Periodicals	19.4
39	Gift Taxes	1	188(d)	Annual Exclusion Amount	18.0
40	Individual Income Tax	16	151.12	Credit for Certain Real Property Donations	15.6

* Includes items grouped to protect confidentiality of taxpayer information. See text for this item for more details.

** 2003 value.

Privilege Taxes (Article 2)

Tax Base Information

Privilege taxes are imposed for the privilege of carrying on business or doing a remunerative act within the state. Privilege taxes on corporations are discussed under the "franchise tax" article.

There is no standard tax base or tax rate for privilege taxes that covers all businesses or activities. However, in order to determine preferential tax rates and exclusions, the tax rate is assumed to be 3% when the tax base is gross receipts and $50 when there is a flat licensing fee.

Exemptions from 3% gross receipts tax

1. **Low Admission Fee**
   Citation: G.S. 105-37.1(a)(1)
   Description: Giving, offering or managing dance or athletic contests with admissions below $.50.

   Estimate (in millions): less than $0.1

   Note: There would have to be over 6.6 million tickets sold for this to be above $100,000.

2. **Charitable Performances by Uncompensated Local Talent**
   Citation: G.S. 105-40(1)
   Description: Performances by local talent exclusively, for the benefit of religious, charitable, benevolent or educational purposes, as long as no compensation is paid to the local talent.

   Estimate (in millions): Unavailable

3. **North Carolina Symphony Society**
   Citation: G.S. 105-40(2)
   Description: NC Symphony Society, Inc., as specified in G.S. 140-10.1.

   Estimate (in millions): $0.1

   Data Source: Estimate based on total budget of $8.5 million reported by the North Carolina Symphony Society. A report from 2002 by the Symphony Orchestra Institute estimated that US symphonies in this budget range covered an average of 40% of their expenses from sales.

4. **Agricultural Fairs**
   Citation: G.S. 105-40(3)
   Description: Exhibits, shows, attractions, and amusements operated by a society or association organized under the provisions of Chapter 106 of the General Statutes where the society or association has obtained a permit from the Secretary of Revenue to operate without the payment of taxes.

   Estimate (in millions): $1.2

   Data Source: List of county fairs and attendance from North Carolina Association of Agricultural Fairs.

   Note: Per person receipts based on average gate price of $10 and additional $10 for amusements.

5. **Outdoor Historical Dramas**
   Citation: G.S. 105-40(4)
   Description: Outdoor historical dramas, as specified in Article 19C of Chapter 143 of the General Statutes.

   Estimate (in millions): $0.1

   Data Source: Institute of Outdoor Drama at the University of North Carolina at Chapel Hill

6. **Events at Primary and Secondary Schools**
   Citation: G.S. 105-40(5)
   Description: Elementary and secondary school athletic contests, dances and other amusements.

   Estimate (in millions): $6.7

   Data Source: Estimates based on 2002 data from the National Center for Educational Statistics. North Carolina's revenues from student activities were not directly available. Estimates were made by averaging revenues in nearby states (Alabama, South Carolina, and Tennessee) and adjusting by the number of schools and the number of students in North Carolina.

7. **First $1,000 of Charitable Amusements**
   Citation: G.S. 105-40(6)
   Description: First $1,000 of gross receipts from amusements promoted and managed by civic organizations when the entire proceeds are used exclusively for civic and charitable purposes and not to defray the expenses of conducting the amusement.

   Estimate (in millions): less than $0.1

   Data Source: Department of Revenue amusement tax records

   Note: Each event would receive a $30 tax break. There would have to be over 3,300 events for the loss to exceed $100,000.

8. Youth Athletic Contests
Citation: G.S. 105-40(6a)
Description: Youth athletic contest with an admission price of $10 or less sponsored by an entity exempt from State income tax.

Estimate (in millions): less than $0.1

Data Source: Department of Revenue amusement tax records

9. Amusements at Nonprofit Arts Centers
Citation: G.S. 105-40(7)
Description: Amusements promoted by a corporation exempt from income tax that operates a center for the performing or visual arts — the exempt events must be held at the center.

Estimate (in millions): $0.2

Data Source: Estimate based on expected receipts of major qualifying events and festivals. Expected receipts or attendance were obtained from *Southern Festivals* website (http://southfest.com), specific event's websites or local newspaper coverage of events.

10. Amusements Promoted by Nonprofit Arts Organization
Citation: G.S. 105-40(7a)
Description: Exemption for all exhibitions, performances, and entertainments promoted and managed by nonprofit arts organization.

Estimate (in millions): $0.2

Data Source: Revenues from exempt arts groups provided by 2002 Economic Census. The share of ticket sales are from the Theatre Communications Group and 2002 Census (for promoters).

Note: The estimate is net of related estimated expenditures in this section.

11. Arts Festivals
Citation: G.S. 105-40(10)
Description: Arts festivals of less than 7 days, no more than twice a year, held outdoors on public property by an income tax-exempt person.

Estimate (in millions): $0.2

Data Source: Estimate based on expected receipts of major qualifying events and festivals. Expected receipts or attendance were obtained from *Southern Festivals* website (http://southfest.com), specific event's websites or local newspaper coverage of events.

12. Community Festivals
Citation: G.S. 105-40(11)
Description: Community festivals held by a person exempt from income tax, no more than one per calendar year, no more than seven days, involving a variety of exhibitions, the majority of which are open to the public.

Estimate (in millions): less than $0.1

Data Source: Estimate based on expected receipts of major qualifying events and festivals. Expected receipts or attendance were obtained from *Southern Festivals* website (http://southfest.com), specific event's websites or local newspaper coverage of events.

13. Amusements by Teen Centers
Citation: G.S. 105-40(8)
Description: Persons exempt from income tax who are operating a teen center.

Estimate (in millions): less than $0.1

Note: Likely to be small given amounts in other amusement categories.

Preferential rate for 3% gross receipts tax

14. 1% Tax on Motion Pictures
Citation: G.S. 105-38.1(a)
Description: 1% gross receipts tax on motion pictures — if a person offers entertainment that includes both a motion picture and another type of amusement, the total gross receipts will be taxed at the normal rate.

Estimate (in millions): $3.0

Data Source: Department of Revenue amusement tax records

Exemptions from license fee of $50.00 for attorneys-at-law and other professionals

15. Professionals over 75 Years Old
Citation: G.S. 105-41(b)(1)
Description: Exemption from license fee for attorneys or other professionals who are over 75 years old.

Estimate (in millions): less than $0.1

Data Source: Derived from Department of Revenue list of licenses and US Census demographic data

16. **Individuals Practicing Art of Healing**
Citation: G.S. 105-41(b)(2)
Description: Exemption from license fee for individuals who practice the art of healing for a fee, if the person is an adherent of an established church or religious organization and confines the healing practice to prayer or spiritual means.

Estimate (in millions): less than $0.1

Data Source: Derived from Department of Revenue list of licenses

17. **Blind Individuals**
Citation: G.S. 105-41(b)(3)
Description: Exemption from license fee for blind individuals.

Estimate (in millions): less than $0.1

Data Source: Derived from Department of Revenue list of licenses and US Census demographic data

Exemptions from loan agency annual privilege tax of $250

18. **Savings Institutions**
Citation: G.S. 105-102.3
Description: Exemption from bank privilege tax for savings institutions under Chapter 54B, 54C or Home Owners' Loan Act of 1933.

Estimate (in millions): $0.2

Data Source: North Carolina Commission on Banks and Federal Depositors' Insurance Corporation

Exemptions from $15 per ton tax on unrecycled newsprint

19. **Unavailability of Recycled Newsprint**
Citation: G.S. 105-102.6(e)
Description: Exemption from tax on unrecycled paper if recycled newsprint is unavailable due to (1) high price, (2) lack of comparable quality or (3) time constraints.

Estimate (in millions): less than $0.1

Data Source: Department of Revenue tax records

Tobacco Tax (Article 2A)

Tax Base Information

The tax rate on a pack of cigarettes increased from 5¢ to 30¢ on September 1, 2005 and will increase to 35¢ on July 1, 2006. Other tobacco products will be taxed at the rate of 3% of the price of the products as of September 1, 2005. (Prior to this date, the tax rate was 2%.)

During Fiscal Year 2004-05, $43.0 million was collected from this tax.

Expenditures

1. **Discount for Timely Reports – Cigarettes**
   Citation: G.S. 105-113.21(a1)
   Description: A distributor who files a timely report and sends a timely payment may deduct from the amount due a discount of 2%.

   Estimate (in millions): $2.5

   Data Source: Department of Revenue tax records

   Note: This deduction was effective August 1, 2004. The estimate includes Item #3. The actual amount of $0.2 million was inflated to provide an estimate at the tax rates that apply after September 1, 2005 and were also adjusted for a full calendar year.

2 **Unsalable Cigarettes and Cigars**
   Citation: G.S. 105-113.21(b) and 105-113.39(b)
   Description: Refund for stale or otherwise unsalable cigarettes and cigars upon which the tax has been paid.

   Estimate (in millions): less than $0.1

   Data Source: Department of Revenue tax records

3. **Discount for Timely Reports – Other Tobacco Products**
   Citation: G.S. 105-113.39
   Description: A wholesale dealer or retail dealer who files a timely report and sends a timely payment may deduct from the amount due a discount of 2%.

   Estimate (in millions): included in item #1

Alcoholic Beverage License and Excise Taxes (Article 2C)

Tax Base Information

An excise tax of 53.177¢ per gallon is levied on the sale of malt beverages.
An excise tax of 21¢ per liter is levied on the sale of unfortified wine and an excise tax of 24¢ per liter is levied on the sale of fortified wine.
An excise tax of 25% is levied on liquor sold in ABC stores.

During Fiscal Year 2004-05, $189.7 million was collected from this tax.

Expenditures

1. **Discount for Timely Reports**
   Citation: G.S. 105-113.85
   Description: A wholesaler or importer who files a timely report and sends a timely payment may deduct from the amount due a discount of 2%.

   Estimate (in millions): $2.4

   Data Source: Department of Revenue tax records

   Note: This deduction was effective August 1, 2004. The actual amount of $0.8 million was adjusted for a full calendar year.

2. **Sacramental Wine**
   Citation: G.S. 105-113.87(a)
   Description: Refund for wine used for sacramental purposes.

   Estimate (in millions): less than $0.1

   Data Source: Department of Revenue tax records

Franchise Tax (Article 3)

Brief Background and Tax Base Information

The franchise tax is a privilege tax on corporations operating in North Carolina. The tax is currently $1.50 for every $1000 of the largest of the following three measures:

1. the total amount of capital stock, surplus and undivided profits
2. the net accounting value of real and tangible property in the State
3. 55% of the appraised value of real and tangible property in the State

For tax year 2002, 61% of C-corporations paying the franchise tax used the first of these measures as the taxable amount, while 26% of corporations used the second and 12% used the third.

For corporations doing business both in and outside North Carolina, the share of capital stock due to North Carolina is calculated by the same method used for the corporation income tax: the average of the corporation's shares of property, payroll and sales, with the sales factor double-weighted.

The minimum franchise tax is $35.00. For tax year 2002, 40% of C-corporations and 47% of S-corporations paid the minimum amount.

In Fiscal Year 2004-05, North Carolina collected $629.8 million in franchise taxes.

Table 3

2004 NC Franchise Tax Expenditure Estimates

Item	Citation	Short Title	2004 Estimate (millions of dollars)
1	114(b)(2)	Limited Liability Companies	Unavailable
2	125(a)(1)	Charitable Nonprofits	50.2
3	125(a)(3)	Local Mutual Nonprofits	2.2
4	125(a)(4)	Cooperative Marketing Associations	0.2
5	125(a)(5)	Production Credit Association	0.5
6	125(a)(6)	Nonprofit Clubs	2.0
7	125(a)(7)	Chambers of Commerce	0.9
8	125(a)(8)	Homeowners' Associations	2.3
9	125(a)(9)	Miscellaneous Nonprofits	2.3
10	125(a)	Real Estate Mortgage Investment Conduits	Unavailable
11	122(b)	Deduction from Capital Stock for Investments in Pollution Abatement	Unavailable
12	122(b)	Deduction from Capital Stock for Investments in Hazardous Waste Abatement	Unavailable

Item	Citation	Short Title	2004 Estimate (millions of dollars)
13	122(b)	Deduction from Capital Stock for Facilities Used for Residential Sewer Services	Unavailable
14	122(b)	Treasury Stock	8.0
15	122(d)	Deduction from Property Investment for Expenses Related to Purchases of Real Estate	Unavailable
16	122(d)	Deduction from Property Investment for Waste Abatement Investments	Unavailable
17	122(d)	Deduction from Property Investment for Investments in Rural Sewer Services	Unavailable
18	125(b)	Real Estate Investment Trusts and Regulated Investment Corporations	3.0
19	122(d1)	Piped Natural Gas Credit	4.4
20	120.2(b)(1)	Cap for Holding Companies	200.0

Exemptions

1. **Limited Liability Companies**
   Citation: G.S. 105-114(b)(2)
   Description: Limited liability companies are exempt from the franchise tax because the definition for corporation in this Article explicitly excludes them. However, under G.S. 105-114.1(b), the assets of a limited liability company are included in the tax bases of corporations that own more than 50% of the LLC.

   Estimate (in millions): Unavailable

2. **Charitable Nonprofits**
   Citation: G.S. 105-125(a)(1)
   Description: Charitable, religious, fraternal, benevolent, scientific or educational nonprofit.

   Estimate (in millions): $50.2

   Data Source: Based on IRS data compiled by the National Center for Charitable Statistics (NCCS)

3. **Local Mutual Nonprofits**
   Citation: G.S. 105-125(a)(3)
   Description: Mutual ditch or irrigation association, mutual or cooperative telephone association, mutual canning association, cooperative breeding association or similar corporation of a purely local character deriving receipts solely from assessments, dues, or fees collected from members for the sole purpose of meeting expenses.

   Estimate (in millions): $2.2

   Data Source: Based on IRS data compiled by the National Center for Charitable Statistics (NCCS)

4. **Cooperative Marketing Associations**
   Citation: G.S. 105-125(a)(4)
   Description: Cooperative marketing associations that operate solely for the purpose of marketing the products of members or other farmers and returns proceeds of sales to members and farmers, less operating costs.

   Estimate (in millions): $0.2

   Data Source: Based on IRS data compiled by the National Center for Charitable Statistics (NCCS)

5. **Production Credit Association**
Citation: G.S. 105-125(a)(5)
Description: Nonprofit production credit association under federal Farm Credit Act of 1933.

Estimate (in millions): $0.5

Data Source: Based on assets of the four farm credit associations in North Carolina

6. **Nonprofit Clubs**
Citation: G.S. 105-125(a)(6)
Description: Clubs organized and operated exclusively for pleasure, recreation, or other nonprofit purposes, a civic league operated solely for the promotion of social welfare, a business league, or a board of trade.

Estimate (in millions): $2.0

Data Source: Based on IRS data compiled by the National Center for Charitable Statistics (NCCS)

7. **Chambers of Commerce**
Citation: G.S. 105-125(a)(7)
Description: Chamber of commerce or merchants' association, not organized for profit.

Estimate (in millions): $0.9

Data Source: Based on IRS data compiled by the National Center for Charitable Statistics (NCCS)

8. **Homeowners' Associations**
Citation: G.S. 105-125(a)(8)
Description: Condominium association, homeowners' association, or cooperative housing corporation not organized for profit.

Estimate (in millions): $2.3

Data Source: Based on IRS data compiled by the National Center for Charitable Statistics (NCCS) and additional information from Department of Revenue 2002 corporate income tax records

9. **Miscellaneous Nonprofits**
   Citation: G.S. 105-125(a)(9)
   Description: Other organization exempt from federal income tax under the Code.

   Estimate (in millions): $2.3

   Data Source: Estimate for credit unions from NC Department of Commerce, Credit Union Division Annual Report (2003). Share of assets taxable for franchise tax derived from comparison to savings banks in Department of Revenue records.

10. **Real Estate Mortgage Investment Conduits**
    Citation: G.S. 105-125(a)
    Description: An entity that qualifies as a real estate mortgage investment conduit, as defined in section 860D of the Code, is exempt from franchise taxes.

    Estimate (in millions): Unavailable

Deductions

11. **Deduction from Capital Stock for Investments in Pollution Abatement**
    Citation: G.S. 105-122(b)
    Description: Deduction for cost of air-cleaning device or sewage or waste treatment plant and pollution abatement equipment.

    Estimate (in millions): Unavailable

12. **Deduction from Capital Stock for Investments in Hazardous Waste Abatement**
    Citation: G.S. 105-122(b)
    Description: Deduction for cost of purchasing equipment or constructing facilities for the purpose of recycling or reducing hazardous wastes.

    Estimate (in millions): Unavailable

13. **Deduction from Capital Stock for Facilities Used for Residential Sewer Services**
    Citation: G.S. 105-122(b)
    Description: Deduction for the cost of constructing facilities used to provide sewer services to residential and outlying areas.

    Estimate (in millions): Unavailable

14. **Treasury Stock**
Citation: G.S. 105-122(b)
Description: Treasury stock shall not be considered in computing the capital stock, surplus and undivided profits as the basis for franchise tax, but shall be excluded proportionately.

Estimate (in millions): $8.0

Data Source: Department of Revenue 2001 C-Corp records

15. **Deduction from Property Investment for Expenses Related to Purchases of Real Estate**
Citation: G.S. 105-122(d)
Description: Deduction from tangible property investments of reserves for depreciation and any indebtedness incurred by virtue of the purchase of any real estate and any improvements.

Estimate (in millions): Unavailable

16. **Deduction from Property Investment for Waste Abatement Investments**
Citation: G.S. 105-122(d)
Description: Deduction from tangible property investments of cost of air-cleaning device or sewage or waste treatment plant.

Estimate (in millions): Unavailable

17. **Deduction from Property Investment for Investments in Rural Sewer Services**
Citation: G.S. 105-122(d)
Description: Deduction from tangible property investments for the cost of constructing facilities built to provide sewer service to residential and outlying areas.

Estimate (in millions): Unavailable

18. **Real Estate Investment Trusts and Regulated Investment Corporations**
Citation: G.S. 105-125(b)
Description: Deduction for market value of a real estate investment trust or regulated investment corporation of investments in the stocks, bonds or debts of other entities.

Estimate (in millions): $3.0

Data Source: Department of Revenue 2002 C-Corp records

Tax Credits

19. Piped Natural Gas Credit
Citation: G.S. 105-122(d1)
Description: Tax credit of one-half amount of piped natural gas tax. The credit allowed may not exceed the tax amount reduced by all credits.

Estimate (in millions): $4.4

Data Source: Department of Revenue 2002 and 2003 C-Corp and S-Corp records

Caps

20. Cap for Holding Companies
Citation: G.S. 105-120.2(b)(1)
Description: Maximum tax of $75,000 for holding companies. A holding company is any corporation which receives during its taxable year more than 80% of its gross income from corporations in which it owns directly or indirectly more than 50% of the outstanding voting stock.

Estimate (in millions): $200.0

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

Corporation Income Tax (Article 4. Part 1)

Brief Description and Tax Base Information

The corporation income tax is a tax on the profits of C-corporations operating in North Carolina. The tax rate is 6.9% of the corporation's State net income.

For corporations doing business both in and outside North Carolina, the share of business income taxable to North Carolina is calculated by the following formula: the average of the corporation's ratios of capital stock, payroll and sales within North Carolina to the company's totals of these factors, with the sales factor double-weighted. For a few types of companies, the sales factor only is used. These companies include building or construction contractors, securities dealers, loan companies, or corporations that receive more than 50% of their ordinary gross income from intangible property.

The corporation tax's base is net income, or profits, since most operating costs can be deducted. There is no minimum tax, so that corporations with negative profits pay no corporation income taxes. Based on 2002 tax returns, two-thirds of corporations filing North Carolina C-Corporation tax returns had no tax liability. This creates a special problem in measuring individual tax expenditures since some companies that claim them would still have negative incomes if they were not allowed that particular deduction. (The tax expenditure is non-binding for these companies.) In the measurement of tax expenditures in this section, attempts were made to include only companies for which the tax expenditure reduces tax liability.

S-corporations may also claim the credits and deductions in this section for nonresident shareholders who elect not to file individual income tax returns in North Carolina.

In Fiscal Year 2004-05, North Carolina collected $1.27 billion in corporate income taxes.

Table 4

2004 NC Corporate Income Tax Expenditure Estimates

Item	Citation	Short Title	2004 Estimate (millions of dollars)
1	130.11(a)(1)	Fraternal Beneficiary Societies	less than 0.1
2	130.11(a)(2)	Certain Cooperative Companies	12.5
3	130.11(a)(3)	Certain Charitable Organizations	49.3
4	130.11(a)(4)	Nonprofit Business Associations	0.7
5	130.11(a)(5)	Nonprofit Promoters of Social Welfare	0.3
6	130.11(a)(6)	Nonprofit Clubs	0.6
7	130.11(a)(7)	Local Mutual Nonprofits	less than 0.1
8	130.11(a)(8)	Nonprofit Agricultural Marketing Memberships	0.1
9	130.11(a)(9)	Certain Agricultural Associations	included in item #8
10	130.11(a)(11)	Homeowners' Association	0.4
11	130.5(b)(1)	US Obligation Interest	63.7
12	130.5(b)(1a)	NC Obligation Interest	1.0
13	130.5(b)(7)	Depreciation of Certain Facilities	0.0
14	130.5(b)(8)	Net Capital Losses Not Deductible from Federal Taxable Income	3.0
15	130.5(b)(9)	Shareholders of a Regulated Investment Company	Unavailable
16	130.5(b)(12)	Reforestation and Cultivation of Trees	less than 0.1
17	130.5(b)(13)	Income from International Banking Facility	included in item #47
18	130.5(b)(14)	Basis Adjustment for Federal Tax Credit	Unavailable

Item	Citation	Short Title	2004 Estimate (millions of dollars)
19	130.5(b)(15)	Marketing Assessments on Tobacco	0.0
20	130.5(b)(16)	Natural Gas Expansion Surcharges	Unavailable
21	130.5(b)(18)	Earnings of Certain Trusts	included in item #47
22	130.5(b)(19)	Income from Hurricane Floyd Reserve Fund	less than 0.1
23	130.5(b)(22)	Disaster Relief Reserve Payments	1.5
24	130.5(c)(2)	Percentage Depletion over Cost Depletion	1.4
25	130.6A(e)	Expenses Related to Nontaxed Dividends for Bank Holding Company	included in item #47
26	130.8	Net Economic Losses	127.4
27	130.9(1)	Charitable Contributions Outside NC	4.6
28	130.9(1)-(3)	Charitable Contributions Within NC	4.0
29	130.10	Amortization of Pollution Abatement Facilities and Equipment	Unavailable
30	130.10A	Amortization of Equipment Mandated by OSHA	Unavailable
31	130.6A(f)	Credit for Bank Holding Companies Related to Expenses on Nontaxed Earnings	included in item #47
32	130.6A(g)	Credit for Electric Power Holding Companies Related to Expenses on Nontaxed Earnings	included in item #47
33	130.22	Rental Units for Handicapped Persons	0.0

Item	Citation	Short Title	2004 Estimate (millions of dollars)
34	130.25	Equipment for Cogenerating Power Plant	0.0
35	130.28	Construction of Renewable Energy Equipment Facility	0.0
36	130.34	Credit for Certain Real Property Donations	0.1
37	130.36	Conservation Tillage Equipment Credit	less than 0.1
38	130.37	Credit for Gleaned Crops	less than 0.1
39	130.39	Credit for Low-Income Residential Telephone Service	3.8
40	130.41	Credit for Costs at NC Ports	0.4
41	130.43	Credit for S&L Supervisory Fees	0.2
42	130.44	Credit for Poultry Composting Facility	0.0
43	130.45	Credit for Manufacturing Cigarettes for Exportation	included in item #47
44	130.46	Alternative Cigarette Export Credit	included in item #47
45	130.47	Film Industry Production Expenses	5.4
46	163.011	Credit for Qualified Investments	less than 0.1
47		Tax Expenditures Combined for Confidentiality	100.1

Exemptions

1. **Fraternal Beneficiary Societies**
   Citation: G.S. 105-130.11(a)(1)
   Description: Exemption for fraternal beneficiary societies, orders or associations (a) operating under the lodge system or providing benefits to members of a lodge system and (b) providing for the payment of life, sick, accident, or other benefits of the organization or their dependents.

   Estimate (in millions): less than $0.1

   Data Source: National Center for Charitable Statistics; "Charities and Other Tax-Exempt Organizations, 2001," Statistics on Income, IRS

   Note: Based on data for IRC 501(c)(8) organizations.

2. **Certain Cooperative Companies**
   Citation: G.S. 105-130.11(a)(2)
   Description: Exemption for nonprofit cooperative banks without capital stock and electric and telephone membership corporations organized under Chapter 117 of the General Statutes.

   Estimate (in millions): $12.5

   Data Source: National Center for Charitable Statistics; "2003 Annual Report of State Chartered Credit Unions," Credit Union Division, NC Department of Commerce

   Note: Based on data for IRC 501(c)(12) and 501(c)(14) organizations.

3. **Certain Charitable Organizations**
   Citation: G.S. 105-130.11(a)(3)
   Description: Exemption for cemetary corporations and corporations organized for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

   Estimate (in millions): $49.3

   Data Source: National Center for Charitable Statistics; "Charities and Other Tax-Exempt Organizations, 2001," Statistics on Income, IRS

   Note: Based on data for IRC 501(c)(3) and 501(c)(13) organizations

4. **Nonprofit Business Associations**
Citation: G.S. 105-130.11(a)(4)
Description: Exemption for business leagues, chambers of commerce, merchants' associations or boards of trade not organized for profit.

Estimate (in millions): $0.7

Data Source: National Center for Charitable Statistics; "Charities and Other Tax-Exempt Organizations, 2001," Statistics on Income, IRS

Note: Based on data for IRC 501(c)(6) organizations.

5. **Nonprofit Promoters of Social Welfare**
Citation: G.S. 105-130.11(a)(5)
Description: Exemption for civic leagues or organizations not organized for profit, but operated for the promotion of social welfare.

Estimate (in millions): $0.3

Data Source: National Center for Charitable Statistics; "Charities and Other Tax-Exempt Organizations, 2001," Statistics on Income, IRS

Note: Based on data for IRC 501(c)(4) organizations.

6. **Nonprofit Clubs**
Citation: G.S. 105-130.11(a)(6)
Description: Exemption for nonprofit clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes.

Estimate (in millions): $0.6

Data Source: National Center for Charitable Statistics; "Charities and Other Tax-Exempt Organizations, 2001," Statistics on Income, IRS

Note: Based on data for IRC 501(c)(7) organizations.

7. **Local Mutual Nonprofits**
Citation: G.S. 105-130.11(a)(7)
Description: Exemption for farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations of a purely local nature.

Estimate (in millions): less than $0.1

Data Source: Data on county farm mutual insurance companies, NC Department of Insurance

8. Nonprofit Agricultural Marketing Memberships
Citation: G.S. 105-130.11(a)(8)
Description: Exemption for farmers' , fruit growers' or like organization for the purposes of marketing member products.

Estimate (in millions): $0.1

Data Source: National Center for Charitable Statistics; "Charities and Other Tax-Exempt Organizations, 2001," Statistics on Income, IRS

Note: Based on data for IRC 501(c)(5) organizations. The estimate includes Item #9.

9. Certain Agricultural Associations
Citation: G.S. 105-130.11(a)(9)
Description: Exemption for mutual associations formed under G.S. 54-111 through 54-128 to conduct agricultural business on the mutual plan and marketing associations organized under G.S. 54-129 through 54-158.

Estimate (in millions): included in item #8

10. Homeowners' Association
Citation: G.S. 105-130.11(a)(11)
Description: Exemption for nonprofit condominium associations, homeowners' associations, or cooperative housing corporation.

Estimate (in millions): $0.4

Data Source: National Center for Charitable Statistics; "Charities and Other Tax-Exempt Organizations, 2001," Statistics on Income, IRS

Deductions

11. US Obligation Interest
Citation: G.S. 105-130.5(b)(1)
Description: Deductions for interest upon the obligations of the US or its possessions, to the extent included in federal taxable income.

Estimate (in millions): $63.7

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

12. **NC Obligation Interest**
Citation: G.S. 105-130.5(b)(1a)
Description: Deductions for interest on the obligations of this State, a political subdivision of this State, or a commission, an authority, or another agency of this State or of a political subdivision of this State, or a nonprofit educational institution.

Estimate (in millions): $1.0

Data Source: Department of Revenue 2001 C-Corp sample records

13. **Depreciation of Certain Facilities**
Citation: G.S. 105-130.5(b)(7)
Description: Deduction for depreciation of emergency facilities acquired prior to Jan 1, 1955.

Estimate (in millions): 0.0

Data Source: Department of Revenue 2001 C-Corp sample records

14. **Net Capital Losses Not Deductible from Federal Taxable Income**
Citation: G.S. 105-130.5(b)(8)
Description: Deduction for the amount of losses realized on the sale or disposition of assets not allowed under section 1211(a) of the Code.

Estimate (in millions): $3.0

Data Source: Department of Revenue 2001 C-Corp sample records

15. **Shareholders of a Regulated Investment Company**
Citation: G.S. 105-130.5(b)(9)
Description: Deduction of the portion of undistributed capital gains of a regulated investment company for which a shareholder in the company takes a federal credit or deduction under Section 852 of the Code.

Estimate (in millions): Unavailable

16. **Reforestation and Cultivation of Trees**
Citation: G.S. 105-130.5(b)(12)
Description: Deduction for reasonable expenses, in excess of deductions allowed under the Code, paid for reforestation and cultivation of commercially grown trees.

Estimate (in millions): less than $0.1

Data Source: Department of Revenue 2001 C-Corp sample records

17. Income from International Banking Facility
Citation: G.S. 105-130.5(b)(13)
Description: Deduction of the eligible income of an international banking facility to the extent included in determining federal taxable income.

Estimate (in millions): included in item #47

Data Source: Department of Revenue 2001 C-Corp sample records

18. Basis Adjustment for Federal Tax Credit
Citation: G.S. 105-130.5(b)(14)
Description: Deduction for the amount that the basis of a depreciable asset is reduced due to Federal tax credit.

Estimate (in millions): Unavailable

19. Marketing Assessments on Tobacco
Citation: G.S. 105-130.5(b)(15)
Description: Deduction for the amount paid, pursuant to 7 U.S.C. § 1445-2, as marketing assessments on tobacco grown by a corporation in North Carolina.

Estimate (in millions): 0.0

Data Source: Department of Revenue 2001 and 2002 C-Corp records and USDA's Farm Service Agency (FSA) data through 2003

Note: The federal provisions on which the marketing assessments were based have been repealed in the American Jobs Creation Act of 2004.

20. Natural Gas Expansion Surcharges
Citation: G.S. 105-130.5(b)(16)
Description: Deduction for the amount of natural gas expansion surcharges collected by a natural gas local distribution company.

Estimate (in millions): Unavailable

21. Earnings of Certain Trusts
Citation: G.S. 105-130.5(b)(18)
Description: Deduction of earnings on a trust for settlement of an agreement by two or more manufacturers with the State for potential claims against the manufacturers.

Estimate (in millions): included in item #47

22. Income from Hurricane Floyd Reserve Fund
Citation: G.S. 105-130.5(b)(19)
Description: Deduction for the amount paid to taxpayer from the Hurricane Floyd Reserve Fund.

Estimate (in millions): less than $0.1

Note: Not likely to be significant in 2004.

23. Disaster Relief Reserve Payments
Citation: G.S. 105-130.5(b)(22)
Description: Deduction for amounts paid to taxpayers for hurricane relief from the Disaster Relief Reserve Fund, not to include amounts paid for goods and services provided.

Estimate (in millions): $1.5

Data Source: Fiscal Research Division fiscal note. The estimate is based on expected payments to compensate for lost crop income.

Note: The estimate includes the amount for similar provision in Individual Income Tax Item #12.

24. Percentage Depletion over Cost Depletion
Citation: G.S. 105-130.5(c)(2)
Description: Federal taxable income must be increased or decreased to account for any difference in the amount of depreciation, amortization, or gains or losses applicable to property which has been depreciated or amortized by use of a different basis or rate for State income tax purposes than used for federal income tax purposes.

Estimate (in millions): $1.4

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

25. Expenses Related to Nontaxed Dividends for Bank Holding Company
Citation: G.S. 105-130.6A(e)
Description: Cap for bank holding companies of $11,000,000 as a result of the limitation of 105-130.6A(c).

Estimate (in millions): included in item #47

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

26. Net Economic Losses
Citation: G.S. 105-130.8
Description: Deduction for net economic losses in any or all of the 15 preceding income years.

Estimate (in millions): $127.4

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

27. Charitable Contributions Outside NC
Citation: G.S. 105-130.9(1)
Description: Deduction for charitable contributions. The amount of deduction for this item may not exceed 5% of the taxpayer's net income.

Estimate (in millions): $4.6

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

Note: This estimate includes only contributions made to donees outside NC; see item #29 for deduction for donees in NC.

28. Charitable Contributions Within NC
Citation: G.S. 105-130.9(1)-(3)
Description: Deductions for contributions to the State of North Carolina, its counties and municipalities and any agency or instrumentality of these institutions, in addition to contributions made to educational institutions located in North Carolina. For companies with income allocable outside North Carolina, charitable contributions to donees inside NC may be deducted fully from taxable income allocated to North Carolina.

Estimate (in millions): $4.0

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

Note: Allowing companies with income allocable outside North Carolina to receive 100% deduction for contributions to NC donees (instead of their apportionment percentage) cost the State $1.7 million of the $4.0 million estimate.

29. Amortization of Pollution Abatement Facilities and Equipment
Citation: G.S. 105-130.10
Description: In lieu of any depreciation allowance, a corporation may opt to deduct amortization of air-cleaning devices, waste treatment facilities, recycling facilities, equipment or plant used to provide sewer service to residential and outlying areas.

Estimate (in millions): Unavailable

30. Amortization of Equipment Mandated by OSHA
Citation: G.S. 105-130.10A
Description: In lieu of any depreciation allowance, a corporation may opt to deduct amortization of equipment mandated by the Occupational Safety and Health Act (OSHA), including the cost of planning, acquiring, constructing, modifying, and installing said equipment.

Estimate (in millions): Unavailable

Tax Credits

31. Credit for Bank Holding Companies Related to Expenses on Nontaxed Earnings
Citation: G.S. 105-130.6A(f)
Description: Credit for bank holding companies of $2 million if they are eligible for the cap in 105-130.6A(e). See item #25.

Estimate (in millions): included in item #47

32. Credit for Electric Power Holding Companies Related to Expenses on Nontaxed Earnings
Citation: G.S. 105-130.6A(g)
Description: After calculating the adjustment for expenses related to dividends under G.S. 105-130.5(c)(3), each electric power holding company must calculate the amount of additional tax that results from the expense adjustment for the taxable year. The electric power holding company is allowed a credit for the following taxable year equal to one-half of this amount of additional tax.

Estimate (in millions): included in item #47

33. Rental Units for Handicapped Persons
Citation: G.S. 105-130.22
Description: Credit for corporate owners of multifamily rental units for handicapped persons of $550 per unit constructed.

Estimate (in millions): 0.0

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

34. Equipment for Cogenerating Power Plant
Citation: G.S. 105-130.25
Description: Credit of 10% of the costs to purchase and install electrical or mechanical equipment for a cogenerating power plant.

Estimate (in millions): 0.0

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

35. Construction of Renewable Energy Equipment Facility
Citation: G.S. 105-130.28
Description: Credit against corporate income tax for 25% of costs of construction of a renewable energy equipment facility.

Estimate (in millions): 0.0

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records and information from the NC Solar Center

36. Credit for Certain Real Property Donations
Citation: G.S. 105-130.34
Description: Credit of 25% for donations of real property for public beach access, public access to water or trails, fish and wildlife conservation, or other similar land conservation purposes. The credit may not exceed $500,000.

Estimate (in millions): $0.1

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

37. Conservation Tillage Equipment Credit
Citation: G.S. 105-130.36
Description: Credit of 25% of the cost of conservation tillage equipment used in a farm business, including tree farming.

Estimate (in millions): less than $0.1

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

38. Credit for Gleaned Crops
Citation: G.S. 105-130.37
Description: Credit of 10% of the market price of the quantity of gleaned crops for companies that allow gleaning of their crop.

Estimate (in millions): less than $0.1

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

39. Credit for Low-Income Residential Telephone Service
Citation: G.S. 105-130.39
Description: Credit for corporation that provides local telephone service to low-income residential consumers at reduced rates. The credit is equal to the difference between what the companies actually charged these customers and the amount they would have charged at normal rates.

Estimate (in millions): $3.8

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

40. Credit for Costs at NC Ports
Citation: G.S. 105-130.41
Description: Credit for loading or unloading cargo at a State-owned port terminal at Wilmington or Morehead City.

Estimate (in millions): $0.4

Data Source: Department of Revenue 2003 tax records

41. Credit for S&L Supervisory Fees
Citation: G.S. 105-130.43
Description: Credit for savings and loan supervisory fees assessed by the Commissioner of Banks of the Department of Commerce.

Estimate (in millions): $0.2

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

42. Credit for Poultry Composting Facility
Citation: G.S. 105-130.44
Description: Credit for 25% of the installation, materials and equipment costs of constructing poultry composting facility.

Estimate (in millions): 0.0

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

43. Credit for Manufacturing Cigarettes for Exportation
Citation: G.S. 105-130.45
Description: Credit of up to $6,000,000 is allowed a company that exports cigarettes to a foreign country through the North Carolina State Ports. The amount of the credit depends on the volume of cigarettes exported compared to the volume in a base year.

Estimate (in millions): included in item #47

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

44. Alternative Cigarette Export Credit
Citation: G.S. 105-130.46
Description: Credit of up to $10,000,000 is allowed a company that exports cigarettes to a foreign country through the North Carolina State Ports. The amount of the credit depends on the employment level at the company compared to the employment level in 2004.

Estimate (in millions): included in item #47

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

45. Film Industry Production Expenses
Citation: G.S. 105-130.47
Description: A film or television production company that spends at least $250,000 in North Carolina on productions during the tax year is allowed a credit equal to 15% of the qualifying expenses.

Estimate (in millions): $5.4

Data Source: Fiscal Research Division fiscal note based on Department of Commerce data on expenses of film companies. The estimate includes individual income tax item #25.

46. Credit for Qualified Investments
Citation: G.S. 105-163.011
Description: A tax credit is allowed to corporations investing in the equity securities of a North Carolina Enterprise Corporation, a limited partnership in which a North Carolina Enterprise Corporation is the only general partner, or a qualified investment organization. The credit is equal to 25% of the amount invested, but may not exceed $750,000. Unused credits may be carried forward 5 years.

Estimate (in millions): less than $0.1

Data Source: Department of Revenue 2001 and 2002 C-Corp and S-Corp records

Note: See Individual Income Tax, Item #26.

47. Tax Expenditures Combined for Confidentiality

Citation: G.S. 105-129.27; G.S. 105-129.28; G.S. 105-130.5(b)(13); G.S. 105-130.5(b)(18); G.S. 105-130.6A(e), (f), (g); G.S. 105-130.45; G.S. 105-130.46; G.S. 105-134.6(b)(15)

Description: All of these tax expenditures are utilized by a small enough number of taxpayers that it would compromise taxpayer confidentiality to report them separately.

Estimate (in millions): $100.1

Data Source: Department of Revenue Corporate Income and Franchise Tax records

Note: Includes Corporate Income Tax Items 17, 21, 25, 31, 32, 43, 44; Individual Income Tax Item 10; and Tax Incentives for Recycling Facilities Items 1 and 2.

Tax Incentives for New and Expanding Businesses (Article 3A)

The amounts of tax expenditures in this section are based on the figures published in the 2005 William S. Lee Act report from the NC Department of Revenue. That report covers returns processed in 2004, most of which were tax year 2003 forms.

1. **Credit for Creating Jobs**
   Citation: G.S. 105-129.8
   Description: A taxpayer that meets the eligibility requirements set out in G.S. 105-129.4, has 5 or more full-time employees, and hires an additional full-time employee to fill a new position located in this State is allowed a credit for creating a new full-time job.

   Estimate (in millions): $10.6

   Data Source: Department of Revenue NC-478 tax credit records

2. **Credit for Investing in Machinery and Equipment**
   Citation: G.S. 105-129.9
   Description: A taxpayer that has purchased or leased eligible machinery and equipment and places them in service in this State is allowed a credit equal to the applicable percentage of the excess of the eligible investment amount over the applicable threshold.

   Estimate (in millions): $42.9

   Data Source: Department of Revenue NC-478 tax credit records

3. **Technology Commercialization Credit**
   Citation: G.S. 105-129.9A
   Description: A taxpayer may receive a 15% or 20% credit for machinery and equipment investments that are directly related to production based on technology developed by and licensed from a research university or are used to produce resources essential to the taxpayer's production based on technology developed by and licensed from a research university.

   Estimate (in millions): less than $0.1

   Data Source: Department of Revenue NC-478 tax credit records

4. **Research and Development Credit**
   Citation: G.S. 105-129.10
   Description: A taxpayer that claims a federal income tax credit under Section 41(a) of the Code for increasing research activities is allowed a credit equal to either 5% of the State's apportioned share of the taxpayer's expenditures for increasing research activities or 25% of the State's apportioned share of the federal credit.

   Estimate (in millions): $9.5

   Data Source: Department of Revenue NC-478 tax credit records

5. **Worker Training Credit**
   Citation: G.S. 105-129.11
   Description: A taxpayer that provides worker training for 5 or more of its employees is allowed a credit equal to the wages paid to the eligible employees during the training.

   Estimate (in millions): $1.4

   Data Source: Department of Revenue NC-478 tax credit records

6. **Credit for Investing in Central Office or Aircraft Facility Property**
   Citation: G.S. 105-129.12
   Description: If a taxpayer that has purchased or leased real property in this State begins to use the property as a central office or aircraft facility, the taxpayer is allowed a credit equal to 7% of the eligible investment amount.

   Estimate (in millions): $1.9

   Data Source: Department of Revenue NC-478 tax credit records

7. **Credit for Substantial Investment in Other Property**
   Citation: G.S. 105-129.12A
   Description: If a taxpayer that has purchased or leased real property in an enterprise tier 1 or 2 area begins to use the property in an eligible business, the taxpayer is allowed a credit equal to 30% of the eligible investment amount if all of the requirements of GS 105-129.4 are met.

   Estimate (in millions): less than $0.1

   Data Source: Department of Revenue NC-478 tax credit records

8. Credit for Development Zone Projects

Citation: G.S. 105-129.13

Description: A taxpayer who contributes cash or property to a development zone agency for an improvement project in a development zone is allowed a credit equal to 25% of the value of the contribution.

Estimate (in millions): less than $0.1

Data Source: Department of Revenue NC-478 tax credit records

Business and Energy Tax Credits (Article 3B)

The estimates for the following tax expenditures are based on reports produced by the NC Department of Revenue covering returns processed from April 1, 2004 through March 31, 2005, most of which were tax year 2003 forms.

1. **Credit for Investing in Business Property**
   Citation: G.S. 105-129.16
   Description: If a taxpayer that has purchased or leased business property places it in service in this State, the taxpayer is allowed a credit equal to 4.5% of the cost of the property, up to a credit of $4,500. This credit was repealed for activity after January 1, 2002.

   Estimate (in millions): $24.6

   Data Source: Department of Revenue records

   Note: The expenditure represents installments of previously-earned credits.

2. **Credit for Investing in Renewable Energy Property**
   Citation: G.S. 105-129.16A
   Description: If a taxpayer that has constructed, purchased, or leased renewable energy property places it in service in this State, the taxpayer is allowed a credit equal to 35% of the cost of the property.

   Estimate (in millions): $2.0 - $5.0

   Data Source: Department of Revenue records

3. **Credit for Investing in Dry-Cleaning Equipment That Does Not Use a Hazardous Substance**
   Citation: G.S. 105-129.16C
   Description: If a taxpayer that has purchased or leased qualified dry-cleaning equipment places it in service in this State for commercial purposes, the taxpayer is allowed a credit equal to 20% of the cost of the equipment.

   Estimate (in millions): less than $0.1

   Data Source: Department of Revenue records

4. Credit for Constructing Renewable Fuel Facilities

Citation: G.S. 105-129.16D

Description: A taxpayer that constructs and installs and places in service in this State a qualified commercial facility for dispensing renewable fuel is allowed a credit equal to 15% of the cost to the taxpayer of constructing and installing the part of the dispensing facility, including pumps, storage tanks, and related equipment, that is directly and exclusively used for dispensing or storing renewable fuel. The credit must be taken in 3 annual installments.

Estimate (in millions): 0.0

Data Source: Department of Revenue records; NC Legislative Fiscal Note for HB 1636 (2003-04 session)

Tax Incentives for Recycling Facilities (Article 3C)

Data for the estimates in this section were derived from evaluation of 2001 C-Corporation and S-Corporation tax returns.

1. **Credit for Investing in Large or Major Recycling Facility**
   Citation: G.S. 105-129.27
   Description: An owner that purchases or leases machinery and equipment for a major recycling facility in this State is allowed a credit equal to 50% of the amount payable by the owner during the taxable year to purchase or lease the machinery and equipment.

   Estimate (in millions): included in item #47 of Corporate Income Tax list

   Data Source: Department of Revenue 2002 and 2003 records

2. **Credit for Reinvestment**
   Citation: G.S. 105-129.28
   Description: A major recycling facility that is accessible by neither ocean barge nor ship and that transports materials to the facility or products away from the facility is allowed a credit against the income tax equal to its additional transportation and transloading expenses incurred due to its inability to use ocean barges or ships. The credit is capped at $10.4 million for 2004 and is refundable.

   Estimate (in millions): included in item #47 of Corporate Income Tax list

   Data Source: Department of Revenue 2003 records

Historic Rehabilitation Tax Credits (Article 3D)

Data for the estimates in this section were derived from evaluation of 2001 C-Corporation and S-Corporation tax returns, in addition to 2003 Individual income tax returns.

1. **Credit for Rehabilitating Income-Producing Historic Structure**
   Citation: G.S. 105-129.35
   Description: A taxpayer who is allowed a federal income tax credit under Section 47 of the Code for making qualified rehabilitation expenditures for a certified historic structure located in this State is allowed a credit equal to 20% of the expenditures that qualify for the federal credit.

   Estimate (in millions): $4.0

   Data Source: Department of Revenue records

2. **Credit for Rehabilitating Nonincome-Producing Historic Structure**
   Citation: G.S. 105-129.36
   Description: A taxpayer who is not allowed a federal income tax credit under Section 47 of the Code and who makes rehabilitation expenses for a State-certified historic structure located in this State is allowed a credit equal to 30% of the rehabilitation expenses. To qualify for the credit, the taxpayer's expenses must exceed $25,000 within a 24-month period.

   Estimate (in millions): $7.0

   Data Source: Department of Revenue records

Low-Income Housing Tax Credits (Article 3E)

The amounts of credits taken come from reports produced by the NC Department of Revenue

1. **Credit for Low-Income Housing Awarded a Federal Credit Allocation before Jan. 1, 2003**
   Citation: G.S. 105-129.41
   Description: A taxpayer that is allowed a federal income tax credit for low-income housing under Section 42 of the Code with respect to a qualified North Carolina low-income building is allowed a credit equal to a percentage of the federal credit.

   Estimate (in millions): included in next item

2. **Credit for Low-Income Housing Awarded on or after Jan. 1, 2003**
   Citation: G.S. 105-129.42
   Description: A taxpayer that is allowed a federal income tax credit for low-income housing under Section 42 of the Code to construct or substantially rehabilitate a qualified North Carolina low-income housing development is allowed a credit equal to a percentage of the development's qualified basis.

   Estimate (in millions): $47.1

   Data Source: Department of Revenue records

Research and Development Tax Credits (Article 3F)

1. **Credit for North Carolina Research and Development**
   Citation: G.S. 105-129.55(a)
   Description: A taxpayer thas has qualified North Carolina research expenses for the taxable year is allowed a credit equal to a percentage of the expenses, determined by the following criteria: (1) if the taxpayer is a small business, the applicable percentage is 3%; (2) for expenses with respect to research performed in an enterprise tier one, two, or three area, the percentage is 3%; (3) for expenses not covered under (1) or (2), the credit is 1% of expenses up to $50 million, 2% of additional expenses up to $200 million, and 3% of additional expenses above $200 million.

   Estimate (in millions): $12.5

   Data Source: NC Legislative Fiscal Note for HB 1631 or SB 1115 (2003-04 Session)

   Note: This credit is effective for business activities occurring on or after May 1, 2005. The estimate is based on the expected amount if the credit had been in effect in 2004. This credit is a close substitute for Item #4 under "Tax Incentives for New and Expanding Businesses," and it is likely that some taxpayers that are currently taking that credit would prefer to switch to this one. However, the estimate above does not reflect any substitution away from the other credit.

2. **Credit for NC University Research Expenses**
   Citation: G.S. 105-129.55(b)
   Description: A taxpayer that has NC university research expenses for the taxable year is allowed a credit equal to 15% of the expenses.

   Estimate (in millions): included in item #1

   Note: This credit is effective for business activities occurring on or after May 1, 2005.

Tax Incentives for Major Computer Manufacturing Facilities (Article 3G)

1. **Tax Incentives for Major Computer Manufacturing Facilities**
   Citation: G.S. 105-129.64
   Description: A taxpayer that is expected to add at least 1,200 employees within five years to a computer manufacturing and distribution facility and invests, directly or indirectly, $100 million in constructing the facility is eligible for a credit against its franchise and income taxes. The credit is $10 million for 2005. For taxable years beginning in 2006, the amount of the credit is determined based on the levels of employment and production at the facility.

   Estimate (in millions): 0.0

   Data Source: NC Legislative Fiscal Note for SB 2 (2004 Extra Session)

   Note: This credit is effective for tax years beginning on or after January 1, 2005. The estimate is based on the expected amount if the credit had been in effect in 2004. The Legislature's Fiscal Note estimated a $10 million cost for 2005.

Individual Income Tax (Article 4, Part 2)

Brief Description and Tax Base Information

The individual income tax is the largest component of the State's general revenues. In fiscal year 2004-05, the State collected over $8.4 billion from this tax.

There are currently four marginal tax rates: 6%, 7%, 7.75% and 8.25%. The highest tax rate is scheduled to expire beginning with the 2008 tax year. Tax brackets vary by marital status and by whether an individual is either (1) the head of a household, (2) elderly, or (3) blind.

The base of the individual income tax is federal taxable income. This implies that all federal tax deductions are passed on to the state. However, certain provisions have been "decoupled" from the federal Code. Specifically, the amounts of the personal deduction and exemptions allowable on North Carolina income are not adjusted for inflation, unlike the federal levels. In addition, there are different provisions for deductions for accelerated depreciation for the years 2002-2004.

Deductions and tax credits estimated in this report reduced North Carolina personal income taxes by $780 million in 2004. This does not include the tax deductions available via the federal Code, such as the standard deduction and personal exemptions, deductions for mortgage interest payments, charitable deductions for itemizers, etc.

Table 5

2004 NC Individual Income Tax Expenditure Estimates

Item	Citation	Short Title	2004 Estimate (millions of dollars)
1	158	Certain Individuals upon Death	less than 0.1
2	134.6(b)(1)	US and NC Obligation Interest	13.4
3	134.6(b)(2)	Disposition of Certain Obligations	0.1
4	134.6(b)(3)	Social Security Benefits in Excess of Federal Limit	179.4
5	134.6(b)(5b)	Government Retirement Income under Bailey Settlement	246.0
6	134.6(b)(6)	Private Retirement Plans and Government Pensions	68.8
7	134.6(b)(10)	Basis Adjustment for Disposed Property	Unavailable
8	134.6(b)(11)	Severance Wages	9.7
9	134.6(b)(14)	Erroneous Conviction and Imprisonment	less than 0.1
10	134.6(b)(15)	Interest Earned on Certain Trusts	included in corporate income tax item #47
11	134.6(b)(16)	Hurricane Floyd Reserve Fund	less than 0.1
12	134.6(b)(18)	Disaster Relief Reserve Payments	included in corporate income tax item #23
13	134.7(a)(4)	Net Economic Losses	$3.0 to $5.0
14	151.1	Construction of Dwellings for Handicapped Persons	0.1
15	151.11	Credit for Child Care and Certain Employment-Related Expenses	41.2

Item	Citation	Short Title	2004 Estimate (millions of dollars)
16	151.12	Credit for Certain Real Property Donations	15.6
17	151.13	Credit for Conservation Tillage Equipment	less than 0.1
18	151.14	Credit for Gleaned Crops	0.1
19	151.18	Credit for the Disabled	0.7
20	151.21	Credit for Property Taxes Paid on Farm Machinery	1.5
21	151.22	Use of North Carolina Ports	less than 0.1
22	151.24	Credit for Children	134.3
23	151.25	Construction of Poultry Composting Facility	less than 0.1
24	151.26	Charitable Contributions by Nonitemizers	23.1
25	151.29	Film Industry Production Expenses	included in corporate income tax item #45
26	163.011	Investments in Qualified Businesses	6.0
27		Carry-Over Provisions	21.0

Exemptions

1. **Certain Individuals upon Death**
   Citation: G.S. 105-158
   Description: Certain armed forces personnel and other individuals are exempted from taxation on all income for the year in which they died.

   Estimate (in millions): less than $0.1

   Data Source: Number of military deaths from Department of Defense

Deductions

2. **US and NC Obligation Interest**
   Citation: G.S. 105-134.6(b)(1)
   Description: Deduction for interest on obligations of US, North Carolina, and nonprofit educational institutions.

   Estimate (in millions): $13.4

   Data Source: Department of Revenue 2003 Individual Income Tax records

   Note: Although not separately stated, the deductible amount for interest on State and local obligations would likely be less than $1 million.

3. **Disposition of Certain Obligations**
   Citation: G.S. 105-134.6(b)(2)
   Description: Deduction for gain from disposition of obligations issued before July 1, 1995, to the extent exempt from tax.

   Estimate (in millions): $0.1

   Data Source: Department of Revenue 2003 Individual Income Tax records

4. **Social Security Benefits in Excess of Federal Limit**
   Citation: G.S. 105-134.6(b)(3)
   Description: Deduction for benefits received under Title II of the Social Security Act and amounts received from retirement annuities or pensions paid under the provisions of the Railroad Retirement Act of 1937.

   Estimate (in millions): $179.4

   Data Source: Department of Revenue 2003 Individual Income Tax records

5. **Government Retirement Income under Bailey Settlement**
Citation: G.S. 105-134.6(b)(5b)
Description: Exemption for State, local or federal government retirement plans to the extent the amount is exempt pursuant to a court order in settlement of Bailey v. State and Patton v. State.

Estimate (in millions): $246.0

Data Source: Department of Revenue 2003 Individual Income Tax records

6. **Private Retirement Plans and Government Pensions**
Citation: G.S. 105-134.6(b)(6)
Description: Deduction for private retirement plans up to $2,000 or a State, local or federal government pension up to $4,000.

Estimate (in millions): $68.8

Data Source: Department of Revenue 2003 Individual Income Tax records

7. **Basis Adjustment for Disposed Property**
Citation: G.S. 105-134.6(b)(10)
Description: Deduction for the amount that the basis of property disposed of exceeds the federal basis.

Estimate (in millions): Unavailable

8. **Severance Wages**
Citation: G.S. 105-134.6(b)(11)
Description: Deduction for severance wages received from an employer as the result of the taxpayer's permanent termination from employment through no fault of the employee. The amount of wages deducted may not exceed $35,000.

Estimate (in millions): $9.7

Data Source: Department of Revenue 2002 Individual Income Tax records and NC Employment Security Commission data on unemployment insurance claims through 2004

9. **Erroneous Conviction and Imprisonment**
   Citation: G.S. 105-134.6(b)(14)
   Description: Deduction for the amount paid to the taxpayer under G.S. 148-84 for erroneous conviction and imprisonment.

   Estimate (in millions): less than $0.1

   Data Source: Industrial Commission of the North Carolina Department of Commerce

10. **Interest Earned on Certain Trusts**
    Citation: G.S. 105-134.6(b)(15)
    Description: Deduction for interest earned on a trust established by two or more manufacturers to pay for damages.

    Estimate (in millions): included in Corporation Income Tax item #47

    Data Source: Department of Revenue 2003 Individual Income Tax records

11. **Hurricane Floyd Reserve Fund**
    Citation: G.S. 105-134.6(b)(16)
    Description: Deduction for amount paid from Hurricane Floyd Reserve Fund.

    Estimate (in millions): less than $0.1

12. **Disaster Relief Reserve Payments**
    Citation: G.S. 105-134.6(b)(18)
    Description: Deduction for amounts paid to taxpayers for hurricane relief from the Disaster Relief Reserve Fund, not to include amounts paid for goods and services provided by taxpayer.

    Estimate (in millions): included in Corporate Income Tax item #23

    Data Source: Fiscal Research Division fiscal note. The estimate is based on expected payments to compensate for lost crop income.

13. **Net Economic Losses**
    Citation: G.S. 105-134.7(a)(4)
    Description: Deductions for net economic losses in last 5 years, arising from business transactions, business capital, or business property.

    Estimate (in millions): $3.0 to $5.0

    Data Source: Department of Revenue 2003 Individual Income Tax records

Tax Credits

14. Construction of Dwellings for Handicapped Persons
Citation: G.S. 105-151.1
Description: An owner of multifamily rental units located in this State is allowed a credit against income tax equal to $550 for each dwelling unit constructed that conforms to Volume I-C of the NC Building Code.

Estimate (in millions): $0.1

Data Source: Department of Revenue 2002 and 2003 Individual Income Tax records

15. Credit for Child Care and Certain Employment-Related Expenses
Citation: G.S. 105-151.11
Description: A person who is allowed a credit against federal income tax for a percentage of employment-related expenses under Section 21 of the Code shall be allowed a proportional credit on State income taxes. The amount of expenses for which a credit is claimed may not exceed $2,400 for one qualifying household member or $4,800 for multiple qualifying members.

Estimate (in millions): $41.2

Data Source: Department of Revenue 2002 and 2003 Individual Income Tax records

16. Credit for Certain Real Property Donations
Citation: G.S. 105-151.12
Description: Credit of 25% for donations of real property for public beach access, public access to water or trails, fish and wildlife conservation, or other similar land conservation purposes. The credit may not exceed $250,000.

Estimate (in millions): $15.6

Data Source: Department of Revenue 2002 and 2003 Individual Income Tax records

17. Credit for Conservation Tillage Equipment
Citation: G.S. 105-151.13
Description: Credit for conservation tillage equipment.

Estimate (in millions): less than $0.1

Data Source: Department of Revenue 2002 and 2003 Individual Income Tax records

18. Credit for Gleaned Crops
Citation: G.S. 105-151.14
Description: A credit of 10% of the market price of unharvested crops donated by the grower to a qualified organization. Any unused credit may be carried forward for the succeeding five years.

Estimate (in millions): $0.1

Data Source: Department of Revenue 2002 and 2003 Individual Income Tax records

19. Credit for the Disabled
Citation: G.S. 105-151.18
Description: A taxpayer who (1) is retired on disability, (2) at the time of retirement was totally and permanently disabled, and (3) claims a federal income tax credit for the elderly and disabaled for the taxable year is allowed a credit equal to 1/3 of the amount of the federal credit. A credit is also available for a disabled dependent.

Estimate (in millions): $0.7

Data Source: Department of Revenue 2002 and 2003 Individual Income Tax records

20. Credit for Property Taxes Paid on Farm Machinery
Citation: G.S. 105-151.21
Description: A credit is allowed to individual farmers and individual shareholders of S Corporations engaged in farming equal to the amount of property taxes paid on farm machinery, or attachments and repair parts for farm machinery. This credit is not to exceed $1,000 and may not be carried forward.

Estimate (in millions): $1.5

Data Source: Department of Revenue 2002 and 2003 Individual Income Tax records

21. Use of North Carolina Ports
Citation: G.S. 105-151.22
Description: A credit is allowed to individuals utilizing North Carolina ports in either Wilmington or Morehead City equal to the excess of current year charges paid on exported, processed cargo over the average of the current year and the two previous years. This credit may not exceed 50% of tax due less all other credits. The cumulative amount of credit cannot exceed $100,000.

Estimate (in millions): less than $0.1

Data Source: Department of Revenue 2003 tax records

22. Credit for Children
Citation: G.S. 105-151.24
Description: An individual who is allowed a federal child tax credit under Section 24 of the Code and whose adjusted gross income (AGI) is less than a specified amount is allowed a credit of $100 for each dependent child. The credit cannot exceed the individual's tax liability for the year reduced by all other credits.

Estimate (in millions): $134.3

Data Source: Department of Revenue 2002 and 2003 Individual Income Tax records

Note: The credit prior to January 1, 2004 was $75 per dependent.

23. Construction of Poultry Composting Facility
Citation: G.S. 105-151.25
Description: A taxpayer who constructs in this State a poultry composting facility is allowed a credit of 25% of the installation, materials, and equipment costs of construction paid during the year. This credit may not exceed $1,000 for any single installation.

Estimate (in millions): less than $0.1

Data Source: Department of Revenue 2003 tax records

24. Charitable Contributions by Nonitemizers
Citation: G.S. 105-151.26
Description: A taxpayer who elects the standard deduction on their Federal income tax is allowed a credit of 7% of the taxpayer's excess charitable contributions. Excess contributions are those over 2% of the taxpayer's federal adjusted gross income.

Estimate (in millions): $23.1

Data Source: Department of Revenue 2002 and 2003 Individual Income Tax records

25. Film Industry Production Credits
Citation: G.S. 105-151.29
Description: A film or television production company that spends at least $250,000 in North Carolina on productions during the tax year is allowed a credit equal to 15% of qualifying expenses.

Estimate (in millions): included in Corporate Income Tax item #45

Data Source: Fiscal Research Division fiscal note. The estimate is based on Department of Commerce data on expenses of productions in North Carolina.

26. Investments in Qualified Businesses

Citation: G.S. 105-163.011

Description: A credit is allowed to individuals investing in the equity securities or subordinated debt of a North Carolina Enterprise Corporation, a limited partnership in which a North Carolina Enterprise Corporation is the only general partner, a qualified business venture, a qualified grantee business, or a qualified investment organization, equal to 25% of the amount invested or $50,000, whichever is less. Unused credits may be carried forward for five years. The total amount of all tax credits allowed to taxpayers may not exceed $7,000,000.

Estimate (in millions): $6.0

Data Source: Department of Revenue 2002 and 2003 Individual Income Tax records

Note: The cap on total tax credits claimed for investments made prior to 2004 was $6,000,000.

Table 6

Carry-Over Provisions for NC Individual Income Tax

Description of tax credit	Length of carry forwards	Other conditions
Credit for construction of dwelling units for handicapped persons	1 year	
Credit for child care and certain employment-related expenses	none	
Credit for certain real property donations	5 years	
Credit for conservation tillage equipment	5 years	
Credit for gleaned crops	5 years	
Credit for the disabled	none	
Credit or partial refund for tax paid on certain federal retirement benefits	2 years	
Credit for property taxes paid on farm machinery	none	Maximum credit = $1,000
Credit for North Carolina State Ports Authority	5 years	Cannot exceed 50% of tax liability; maximum=$2 million
Credit for children	none	
Credit for construction of a poultry composting facility	none	Maximum=$1,000 per facility
Credit for charitable contributions by non-itemizers	none	

27. Carry-Over Provisions

Description: Various individual income tax credits may be carried forward.

Estimate (in millions): $21.0

Data Source: Department of Revenue 2002 and 2003 Individual Income Tax records

Sales and Use Tax (Article 5)

Tax Base Information

The sales tax in North Carolina is imposed on retail sales (including the value of leases and rentals) of tangible property occurring in the State and the use tax is imposed on purchases made outside the State if the property purchased is used in the State. Currently, the sales tax is 4½%. Local governments are allowed to add 2½% to the tax. Mecklenburg County has an additional ½% tax.

In addition to retail sales, the sales and use tax is imposed on several services, such as accommodation rentals and laundry and dry cleaning services.

Telecommunications services are taxed at 6% until November 2005 and 7% thereafter. All these funds are paid to the State. However, the Department of Revenue must distribute 18.26% of the taxes collected to local governments each quarter, less $2,620,948. After January 1, 2006, the reimbursement rate to local governments changes to 18.03%. (See G.S. 105-164.44F.) Satellite services are taxed at 5% until November 2005 and 7% thereafter.

The sales tax rate on spirituous liquor is 7% as of October 1, 2005.

For Fiscal Year 2004-05, sales and use tax receipts for the State (excluding local receipts) were approximately $4.6 billion.

Table 7

2004 NC Sales and Use Tax Expenditure Estimates

Item	Citation	Short Title	2004 Estimate (millions of dollars)
1	164.4C(c)(5)	Pay Telephone Services	less than 0.1
2	164.4C(c)(7)	One-Way Paging Services	4.8
3	164.4C(c)(8)	Telephone Charges by a Hotel or Motel	1.2
4	164.4C(c)(9)	Sales, Installation, Repair of Telecommunications Property	19.7
5	164.4C(c)(10)	Directory and Yellow-Page Advertising	1.9
6	164.4C(c)(12)	Information Services	26.1
7	164.4C(c)(13)	Internet Access Charges	53.5
8	164.4C(c)(16)	Charges Related to NC Information Highway and Other Government Data Networks	1.0
9	164.4C(f)	Out-of-State Call Centers	14.1
10	164.13(1) and (1a)	Items Sold to Farmers	51.1
11	164.13(2a)a	Feeds, Litter and Medications for Farming	128.0
12	164.13(2a)b	Pesticides, Rodenticides and Related Products for Farming	10.7
13	164.13(2a)c	Defoliants for Commercial Use	included in item #12
14	164.13(2a)d	Plant Growth Inhibitors	included in item #12
15	164.13(2a)e	Semen for Artificial Insemination	less than 0.1

Item	Citation	Short Title	2004 Estimate (millions of dollars)
16	164.13(3)	Certain Products of Forests and Mines by Producers	Unavailable
17	164.13(4b)	Farm Products Requiring Ice Preservation For Further Sale	Unavailable
18	164.13(4c)a	Manufactured Facilities for Commercial Housing of Animals	Unavailable
19	164.13(4c) b and c	Building Materials and Equipment for Animal Enclosures and Housing	Unavailable
20	164.13(4d)	Tobacco Farming Items	less than 0.1
21	164.13(4e)	Grain, Feed, or Soybean Storage Facilities	Unavailable
22	164.13(5b)	Telephone Equipment	2.8
23	164.13(5c)	Radio and Television Broadcast Equipment	1.3
24	164.13(5d)	Cable Service Broadcast Equipment	Unavailable
25	164.13(7)	Aquacultural Products in Raw State	Unavailable
26	164.13(9)	Tangible Property Purchased for Commercial Fishing	1.5
27	164.13(10)	Items Used by Laundries and Dry Cleaning Businesses	1.0
28	164.13(10a)a and b	Lubricants Used by Major Recycling Facility	Unavailable
29	164.13(10a)c	Electricity Used by Major Recycling Facility	Unavailable
30	164.13(11a)	Diesel Fuel for Railroads	Unavailable

Item	Citation	Short Title	2004 Estimate (millions of dollars)
31	164.13(12)	Durable Medical Equipment	30.0
32	164.13(13)	Prescription Drugs and Insulin	242.0
33	164.13(13c)	Chiropractors' Nutritional Supplements	0.2
34	164.13(14)	Public School Books	2.6
35	164.13(15)	Accounts of Sales Charged Off for Income Purposes	Unavailable
36	164.13(20)	Sales by Blind Merchants	0.5
37	164.13(21)	Lease or Rental of Films for Exhibition	2.8
38	164.13(22)	Lease or Rental of Films, Transcriptions and Recordings to Broadcasters	Unavailable
39	164.13(22a)	Audiovisual Masters	0.2
40	164.13(23)a	Packaging Items for Manufacturers, Producers and Retailers	52.8
41	164.13(23)b	Packaging Returned to Seller	0.1
42	164.13(26)	Food Sold by a Public or Private School Cafeteria	11.1
43	105.164.13(26a)	Food Sold by a Public School Cafeteria to Certain Child Care Centers	included in item #42
44	164.13(27)	Food Sold in Dining Rooms Operated by Educational Institutions	22.0
45	164.13(28)	Certain Sales of Newspapers	11.8

Item	Citation	Short Title	2004 Estimate (millions of dollars)
46	164.13(30)	Vending Machine One-Cent Sales	less than 0.1
47	164.13(31)	Meals for the Elderly	less than 0.1
48	164.13(31a)	Food Sold by a Church or Religious Organization	Unavailable
49	164.13(34)	Sales by Nonprofits Whose Proceeds Go to the State	Unavailable
50	164.13(35)	Sales by Nonprofits Conducted Annually	1.0
51	164.13(36)	Advertising Supplements Sold with Newspapers	4.0
52	164.13(38)	Food Stamp Purchases	33.1
53	164.13(39)	Components of Free Distribution Periodicals	19.4
54	164.13(41)	Mobile Classrooms Purchased by Boards of Education or Community Colleges	0.5
55	164.13(43)	Custom Computer Software	5.0
56	164.13(43a)	Software Delivered Electronically	Unavailable
57	164.13(45)	Items Purchased by Interstate Air Carriers	included in item #58
58	164.13(45a)	Lubricants Used in Maintenance of Commercial Aircraft	4.0
59	164.13(45b)	Items Purchased by Interstate Air Couriers	Unavailable
60	164.13(46)	Electricity to Municipalities Supplied by Federal Agency	Unavailable
61	164.13(49a)	Delivery Charges of Direct Mail	0.3

Item	Citation	Short Title	2004 Estimate (millions of dollars)
62	164.13(50)	Goods Sold Through Vending Machines	4.5
63	164.13(51)	Water Delivered Through Main Pipes	43.5
64	164.13A	Tips on Meals and Beverages	29.7
65	164.13B	Food Exemption	416.8
66	164.13C	Sales and Use Tax Holiday	11.0
67	164.14(a1)	Cap on Tax of Aviation Fuel for Interstate Air Carriers	5.0
68	164.14(b)	Refund of Sales Taxes to Nonprofits	183.0
69	164.14(c)	Refund of Sales Taxes to Local Government	62.5
70	164.14(k)	Motor Sports Events Refunds	Unavailable
71	164.4(a)(1a)	Manufactured Homes	23.7
72	164.4(a)(8)	Modular Homes	6.6
73	164.4(a)(1b)	Aircraft and Boats	12.7
74	164.4(1f)	Electricity to Farmers, Manufacturers and Commercial Laundries	20.6
75	164.4(1h)	Electricity to Aluminum Smelting Facility	0.0
76	164.4(4a)	Electricity to Commercial Businesses and Residences	107.1
77	164.21B	Credit for Local Cable Television Franchise Taxes	65.3

Exemptions

1. **Pay Telephone Services**
   Citation: G.S. 105-164.4C(c)(5)
   Description: Receipts of a pay telephone provider from the sale of pay telephone services.

   Estimate (in millions): less than $0.1

   Note: Volume of sales is not likely to exceed the level for a tax revenue loss of $100,00 or more.

2. **One-Way Paging Services**
   Citation: G.S. 105-164.4C(c)(7)
   Description: Paging service, unless the service provides two-way communication.

   Estimate (in millions): $4.8

   Data Source: 2002 Economic Census data for telecommunications

   Note: The estimate has been adjusted to take into account the tax rates on telecommuncations that apply after January 1, 2006. Consequently, the estimate uses an effective State tax rate of 5.74% (that is, the 7% rate less the 18.03% share distributed to the local governments).

3. **Telephone Charges by a Hotel or Motel**
   Citation: G.S. 105-164.4C(c)(8)
   Description: Charges for telephone service made by a hotel, motel, or another entity whose gross receipts are taxable under G.S. 105-164.4(a)(3) when the charges are incidental to the occupancy of the entity's accomodations.

   Estimate (in millions): $1.2

   Data Source: 2002 Economic Census data for accomodations

   Note: See the note on Item #2.

4. **Sales, Installation, Repair of Telecommunications Property**
   Citation: G.S. 105-164.4C(c)(9)
   Description: Receipts from the sale, installation, maintenance or repair of tangible personal property.

   Estimate (in millions): $19.7

   Data Source: 2002 Economic Census data for telecommunications

   Note: See the note on Item #2.

5. **Directory and Yellow-Page Advertising**
Citation: G.S. 105-164.4C(c)(10)
Description: Directory advertising and yellow-page classified listings.

Estimate (in millions): $1.9

Data Source: 2003 Economic Census data for telecommunications

Note: See the note on Item #2.

6. **Information Services**
Citation: G.S. 105-164.4C(c)(12)
Description: An information service is a service that can generate, acquire, store, transform, process, retrieve, use, or make available information through a communications service.

Estimate (in millions): $26.1

Data Source: 2002 Economic Census data for telecommuncations and internet service providers

Note: Includes data transmission services, data storage services and data management services. See the note on Item #2.

7. **Internet Access Charges**
Citation: G.S. 105-164.4C(c)(13)
Description: Internet access service, electronic mail service, electronic bulletin board service, or similar on-line services.

Estimate (in millions): $53.5

Data Source: 2002 Economic Census data for internet service providers

Note: Includes web hosting services. See the note on Item #2.

8. **Charges Related to NC Information Highway and Other Government Data Networks**
Citation: G.S. 105-164.4C(c)(16)
Description: Charges to a State agency or to a local unit of government for the North Carolina Information Highway and other data networks owned or leased by the State or unit of local government.

Estimate (in millions): $1.0

Data Source: ITS telecommunications revenues in 2003-05 Certified Budget, Office of State Budget and Management; State Controller's 2004 IT report

9. Out-of-State Call Centers

Citation: G.S. 105-164.4C(f)

Description: The gross receipts tax on telecommunications service that originates outside this State, terminates in this State, and is provided by a call center that has a direct pay permit many not exceed $50,000.

Estimate (in millions): $14.1

Data Source: 1997 and 2002 Economic Census data for Telephone Call Centers, US Census Bureau

Note: The cap effectively eliminates taxes on company revenues over $833,333. See the note on Item #2.

10. Items Sold to Farmers

Citation: G.S. 105-164.13(1) and (1a)

Description: Various items sold for agricultural purposes: (a) commercial fertilizer, lime, land plaster, plastic mulch, plant bed covers, potting soil, and seeds (b) farm machinery, attachment and repair parts for farm machinery, and lubricants applied to farm machinery, (c) horse or mule, (d) fuel other than electricity, (e) containers sold to a farmer used to transport or package products.

Estimate (in millions): $51.1

Data Source: Department of Revenue sales tax records; North Carolina Department of Agriculture and Consumer Services (NCDACS); 2002 Economic Census; USDA Economic Research Service

11. Feeds, Litter and Medications for Farming

Citation: G.S. 105-164.13(2a)a

Description: Remedies, vaccines, medications, litter materials, and feeds for animals raised for commercial purposes.

Estimate (in millions): $128.0

Data Source: National Agriculture Statistics Service (NSS), USDA; North Carolina Department of Agriculture and Consumer Services (NCDACS)

12. Pesticides, Rodenticides and Related Products for Farming

Citation: G.S. 105-164.13(2a)b

Description: Rodenticides, insecticides, herbicides, fungicides and pesticides for use on plants grown for commercial purposes.

Estimate (in millions): $10.7

Data Source: National Agriculture Statistics Service (NSS), USDA; North Carolina Department of Agriculture and Consumer Services (NCDACS)

Note: Includes Items #13 and 14.

13. Defoliants for Commercial Use
Citation: G.S. 105-164.13(2a)c
Description: Defoliants for use on cotton or other crops grown from commercial purposes.

Estimate (in millions): included in item #12

14. Plant Growth Inhibitors
Citation: G.S. 105-164.13(2a)d
Description: Plant growth inhibitors, regulators, or stimulators, including systemic and contact or other sucker control agents for tobacco and other crops grown for commercial purposes.

Estimate (in millions): included in item #12

15. Semen for Artificial Insemination
Citation: G.S. 105-164.13(2a)e
Description: Sale of semen for artificial insemination.

Estimate (in millions): less than $0.1

Note: Although no direct information on semen sales were found, North Carolina is not a major cattle or dairy producer; the cost of artificial insemination of poultry and hogs is not likely to be large. Comparable estimates from other states were used to support estimate.

16. Certain Products of Forests and Mines by Producers
Citation: G.S. 105-164.13(3)
Description: Exemption for sales of products of forests and mines in their original or non-manufactured state when such sales are made by the producer in the capacity of producer.

Estimate (in millions): Unavailable

Note: Although a portion of sales of these products will undergo further processing or be sold for resale, a sizable amount of goods will be sold at retail by the producer, especially products of the mine such as gravel sold to road contractors.

17. **Farm Products Requiring Ice Preservation For Further Sale**
Citation: G.S. 105-164.13(4b)
Description: Exemption for sales of products of a farm sold in their original state by the producer of the products if the producer is not primarily a retail merchant and ice is used to preserve agriculture, aquaculture and commercial fishery products until the products are sold at retail.

Estimate (in millions): Unavailable

Note: No information on direct retail sales by farmers for this category was available.

18. **Manufactured Facilities for Commercial Housing of Animals**
Citation: G.S. 105-164.13(4c)a
Description: Sales of commercially manufactured facilities for commercial purposes in housing, raising or feeding animals or for housing related equipment.

Estimate (in millions): Unavailable

19. **Building Materials and Equipment for Animal Enclosures and Housing**
Citation: G.S. 105-164.13(4c)b and c
Description: Buildings, materials, supplies, fixtures, and equipment that become a part of and are used in the construction, repair, or improvement of an enclosure or a structure as specified in this subsection. Commercially manufactured equipment, and parts and accessories for the equipment, used in a facility that is exempt from tax in this subsection.

Estimate (in millions): Unavailable

20. **Tobacco Farming Items**
Citation: G.S. 105-164.13(4d) and (4e)
Description: (a) lease or rental of tobacco sheets used in handling tobacco in the warehouse and transporting tobacco to and from the warehouse, (b) metal flue sold for use in curing tobacco, whether the flue is attached to a handfired furnace or used in connection with a mechanical burner, (c) bulk tobacco barn or rack, parts and accessories attached to the tobacco barn or rack, and any similar apparatus, part or accessory used to cure or dry tobacco or another crop, (4e) a grain, feed, or soybean storage facility, and parts and accessories attached to the facility.

Estimate (in millions): less than $0.1

Note: Volume is not likely to exceed the level for a loss of $100,000 or more.

21. Grain, Feed, and Soybean Storage Facilities
Citation: G.S. 105-164.13(4e)
Description: Sales of grain, feed, or soybean storage facilities and attached parts and accessories.

Estimate (in millions): Unavailable

22. Telephone Equipment
Citation: G.S. 105-164.13(5b)
Description: Sales to a telephone company of central office equipment, private branch exchange equipment, terminal equipment (other than public pay telephone), switchboard equipment, and attached parts and accessories.

Estimate (in millions): $2.8

Data Source: Department of Revenue sales tax records; 2002 Economic Census

23. Radio and Television Broadcast Equipment
Citation: G.S. 105-164.13(5c)
Description: Sales of towers, broadcasting equipment, and attached parts and accessories to an FCC-licensed radio or television company.

Estimate (in millions): $1.3

Data Source: Department of Revenue sales tax records; 2002 Economic Census

24. Cable Service Broadcast Equipment
Citation: G.S. 105-164.13(5d)
Description: Sales of broadcasting equipment and attached parts and accessories, excluding cable, to a cable service provider.

Estimate (in millions): Unavailable

25. Aquacultural Products in Raw State
Description: Exemption for sales of products of waters in their original or non-manufactured state when such sales are made by the producer in the capacity of producer. Fish and seafoods are likewise exempt when sold by the fisherman in that capacity.
Citation: G.S. 105-164.13(7)

Estimate (in millions): Unavailable

Note: No information on direct retail sales by producers for this category was available.

26. Tangible Property Purchased for Commercial Fishing
Citation: G.S. 105-164.13(9)
Description: Sales of boats, fuel oil, lubricating oils, machinery, equipment, nets rigging, paints, parts, accessories, and supplies used in commercial fishing.

Estimate (in millions): $1.5

Data Source: NC Fisheries Association, NC Division of Marine Fisheries; sample of NC corporate income tax returns

27. Items Used by Laundries and Dry-Cleaning Businesses
Citation: G.S. 105-164.13(10)
Description: Sales to commercial laundries or to pressing and dry-cleaning establishments of articles or materials used for the identification of garments being laundered or dry-cleaned, wrapping paper, bags, hangers, starch, soaps, detergents, cleaning fluids and other compounds or chemicals applied directly to the garments.

Estimate (in millions): $1.0

Data Source: 2002 Economic Census, US Census Bureau; sample of NC corporate income tax returns

28. Lubricants Used by Major Recycling Facility
Citation: G.S. 105-164.13(10a)a and b
Description: Sales to major recycling facility of lubricants and other additives for motor vehicles or machinery and supplies used at the facility and accessories.

Estimate (in millions): Unavailable

29. Electricity Used by Major Recycling Facility
Citation: G.S. 105-164.13(10a)c
Description: Sales to a major recycling facility of electricity used at the facility.

Estimate (in millions): Unavailable

30. Diesel Fuel for Railroads
Citation: G.S. 105-164.13(11a)
Description: Diesel fuel for railroad companies for use in rolling stock other than motor vehicles.

Estimate (in millions): Unavailable

31. Durable Medical Equipment
Citation: G.S. 105-164.13(12)
Description: Sales of prosthetic devices, mobility-enhancing equipment sold on a prescription, durable medical equipment sold on prescription, durable medical supplies sold on prescription.

Estimate (in millions): $30.0

Data Source: Centers for Medicare & Medicaid Services, US Department of Health and Human Services (www.cms.gov)

32. Prescription Drugs and Insulin
Citation: G.S. 105-164.13(13)
Description: Drugs required by federal law to be dispensed only on prescription, over-the-counter drugs sold on prescription, insulin.

Estimate (in millions): $242.0

Data Source: Centers for Medicare & Medicaid Services, US Department of Health and Human Services (www.cms.gov)

33. Chiropractors' Nutritional Supplements
Citation: G.S. 105-164.13(13c)
Description: Nutritional supplements sold by a chiropractic physician at a chiropractic office to a patient as part of the patient's plan of treatment.

Estimate (in millions): $0.2

Data Source: Department of Revenue sales and use tax records; 1997 and 2002 Economic Census data for Health Care and Social Assistance Industries

34. Public School Books
Citation: G.S. 105-164.13(14)
Description: Sales of public school books on the adopted list, the selling price of which is set by State contract.

Estimate (in millions): $2.6

Data Source: State revenue from sales of textbooks from 2003-04 Statistical Report, NC Department of Public Instruction

35. Accounts of Sales Charged Off for Income Purposes
Citation: G.S. 105-164.13(15)
Description: Accounts of purchasers, representing taxable sales, on which the sales and use tax has been paid, that are found to be worthless and actually charged off for income tax purposes may be deducted from gross sales. In the case of a municipality that sells electricity, the account may be deducted if it meets all the conditions for charge-off that would apply if the municipality were subject to income tax.

Estimate (in millions): Unavailable

36. Sales by Blind Merchants
Citation: G.S. 105-164.13(20)
Description: Sales by blind merchants operating under supervision of the Department of Health and Human Services.

Estimate (in millions): $0.5

Data Source: Services for the Blind, NC Department of Health and Human Services

37. Lease or Rental of Films for Exhibition
Citation: G.S. 105-164.13(21)
Description: Lease or rental of motion picture films used for exhibition purposes where the lease or rental of such property is an established business or part of an established business.

Estimate (in millions): $2.8

Data Source: Sample of income tax returns for movie theaters; Department of Revenue privilege tax records

38. Lease or Rental of Films, Transcriptions and Recordings to Broadcasters
Citation: G.S. 105-164.13(22)
Description: Lease or rental of films, motion picture films, transcriptions and recordings to radio stations and television stations operating under a certificate from the Federal Communications Commission.

Estimate (in millions): Unavailable

39. Audiovisual Masters
Citation: G.S. 105-164.13(22a)
Description: Sales of audiovisual masters made or used by a production company in making images for first generation reproduction.

Estimate (in millions): $0.2

Data Source: Department of Revenue Sales and Use Tax records; NC Film Office

40. Packaging Items for Manufacturers, Producers and Retailers
Citation: G.S. 105-164.13(23)a
Description: Sales of the following packaging items: wrapping paper, cloth, plastic bags, labels, wrapping twine, packages and containers, cartons, cores, cones or spools, wooden boxes, baskets, coops and barrels, including paper cups, napkins and drinking straws and like articles sold to manufacturers, producers and retailers, when such materials constitute a part of the sale of tangible personal property.

Estimate (in millions): $52.8

Data Source: Packaging costs from 1997 economic census (manufacturers) and 2002 Business Expenses Survey (retailers, wholesalers)

41. Packaging Returned to Seller
Description: Packaging that is required to be returned to seller.
Citation: G.S. 105-164.13(23)b

Estimate (in millions): $0.1

Note: Prior to the enactment of this exemption, these items were being taxed as reusable containers. In practice, many of these containers contained ingredient materials that were exempt from taxation. The sellers of the products were taxed on the lease of the containers.

42. Food Sold by a Public or Private School Cafeteria
Citation: G.S. 105-164.13(26)
Description: Food sold not for profit by public or private school cafeterias within school building during the regular school day.

Estimate (in millions): $11.1

Data Source: Common Core of Data, National Center for Education Statistics; statistical report from NC Dept. of Public Instruction

Note: Includes Item #43.

43. Food Sold by a Public School Cafeteria to Certain Child Care Centers
Citation: G.S. 105-105.164.13(26a)
Description: sales of food sold not for profit by a public school cafeteria to a child care center that participates in the Child and Adult Care Food Program.

Estimate (in millions): included in item #42

44. Food Sold in Dining Rooms Operated by Educational Institution
Citation: G.S. 105-164.13(27)
Description: Sales of food served to students in dining rooms regularly operated by State or private education institutions or student organizations thereof.

Estimate (in millions): $22.0

Data Source: *Statistical Abstract of Higher Education in North Carolina*, University of North Carolina

45. Certain Sales of Newspapers
Citation: G.S. 105-164.13(28)
Description: Sales of newspapers by newspaper street vendors, by newspaper carriers making door-to-door deliveries and by means of vending machines and sales of magazines by magazine vendors making door-to-door sales.

Estimate (in millions): $11.8

Data Source: Department of Revenue Sales and Use Tax records

46. Vending Machine One-Cent Sales
Citation: G.S. 105-164.13(30)
Description: Sales from vending machines when sold by the owner or lessee of said machines at a price of $0.01 per sale.

Estimate (in millions): less than $0.1

Note: Volume is not likely to exceed the level for a $100,000 loss.

47. Meals for the Elderly
Citation: G.S. 105-164.13(31)
Description: Sales of meals not for profit to elderly and incapacitated persons by charitable or religious organizations not operated for profit which are entitled to the refunds provided by G.S. 105-164.14(b), when such meals are delivered to the purchasers at their places of abode.

Estimate (in millions): less than $0.1

Data Source: Sales of Meals on Wheels data from Wake, Buncombe and Forsyth Counties

48. Food Sold by a Church or Religious Organization
Citation: G.S. 105-164.13(31a)
Description: Food sold by a church or religious organization when proceeds are used for religious purposes.

Estimate (in millions): Unavailable

49. Sales by Nonprofits Whose Proceeds Go to the State
Citation: G.S. 105-164.13(34)
Description: Sales of items by a nonprofit civic, charitable, educational, scientific or literary organization when the net proceeds of the sales will be given to the State of North Carolina or to one of its agencies or instrumentalities, or to one or more nonprofit charitable organizations, one of whose purposes is to serve as a conduit through which such net proceeds will flow to the State or to one or more of its agencies or instrumentalities.

Estimate (in millions): Unavailable

50. Sales by Nonprofits Conducted Annually
Citation: G.S. 105-164.13(35)
Description: Sales by nonprofits conducted annually when the proceeds are used for the organization's activities. The products sold must be delivered to the purchaser within 60 days after the first solicitation of any sale made during the organization's annual sales period.

Estimate (in millions): $1.0

Data Source: Annual reports of Girl Scout Councils

51. Advertising Supplements Sold with Newspapers
Citation: G.S. 105-164.13(36)
Description: Advertising supplements and any other printed matter ultimately to be distributed with newspaper.

Estimate (in millions): $4.0

Data Source: 2002 Economic Census, US Census Bureau

52. Food Stamp Purchases

Citation: G.S. 105-164.13(38)

Description: Food and other items lawfully purchased under the Food Stamp Program and supplemental foods lawfully purchased with a food instrument issued under the Special Supplemental Food Program and supplemental foods purchased for direct distribution by the Special Supplemental Food Program.

Estimate (in millions): $33.1

Data Source: Food Stamp Program, US Department of Agriculture estimates of NC food stamps receipts through 2003. Estimate for 2004 based on the reported 14% increase in the number of Food Stamp recipients in NC between July 2003 and July 2004.

53. Components of Free Distribution Periodicals

Citation: G.S. 105-164.13(39)

Description: Sales of paper, ink, and other tangible personal property to commercial printers and commercial publishers for use in free distribution periodicals and sales by printers of free distribution periodicals to the publishers of these periodicals.

Estimate (in millions): $19.4

Data Source: Estimate derived by Fiscal Research Division of the NC Legislature for HB 1149 (2003-04 session)

54. Mobile Classrooms Purchased by Boards of Education or Community Colleges

Citation: G.S. 105-164.13(41)

Description: Sales of mobile classrooms to local boards of education or to local boards of trustees of community colleges.

Estimate (in millions): $0.5

Data Source: Statistical Reports, NC Department of Public Instruction provided growth of pupils by county; Wake County Public School System reports on school construction

Note: This tax expenditure is based on the exemption from the 4.5% State tax rate, although these purchases would also be exempt under G.S. 105-164.14(c). No information on community college use of mobile classrooms was obtained.

55. Custom Computer Software
Citation: G.S. 105-164.13(43)
Description: Sales of custom computer software and the portion of prewritten computer software that is modified or enhanced.

Estimate (in millions): $5.0

Data Source: 2002 and 2003 revenues of software publishers from "customization and integration of packaged software," from 2003 Service Annual Survey, US Census Bureau

56. Software Delivered Electronically
Citation: G.S. 105-164.13(43a)
Description: Computer software delivered electronically or delivered by load and leave.

Estimate (in millions): Unavailable

57. Items Purchased by Interstate Air Carriers
Citation: G.S. 105-164.13(45)
Description: Sales to an interstate air carrier of (a) aircraft lubricants, repair parts and accessories, (b) aircraft simulators for flight crew training.

Estimate (in millions): included in item #58

58. Lubricants Used in Maintenance of Commercial Aircraft
Citation: G.S. 105-164.13(45a)
Description: Sales to an interstate air business of tangible personal property that becomes a component part of or is dispensed as a lubricant into commercial aircraft during its maintenance, repair, or overhaul.

Estimate (in millions): $4.0

Data Source: Estimate derived by Fiscal Research Division of the NC Legislature for HB 1414 (2003-04 session)

Note: Includes Item #57

59. Items Purchased by Interstate Air Couriers
Citation: G.S. 105-164.13(45b)
Description: Sales to an interstate air courier of (a) aircraft lubricants, repair parts and accessories, (b) materials handling equipment, racking systems, and related parts and accessories for the storage or handling and movement of tangible personal property at an airport or in a warehouse or distribution facility.

Estimate (in millions): Unavailable

60. Electricity to Municipalities Supplied by Federal Agency
Citation: G.S. 105-164.13(46)
Description: Sales of electricity by a municipality whose only wholesale provider is a federal agency and who is required by a contract with that federal agency to make payments in lieu of taxes.

Estimate (in millions): Unavailable

61. Delivery Charges of Direct Mail
Citation: G.S. 105-164.13(49a)
Description: Delivery charges for delivery of direct mail if the charges are separately stated on an invoice.

Estimate (in millions): $0.3

Data Source: Estimate derived by Fiscal Research Division of the NC Legislature for HB 1414 (2003-04 session)

62. Goods Sold Through Vending Machines
Citation: G.S. 105-164.13(50)
Description: 50% of the sales price of goods sold through vending machines, except tobacco.

Estimate (in millions): $4.5

Data Source: 2002 Retail Economic Census data on vending machine companies

63. Water Delivered Through Main Pipes
Citation: G.S. 105-164.13(51)
Description: Water delivered through main lines for either commercial or domestic use or consumption.

Estimate (in millions): $43.5

Data Source: Amount of water used derived from 2000 estimate by NC Department of Energy and Natural Resources. Average water rates were estimated from a sample of April 2005 municipal rates.

64. Tips on Meals and Beverages

Citation: G.S. 105-164.13A

Description: Service charges, considered tips, imposed on food, beverages or meals when not above 20% of the sale price.

Estimate (in millions): $29.7

Data Source: Receipts at full-service restaurants and drinking places in North Carolina were obtained from the 2002 Economic Census.

Note: Receipts were inflated to 2003 and 2004 by considering both the increase in employment and the increase in prices of food and beverages. It was assumed that tips represented 15% of total receipts.

65. Food Exemption

Citation: G.S. 105-164.13B

Description: Food is exempt from sales and use taxes unless the food is in one of the following categories: (1) alcoholic beverages, (2) dietary supplements, (3) food sold through a vending machine, (4) prepared food, (5) soft drinks, (6) candy.

Estimate (in millions): $416.8

Data Source: Department of Revenue 2% local food sales tax records

66. Sales and Use Tax Holiday

Citation: G.S. 105-164.13C

Description: The sales and use taxes do not apply on the following items during the first weekend of August: (1) clothing with a sales price of $100 or less, (2) school supplies with a sales price of $100 or less, (3) computers will a sales price of $3,500 or less, (3a) computer supplies with a sales price of $250 or less per item, (4) sport or recreational equipment with a sales price of $50 or less. The exemption does not apply to sales of clothing accessories or equipment, sales of protective equipment, sales of furniture, sales of items for use in trade or business, rentals.

Estimate (in millions): $11.0

Data Source: National Income and Product Accounts, Bureau of Economic Analysis, US Department of Commerce; National Retail Federation survey on back-to-school spending in 2003

67. Cap on Tax of Aviation Fuel for Interstate Air Carriers
Citation: G.S. 105-164.14(a1)
Description: Interstate passenger air carriers are allowed refunds on the amount of sales and use tax paid on aviation fuel in a calendar year in excess of $2.5 million.

Estimate (in millions): $5.0

Data Source: Department of Revenue sales tax and motor fuel tax records; US Energy Information Administration

68. Refund of Sales Taxes to Nonprofits
Citation: G.S. 105-164.14(b)
Description: Refunds for sales taxes paid on purchases, other than electricity and telecommunications, for use in carrying on the work of the nonprofit and indirect purchases of building materials. The refund is only for nonprofits in the following categories: (1) hospitals, (2) educational institutions, (3) churches, orphanages and other charitable or religious institutions, (4) qualified retirement facilities.

Estimate (in millions): $183.0

Data Source: Department of Revenue sales and use tax records

69. Refund of Sales Taxes to Local Government
Citation: G.S. 105-164.14(c)
Description: Refunds for sales taxes paid on purchases, other than electricity and telecommunications, by local government entities and indirect purchases of building materials.

Estimate (in millions): $62.5

Data Source: Department of Revenue sales and use tax records

Note: The estimate does not include refunds for schools, which were repealed as of July 1, 2005.

70. Motor Sports Events Refunds
Citation: G.S. 105-164.14(k)
Description: A motor sports racing team or sanctioning body is allowed a refund on sales taxes paid on aviation fuel used in conjunction with travel to and from motor sports events.

Estimate (in millions): Unavailable

Preferential tax rates

71. Manufactured Homes
Citation: G.S. 105-164.4(a)(1a)
Description: Tax rate of 2% on sales of manufactured homes, with a maximum of $300. Each section of a manufactured home that is transported separately to the site where it is to be erected is a separate article.

Estimate (in millions): $23.7

Data Source: Department of Revenue sales and use tax records; sales prices on manufactured homes from US Housing and Urban Development (HUD)

72. Modular Homes
Citation: G.S. 105-164.4(a)(8)
Description: Tax rate of 2½% on sales of modular homes.

Estimate (in millions): $6.6

Data Source: Department of Revenue sales and use tax records

Note: Assumes State would recapture the 20% of revenues currently sent to local governments due to the tax exemption (see G.S. 105-164.44G).

73. Aircraft and Boats
Citation: G.S. 105-164.4(a)(1b)
Description: Tax rate of 3%, up to a maximum of $1,500, on sales of aircraft and boats.

Estimate (in millions): $12.7

Data Source: Department of Revenue sales and use tax records; National Marine Manufacturers Association

74. Electricity to Farmers, Manufacturers and Commercial Laundries
Citation: G.S. 105-164.4(1f)
Description: Tax rate of 2.83% for sale of electricity to (a) farmers for farm-related purposes, (b) manufacturing industries and plants, and (c) commercial laundries or dry-cleaning establishments.

Estimate (in millions): $20.6

Data Source: Department of Revenue sales and use tax records

75. Electricity to Aluminum Smelting Facility
Citation: G.S. 105-164.4(1h)
Description: Tax rate of 0.17% applies to sales of electricity to an aluminum smelting facility.

Estimate (in millions): 0.0

Data Source: Department of Revenue sales and use tax records

76. Electricity to Commercial Businesses and Residences
Citation: G.S. 105-164.4(4a)
Description: Tax rate of 3% for gross receipts derived from sales of electricity, other than sales of electricity subject to tax under another subdivision of this section.

Estimate (in millions): $107.1

Data Source: Department of Revenue sales and use tax records; State Electricity Profiles 2002, Energy Information Administration, US Department of Energy

Credits

77. Credit for Local Cable Television Franchise Taxes
Citation: G.S. 105-164.21B
Description: Cable service providers are allowed a credit equal to the amount of local franchise tax payable on gross receipts.

Estimate (in millions): $65.3

Data Source: National Cable and Telecommunications Association (NCTA); J.D. Power and Associates 2003 Residential Cable/Satellite TV Customer Satisfaction Study

Highway Use Tax (Article 5A)

Tax Base Information

The highway use tax is applied to retail sales or leases of motor vehicles in North Carolina. The tax rate on sales and long-term leases is 3%, while there is an 8% tax on short-term leases.

In Fiscal Year 2004-05, the total amount of tax collected was $623.9 million, mostly from retail sales. A large percentage of these funds are deposited into the Highway Trust Fund.

Expenditures

1. **Class A or Class B Commercial Motor Vehicles and Recreational Vehicles**
   Citation: G.S. 105-187.3(a)
   Description: Cap of 3% tax of $1,000 on Class A or Class B commercial motor vehicles or $1,500 for recreational vehicles.

   Estimate (in millions): $10.7

   Data Source: Highway use tax records, NC Department of Motor Vehicles

   Note: $4.8 for commercial vehicles; $5.9 million for RVs.

2. **Vehicles Modified for Disabled Individuals**
   Citation: G.S. 105-187.6(a)(7)
   Description: Full exemption when a certificate of title is issued to a handicapped person from DHHS after the vehicle has been equipped by DHHS for use by handicapped.

   Estimate (in millions): less than $0.1

   Data Source: NC Department of Health and Human Services

3. **Vehicles Leased to Public School Driver Education Programs**
   Citation: G.S. 105-187.6(a)(8)
   Description: Full exemption when a certificate of title is issued to a local board of education for use in a driver education program when the vehicle is transferred back to retailer within 300 days or from another board of education.

   Estimate (in millions): less than $0.1

   Data Source: NC Department of Education; local schools

4. **Volunteer Fire and Rescue Squad Vehicles**
Citation: G.S. 105-187.6(a)(9)
Description: Full exemption for volunteer fire department or rescue squad.

Estimate (in millions): $0.3

Data Source: Highway use tax records, NC Department of Motor Vehicles

5. **Secured Party with Perfected Interest**
Citation: G.S. 105-187.6(b)(1)
Description: Maximum tax of $40 when a certificate is issued to a secured party who has a perfected interest in the motor vehicle.

Estimate (in millions): $2.6

Data Source: Highway use tax records, NC Department of Motor Vehicles

Note: Includes Item #6.

6. **Sales to Related Businesses**
Citation: G.S. 105-187.6(b)(2)
Description: Maximum of $40 when a certificate of title is issued to a business that is not a separate entity from the seller.

Estimate (in millions): included in item #5

7. **Vehicles Titled in Another State**
Citation: G.S. 105-187.6(c)
Description: Maximum tax of $150 if vehicle has been titled in another state for at least 90 days.

Estimate (in millions): $1.7

Data Source: Highway use tax records, NC Department of Motor Vehicles

8. **Credit for Tax Paid in Another State**
Citation: G.S. 105-187.7(a)
Description: Credit for amount of tax paid in another state within 90 days of applying for title.

Estimate (in millions): Unavailable

9. Credit for Tax Paid in Another State if Previously Titled in NC
Citation: G.S. 105-1987.7(b)
Description: Credit for amount paid in another state within 1 year if vehicle was previously titled in NC.

Estimate (in millions): Unavailable

10. Return of Purchased Vehicle
Citation: G.S. 105-187.8
Description: Refund for return of purchased vehicle.

Estimate (in millions): Unavailable

Scrap Tire Disposal Tax (Article 5B)

Tax Base Information

For tires with bead diameter less than 20 inches, the tax rate is 2%. For tires with bead diameter 20 inches or greater, the tax rate is 1%.

In Fiscal Year 2004-05, $4.1 million was collected from this tax.

Expenditures

1. **Exemption for Certain Tire Sales**
   Citation: G.S. 105-187.18
   Description: Exemption for bicycle tires, recapped tires, tires sold for placement on new vehicle.

   Estimate (in millions): Unavailable

White Goods Disposal Tax (Article 5C)

Tax Base Information

The tax is imposed on a white goods retailer at a flat rate of $3 for each new white good sold.

In Fiscal Year 2004-05, $1.7 million was collected from this tax.

Expenditures

1. **Refund for Large Purchases**
   Citation: G.S. 105-187.23
   Description: Refund of 60% for person who buys at least 50 new white goods of any kind in the same sale.

   Estimate (in millions): less than $0.1

   Data Source: Department of Revenue records

Piped Natural Gas Tax (Article 5E)

Tax Base Information

The tax is imposed on piped natural gas received for consumption in this State. The marginal tax rate declines as the amount of piped gas consumed increases. For the first 200 therms used in a month, the tax rate is 4.7%. The rate declines to 0.3% for therms over 500,000.

In Fiscal Year 2004-05, $60.5 million was collected from this tax.

Expenditures

1. **Gas Received from a Gas City**
   Citation: G.S. 105-187.41(c)
   Description: Exemption for gas received from a gas city.

   Estimate (in millions): $3.9

   Data Source: State revenues from piped natural gas tax from Department of Revenue; proportion of gas provided by gas cities calculated from NC Utilities Commission report and 2000 US Census

Gift Taxes (Article 6)

Tax Base Information

A tax is imposed on transfers of real or personal property located in the State. Tax rates differ by the relationship between the donor and donee and the amount of the net gift.

In Fiscal Year 2004-05, $18.9 million was collected from this tax.

Expenditures

1. **Annual Exclusion Amount**
   Citation: G.S. 105-188(d)
   Description: Annual exclusion amount equal to the IRS exclusion – $11,000 per donee in 2004.

   Estimate (in millions): $18.0

   Data Source: Gift Tax Statistics, Statistics of Income Division, Internal Revenue Service

   Note: The estimate was available for only those taxpayers that filed a federal gift tax return.

2. **Lifetime Exemption Amount**
   Citation: G.S. 105-188(g)
   Description: Lifetime exemption of $100,000 to donees in family.

   Estimate (in millions): $0.2

   Data Source: Calculations based on Gift Tax Statistics, Statistics of Income Division, Internal Revenue Service

3. **Gifts to State and Nonprofits**
   Citation: G.S. 105-188(h)
   Description: Exemption for gifts to State, nonprofits in NC, nonprofits in other States if certain conditions are met.

   Estimate (in millions): $3.0

   Data Source: Gift Tax Statistics, Statistics of Income Division, Internal Revenue Service

Taxes on Insurance Companies (Article 8B)

Tax Base Information

The tax on an insurer is measured by gross premiums from business done in this State during the calendar year. The basic tax rate is 1.9%. However, premiums on worker compensation plans are taxed at 2.5% and there are additional taxes on premiums related to fire and lightning insurance coverage.

In Fiscal Year 2004-05, $463.6 million was collected from this tax and related regulatory fees.

Expenditures

1. **Federally Tax-Exempt Pensions, Annuities or Profit-Sharing Plan**
   Citation: G.S. 105-228.5(c)(1)
   Description: Excludes premiums connected with funding a pension, annuity or profit-sharing plan qualified or exempt under the Code.

   Estimate (in millions): Unavailable

2. **Premiums Received from Annuities**
   Citation: G.S. 105-228.5(c)(2)
   Description: Excludes premiums if received from annuities, as defined in G.S. 58-7-15.

   Estimate (in millions): $95.0

   Data Source: Life and Annuity Business financial summary for 2003, North Carolina Department of Insurance

3. **Premiums Related to Funding Agreements**
   Citation: G.S. 105-228.5(c)(3)
   Description: Excludes premiums if connected with funding agreements defined in GS 58-7-16.

   Estimate (in millions): $26.0

   Data Source: Life and Annuity Business financial summary for 2003, North Carolina Department of Insurance

4. **Farmers' Mutual Assessment Fire Insurance Companies and Fraternal Organizations**
Citation: G.S. 105-228.5(g)
Description: Excludes farmers' mutual assessment fire insurance companies and nonprofit fraternal organizations.

Estimate (in millions): $3.3

Data Source: North Carolina Department of Insurance

Note: Based on 1.9% tax rate; does not include exemption from additional fire and lightning rate.

5. **Assessments Paid to Insurance Guaranty Association and Life and Health Insurance Guaranty Association**
Citation: G.S. 105-228.5A
Description: Credit against gross premiums for assessments paid to the Insurance Guaranty Association and the Life and Health Insurance Guaranty Associaton.

Estimate (in millions): $3.3

Data Source: Department of Revenue Insurance Tax records

Excise Stamp Tax on Conveyances (Article 8E)

Tax Base Information

This tax is levied on each instrument by which any interest in real property is conveyed to another person. The tax rate is $1 on each $500 of real property value or fractional part thereof.

This tax applies to timber deeds and contracts for the sale of standing timber as if these were transfers of real property.

Fifty percent of the taxes collected are deposited in county funds, and the counties may also retain an additional 2% for administrative costs.

In Fiscal Year 2004-05, $59.7 million was collected by the State from this tax. The proceeds are deposited into the Natural Heritage Trust Fund and the Parks and Recreation Trust Fund. None go directly to the General Fund.

Expenditures

1. **Transfers of Property by Operation of Law**
   Citation: G.S. 105-228.29(1)
   Description: Does not apply to transfer of real property if by operation of law.

   Estimate (in millions): less than $0.1

   Data Source: County deed statistics

2. **Transfers of Property by Lease**
   Citation: G.S. 105-228.29(2)
   Description: Does not apply to a transfer by lease for a term of years.

   Estimate (in millions): $3.5

   Data Source: Data on revenues of Real Estate Lessors in North Carolina from 2002 Economic Census

   Note: The estimate is based on the leased price of the property, not on the total value of the property.

3. **Transfers of Property Pursuant to a Will**
Citation: G.S. 105-228.29(3)
Description: Does not apply to transfers pursuant to a will.

Estimate (in millions): $4.0

Data Source: NC Superior Court data on estate cases; Survey of Income and Program Participation, US Census Bureau

Note: Includes Item #4.

4. **Transfers of Property by Intestacy**
Citation: G.S. 105-228.29(4)
Description: Does not apply to transfers by intestacy.

Estimate (in millions): included in item #3

5. **Transfers of Property by Gift**
Citation: G.S. 105-228.29(5)
Description: Does not apply to transfers by gift.

Estimate (in millions): Unavailable

6. **Transfers Involving No Payments**
Citation: G.S. 105-228.29(6)
Description: Does not apply if no consideration in property or money is due or paid by the tranferee to the transferor.

Estimate (in millions): less than $0.1

Note: If no money is paid, the value of the real estate is likely to be low.

7. **Transfers by Merger, Conversion or Consolidation**
Citation: G.S. 105-228.29(7)
Description: Does not apply if transfer is by merger, conversion or consolidation.

Estimate (in millions): Unavailable

8. **Transfers by Instrument Securing Debt**
Citation: G.S. 105-228.29(8)
Description: Does not apply if transfer is by an instrument securing indebtedness.

Estimate (in millions): $1.0

Data Source: County deed statistics

Excise Tax on Motor Fuels (Article 36C) and Alternative Fuels (Article 36D)

Tax Base Information

The motor fuel excise tax rate consists of a per gallon flat rate (17.5¢) plus a variable wholesale component which is the greater of either 3.5¢ or 7% of the average wholesale price of motor fuel for an applicable base period.

The tax rate on Alternative Fuels is set "equivalent" to the tax on motor fuels, as determined by the Secretary of Revenue.

In Fiscal Year 2004-05, $1.36 billion was collected from this tax.

All information on tax expenditure amounts comes from Department of Revenue records, unless otherwise noted.

Expenditures

1. **Sales to Local Boards of Education**
   Citation: G.S. 105-449.88(4)
   Description: Exemption for motor fuel sales to local boards of education.

   Estimate (in millions): $7.5

   Data Source: Motor Fuels Tax Division, Department of Revenue

2. **Diesel Sold to an Airport**
   Citation: G.S. 105-449.88(5)
   Description: Exemption for sales of diesel that is kerosene and sold to an airport.

   Estimate (in millions): Unavailable

3. **Sales to Charter Schools**
   Citation: G.S. 105-449.88(6)
   Description: Exemption of motor fuels sales to charter schools.

   Estimate (in millions): less than $0.1

   Data Source: Motor Fuels Tax Division, Department of Revenue

4. **Sales to Community Colleges**
Citation: G.S. 105-449.88(7)
Description: Exemption of motor fuel sales to community colleges.

Estimate (in millions): less than $0.1

Data Source: Motor Fuels Tax Division, Department of Revenue

5. **Sales to County or Municipal Corporation**
Citation: G.S. 105-449.88(8)
Description: Exemption for motor fuel sales to a county or municipal corporation.

Estimate (in millions): $14.5

Data Source: Motor Fuels Tax Division, Department of Revenue

6. **Discount for Timely Payment – Distributors**
Citation: G.S. 105-449.93(b)
Description: 1% discount to a licensed distributor for timely payment.

Estimate (in millions): $8.0

Data Source: Calculations based on summary tax collection data, Department of Revenue

7. **Hold Harmless Refunds to Distributors and Some Importers**
Citation: G.S. 105-449.95
Description: Distributors are allowed a 2% discount for the first 150,000 gallons of gasoline purchased, 1.5% for the next 100,000 gallons and 1% for the amount over 250,000 gallons. If the amount of refund received under G.S. 105-449.93(b) is less than the amount the distributor or importer would have received under the above schedule, the Secretary of Revenue must send a check to the distributor or importer for the difference.

Estimate (in millions): $0.7

Data Source: Motor Fuels Tax Division, Department of Revenue

8. **Discount for Timely Payment – Suppliers**
Citation: G.S. 105-449.97(b)
Description: 0.1% discount to supplier for timely payment, not to exceed $8,000 per month.

Estimate (in millions): $0.9

Data Source: Motor Fuels Tax Division, Department of Revenue

9. **Discount for Timely Filing and Payment — Sales to Unlicensed Distributors or Bulk-End Users**
   Citation: G.S. 105-449.97(c)
   Description: 1% discount to supplier for timely filing and payment.

   Estimate (in millions): $2.1

   Data Source: Motor Fuels Tax Division, Department of Revenue

10. **Damage to Conveyance**
    Citation: G.S. 105-449.105(b)
    Description: Exemption for loss of fuel due to damage to a conveyance transporting the motor fuel, fire, a natural disaster, an act of war, or an accident.

    Estimate (in millions): 0.0

    Data Source: Motor Fuels Tax Division, Department of Revenue

11. **Accidentally Combining Fuels**
    Citation: G.S. 105-449.105(c)
    Description: Refund for accidentally combining any of the following: (1) dyed diesel fuel with tax-paid motor fuel, (2) gasoline with diesel fuel, or (3) undyed diesel fuel with dyed kerosene.

    Estimate (in millions): $0.1

    Data Source: Motor Fuels Tax Division, Department of Revenue

12. **Certain Government-Related Entities**
    Citation: G.S. 105-449.106(a)
    Description: Refunds of tax less 1¢ per gallon for nonprofits and local government entities in the following list: (1) private nonprofit organization that transports passengers under contract with or at the express designation of a unit of local government, (2) a volunteer fire department, (3) a volunteer rescue squad, (4) a sheltered workshop recognized by the Department of Health and Human Services.

    Estimate (in millions): $0.4

    Data Source: Motor Fuels Tax Division, Department of Revenue

13. Refunds for Taxicabs

Citation: G.S. 105-449.106(b)

Description: Refunds of tax less 1¢ per gallon for taxicabs and local city transit systems.

Estimate (in millions): $0.2

Data Source: Motor Fuels Tax Division, Department of Revenue

Note: City-run transit systems receive the complete exemption under item #5.

14. Partial Refund for Power Takeoff Vehicles

Citation: G.S. 105-449.107(b)

Description: Annual refund of 33.3% of taxes for certain vehicles, less sales tax. The vehicles include concrete mixing vehicles; solid waste compacting vehicle; bulk feed vehicle that delivers feed to poultry or livestock and uses a power takeoff to unload the feed; a vehicle that delivers lime or fertilizer in bulk to farms and uses a power takeoff to unload the lime or fertilizer; a tank wagon that delivers alternative fuel or motor fuel or another type of liquid fuel into storage tanks and uses a power takeoff to make the delivery; a commercial vehicle that delivers and spreads mulch, soils, composts, sand, sawdust, and similar materials and that uses a power takeoff to unload, blow and spread the materials; commercial vehicles that use a power takeoff to remove and dispose of septage and for which an annual fee is required; or a sweeper.

Estimate (in millions): $2.0

Data Source: Motor Fuels Tax Division, Department of Revenue; Fiscal Research Division fiscal note: estimates for pumps and sweepers are based on information from the Department of Environment and Natural Resources and industry representatives

Appendix: Tax Exclusions and Exemptions That Are Not Proper Tax Expenditures

Privilege Tax

1. **Amusements on Cherokee Indian Reservations**
   Description: All amusements offered or given on the Cherokee Indian Reservation when the person is authorized to do business on the reservation and pays the tribal gross receipts tax.
   Citation: G.S. 105-40(9)
   Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

Bank Annual Privilege Tax

2. **Assets of US Banks Employed Outside NC**
   Description: Assets of US banks that are employed outside the State of North Carolina.
   Citation: G.S. 105-102.3
   Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

3. **Certain Assets of International Banks**
   Description: Assets of international banking facility employed outside the United States.
   Citation: G.S. 105-102.3
   Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

Tobacco Tax

4. **Out-of-State Shipments**
   Description: A distributor is exempt from tax if possession is for out-of-state shipments.
   Citation: G.S. 105-113.9
   Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

5. **Sales to Distributors**
   Description: Manufacturers shipping cigarettes to other distributors are exempt.
   Citation: G.S. 105-113.10
   Reason for Exclusion from Tax Expenditure List: Double Taxation

6. **Out-of-State Sales**
   Description: Exemption for tobacco products sold outside the State.
   Citation: G.S. 105-113.35(a)(1)
   Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

7. **Sales to Federal Government**
   Description: Exemption for tobacco products sold to the federal government.
   Citation: G.S. 105-113.35(a)(2)
   Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

8. **Distribution of Sample Tobacco Products**
   Description: Exemption for a sample tobacco product distributed without charge.
   Citation: G.S. 105-113.35(a)(3)
   Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

Alcoholic Beverage License and Excise Taxes

9. **Unsalable Beverages**
   Description: Exemption if beverage is unsalable due to a major disaster.
   Citation: G.S. 105-113.81(a)
   Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

10. **Sales to Ocean-Going Vessels**
    Description: Exemption if beverage is sold for use on an ocean-going vessel.
    Citation: G.S. 105-113.81(b)
    Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

11. **Sales to US Armed Forces**
    Description: Exemption if beverage is sold to the US Armed Forces.
    Citation: G.S. 105-113.81(c)
    Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

12. **Out-of-State Sales**
    Description: Exemption if beverage is sold outside the State.
    Citation: G.S. 105-113.81(d)
    Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

13. **Free Tastings**
    Description: Exemption for tasting given free of charge on the manufacturer's licensed premises for consumption on the premises.
    Citation: G.S. 105-113.81(e)
    Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

Franchise Tax

14. Adjustment for Capital Stock of International Banking Facility
Description: The capital base of international banking facilities may be reduced by the excess of the amount of all assets employed outside the US over liabilities owed to foreign persons.
Citation: G.S. 105-122(b)
Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

15. Insurance Companies
Description: Exemption for an insurance company subject to tax under Article 8B of this Chapter.
Citation: G.S. 105-125(a)(2)
Reason for Exclusion from Tax Expenditure List: Double Taxation

16. Transfers of Debt
Description: For debtor corporations, a proportionate part of debt determined on the bases of the ratio of capital borrowed by a creditor corporation from a source other than a parent, subsidiary or affiliate to the total assets of the creditor corporation. For creditor corporations, the amount of any debt owed to it by a parent, subsidiary, or affiliated corporation to the extent that such debt has been included in the tax base of the parent, subsidiary, or affiliated debtor corporation reporting for taxation under the provisions of this section.
Citation: G.S. 105-122(b)
Reason for Exclusion from Tax Expenditure List: Double Taxation

Corporation Income Tax

17 Payments Received from an Affiliated Company That Paid Tax on Payment
Description: Payment received from a parent, subsidiary or affiliated corporation in excess of fair compensation in inter-company transactions which in the determination of the net income or net loss of such corporation were not allowed as a deduction.
Citation: G.S. 105-130.5(b)(2)
Reason for Exclusion from Tax Expenditure List: Double Taxation

18. Royalty Payments Taxed by Related Member
Description: Exemption for royalty payments received from a related member who added the payments to income.
Citation: G.S. 105-130.5(b)(2)
Reason for Exclusion from Tax Expenditure List: Double Taxation

19. **Dividends Treated as Received from Outside the US**
Description: Deduction for dividends treated as received from sources outside the United States as determined under Section 862 of the Code, net of related expenses, to the extent included in federal taxable income.
Citation: G.S. 105-130.5(b)(3a)
Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

20. **Dividends Received from Outside the US**
Description: Deduction for any amount included in federal taxable income under Section 78 or Section 951 of the Code, net of related expenses.
Citation: G.S. 105-130.5(b)(3b)
Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

21. **Adjustment for Federal Tax Credits**
Description: Deduction for business expenses when a federal tax credit was taken in lieu of a deduction.
Citation: G.S. 105-130.5(b)(11)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

22. **Insurance Companies, Except for Unrelated Income**
Description: Insurance companies paying the tax on gross premiums as specified in G.S. 105-228.5 (These companies are not exempt from income tax on unrelated business income).
Citation: G.S. 105-130.11(a)(10)
Reason for Exclusion from Tax Expenditure List: Double Taxation

23. **Real Estate Mortgage Investment Conduits**
Description: An entity that qualifies as a real estate mortgage investment conduit, per Section 860D of the Code is exempt.
Citation: G.S. 105-130.11(d)
Reason for Exclusion from Tax Expenditure List: Double Taxation

24. **Distributed Earnings of Regulated Investment Companies and Real Estate Investment Trusts**
Description: A regulated investment company or real estate investment trust shall be taxed only on that part of its net income which is not distributed or declared for distribution to shareholders.
Citation: G.S. 105-130.12
Reason for Exclusion from Tax Expenditure List: Double Taxation

25. **S-Corporation Shareholders**
Description: Credits shall be given to prevent double taxation of S-corporation shareholders.
Citation: G.S. 105-131.8
Reason for Exclusion from Tax Expenditure List: Double Taxation

Individual Income Tax

26. Refunds of State, Local or Foreign Taxes in Federal AGI
Description: Refunds of state, local, and foreign income taxes included in the taxpayer's federal adjusted gross income are exempt.
Citation: G.S. 105-134.6(b)(5)
Reason for Exclusion from Tax Expenditure List: Double Taxation

27. Income from Federally-Recognized Indian Reservation
Description: Exemption for income that is (1) earned or received by an enrolled member of a federally recognized Indian Tribe and (2) derived from activities on a federally recognized Indian reservation while the member resides on the reservation.
Citation: G.S. 105-134.6(b)(9)
Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

28. Inheritance or Estate Taxes Included in Federal AGI
Description: The amount of inheritance or estate tax attributable to an item of income in respect of a decedent required to be included in gross income under the Code may be deducted in the year the item of income is included.
Citation: G.S. 105-134.6(d)(1)
Reason for Exclusion from Tax Expenditure List: Double Taxation

29. Federal Tax Credit Allowance
Description: Deductions not allowed under the Code because the taxpayer took a tax credit in lieu of deduction on federal income tax.
Citation: G.S. 105-134.6(d)(2)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

30. Income Taxes Paid to Other States
Description: Individuals residing in North Carolina may receive a tax credit for income taxes paid to other states.
Citation: G.S. 105-151
Reason for Exclusion from Tax Expenditure List: Double Taxation

Sales and Use Tax

31. Telecommunications Services That Are Integrated Into Another Service
Description: Exemption of charges for telecommunications services that are a component part of or are integrated into a telecommunications service that is resold.
Citation: G.S. 105-164.4C(c)(1)
Reason for Exclusion from Tax Expenditure List: Double Taxation

32. Telecommuncations Services That Are Part of Prepaid Telephone Calling Service
Description: Exemption for telecommunications services that are resold as part of a prepaid telephone calling service.
Citation: G.S. 105-164.4C(c)(2)
Reason for Exclusion from Tax Expenditure List: Double Taxation

33. One-Way Video and Audio Services
Description: Charges for commercial, cable, mobile, broadcast, or satellite video or audio service unless the service provides two-way communication, other than the customer's interactive communication in connection with the customer's selection or use of the video or audio service.
Citation: G.S. 105-164.4C(c)(6)
Reason for Exclusion from Tax Expenditure List: Double Taxation

34. Telecommunications Billing and Collection Services
Description: Exemption for billing and collection services.
Citation: G.S. 105-164.4C(c)(14)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

35. Telecommunications Charges for Nonpayment
Description: Exemption for charges for bad checks or late payments.
Citation: G.S. 105-164.4C(c)(15)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

36. Farm Products Requiring Further Processing
Description: Exemption for sales of cotton, tobacco, peanuts or other farm products sold to manufacturers for further manufacturing or processing.
Citation: G.S. 105-164.13(4)
Reason for Exclusion from Tax Expenditure List: Purchase of Intermediate Good

37. Baby Chicks or Poults Sold for Further Production
Description: Exemption for sales of baby chicks and poults sold for commercial poultry or egg production.
Citation: G.S. 105-164.13(4a)
Reason for Exclusion from Tax Expenditure List: Purchase of Intermediate Good

38. Manufactured Products Sold for Resale
Description: Exemption for sales of manufactured products produced and sold by manufacturers or producers to other manufacturers, producers, or registered retailers or wholesale merchants, for the purpose of resale.
Citation: G.S. 105-164.13(5)
Reason for Exclusion from Tax Expenditure List: Purchase of Intermediate Good

39. Ingredients in Manufacturing Process
Description: Exemption for sales to a manufacturer of tangible personal property that enters into or becomes an ingredient or component part of tangible personal property that is manufactured.
Citation: G.S. 105-164.13(8)
Reason for Exclusion from Tax Expenditure List: Purchase of Intermediate Good

40. Fuel for Small Power Production Facility
Description: Exemption for sales to a small power production facility of fuel used by the facility to generate electricity.
Citation: G.S. 105-164.13(8a)
Reason for Exclusion from Tax Expenditure List: Purchase of Intermediate Good

41. Articles Repossessed by Vendor
Description: Exemption for sales of an article repossessed by the vendor if the tax was paid on the sales price of the article.
Citation: G.S. 105-164.13(16)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

42. Items for Use on Ocean-Going Vessels
Description: Sales of fuel and other items for use or consumption by or on ocean-going vessels.
Citation: G.S. 105-164.13(24)
Reason for Exclusion from Tax Expenditure List: Sales for Use Outside North Carolina

43. Sales on Cherokee Indian Reservation
Description: Exemption for sales by merchants on the Cherokee Indian Reservation.
Citation: G.S. 105-164.13(25)
Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

44. Sales of Motor Vehicles
Description: Sales of motor vehicles, the sale of a motor vehicle body to be mounted on a motor vehicle chassis when a certificate of title has not been issued for the chassis, and the sale of a motor vehicle body mounted on a motor vehicle chassis that temporarily enters the State so the manufacturer of the body can mount the body or chassis.
Citation: G.S. 105-164.13(32)
Reason for Exclusion from Tax Expenditure List: Double Taxation

45. Articles Purchased for Resale
Description: Exemption for tangible property purchased solely for the purpose of export to a foreign country for exclusive use or consumption in that or some other foreign country.
Citation: G.S. 105-164.13(33)
Reason for Exclusion from Tax Expenditure List: Sales for Use Outside North Carolina

46. Purchases Delivered Outside NC
Description: Exemption for tangible property sold by a retailer to purchasers within or without this State, when the property is delivered in this State to a common carrier or to the United States Postal Service for delivery to the purchaser or the purchaser's designees outside this State and the purchaser does not subsequently use the property in this State.
Citation: G.S. 105-164.13(33a)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

47. Articles Donated by Retailer or Wholesaler
Description: Exemption for tangible personal property that is purchased by a retailer for resale or is manufactured or puchased by a wholesale merchant for resale and then withdrawn from inventory and donated by the retailer or wholesale merchant.
Citation: G.S. 105-164.13(42)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

48. Deposit on Returnable Beverage Container
Description: Exemption for an amount charged as a deposit on a beverage container that is returnable to the vendor for reuse when the amount is refundable or creditable to the vendee.
Citation: G.S. 105-164.13(47)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

49. Deposit on Returnable Replacement Part
Description: Exemption for an amount charged as a deposit on an aeronautic, automotive, industrial, marine or farm replacement part that is returnable to the vendor for rebuilding or remanufacturing when the amount is refundable or creditable to the vendee. This exemption does not include tires or batteries.
Citation: G.S. 105-164.13(48)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

50. Installation Charges
Description: Installation charges when separately stated.
Citation: G.S. 105-164.13(49)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

Highway Use Tax

51. Resale of Automobile by Manufacturer or Retailer
Description: Full exemption when a certificate of title is issued to either a manufacturer or a motor vehicle retailer for the purpose of resale.
Citation: G.S. 105-187.6(a)(2)
Reason for Exclusion from Tax Expenditure List: Double Taxation

52. Correction in Owner's Name on Title
Description: Full exemption when a certificate of title is issued to the same owner to reflect a change or correction in the owner's name.
Citation: G.S. 105-187.6(a)(3)
Reason for Exclusion from Tax Expenditure List: Double Taxation

53. Removal of a Co-Owner's Name from Title
Description: Full exemption when a certificate is of title is issued to one or more of the same co-owners to reflect the removal of one or more other co-owners.
Citation: G.S. 105-187.6(a)(3a)
Reason for Exclusion from Tax Expenditure List: Double Taxation

54. Title Issued by Will or Intestacy
Description: Full exemption when a certificate of title is issued by will or intestacy.
Citation: G.S. 105-187.6(a)(4)
Reason for Exclusion from Tax Expenditure List: Double Taxation

55. Change in Title Due to Gift Between Close Family Members
Description: Full exemption when a certificate of title is issued by a gift between a husband and wife, a parent and child, or a stepparent and a stepchild.
Citation: G.S. 105-187.6(a)(5)
Reason for Exclusion from Tax Expenditure List: Double Taxation

56. Change in Title Due to Marital Separation or Divorce
Description: Full exemption when a certificate of title is issued by a distribution of marital or divisible property incident to a marital separation or divorce.
Citation: G.S. 105-187.6(a)(6)
Reason for Exclusion from Tax Expenditure List: Double Taxation

57. Salvage Vehicles
Description: Full exemption when a certificate of title is issued to the insurer of the motor vehicle because the vehicle is a salvage vehicle.
Citation: G.S. 105-187.6(a)(1)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

Tax on Insurance Companies

58. Premiums from Federal Employees Health Benefits Plan and Medicare or Medicaid
Description: Excludes premiums to the extent prohibited by federal law from Federal Employees Health Benefits Plan and Medicare or Medicaid.
Citation: G.S. 105-228.5(c)(4)
Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

Excise Tax on Motor Fuels and Alternative Fuels

59. Sales for Out-of-State Use
Description: The excise tax on motor fuel does not apply to motor fuel removed from a terminal for export if the motor fuel is removed by a licensed distributor or a licensed exporter and the supplier of the motor fuel collects tax on it at the rate of the motor fuel's destination state.
Citation: G.S. 105-449.88(1)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

60. Sales to Out-of-State Suppliers
Description: The tax does not apply to motor fuel removed by transport truck from a terminal for export if the motor fuel is removed by a licensed distributor or licensed exporter, the supplier that is the position holder for the motor fuel sells the motor fuel to another supplier as the motor fuel crosses the terminal rack, the purchasing supplier or its customer receives the motor fuel at the terminal rack for export, and the supplier that is the position holder collects the tax on the motor fuel at the rate of the motor fuel's destination state.
Citation: G.S. 105-449.88(1a)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

61. Sales to the Federal Government
Description: The tax does not apply to motor fuel sold to the federal government for its use.
Citation: G.S. 105-449.88(2)
Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

62. Sales to the State Government
Description: The tax does not apply to motor fuel sold to the State government for its use.
Citation: G.S. 105-449.88(3)
Reason for Exclusion from Tax Expenditure List: Expenditure savings cancels out tax revenue loss

63. Refunds for Sale to Exempt Entity
Description: An entity whose use of motor fuel is exempt from tax may obtain a refund of any motor fuel excise tax the entity pays. The person who sells the fuel to the exempt entity is also allowed to obtain a refund of any taxes paid on the fuel.
Citation: G.S. 105-449.105(a)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

64. Sale of Kerosene for Uses Not Related to Motor Vehicles
Description: A distributor who sells kerosene may obtain a refund for the excise tax paid on the kerosene if the distributor dispenses the kerosene into a storage facility for use in: (1) heating, (2) drying crops, (3) a maunfacturing process.
Citation: G.S. 105-449.105A(a)(1)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

65. Sale of Kerosene for Uses Not Related to Motor Vehicles
Description: A distributor who sells kerosene may obtain a refund for the excise tax paid on the kerosene if the distributor dispenses the kerosene into a storage facility marked "Undyed, Untaxed Kerosene, Nontaxable Use Only" or if it has a dispensing device that is not suitable for fueling a highway vehicle.
Citation: G.S. 105-449.105A(a)(2)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

66. Motor Fuel for Off-Highway Equipment
Description: Quarterly refunds of the estimated entire tax to a person who purchases and uses motor fuel to operate special mobile equipment off-highway.
Citation: G.S. 105-449.106(c)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

67. Sale of Motor Fuel for Uses Not Related to Highway Vehicle
Description: Refund for purchases and uses of motor fuel for a purpose other than to operate a licensed highway vehicle.
Citation: G.S. 105-449.107(a)
Reason for Exclusion from Tax Expenditure List: Not in Taxable Base

68. Sales to Cherokee Indian Reservation
Description: Refund for motor fuels and special fuels taxes to the Cherokee Indians on behalf of its members who reside on or engage in otherwise taxable transactions within Cherokee trust lands.
Citation: G.S. 105-449.114
Reason for Exclusion from Tax Expenditure List: Constitutional Restrictions

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REVENUE LAWS STUDY COMMITTEE
Wednesday, March 1, 2006 at 1:00 PM
Room 544, Legislative Office Building

MINUTES

The Revenue Laws Study Committee met at 1:00 PM on March 1, 2006, in Room 544 of the Legislative Office Building. Thirteen members of the committee were present. Senator Kerr and Representative Luebke presided.

Approval of the Minutes.

Rep. Hill motioned for the approval of the February 8, 2006 minutes and the motion carried. A copy of the minutes is attached.

Revenue Laws Technical Changes: Draft Proposal and Summary.

Cindy Avrette, a staff attorney with the Research Division, was recognized to explain the draft proposal's provisions to improve the collection and administration of the motor fuel tax. A copy of the draft and the summary are attached.

Streamlined Sales Tax Definitions: Draft Proposal and Summary.

Sabra Faires, the Senate Tax Counsel, was recognized to explain the draft proposal. A copy of the draft, summary and fiscal memo are attached.

S Corp Income Tax Adjustments: Draft Proposal and Summary.

Trina Griffin, a staff attorney with the Research Division, was recognized to explain the draft proposal. A copy of the draft proposal and summary are attached.

Clarify Additional Gross Premiums Tax: Draft Proposal and Summary.

Cindy Avrette, a staff attorney with the Research Division, was recognized to explain the draft proposal. A copy of the draft proposal and summary are attached.

Franchise Tax Loophole Closing: Draft Proposal and Summary.

Trina Griffin, a staff attorney with the Research Division, was recognized to explain the draft proposal. A copy of the draft proposal, summary and fiscal memo are attached.

Franchise Tax Base Calculation: Draft Proposal and Summary.

Cindy Avrette, a staff attorney with the Research Division, was recognized to explain the draft proposal. Jonathan Tart, Administrative Officer of the Corporate, Excise, and Insurance Tax Division, NC Department of Revenue, was available to answer questions. A copy of the draft proposal and summary are attached.

Expansion of Royalty Reporting Option: Draft Proposal and Summary

Trina Griffin, a staff attorney with the Research Division, was recognized to explain the draft proposal. Sen. Kerr made a motion for consideration of the draft proposal and the motion carried. A copy of the draft proposal, summary and fiscal memo are attached.

Real Estate Investment Trusts

Cindy Avrette, a staff attorney with the Research Division, was recognized to explain the proposal. Greg Radford, Director of the Corporate, Excise, and Insurance Tax Division, NC Department of Revenue, was available to answer questions. A copy of the proposal is attached.

Taxation of Communication Services

- **Review of Current Tax Treatment** – Cindy Avrette was recognized to explain the current tax treatment.
- **Review of Current NC Market** – Brenna Erford, Fiscal Research Division, was recognized to explain the current market. A copy of her presentation is attached.
- **Review of Current Legislation in other States** – Sabra Faires, the Senate Tax Counsel, was recognized to explain current and pending legislation in other states. A copy of her presentation is attached.

The meeting adjourned at 3:10 PM.

Senator John H. Kerr, III, Co-Chair
Revenue Laws Study Committee

Representative Paul Luebke, Co-Chair
Revenue Laws Study Committee

DeAnne Mangum, Committee Clerk

REVENUE LAWS STUDY COMMITTEE
Wednesday, February 8, 2006 at 1:00 PM
Room 544, Legislative Office Building

MINUTES

The Revenue Laws Study Committee met at 1:00 PM on February 8, 2006, in Room 544 of the Legislative Office Building. Fourteen members of the committee were present. Senator Kerr and Representative Luebke presided.

Approval of the Minutes.

Sen. Clodfelter motioned for the approval of the January 11, 2005 minutes and the motion carried. A copy of the minutes is attached.

Synopsis of the Institute of Emerging Issues Forum on 'Financing the Future'.

Sabra Faires, Senate Tax Counsel, was recognized for a description of the 2006 Emerging Issues Forum on 'Financing the Future". A copy of the presentation is attached.

Streamlined Sales Tax Update.

Andy Sabol, Director of the Sales & Use Tax Division, Department of Revenue, was recognized for an update on the Streamlined Sales Tax. A copy of the presentation is attached.

Additional Personal Income Tax Filing Option.

Martha Walston, a staff attorney with the Fiscal Research Division, was recognized to explain the 'Additional Personal Income Tax Filing Option' draft proposal and fiscal memo. Rep. Luebke made a motion for consideration of the draft proposal and the motion carried. A copy of the draft proposal, summary and fiscal memo are attached.

IRC Update.

Canaan Huie, a staff attorney with the Bill Drafting Division, was recognized to explain the 'IRC Update' draft proposal and fiscal memo. Greg Radford, Director of the Corporate, Excise, and Insurance Tax Division, NC Department of Revenue, was available to answer questions. In addition to updating the reference to the Internal Revenue Code, the bill would shorten the time span in which a taxpayer must report a federal change from two years to six months. Rep. Brubaker made a motion that this part of the bill be amended to provide a taxpayer with the right to request a six-month extension of time to report the federal change. The motion carried. A copy of the draft proposal and summary are attached.

Property Tax Changes.

Martha Walston, a staff attorney with the Fiscal Research Division, was recognized to explain the 'Property Tax Changes' draft proposal and fiscal memo. Pete Rodda, Forsyth County Tax Administrator, and Paul Meyer, Assistant Counsel for NC Association of County Commissioners, were available to answer questions. A copy of the draft proposal, summary and fiscal memo are attached.

Revenue Laws Technical Changes.

Trina Griffin, a staff attorney with the Research Division, was recognized to explain the 'Revenue Laws Technical Changes' draft proposal. Greg Radford, Director of the Corporate, Excise, and Insurance Tax Division, NC Department of Revenue, was available to answer questions. A copy of the draft proposal and summary are attached.

2005 Biennial Tax Expenditure Report.

Karl Knapp, Director of the Tax Research Division, Department of Revenue, presented the 2005 Biennial Tax Expenditure report as required by G.S. 105-256(a)(2). A copy of the report is attached.

Rep. Wainwright made a motion to adjourn the meeting and the motion carried. The meeting adjourned at 3:37 PM.

Senator John H. Kerr, III, Co-Chair
Revenue Laws Study Committee

Representative Paul Luebke, Co-Chair
Revenue Laws Study Committee

DeAnne Mangum, Committee Clerk

REVENUE LAWS STUDY COMMITTEE
State Legislative Building
Raleigh, North Carolina 27603

Senator John H. Kerr, III, Co-Chair *Representative Paul Luebke, Co-Chair*

February 14, 2006

NOTICE

TO: Members, Revenue Laws Study Committee

FROM: Senator John Kerr, Co-Chair
Representative Paul Luebke, Co-Chair

SUBJECT: Revenue Laws Study Committee Meeting

There will be a meeting of the **Revenue Laws Study Committee** as follows:

DAY:	**Wednesday**
DATE:	**March 1, 2006**
TIME:	**1:00 pm**
LOCATION:	**Room 544, Legislative Office Building**

Please advise DeAnne Mangum, at (919) 733-2405 or e-mail deannem@ncleg.net if you will be unable to attend.

Posted: 02-14-06

House Pages

REVENUE LAW STUDY COMM

Name Of Committee: _____ Date: 3-1-06

1.0

1. Name: _____

   County: _____

   Sponsor: _____

2. Name: _____

   County: _____

   Sponsor: _____

3. Name: _____

   County: _____

   Sponsor: _____

4. Name: _____

   County: _____

   Sponsor: _____

5. Name: _____

   County: _____

   Sponsor: _____

	HOUSE	Sgt-At-Arms	SENATE
1. Name:	TOM WILDER		LESLIE WRIGHT
2. Name:	DUSTY RHODES		CHARLES MARCELLUS
3. Name:	FRED NINES		
4. Name:			
5. Name:			

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — March 1, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
John Goodman	Alley Associates
Hugh Tilson	NCHA
David Miner	Echostar Communications
Betty Turner	Bank of America
Paul H. Stock	NC BA
Sandy Sands	WCSR
Wanda Montano	[illegible]
Bill Scoggin	KCCH
[illegible]	[illegible]
[illegible]	[illegible]
Stephen A. Woodson	NC Farm Bureau

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — March 1, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Doris J. Boris	600 E 4th – 28202 Charlotte-Mecklenburg Cable Offic
Don Hobbs	NC DOC
Jon Carr	Jordan Price Law Firm
Cam Cover	BPM HC
Marcus Trotter	BPM HC
Paul Fox	TWC
Mark Prak	BPM HC
Lee Mandell	NCLM
Sharon Miller	CUCA
Rebecca Troutman	NCACC
Frank W. Foger	NC DOT

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — March 1, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Marty Bocock	Sprint
Michael Williams	City of Raleigh

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — March 1, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Connie Wilson	SST
Tim Mcdowell	NCICU
Rudolph E. Ward	Rudolph E. Ward + Assoc.
Ken McHon	N.C. DOR.

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — March 1, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Greg Redford	Revenue
Virginia Tayloe	Insurance
Lennie Collins	DOR
Jonathan Tart	DOR
Gail Beamon	DOR
Nancy Pomeranz	DOR
Karl Knapp	DOR
Donna Alderman	DOR
Janice Davidson	DOR
Stacy Cowell	DOR
John D Panza	DOR

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — March 1, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Becki Gray	Civitas Institute
Anna Cameron	NC Justice Center
Dwight Allen	NC Telephone Cooperatives
Bill Wells	N.C. TELCO Alliance
Stan Pace	Verizon
Jonathan Smith	SAS Institute
Anna Mitchell	NC DOR
Andy Small	NC DOR
Jeff VanDyke	BellSouth
Paul Matthews	Progress Energy
Cabney	MT

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-RBxz-29 [v.7] (02/08)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
3/1/2006 9:54:47 AM

Short Title: Revenue Laws Technical Changes. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO MAKE TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES TO THE REVENUE LAWS AND RELATED STATUTES AND TO IMPROVE THE COLLECTION AND ADMINISTRATION OF THE MOTOR FUEL TAX.

The General Assembly of North Carolina enacts:

...

SECTION 15.(a) G.S. 105-449.65(b) reads as rewritten:

"(b) Multiple Activity. – A person who is engaged in more than one activity for which a license is required must have a separate license for each activity, unless this subsection provides otherwise. A person who is licensed as a supplier is considered to have a license as a distributor. A person who is licensed as an occasional importer or a tank wagon importer is not required to obtain a separate license as a distributor unless the importer is also purchasing motor fuel, at the terminal rack, from an elective or permissive supplier who is authorized to collect and remit the tax to the State. A person who is licensed as a distributor is not required to obtain a separate license as an importer if the distributor acquires fuel for import only from an elective supplier or a permissive supplier and is not required to obtain a separate license as an exporter. A person who is licensed as a distributor or a blender ~~is not required to obtain a separate license~~ and who transports fuel is considered to be licensed as a motor fuel ~~transporter if the distributor or blender does not transport motor fuel for others for hire.~~transporter."

SECTION 15.(b) G.S. 105-449.101 reads as rewritten:

"**§ 105-449.101. Motor fuel transporter to file informational return showing deliveries of ~~imported or exported~~ motor fuel.**

(a) Requirement. – A motor fuel transporter ~~that imports motor fuel into this State or exports motor fuel from this State~~ must file a monthly informational return with the Secretary that shows motor fuel ~~received or delivered for import or export~~

transported in this State by the transporter during the month. ~~This requirement does not apply to a distributor that is not required to be licensed as a motor fuel transporter.~~

(b) Content. – The return required by this section is due ~~by the 25th day of the month following the month covered by the return.~~ on the same date as a monthly return due under G.S. 105-449.90. The return must contain the following information and any other information required by the Secretary:

(1) The name and address of each person from whom the transporter received motor fuel outside the State for delivery in the State, the amount of motor fuel received, the date the motor fuel was received, and the destination state of the fuel.

(2) The name and address of each person from whom the transporter received motor fuel in the State for delivery outside the State, the amount of motor fuel delivered, the date the motor fuel was delivered, and the destination state of the fuel.

(3) The name and address of each person from whom the transporter received motor fuel in the State for delivery in the State, the amount of motor fuel received, the date the motor fuel was received, and the destination state of the fuel."

SECTION 16.(a) G.S. 105-449.60 is amended by adding a new subdivision to read:

"**§ 105-449.60. Definitions.**

The following definitions apply in this Article:

...

(10a) Exempt card or code. – A credit card or an access code that enables the person to whom the card or code is issued to buy motor fuel at retail without paying the motor fuel excise tax on the fuel."

SECTION 16.(b) G.S. 105-449.88A reads as rewritten:

"**§ 105-449.88A. Liability for tax due on motor fuel designated as exempt by the use of cards or codes.**

~~(a) Exempt Cards at Rack. When a licensed distributor or licensed importer removes motor fuel from a terminal by means of an exempt card or exempt access code issued by the supplier, the distributor or importer represents that the fuel removed will be resold to a governmental unit that is exempt from the tax. A supplier may rely on this representation. A licensed distributor or licensed importer that does not resell motor fuel removed from a terminal by means of an exempt card or exempt access code to an exempt governmental unit is liable for any tax due on the fuel.~~

(b) Exempt ~~Cards at Retail.~~ Card or Code. ~~An "exempt card or code" is a credit card or an access code that enables the person to whom the card or code is issued to buy motor fuel at retail without paying the motor fuel excise tax on the fuel.~~ An entity that issues an exempt card or code has a duty to determine if the person to whom it is issued is exempt from the motor fuel excise tax. An entity that issues an exempt card or code to a person who is not exempt from tax is liable for tax due on motor fuel the person purchases at retail by use of the exempt card or code. If a supplier authorizes another entity to issue an exempt card or code to a person who is not exempt from tax, the

supplier and the entity that issued the card are jointly and severally liable for tax due on motor fuel the person purchases at retail by use of the exempt card or code.

(c) Card Holder. – A person to whom an exempt card or ~~exempt access card~~ code is issued ~~for use at a terminal or at retail~~ is liable for any tax due on fuel purchased with the card or code for a purpose that is not exempt. A person who misuses an exempt card or code by purchasing fuel with the card or code for a purpose that is not exempt is liable for the tax due on the fuel."

SECTION 16.(c) G..S. 105-449.90(c) is repealed.

SECTION 16.(d) G.S. 105-449.93 reads as rewritten:

"**§ 105-449.93. ~~Exempt sale deduction and percentage~~ Percentage discount for licensed distributors and some licensed importers.**

~~(a) Deduction. A license holder listed below may deduct from the amount of tax otherwise payable to a supplier the amount calculated on motor fuel the license holder received from the supplier and resold to a governmental unit whose purchases of motor fuel are exempt from the tax under G.S. 105-449.88 if, when removing the fuel, the license holder used an access card or code specified by the supplier to notify the supplier of the license holder's intent to resell the fuel in an exempt sale:~~

~~(1) A licensed distributor.~~

~~(2) A licensed importer that removed the motor fuel from a terminal rack of a permissive or an elective supplier.~~

(b) Percentage Discount. – A licensed distributor that pays the tax due a supplier by the date the supplier must pay the tax to the State may deduct from the amount due a discount of one percent (1%) of the amount of tax payable. A licensed importer that removes motor fuel from a terminal rack of a permissive or an elective supplier and that pays the tax due the supplier by the date the supplier must pay the tax to the State may deduct from the amount due a discount of the same amount allowed a licensed distributor. The discount covers the expense of furnishing a bond and losses due to shrinkage or evaporation. A supplier may not directly or indirectly deny this discount to a licensed distributor or licensed importer that pays the tax due the supplier by the date the supplier must pay the tax to the State."

SECTION 16.(e) G.S. 105-449.94 is repealed.

SECTION 16.(f) G.S. 105-449.97(d) reads as rewritten:

"(d) Taxes Paid on Exempt Retail Sales. – When filing a return, a supplier that issues or authorizes the issuance of an exempt card or ~~an exempt access~~ code to a person that enables the person to buy motor fuel ~~at retail~~ without paying tax on the fuel may deduct the amount of excise tax imposed on fuel purchased with the exempt ~~retail~~ card or code. The amount of excise tax imposed on fuel purchased ~~at retail~~ with an exempt ~~retail~~ card or code is the amount that was imposed on the fuel when it was delivered to the retailer of the fuel."

SECTION 16.(g) G.S. 105-449.105A(a) reads as rewritten:

"(a) Refund. – A distributor who sells kerosene to any of the following may obtain a refund for the excise tax the distributor paid on the kerosene, less the amount of any discount allowed on the kerosene under G.S. 105-449.93:

(1) The end user of the kerosene, if the distributor dispenses the kerosene into a storage facility of the end user that contains fuel used only for one of the following purposes and the storage facility is installed in a manner that makes use of the fuel for any other purpose improbable:
a. Heating.
b. Drying crops.
c. A manufacturing process.

(2) A retailer of kerosene, if the distributor dispenses the kerosene into a storage facility that meets both of the following conditions:
a. It is marked with the phrase "Undyed, Untaxed Kerosene, Nontaxable Use Only" or a similar phrase that clearly indicates that the fuel is not to be used to operate a highway vehicle.
b. It either has a dispensing device that is not suitable for use in fueling a highway vehicle or is kept locked by the retailer and must be unlocked by the retailer for each sale of kerosene.

(3) An airport. if the distributor dispenses the kerosene into a storage facility that contains fuel used only for fueling airplanes and that meets at least one of the following conditions:
a. It is marked with the phrase "Undyed, Untaxed Kerosene, Nontaxable Use Only" or a similar phrase that clearly indicates that the fuel is not to be used to operate a highway vehicle.
b. It has a dispensing device that is not suitable for use in fueling a highway vehicle."

SECTION 17.(a) G.S. 105-449.100 reads as rewritten:

"**§ 105-449.100. Terminal operator to file informational return showing changes in amount of motor fuel at the terminal.**

A terminal operator must file a monthly informational return with the Secretary that shows the amount of motor fuel received or removed from the terminal during the month. The return is due ~~by the 25th day of the month following the month covered by the return.~~ on the same date as a monthly return due under G.S. 105-449.90. The return must contain the following information and any other information required by the Secretary:

(1) The number of gallons of motor fuel received in inventory at the terminal during the month and each position holder for the fuel.
(2) The number of gallons of motor fuel removed from inventory at the terminal during the month and, for each removal, the position holder for the fuel and the destination state of the fuel.
(3) The number of gallons of motor fuel gained or lost at the terminal during the month."

SECTION 17.(b) G.S. 105-449.102(a) reads as rewritten:

"(a) Return. – A distributor that exports motor fuel from a bulk plant located in this State must file a monthly return with the Secretary that shows the exports. The return is due ~~by the 25th day of the month following the month covered by the return.~~

on the same date as a monthly return due under G.S. 105-449.90. The return serves as a claim for refund by the distributor for tax paid to this State on the exported motor fuel."

SECTION 17.(c) G.S. 105-449.137(b) reads as rewritten:

"(b) Payment. – The tax imposed by this Article is payable when a return is due. A return is due ~~monthly within 25 days after the end of each month.~~ on the same date as a monthly return due under G.S. 105-449.90. A monthly return covers liabilities that accrue in the calendar month preceding the date the return is due. A return must be filed with the Secretary and must be in the form and contain the information required by the Secretary."

SECTION 17.(d) G.S. 119-18(a) reads as rewritten:

"(a) Tax. – An inspection tax of one fourth of one cent (1/4 of 1¢) per gallon is levied upon all of the fuel listed in this subsection regardless of whether the fuel is exempt from the per-gallon excise tax imposed by Article 36C or 36D of Chapter 105 of the General Statutes. The inspection tax on motor fuel is due and payable to the Secretary of Revenue at the same time that the per gallon excise tax on motor fuel is due and payable under Article 36C of Chapter 105 of the General Statutes. The inspection tax on alternative fuel is due and payable to the Secretary of Revenue at the same time that the excise tax on alternative fuel is due and payable under Article 36D of Chapter 105 of the General Statutes. The inspection tax on kerosene is payable monthly to the Secretary by a supplier that is licensed under Part 2 of Article 36C of Chapter 105 of the General Statutes and by a kerosene supplier. A monthly report is due ~~by the 22nd of each month~~ on the same date as a monthly return due under G.S. 105-449.90 and applies to kerosene sold during the preceding month by a supplier licensed under that Part and to kerosene received during the preceding month by a kerosene supplier. A kerosene terminal operator must file a return in accordance with the provisions of ~~G.S. 105-449.100.~~G.S. 105-449.90.

(1) Motor fuel.

(2) Alternative fuel used to operate a highway vehicle.

(3) Kerosene."

SECTION 18. G.S. 105-449.120(a)(3a) is repealed.

SECTION 19. ... Sections 15 through 18 of this act become effective January 1, 2007, and apply to motor fuel purchased on or after that date. An exempt card or code will not be valid for sales of motor fuel at the terminal rack on or after January 1, 2007. The remainder of this act is effective when it becomes law.

BILL DRAFT 2005-RBxz-29: Revenue Laws Technical Changes

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	March 1, 2006
Introduced by:		**Summary by:**	Cindy Avrette Committee Counsel
Version:	Draft		

SUMMARY: Draft Proposal 2005-RBx-29 makes the following changes to the motor fuel tax laws:

- *It would allow the Department of Revenue to track both interstate and intrastate movements of motor fuel.*
- *It would provide that the motor fuel tax must be paid on all motor fuel that leaves the rack by removing the current motor fuel exemptions that apply to fuel at the rack and replacing them with refunds.*
- *It would provide that all returns, both informational returns and tax returns, are due on the same date.*
- *It would delete an obsolete misdemeanor.*

BILL ANALYSIS: The following changes to the motor fuel tax statutes are proposed as an addition to the 'Revenue Laws Technical Changes' proposal discussed at the last meeting. The Department of Revenue requested the changes to enable it to better administer and enforce the motor fuel tax laws.

Section 15 would give the Department the ability to cross match all motor fuel to ensure compliance with the motor fuel tax laws. Under current law, the Department may cross-match information regarding fuel entering the State and fuel leaving the State, but it cannot cross-match information regarding the intrastate movement of motor fuel. The Department has a new fuel tracking system that will better enable it to monitor the movement of fuel. The Department expects the system to be operational by the last quarter of this fiscal year. Section 15 makes the statutory changes necessary to enable the Department to review intrastate movements of fuel by providing that anyone who transports fuel must be licensed as a transporter and that all transporters must file informational returns on all movements of motor fuel.

Section 15(a) provides that all people who transport motor fuel will be licensed as a motor fuel transporter. Under current law, a person licensed as a distributor or blender is considered to be licensed as a motor fuel transporter if the person transports the fuel for other for hire. This section would remove the exception for persons who transport their own fuel so that any distributor or blender who transports fuel – whether for hire or for their own use – would also be considered licensed as a transporter.

Section 15(b) provides that a transporter must file an informational return showing deliveries of motor fuel. Under current law, only interstate movements of fuel must be reported on a monthly informational return. The change in this section of the bill would require such a return for all deliveries of fuel.

Section 16 would provide that all motor fuel leaving the terminal rack would be subject to the motor fuel excise tax. The Department requested this change to reduce the areas of evasion and inadvertent duplicate refunds. Under current law, a licensed distributor or importer may remove fuel from a terminal without paying the tax if the person has an exempt card issued by the supplier. This section would remove the ability of distributors and importers to use exempt cards at the terminal rack. Instead, they

would be able to obtain a monthly refund on any sales of fuel to exempt entities.[1] This change would conform North Carolina's law to the laws of the surrounding states who do not allow untaxed gasoline or undyed fuel to leave their terminals without the imposition of the tax.

Section 16(a) puts the definition of 'exempt card or code' in the definitional statute for the motor fuel article. Section 16(b) repeals the portion of the statute that allows fuel to be removed from the terminal without paying the tax. Section 16(c) removes the deduction a licensed distributor or importer may make for tax exempt fuel taken from the terminal rack because the ability to obtain the fuel without paying the tax is repealed in section 16(b). Section 16(d) repeals the statute requiring a licensed distributor or importer who obtains fuel at the terminal rack with an exempt card to file a quarterly reconciling return. Section 16(e) makes conforming changes. Section 16(f) provides a monthly refund procedure for a distributor who sells diesel fuel to an airport. A refund procedure already exists for sales of motor fuel to the other listed exempt entities.

Section 15(b) and section 17 would establish a common due date for all motor fuel tax due and informational returns. Under current law, most of the monthly tax returns are due on the 22nd day of the month following the month covered by the return. Informational returns are due on the 25th day of the month following the month covered by the return. These sections provide that all monthly returns are due on the 22nd day of the month following the month covered by the return.

Section 18 would remove the misdemeanor for taxpayers failing to pay the destination state taxes collected to that state. This provision was put into the law when North Carolina first moved to tax-at-the-rack. Today, all of the surrounding states have destination state tax laws. North Carolina does not collect and remit the taxes to those states, therefore this misdemeanor is no longer needed.

Sections 15 through 17 become effective January 1, 2007, and apply to motor fuel purchased on or after that date. Section 18 is effective when it becomes law.

[1] G.S. 105-449.88 exempts the following entities from the motor fuel excise tax if it is sold to them for their use: the federal government, the State, local boards of education, charter schools, community colleges, counties, municipalities, and airports.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-RBxz-33 [v.4] (02/27)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/28/2006 3:26:10 PM

Short Title: Streamlined Sales Tax Definitions. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO INCORPORATE THE STREAMLINED SALES TAX DEFINITIONS CONCERNING TELECOMMUNICATIONS.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-164.3 is amended by amending or adding the following definitions to read:

"**§ 105-164.3. Definitions.**

The following definitions apply in this Article:

(01) Ancillary service. – A service associated with or incidental to the provision of a telecommunications service. The term includes detailed communications billing, directory assistance, vertical service, and voice mail service. A vertical service is a service, such as call forwarding, caller ID, three-way calling, and conference bridging, that allows a customer to identify a caller or manage multiple calls and call connections.

...

(27) Prepaid telephone calling service. – Prepaid wireline calling service or prepaid wireless calling service.

(27a) Prepaid Wireline Calling Service. -- A right that meets all of the following requirements:

a. Authorizes the exclusive purchase of wireline telecommunications service.

b. Must be paid for in advance.

c. Enables the origination of calls by means of an access number, authorization code, or another similar means, regardless of whether the access number or authorization code is manually or electronically dialed.

d. Is sold in units or dollars whose number or dollar value declines with use and is known on a continuous basis.

(27b) Prepaid Wireless Calling Service. – A right that meets all of the following requirements:

a. Authorizes the purchase of mobile telecommunications service, either exclusively or in conjunction with other services.

b. Must be paid for in advance.

c. Is sold in units or dollars whose number or dollar value declines with use and is known on a continuous basis.

...

(45a) Streamlined Agreement. – The Streamlined Sales and Use Tax Agreement ~~adopted November 12, 2002,~~ as amended on ~~November 19, 2003, November 16, 2004, and April 16, 2005.~~November, 2005.

...

(48) Telecommunications service. – The electronic transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a point, or between or among ~~points, by or through any electronic, radio, satellite, optical, microwave, or other medium, regardless of the protocol used for the transmission, conveyance, or routing. The term includes mobile telecommunications service and vertical services. Vertical services are switch-based services offered in connection with a telecommunications service, such as call forwarding services, caller ID services, and three-way calling services.~~ points. The term includes any transmission, conveyance, or routing in which a computer processing application is used to act on the form, code, or protocol of the content for purposes of the transmission, conveyance, or routing, regardless of whether it is referred to as voice over Internet protocol or the Federal Communications Commission classifies it as enhanced or valued added. The term does not include the following:

a. Data processing and information services that allow data to be generated, acquired, stored, processed, or retrieved and delivered by an electronic transmission to a customer whose primary purpose for using the service is to obtain the processed data or information.

b. The sale, installation, maintenance, or repair of tangible personal property.

c. Directory advertising and other advertising.

d. Billing and collection services provided to a third party.

e. Internet access service.

f. Radio and television audio and video programming service, regardless of the medium of delivery, and the transmission, conveyance, or routing of the service by the programming service provider. The term includes cable service and audio and video

programming service provided by a mobile telecommunications service provider.

g. Ancillary service.

h. A digital product delivered electronically, including software, music, a ring tone, video, and reading material."

SECTION 2. G.S. 105-164.4(a)(4c) and (4d) read as rewritten:

"**§ 105-164.4. Tax imposed on retailers.**

(a) **(Effective for sales made before July 1, 2007)** A privilege tax is imposed on a retailer at the following percentage rates of the retailer's net taxable sales or gross receipts, as appropriate. The general rate of tax is four and one-half percent (4 1/2%).

(4c) The combined general rate applies to the gross receipts derived from providing telecommunications service and ancillary service. A person who provides telecommunications service or ancillary service is considered a retailer under this Article. ~~Telecommunications service is~~ These services are taxed in accordance with G.S. 105-164.4C.

(4d) The sale or recharge of prepaid telephone calling service is taxable at the general rate of tax. The tax applies regardless of whether tangible personal property, such as a card or a telephone, is transferred. The tax applies to a service that is sold in conjunction with prepaid wireless calling service. Prepaid telephone calling service is taxable at the point of sale instead of at the point of use and is sourced in accordance with G.S. 105-164.4B. Prepaid telephone calling service taxed under this subdivision is not subject to tax as a telecommunications service."

SECTION 3. G.S. 105-164.4B(a)(3) reads as rewritten:

"**§ 105-164.4B. Sourcing principles.**

(a) General Principles. – The following principles apply in determining where to source the sale of a product. These principles apply regardless of the nature of the product.

(1) Over-the-counter. – When a purchaser receives a product at a business location of the seller, the sale is sourced to that business location.

(2) Delivery to specified address. – When a purchaser receives a product at a location specified by the purchaser and the location is not a business location of the seller, the sale is sourced to the location where the purchaser receives the product.

(3) Delivery address unknown. – When a seller of a product does not know the address where a product is received, the sale is sourced to the first address or location listed in this subdivision that is known to the seller:

a. The business or home address of the purchaser.

b. The billing address of the purchaser or, if the product is ~~a~~ prepaid ~~telephone~~ wireless calling ~~service that authorizes the purchase of mobile telecommunications~~ service, the location associated with the mobile telephone number.

c. The address from which tangible personal property was shipped or from which a service was provided."

SECTION 4. G.S. 105-164.4C reads as rewritten:

"**§ 105-164.4C. ~~Tax on telecommunications.~~Telecommunications service and ancillary service.**

(a) General. – The gross receipts derived from providing telecommunications service or ancillary service in this State are taxed at the rate set in G.S. 105-164.4(a)(4c). Telecommunications service is provided in this State if the service is sourced to this State under the sourcing principles set out in subsections (a1) and (a2) of this section. Ancillary service is provided in this State if the telecommunications service to which it is ancillary is provided in this State. The definitions and provisions of the federal Mobile Telecommunications Sourcing Act apply to the sourcing and taxation of mobile telecommunications services.

(a1) General Sourcing Principles. – The following general sourcing principles apply to telecommunications services. If a service falls within one of the exceptions set out in subsection (a2) of this section, the service is sourced in accordance with the exception instead of the general principle.

(1) Flat rate. – A telecommunications service that is not sold on a call-by-call basis is sourced to this State if the place of primary use is in this State.

(2) General call-by-call. – A telecommunications service that is sold on a call-by-call basis and is not a postpaid calling service is sourced to this State in the following circumstances:

a. The call both originates and terminates in this State.

b. The call either originates or terminates in this State and the telecommunications equipment from which the call originates or terminates and to which the call is charged is located in this State. This applies regardless of where the call is billed or paid.

(3) Postpaid. – A postpaid calling service is sourced to the origination point of the telecommunications signal as first identified by either the seller's telecommunications system or, if the system used to transport the signal is not the seller's system, by information the seller receives from its service provider.

(a2) Sourcing Exceptions. – The following telecommunications services and products are sourced in accordance with the principles set out in this subsection:

(1) Mobile. – Mobile telecommunications service is sourced to the place of primary use, unless the service is ~~authorized by a~~ prepaid ~~telephone~~ wireless calling service or is air-to-ground radiotelephone service. Air-to-ground radiotelephone service is a postpaid calling service that is offered by an aircraft common carrier to passengers on its aircraft and enables a telephone call to be made from the aircraft. The sourcing principle in this subdivision applies to a service provided as an adjunct to mobile telecommunications service if the charge for the service is

included within the term "charges for mobile telecommunications services" under the federal Mobile Telecommunications Sourcing Act.

(2) Prepaid. – Prepaid telephone calling service is sourced in accordance with G.S. 105-164.4B.

(3) Private. – Private telecommunications service is sourced in accordance with subsection (e) of this section.

~~(b) Included in Gross Receipts. Gross receipts derived from telecommunications service include the following:~~

~~(1) Receipts from flat rate service, service provided on a call-by-call basis, mobile telecommunications service, and private telecommunications service.~~

~~(2) Charges for directory assistance, directory listing that is not yellow page classified listing, call forwarding, call waiting, three-way calling, caller ID, voice mail, and other similar services.~~

~~(3) Customer access line charges billed to subscribers for access to the intrastate or interstate interexchange network.~~

~~(4) Charges billed to a pay telephone provider who uses the telecommunications service to provide pay telephone service.~~

~~(c) Excluded From Gross Receipts. Gross receipts derived from telecommunications service do not include any of the following:~~

~~(1) Charges for telecommunications services that are a component part of or are integrated into a telecommunications service that is resold. Examples of services that are resold include carrier charges for access to an intrastate or interstate interexchange network, interconnection charges paid by a provider of mobile telecommunications service, and charges for the sale of unbundled network elements. An unbundled network element is a network element, as defined in 47 U.S.C. § 153(29), to which access is provided on an unbundled basis pursuant to 47 U.S.C. § 251(c)(3).~~

~~(2) Telecommunications services that are resold as part of a prepaid telephone calling service.~~

~~(3) 911 charges imposed under G.S. 62A-4 or G.S. 62A-23 and remitted to the Emergency Telephone System Fund under G.S. 62A-7 or the Wireless Fund under G.S. 62A-24.~~

~~(4) Allowable surcharges imposed to recoup assessments for the Universal Service Fund.~~

~~(5) Receipts of a pay telephone provider from the sale of pay telephone service.~~

~~(6) Charges for commercial, cable, mobile, broadcast, or satellite video or audio service unless the service provides two-way communication, other than the customer's interactive communication in connection with the customer's selection or use of the video or audio service.~~

~~(7) Paging service, unless the service provides two-way communication.~~

~~(8) Charges for telephone service made by a hotel, motel, or another entity whose gross receipts are taxable under G.S. 105-164.4(a)(3) when the charges are incidental to the occupancy of the entity's accommodations.~~

~~(9) Receipts from the sale, installation, maintenance, or repair of tangible personal property.~~

~~(10) Directory advertising and yellow page classified listings.~~

(11) Repealed by Session Laws 2005-276, s. 33.7, effective October 1, 2005.

~~(12) Information services. An information service is a service that can generate, acquire, store, transform, process, retrieve, use, or make available information through a communications service. Examples of an information service include an electronic publishing service and a web hosting service.~~

~~(13) Internet access service, electronic mail service, electronic bulletin board service, or similar on-line services.~~

~~(14) Billing and collection services.~~

~~(15) Charges for bad checks or late payments.~~

~~(16) Charges to a State agency or to a local unit of government for the North Carolina Information Highway and other data networks owned or leased by the State or unit of local government.~~

(d) Bundled Services. – When a taxable telecommunications service is bundled with a service that is not taxable, the tax applies to the gross receipts from the taxable service in the bundle as follows:

(1) If the service provider offers all the services in the bundle on an unbundled basis, tax is due on the unbundled price of the taxable service, less the discount resulting from the bundling. The discount for a service as the result of bundling is the proportionate price decrease of the service, determined on the basis of the total unbundled price of all the services in the bundle compared to the bundled price of the services.

(2) If the service provider does not offer one or more of the services in the bundle on an unbundled basis, tax is due on the taxable service based on a reasonable allocation of revenue to that service. If the service provider maintains an account for revenue from a taxable service, the service provider's allocation of revenue to that service for the purpose of determining the tax due on the service must reflect its accounting allocation of revenue to that service.

(e) Private Line. – The gross receipts derived from private telecommunications service are sourced as follows:

(1) If all the customer's channel termination points are located in this State, the service is sourced to this State.

(2) If all the customer's channel termination points are not located in this State and the service is billed on the basis of channel termination

points, the charge for each channel termination point located in this State is sourced to this State.

(3) If all the customer's channel termination points are not located in this State and the service is billed on the basis of channel mileage, the following applies:

a. A charge for a channel segment between two channel termination points located in this State is sourced to this State.

b. Fifty percent (50%) of a charge for a channel segment between a channel termination point located in this State and a channel termination point located in another state is sourced to this State.

(4) If all the customer's channel termination points are not located in this State and the service is not billed on the basis of channel termination points or channel mileage, a percentage of the charge for the service is sourced to this State. The percentage is determined by dividing the number of channel termination points in this State by the total number of channel termination points.

(f) Call Center Cap. The gross receipts tax on telecommunications service that originates outside this State, terminates in this State, and is provided to a call center that has a direct pay permit issued by the Department under G.S. 105-164.27A may not exceed fifty thousand dollars ($50,000) a calendar year. This cap applies separately to each legal entity.

(g) Credit. – A taxpayer who pays a tax legally imposed by another state on a telecommunications service taxable under this section is allowed a credit against the tax imposed in this section.

(h) Definitions. – The following definitions apply in this section:

(01) Ancillary service. – Defined in G.S. 105-164.3.

(1) Call-by-call basis. – A method of charging for a telecommunications service whereby the price of the service is measured by individual calls.

(2) Call center. – Defined in G.S. 105-164.27A.

(3) Mobile telecommunications service. – Defined in G.S. 105-164.3.

(4) Place of primary use. – Defined in G.S. 105-164.3.

(5) Postpaid calling service. – A telecommunications service that is charged on a call-by-call basis and is obtained by making payment at the time of the call either through the use of a credit or payment mechanism, such as a bank card, travel card, credit card, or debit card, or by charging the call to a telephone number that is not associated with the origination or termination of the telecommunications service. A postpaid calling service includes a service that meets all the requirements of a prepaid wireline telephone calling service, except the exclusive use requirement.

(6) Prepaid telephone calling service. – Defined in G.S. 105-164.3.

(7) Private telecommunications service. – Telecommunications service that entitles a subscriber of the service to exclusive or priority use of a communications channel or group of channels.

(8) Telecommunications service. – Defined in G.S. 105-164.3."

SECTION 5. G.S. 105-164.13 is amended by adding the following subdivision to read:

"(54) The following telecommunications services and charges:

a. Telecommunications service that is a component part of or is integrated into a telecommunications service that is resold. This exemption does not apply to service purchased by a pay telephone provider who uses the service to provide pay telephone service. Examples of services that are resold include carrier charges for access to an intrastate or interstate interexchange network, interconnection charges paid by a provider of mobile telecommunications service, and charges for the sale of unbundled network elements. An unbundled network element is a network element, as defined in 47 U.S.C. § 153(29), to which access is provided on an unbundled basis pursuant to 47 U.S.C. § 251(c)(3).

b. Pay telephone service.

c. 911 charges imposed under G.S. 62A-4 or G.S. 62A-23 and remitted to the Emergency Telephone System Fund under G.S. 62A-7 or the Wireless Fund under G.S. 62A-24.

d. Charges for telecommunications service made by a hotel, motel, or another entity whose gross receipts are taxable under G.S. 105-164.4(a)(3) when the charges are incidental to the occupancy of the entity's accommodations.

e. Telecommunications service purchased by a State agency or a unit of local government for the North Carolina Information Highway or another data network owned or leased by the State or unit of local government."

SECTION 6. This act becomes effective January 1, 2007.

LEGISLATIVE PROPOSAL 2005-RBx-33: Streamlined Sales Tax Definitions

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	March 1, 2006
Introduced by:		**Summary by:**	Sabra Faires
Version:	Draft 2005-RB xz-33		Senate Tax Counsel

SUMMARY: This legislative proposal modifies the definitions used in the sales and use tax law that apply to telecommunications services. The changes are made to adopt the definitions in the Streamlined Sales Tax Agreement.

BILL ANALYSIS: A section-by-section-analysis follows:

Section-1. Definitions.

1. Adds definition of "ancillary service" in new (01) because the Streamlined definitions separate ancillary services from telecommunications services. Current North Carolina law considers ancillary services to be part of telecommunications services. All of the ancillary services are currently taxed and will continue to be taxed.
2. Modifies the definition of "prepaid telephone calling service" in (27) to include the newly defined terms for "prepaid wireless calling service" and prepaid wireline calling service." Current law does not distinguish between prepaid wireline and prepaid wireless. The definition of prepaid wireless was added to recognize that prepaid wireless includes whatever services can be obtained with the same card used to obtain wireless telecommunications service. Prepaid cards are taxed at the point of sale rather than as telecommunications when the minutes are used. Some services that are not within the definition of telecommunications service can be purchased with the card that authorizes prepaid wireless use. The current definition of prepaid telephone calling service has an exclusive use requirement that conflicts with the practice for prepaid wireless.
3. Converts the current definition of prepaid telephone calling service into the definition of "prepaid wireline calling service" in new (27a). This is a technical change for prepaid wireline with no change in meaning.
4. Adds a definition for "prepaid wireless calling service" in new (27b). This does not have an exclusive use requirement, in contrast to prepaid wireline.
5. Updates the definition for "Streamlined Agreement" in (45a) to include the latest (January 13, 2006) amendments.
6. Conforms the definition of "telecommunications service" in (48) to the Streamlined definition and incorporates into the definition the appropriate inclusions and exclusions that are now in G.S. 105-164.4C(b) and (c). (See also the new exemptions in G.S. 105-164.13(54) in Section 5.) As changed, the definition is the same as current law with two exceptions. The first is Universal Service Fund surcharges. These surcharges are part of the sales price and will be subject to tax. The second is paging service. Universal Service Fund surcharges cannot be "carved out" and remain as is because there is no Streamlined "carve out" in sales price or telecommunications service for this. Paging service could be carved out because there is a Streamlined definition for this, but this draft does not include that carve out. The subparts of new (48) match up with current law as follows:

Subpart in (48)	Location in Current Law
a. (info service)	105-164.4C(c)(12) and (13)
b. (sale, etc. of tpp)	105-164.4C(c)(9)
c. (advertising)	105-164.4C(c)(10)
d. (billing)	105-164.4C(c)(14)
e. (Internet)	105-164.4C(c)(13)
f. (cable and radio)	105-164.4C(c)(6)
g. (ancillary)	105-164.4C(b)(2)
h. (digital)	No specific exclusion but not taxed now.

Section 2: 105-164.4.

Changes the tax imposition statute to add the now-separate category of "ancillary service" and to include non-telecommunications services that are sold as part of a prepaid wireless calling service.

Section 3: 105-164.4B

Makes a conforming change to the sourcing statute to apply the new definition of prepaid wireless call service.

Section 4: 105-164.4C

Makes conforming changes to the separate statute on telecommunications to include ancillary service and to apply the new definition of prepaid wireless calling service. The items that were in subsections (b) and (c) are now either part of the definition of telecommunications or are exempt in Section 5.

Section 5: 105-164.13

Moves to the exemption statute the items that were formerly excluded from the definition of telecommunications and are not intended to be taxed. The items in new (54) were all in G.S. 105-164.4C(c).

EFFECTIVE DATE: This act would become effective for taxable years beginning on or after January 1, 2007.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: March 1, 2006

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: 2005-RBxz-33 [v.4] – Streamlined Sales Tax Definitions

FISCAL IMPACT

Yes ( )	No (X)	No Estimate Available ( )		
FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11
REVENUES:	See Assumptions			
EXPENDITURES:				
POSITIONS (cumulative):				

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: January 1, 2007.

BILL SUMMARY: The bill makes numerous technical changes to the sales tax statutes, most to comply with the revised requirements of the Streamlined Sales Tax Project. These changes must be made by January 1, 2008 to continue to be in compliance with the Agreement.

ASSUMPTIONS AND METHODOLOGY: Sections 1 and 2 make several changes to telecommunications related definitions. Definitions altered or added include ancillary service, prepaid wireless calling service, and telecommunications service. The first to of these changes are technical in nature and are not expected to have a fiscal impact. The third – telecommunications

service – actually consolidates and clarifies some definitions already addressed by the General Assembly in previous sessions. This change is also not expected to have a significant fiscal impact. Section 1 also updates the reference date for the Agreement, which has no fiscal affect. Section 3 addresses the sourcing of sales of prepaid wireless services. Because it only impacts local revenues, no state impact is expected. Moreover, because the change is not expected to actually alter the treatment of these sales, no local impact is expected. Section 4 makes conforming definitional changes and is not expected to have a fiscal impact. Section 5 moves to the exemption statute the items that were formerly excluded from the definition of telecommunications and are not intended to be taxed. The items in exemption section were all in the prior telecommunication section statutes. No fiscal impact is expected.

SOURCES OF DATA: NC Department of Revenue.

TECHNICAL CONSIDERATIONS: None

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-SVxz-11 [v.5] (02/13)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/28/2006 3:00:15 PM

Short Title: S Corp Income Tax Adjustments. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO MAKE CORPORATE INCOME TAX ADJUSTMENTS INAPPLICABLE TO S CORPORATIONS.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-131.2 reads as rewritten:

"**§ 105-131.2. Adjustment and characterization of income.**

(a) Adjustment. – ~~The pro rata share of each shareholder in the income attributable to the State of an S Corporation shall be adjusted as provided in G.S. 105-130.5. The pro rata share of each resident shareholder in the income not attributable to the State of an S Corporation shall be adjusted as provided in G.S. 105-134.6(b), (c), and (d).~~Each shareholder's pro rata share of an S Corporation's income is subject to the adjustments provided in G.S. 105-134.6.

(b) Repealed by Session Laws 1989, c. 728, s. 1.35.

(c) Characterization of Income. – S Corporation items of income, loss, deduction, and credit taken into account by a shareholder pursuant to G.S. 105-131.1(b) ~~shall be~~ are characterized as though received or incurred by the S Corporation and not its shareholder."

SECTION 2. G.S. 105-134.6(a) reads as rewritten:

"(a) S Corporations. ~~The pro rata share of each shareholder in the income attributable to the State of an S Corporation shall be adjusted as provided in G.S. 105-130.5. The pro rata share of each resident shareholder in the income not attributable to the State of an S Corporation shall be~~ Each shareholder's pro rata share of an S Corporation's income is subject to the adjustments provided in ~~subsections (b), (c), and (d) of~~ this section."

SECTION 3. This act is effective for tax years beginning on or after January 1, 2006.

LEGISLATIVE PROPOSAL 2005-SVxz-11: S Corp. Income Tax Adjustments

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	March 1, 2006
Introduced by:		**Summary by:**	Trina Griffin Committee Counsel
Version:	Draft 2005-SVxz-11		

SUMMARY: This legislative proposal would make corporate income tax adjustments inapplicable to S Corporations, effective beginning with the 2006 taxable year.

CURRENT LAW: An S Corporation is a corporation that has elected to have the corporation's income pass through to the shareholders. Thus, the business profits are taxed at individual tax rates. An S Corporation election allows the shareholders to preserve the benefit of limited liability for the corporate form while at the same time being treated as partners for federal income tax purposes. The S Corporation itself does not pay any income tax, but an S Corporation is required to file an informational return with the IRS, similar to a partnership tax return, to inform the IRS of each shareholder's ownership interest in the S corporation. To be eligible for S Corporation status, a corporation must meet all of the following requirements:

- The corporation may have no more than 75 shareholders.
- The corporation may have only one class of stock, although different voting rights among shareholders are allowed.
- All shareholders must be individuals or trusts.
- The corporation must be formed in the United States.
- No shareholder may be a non-resident alien.
- The corporation may not be an insurance company or a domestic international sales corporation.

A C Corporation, on the other hand, assumes a separate legal and tax life distinct from its shareholders. A corporation pays taxes at its own corporate income tax rates and files its own corporate tax forms each year. C Corporations may choose to retain their profits and earnings as part of their operating capital, or they may choose to distribute some or all of their profits and earnings as dividends paid to shareholders. Dividends paid to shareholders are essentially taxed twice. They are taxed once at the corporate level and again at the individual level.

As noted above, C Corporations cannot be shareholders of an S Corporation. All shareholders must be individuals or trusts. Trusts, and obviously individuals, are subject to tax using the individual income tax rates. Thus, the tax imposed on the income of an S Corporation is an individual income tax, not a corporate tax. However, current law results in an individual's pro rata share of S Corporation income attributable to North Carolina being subject to corporate income tax adjustments, while S Corporation income not attributable to North Carolina is subject to individual income tax adjustments.

BILL ANALYSIS: This bill would make an individual's pro rata share of income from an S Corporation subject only to the individual income tax adjustments, rather than being subject to both individual and corporate income tax adjustments. This approach would be more consistent with the tax treatment of an S Corporation generally and would simplify tax form preparation. Consequently, it may result in a higher degree of compliance with the law.

EFFECTIVE DATE: This act would become effective for taxable years beginning on or after January 1, 2006.

BACKGROUND: Of the approximately 20 states that tax S Corporation income at the shareholder level, 18 of those states use the individual law to make adjustments. Louisiana applies corporate adjustments. North Carolina is the only state that uses both.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: March 1, 2006

TO: Revenue Laws

FROM: Dave Crotts
Fiscal Research Division

RE: Draft 2005-SVxz-11 (v.5) (S Corporation Income Tax Adjustments)

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:	See "Assumptions and Methodology"				
EXPENDITURES:					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: Tax years beginning on or after January 1, 2006.

BILL SUMMARY: A C Corporation cannot be a shareholder of an S Corporation. All S shareholders must be individuals or trusts, which means that the taxpayer is subject to the individual income tax. However, current law results in an individual's pro rata share of S Corporation income attributable to North Carolina being subject to corporate income tax adjustments, while S Corporation income not attributable to North Carolina is subject to individual income tax adjustments. The proposal would make an individual's pro rata share of income from an S Corporation subject only to the individual income tax adjustments, rather than being subject to both individual and corporate income tax adjustments. This approach would be more consistent

with the tax treatment of an S Corporation generally and would simplify tax form preparation. Consequently, it may result in a higher degree of compliance with the law.

ASSUMPTIONS AND METHODOLOGY: The Department of Revenue indicates that the proposal would have a negligible revenue impact because many of the adjustments are duplicated in both individual and corporate income tax law and that some of the adjustments under the corporate income tax that are not under the individual income tax are not applicable to S corporation income tax. Thus, the change has limited application

SOURCES OF DATA: North Carolina Department of Revenue.

TECHNICAL CONSIDERATIONS: None

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-RBxz-30 [v.4] (02/23)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
3/1/2006 8:56:48 AM

Short Title: Clarify Additional Gross Premiums Tax. (Public)

Sponsors:

Referred to:

A BILL TO BE ENTITLED

AN ACT TO CLARIFY THE APPLICATION OF THE ADDITIONAL GROSS PREMIUMS TAXES ON FIRE AND LIGHTNING COVERAGE AND TO INCLUDE ALL POLICIES.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-228.5(d)(3) reads as rewritten:

"(d) Tax Rates; Disposition. –

...

(3) Additional Statewide Fire and Lightning Rate. – An additional tax ~~shall be applied to gross premiums on contracts of insurance applicable to fire and lightning coverage, except in the case of marine and automobile policies.~~ at the rate of one and thirty-three hundredths percent ~~(1.33%).~~(1.33%) applies to gross premiums on insurance contracts that provide fire and lightning coverage. The tax is a percentage of the gross premiums from the contracts, determined in accordance with the table in this subdivision. Twenty-five percent (25%) of the net proceeds of this additional tax shall be deposited in the Volunteer Fire Department Fund established in Article 87 of Chapter 58 of the General Statutes. The remaining net proceeds shall be credited to the General Fund.

Type of Insurance Contract	Taxable Percentage
Fire Loss	100%
Commercial Multiple Peril	
Other than Liability Coverage	100%
Liability Coverage	0%
Homeowner's	50%
Farm Owner's	30%."

SECTION 2. G.S. 105-288.5(d)(4) reads as rewritten:

"(d) Tax Rates; Disposition. –

...

(4) Additional Local Fire and Lightning Rate. – An additional tax ~~shall be applied to gross premiums on contracts of insurance applicable to fire and lightning coverage within fire districts~~ at the rate of one-half of one percent ~~(½ of 1%)~~.(0.5%) applies to gross premiums on insurance contracts that provide fire and lightning coverage within a fire district. The tax is a percentage of the gross premiums from the contracts, determined in accordance with the table in subdivision (3) of this subsection. The net proceeds shall be credited to the Department of Insurance for disbursement pursuant to G.S. 58-84-25."

SECTION 3. G.S. 105-288.5(d)(3), as amended by Section 1 of this act, reads as rewritten:

"(d) Tax Rates; Disposition. –

...

(3) Additional Statewide Fire and Lightning Rate. – An additional tax at the rate of one and thirty-three hundredths percent (1.33%) applies to gross premiums on insurance contracts that provide fire and lightning coverage. The tax is a percentage of the gross premiums from the contracts, determined in accordance with the table in this subdivision. Twenty-five percent (25%) of the net proceeds of this additional tax shall be deposited in the Volunteer Fire Department Fund established in Article 87 of Chapter 58 of the General Statutes. The remaining net proceeds shall be credited to the General Fund.

Type of Insurance Contract	Taxable Percentage
Fire Loss	100%
Commercial Multiple Peril	
Liability Coverage	100%
Other Type of Coverage	0%
Homeowner's	50%
Farm Owner's	30%
Marine	20%
Automobile	10%
Other	10%."

SECTION 4. Sections 1 and 2 of this act are effective for taxable years beginning on or after January 1, 2006. Section 3 of this act is effective for taxable years beginning on or after January 1, 2007. The remainder of this act is effective when it becomes law.

BILL DRAFT 2005-RBxz-30: Clarify Additional Gross Premiums Tax

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	March 1, 2006
Introduced by:		**Summary by:**	Cindy Avrette Committee Counsel
Version:	Draft		

SUMMARY: Draft Proposal 2005-RBxz-30 would clarify the application of the additional gross premiums tax on fire and lightning coverage and it would provide that the additional tax would apply to all types of policies.

BILL ANALYSIS: North Carolina imposes a 1.9% tax rate on the gross premiums of most insurance policies.[1] In addition to the general rate, there is a 1.33% rate applied to the gross premiums on insurance policies that provide fire and lightning coverage. The statute specifically excludes marine and automobile policies from this additional tax. Twenty-five percent of the net proceeds of this additional tax are credited to the Volunteer Fire Department Fund[2] and the remainder is credited to the General Fund. There is also a 0.5% rate applied to gross premiums on insurance policies that provide fire and lightning coverage within fire districts. The statute does not provide any exceptions from this tax. The net proceeds of this tax are credited to the Department of Insurance.[3]

The General Assembly enacted the additional statewide fire and lightning tax in 1959. Although the statute does not provide that the tax will apply differently to different types of policies, the Department has administered the tax this way. The additional tax has been imposed on 100% of premiums from insurance that covers only fire losses and on a percentage of premiums from insurance that covers multiple risks. The percentages applied are neither statutory nor imposed by administrative rule. Within the past few years, the Department has been informally advised by both the Department of Insurance and the Attorney General's Office that the statute as written does not provide for assessing the tax against only a percentage of a policy's premium. Rather, without a statutory change, it is their opinion that the tax should be applied to 100% of the premiums of any policy that includes fire and lightning coverage.

Section 1 of this bill draft would codify the current administrative practice of the Department by setting in statute the percentage of an insurance policy's gross premiums to which the additional tax applies. It would provide that policies covering fire loss would be taxable at 100% and that commercial multiple peril liability coverage would be taxable at 100%.[4] It would provide that 50% of homeowner's policy premiums[5] would be subject to the additional tax and 30% of farm owner's policy premiums [6]would be

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[1] Workers' compensation policies are taxed at 2.5%. HMO policies are currently taxed at a rate of 1%; however, effective January 1, 2007, these policies will be taxed at the general rate of 1.9%.

[2] Funds in the Volunteer Fire Department Fund provide matching grants to volunteer fire departments to purchase equipment and make capital improvements.

[3] Three percent (3%) of the tax proceeds are credited to the State Firemen's Association for general purposes. Two percent (2%) of the proceeds are used by the Department of Insurance for the purpose of administering the disbursement. The remaining funds are allocated among the fire districts in proportion to the amount of business done in the district and used by the local district for firemen's local relief purposes. *See Article 84 of Chapter 58 of the General Statutes.*

[4] In 1992, the tax forms split commercial multiple peril policies into two categories: fire and allied coverage and liability coverage. Since that time, the additional fire and lightning rate has been applied only to the coverage designated as 'fire and allied coverage'.

[5] The Department has applied the tax against 50% of homeowner's policy premiums since 1998.

subject to the tax. The percentages used for homeowner's policies and farm owner's policies were determined several years ago using information from the Department of Insurance based on industry loss experiences.

It appears 21 other states impose a gross premiums tax on policies covering fire losses. Of those states, seven provide for the taxable percentage statutorily – of those two use 100% for all policies that include fire and lightning coverage and five have a range of percentages for different types of coverage.[7] Florida sets its taxable percentages through administrative rule. At least ten states provide taxable percentages on tax forms without statutory support or administrative rule[8] and Montana instructs taxpayers to use their own experience to determine the percentage of their premiums subject to the additional tax.

Section 2 of the bill provides that the taxable percentages applicable for the statewide fire and lightning tax would also apply to the local fire and lightning tax rate.

Section 3 would eliminate the current exemption for marine and automobile policies from the additional statewide fire and lightning rate. North Carolina is the only state that imposes an additional statewide fire and lightning tax that excludes premiums from marine and automobile coverage from the taxable premiums base. The local fire and lightning tax does not exclude these policies. The bill draft provides that the taxable percentage for a marine policy would be 20% and the taxable percentage for all other types of policies would be 10%.

Sections 1 and 2 of the bill would become effective for taxable years beginning on or after January 1, 2006. Section 3 would become effective for taxable years beginning on or after January 1, 2007.

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[6] The Department has applied the tax against 30% of farm owner's policy premiums since 1985.

[7] Arkansas, Georgia, Kansas, Mississippi, Oregon, Tennessee, and Virginia. Arkansas and Virginia tax all policy premiums at 100%.

[8] Kentucky, Louisiana, Maine, Minnesota, Nebraska, Ohio, South Carolina, South Dakota, West Virginia, and Wisconsin. One other state, Indiana, provides percentages on the tax form, but it could not verify its authority for the percentages used.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-SVxz-12 [v.2] (02/15)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/28/2006 2:51:12 PM

Short Title: Franchise Tax Loophole Closing. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO APPLY THE FRANCHISE TAX TO CERTAIN LIMITED LIABILITY COMPANIES AND TO PROVIDE A CREDIT FOR ADDITIONAL ANNUAL REPORT FEES PAID BY LIMITED LIABILITY COMPANIES SUBJECT TO FRANCHISE TAX.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-114(b) reads as rewritten:

"(b) Definitions. – The following definitions apply in this Article:

(1) City. – Defined in G.S. 105-228.90.

(1a) Code. – Defined in G.S. 105-228.90.

(2) Corporation. – A domestic corporation, a foreign corporation, an electric membership corporation organized under Chapter 117 of the General Statutes or doing business in this State, or an association that is organized for pecuniary gain, has capital stock represented by shares, whether with or without par value, and has privileges not possessed by individuals or partnerships. The term includes a mutual or capital stock savings and loan association or building and loan association chartered under the laws of any state or of the United States. The term includes a limited liability company that elects to be taxed as a C Corporation under the Code, but does not otherwise include a limited liability company.

(3) Doing business. – Each and every act, power, or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State.

(4) Income year. – Defined in G.S. 105-130.2(5)."

SECTION 2. G.S. 105-114.1 reads as rewritten:

"**§ 105-114.1. Limited liability companies.**

(a) Definitions. – The following definitions apply in this section:

(1) Affiliated group. – Defined in section 1504 of the Code.

(2) Capital interest. – The right under a limited liability company's governing law to receive a percentage of the company's assets upon dissolution after payments to creditors.

(3) Entity. – A person that is not a human being.

(4) Governing law. – A limited liability company's governing law is determined under G.S. 57C-6-05 or G.S. 57C-7-01, as applicable.

(5) Noncorporate limited liability company. – A limited liability company that does not elect to be taxed as a C Corporation under the Code.

(b) Controlled Companies. – If a corporation or an affiliated group of corporations owns more than fifty percent (50%) of the capital interests in a noncorporate limited liability company, the corporation or group of corporations must include in its three tax bases pursuant to G.S. 105-122 the same percentage of (i) the noncorporate limited liability company's capital stock, surplus, and undivided profits; (ii) fifty-five percent (55%) of the noncorporate limited liability company's appraised ad valorem tax value of property; and (iii) the noncorporate limited liability company's actual investment in tangible property in this State, as appropriate.

(c) Constructive Ownership. – Ownership of the capital interests in a noncorporate limited liability company is determined by reference to the constructive ownership rules for partnerships, estates, and trusts in section 318(a)(2)(A) and (B) of the Code with the following modifications:

(1) The term "capital interest" is substituted for "stock" each place it appears.

(2) A noncorporate limited liability company and any noncorporate entity other than a partnership, estate, or trust is treated as a partnership.

(3) The operating rule of section 318(a)(5) of the Code applies without regard to section 318(a)(5)(C).

(d) No Double Inclusion. – If a corporation is required to include a percentage of a noncorporate limited liability company's assets in its tax bases under this Article pursuant to subsection (b) of this section, its investment in the noncorporate limited liability company is not included in its computation of capital stock base under G.S. 105-122(b).

(e) Affiliated Group. – If the owner of the capital interests in a noncorporate limited liability company is an affiliated group of corporations, the percentage to be included pursuant to subsection (b) of this section by each group member that is doing business in this State is determined by multiplying the capital interests in the noncorporate limited liability company owned by the affiliated group by a fraction. The numerator of the fraction is the capital interests in the noncorporate limited liability company owned by the group member, and the denominator of the fraction is the capital interests in the noncorporate limited liability company owned by all group members that are doing business in this State.

(f) Exemption. – This section does not apply to assets owned by a noncorporate limited liability company if the total book value of the noncorporate limited liability

company's assets never exceeded one hundred fifty thousand dollars ($150,000) during its taxable year.

(g) Timing. – Ownership of the capital interests in a noncorporate limited liability company is determined as of the last day of its taxable year. The adjustments pursuant to subsections (b) and (d) of this section must be made to the owner's next following return filed under this Article. If a noncorporate limited liability company and a corporation or an affiliated group of corporations have engaged in a pattern of transferring assets between them with the result that each did not own the capital interests on the last day of its taxable year, the ownership of the capital interests in the noncorporate limited liability company must be determined as of the last day of the corporation or group of corporations' taxable year.

(h) Penalty. – A taxpayer who, because of fraud with intent to evade tax, underpays the tax under this Article on assets attributable to it under this section is guilty of a Class H felony in accordance with G.S. 105-236(7)."

SECTION 3. Article 3 of Chapter 105 is amended by adding a new section to read:

"**§ 105-122.1. Credit for additional annual report fees paid by limited liability companies subject to franchise tax.**

A limited liability company subject to tax under this Article is allowed a credit against the tax imposed by this Article equal to the difference between the annual report fee for corporations under G.S. 55-1-22 and the annual report fee for limited liability companies under G.S. 57C-1-22(a). The credit allowed by this section may not exceed the amount of tax imposed by this Article for the taxable year reduced by the sum of all credits allowed, except payments of tax made by or on behalf of the taxpayer."

SECTION 4. This act is effective for taxable years beginning on or after January 1, 2007.

LEGISLATIVE PROPOSAL 2005-SVxz-12: Franchise Tax Loophole Closing

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	March 1, 2006
Introduced by:		**Summary by:**	Trina Griffin Committee Counsel
Version:	Draft 2005-SVxz-12		

SUMMARY: This legislative proposal would apply the corporate franchise tax to limited liability companies that elect to be taxed as a C Corporation for federal income tax purposes. The bill would also provide LLCs that elect to be taxed as a C Corporation a credit for the difference between annual report fees for corporations and LLCs such that those LLCs are paying the lower corporation annual report fee rate. This proposal is substantially similar to Senate Bill 540, introduced last session, which has passed the Senate.

CURRENT LAW: Under North Carolina law, limited liability companies[1] (LLCs) are not subject to the franchise tax. In 1997, the North Carolina law regarding LLCs was changed to allow for a single-member LLC. This change had the unintended consequence of allowing a corporation subject to North Carolina franchise tax to set up an LLC and transfer assets to the LLC in a tax-free transfer. The assets then held by the LLC would not be subject to the franchise tax. Thus, the corporation could avoid a significant portion of its franchise tax liability by transferring assets into a wholly owned LLC without affecting its income tax liability. This loophole was the first of a number of loopholes that gave rise to a series of legislative changes enacted over the last five years attempting to close those loopholes.[2]

Under current law, the franchise tax now extends to all LLC assets that a corporation controls through trusts and other entities, with some limitation. Specifically, a corporation (or an affiliated group of corporations) must own more than 50% of the capital interests in a limited liability company for the attribution rules to apply, and LLCs whose assets do not exceed $150,000 are exempt.

The concept of control is determined by tracing ownership of the capital interests in the LLC's assets. A capital interest is the right to receive some or all of the assets under the LLC's governing law if the LLC was dissolved. Ownership of the capital interests in an LLC is traced, using the principles of constructive ownership, through any noncorporate entities. The chain of constructive ownership can run through layers of noncorporate entities but not through individuals. The franchise tax is payable by the corporation or affiliated group of corporations to which ownership of the capital interests is traced. Ownership of capital interests in an LLC is determined as of the last day of the LLC's tax year. If an LLC and a corporation engage in a pattern of trading assets back and forth so that neither owns them on its respective trigger date, the Secretary may require the determination to be made as of the last day of the corporation's tax year. If the capital interests in an LLC are owned by an affiliated group of corporations, the value of the assets is allocated among the members of the group for franchise tax purposes so that there will not be double taxation of any assets. The allocation is in proportion to each affiliate's ownership interest.

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[1] A limited liability company is a business entity that is essentially a hybrid of a partnership and a corporation. Like a corporation, an LLC limits the liability of its owners. Like a partnership, an LLC is usually not subject to entity-level taxation.

[2] See the BACKGROUND section of this summary for a detailed description of recent legislative changes regarding the franchise tax loophole.

BILL ANALYSIS: This legislative proposal is virtually identical to Senate Bill 540, which was introduced during the 2005 session and passed the Senate. The Department has requested that the Revenue Laws Study Committee revisit this issue and would encourage the General Assembly to address it during the short session.

The bill would apply the corporate franchise tax to limited liability companies that elect to be taxed as a C Corporation. It also makes conforming changes to G.S. 105-114.1 regarding the attribution of certain LLC assets to controlling corporations for franchise tax purposes.

This bill originated as the result of at least one request for a private letter ruling from a major accounting firm. Based on this request, the Department of Revenue identified another scenario that could result in a corporation's avoidance of paying franchise tax. This scenario would involve a corporation headquartered in North Carolina, but whose parent company is domiciled outside North Carolina. In addition, the parent's only contact with North Carolina is its ownership of the corporation. This corporation, which already files as a C Corporation for federal tax purposes, could convert to an LLC but make an election to continue being taxed as a C Corporation and avoid franchise tax because the parent has no nexus with this State and thus the "constructive ownership" attribution rules do not apply.

Current law provides that an LLC may be disregarded and treated as a division of its parent. The parent company is then considered to own property in this State and therefore has nexus, making it subject to income and franchise tax, and the constructive ownership rules apply for attributing the LLC's assets to the parent's franchise tax calculation. However, when an LLC elects to be taxed as a C Corporation, nexus is not conferred on the parent and the attributes of the LLC do not flow to the parent. Therefore, companies currently operating in this State as C Corporations could convert to an LLC, make an election to file as a C Corporation, as they always have, and eliminate their North Carolina franchise tax obligations.

Under this bill, LLCs that elect to be taxed as a C Corporation would be subject to franchise tax. LLCs that do not elect to be taxed as a C Corporation would be considered "noncorporate LLCs" and would be subject to the attribution rules in G.S. 105-114.1 for franchise tax purposes.

The bill also provides LLCs that elect to be taxed as a C Corporation a nonrefundable credit for the difference between the annual report fee for corporations, which is $20.00, and the annual report fee for limited liability companies, which is $200.

EFFECTIVE DATE: This bill would become effective for taxable years beginning on or after January 1, 2007.

BACKGROUND:

Franchise Tax Generally – The State franchise tax is among the oldest taxes in North Carolina. It is a tax on S Corporations and C Corporations for the privilege of doing business in the State. The tax rate is $1.50 per $1,000 of value of the greatest of (1) apportioned net book value of the corporation; (2) 55% of appraised value of real and tangible personal property in NC; or (3) total actual investment in tangible property in NC.

The Department of Revenue, in its 2003 reports to the Revenue Laws Study Committee, noted that there exists a general franchise tax inequity because the imposition of the tax depends on the type of entity. The Governor's Commission to Modernize State Finances recommended that the State impose the franchise tax on all types of business entities, not just on traditional corporations. The Commission recommended that the revenues generated from this base broadening could be used to establish a minimum net worth threshold for payment of the tax.

Franchise Tax Loophole History – In 2001, the General Assembly enacted S.L. 2001-327 to close a loophole whereby a corporation, subject to North Carolina franchise tax, could set up a single-member LLC, transfer assets to the LLC in a tax-free transfer, and avoid paying taxes on the transferred assets since LLCs are not subject to the franchise tax. The 2001 legislation tried to address the problem by requiring a corporation to pay tax on assets owned by the LLC if the corporation, including its affiliated corporations, indirectly owned[3] at least 70% of the LLC's assets. Unfortunately, tax planners found that the tax could still be avoided by using an additional paper transaction. If the corporation interposed a partnership between itself and the LLC holding its assets, then technically the 2001 legislation would not apply and the assets would continue to escape franchise tax.

In 2002, the General Assembly enacted S.L. 2002-126 to tighten the 2001 law. The 2002 legislation required attribution through "related members" (other entities and individuals) who may partner with one or more corporate entities to own the LLC that will hold the corporate assets. "Related members" is a defined term and includes shareholders, partnerships, etc. If a corporation and its related members together indirectly own at least 70% of an LLC's assets, the 2002 legislation provides that each corporation pays franchise tax on its relative share of the LLC's assets. The relative share is calculated after excluding those related members that are not corporations. Thus, the entire assets are subject to franchise tax, with the tax burden shared proportionally by the corporations that are involved in the ownership scheme.

After the 2002 legislation was enacted, it became apparent that it not only failed to close the loophole but also extended the franchise tax to situations that did not involve corporate control of LLC assets. The loophole remained open because there are additional paper transactions that can be interposed between the corporation and the LLC in order to circumvent the attribution of the LLC's assets to the corporation. For example, control may be passed through a business trust.[4]

In 2004, the General Assembly enacted S.L. 2004-74 to address these issues by providing that for purposes of determining ownership of an LLC's assets, any membership interest of a business trust would be attributed to the owners of the beneficial interest in the business trust, according to their interests in the trust, and the trust itself would be disregarded as a separate entity. In addition, the legislation limited the tax to only those assets that a corporation controls, it reduced the minimum threshold of LLC asset ownership from 70% or more to more than 50%, and it exempted small LLCs.

2005-SVxz-12-SMSV

[3] Indirect ownership of an LLC's assets is determined based on who is entitled to receive those assets upon dissolution of the LLC.

[4] A business trust is not considered a related member, as that term is defined in G.S. 105-130.7A, because it would be the corporation, not the shareholders, that would form the trust.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: March 1, 2006

TO: Revenue Laws Study Committee

FROM: David Crotts
Fiscal Research Division

RE: Proposal 2005-SVxz-12 (Franchise Tax Loophole Closing)

FISCAL IMPACT

Yes ( ) **No ( )** **No Estimate Available (x**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:					
EXPENDITURES:					
POSITIONS (cumulative):					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: The franchise tax is administered by the Department of Revenue. The enactment of the bill is not expected to affect the Department's budget requirements.

EFFECTIVE DATE: Tax years beginning on or after January 1, 2007.

ISSUE BACKGROUND: Under North Carolina law, limited liability companies (LLCs) are not subject to the franchise tax. In 1997 single-member LLCs were authorized in North Carolina. This allowed a corporation the opportunity to set up an LLC and transfer assets to the LLC in a tax-free transfer. The assets then held by the LLC would not be subject to the franchise tax.

The 2001 General Assembly attempted to correct this situation by requiring a corporation to pay tax on assets owned by the LLC if the corporation, including its affiliated corporations, indirectly owned at least 70% of the LLC's assets. However, tax planners found that the tax could still be avoided by using an additional paper transaction. For example, if the corporation interposed a partnership between itself and the LLC holding its assets, the assets would continue to escape the franchise tax.

In 2002, the General Assembly addressed this issue by including "related members" (other entities and individuals) who may partner with one or more corporate entities to own the LLC to which the corporate assets are transferred. If a corporation and its related members together indirectly own at least 70% of an LLC's assets, each corporation would pay the franchise tax on its relative share of the LLC's assets.

After the enactment of the 2002 session change, it was discovered that there are other paper transactions that can be interposed between the corporation and the LLC to avoid the franchise tax. One example is a business trust. The tax does not apply in this situation because the trust is not considered a "related member". In addition, the 2002 legislation also had the effect of extending the tax to situations that did not involve corporate control of LLC assets.

The 2004 General Assembly attempted to address these issues by providing that for purposes of determining the ownership of an LLC's assets, any membership interest of a business trust would be attributed to the owners of the beneficial interest in the business trust, according to their interests in the trust, and the trust itself would be disregarded as a separate entity. In addition, the 2002 bill limits the tax to only those assets that a corporation controls and exempts small LLC's.

BILL SUMMARY: (1) Applies the corporate franchise tax to limited liability companies (LLCs) that elect to be taxed as a C corporation for federal income tax purposes; (2) provides these corporations are eligible for a nonrefundable credit equal to the difference between the annual report fee for corporations ($20) and the same fee for LLC's ($200); (3) makes conforming changes regarding attribution of certain LLC assets to controlling corporations for franchise tax purposes.

ASSUMPTIONS AND METHODOLOGY: Discussions with the Department of Revenue indicate that the practical effect of the legislation is to address another potential method of avoiding franchise tax liability by corporate structuring arrangements. The concern arose as a result of a request from a major accounting firm for a private letter ruling. The tax planning scenario would involve a corporation headquartered in North Carolina, but whose parent company is domiciled outside the State. In addition, the parent's only contact with North Carolina is its ownership of the corporation. This corporation, which already files as a C-corporation for federal tax purposes, could convert to an LLC but make an election to continue being taxed as a C-corporation and avoid franchise tax because the parent has no nexus (tax situs) with this State, Thus, the "constructive ownership" attribution rules do not apply.

The Department has no data on whether any companies have already established such arrangements. However, the request for a private letter ruling suggests that one or more accounting firms were contemplating the use of such a tax sheltering vehicle. Thus, the proposed legislation attempts to prevent a potential tax avoidance scheme. In addition, it could be argued

that the fiscal impact of the bill's concept has been captured in the estimates used for the 2001 legislation that attempted to close the original franchise tax loophole.

SOURCES OF DATA: Discussions with Department of Revenue

TECHNICAL CONSIDERATIONS: None

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-RBz-31 [v.5] (02/24)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
3/1/2006 11:05:37 AM

Short Title: Franchise Tax Base Calculation. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO CLARIFY THE TREATMENT OF DEFERRED TAX ASSETS IN THE COMPUTATION OF THE FRANCHISE TAX CAPITAL BASE.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-122(b) reads as rewritten:

"(b) Determination of Capital Base. -- ~~Every such~~ A corporation taxed under this section shall determine the total amount of its issued and outstanding capital stock, ~~surplus~~ surplus, and undivided ~~profits; no reservation or allocation~~ profits. No reservation or allocation from surplus or undivided profits ~~shall be~~ is allowed ~~other than for~~ except as provided below:

(1) Definite ~~definite~~ and accrued legal ~~liabilities, except as herein provided;~~ liabilities.

OPTION 1: CLARIFICATION OF CURRENT LAW

(2) ~~taxes~~ Taxes accrued, dividends ~~declared~~ declared, and reserves for depreciation of tangible assets as permitted for income tax ~~purposes shall be treated as deductible liabilities. There shall also be treated as a deductible liability reserves for the entire cost~~ purposes. Deferred tax assets are not deductible.

OPTION 2: ALLOW DEFERRED TAX LIABILITIES TO BE REDUCED BY DEFERRED TAX ASSETS

(2) ~~taxes~~ Taxes accrued, dividends ~~declared~~ declared, and reserves for depreciation of tangible assets as permitted for income tax ~~purposes shall be treated as deductible liabilities. There shall also be treated as a deductible liability reserves for the entire cost~~ purposes.

(3) When including a deferred tax liability account, a corporation may reduce the amount included in its base by netting against that account the amount of a deferred tax asset account. The reduction may not decrease the deferred tax liability below zero (0).

(4) Reserves for the cost of any air-cleaning device or sewage or waste treatment plant, including waste lagoons, and pollution abatement equipment purchased or constructed and installed which reduces the amount of air or water pollution resulting from the emission of air contaminants or the discharge of sewage and industrial wastes or other polluting materials or substances into the outdoor atmosphere or streams, lakes, or rivers, upon condition that the corporation claiming such deductible liability shall furnish to the Secretary a certificate from the Department of Environment and Natural Resources or from a local air pollution control program for air-cleaning devices located in an area where the Environmental Management Commission has certified a local air pollution control program pursuant to G.S. 143-215.112 certifying that the Environmental Management Commission or local air pollution control program has found as a fact that the air-cleaning device, waste treatment plant or pollution abatement equipment purchased or constructed and installed as above described has actually been constructed and installed and that such plant or equipment complies with the requirements of the Environmental Management Commission or local air pollution control program with respect to such devices, plants or equipment, that such device, plant or equipment is being effectively operated in accordance with the terms and conditions set forth in the permit, certificate of approval, or other document of approval issued by the Environmental Management Commission or local air pollution control program and that the primary purpose thereof is to reduce air or water pollution resulting from the emission of air contaminants or the discharge of sewage and waste and not merely incidental to other purposes and functions.

(5) ~~The~~ Reserves for the cost of purchasing and installing equipment or constructing facilities for the purpose of recycling or resource recovering of or from solid waste or for the purpose of reducing the volume of hazardous waste generated shall be treated as deductible for

the purposes of this section upon condition that the corporation claiming such deductible liability shall furnish to the Secretary a certificate from the Department of Environment and Natural Resources certifying that the Department of Environment and Natural Resources has found as a fact that the equipment or facility has actually been purchased, installed or constructed, that it is in conformance with all rules and regulations of the Department of Environment and Natural Resources, and the recycling or resource recovering is the primary purpose of the facility or equipment.

(6) ~~The~~ Reserves for the cost of constructing facilities of any private or public utility built for the purpose of providing sewer service to residential and outlying areas shall be treated as deductible for the purposes of this section; the deductible liability allowed by this section shall apply only with respect to such pollution abatement plants or equipment constructed or installed on or after January 1, 1955.

(7) ~~Treasury stock shall not be considered in computing the capital stock, surplus and undivided profits as the basis for franchise tax, but shall be excluded proportionately from said capital stock, surplus and undivided profits as the case may be upon the basis and to the extent of the cost thereof.~~ The cost of treasury stock.

(8) In the case of an international banking facility, the capital base shall be reduced by the excess of the amount as of the end of the taxable year of all assets of an international banking facility which are employed outside the United States over liabilities of the international banking facility owed to foreign persons. For purposes of such reduction, foreign persons shall have the same meaning as defined in G.S. 105-130.5(b)(13)d.

Every corporation doing business in this State which is a parent, subsidiary, or affiliate of another corporation shall add to its capital stock, ~~surplus~~ surplus, and undivided profits all indebtedness owed to a parent, ~~subsidiary~~ subsidiary, or affiliated corporation as a part of its capital used in its business and as a part of the base for franchise tax under this section. ~~The term "indebtedness" as used in this paragraph includes all loans, credits, goods, supplies, or other capital of whatsoever nature furnished by a parent, subsidiary, or affiliated corporation, other than indebtedness endorsed, guaranteed, or otherwise supported by one of these corporations. The terms "parent," "subsidiary," and "affiliate" as used in this paragraph shall have the meaning specified in G.S. 105-130.6.~~ If any part of the capital of the creditor corporation is capital borrowed from a source other than a parent, ~~subsidiary~~ subsidiary, or affiliate, the debtor corporation, which is required under this ~~paragraph~~ subsection to include in its tax base the amount of debt by reason of being a parent, subsidiary, or affiliate of the ~~said~~ creditor corporation, may deduct from the debt ~~thus~~ included a proportionate part determined on the basis of the ratio of ~~such~~ the borrowed capital ~~as above specified~~ of the creditor corporation to the total assets of the ~~said~~ creditor corporation. If ~~Further, in case~~ the creditor corporation ~~as above specified~~ is also taxable under the provisions of

this section, ~~such~~ the creditor corporation ~~shall be~~ is allowed to deduct from the total of its capital, ~~surplus~~ surplus, and undivided profits the amount of any debt owed to it by a parent, subsidiary or affiliated corporation to the extent that ~~such~~ the debt has been included in the tax base of ~~said~~ the parent, ~~subsidiary~~ subsidiary, or affiliated debtor corporation reporting for taxation under the provisions of this section.

The following definitions apply in this subsection:

(1) Affiliate. – The same meaning as specified in G.S. 105-130.6.

(2) Indebtedness. – All loans, credits, goods, supplies, or other capital of whatsoever nature furnished by a parent, subsidiary, or affiliated corporation, other than indebtedness endorsed, guaranteed, or otherwise supported by one of these corporations

(3) Parent. – The same meaning as specified in G.S. 105-130.6.

(4) Subsidiary. – The same meaning as specified in G.S. 105-130.6."

SECTION 2. Effective date

OPTION 1:

This act becomes effective for taxable years beginning on or after January 1, 2007.

OPTION 2:

This act is effective when it becomes law.

BILL DRAFT 2005-RBxz-31: Franchise Tax Base Calculation

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	March 1, 2006
Introduced by:		**Summary by:**	Cindy Avrette Committee Counsel
Version:	Draft		

SUMMARY: Draft Proposal 2005-RBz-31 seeks to clarify the treatment of deferred tax assets in the computation of the franchise tax capital base.

BILL ANALYSIS: North Carolina imposes a franchise tax at the rate of $1.50 per $1,000 of the total amount of a corporation's capital stock, surplus, and undivided profits (hereinafter referred to as the corporation's capital base). The corporation's capital base may not be less than 55% of the appraised value of all the real and tangible personal property owned by the corporation in the State nor less than its total actual investment in tangible property in the State.

Most public corporations compute their capital base for financial reporting purposes. Public corporations must comply with the requirements of the Financial Accounting Standards Board (FASB) when reporting the results of their operations and financial positions. Under FASB, corporations are required to accrue certain liabilities and the related deferred tax assets which are applicable to those accrued liabilities in order to accurately reflect the financial position of the corporation.

A corporation's determination of its capital base for purposes of the franchise tax is not the same as the calculation of its capital base for financial reporting purposes. The calculation of its capital base for franchise tax purposes is determined by G.S. 105-122(b), not by the requirements of FASB. The statute refers to book value as 'issued and outstanding capital stock, surplus, and undivided profits.' This is similar to net book value with certain adjustments. The principal adjustment is for contingent or deferred liabilities.

Deferred tax assets and deferred tax liabilities are accounts carried on the books of a corporation for financial reporting purposes. They represent timing differences in the recognition of income and deductions for income tax purposes and for financial accounting purposes. Deferred tax liability typically arises where income has been recognized on the corporation's books but not for tax purposes. For example, where a gain is reflected on the books but reported for tax purposes on the installment basis.

- Under FASB, deferred tax liabilities are recognized as liabilities for accounting purposes.
- Deferred liabilities are not recognized for franchise tax purposes because they are not 'definite and accrued'. Therefore, deferred tax liabilities must be added back to a corporation's capital base for franchise tax purposes.
- Frequently, a taxpayer that has a deferred liability will also have a deferred tax asset. The issue is whether the deferred liability that must be added-back can be reduced by the amount of the related deferred tax asset. In 1996, the Department of Revenue issued a TAM (technical advice memorandum) that permitted the netting of deferred liability accounts and deferred tax asset accounts. The TAM provided that the deferred asset account had to be clearly identified with the deferred liability account and the deferred asset could not reduce the related deferred liability below zero (0).

Franchise Tax Base Calculation

The statute, the 1996 TAM, and GAAP differ on how to account for deferred liabilities. The purpose of this bill is to determine how deferred tax liabilities should be treated for franchise tax purposes and to state that treatment clearly in the statute.

The franchise tax statute begins the calculation of a corporation's franchise tax capital base with the '*total amount of its issued stock, surplus, and undivided profit*'. The statute provides that '*no reservation or allocation from surplus or undivided profits shall be allowed other than for definite and accrued legal liabilities, except as herein provided: taxes accrued, dividends declared and reserves for depreciation of tangible assets as permitted for income tax purposes shall be treated as deductible liabilities.*'

The question as to the proper franchise tax treatment of deferred tax liability has been an issue for many years. In 1976, the North Carolina Supreme Court in Broadwell Realty v. Coble, 291 N.C. 608, ruled that a deferred tax liability may not be deducted from the capital stock base for the reason that it constitutes neither a definite and accrued legal liability nor taxes accrued, and is therefore, not within the scope of the deductions allowable by the express terms of G.S. 105-122(b). The same determination was made in an Attorney General's opinion in 1983 and in a final decision of the Secretary of Revenue in 1990.

In 1992, FASB Statement No. 109 established financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. The statement resulted in deferred tax assets being separately stated from deferred tax liabilities. When the two accounts were netted, a smaller net tax liability account was added-back to the franchise tax base. When the accounts had to be separately stated, the Department did not permit the netting of the two accounts. This resulted in the add-back of the deferred tax liability unreduced by the amount of the related deferred tax asset.

Taxpayers having deferred tax asset accounts contended that they should be allowed to reduce their capital stock bases by the balances in those accounts. Since the asset and liability accounts are reciprocal concepts, they argued that it was inequitable to include a deferred tax liability in the capital stock base without decreasing it by its related deferred tax asset.

In response to taxpayer concerns, the Department of Revenue issued TAM-CF-96-1 in August of 1996. The TAM appears to contradict the plain meaning of the statute because it permits the deferred liability accounts to be reduced by deferred tax asset accounts.[1] In explaining the change, the TAM states that a more equitable and consistent position is to recognize that net worth is incorrectly stated when the total amount of a deferred liability is included without a netting adjustment for the deferred tax benefit resulting directly from such liability. The TAM provides that the inclusion of a deferred liability in the computation of the net worth base should permit an offset or adjustment for the deferred tax asset required to be computed under the accounting standards without regard to how the deferred tax asset is reflected on the financial statement.

The FASB change in 1992 concerned the accounting for income taxes. Arguably, the TAM written in 1996 attempted to address the accounting changes precipitated by that FASB change. The wording of the TAM, however, refers to deferred liabilities. Any deferred liability may create a corresponding deferred tax asset. Taxpayers contend that the TAM permits them to reduce the amount of any deferred liability required to be added back to its net book value for franchise tax purposes by the amount of a deferred tax asset. Examples of the types of contingent and deferred liabilities that have been reduced include post retirement benefits, loan loss reserves, credit card reserves, and litigation reserves.

[1] The TAM became effective for tax years ending on or after July 1, 1996.

The bill draft provides two different options for the Committee to consider: **Option 1** would retain a strict interpretation of the statute. By so doing, it would clarify that deferred tax assets are not deductible and thus effectively repeal the TAM issued by the Department in 1996. **Option 2** would change the law to allow deferred tax liabilities to be reduced by their corresponding deferred tax assets.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-SVz-13 [v.6] (02/15)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/28/2006 2:02:17 PM

Short Title: Expansion of Royalty Reporting Option. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO EXPAND THE ROYALTY INCOME REPORTING OPTION TO INCLUDE ADDITIONAL TYPES OF INTANGIBLE PROPERTY.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-130.7A reads as rewritten:

"**§ 105-130.7A. Royalty income reporting option.**

(a) Purpose. – Royalty payments received for the use of ~~trademarks~~ intangible property in this State are income derived from doing business in this State. This section provides taxpayers with an option concerning the method by which these royalties can be reported for taxation when the recipient and the payer are related members. As provided in this section, these royalty payments can be either (i) deducted by the payer and included in the income of the recipient, or (ii) added back to the income of the payer and excluded from the income of the recipient.

(b) Definitions. – The following definitions apply in this section:

(1) Component member. – Defined in section 1563(b) of the Code.

(1a) Intangible property. – Copyright, patent, trademark, or similar type of intangible asset.

(2) North Carolina royalty. – An amount charged that is for, related to, or in connection with the use in this State of ~~a trademark.~~ intangible property. The term includes royalty and technical fees, licensing fees, and other similar charges.

(3) Own. – To own directly, indirectly, beneficially, or constructively. The attribution rules of section 318 of the Code apply in determining ownership under this section.

(4) Related entity. – Any of the following:

a. A stockholder who is an individual, or a member of the stockholder's family enumerated in section 318 of the Code, if

the stockholder and the members of the stockholder's family own in the aggregate at least eighty percent (80%) of the value of the taxpayer's outstanding stock.

b. A stockholder, or a stockholder's partnership, limited liability company, estate, trust, or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts, and corporations own in the aggregate at least fifty percent (50%) of the value of the taxpayer's outstanding stock.

c. A corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of section 318 of the Code, if the taxpayer owns at least eighty percent (80%) of the value of the corporation's outstanding stock.

(5) Related member. – A person that, with respect to the taxpayer during any part of the taxable year, is one or more of the following:

a. A related entity.

b. A component member.

c. A person to or from whom there would be attribution of stock ownership in accordance with section 1563(e) of the Code if the phrase "5 percent or more" were replaced by "twenty percent (20%) or more" each place it appears in that section.

(6) Royalty payment. – Either of the following:

a. Expenses, losses, and costs paid, accrued, or incurred for North Carolina royalties, to the extent the amounts are allowed as deductions or costs in determining taxable income before operating loss deduction and special deductions for the taxable year under the Code.

b. Amounts directly or indirectly allowed as deductions under section 163 of the Code, to the extent the amounts are paid, accrued, or incurred for a time price differential charged for the late payment of any expenses, losses, or costs described in this subdivision.

(7) Trademark. – A trademark, trade name, service mark, or other similar type of intangible asset.

(8) Use. – Use of ~~a trademark~~ intangible property includes direct or indirect maintenance, management, ownership, sale, exchange, or disposition of the ~~trademark.~~ intangible property.

(c) Election. – For the purpose of computing its State net income, a taxpayer must add royalty payments made to, or in connection with transactions with, a related member during the taxable year. This addition is not required for an amount of royalty payments that meets either of the following conditions:

(1) The related member includes the amount as income on a return filed under this Part for the same taxable year that the amount is deducted

by the taxpayer, and the related member does not elect to deduct the amount pursuant to G.S. 105-130.5(b)(20).

(2) The taxpayer can establish that the related member during the same taxable year directly or indirectly paid, accrued, or incurred the amount to a person who is not a related member.

(d) Indirect Transactions. – For the purpose of this section, an indirect transaction or relationship has the same effect as if it were direct."

SECTION 2. This act is effective for taxable years beginning on or after January 1, 2006.

LEGISLATIVE PROPOSAL 2005-SVz-13: Expansion of Royalty Reporting Option

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	March 1, 2006
Introduced by:		**Summary by:**	Trina Griffin Committee Counsel
Version:	Draft 2005-SVz-13		

SUMMARY: This legislative proposal expands the reporting option available to corporations and their related members with regard to reporting the receipt of royalty payments by including payments for other types of intangible property, such as patents and copyrights.

BACKGROUND[1] & CURRENT LAW: In recent years, intellectual property has become an enormously valuable intangible corporate asset due to the rapid change in science and technology coupled with expanding legal protections and increasing commercial success based on innovation. As intellectual property becomes a more important corporate asset, many companies with large intellectual property portfolios search for ways to maximize revenues, such as licensing those assets. Income derived from licensing intellectual property is subject to federal and state taxation as ordinary income. Given this, many companies have also developed tax strategies to minimize state taxation of royalty income.

Under one such strategy, a company with a large intellectual property portfolio forms a wholly-owned subsidiary to hold its intellectual property assets in a state that does not tax royalty income received from licensing intellectual property assets. The parent company transfers all of its intellectual property assets to the subsidiary in exchange for ownership of stock in the subsidiary. The subsidiary then licenses the intellectual property assets back to the parent company in exchange for royalties. If the parent corporation is late paying these royalties, it also owes the subsidiary late fees. The parent corporation deducts against its state income tax the royalties and late fees it owes the subsidiary. The subsidiary likely pays little or no tax on these receipts to the state in which it was formed because the receipts are either exempt or apportioned away from that state. Moreover, the subsidiary's receipts are paid back to the parent corporation in the form of deductible dividends. As a result of this arrangement, the parent corporation ends up paying little or no state tax on these profits even though it may generate substantial profits from its retail or manufacturing activities in a state. Recognizing this transfer and license-back arrangement as a tax avoidance strategy, many states have enacted laws attempting to reach this income for taxation.

In North Carolina, every C Corporation "doing business" in this State is subject to corporate income and franchise taxes.[2] Some corporations have argued that an out-of-state investment company's receipt of royalty income from the use of trademarks in this State does not constitute "doing business" in North Carolina and, therefore, the investment company is not subject to North Carolina income or franchise tax on the royalties.

However, in *A&F Trademark, Inc. v. Tolson* the North Carolina Court of Appeals upheld the State's position on the taxation of royalty income received by an out-of-state investment company for the use of trademarks in this State. The Court ruled that the out-of-state taxpayers who hold trademarks used in North Carolina were doing business in North Carolina. Therefore, under current law, an out-of-state

[1] Much of this information is drawn from Xuan-Thao N. Nguyen, "Holding Intellectual Property," 38 State Tax Notes 699 (November 21, 2005).

[2] See G.S. 105-130.3 and G.S. 105-122.

holding company receiving royalty payments for the use of trademarks, patents, or copyrights in North Carolina is subject to both North Carolina income and franchise taxes.

In 2001, the General Assembly enacted G.S. 105-130.7A to enhance corporate compliance with taxes on trademark income. This statute did not change what was already considered taxable but merely enhanced compliance with the State tax on income generated from using trademarks and added a reporting option to the income tax statute.

Specifically, G.S. 105-130.7A restates that a company's receipts from royalty payments for the use of trademarks in North Carolina are income from doing business in North Carolina. Then it provides adjustments to assure full and fair accountability of this income in relationship to where it is actually earned. In cases where the recipient of the North Carolina royalty income is unrelated to the payer, the recipient is required to pay tax on the income to North Carolina. In cases where the recipient and the payer are related, they have an option on how the income is reported to North Carolina. Either the payer can deduct the North Carolina royalty payments on its North Carolina return and the recipient can include them on its North Carolina return, or the payer can add them to its North Carolina income and the recipient can deduct them on its North Carolina return.[3]

This provision solves the problem as it relates to trademarks and trade names, but does not address other types of intellectual property, such as patents,[4] copyrights,[5] or other types of intangible assets.

BILL ANALYSIS: This legislative proposal would expand the royalty payment reporting option for corporations and their related members to include payments received for use of other types of intangible property, such as patents and copyrights.

This proposal does not change or expand what is already taxable in North Carolina. Royalty income received for the use of trademarks, patents, and copyrights in North Carolina *is* taxable and must be reported to North Carolina by an out-of-state corporation receiving this income. However, there is a reporting option currently available to corporations and their related members for royalty payments received for trademark usage that is not available when those payments are for patent or copyright usage.

This proposal would give corporations and their related members that receive royalty payments derived from patent or copyright usage (or other similar intangible property) the ability to select which entity, the parent or the holding company, reports the income, just as that option is currently available to those corporations with regard to trademark royalties. That is, the payer has the option of deducting the payments on its North Carolina return and the recipient can include them on its North Carolina return, or the payer can add them to its North Carolina return and the recipient can deduct them on its North Carolina return.

EFFECTIVE DATE: This act would become effective for taxable years beginning on or after January 1, 2006.

[3] See *Geoffrey, Inc. v. South Carolina Tax Com'n*, 437 S.E.2d 13 SC, 1993, cert. denied by U.S. Supreme Court, 114 S.Ct. 50 (1993). The South Carolina Supreme Court held that (1) royalty income of a foreign corporation, obtained from trademark licenses issued to an affiliate, could be taxed without violating due process clause and (2) tax could be imposed without violating interstate commerce clause.

[4] A patent for an invention is the grant of a property right to the inventor that gives the inventor the right to exclude others from making, using, offering for sale, selling or importing the invention for a specified period of time.

[5] Copyright is a form of protection provided under federal law to the authors of original works of authorship, including literary, dramatic, musical, artistic, and certain other intellectual works, both published and unpublished.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: March 1, 2006

TO: Revenue Laws

FROM: Dave Crotts
Fiscal Research Division

RE: Draft 2005-SVz-13 (v.6) (Expansion of Royalty Reporting Option)

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:			See "Assumptions and Methodology"		
EXPENDITURES:					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: Tax years beginning on or after January 1, 2007.

BILL SUMMARY .The 2001 General Assembly enacted legislation that eliminated the tax planning strategy of shifting trademark royalty income to another state in order to avoid the North Carolina income tax. The proposal would extend the 2001 treatment to royalty income patents and copyrights.

ASSUMPTIONS AND METHODOLOGY: A discussion with the Department of Revenue indicates that the enactment of the bill could have a positive impact on General Fund tax revenue but the magnitude of this amount is not known. One factor limiting the impact of the proposal is

that fact that in the wake of the **A & F Trademark** case, some affected taxpayers may be in compliance. Another issue is the fact that the proposal applies to patent and copyright royalty income only. In general, any revenue gain would be smaller than the receipts from the 2001 act affecting trademark income. During the 2001 discussion the estimated fiscal impact from the trademark provision was $20 million per year.

SOURCES OF DATA: North Carolina Department of Revenue.

TECHNICAL CONSIDERATIONS: None

Discussion of Issue:
Real Estate Investment Trusts

BILL ANALYSIS

Committee: Revenue Laws Study Committee
Introduced by:
Version:

Date: March 1, 2006
Summary by: Cindy Avrette
Committee Counsel

REIT – A real estate investment trust (REIT) is a corporation or trust that uses the pooled capital of many investors to purchase and manage real estate. REITs are traded on major exchanges just like stocks and are granted special tax considerations. A REIT pays yields in the form of dividends. It is required to pay out at least 90% of its income to shareholders and deducts the amounts paid out. The REIT is subject to federal and State income tax only on the income that is not distributed to its shareholders. The shareholders pay tax on the dividends they receive.[1]

DIVIDENDS RECEIVED DEDUCTION. – The federal dividends received deduction[2] is meant to reduce the negative effects of the double tax on C corporation profits distributed as dividends to corporate shareholders. Subject to certain limitations, corporations may deduct a percentage of the dividends it receives from another domestic corporation. The percentage it may deduct varies depending upon the receiving corporation's ownership share in the distributing corporation. If the corporations are affiliated under the Internal Revenue Code, then the receiving corporation may deduct 100% of the dividends received from the distributing corporation.[3] In 2001, North Carolina began piggy-backing the federal dividends received deduction. In 2003, it began treating dividends from REITs the same as federal law.[4]

EXAMPLE 1 – If a North Carolina corporation owns a REIT that owns North Carolina rental property, the REIT gets a deduction for the income it distributes to the corporation and the corporation pays tax on the distribution.

EXAMPLE 2 – If a North Carolina corporation establishes a holding company in another state and transfers it ownership in the REIT to the holding company, the distributions from the REIT escape taxation: The REIT distributes all of its income to the holding company so it has no tax liability. The holding company has no nexus with North Carolina so it has not tax liability on the dividends received. The holding company dividends the income to the North Carolina corporation, which pays no tax on the dividend because it qualifies for the dividends received deduction.

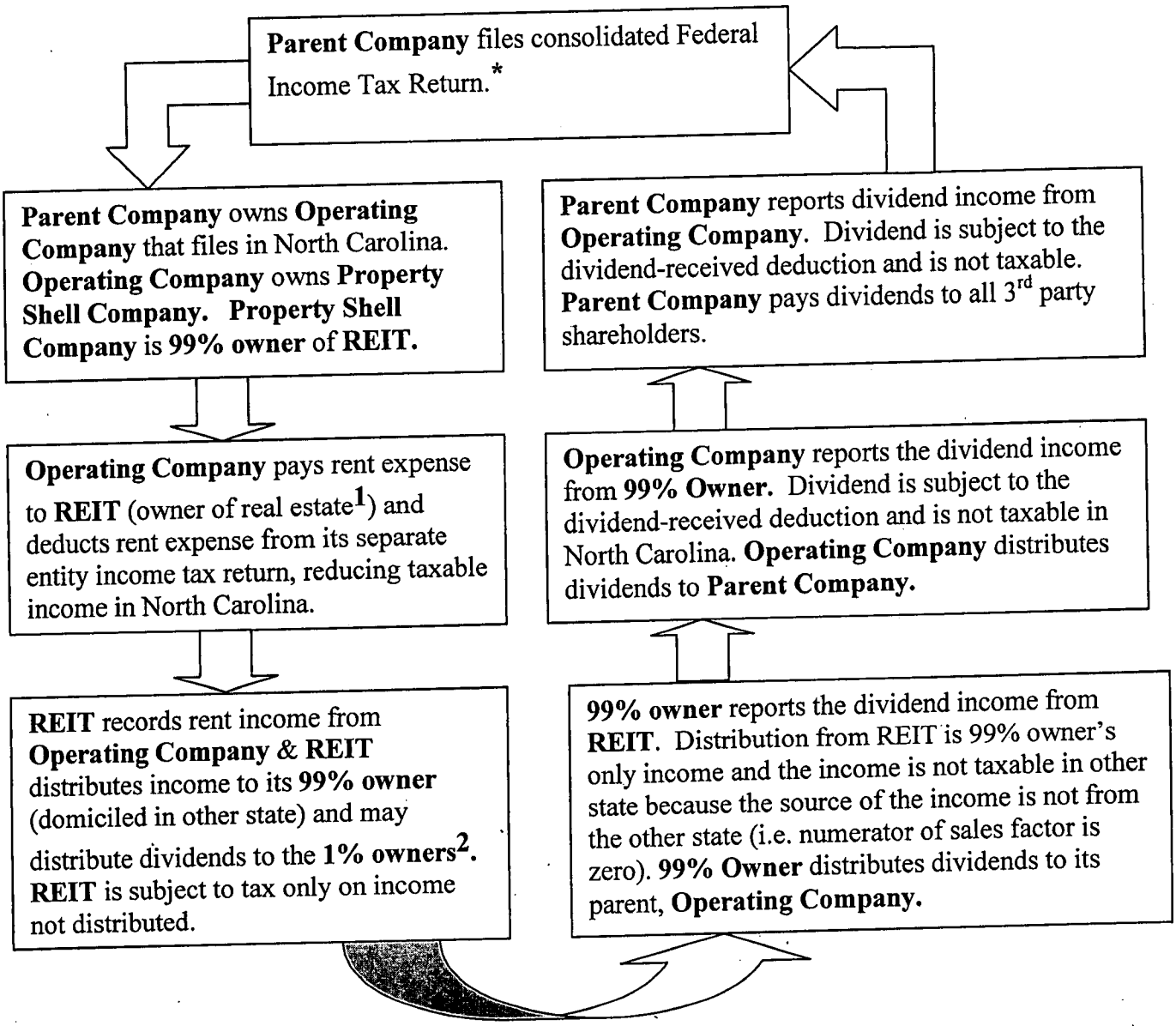
ALTERNATIVES –

1. For instances where the corporation and the REIT are related entities, the rental expense deduction could be disallowed for the operating corporation.
2. Require the REIT to pay tax on its income from a related entity.

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[1] The dividend received deduction does not apply to dividends received from a REIT.
[2] 26 U.S.C. 243.
[3] Corporations are considered 'affiliated' under the Code if the receiving corporation owns 80% or more of the distributing corporation.
[4] Prior to 2003, North Carolina allowed shareholders to deduct dividends received from a REIT to the extent that the income would not be taxed by the State if it had been received directly by the corporation.

REIT Income Shifting Structure
Cash Flow

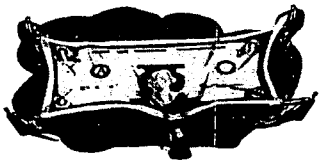


***Note: REIT is not included in the consolidated US Federal income tax return for Parent Company and Subsidiaries pursuant to the Internal Revenue Code. One requirement for qualification as a REIT is that the REIT must distribute at least 90% of its income to its shareholders.**

[1] REIT assets consist of real estate or real estate mortgages.

[2] A REIT is required to have 100 beneficial owners.

Summary result: Operating income subject to tax in North Carolina is diluted by a "manufactured" rental expense. The entity receiving the rental income is not taxable in North Carolina.



Video Competition in North Carolina

Revenue Laws Study Committee
March 1, 2006

FCC's 12th Annual Video Competition Report

(adopted Feb. 10, 2006)

- Annual national report
- Cable still serves largest % of households, but market share is declining (69.4%, down 2.2% from June 2004)
- DBS comprise second largest group of households (27.7%)
- 14% of U.S. households still get broadcast

NC video market reflects national trends in FCC report

- Cable leads in NC with 1.8 million subscribers, but market share has declined
- DBS holds 26% market share in NC
- Most North Carolinians have option of purchasing video service from at least one cable operator or one or more satellite operators

Incumbent Local Exchange Carriers (ILECs)

- FCC report states that most ILECs have reported plans to provide video service
- Larger LECs have accelerated plans to roll out video services in some markets (Verizon, SBC)
- Smaller LECs are offering video service over existing lines using VDSL or ADSL technologies

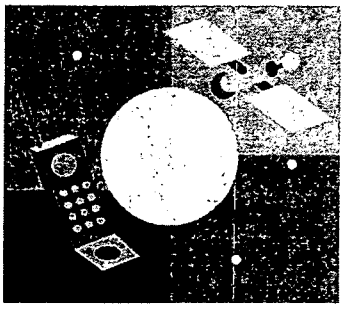
NCGA Revenue Laws Cable Franchise Survey

- Purpose: to gather current information on both the tangible and intangible value of existing local franchise agreements
- Approximately 270 local governments (county & municipal) asked to respond

NCGA Revenue Laws Cable Franchise Survey

- Data requested:
  - Franchise fee collections
  - Negotiation of franchise agreement
  - In-kind contributions
  - Competition and cable prices
  - Length and expiration date of contracts
- Results will be presented at next meeting of Revenue Laws Study Committee

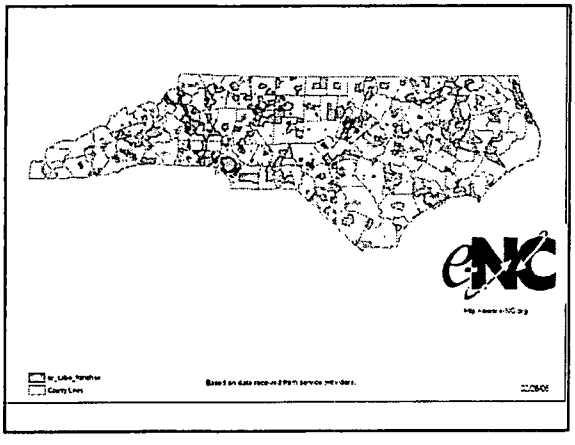
In the meantime …

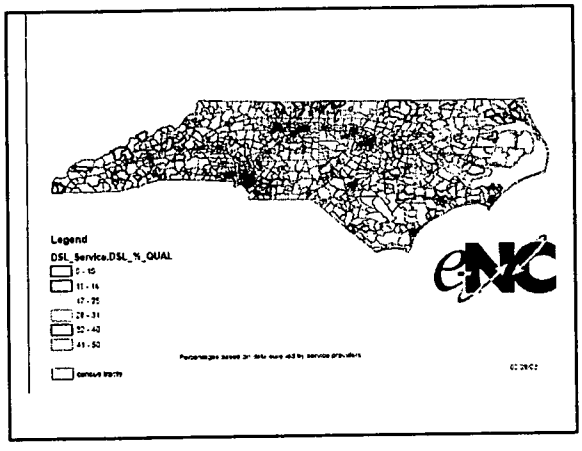


e-NC Telecom Service Provider Mapping System

- http://204.211.135.120/enc-telco-maps/eNC_LaunchMap.htm






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State Cable Legislation

State	Bill #	Type of Franchise	Application to Incumbent Operators	Franchise Fees	Buildout	PEG Channels
Florida	H 1199	Statewide - issued by Secretary of State in 15 days	When existing franchise expires (incumbent is one serving at least 40% of subscribers) and incumbent can opt for statewide if another provider enters 50% of service area	None	None	Same number as incumbent
Indiana	S 245; H1279	Statewide - issued by Utility Regulatory Commission	Has option of existing franchise or statewide	Payable quarterly to locality on comparable basis as incumbent. If no incumbent, rate is 5%. If incumbent is required to make payments to support PEG programming, statewide franchise holder must make similar payments.	None	Same number as incumbent
Iowa	H 670; S 3146	Statewide - issued by Secretary of State; utility providing local telephone service is considered to have a franchise	When existing franchise expires (incumbent is one serving at least 40% of subscribers)	Payable quarterly to locality on percentage of gross revenue set by locality, not to exceed incumbent rate	None	Same number as incumbent
Kansas	S 449	Statewide - issued by Secretary of State	When existing franchise expires, but incumbent can ask for modification of its franchise agreement if another provider enters its service area	Locality can impose at % of gross revenues, with rate not to exceed incumbent rate. Payable quarterly.	None	Same number as incumbent
Louisiana	Expect Soon					
Missouri	S 816	Statewide - issued by Public Service Commission; entity providing local telephone service is considered to have a franchise	When existing franchise expires	Payable quarterly to locality on percentage of gross revenue at rate of incumbent	None	Same number as incumbent

State Cable Legislation

State	Bill #	Type of Franchise	Application to Incumbent Operators	Franchise Fees	Buildout	PEG Channels
New Jersey	A804; S192	Statewide - issued by Board of Public Utilities	When existing franchise expires	3% to city and 1.5% to county in which city is located; payment assistance to low-income subscribers	6 yrs to cover state	2 PEG channels; free cable and Internet to public buildings; some infrastructure to assist w/ PEG transmission
South Carolina	H 4428	Statewide - issued by Secretary of State in 10 days	When existing franchise expires, but can opt for statewide if another provider enters service area	Locality can impose fee at lowest incumbent rate; fee collected quarterly by locality; gross revenue defined	None	Same number as incumbent
Tennessee	H 3636; S 3210	Statewide - issued by Secretary of State in 10 days	When existing franchise expires (incumbent is one serving most customers)	Locality can impose fee at lowest incumbent rate; fee collected quarterly by State Comptroller and distributed to source; gross revenue defined	None	Same number as incumbent
Texas	Enacted	Statewide - issued by Public utilities Commission	When existing franchise expires (incumbent is one serving at least 40% of subscribers)	5% of gross revenue payable quarterly plus same per subscriber payments as incumbent until incumbent's franchise expires, then additional 1% or subscriber fee in lieu of in-kind compensation and grant	None	Same number as incumbent
Virginia	H 1404; S 706	Local: Negotiated Franchise (applies to anyone) and Ordinance Franchise (applies to telco provider or incumbent). To get ordinance franchise, telco must file request to negotiate, then notice for ordinance franchise	Incumbent can obtain an ordinance franchise if a new provider receives an ordinance franchise	Franchise Fee at lowest incumbent rate payable quarterly; PEG Capital Fee at lowest recurring per subscriber or % of revenue basis; PEG Capital Grant Surcharge Fee of 1.5% or lowest capital contribution paid or provided in-kind. Gross revenue defined.	100% of initial area in 3 yrs.; 65% of phone service area in 7 yrs and 100% in 10 yrs. 35 homes per mile exception	Same number as incumbent, but at least 3 and no more than 7

THE BUSINESS OF TELEVISION
BROADCASTING & CABLE
www.broadcastingcable.com

Virginia Eases Way for Telcos

By John Eggerton -- Broadcasting & Cable, 2/27/2006 5:35:00 PM

Virginia has joined Texas as the second state to pass legislation easing the entry for cable competitors. While not a statewide franchise like Texas, Virginia is essentially guaranteeing a franchise anyplace in the state where a new entrant agrees to meet certain specific franchise terms.

Verizon says the Virginia House and Senate have both passed legislation that makes it easier for telco video services, like Verizon's FiOS, to roll out video service in the state. Essentially the idea is to agree to a set list of access and provision requirements without having to go through the time-consuming local franchise process.

The FCC and Congress have made easing the roll-out of broadband a priority.

If signed by the governor--one of his aides helped negotiate the final compromise bill, according to Verizon--the legislation would become effective July 1.

Unlike the Texas bill, which created a statewide franchising regime, the Virginia franchises remain under the control of the municipalities, according to Verizon spokesman Harry Mitchell. Verizon had pushed for a statewide franchise, but was foreclose that route by the Virgininia Constitution, which establishes municipalities' control over their rights of way. Verizon would still prefer the state franchise route.

Instead, in a sort of must-carry take on the franchise process, new video entrants can opt for either a standard franchise process, or after 45 days of negotiations without a deal, officially opt for a so-called "ordinance" franchise.

So long as the video service provider agrees to the terms of that franchise, which include service build-out requirements as well as fee and channel commitments similar to incumbent cable operators, the new provider may begin offering video service within 75 days and the municipality must accommodate it.

Mitchell said the company still thinks the build-out requirements-100% of a pre-established coverage area within three years, for instance--are a barrier to entry, saying neither side got everything it wanted.

Still, Verizon got a faster track to entry, and essentially a guaranteed franchise wherever it agrees to requirements for access and service provision, franchise fees, and customer service as set forth in the bill.

Verizon also got a three-year out clause. That means that if it finds after three years it cannot make a business out of the franchise, it can get out of the deal--a provision it has gotten in most other markets. But there is a compromise there, too.

If it does exit, it cannot re-enter for the balance of the unexpired franchise, which would be a dozen years in most cases.

There is no three-year out clause in its Fairfax franchise, but that is grandfathered, said Mitchell.

"With this compromise legislation, Verizon will be able to accelerate investment in our fiber-optic network in Virginia, more quickly adding an awesome FiOS TV component to our reliable voice phone service and blazing-fast FiOS Internet Service," said Verizon Virginia President Robert W. Woltz Jr.

"We will have more to say about our investment plans in Virginia in coming days," said Woltz, "but it's safe to say that – as this legislation becomes law – those plans will reflect the progressive business environment in the Commonwealth."

Verizon, the most aggressive telco video provider to date, has launched a franchise in the Virginia suburb of Herndon, Va., having secured a franchise to overbuild the market last July. Cox has the cable franchise there.

FiOS expanded its Virginia presence with a franchise deal with Fairfax County, the suburb that surrounds the separately incorporated Herndon.

Verizon had been working to secure franchises in over 200 Virginia municipalities but was also seeking some help from the Virginia legislature.

Telcos argue that not having to seek individual franchises will allow it to more quickly provide more competition in the multichannel video market, one of the Bush administration's, the FCC's and Congress's stated priorities.

Cable argues that if the franchising process is to be streamlined or short-cut, the same advantages should apply to cable.

Verizon's FiOS TV debuted in Keller, Tex., Sept. 22. Verizon. Texas' Public Utility Commission last month approved that state's first statewide franchise for telco video service. Verizon had filed for franchises in 21 communities under the state's franchise law.

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ARTICLE VII
Local Government

...

Section 8. Consent to use public property.

No street railway, gas, water, steam or electric heating, electric light or power, cold storage, compressed air, viaduct, conduit, telephone, or bridge company, nor any corporation, association, person, or partnership engaged in these or like enterprises shall be permitted to use the streets, alleys, or public grounds of a city or town without the previous consent of the corporate authorities of such city or town.

Section 9. Sale of property and granting of franchises by cities and towns.

No rights of a city or town in and to its waterfront, wharf property, public landings, wharves, docks, streets, avenues, parks, bridges, or other public places, or its gas, water, or electric works shall be sold except by an ordinance or resolution passed by a recorded affirmative vote of three-fourths of all members elected to the governing body.

No franchise, lease, or right of any kind to use any such public property or any other public property or easement of any description in a manner not permitted to the general public shall be granted for a longer period than forty years, except for air rights together with easements for columns of support, which may be granted for a period not exceeding sixty years. Before granting any such franchise or privilege for a term in excess of five years, except for a trunk railway, the city or town shall, after due advertisement, publicly receive bids therefor. Such grant, and any contract in pursuance thereof, may provide that upon the termination of the grant, the plant as well as the property, if any, of the grantee in the streets, avenues, and other public places shall thereupon, without compensation to the grantee, or upon the payment of a fair valuation therefor, become the property of the said city or town; but the grantee shall be entitled to no payment by reason of the value of the franchise. Any such plant or property acquired by a city or town may be sold or leased or, unless prohibited by general law, maintained, controlled, and operated by such city or town. Every such grant shall specify the mode of determining any valuation therein provided for and shall make adequate provisions by way of forfeiture of the grant, or otherwise, to secure efficiency of public service at reasonable rates and the maintenance of the property in good order throughout the term of the grant.

....

VA SB706 / HB1404
Cable Competition Act
Key Provisions

1. Definitions [§ 15.2-2108.19] – Updates Virginia definitions to agree with federal Cable Act and:
   a. Cable Service excludes video programming provided by a CMRS provider
   b. Gross Revenues defined to apply uniformly to ordinance based franchises
   c. Transfers requiring LFA approval limited

2. Two types of franchise: (1) negotiated cable franchise [§ 15.2-2108.20(A)] and (2) new ordinance cable franchise [§ 15.2-2108.21]

3. Eligibility for Ordinance Cable Franchise [§ 15.2-2108.21(B)]

   a. Certificated telecom provider with previous consent to use ROW
   b. Certificated telecom provider without prior consent who provides services over facilities leased from an entity with previous consent to use the ROW
   c. Cable operator that has a cable franchise can renew its existing franchise as an ordinance franchise or opt into the new terms of an ordinance franchise granted to another cable operator in the locality under mandatory reciprocity in § 15.2-2108.26

4. General Requirements for ordinance cable franchises [§ 15.2-2108.21]

   a. Ordinance franchise has 15-year term [§ 15.2-2108.21(B)]
   b. Applicant must file request with locality to negotiate and be available to negotiate at least 45 days prior to filing notice that it elects an ordinance franchise. This prerequisite does not apply if locality refuses to negotiate or the applicant already holds a negotiated cable franchise from the locality. [§ 15.2-2108.21(C)]
   c. Must file notice with locality at least 30 days prior to offering service, along with map/description of initial service area in which applicant intends to provide service within the three year period required for an initial service area, and the area in the locality in which operator has its telephone facilities. May amend later. [§ 15.2-2108.21(C)]
   d. Compliance with nondiscrimination standard. Cable operator shall assure that access to cable service is not denied to any group of potential residential subscribers because of the income of the residents of the local area in which such group resides. [§ 15.2-2108.21(D)]
      1. LFA may monitor and inspect deployment of cable services. Cable operators required to submit semi-annual progress reports detailing current provision of services under the deployment schedule and new service area plans for the next six months. [§ 15.2-2108.21(D)]
      2. Failure to correct or remedy any material deficiencies shall be subject to same remedies as those in existing cable franchise. [§ 15.2-2108.21(D)]
   e. LFA has 120 days to pass required ordinances to regulate new franchisee which will apply retroactively to the date on which the cable operator began offering service. [§ 15.2-2108.21(E)]

5. Permitted provisions in cable franchise ordinances [§ 15.2-2108.22]

   a. PEG channels – Access to channels equal to lowest number of channels provided by any other operator, with an opportunity for non-discriminatory growth of based on substantial utilization of existing channels. Locality can get up to an additional 3 PEG channels in the basic service tier so long as total number of PEG channels doesn't exceed 7 channels in aggregate. [§ 15.2-2108.22(1)]

b. PEG interconnection may be required; if no agreement within 180 days of request to interconnect by new operator, then locality can determine interconnection point. [§ 15.2-2108.22(1)]
c. Franchise fee – Not exceed 5% or lowest fee rate paid by an incumbent in locality, based on statewide definition of gross revenues. [§ 15.2-2108.22(2)]
d. PEG and INET fee [§ 15.2-2108.22(3)]
    i. New operator pays 1% if existing cable operator provides in-kind; can be higher if necessary to match fees paid by incumbent, but higher fee only paid during remainder of existing operator's franchise.
    ii. At expiration of existing term, locality may negotiate with all operators regarding amount of any support. If parties cannot agree, LFA may continue to impose fee to support capital costs which does not exceed the amount paid by the existing cable operator. LFA may assess this additional fee on a per subscriber basis or as % of gross revenue. Offset may be allowed for unamortized value of in-kind services provided.
e. Customer service requirements – comply with requirements imposed by LFA under limitations of bill or with federal requirements if none are established by LFA. [§ 15.2-2108.22(4)]

6. Service Availability Requirements [§ 15.2-2108.22(12)]

    a. Locality shall adopt ordinance to require cable operators to make cable service available to (i) up to 100% of initial service area within three years, and (ii) no more than 65% of the entire locality in which the cable operator has its telephone facilities, within seven years of the date the franchise is granted, subject to statutory exclusions.
    b. Availability subject to exclusions – e.g., force majeure; certain delays or lack of access caused by locality or others; certain technical reasons or lack of facilities; average occupied residential household density is less than 30 occupied residential dwelling units per mile; and when prior service, payment, or theft of service history with a subscriber or potential subscriber has been unfavorable.
    c. Cable operator using its telephone facilities to provide cable service not required to provide any cable service outside of the area in the locality in which it has its telephone facilities.
    d. Between the seventh and eighth years from the date of grant of the franchise, cable operator may be required, after a public hearing and a finding that it is necessary to foster competition, to make service available to no more than 80% of the entire locality in which the cable operator has its telephone facilities within 10 years, subject to the exclusions. If cable operator notifies locality that it is unwilling to accept this requirement, the locality may terminate the cable operator's ordinance cable franchise. The cable operator must certify compliance at third, seventh and tenth anniversary dates with the service requirements.
    e. For cable ordinance franchise, the date of grant of the franchise is the date the required notice is filed with the LFA.

7. Free service for government buildings [§ 15.2-2108.22(9)]

8. Enforcement mechanisms

    a. Default process (informal discussions, notice, cure period, public hearing) [§ 15.2-2108.22(5)]
    b. Civil penalties - For customer service, carriage of PEG, reporting requirements, and nonpayment [§ 15.2-2108.22(6)]
    c. Audits – books and records for fee payment only [§ 15.2-2108.22(7)]
    d. Reports – May require annual financial and quarterly customer service information so long as it does not exceed requirements on any other provider. [§ 15.2-2108.22(8)]

9. Line items on bill – Franchise fees, PEG and INET fees; and any other fee, tax, assessment or charge may be passed through by any cable operator with negotiated or ordinance franchise. [§ 15.2-2108.25]

10. ROW fee consistency and override to existing state cable bidding process. [§ 15.2-2108.23 and 24]

11. Prohibits localities from forcing renegotiation or modification, etc. of franchises. [§ 15.2-2108.27]

12. Transfer provisions – key term is the definition of "transfer" that excludes affiliate transactions and mergers; must have prior consent of locality. [§ 15.2-2108.28]

13. Optional Surrender – new franchisee within three years after grant of cable franchise may notify locality and surrender cable franchise for entire locality without liability; no effect on other franchises held by new franchisee. If a franchisee surrenders, it is not eligible to receive another franchise in the locality for the unexpired term of the surrendered franchise. [§ 15.2-2108.29]

14. Mandatory Reciprocity – Existing cable operator has ability to substitute new terms and conditions of any new negotiated franchise or ordinance cable franchise granted to a new cable franchisee in lieu of its existing franchise. LFA must make terms and conditions in all negotiated franchises granted to new operator available to existing cable operator in the same franchise area. LFA must also make available to existing cable operator terms and conditions from any ordinance franchise by allowing it to opt into an ordinance cable franchise. Existing operator must accept in entirety all applicable terms and conditions. [§ 15.2-2108.26]

15. Allows allocation of discounts for bundled services. [§ 15.2-2108.22(11)]

16. Federal law includes amendments. [§ 15.2-2108.19]

17. Process for renewal of negotiated cable franchises [§ 15.2-2108.30]

    a. May elect to renew under the Cable Act or opt into an ordinance cable franchise
    b. Opt-in option requires prior notification to local government

18. Fact that person obtains negotiated franchise or ordinance cable franchise under this article does not create presumption that such person is providing cable services, is controlling or responsible for the management and operation of a cable system, or is a cable operator, for purposes of federal law. [e.g., IPTV] [§ 15.2-2108.31]

REVENUE LAWS STUDY COMMITTEE

State Legislative Building
Raleigh, North Carolina 27603

Senator John H. Kerr, III, Co-Chair *Representative Paul Luebke, Co-Chair*

March 22, 2006

Rescheduled

NOTICE

TO: Members, Revenue Laws Study Committee

FROM: Senator John Kerr, Co-Chair
Representative Paul Luebke, Co-Chair

SUBJECT: Revenue Laws Study Committee Meeting

There will be a meeting of the **Revenue Laws Study Committee** as follows:

DAY:	**Monday**
DATE:	**APRIL 17, 2006**
TIME:	**1:00 pm**
LOCATION:	**Room 544, Legislative Office Building**

Please advise DeAnne Mangum, at (919) 733-2405 or e-mail deannem@ncleg.net if you will be unable to attend.

Posted: 03-22-2006

REVENUE LAWS STUDY COMMITTEE
Wednesday, April 19, 2006 at 1:00 PM
Room 544, Legislative Office Building

MINUTES

The Revenue Laws Study Committee met at 1:00 PM on April 19, 2006, in Room 544 of the Legislative Office Building. Thirteen members of the committee were present. Senator Kerr and Representative Luebke presided.

Approval of the Minutes.

Rep. Carney motioned for the approval of the March 1, 2006 minutes and the motion carried. A copy of the minutes is attached.

Draft Proposal: Video Services Competition Act.

Cindy Avrette, Research Division staff attorney, and Brenna Erford, Fiscal Research Division fiscal analyst, were recognized to explain the bill draft. A copy of the bill draft, the summary, the fiscal note, and the power point presentations are attached.

The floor was opened to public with the following citizens commenting:

Connie Book, PhD., Associate Professor and Department Chair, School of Communications, Elon University, requested further changes in the bill. A copy of her comments is attached.

Manzoor Cheema, Triangle Area Muslim Community and The People's Channel, spoke in opposition to the bill because he feels it offers limited PEG support.

Kathy Hartkopf, legislative liaison for FreedomWorks and Citizens for Sound Economy, spoke in favor of the bill because of increased competition issues.

Chad Johnston, Executive Director, The People's Channel, spoke in opposition to the bill because of concerns about PEG channel issues. A copy of his comments is attached.

Joyce Krawiec, FreedomWorks from Forsyth County, spoke in favor of the bill because of increased competition issues. A copy of her comments is attached.

Erroll Reese, Durham small business owner, spoke in favor of the bill.

Al Ripley, Attorney for Consumer and Housing Issues, NC Justice Center, spoke in favor of the bill, but requests further changes.

Eugene Weeks, Southeast Raleigh, spoke in favor of the bill because of increased competition issues.

Marcos Zarate, Apex, spoke in favor of the bill because of increased competition issues.

Doris Boris, Charlotte-Mecklenburg cable administrator and SouthEast Assn. of Telecommunications Officers and Advisors President, spoke in opposition to the bill because of municipality franchise issues.

Wade Hargrove, attorney with Brooks, Pierce etal, requested equal regulations and taxes for all video service providers.

Rebecca Troutman, Director of Research & Public Technology, NC Association of County Commissioners, expressed concerns about the lack of build-out requirements. A copy of her comments is attached.

Andy Romanet, counsel, NC League of Municipalities, felt most of the League's concerns had been addressed but requested build-out requirement language is included in the bill.

Krista Tillman, President, BellSouth NC Operations, spoke in favor of the bill because of three major points: industry convergence, municipalities' benefits and consumer issues. A copy of her comments is attached.

Michael Williams, Raleigh cable administrator, had positive and negative opinions regarding the bill. He supports competition, concerned about PEG channels, municipalities' regulatory powers, and build-out requirements. A copy of his comments is attached.

Drew Wofford, Raleigh TV Network producer, spoke in favor of stronger PEG requirements. A copy of his comments is attached.

Lynn Connelly, FreedomWorks, spoke in favor of competition, but expressed concern for PEG channels and the rights of municipalities. A copy of her comments is attached.

Dr. Jarvis Hall, NC – NAACP and NC Central Political Science professor, expressed concern about cherry picking, but supports PEG channels and community investment by video service providers.

Phaedra Kelly, director, the Arts Center in Carrboro, expressed concern for PEG channels.

Rob Thompson, NC PIRG, spoke in favor of competition but expressed concern about customer service enforcement and cherry picking. A copy of his comments is attached.

Bill Wilson, AARP North Carolina Associate State Director, spoke in favor of new competition, but expressed concern about build-out, the future of PEG channel funding and consumer complaint issues. A copy of his comments is attached.

Bill Nichols, The People's Channel, expressed concern about PEG channels and the costs of upgrading to digital standards.

Hart Pillow, Durham citizen, is concerned about PEG channels. A copy of her comments is attached.

Don Yelton, Weaverville citizen, is concerned about distribution of municipal moneys and opposes his money going to support PEG channels and any other nonprofits.

Robert Gwyn, The People's Channel, voiced support for video service competition and the preservation of PEG channels.

Vimala Rajendan, The People's Channel, spoke of fighting for the freedom of expression and supports maintaining current agreements.

Lisa Beimler, SECURE and Action Audits, spoke in opposition of the bill because she feels it offers false competition, has no build-out regulations, has consumer protection issues, has poor support for PEG channels and has local government issues. A copy of her comments is attached.

David Kasper, The People's Channel president, was concerned about the bill improving competition and consumer service, thought the PEG provision was "laughable" and that new PEG channels might be prevented from starting up.

Patricia Boyd stated that she is disabled and lives on a fixed income which limits technology in her home; she felt that video service is a necessity "like water".

Draft Proposal: Amend Taxation of Logging Machinery.

Trina Griffin, Research Division staff attorney, was recognized to explain the "Amend Taxation of Logging Machinery" draft proposal. Bob Slocum, NC Forestry Association Executive Vice President, was recognized to answer questions and spoke in favor of the bill. Norris Tolson, Secretary of the Department of Revenue, was recognized to answer questions and spoke in favor of the bill. Rep. Wilkins moved for a

favorable report, the motion passed unanimously and the draft proposal will be recommended to the 2006 General Assembly. A copy of the bill draft and the summary are attached.

Draft Proposal: Amend Delinquent Property Tax Collection.

Martha Walston, a staff attorney with the Fiscal Research Division, was recognized to explain the "Amend Delinquent Property Tax Collection" draft proposal. Sen. Webster moved for a favorable report, the motion passed unanimously and the draft proposal will be recommended to the 2006 General Assembly for consideration. A copy of the draft proposal and the summary are attached.

Draft Proposal: Public Service Company Property.

Martha Walston, a staff attorney with the Fiscal Research Division, was recognized to explain the "Public Service Company Property" draft proposal. Bill Wilkes, Assistant Director of the Property Tax Division, NC Department of Revenue, was available to answer questions. Rep. Carney moved for a favorable report. The motion carried. A copy of the draft proposal and summary are attached.

Status Report on Electricity Franchise Tax Distribution and Real Estate Investment Trust.

Cindy Avrette, a staff attorney with the Research Division, was recognized to explain "Electricity Franchise Tax Distribution" and "Real Estate Investment Trust".

Expansion of Sales Tax Base to include Maintenance Agreements.

Linda Millsaps, a fiscal analyst with the Fiscal Research Division, was recognized for a power point explanation of the results of a statewide survey on service contracts. A copy of the presentation is attached.

Sen. Kerr made a motion to adjourn the meeting and the motion carried. The meeting adjourned at 4:22 PM.

Senator John H. Kerr, III, Co-Chair
Revenue Laws Study Committee

Representative Paul Luebke, Co-Chair
Revenue Laws Study Committee

DeAnne Mangum, Committee Clerk

REVENUE LAWS STUDY COMMITTEE
Wednesday, March 1, 2006 at 1:00 PM
Room 544, Legislative Office Building

MINUTES

The Revenue Laws Study Committee met at 1:00 PM on March 1, 2006, in Room 544 of the Legislative Office Building. Thirteen members of the committee were present. Senator Kerr and Representative Luebke presided.

Approval of the Minutes.

Rep. Hill motioned for the approval of the February 8, 2006 minutes and the motion carried. A copy of the minutes is attached.

Revenue Laws Technical Changes: Draft Proposal and Summary.

Cindy Avrette, a staff attorney with the Research Division, was recognized to explain the draft proposal's provisions to improve the collection and administration of the motor fuel tax. A copy of the draft and the summary are attached.

Streamlined Sales Tax Definitions: Draft Proposal and Summary.

Sabra Faires, the Senate Tax Counsel, was recognized to explain the draft proposal. A copy of the draft, summary and fiscal memo are attached.

S Corp Income Tax Adjustments: Draft Proposal and Summary.

Trina Griffin, a staff attorney with the Research Division, was recognized to explain the draft proposal. A copy of the draft proposal and summary are attached.

Clarify Additional Gross Premiums Tax: Draft Proposal and Summary.

Cindy Avrette, a staff attorney with the Research Division, was recognized to explain the draft proposal. A copy of the draft proposal and summary are attached.

Franchise Tax Loophole Closing: Draft Proposal and Summary.

Trina Griffin, a staff attorney with the Research Division, was recognized to explain the draft proposal. A copy of the draft proposal, summary and fiscal memo are attached.

Franchise Tax Base Calculation: Draft Proposal and Summary.

Cindy Avrette, a staff attorney with the Research Division, was recognized to explain the draft proposal. Jonathan Tart, Administrative Officer of the Corporate, Excise, and Insurance Tax Division, NC Department of Revenue, was available to answer questions. A copy of the draft proposal and summary are attached.

Expansion of Royalty Reporting Option: Draft Proposal and Summary

Trina Griffin, a staff attorney with the Research Division, was recognized to explain the draft proposal. Sen. Kerr made a motion for consideration of the draft proposal and the motion carried. A copy of the draft proposal, summary and fiscal memo are attached.

Real Estate Investment Trusts

Cindy Avrette, a staff attorney with the Research Division, was recognized to explain the proposal. Greg Radford, Director of the Corporate, Excise, and Insurance Tax Division, NC Department of Revenue, was available to answer questions. A copy of the proposal is attached.

Taxation of Communication Services

- **Review of Current Tax Treatment** – Cindy Avrette was recognized to explain the current tax treatment.
- **Review of Current NC Market** – Brenna Erford, Fiscal Research Division, was recognized to explain the current market. A copy of her presentation is attached.
- **Review of Current Legislation in other States** – Sabra Faires, the Senate Tax Counsel, was recognized to explain current and pending legislation in other states. A copy of her presentation is attached.

The meeting adjourned at 3:10 PM.

Senator John H. Kerr, III, Co-Chair
Revenue Laws Study Committee

Representative Paul Luebke, Co-Chair
Revenue Laws Study Committee

DeAnne Mangum, Committee Clerk

REVENUE LAWS STUDY COMMITTEE AGENDA

Sen. John Kerr Rep. Paul Luebke

Wednesday, March 1, 2006
Room 544, Legislative Office Building
1:00 p.m.

I. **Approval of the Minutes from the February 8, 2006, Meeting**

II. **Revenue Laws Technical Changes: Draft Proposal and Summary**

Continuation of the draft from previous meeting – Provisions to improve the collection and administration of the motor fuel tax.

Cindy Avrette, Research Division

III. **Streamlined Sales Tax Definitions: Draft Proposal and Summary**

Sabra Faires, Senate Tax Counsel

IV. **S Corp Income Tax Adjustments: Draft Proposal and Summary**

Trina Griffin, Research Division

V. **Clarify Additional Gross Premiums Tax: Draft Proposal and Summary**

Cindy Avrette, Research Division

VI. **Franchise Tax Loophole Closing: Draft Proposal and Summary**

Trina Griffin, Research Division

VII. **Franchise Tax Base Calculation: Draft Proposal and Summary**

Cindy Avrette, Research Division

VIII. **Expansion of Royalty Reporting Option: Draft Proposal and Summary**

Trina Griffin, Research Division

IX. **Real Estate Investment Trusts**

Cindy Avrette, Research Division

X. **Taxation of Communications Services**

- **Review of Current Tax Treatment** – Cindy Avrette, Research Division
- **Review of Current NC Market** – Brenna Erford, Fiscal Research Division
- **Review of Current Legislation in other States** – Sabra Faires, Senate Tax Counsel

XI. **Adjournment**

Next Meeting: April 5, 2006, in Room 544 LOB at 1:00 pm

REVENUE LAWS STUDY COMMITTEE AGENDA

Sen. John Kerr Rep. Paul Luebke

Wednesday, April 19, 2006
Room 544, Legislative Office Building
1:00 p.m.

I. **Approval of the Minutes from the March 1, 2006, Meeting**

II. **Draft Proposal: Video Services Competition Act**

- **Overview of the Issue and Presentation of Draft Proposal**
  Cindy Avrette, Research Division
  Brenna Erford, Fiscal Research Division
- **Public Comments**

III. **Draft Proposal: Amend Taxation of Logging Machinery**
Trina Griffin, Research Division
Linda Millsaps, Fiscal Research Division

IV. **Draft Proposal: Amend Delinquent Property Tax Collection**
Martha Walston, Fiscal Research Division
Walker Reagan, Research Division

V. **Draft Proposal: Public Service Company Property**
Martha Walston, Fiscal Research Division

VI. **Status Report:**

- **Electricity Franchise Tax Distribution**
- **Real Estate Investment Trust**

VII. **Expansion of Sales Tax Base to include Maintenance Agreements**
Linda Millsaps

VIII. **Corporate Tax Issues, Continued from March 1, 2006, Meeting**

- **Draft Proposal: Franchise Tax Base Calculation**
  Cindy Avrette, Research Division
  David Crotts, Fiscal Research Division
- **Draft Proposal: Clarify Additional Gross Premiums Tax**
  Cindy Avrette, Research Division
  Rodney Bizzell, Fiscal Research Division
- **Draft Proposal: Franchise Tax Loophole Closing**
  Trina Griffin, Research Division
  David Crotts, Fiscal Research Division

- **Draft Proposal: S Corporation Income Tax Adjustments**
  Trina Griffin, Research Division
  David Crotts, Fiscal Research Division
- **Draft Proposal: Expansion of Royalty Reporting Option**
  Trina Griffin, Research Division
  David Crotts, Fiscal Research Division

IX. **Draft Proposal: Property Tax Changes**
(Continuation of draft from February 8, 2006 Meeting)
Martha Walston, Fiscal Research Division

X. **Draft Proposal: Streamlined Sales Tax Changes**
(Continuation of draft from March 1, 2006 Meeting)
Cindy Avrette, Research Division
Linda Millsaps, Fiscal Research Division

XI. **Draft Proposal: Revenue Laws Technical Changes**
(Continuation of draft from previous meetings)
Trina Griffin, Research Division

XII. **Adjournment: Next meeting May 2, 2006, in Room 544 LOB at 1:00 pm**

House Pages

Revenue Laws Study Com

Name Of Committee: _____ Date: 4-19-06

1. Name: _____

   County: _____

   Sponsor: _____

2. Name: _____

   County: _____

   Sponsor: _____

3. Name: _____

   County: _____

   Sponsor: _____

4. Name: _____

   County: _____

   Sponsor: _____

5. Name: _____

   County: _____

   Sponsor: _____

Sgt-At-Arms

1. Name: Fred Hiles CURTIS DOWD
2. Name: TOM WILDER WADE ANDERS
3. Name: JAMES WORTH
4. Name: Dusty Rhodes
5. Name: _____

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — April 19, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Michael Boykin	Ernst & Young Raleigh, NC
Paul Matthews	Progress Energy Raleigh NC
Mary N. Copeland	Mebane, N.C. 1221 Buchanan Rd
H.E. Copeland	" "
Greg Wood	NCDOR
Bill Wilkes	NCDOR
David Baker	" "
Kirk Boone	" "
Pete Rockola	NC Tax Collectors NC Tax Assessors
Karl Knapp	NCDOR
Lennie Collins	NC DOR

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee
Name of Committee

April 19, 2006
Date

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Guy Rudolph	DOR

VISITOR REGISTRATION SHEET

Name of Committee | Date

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NAME	FIRM OR AGENCY AND ADDRESS
[signature]	Rose Rand
Eugene Weeks	2509 Foxgate Dr Raleigh NC
W. Lynn Weeks	2509 Foxgate Dr Raleigh, NC
Tom Roysteer	5668 Grouse Rd. Grouse NC 28033
Dot Roysteer	5668 Grouse Rd. Grouse NC 28033

VISITOR REGISTRATION SHEET

Regulated Laws — 4/19/06

Name of Committee — Date

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NAME	FIRM OR AGENCY AND ADDRESS
Connie Book	Elon University Elon, NC
Lynn Connelly	with Freedom Works NC — Home: Greensboro, NC
Rob Rhodes	with Freedom Works - N.C. Home Germanton N.C.
Michael Smith	Freedom Works
Joyce Krawiec	Freedom Works NC
Nancy E Burnett	Freedom Works NC
Linda Mills	City of Greensboro
Jo Nola Brown	Greensboro
Bill Culpepper	NCUC, Dobbs Bldg.
Stephanie McGarrah	Red Hat
Debbie Bowman Cone	Cypress

VISITOR REGISTRATION SHEET

Judiciary Laws — 4/19/06

Name of Committee — Date

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NAME	FIRM OR AGENCY AND ADDRESS
CARLOS E. SANCHEZ	300 SOUTH BREVARD ST. CHARLOTTE, NC 28202
Lee Mandell	NCLM
Todd Lanham	300 S. Brevard St. Charlotte, NC 28202
Claude SECREST	14424 Mallard Creek Rd Charlotte N.C. 28262
SHIRLEY BURNS	600 PAGE CT - CHARLOTTE N.C. 28270
Xanis Lanier	1801 Laurel Hill Dr. Lincolnton, NC 28092
Faye Bowden	P.O. Box 1 Cherryville, N.C. 28021
Wilson A. Bowden	8078 McConnell Rd Denver NC. 28037
Lib Crawford	8078 McConnell Rd Denver, N.C. 28037
	SD, AL, PA

VISITOR REGISTRATION SHEET

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NAME	FIRM OR AGENCY AND ADDRESS
David Stoller	STATE FARM INS COS.
Robert PASCHAL	Young, Moore
Rebecca Troutman	NCACC
Teresa Byant	Brooks Pierce McLendon Humphrey & Leonard Cable Assoation
MARTIN Feuner	Time WARNER CABLE
William Greene	Time Warner Cable.
Wade Hargrove	Brooks Pierce
Brad Fraser	Time Warner Cable
Tom ADAMS	TIME WARNER CABLE
Carol Hwey	Time Warner Cable
Sue Breckenridge	TIME WARNER CABLE

VISITOR REGISTRATION SHEET

Name of Committee

Date

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NAME	FIRM OR AGENCY AND ADDRESS
DK McLaughlin Jr	Time Warner Cable / Greensboro
Pat Smith	Time Warner Cable / Elizabethtown
Sammy Roberson	Cox Communications / Greenville NC
Skip James	Charter Communications - Suffolk VA/Hickory NC
Brad Phillips	Time Warner Cable / Raleigh
Connie Wilson	SSI
Kathy Hawkins	Progress Energy
[illegible]	Duke Govt affairs
Don Holbert	NC DOC
John McKay	Governor's Office
Andy Ellen	NCRMA
Fran Preston	NCRMA

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Revenue Laws Study Committee — April 19, 2006

Name of Committee — **Date**

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NAME	FIRM OR AGENCY AND ADDRESS
DON YELTON	221 JUPITER RD WEAVERVILLE NC YELTON221@Charter.Net 28787 CITIZEN
Warren Tindy Collins	1139 Jupiter Rd Weaverville N.C. 28787
Paul & Margaret Boyd	Paul Boyd Services + Real Estate Dev. paulfboyd2004@yahoo.com 3494 US 221 Al MARION, NC 28752
Molly Black	185 Love Valley Rd Statesville NC 28625
Robin Staudt	2324 Bushy Cook Rd Efland, NC 27243 O.C. Freedomworks
Kathy Hartkopf	Legislative Liaison NC Freedom Works / CSE
Gr. & Elaine Robbins	CITIZEN
Patricia Boyd	51 Myrtle Bell Dr. Nebo, NC 28761
Mrs. Devon Boyd	3879 Harmony Grove Rd. Nebo, NC 28761
Shirley B. Washburn	95 miracle dr. Marion, N.C. 28752
Jesse and Kenney Burnette	19 arbor View Dr. Marion, N.C. 28752

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Name of Committee

Date

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NAME	FIRM OR AGENCY AND ADDRESS
John Weeks	Brez Assn
JEFF VAN DYKE	BELLSOUTH
HERB CRENSHAW	BELLSOUTH
David Miner	Echostar Communications / DirecTV
Doug J. Boris	City of Charlotte
Michael Williams	City of Raleigh
Sam Goodstein	Chapel Hill Cable TV
Gerald Anders	FREEDOMWORKS (BARNARDSVILLE)
BILL LACK	FREEDOMWORKS (Asheville)
Bill Reynolds	Freedom Works (Blch. Mtn)
Tim Peck	FreedomWorks, Asheville NC

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Name of Committee | Date

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Kathy Rhodarmer	Freedom Works (Buncombe County)
Carrie Grace	[illegible]
Jennifer Weaver	The Peoples' Channel (Chapel Hill

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-RBxz-36A [v.7] (03/30)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/18/2006 7:30:05 PM

Short Title: Video Service Competition Act. (Public)

Sponsors:

Referred to:

A BILL TO BE ENTITLED

AN ACT TO PROMOTE CONSUMER CHOICE IN VIDEO SERVICE PROVIDERS AND TO ESTABLISH UNIFORM TAXES FOR VIDEO PROGRAMMING SERVICES.

The General Assembly of North Carolina enacts:

SECTION 1. Chapter 66 of the General Statutes is amended by adding a new Article to read:

"Article 42.

"State Franchise for Cable Television Service.

"**§ 66-350. Definitions.**

The following definitions apply in this Article:

(1) Cable service. – Defined in G.S. 105-164.3.

(2) Cable system. – Defined in 47 U.S.C. 522.

(3) Commission. – The North Carolina Utilities Commission.

(4) Existing agreement. – A local franchise agreement that was awarded under G.S. 153A-137 or G.S. 160A-319 and is in effect on January 1, 2007.

(5) PEG channel. – A public, educational, or governmental access channel offered by a county or city.

"**§ 66-351. State franchising authority.**

(a) Authority. – The North Carolina Utilities Commission is designated the exclusive franchising authority in this State for cable service provided over a cable system. This designation replaces the authorization to counties and cities in former G.S. 153A-137 and G.S. 160A-319 to award a franchise for cable service. This designation is effective January 1, 2007. After this date, a county or city may not award or renew a franchise for cable service.

(b) Award and Scope. – The Commission is considered to have awarded a franchise to a person who files a notice of service under G.S. 66-352. A franchise for cable service authorizes the holder of the franchise to construct and operate a cable system over public rights of way within the area to be served. Chapter 160A of the General Statutes governs the regulation of public rights-of-way by a city.

§ 66-352. Notice requirements.

(a) Notice of Service. – A person who intends to provide cable service over a cable system in an area must file a notice of service with the Commission before providing the service. The notice must be filed at least 30 days before the service is offered. The notice is effective when it is filed with the Commission. The notice of service must include all of the following:

(1) The applicant's name and principal place of business.
(2) A description and map of the area to be served.
(3) A list of the county and any city in which the described service area is located, in whole or in part.
(4) A schedule indicating when service is expected to be offered in part or all of the service area.

(b) Annual Service Report. – A holder of a State-issued franchise must file an annual service report with the Commission. The report must be filed on or before July 15 of each year. The report must include all of the following:

(1) The effective date of a notice of service for that area.
(2) A description and map of the service area.
(3) The approximate number of households in the service area.
(4) A description and a map of the households passed in the service area as of July 1. A household is passed if service is available to that household regardless of whether the household subscribes to the service.
(5) The percentage of households passed in the service area as of July 1.
(6) The percentage of households passed in the service area as of July 1 of any preceding year for which a report was required under this subsection.
(7) A schedule indicating when service is expected to be offered in part or all of the service area, to the extent the schedule differs from one included in the notice of service or in a report previously submitted under this subsection.

(c) Extension or Withdrawal. – A person who intends to provide cable service over a cable system in an area that is outside the service area described in a notice of service on file with the Commission must file a notice of service that includes the proposed area. A person may withdraw a notice of service by filing a notice of withdrawal with the Commission. The notice of withdrawal must be filed at least 90 days before the service is withdrawn.

(d) General Requirements. – A document filed with the Commission under this section must be signed by an officer or general partner of the person submitting the document. Within five days after a person files a document with the Commission under

this section, the person must send a copy of the document to any county or city included in the service area described in the document. A successor in interest to a person who has filed a notice of service is not required to file another notice of service. When a change in ownership occurs, the owner must file a notice of change in ownership with the Commission within 14 days after the change becomes effective. A document filed under this section is a public record as defined in G.S. 132-1.

"**§ 66-353. Effect on existing local franchise agreement.**

(a) Existing Agreement. – This Article does not affect an existing agreement except as follows:

(1) Effective January 1, 2007, gross revenue used to calculate the payment of the franchise tax imposed by G.S. 153A-154 or G.S. 160A-214 does not include gross receipts from cable service subject to sales tax under G.S. 105-164.4. This exclusion does not otherwise affect the calculation of gross revenue and the payment to counties and cities of franchise tax revenue under existing agreements.

(2) A cable service provider under an existing agreement may terminate the agreement in the following circumstances:

a. When one or more households in the franchise area of the existing agreement are passed by both the cable service provider under the existing agreement and the holder of a State-issued franchise. The annual service report filed by the holder of a State-issued franchise under G.S. 66-352 determines whether the holder passes a household.

b. When the holder of a State-issued franchise for an area included in the franchise service area of the cable service provider's existing agreement does not file an annual service report as required by G.S. 66-352 within 30 days after the required date.

(b) Termination. – To terminate an existing agreement, the provider must file a notice of termination with the affected county or city and file a notice of service with the Commission. The notice of termination must be filed with the affected county or city at least sixty (60) days before the notice of service is filed with the Commission. A termination of an existing agreement must become effective at the end of a calendar quarter. A termination of an existing agreement ends the obligations under the agreement as of the effective date of the termination, but does not affect the rights or liabilities of the county or city, a taxpayer, or another person arising under the existing agreement before the effective date of the termination.

"**§ 66-354. Service standards and requirements.**

(a) Discrimination Prohibited. – A person who provides cable service over a cable system may not deny access to the service to any group of potential residential subscribers within the filed service area because of the race or income of the residents. A violation of this subsection is considered an unfair or deceptive act or practice under G.S. 75-1.1.

(b) FCC Standards. – A person who provides cable service must comply with the customer service requirements in 47 C.F.R. 76.309 and emergency alert requirements

established by the Federal Communications Commission. The Consumer Protection Division of the Attorney General's Office is designated as the State agency to receive customer complaints concerning cable service. The number for the Division must be printed on the customer's bill.

(c) No Build-out. – No build-out requirements apply to a person who provides cable service under a State-issued franchise.

"**§ 66-355. Public, educational, and governmental access channels.**

(a) Application. – This section applies to a person who provides cable service under a State-issued franchise. A person who provides cable service under an existing agreement must comply with the terms of that agreement.

(b) Local Request. – A county or city must make a written request to a cable service provider for PEG channel capacity. The request must include a statement describing the county's or city's plan to operate and program each channel requested. The cable service provider must provide the requested PEG channel capacity within 120 days after it receives the written request.

(c) Initial PEG Channels. – If an area is included in both the franchise area of an existing agreement and the service area of State-issued franchise, the existing agreement determines the required number, placement, and quality of initial PEG channels. The cable service provider must provide the number of PEG channels activated under the existing agreement, giving equivalent placement and quality to those channels. If no existing agreement includes the service area of a State-issued franchise, then the number, placement, and quality of the initial PEG channels a cable service provider must provide depends upon the population of the city in which part or all of the service area is located. If the city's population is at least 50,000, the cable service provider must provide up to three PEG channels on a basic tier. If the city's population is less than 50,000, a cable service provider must provide up to two PEG channels on a basic tier. The quality of these PEG channels must be equivalent to those of the closest city covered by an existing agreement.

(d) Additional PEG Channels. – If a county or city has scheduled programming on all of its initial PEG channels for at least eighty percent (80%) of the time between the hours of 6 a.m. and midnight, then it may make a written request to the cable service provider for access to additional channel capacity. A cable service provider must provide access to one additional channel within 120 days after receiving the request. The additional channel may be provided on any tier of service. The quality of the additional channel must be at least equivalent to the quality of the other channels provided. A cable service provider is not required to provide capacity for more than seven PEG channels, including the initial channels. A county or city may request additional PEG channel capacity until it reaches the maximum allowed under this subsection.

(e) Use of Channels. – If a county or city no longer uses a PEG channel it has activated, the channel may be re-programmed at the cable service provider's discretion. A cable service provider must give at least 60 days notice to a county or city before it re-programs a PEG channel that is not used. The cable service provider must restore a

previously lost PEG channel within 120 days of the date a county or city certifies to the provider a schedule that demonstrates the channel will be used.

(f) Operation of Channels. – The operation and content of a PEG channel is the responsibility of the county or city. A person who provides cable service is only responsible for the transmission of the channel.

A county or city must ensure that all transmissions of content and programming are submitted to the cable provider in a manner or form that is capable of being accepted and transmitted by the provider over its network without further alteration or change in the content or transmission signal. The transmission by the county or city to the cable provider must also be compatible with the technology or protocol utilized by the cable provider to deliver its cable services. A cable service provider is not required to transmit content on a PEG channel that is branded with the logo, name, or other identifying marks of another cable service provider.

(g) Interconnection. – A cable service provider must make a reasonable effort to interconnect its cable system on competitively neutral terms with any cable system operated in the provider's service area in order to provide PEG channel programming. Interconnection may be accomplished by direct cable microwave link, satellite, or other method of connection."

SECTION 2. G.S. 105-164.3 is amended by adding a new subdivision to read:

"**§ 105-164.3. Definitions.**

The following definitions apply in this Article:

...

(50c) Video programming. – Programming provided by, or generally considered comparable to programming provided by, a television broadcast station."

SECTION 3. G.S. 105-164.4(a)(6) reads as rewritten:

"(6) The combined general rate applies to the gross receipts derived from providing ~~any of the following broadcast services~~ video programming to a subscriber in this State. A cable service provider, a direct-to-home satellite service provider, and any other person engaged in the business of providing ~~any of these services~~ video programming is considered a retailer under this ~~Article:~~Article.

~~a. Direct-to-home satellite service.~~

~~b. Cable service.~~"

SECTION 4. G.S. 105-164.4C(d) is recodified as G.S. 105-164.4D with the catchline "Bundled services."

SECTION 5. G.S. 105-164.4D, as recodified by Section 4 of this act, reads as rewritten:

"**§ 105-164.4D. Bundled services.**

~~Bundled Services.~~ When a taxable ~~telecommunications~~ service is bundled with a service that is not taxable, the tax applies to the gross receipts from the taxable service in the bundle as follows:

(1) If the service provider offers all the services in the bundle on an unbundled basis, tax is due on the unbundled price of the taxable service, less the discount resulting from the bundling. The discount for a service as the result of bundling is the proportionate price decrease of the service, determined on the basis of the total unbundled price of all the services in the bundle compared to the bundled price of the services.

(2) If the service provider does not offer one or more of the services in the bundle on an unbundled basis, tax is due on the taxable service based on a reasonable allocation of revenue to that service. If the service provider maintains an account for revenue from a taxable service, the service provider's allocation of revenue to that service for the purpose of determining the tax due on the service must reflect its accounting allocation of revenue to that service."

SECTION 6. The catchline to G.S. 105-164.12B reads as rewritten:

"**§ 105-164.12B. ~~Bundled transactions.~~Tangible personal property bundled with service contract.**"

SECTION 7. G.S. 105-164.44F(a) reads as rewritten:

"(a) Amount. – The Secretary must distribute ~~to the cities~~ part of the taxes imposed by G.S. 105-164.4(a)(4c) on telecommunications service. The Secretary must make the distribution within 75 days after the end of each calendar quarter. The amount the Secretary must distribute is ~~eighteen and three one-hundredths percent (18.03%)~~ the following percentages of the net proceeds of the taxes collected during the ~~quarter,~~ quarter:

(1) Eighteen and three one-hundredths percent (18.03%), minus two million six hundred twenty thousand nine hundred forty-eight dollars ~~($2,620,948).~~($2,620,948), must be distributed to cities in accordance with this section. ~~This~~ The deduction is one-fourth of the annual amount by which the distribution to cities of the gross receipts franchise tax on telephone companies, imposed by former G.S. 105-20, was required to be reduced beginning in fiscal year 1995-96 as a result of the "freeze deduction." ~~The Secretary must distribute the specified percentage of the proceeds, less the "freeze deduction" among the cities in accordance with this section.~~

(2) Five and sixty-three one-hundredths percent (5.63%) must be distributed to counties and cities as provided in G.S. 105-164.44I."

SECTION 8. Article 5 of Chapter 105 of the General Statutes is amended by adding a new section to read:

"**§ 105-164.44I. Distribution of part of sales tax on video programming service and telecommunications service to counties and cities.**

(a) Distribution. – The Secretary must distribute to the counties and cities part of the taxes imposed by G.S. 105-164.4(a)(4c) on telecommunications service and G.S. 105-164.4(a)(6) on video programming service. The Secretary must make the distribution

within 75 days after the end of each calendar quarter. The amount the Secretary must distribute is the sum of the following:

(1) The amount specified in G.S. 105-164.44F(a)(2).

(2) Twenty-three and sixty-six one-hundredths percent (~~23.66%~~ 22.2%) of the net proceeds of the taxes collected during the quarter on video programming, other than on direct-to-home satellite service.

(3) Thirty-seven percent (37%) of the net proceeds of the taxes collected during the quarter on direct-to-home satellite service.

(b) PEG Support. – The Secretary must include the applicable amount of PEG channel support in each quarterly distribution to a county or city. The amount to include is one-fourth of sixteen thousand dollars ($16,000) for each qualifying PEG channel operated by the county or city. The amount of money distributed under this subsection may not exceed two million dollars ($2,000,000) in a calendar year. If the amount to be distributed for qualifying PEG channels in a calendar year would otherwise exceed this maximum amount, the Secretary must proportionately reduce the applicable amount distributable for each PEG channel.

A county or city must certify to the Secretary by January 15 of each year the number of qualifying PEG channels it operates. A qualifying PEG channel is one that has scheduled programming for at least eighty percent (80%) of the time between the hours of 6 a.m. and midnight. A county or city may not receive PEG channel support for more than three qualifying PEG channels.

The money distributed to a county or city under this subsection must be used by it for the operation and support of PEG channels. For purposes of this subsection, the term "PEG channel" has the same meaning as in G.S. 66-350.

(c) Cities Without Local Cable Revenue. – The share of a city that did not impose a cable franchise tax under G.S. 160A-214 before January 1, 2007, is two dollars ($2.00) times the most recent annual population estimate for that city, as certified to the Secretary by the State Budget Officer.

(d) Counties and Cities With Local Cable Revenue. – The share of a county or city that imposed a cable franchise tax under either G.S. 153A-154 or G.S. 160A-214 before January 1, 2007, is its proportionate share of the amount to be distributed to all counties and to all cities eligible to receive a distribution under this subsection. The amount to be distributed under this subsection is the amount determined under subsection (a) of this section, minus the amount distributed under subsections (b) and (c) of this section. A county's and city's proportionate share is the amount of cable franchise tax it received under G.S. 153A-154 or G.S. 160A-214 during the 2005-06 fiscal year plus the amount of a subscriber fee imposed during the 2005-06 fiscal year compared to the amount of cable franchise tax revenue and subscriber fee revenue all counties and cities received in that fiscal year. Each county or city that imposed a franchise tax under G.S. 153A-154 or G.S. 160A-214 must certify to the Secretary by January 15, 2007, the amount of cable franchise tax revenue and subscriber fee revenue it received in the 2005-06 fiscal year.

For subsequent fiscal years, the Secretary must multiply the amount of a county's or city's share under this subsection for the preceding year by the percentage change in its

population for that fiscal year. Each county's or city's proportionate share is its adjusted amount calculated by the Secretary compared to the sum of the adjusted amounts for all counties and cities. For purposes of this adjustment, the population of the county is the population of its unincorporated areas plus the population of a city in the county ineligible to receive a distribution under this section. In making this adjustment, the Secretary must use the most recent annual population estimates certified to the Secretary by the State Budget Officer.

(e) Change in City Structure. – The following changes apply when a city alters its corporate structure:

(1) If a city dissolves and is no longer incorporated, the proportional shares of the remaining counties and cities must be recalculated to adjust for the dissolution of that city.

(2) If two or more cities merge or otherwise consolidate, their proportional shares are combined.

(3) If a city divides into two or more cities, the proportional share of the city that divides is allocated among the new cities on a per capita basis.

(f) Ineligible Cities. – An ineligible city is disregarded for all purposes under this section. A city incorporated on or after January 1, 2000, is not eligible for a distribution under this section unless it meets both of the following requirements:

(1) It is eligible to receive funds under G.S. 136-41.2.

(2) A majority of the mileage of its streets is open to the public.

(g) Nature. – The General Assembly finds that the revenue distributed under this section is local revenue, not a State expenditure, for the purpose of Section 5(3) of Article III of the North Carolina Constitution. Therefore, the Governor may not reduce or withhold the distribution."

SECTION 9. G.S. 105-164.21B is repealed.

SECTION 10. G.S. 153A-137 is repealed.

SECTION 11. G.S. 153A-154 is repealed.

SECTION 12. G.S. 160A-211 reads as rewritten:

"**§ 160A-211. Privilege license taxes.**

(a) Authority. – Except as otherwise provided by law, a city shall have power to levy privilege license taxes on all trades, occupations, professions, businesses, and franchises carried on within the city. A city may levy privilege license taxes on the businesses that were formerly taxed by the State under the following sections of Article 2 of Chapter 105 of the General Statutes only to the extent the sections authorized cities to tax the businesses before the sections were repealed:

G.S. 105-36	Amusements – Manufacturing, selling, leasing, or distributing moving picture films.
G.S. 105-36.1	Amusements – Outdoor theatres.
G.S. 105-37	Amusements – Moving pictures – Admission.
G.S. 105-42	Private detectives and investigators.
G.S. 105-45	Collecting agencies.
G.S. 105-46	Undertakers and retail dealers in coffins.

G.S. 105-50	Pawnbrokers.
G.S. 105-51.1	Alarm systems.
G.S. 105-53	Peddlers, itinerant merchants, and specialty market operators.
G.S. 105-54	Contractors and construction companies.
G.S. 105-55	Installing elevators and automatic sprinkler systems.
G.S. 105-61	Hotels, motels, tourist courts and tourist homes.
G.S. 105-62	Restaurants.
G.S. 105-65	Music machines.
G.S. 105-65.1	Merchandising dispensers and weighing machines.
G.S. 105-66.1	Electronic video games.
G.S. 105-74	Pressing clubs, dry cleaning plants, and hat blockers.
G.S. 105-77	Tobacco warehouses.
G.S. 105-80	Firearms dealers and dealers in other weapons.
G.S. 105-85	Laundries.
G.S. 105-86	Outdoor advertising.
G.S. 105-89	Automobiles, wholesale supply dealers, and service stations.
G.S. 105-89.1	Motorcycle dealers.
G.S. 105-90	Emigrant and employment agents.
G.S. 105-91	Plumbers, heating contractors, and electricians.
G.S. 105-97	Manufacturers of ice cream.
G.S. 105-98	Branch or chain stores.
G.S. 105-99	Wholesale distributors of motor fuels.
G.S. 105-102.1	Certain cooperative associations.
G.S. 105-102.5	General business license.

(b) Barbershop and Salon Restriction. – A privilege license tax levied by a city on a barbershop or a beauty salon may not exceed two dollars and fifty cents ($2.50) for each barber, manicurist, cosmetologist, beautician, or other operator employed in the barbershop or beauty salon.

(c) ~~Piped Gas Restriction.~~ Prohibition.– A city may not ~~levy a privilege license tax on a person who is engaged in the business of supplying piped natural gas and is subject to tax under Article 5E of Chapter 105 of the General Statutes.~~ impose a license, franchise, or privilege tax on a person engaged in any of the businesses listed in this subsection. These businesses are subject to a State tax for which the city receives a share of the tax revenue.

(1) Supplying piped natural gas taxed under Article 5E of Chapter 105 of the General Statutes.

(2) Providing telecommunications service taxed under G.S. 105-164.4(a)(4c).

(3) Providing video programming taxed under G.S. 105-164.4(a)(6).

~~(d) Telecommunications Restriction. A city may not impose a license, franchise, or privilege tax on a company taxed under G.S. 105-164.4(a)(4c).~~"

SECTION 13. G.S. 160A-214 is repealed.

SECTION 14. G.S. 160A-319(a) reads as rewritten:

"(a) A city shall have authority to grant upon reasonable terms franchises for the operation within the city of a telephone system and of any of the enterprises listed in ~~G.S. 160A-311 and for the operation of telephone systems.~~ G.S. 160A-311, except a cable television system. No franchise shall be granted for a period of more than 60 years, except that a franchise for solid waste collection or disposal systems and facilities shall not be granted for a period of more than 30 ~~years and cable television franchises shall not be granted for a period of more than 20~~ years. Except as otherwise provided by law, when a city operates an enterprise, or upon granting a franchise, a city may by ordinance make it unlawful to operate an enterprise without a franchise."

SECTION 15. If any provision of this act or its application is held invalid, the invalidity does not affect other provisions or applications of this act that can be given effect without the invalid provisions or application, and to this end the provisions of this act are severable.

SECTION 16. The Revenue Laws Study Committee shall review the effect Article 42 of Chapter 66, as enacted by this act, has on competition in video programming services and on the deployment of broadband in the State to determine if any changes to the law are needed. The Committee must report its findings to the 2009 Session of the North Carolina General Assembly.

SECTION 17. This act becomes effective January 1, 2007. Sections 7 and 8 of this act apply to the distribution made within 75 days after March 31, 2007, for the quarter starting January 1, 2007.

Taxation of Video Programming

Cindy Avrette
Revenue Laws Study Committee
April 19, 2006

Overview of Committee's Work

- 2005 Budget Act
- December 12th Meeting
  - Convergence of technologies
  - Taxation of services based upon who provides the service rather than the service itself
  - Established goal to provide equity of taxation
- January 11th Meeting
  - Cable, Satellite, Telephone
  - Counties and Cities

Overview of Committee's Work

- March 1st Meeting
  - North Carolina video market
  - Survey to all cities and counties
  - Legislation in other states
- Week of March 6th
  - Staff met with the interested parties separately
  - Cable industry
  - Telephone industry
  - Counties and cities
  - Cable Administrators

Overview of Committee's Work

- March 16
  - Meeting with Sen. Kerr, Rep. Luebke, Sen. Clodfelter, Rep. Carney
  - Established principles and goals
- Series of meetings with interested parties
  - March 22nd
  - March 28th
  - April 4th
  - April 11th

Principles

- Equal taxation of the same service
- Tax system that is easy to administer
- Tax and regulatory system that do not impede competition
- Equal compensation to cities for use of rights of way
- PEG channels serve public purpose and should be supported

Goals

- Apply principles
- No tax or fee increase
- Preserve local government revenue stream
- Promote competition in marketplace
- Promote deployment of broadband as a basic communication tool

Equal Taxation of Same Service Tax System Easy to Administer

- Define 'video programming' to include all programming comparable to television broadcast, regardless of provider
- Apply existing 7% State sales tax to video programming service
- Repeal local authority to impose local franchise tax
- Repeal the credit allowed to cable companies for local franchise tax paid

Preserve Local Gov't Revenue Stream Equal Percentage Compensation

- Tax revenue from telecommunications and video programming – 23.66%
- Give locals the 2.5% share of satellite TV – treat the same as satellite radio
- Distribution of video programming revenues based on the amount of cable franchise tax received in 2005-06 PLUS any subscriber fees received in 2005-06
- Annual distribution adjusted for pop. growth

Promote Competition Encourage Broadband Deployment

- Federal law requires franchising of cable service
- NC law provided franchising through locally negotiated contracts
- **Proposal would provide State franchise**
  - **Notice filing with Utilities Commission**
  - **Repeals local authority to award or renew local franchises**
  - **Other states**
  - **Federal legislation**

Competitive Neutrality

- Existing local agreements cannot be renewed
- Opt-out provision for cable service providers under existing local agreements
  - When one or more households in the franchise area are passed by both the existing provider and the holder of a State-issued franchise
  - When the holder of a State-issued franchise for an area included in the existing provider's franchise are fails to file an annual service report

Anti-Discrimination

- Federal law provides that access to cable service cannot be denied to residents based on income
- Local agreements used 'build out'
- Is build out necessary in a competitive market?
- Surrounding states not requiring build out
- **Proposal does not require build out**

Anti-Discrimination

- **Proposal addresses issue differently than locally negotiated contracts**
  - Notice of Filing must include a schedule indicating when service is expected to be offered
  - Annual Service Reports must include information on the percentage of households in the service area 'passed', as well as a description and map
  - Legislation specifically prohibits discrimination based on income or race
  - Violation of law declared an unfair or deceptive trade practice under G.S. 75-1.1

Service Standards

- Holder of State-issued franchise must comply with customer service requirements established by the FCC
- Holder of State-issued franchise must comply with emergency alert requirements established by the FCC
- Consumer Protection Division of the AG's Office designated to receive customer complaints – Number printed on bill

PEG Channels

- Provides up to $2 million for PEG support
  - Portion of video programming sales tax revenue
  - $16,000 a year for qualifying PEG channel
- Includes per subscriber revenue in distribution base
- Existing franchise agreement determines number, placement, and quality of channels
- If no existing agreement
  - Number of PEG channels based on population
  - Initial channels must be on basic tier
- Additional PEG channels (up to 7)
- No minimum qualifications on use

Other Local Government Concerns

- Local regulation of rights-of-way preserved
- Copies of all documents filed with Utilities Commission must be sent to affected counties and cities within 5 days of filing
- Finding that the video programming sales tax revenue distributed to counties and cities is a local revenue, not a State expenditure.

Revenue Laws Study Committee

- Directed to review the effects of these law changes on competition in video programming service
- Directed to determine if any changes to the law are needed
- Report its findings to the 2009 Session of the General Assembly

Revenue Laws Study Committee

Cable Franchise Survey Summary

April 19, 2006

Summary of Cable Franchise Survey

The following statistics are taken from a survey of 272 North Carolina local governments regarding their franchise fee collections and other nonmonetary contributions received in accordance with their cable franchise agreement or agreements. The survey was conducted by the North Carolina General Assembly Fiscal Research Division. A total of 161 local governments responded to the survey.

Type of Respondent	Number surveyed	Number responded	Percent
Municipalities	172	109	63.4%
Counties	100	52	52.0%

The municipality-to-county ratio in the following survey data is:

Type of respondent	Number of respondents	Percent of total
Cities or towns	109	67.7%
Counties	52	32.3%
Total	161	100%

The purpose of this document is to summarize the survey's findings. The survey requested actual franchise fee collections for fiscal years 2004 and 2005. This data is reported separately in Appendix A.

Franchise Agreements & Fees

- One hundred and fourteen survey respondents (70.8%) negotiated their current franchise agreement or agreements independent of other local governments.[1]
- The majority of responding local governments (75.8%) assess franchise fees at the rate of 5% of gross revenues. (Please see Appendix B for detail on the assessment of franchise fees.)

Network Infrastructure and Other Equipment

- Twenty respondents (12.4%) indicated they receive some network infrastructure from their cable operator or operators.[2]
- Twenty-one respondents (13.1%) indicated they receive equipment for PEG programming from their cable operator or operators. In addition, four respondents (2.5%) indicated they receive some computer hardware or software related to PEG programming. Four respondents (2.5%) also indicated they receive a PEG studio from their cable operator.[3]
- Eleven respondents (6.8%) indicated they receive some other form of capital from their cable operators.

Public, Educational, and Governmental (PEG) Channels

- More than half (50.9%) of respondents indicated they receive PEG channels from their cable operator.[4]
- The number of channels provided by cable operators ranged from 1 to 6 per local government. The chart below shows that the majority of local governments receiving PEG channels are allotted 3 or less by their cable operator.

Number of PEG channels provided	Number of responding local governments	Percent of total
1	44	57.9%
2	12	15.8%
3	11	14.5%
4	5	6.6%
5	1	1.3%
6	3	3.9%
Total	***76***	***100%***

- Twenty-eight survey respondents indicated how many of their allotted PEG channels are currently in use. Their responses ranged from all in use (100%) to none (0%). Unfortunately, too few respondents offered data on how many PEGs are currently in use to generalize these findings to North Carolina local governments in general.[5]

Broadband Internet Service

- Only seven respondents (4.3%) indicated they receive broadband internet service from their cable operator as part of their franchise agreement. Most of those who receive service indicated that it is provided in the public schools.[6]

Basic Cable Service

- Seventy-one respondents (44.1%) receive basic cable service free of charge in some or all government-owned buildings.[7] Of those local governments that receive basic cable service:
    - Forty-one respondents (25.5%) receive free basic cable service in all government-owned buildings[8]
    - Fifty-six respondents (34.8%) receive free basic cable service in all administrative buildings[9]
    - Forty-six respondents (28.6%) receive free basic cable service in all public schools[10]
    - Thirty-six respondents (22.4%) receive free basic cable service in all public libraries[11]

Competition

- Although this survey was not designed to study competition within the cable industry in North Carolina, respondents were asked to indicate if they held more than one current cable franchise agreement with separate operators.
    - Twenty-four local governments surveyed (14.9% of respondents) hold cable franchise agreements with more than one cable operator in their area
    - One hundred and thirty-two local government surveyed (82.0%) hold only one cable franchise with one cable operator
    - Five local governments (3.1%) did not respond to the question
- Respondents were also asked to estimate what percent of households in their franchise area are able to obtain cable television service from more than one cable operator. Out of the twenty-four local governments with multiple franchises, twenty (or 83.3%) responded to this question.
    - Of those twenty local governments, eleven (or 45.8%) indicated that the multiple cable operators in their area do not serve the same areas, so in effect the "overlap" of cable operators' service areas was 0.0%.
    - The remaining thirteen local governments (or 54.2%) indicated that 1.0% to 60.0% of households in their area have access to service from more than one cable operator.

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[1] 24.2% of survey respondents negotiated their current franchise agreement or agreements in partnership with other local governments (5% did not respond to this question).

[2] 57.8% indicated that they do not receive any network infrastructure from their cable operator (29.8% did not respond)

[3] 55% of respondents indicated they do not receive any PEG-related equipment from their cable operator (31.9% did not respond). 42.2% of respondents indicated they do not receive computer hardware or software (55.3% did not respond), and 41.6% indicated they do not receive a PEG studio (55.9% did not respond).

[4] 29.2% indicated they do not receive PEG channels (19.9% did not respond).

[5] Twenty-seven local governments indicated how many of their allotted PEG channels are in use, but eight of the 27 are urban centers that have both a higher number of PEG channels than their less urban counterparts and also tend to utilize them differently. For example, the city of Raleigh has been allocated 5 PEG channels, but currently only uses 3, or 60%. In contrast, the cities of Elkin and Davidson each receive 1 PEG channel, which they indicated is used (100%). Using averages regardless of population size would result in overestimation of PEG use by urban areas and underestimation of their use in more rural areas.

[6] A few (less than five) respondents indicated they receive a "VPN discount" equal to 20% off the retail price of broadband service. These responses were not included in the broadband totals for the survey since they were understood to constitute something other than the provision of broadband service *free of charge*.

[7] 26.7% do not receive basic cable service free of charge (29.2% did not respond).

[8] 74.5% did not respond.

[9] For purposes of this survey, "administrative buildings" include city halls, town administrative buildings, public utilities facilities, and police and fire departments (65.2% did not respond).

[10] 71.4% did not respond

[11] 77.6% did not respond

Appendix A

County Cable Franchise Revenues		
	FY 03-04	**FY 04-05**
Alamance County	158,287	164,821
Alexander County	97,392	99,765
Anson County	27,003	28,658
Ashe County	100	-
Bertie County	12,867	13,597
Buncombe County	1,082,921	1,112,675
Burke County	266,853	260,199
Cabarrus County	392,977	452,437
Camden County	41,844	45,978
Caswell County	19,187	11,391
Catawba County	577,509	573,138
Chatham County	98,000	115,000
Chowan County	19,731	19,551
Craven County	150,000	150,000
Dare County	-	-
Davidson County	724,830	896,534
Duplin County	24,684	20,525
Forsyth County	620,892	715,111
Franklin County	101,712	75,393
Gates County	2,645	2,283
Graham County	90,578	98,670
Guilford County	506,090	520,014
Harnett County	165,456	169,336
Haywood County	285,865	284,196
Johnston County	153,113	150,536
Jones County	-	-
Lee County	189,949	194,335
Macon County	76,941	71,794
Mecklenberg County	426,356	468,957
Montgomery County	16,992	17,643
Moore County	112,961	186,848
Onslow County	389,051	435,013
Orange County	214,991	247,065
Pender County	194,656	216,748
Person County	68,668	69,024
Pitt County	253,149	281,452
Polk County	17,570	18,878
Randolph County	213,194	217,819
Robeson County	159,821	246,428
Rockingham County	207,266	208,965
Stokes County	118,771	118,755
Surry County	251,000	215,000
Transylvania County	100	100
Tyrrell County	1,496	-
Warren County	7,307	7,416
Washington County	11,878	11,794
Watauga County	142,678	148,116
Wayne County	377,133	438,185
Wilson County	57,900	68,853
Yadkin County	100,013	100,675
Lenoir County	100,610	120,109
Total, all responding counties:	**$ 9,330,987**	**$ 10,089,780**

Estimated total NC county cable franchise revenues (based on FY04-05)	**$ 19,389,072**

Appendix A

Municipal Cable Franchise Revenues

	FY 03-04	FY 04-05
Archdale	88,367	95,777
Asheboro	123,800	128,777
Asheville	784,115	801,623
Aulander	8,769	-
Aurora	4,725	4,904
Autryville	2,381	2,425
Bald Head Island	17,488	19,010
Benson	21,864	28,524
Benson	28,524	21,864
Biscoe	4,246	4,463
Bladenboro	11,500	13,029
Boiling Spring Lakes	18,133	21,016
Bolivia	-	-
Bridgeton	2,188	2,241
Burlington	353,320	368,880
Calabash	-	-
Cary	1,152,212	975,028
Caswell Beach	4,995	5,410
Chapel Hill	297,888	293,993
Charlotte	5,586,079	6,110,881
Clayton	77,702	95,414
Columbia	5,630	5,606
Concord	431,884	395,717
Conetoe	1,350	1,392
Conway	121,519	117,446
Cornelius	-	-
Davidson	240,505	251,339
Eden	134,924	146,827
Elizabethtown	32,345	37,060
Elkin	30,196	31,188
Elon	52,248	59,240
Erwin	18,633	18,509
Farmville	32,569	36,076
Fletcher	53,202	59,737
Gaston	11,369	12,299
Gastonia	516,455	561,221
Gibsonville	39,879	41,976
Goldsboro	247,875	275,402

	FY 03-04	FY 04-05
Goldston	865	944
Havelock	98,991	107,758
Haw River	13,780	13,616
Hendersonville	41,962	33,947
High Point	778,281	829,394
Highlands	38,800	31,978
Holden Beach	29,579	33,310
Jamestown	32,988	37,205
Jamesville	.	2,537
Jefferson	11,225	10,947
King	45,122	38,034
Lansing	-	-
Leland	-	-
Lewiston Woodville	2,675	2,495
Lexington	148,184	162,848
Liberty	15,792	16,612
Littleton	13,049	12,354
Madison	21,372	23,622
Marion	42,502	43,545
Matthews	301,123	377,486
Maxton	16,239	15,887
Mayodan	24,884	25,471
Mebane	39,808	43,881
Middlesex	716	-
Mocksville	27,294	25,629
Morganton	115,493	145,100
Mount Airy	48,219	46,798
Murphy	11,291	11,526
New Bern	214,040	228,868
Northwest	56	56
Oak Ridge	-	-
Orrum	-	-
Pantego	-	-
Polkton	-	1,054
Powellsville	5,102	5,271
Raeford	28,773	32,736
Raleigh	3,270,199	3,621,342
Ramseur	11,050	11,358

	FY 03-04	FY 04-05
Randleman	23,081	27,101
Reidsville	121,293	130,936
Roanoke Rapids	176,529	177,383
Rocky Mount	483,383	471,702
Roxboro	59,011	48,712
Roxobel	1,301	1,195
Rural Hall	17,387	21,738
Rutherfordton	33,992	34,214
Shallotte	-	-
Siler City	35,352	35,723
Southern Pines	146,522	138,132
Southport	23,903	37,495
Sparta	2,604	2,872
Stokesdale	-	-
Summerfield	-	-
Sunset Beach	-	-
Swansboro	9,087	10,230
Tar Heel	428	514
Tarboro	90,229	96,249
Taylorsville	34,863	34,235
Trent Woods	22,800	24,000
Troy	15,652	13,511
Vass	7,219	2,781
Wadesboro	15,000	27,746
Wake Forest	137,956	179,331
Washington Park	2,587	2,769
White Lake	18,129	20,328
Whiteville	56,540	50,281
Wilmington	1,012,035	1,230,419
Wilson	369,719	413,855
Windsor	17,601	-
Winston-Salem	1,885,092	1,862,247
Yadkinville	29,706	32,677
Yanceyville	15,722	15,034
Total, all responding municipalities:	**$ 20,873,056**	**$ 22,181,313**

Estimated total NC municipal cable franchise revenues (based on 04-05)	**$ 41,483,686**

Appendix B

Fee rate	Number of Responses	Percent	Cumulative Percent
5% of gross revenues	122	75.8%	75.8%
3% of gross revenues	21	13.0%	88.8%
Fixed annual payment	4	2.5%	91.3%
4% of gross revenues	1	0.6%	91.9%
Different rates for different cable providers	1	0.6%	92.5%
Other	1	0.6%	93.2%
No response	11	6.8%	100.0%

Appendix C

Assumptions and Methodology

Sampling

The State of North Carolina has one hundred counties and more than five hundred municipalities, most of which hold independent cable franchise agreements with one or more cable operators according to records maintained by the Federal Communications Commission. Since the primary purpose of this survey was to obtain local governments' actual cable franchise revenue collections for the purpose of estimating the cable industry's current sales tax credit for franchise fees paid, all one hundred North Carolina counties were surveyed, as well as all North Carolina municipalities with populations greater than 25,000. In the interests of keeping the survey at a manageable size considering the time window for completion, a modified random sample was taken of all North Carolina municipalities with populations under 25,000.

Sampling Issues

This survey was designed with the input of both partisan and nonpartisan General Assembly staff. Although the researcher initially suggested taking a stratified random sample of North Carolina municipalities with populations under 25,000 that were on the FCC list of franchised areas, partisan staff wished to develop a more specific, targeted list of communities to survey. In conjunction with the researcher, partisan support staff developed a list of local governments under franchise that they believe to more accurately reflect the current state of areas under cable franchise in North Carolina. In support of this effort, partisan support staff spoke with approximately fifteen local cable operators who indicated, for example, which rural areas in North Carolina receive service under a county-wide cable franchise agreement, which areas are in effect served by only one cable operator due to bankruptcy proceedings against another currently franchised cable operator, and other, similarly extenuating circumstances. Based on this information, the researcher and partisan staff generated a survey distribution list of approximately 160 North Carolina local governments with populations under 25,000.

Survey Instrument

Local governments had the option of responding via a web-based survey client or via mail. Approximately 43% of respondents chose to reply to the survey online, while the remaining 57% chose mail.

The survey consisted of a mix of single-answer and open field questions. The open field questions asked respondents to list nonmonetary benefits or contributions from their franchised cable operator by type. These types were grouped into three broad categories (capital, services, and other), which were then subdivided into more specific subcategories (network infrastructure, equipment, broadband service, PEG support, etc.). Open fields were used because Fiscal Research Division staff did not have reliable, detailed information on which to base assumptions about what local governments receive, other than franchise fee revenues, as part of their cable franchise agreements.

Data Analysis

The data from the survey was analyzed in two parts; the first was a revenue estimate based on survey respondents' data regarding cable franchise fee collections, and the second was an analysis of the frequency of certain types of nonmonetary contributions received by local governments from local cable operators as part of their franchise agreements.

Part I: Revenue Estimate

Financial data provided by survey respondents was separated into city data and county data.[1] The data was then further subdivided by population size. For county data, respondents were sorted into three groups: counties with populations of 4,000 to 25,000; counties with populations of 25,001 to 45,000; and counties with populations greater than 45,001. City data was subdivided in a similar way: cities with populations of less than 1,000; cities with populations of 1,001 to 4,000; cities with populations of 4,001 to 10,000; and cities with populations of 10,001 to 25,000.[2] Survey data on franchise fee rates[3] were used to derive 1% of annual revenues for each local government. Using population estimates,[4] a 1% revenue per capita figure was derived for each respondent. These per capita numbers were averaged by groups based on population size, and the resulting average was applied to corresponding non-responding and non-surveyed local governments. The total of both responding local governments and estimated non-respondents and non-surveyed local governments was approximately $60.9 million, which is assumed to be both the approximate value of all cable franchise fees collected by North Carolina local governments and the approximate value of the tax credit cable companies are allowed to claim against their North Carolina sales tax liability under current state law.

Part II: Analysis of Nonmonetary Contributions to Local Governments

Survey respondents were asked to provide detail on nonmonetary contributions provided to their local government by local cable operators as part of their cable franchise agreement.

Open field responses in most categories were consistent enough to be converted into numeric codes for analysis; for example, a large number of respondents specifically indicated that they receive basic cable service free of charge in one or more government

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[1] Since a small number of population-dense cities and counties generate the largest portion of cable franchise fee revenues (nearly 50% of total), actual collections numbers for nonresponding urban cities and counties were obtained from their 2004-05 CAFRs or directly from the local government's finance office for the purposes of the final cable franchise fee revenue estimate.

[2] Survey data was used only to extrapolate estimates for nonresponding or non-surveyed cities with populations under 25,000. Actual revenues were used for all cities over 25,000.

[3] Most responding local governments assess franchise fees at 5% of gross revenues, with exceptions. Some local governments assess fees at 3% of gross revenues, others take lump sum annual fee payments from cable operators, and a few respondents have other arrangements. This projection accounts for variations in fee rate among respondents; therefore, the researcher has confidence that the estimates for 1% of revenue per local government are sound.

[4] 2004 U.S. Census population estimates for North Carolina municipalities were used for cities, and the North Carolina State Data Center's 2004 estimated non-municipal county population estimates were used to derive per capita figures for counties.

buildings even though that question was not posed by the survey instrument. In that case, the information given was broken down into component parts (receives or does not receive free basic cable service, receives service in all government-owned buildings, receives service in public schools, number of buildings by type if given, etc.) which were numerically coded for analysis.

Since legislators and legislative staff are the intended audience for this survey, a simple frequency analysis was presented for all major variables. Correlations run on major variables yielded several statistically significant relationships between provision of certain nonmonetary capital or services by cable operators, but several of those relationships were due to a high number of nonrespondents to those questions. Several relationships that did not exhibit that particular problem withstood some further exploration, but linear regression[5] revealed only that there is a possible causal relationship between the provision of PEG channels and free basic cable service. This stands to reason since it is not uncommon for a local cable provider to establish cable service in public buildings partly so that public meetings may be broadcast over the PEG channel (or channels). However, this finding is not of particular interest to the intended audience for the survey since many of them already know about the practice, so it was omitted from the summary statement at the beginning of this report.

[5] Linear regression of the variable for provision of PEG channels (dependent) and provision of basic cable service (independent) yielded a model that was statistically significant at the .001 level.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 19, 2006

TO: Revenue Laws Study Committee

FROM: Brenna Erford
Fiscal Research Division

RE: Consumer Choice in Cable and Uniform Taxation of Video Programming Services

FISCAL IMPACT

	Yes (X)	No ( )	No Estimate Available ( )		
	FY 2006-07	**FY 2007-08**	**FY 2008-09**	**FY 2009-10**	**FY 2010-11**
REVENUES:					
General Fund	**No Impact to General Fund**				
Local governments	**Possible net gain up to $4.0 million; see Assumptions & Methodology**				
EXPENDITURES:	**See Assumptions & Methodology**				
POSITIONS (cumulative):	**See Assumptions & Methodology**				

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: NC Department of Revenue, NC Utilities Commission, local governments

EFFECTIVE DATE: January 1, 2007

BILL SUMMARY: The Consumer Choice in Cable and Uniform Taxation of Video Programming Services Act:

- Establishes a statewide video service franchising process;
- Makes changes to the regulatory treatment of existing local cable franchises;
- Eliminates local governments' authority to assess and collect cable franchise fees;

- Replaces local revenues from franchise fees with a new distribution of shared sales tax collections from telecommunications, cable service, and satellite television service;
- Removes the state tax credit for franchise fees paid to local governments;
- Provides for a proportional tax distribution to local governments based on previous revenues from cable, including franchise fees and per subscriber charges;
- Provides for public, educational, and governmental (PEG) channel funding;
- Designates the North Carolina Utilities Commission as the agency responsible for administering statewide video service franchises and consumer complaints.

This bill does not raise taxes on cable service, telecommunications, or home satellite television services. All these services remain subject to the general shared sales tax rate of 7%. However, this bill significantly alters the calculation of the local share of shared sales tax and creates an entirely new distribution method for the local share of shared sales tax collections. The bill does three things that significantly alter the composition of the local share:

- Local governments will no longer be able to assess and collect cable franchise fees. This revenue will be replaced by the local distribution scheme set forth in the bill. Under this proposal, local governments will receive a portion of sales tax collections from cable service equal to 22.2%, an increased portion of the existing telecommunications sales tax, and a share of sales tax collections on satellite television service.
- The tax credit equal to the amount of franchise fees paid to local governments created in 2005 is eliminated.
- Local governments will effectively receive a larger portion of state sales tax collections on telecommunications. This new portion will be equal to 22.2% of total sales tax collections for telecommunications less the local share already received pursuant to G.S. 105-164.44F.
- Local governments will be granted a share of sales tax collections from home satellite television service equal to 2.5% of the 7% general sales tax, or approximately 37% of sales tax collections.

ASSUMPTIONS AND METHODOLOGY: Fiscal Research estimates that all North Carolina local governments will be effectively be held harmless by this change, and that some local governments may even see slightly higher revenues. The sum of the local shares of these three industries (approximately $65.3 million) is estimated to slightly exceed actual aggregate local collections of cable franchise fees.

During the 2005 session, cable service, telecommunications, and home satellite television service were brought under the general state sales tax rate of 7%.

Current Law and Estimated Tax Collections by Industry

The chart below shows estimated total sales tax collections for cable service, telecommunications, and home satellite television service for FY 2005-06. These amounts have been adjusted to reflect the 2005 rate changes. The municipal share amount shows the amount received or collected by local governments under current law.

Estimated Sales Tax Collections by Industry and State/Local Share under Current Law			
	2005-06 Adjusted		
	Net collections	State share	Local share*
Telecommunications sales tax	445,050,000	375,291,277	69,758,723
Cable service**	91,350,000	26,100,000	65,250,000
Satellite	43,220,000	43,220,000	N/A
Total, all industries	579,620,000	436,748,433	142,871,567

*Local share reflects 18.03% of total telecommunications sales tax less the "freeze deduction" as required in G.S. 105-164.44F

**Net collections for cable have been estimated from municipal share. The local share ($65.3 million) reflects estimated total cable revenues collected directly by local governments, not by the state.

- For telecommunications, the $69.8 million local share is the 18.03% of telecommunications sales tax distributed to locals under G.S. 105-164.44F. This portion of the local share is not altered by this legislation.
- For cable service, the local share shown ($65.3 million) is the estimated amount of cable revenues assessed and collected by local governments in 2005. Currently this money is collected directly by local governments, largely in the form of cable franchise fees. Under federal law, local government units can assess up to a 5% franchise fee on a locally negotiated definition of gross revenues. This is also the estimated amount of the cable tax credit.
- Sales tax collections from home satellite television service are not currently shared with local governments.

The following sections outline the change in calculation of the local share of cable, telecommunications, and satellite sales tax collections as well as the change in distribution to local governments as it pertains to each industry.

Telecommunications

In 2005, the tax on telecommunications was increased from 6.0% to the general sales tax rate of 7.0%. The change was effective Oct. 1, 2005. Under G.S. 105-164.44F local governments receive a per capita distribution of 18.03% of sales tax collections on telecommunications service less a "freeze deduction" of $2,620,948 on a quarterly basis. This legislation does not alter this portion of the local government share of sales tax on telecommunications. Under this bill, local governments will continue to receive a distribution of total sales tax collections on telecommunications pursuant to G.S. 105-164.44F, plus an additional share of collections equal to 22.2% of gross sales tax collections on telecommunications less the amount distributed under that section. This additional share of collections is estimated at $29.0 million based on 2005-06 estimated collections.

Cable Service

Effective January 1, 2006, the general sales tax rate of 7% was applied to cable service, which had previously only been taxed at the local level. Taxpayers also receive an approximate 5% credit against this tax for local cable franchise taxes paid,[1] which is removed by the bill.

At this time, the two months of collections data available for this tax expenditure are not sufficient to estimate the credit's actual cost, so this memo assumes an estimated $65 million for the cost of the cable tax credit.[2] However, survey research conducted by the Fiscal Research Division suggests that the actual amount of cable franchise fees collected by North Carolina local governments is approximately $61 million, which suggests that local governments may gain up to $4 million in new money from this legislation.

The local share of cable sales tax collections under the distribution established by this bill is estimated at $20.3 million based on 2005-06 estimated collections.

Satellite

The tax on home satellite television service was increased from 5.0% to 7.0% effective Oct. 1, 2005. Currently, all collections of this tax go to the General Fund. Under this legislation, 37% (or 2.5% of the 7.0% general sales tax rate) of satellite tax collections would be shared with local governments.

Based on early Department of Revenue data, satellite tax collections are exhibiting a rapid rate of growth, especially in relation to collections from cable service. This estimate for satellite uses a conservative annual growth rate of 8%.

Fiscal Research estimates that sales tax collections for satellite will be approximately $43.2 million for FY 2005-06. The 37% local share would be $16.0 million based on 2005-06 estimated collections.

Proposed Local Share of Sales Tax Collections by Industry

The chart below illustrates the local share of sales tax collections by industry. **This local share calculation is intended to hold local governments whole with the elimination of local franchise fees and to supply local governments with funds for PEG channel support.** The $65.3 million local share calculated through this distribution equals the estimated 2005 cable franchise fee revenues that would be foregone under this legislation.

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[1] Federal law caps local franchise taxes at 5% of gross revenues, suggesting 2% of the 7% state sales tax goes to the state. Fiscal Research Division survey research suggests that not all North Carolina local governments with cable franchises assess franchise fees at the maximum 5% rate, and that the actual value of the tax credit may be somewhat less than 5% of cable's total sales tax liability.

[2] The cost of the cable tax credit was estimated at $65 million in the 2005 Tax Expenditure Report published by the North Carolina Department of Revenue

Proposed Local Share of Sales Tax Collections by Industry	
2005-06 Adjusted	
Industry	Local share
Telecommunications***	29,042,377
Cable	20,279,700
Subtotal	*49,322,077*
Satellite	15,991,400
Total	**65,313,477**

***Telecommunications local share was computed by taking 22.2% of net telecommunications ($105.3 million) and subtracting $77.6 million of local share from G.S. 105-164.44F

Distribution of Sales Tax to Local Governments

Under this bill, the combined 22.2% of state sales tax collections on cable service and telecommunications plus 37% of sales tax collections on home satellite television service would be distributed to North Carolina local governments on a proportional basis. The proportionate share for each local government is calculated by dividing its actual 2005 revenues from cable services, including actual franchise fee collections and any per subscriber charges for PEG support, by the total of all 2005 local government cable revenues. In subsequent years, the proportionate share for each municipality will be recalculated to reflect per capita growth. The distribution would be effective January 1, 2006.

Based on available data, Fiscal Research believes that under this distribution scheme no municipality will receive less revenue than they would without this legislation, and some may actually realize small gains.

PEG Support

The bill allows local governments that operate PEG channels providing local programming to collect $16,000 per channel, up to 3 channels, per year in the form of four quarterly installments of $4,000. **These funds are to be deducted from the total local share of sales tax collections before the local distribution formula is applied.** The bill caps the amount of annual PEG support to local governments at $2 million. At this time, Fiscal Research does not have data needed to accurately estimate the impact of this provision.

Franchise Administration and Consumer Issues

The North Carolina Utilities Commission is named as the agency responsible for administering cable franchises and addressing consumer issues. At this time, the Utilities Commission has not indicated a need for additional staff or appropriations to meet these demands.

Conclusion

The chart below contrasts current law with the proposed tax changes in this bill and illustrates how the total shared sales tax revenue to both the state and local governments is held the same.

Comparison of State and Local Share under Current and Proposed Law						
	(in millions)					
	Current law		Proposed		Change	
	State	Local	State	Local	State	Local
Telecommunications	375.3	69.8	346.3	98.8	(29.0)	29.0
Cable service	26.1	65.3	71.1	20.3	45.0	(45.0)
Satellite	43.2	-	27.2	16.0	(16.0)	16.0
Total	**444.6**	**135.1**	**444.6**	**135.1**	-	-

SOURCES OF DATA: North Carolina Department of Revenue, North Carolina Fiscal Research Division, North Carolina State Data Center, Federal Communications Commission, U.S. Census Bureau, North Carolina Utilities Commission

TECHNICAL CONSIDERATIONS: None

PUBLIC COMMENTS REGISTRATION SHEET
April 19, 2006

THERE IS A TWO MINUTE TIME LIMIT IN ORDER TO ACCOMMODATE EVERYONE WHO WISHES TO SPEAK

NAME	FIRM OR AGENCY AND ADDRESS
Connie Ledoux Book, PhD	Dept. Chair, School of Communications, Elon
Manzoor Cheema	The People's Channel, Chapel Hill
Kathy Hartkopf	N C Freedom Works
Chad Johnston	The People's Channel, Chapel Hill
Joyce Krawiec	
Erroll Reese	
Al Ripley	Justice Center
Eugene Weeks	
Marcos Zarate	
Doris Boris	Charlotte-Mecklenburg and SouthEast Assn. of Telecommunications Officers & Advisors
Randy Fraser	Time Warner

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PUBLIC COMMENTS REGISTRATION SHEET
April 19, 2006

THERE IS A TWO MINUTE TIME LIMIT IN ORDER TO ACCOMMODATE EVERYONE WHO WISHES TO SPEAK

NAME	FIRM OR AGENCY AND ADDRESS
~~Paul Meyers~~ Rebecca Troutman	~~Counsel~~, NC Assn. of County Commissioners
Andy Romanet	Counsel, NC League of Municipalities
Krista Tillman	President, BellSouth NC Operations
Michael Williams	Cable Administrator, City of Raleigh
Drew Wofford	community TV producer
Lynn Connelly	FreedomWorks NC
Jarvis Hall	NC-NAACP
Phaedra Phaedra Kelly	The Arts Center in Carrboro
~~Doris Bass~~	~~Charlotte-Mecklenburg Cable Administrator~~
~~Joyce Krawiec~~	~~Freedom Works NC~~
~~Alfred Ripley~~	N.C. Justice Center
Rob Thompson	N.C. PIRG.
Bill Wilson	N.C. AARP
~~Eugene Weeks~~	~~Raleigh~~ community Activist
~~Connie Book~~	Elon University

3

PUBLIC COMMENTS REGISTRATION SHEET
April 19, 2006

THERE IS A TWO MINUTE TIME LIMIT IN ORDER TO ACCOMMODATE EVERYONE WHO WISHES TO SPEAK

NAME	FIRM OR AGENCY AND ADDRESS
Bill Nichols	Citizen
Hart Pillow	Citizen
John Crane	✓
~~Wade Hargrove~~	~~NCCTA~~

4

PUBLIC COMMENTS REGISTRATION SHEET
April 19, 2006

THERE IS A TWO MINUTE TIME LIMIT IN ORDER TO ACCOMMODATE EVERYONE WHO WISHES TO SPEAK

NAME	FIRM OR AGENCY AND ADDRESS
DON YELTON	CITIZEN 221 JUPITER ROAD Weaverville, NC 28787
ROBERT GWYN	CITIZEN 750 Weaver Dairy Rd Chapel Hill, NC
VIMALA RAJENDRAN	CITIZEN 105 Lexington Rd Chapel Hill
Lisa Beinar	SECURE Action Audits 101 [illegible] Cary, NC 27513
~~Randy Fraser~~	
DAVID KASPER	THE PEOPLES CHANNEL
Patricia Boyd	

ELON UNIVERSITY

SCHOOL OF
COMMUNICATIONS

April 26, 2006

Dear Revenue Laws Committee Members,

This letter is response to the study, *Cable Survey Overview & Tax Distribution*, presented during the April 19, 2006 meeting of the committee. This study, conducted by the fiscal research division, offers data collected on the local municipal franchising process in North Carolina.

I want to strongly caution the committee's use of this data for the following reasons:

The data collected represents a 59% response rate, reflecting 52 counties and 109 municipalities. However, the analysis of data does not reflect the population of each of these responding communities and therefore, does not accurately reflect the tax impact of a statewide franchising system in these areas.

For example, on slide 5, the network infrastructure provided by the cable company to communities is described as *only* available in 12% of responding communities. We don't know the population of these communities and therefore the use of the word "only" is inappropriate. What if all 12% of active network infrastructures fall in the state's metropolitan areas? I know one of the communities that receive network infrastructure support is Guilford County. The network provides, for example, internet services to public schools, data monitoring for street lights and connects municipal buildings. These services would become pay services if the state's cable franchising bill is passed. That pay service would likely have an annual charge in excess of $2,000,000 dollars, creating significant funding issues for that local government.

The same observation is true for the 13% that receive PEG equipment as part of their franchise agreement. In Raleigh, the public access equipment inventory is significant, more than a $1,000,000. If Raleigh is one of the 13% of respondents, and I expect it was, this again is a future pay service under the state cable franchise bill.

The data on the following slides regarding number of PEG channels, also leaves one wondering, what services are provided on the channels where communities receive more than 3 channels. I suspect it is in our largest communities where, for example, cable networks might be used to provide public safety training channels on closed networks to fire houses and police substations. What is the price tag when these become pay services under the new state cable franchise and create funding issues for local cities and counties?

The "broadband internet service" should be considered with network services and the VPN data the researcher did not include, should be included. VPN is an acronym for Virtual Private Network. This is a network configuration that would become a pay service under the state cable franchise.

Basic cable and internet services to public facilities will become pay services under the new state franchise agreement. At an estimated value of $80 per drop, per month, the fact that 44% of responding communities

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would be impacted is another telling tax story. However, the committee still doesn't know the scope of this impact because we don't know the responding cities and the number of drops.

Data missing from the study includes the level of staff support that communities provide to administrate the cable franchise. In the State of NC, there are more than twenty full-time cable administration employees and dozens of other employees where cable administration is one of several duties. These employees can tell you about the hurdles they face and why their community found it important enough to staff this position. Under the state cable franchise, the administrative staff needed would be significant to handle these issues. People have a vested interest in television and are active consumers. The importance of this should not be minimized in your future discussions.

Thank you for your consideration of these ideas.

Respectfully submitted,

Connie Ledoux Book, Ph.D.
Associate Dean
School of Communications

ELON UNIVERSITY

SCHOOL OF
COMMUNICATIONS

April 24, 2006

Dear Revenue Laws Committee Members:

Thank you for the opportunity to speak on the proposed *Consumer Choice in Cable and Uniform Taxation of Video Programming Services* last week. As a person not invested in cable or telephone, but simply an academic that studies this issue, I hope that you will consider the following observations before moving forward on this legislation.

Before dismantling a local cable franchising system that works in the state of North Carolina and has never prohibited competition, but in fact has *asked* for phone companies to compete, please ask BellSouth, Verizon and all other telephone stakeholders to provide a five-year business plan. Remember that this legislation does not *require* these companies to compete, and I suspect the roll-out will be slow and only in North Carolina's wealthiest communities.

A likely outcome of the State franchising system will be telephone companies doing business only in the larger North Carolina cities where incomes are higher and rural North Carolina residents continuing to be served by the local cable company, but now under a less public interest oriented State franchise. Currently, local franchises have provisions well beyond PEG channels, such as network services for local government and schools. As cable companies move to the state franchise, these services will become pay services and have significant tax impact on these communities. I think it would be beneficial to understand the potential dollar amount of these and what it holds for residents. In many of North Carolina's rural communities, the cable provider is the only efficient video/data network available and telephone companies will not be competing there.

If the State moves forward with this legislation, in addition to requiring PEG channels, the State should require that the cable provider set aside up to 5% of its bandwidth for public interest services. This would give rural communities who likely have no need or desire for three separate PEG channels to negotiate for "other" services, such as network services to the public schools. The 5% set aside of bandwidth is the federal model and requires communities to prioritize and efficiently use the public interest stake that they have.

The Revenue Laws Study Committee should also be required to review the impact of any new cable franchise process on local city/county needs and interests related to cable television on a bi-annual basis.

Recommendations to Enhance Sections:

§66-352 Notice requirements.

(a) Notice should be filed at the local level, such as posting notice in the primary civic buildings of impacted communities, libraries, fire stations and other areas of public activity.

§66-354 Service standards and requirements.

Annual service report should also include compliance with the federal customer service standards.

Non-compliance with the State franchise should create a re-opener on the franchise agreement. Dollar amounts in penalties established for non-compliance as well.

§66-355 Public, Educational and Government Access Channels.

I would **strongly** recommend that the State drop the language of channels and negotiate capacity to the cable system in the same language that the industry uses—as a portion of the bandwidth. The federal government has now adopted this process and several communities as well. The federal government requires between 4-5% of a system capacity for public interest activities. Cities have negotiated for higher rates. That said, I would recommend 5% of a system's capacity be set aside for local and state interests.

To negotiate for "channels" is use of an old broadcast term that is quickly dying. A set aside of 5% of the system bandwidth will allow the State and local communities to work together to establish the most needed services in their communities. The economies of a 5% set-aside also force the State and local communities to determine what would be most valuable in their community, such as Internet service to rural schools, hospitals or a data connection for public safety.

Under section (d) and (h) Use of Channels.
All of this flack over repeat programs and utilization is a red herring. The programming model of many cable channels is built around repeat programming, reruns and syndication.

Headline News repeats its programming every 30 minutes, the Weather Channel every 20 minutes and the TV Guide Channel repeats continuously. When the industry adopts a model of no repeats then we can all climb aboard. Repeats capture different audiences at different times of day and the cable industry continues to use it because it is effective. Therefore, so should PEG programmers.

Viewership of Access Channels
The other red herring is that the viewership of access channels is low. In fact, viewership of access channels exceeds the vast majority of niche digital cable networks (and consumers pay top dollar for these).

(g) It should be incumbent on the cable operator to assist communities in establishing a quality signal to the system.

(f) Interconnection should have a time frame window on it—maybe 60 days.

§160A-319 Utility Franchises.

A term of 30 years? The average term for cable franchises is 9 years in other State franchised areas. I would recommend a 10 year franchise with a re-opener if desired by any party at 5 years.

Revenue Laws Committee
. 3

Under SECTION 16.
These are the missing provisions:

- The ability to establish local regional advisory boards, if a local community desires, that report to the State franchising authority so that the State can represent their needs during franchise monitoring.
- Personal privacy legislation (this is a significant issue with the telcos and the Attorney General's office probably has some recommendations here.)
- Emergency procedures for restoring interrupted service and improving substandard service. Our State's experience with Duke Power during the 2003 weather event should make everyone sensitive to the importance of this information.
- Undergrounding of service lines. As more essential services are provided over one wire, it is imperative that this wire be protected to the fullest extent. Undergrounding of infrastructure, specifically in North Carolina with our weather events, makes sense.
- Availability of equipment for deaf or hearing impaired subscribers.
- Senior citizen discount.
- Discrimination among subscribers prohibited.
- Credit or refund for interrupted service.
- Communication related to programming and rate changes.
- Free basic cable and Internet service for libraries, schools, civic facilities and housing authorities.
- Local office operating requirements. Office hours. Complaint or dispute procedures.
- Establishment of a universal PEG fee. It should not be incumbent on local taxpayers without cable service to provide funding for equipment and operating expenses that benefit only cable subscribers. The State of Connecticut has a fee of approximately $.40 per subscriber, per month to facilitate production on these channels. Cable subscribers pay for every channel they receive, not watch. This model is effective and should be extended to PEG channels.

Please be cautious. I don't believe this is an urgent issue and does not require action this year.

Respectfully submitted,

Connie Ledoux Book, Ph.D.
Associate Dean
School of Communications

Revenue Laws Committee, February 8, 2006

Testimony of Chad A. Johnston, Executive Director – The Peoples Channel, Chapel Hill, NC and Board Member – The Alliance for Community Media

Mr. Chairman and the Honorable Members of the Committee:

My name is Chad A. Johnston, Executive Director of The Peoples Channel, Chapel Hill and Orange County's non-profit Public Access television station and technology resource center. I also sit on the Board of the Alliance for Community Media, a national membership organization representing 3,000 Public, Educational, and Governmental (PEG) cable television access centers across the nation. Those centers include over a million volunteers and 250,000 community groups and organizations that provide PEG Access television programming in local communities across the United States. Local PEG programmers produce 20,000 hours of new programs a week – which is more new programming than all of the broadcast networks combined.

I am here mainly today to speak to the power of local programming produced in PEG centers and the importance of those facilities across North Carolina. I would also like to talk about the importance of local franchising and management of the Public Right of Way. I'm speaking to you today wearing a number of different hats: as a citizen who has been involved in PEG Access since the age of 14, as a Director of a Public access station and as a Board member of an organization who's mission is to support community based media.

We are in an age where media consolidation has drastically hurt local programming. At a time when studies show that less than one-half of 1% of programming on commercial television is local public affairs, PEG centers serve the cities, towns and counties throughout North Carolina and produce a reflection of the diverse communities that we are. I would urge you today to oppose any bills or laws that would directly and substantially threaten PEG Access in North Carolina.

I was working with one our youth volunteers recently, a very talented 14 year old, who has been producing a program covering Philips Middle School events. He asked me one day, "If The Peoples Channel isn't around, where will I be able to show my program?" I told him I didn't have a simple answer and tried to explain why PEG Access centers existed in the first place. When I explained the Franchising process to him, and explained that people were interested in changing the rules behind them, he got a very confused look on his face. I figured that the issues were perhaps a little over his head, but then he surprised me. He was confused why a company, who would provide so many channels, couldn't set aside some for him and his classmates to watch a re-cap of the events so important in their young lives. Though the issues are not as simple as those from the eyes of a 14 year old, I think we can all learn something from his incite.

PEG channels provide something so important to local communities: they give a reflection of the community, back to the community. North Carolina supports an ever growing diversity of cultures, backgrounds and identities, and PEG access helps promote conversations about these differences. It is something we often loose in today's society; it's an authentic space for democratic discourse. The best way to secure the diversity of voices

required of a Democratic society is to create and support a free standing, independent space for public dialogue. Congress did just that by providing for PEG facilities with financial support and placing them under the stewardship of local franchising authorities. What has happened under this model in the past 30 years is a necessary communications resource that truly celebrates the unique character of the cities, towns and counties both here in North Carolina and the rest of this great nation.

The current regulations of the federal Cable Act assure that each local franchising authority can have set aside channels for PEG use and also ensure that cable companies provide over and above the 5% cable franchise fee and funding for PEG capital equipment and facilities. Each franchising authority is treated uniquely based on its cable-related needs. Raleigh has very different needs than Boone, and they should be treated as such. This model insures that the average citizen has access to the medium of television, and serves its community very well with a variety of importance functions.

The current version of the Revenue Laws Committee bill regarding the promotion of consumer choice in cable television providers and establishing uniform taxes for video programming services is an assault on local communities and opens a flood gate for telecom corporations crush local municipal authority. The North Carolina Coalition of Community Media Centers opposes this bill for the following reasons.

- The bill eliminates local government authority over cable TV and telco TV franchises, which require access to local public right-of-ways.

When a entity uses the public right of way, they have an obligation to work with the local municipality. This bill currently gives no real authority to the municipality, and gives the telco blanket rights to dig in public streets without consulting localities. (we could use another point here...)

- The bill allows cable and telco TV franchisees to "red-line" low-income areas of urban and rural communities.

Access to broadband technology is essential for every citizen. We cannot allow a company to choose which populations will receive access. Eighty percent of North Carolina counties are designated rural, and we should consider that under this bill, those counties would be left behind in the broadband world. Only offering service to what AT&T has called "high value" neighborhoods, will also increase the digital divide. In order to promote positive economic development, the digital divide must be closed and we cannot accomplish this if only a selected few have access.

- The bill eliminates locally-negotiated funding for public (P), education (E) and government (G) TV channels -- commonly called PEG -- which are increasingly the local catalyst for growing the Digital Media Economy.

PEG centers in North Carolina serve hundreds of non-profits who would normally not have a mechanism to get their information out to the public. PEG centers in North Carolina also serve thousands of church and religious groups who reach out to community members and

especially serve those who may be homebound, elderly, or invalid. PEG centers work with universities, local school boards, high and middle schools to disseminate educational information and services offered nowhere else in the main stream media. Finally, PEG centers also offer local citizens access to government meetings and events which are integral to having an informed citizenry.

These centers cannot function without funding and technical support. When we cut funding and capacity to PEG channels, we hurt our communities and we damage our democratic values.

- The bill eliminates funding for local government networks, or I-NETs, which interconnect government offices and agencies, save thousands of taxpayer dollars, and strengthen emergency communications in a post-9/11, post-Katrina world.

Hundreds of I-NETs have been built for local governments via a franchise renewal. In 2003, a partial I-NET valued at $1.3 million was built for the Buncombe County school system via a franchise renewal. Gilroy, CA is saving more than $70,000 a year in telecommunications charges with its five-year old I-NET, which has greatly increased the efficiency of government services such as emergency response, staff training, and financial management.

- This bill makes consumer protection rules unenforceable by replacing local government authority with an unfunded, unstaffed state authority.

Charlotte receives on average about 3,000 cable complaints a month. There is not adequate staff at the state level to handle this kind of activity. Local governments are able to handle complaints and need authority to address these issues.

- This bill empowers the state to collect franchise fees for use of public right-of-ways, with no guarantee that those fees would be shared with local governments.

Franchise fees not only help provide support to PEG channels, but municipalities count on these funds for everything from police uniforms to filling pot holes. The State is not positioned to understand the details of a municipality's right of way issues, nor should they collect funds for using that space.

CONCLUSION:

- Local governments are better-positioned to understand and to meet local community needs in video franchise negotiations. Statewide franchising would replace local control with a "one size fits all" franchise that will be most harmful to low-wealth communities, both urban and rural.
- Eliminating local franchising hits North Carolina's Digital Divide effort especially hard. The E-NC Authority has spent almost $6 million to create seven community media centers, called TeleCenters, to promote broadband training and access.

NCCCMC believes that ALL communities in North Carolina, urban and rural, deserve the opportunity to create community media centers. For more than three

decades, local franchising has made community media centers possible. Local franchising must be preserved.

North Carolina Coalition of Community Media Centers

...creating change...through media...

www.ncccmn.org

Access 21

Charlotte Mecklenburg Public Access Corporation
613 Calvert Street
Charlotte, NC
28208
704.377.8988

Greensboro Community Television

200 North Davie Street
Suite 16
Greensboro, NC
27401
336.373.1100

Mountain Area Information Network

34 Wall Street
Suite 407
Asheville, NC,
28801
866.962.6246

The Peoples Channel

300AC South Elliott Road
Chapel Hill, NC
27154
919.960.0088

URTV Media Center

31 College Place
Suite 20 A
Asheville, NC
28801
828.251.8257

April 19, 2006

Why NCCCMC opposes "statewide video franchising":

Statewide video franchising, now before the Revenue Laws Study Committee of the N.C. General Assembly, would . . .:

- eliminate local government authority over cable TV and telco TV franchises, which require access to local public right-of-ways.
- allow cable and telco TV franchisees to "red-line" low-income areas of urban and rural communities.
- eliminate locally-negotiated funding for public (P), education (E) and government (G) TV channels -- commonly called PEG -- which are increasingly the local catalyst for growing the Digital Media Economy and bridging the broadband Digital Divide.
- eliminate funding for local government networks, or I-NETs, which interconnect government offices and agencies, save thousands of taxpayer dollars, and strengthen emergency communications in a post-9/11, post-Katrina world.
- make consumer protection rules unenforceable by replacing local government authority with an unfunded, unstaffed state authority.
- empower the state to collect franchise fees for use of public right-of-ways, with no guarantee that those fees would be shared with local governments.

CONCLUSION:

- Local governments are better-positioned to understand and to meet local community needs in video franchise negotiations. Statewide franchising would replace local control with a "one size fits all" franchise that will be most harmful to low-wealth communities, both urban and rural.
- Eliminating local franchising hits North Carolina's Digital Divide effort especially hard. The E-NC Authority has spent almost $6 million to create seven community media centers, called TeleCenters, to promote broadband training and access.

NCCCMC believes that ALL communities in North Carolina, urban and rural, deserve the opportunity to create community media centers. For more than three decades, local franchising has made community media centers possible. Local franchising must be preserved.

[redacted] Joyce Krawiec

Freedom is our greatest commodity in this country. We value it above all else. It works. It works in allowing citizens to follow our dreams and achieve great success and happiness. It also works in allowing citizens to make choices...this means competition.

I am a businesswoman, owner of a small company. I have to compete for business everyday as many others here do also. Why should cable companies be treated differently. Why should we, as consumers, be told that we can only use the cable service that is allowed to service our area and all others are blocked out of the competitive process.

According to statistics, cable rates have risen 86% in the past 10 years. This is proof that satellite based competition is not sufficient to constrain price increases.

I live in Forsyth County. I am told that cable rates in Lexington, the next county over, are 25% lower. This is currently the only area where there is land based alternative to traditional cable available. Incidentally, I believe both areas are serviced by the same cable company.

It is time for competition to be introduced in North Carolina and our citizens be allowed to reap the benefits of lower cost and better service.

When competition and state franchises were introduced in Texas in Oct. 05, rates immediately began to come down as competitors have entered more than 100 markets.

We have all witnessed the competition regarding our phone service. We have seen rates continue to fall throughout many years as competition has grown. It is time for us to see the same change in cable franchising.

We urge you to open up the competition for the citizens of NC. Allow state franchises for competitors to begin

offering services to the citizens. If competitors are required to have individual franchises for each municipality, we will never see the changes that need to take place happen.

Freedom works everytime. Now we should have the freedom to choose the service we desire...and watch what happens when we are free to choose.

NORTH CAROLINA
ASSOCIATION OF COUNTY COMMISSIONERS

Memorandum

To: N.C. General Assembly Revenue Laws Study Committee

From: Rebecca Troutman, NCACC Research and Public Technology Director

Date: April 26, 2006

Subject: NCACC Comments on Proposed Video Service Competition Act
April 19, 2006 Study Committee Meeting

The North Carolina Association of County Commissioners appreciates the Revenue Laws Study Committee's interest in the county perspective on cable franchising authority. Paul Meyer, NCACC Assistant General Counsel, outlined our counties' major interests and concerns at the committee's January 11, 2006 meeting, and we are pleased to see that the most recent draft of the proposed state-authorized cable franchising system has addressed some of these concerns.

Our counties remain very supportive of a competitive video programming environment made available throughout North Carolina. Widespread access, availability, and affordability underlie the need for some build-out requirements. It was our understanding that the pending bills before Congress did contain some build-out requirements once the competitive base had been established.

We are also concerned that the current proposal provides a revenue substitution only to those counties receiving cable revenue through their current cable franchise agreements. We do not believe that all counties have entered into franchise agreements or that all agreements impose fees. We are confirming this with our membership and will make this available to the committee upon receipt. Clearly, a more competitive market would expand service offerings to new services areas. We would appreciate these counties being offered the same revenue parity as that being offered to any new cities as provided for in Section 8 (c).

In closing, we will pledge to continue to work with committee staff and industry representatives to address these two major concerns, and again, we appreciate the committee's interest in county cable franchising authority.

P.O. Box 1488, Raleigh, NC 27602-1488 * Phone: (919) 715-2893 * Fax: (919) 733-1065 * www.ncacc.org

Remarks of Krista S. Tillman
To the Joint Revenue Laws Committee of the N.C. General Assembly
April 19, 2006
(As prepared for delivery)

Thank you, Chairman Leubke, Chairman Kerr, Members of the Committee.

My name is Krista Tillman. I am President of BellSouth's North Carolina operations. I represent the more than 7,500 employees of BellSouth and our Cingular affiliate. As a reference, the telecom industry overall has more than 25,000 employees statewide.

I come before you today to share three points.

First, technological convergence in the communications industry is encouraging competition. This legislation is a progressive recognition of that trend.

Industry convergence simply means the communications playing field is no longer divided into individual markets. There are not a distinct cable, phone, broadband or wireless market. Instead, it is one single market, where companies offer all four services.

Ten years ago, laws were changed allowing competitors entry into the local telephone market. This Legislature had a leading role in that transition, acting a year before Congress enacted the Telecommunications Act of 1996. Since then, the consumer has been the winner. Nationwide, telephone rates have dropped some 22 percent in just five years.

When the laws were changed and local phone markets opened to competition, new competitors faced no hurdles or roadblocks. No mandatory investment was required of these competitors, which includes cable companies. The result of this market-based policy is competition has flourished.

As we talk about bringing competition to the cable market, a similar approach to open-market competition is warranted. It worked before and it will be equally effective again, this time in the cable market.

Incumbent cable companies have near-monopoly control over the local market. This fact alone creates an enormous business hurdle for any facility based provider. The bill, as currently drafted, appropriately encourages competition.

Secondly, the current draft also protects cities' rights.

At BellSouth, we understand the proposed changes in the video franchising process will have a profound impact on our local government friends.

We understand local governments rely on franchise fee revenue. We support them continuing to receive these revenues.

We understand the concern cities have for rights of way. BellSouth has historically done a good job respecting rights of way while working to provide service to customers; we will continue to support the cities' oversight of their rights of way.

We also understand PEG channels provide a voice for many in the community who otherwise might not have, as well as providing a valuable conduit to keep citizens informed about the workings of their government. This is why BellSouth supports new competitors providing PEG channels.

This legislation addresses of all these issues.

And that brings me to my third, and final, point: we support this legislation.

The legislation as currently proposed has been developed through some extraordinary staff work. We appreciate being part of the process.

I wish I could say we are happy with every aspect of the legislation. That's not the case. We recognize, however, this bill is a compromise. We support it in its current form.

While this is an important issue for the communications industry and for local governments, in the end, it should all be about the consumer. That's why I've been concerned about some of the confusion surrounding who new competitors would serve, whether we would serve only select groups of customers or select neighborhoods.

Let me put those questions to rest right now. From a practical perspective, our technology utilizes our existing network which is built to serve everybody. From a legal perspective, the federal Cable Act prohibits redlining and there is similar anti-discrimination language in this bill as well.

Just as important, studies by many groups – including the Yankee Group, the FCC and our own internal studies – show a market for cable services in all neighborhoods.

The US Internet Industry Association recently released a study this month which directly addresses the question. Allow me to quote from it: "As the data clearly shows, affluent white neighborhoods are not the most desirable subscribers for these services. Ethnic and lower income neighborhoods are the most aggressive users not only of the advanced services but of premium levels of service and video on demand"

Competition is good for the consumer. As I said previously, the competitive telephone market has decreased some 22 percent in the last 5 years. However, Cable TV rates have increased 41percent in the last 5 years, 86 percent in the last 10 years.

We know land-based cable competition works. Where that competition exists today, consumers' rates are 25 percent lower.

I look forward to operating in an open market where consumers – not rules or policies – determine winners and losers, where investment and innovation is rewarded, and where consumers have real choices.

Thank you for your time today

COMMENTS TO REVENUE LAWS STUDY COMMITTEE
APRIL 19, 2006

Good afternoon. My name is Michael Williams. I am the Cable Television Administrator for the City of Raleigh, North Carolina. I'd like to thank the Committee for the opportunity to speak regarding the proposed changes in the franchising process. I'd also like to thank the Committee staff for their dedicated and professional work. The language of the proposed bill has come a long way since the first draft in addressing and resolving the City of Raleigh's concerns. But a great deal of work still remains to be done.

First, the City supports the goal of providing competition for the incumbent cable operator. I think that it is safe to say that every government body in the state supports the goal of encouraging competition. In fact, I don't believe that in the more than 20 years I managed cable systems, prior to joining the city of Raleigh, I ever found a city that did not want competition, no matter how good a job the incumbent cable operator was doing.

At first I couldn't decide on which aspect of the proposed new legislation I should focus. There are so many things that will be affected by the new legislation. So I hope you understand how pleased and excited I was when I found out that I would be following Bell South in addressing you. I think it is fair to say that this situation was initiated by the telephone companies, including Bell South, contention that municipalities will not grant them franchises.

As you know, telephone companies have had the right to seek local franchises since 1996. Their allegation regarding franchising is simply not true. The City of Raleigh has offered Bell South a franchise on two separate occasions since 1996 and they declined each time. The only reason Bell South doesn't have a franchise for the City of Raleigh, and isn't already providing competitive services to the citizens they have expressed so much concern about, is because they have deliberately chosen not to.

The City of Raleigh whole-heartedly supports maintaining PEG channels and support funding. We actively operate and program four PEG channels. PEG channels provide a valuable community service. I won't speak for PEG producers because, as you have already seen, they are very capable of speaking for themselves.

The City of Raleigh firmly supports retention of local regulatory powers, including the authority to address and assist in the resolution of customer complaints, and the need to require and assure equal access to Broadband services by all citizens, regardless of income or location. Money follows money. Without appropriate service area requirements people n lower income and rural neighborhoods will never acquire adequate access to these services.

Once again, thank you for the opportunity to address you on this important matter.

Hi,
My name is Drew Wofford and I am just one of many teens here in Raleigh.
I am unlike any other teen you will ever meet in your life! After battling years of depression, I finally found my way out with the help of RTN. RTN and community access channels alike provide a safe, structured environment for teens to learn, and express there creative potential. The wonderful supportive staff at RTN has helped me on my way to producing my own show and learning many new skills.

I would really hate to see this valuable resource to the community lost. PEG channels provide a place for the community to voice their opinion. It is the ONLY place you will see such a diverse mixture of programming geared to all ages and genders. RTN has completely opened the door for me and is an invaluable resource for me on my resume. Before I started volunteering at RTN I had no idea what I wanted to be when I grew up now I know and I am well on my way to a career in broadcast journalism.

Think of your kids... Do you want them on the streets getting mixed up in drugs and gangs? NO! You want them in a safe place where they can learn invaluable skills. THAT'S RIGHT PEG channels even have summer camps for teens to stay off the streets and learn skills to help them get a job so when they get older they can keep themselves off welfare. Think about the consequences of losing PEG channels.

That's all I have to say,
Drew Wofford

DeAnne Mangum (Finance CA)

From: roland connelly [rlclsc@bellsouth.net]
Sent: Tuesday, April 25, 2006 11:56 PM
To: a.page@mindspring.com
Subject: Telecom hearing statement

The gist of what I said to the committee follows:

As many others have said here today, I am for open and fair competition in the cable service industry.

That being said I would like to thank the Chairman and the Committee for giving us all the opportunity to speak with this body. I have learned a great deal from what I have heard here in this committee room today and I would ask that the committee please carefully consider two points that popped to the forefront of my mind. The first item that unsettled me is that there are those who are considering incorporating into this bill a means by which the state will collect fees and taxes from the various cable providers in the state and return the funds deemed appropriate by the state to the local governments. This is just more control over local governments and businesses. The cities and/or counties are perfectly able to collect their own negotiated fees and/or taxes and the state should allow them to continue to do so.

I assumed, prior to coming into this hearing, that there were laws or ordinances in place to keep competition out of the market place in the various venues. From a couple of speakers, [particularly the professor from Elon College], it seems as if that is not the case. If there is nothing in place by the local governments (or any other entity) to keep other providers from coming into an area and competing fairly, I do not see the need for the state to even consider this bill. If there are problems keeping legitimate competitors from entering a market, the state should then oversee this area to make sure that FAIR competition is allowed in all venues-no one company should be given any concessions, over any other company.

Lynn S. Connelly
Lynn S. Connelly
3926 Starmount Drive
Greensboro, NC 27410
lsctiger@bellsouth.net
336-297-0165

Comments on draft bill

My name is Rob Thompson, I am the advocate for the NC Public Interest Research Group. NCPIRG is a statewide consumer advocacy group with over 8,000 members. Let me begin by saying that NCPIRG wants to see competition in the cable TV industry. Competition will lower prices and create more choice for consumers. However, we believe that a set of consumer service standards must be met in the transition to a competitive cable TV market.

After reviewing the most recent draft bill, we do not believe that all of these standards are met. I'll touch on two of these here:

1. Cherry-picking: NCPIRG believes that, to the extent that it is technologically feasible, all consumers in the state should have access to cable television, and all consumers have the right to a competitive market. Unfortunately, this bill allows cable providers to cherry pick their franchise areas, choosing only the highest profit markets, potentially leaving some poor and rural areas with limited or no options other than satellite service.

   Furthermore, what happens when cable companies opt out of local franchise agreements: will traditional cable companies begin cherry-picking the highest profit markets? Will they simply raise prices in non-competitive areas to compensate for competition in the cherry-picked markets? We believe that these are questions that need to be answered before any new law is adopted.

2. Enforcement: Currently, localities have the ability to negotiate local franchise agreements, thereby ensuring a sufficient level of customer service. In the current draft bill, there is no designated state or local authority to ensure that cable providers are serving the public interest. We believe that a government entity should have the ability to revoke, deny, or suspend franchise agreements.

Let me close by saying that we would like to see true competition in the cable TV industry, but we need to ensure that a minimum level of customer service is provided before any new legislation is passed.

AARP North Carolina

The power to make it better.™

Video Franchise Legislation
Revenue Laws Study Commission – April 19, 2006

Mr. Chairman and members of the Commission, I am Bill Wilson, Associate State Director for AARP North Carolina, representing over one million members in North Carolina.

AARP North Carolina believes the entry of the telephone companies in the video services market can create welcome competition that will benefit consumers, so long as the protections and benefits for cable subscribers inherent within the local franchising authority remain intact.

We appreciate the Commission's work on the bill. The new version is significantly better.

We support expansion of the anti-discrimination provision to include race in addition to income, and the addition of the enforcement provision. However, the ability to discriminate against consumers is more likely to occur in defining the area of the franchise, than in providing service to consumers within the franchise area.

AARP also supports the provision that provides earmarked funds for the operation and support of PEG channels. We would like to see the limitation of funding for PEG channel support raised above the three qualifying channels authorized in the bill.

While the cable provider is required to comply with federal customer service requirements, and the Consumer Protection Division of the Attorney General's office is designated to receive complaints concerning cable service, the bill lacks any enforcement if complaints are not satisfactorily resolved. AARP supports language that allows a franchise to be fined or revoked if service is substantially lacking.

Widespread access to competitive choices in video service is important to AARP. We understand that "build-out" requirements are controversial. AARP supports build-out requirements to the telephone company's entire existing phone service area, along with reasonable build-out waivers.

AARP is willing to work with the telephone companies, cable companies, local governments, and consumer advocates so that when a video service provider enters an area, it makes service available to all neighborhoods within a reasonable period of time.

Bill Wilson
Associate State Director for Advocacy
919-508-0299

Good afternoon, ladies and gentlemen,
My name is Hart Pillow, and I am an ordinary citizen living in Durham, N.C. Today I speak for myself and for all citizens who are unable to attend this meeting of the Revenue Laws Committee. We are interested in this committee upholding the great Democratic process of hearing from citizens on important issues like this one, Preservation of PEG access television in the State of North Carolina. We are concerned that the Cable Companies and the Telephone Companies were part of your early committee meetings, but we, the citizens, were not informed nor invited to give input. In fact to us this bill appears to put an end to PEG access TV and give these companies free reign. Why were the citizens left out of the process? We are here today because, in spite of our jobs and busy lives, we are determined to preserve PEG access television as the purest form of free speech for people speaking to their local communities.

PEG access benefits us citizens in the following ways:

- Gives citizens an avenue for local issues to be aired and discussed
- Provides independent news sources such as Democracy Now!
- Preserves a pure form of Freedom of Speech
- Provides local programming on important issues
- Provides a training ground for young and old people interested in media
- Builds real community and an informed citizenry

This bill is unacceptable and must be redrafted. Please understand that we will not concede any of the following of the minimum requirements for the new draft of this Video Franchises Bill. Here are our minimum requirements:

1. Towns and municipalities maintain local control of public access to video providers by means of local franchising
2. PEG access supported at the current level of funding from video providers
3. PEG access channel allocation maintained at the level of present availability
4. Local governments keep the right to own and operate wireline broadband internet systems in unserved areas

Why are these minimum requirements the right and democratic way to go?

- Hold servers responsible at the local level where cable issues can best be handled
- Preserve the much needed revenues that help fund basic services such as fire and police in towns and municipalities
- Protect the important avenue for Freedom of Speech for all citizens
- Uphold real community by airing issues that local citizens care about
- Assure that neighborhoods get equal access to information technology
- Help to close the digital divide between rich and poor

In closing we ask each one of you on the Revenue Laws Committee to reflect upon the kind of world that you want your children and grandchildren to enjoy. We hope you join us in protecting one of the great freedoms of our democratic society—Freedom of Speech by way of PEG access television.

Hart Pillow

Lisa Beamler

Action Audits, LLC

Cable Consultant to Triangle J Council of Governments

WHY N.C. CABLE CHOICE BILL IS BAD FOR CONSUMERS, BAD FOR RURAL NORTH CAROLINA AND BAD FOR LOCAL GOVERNMENT

Second version of draft bill continues to fail to stimulate broadband video competition, while decimating consumer protections for local cable subscribers, removing PEG channel and I-NET funding, and eliminating franchise fees used to pay for community service, like police and fire. This bill is not good public policy for North Carolina.

1. **The Bill does not achieve real competition.** New cable operators are state franchised and relieved of all local public interest obligations without any commitment to build competitive cable systems. Current cable operators are relieved of all local franchising public interest obligations as soon as their franchises expire, without any evidence of competition. AT&T (perspective owner of Bell South) would be immediately exempt from all state and local franchising requirements.

2. **The Bill Abandons low wealth, low density and rural areas.**
   The Bill allows new state franchised cable providers to define their own service areas and serve only the wealthier neighborhoods. The bill fails to provide penalties if service discrimination occurs due to income. Half of North Carolina communities consist of low wealth, rural communities. They will be bypassed by these new providers, yet their cable operators will likely raise their rates to offset discounts offered in competition-rich, wealthier communities. The bill allows current cable operators to terminate broadband cable service in lower income, rural communities to maximize resources for fighting competition in high-wealth service areas. Lower income communities will become digital have-nots.

3. **The Bill eliminates cable consumer protections**
   State franchised operators are relieved of local consumer protections that are more severe than the FCC's. Cable consumers of state-franchised cable systems must call the State Public Utility Commission regarding cable complaints. The Commission is given no additional staff or enforcement authority to handle potential calls from North Carolina's 1.89 million cable consumers. Current cable operators can abandon all local government consumer obligations as soon as their franchise expires, or when a state franchised cable company makes an unverified claim that cable service is available to 20% of the homes its self-defined service area (such as a three-block neighborhood) or simply if a state –franchised operator fails to file a Notice of Service with the PUC on time. There are no penalties for falsifying these NOS reports. No provision exists for the renewal of local cable franchising if competitors abandon their service areas and "competition" disappears.

4. **The Bill does not preserve PEG channels or I-NETs.**
   The Bill attempts to hold incumbent cable operators to current local public, educational and government channel and funding obligations, but provides the State no enforcement authority if these terms are not met. The Bill relieves state franchised operators of these obligations in communities where there are no current PEG channels, penalizing slow-start communities who have current contract rights to obtain funding and such channels in the future. New cable operators are relieved of Institutional network obligations, which save public institutions thousands of dollars in data costs every year. Current cable operators can abandon I-NET obligations when they become state-franchised.

5. **The Bill does not keep Local Government Whole.**
   The measure eliminates local cable franchise fees (currently used to cover community services like police and fire), and attempts to redistribute new state video programming and telecom taxes, based on past franchise fees, adjusted for population changes, but not for inflation. Slow growth communities with high growth in video programming subscribers are the losers.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-SVz-16A [v.5] (03/01)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/18/2006 3:51:59 PM

Short Title: Amend Taxation of Logging Machinery. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO TREAT COMMERCIAL LOGGING MACHINERY THE SAME AS FARM MACHINERY UNDER THE SALES TAX.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-164.13 is amended by adding a new subdivision to read:

"..

(4f) Sales of the following to a person who is engaged in the commercial logging business:

a. Logging machinery. Logging machinery is machinery used to harvest raw forest products for transport to first market.

b. Attachments and repair parts for logging machinery.

c. Lubricants applied to logging machinery.

d. Fuel used to operate logging machinery.

..."

SECTION 2. Article 5F of Chapter 105 of the General Statutes is amended by adding a new section to read:

"**§ 105-187.53. Commercial logging items.**

This Article does not apply to an item that is exempt from sales and use tax under G.S. 105-164.13(4f)."

SECTION 3. This act does not affect the rights or liabilities of the State, a taxpayer, or another person arising under a statute amended by this act before the effective date of this act, nor does it affect the right to any refund of a tax that accrued under the amended statute before the effective date of its amendment.

SECTION 4. This act becomes effective July 1, 2006 and applies to items purchased on or after that date.

LEGISLATIVE PROPOSAL 2005-SVz-16A: Amend Taxation of Logging Machinery

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	April 19, 2006
Introduced by:		**Summary by:**	Trina Griffin
Version:	Draft 2005-SVz-16A		Committee Counsel

SUMMARY: ***This legislative proposal would exempt from the 1% privilege tax, with an $80 maximum tax per article, commercial logging machinery, attachments, repair parts for commercial logging machinery, lubricants applied to commercial logging machinery, and fuel to operate commercial logging machinery for use in commercial logging operations, effective for purchases made on or after July 1, 2006.***

BACKGROUND & CURRENT LAW: For years, State tax law has provided that the sales and use tax rate on mill machinery is 1%, with an $80 maximum tax per article. There has never been a specific reference in the sales tax statutes to machinery used in the forestry and logging business. However, based on a long-standing interpretation by the Department of Revenue, logging firms that had contracts with wood product manufacturers to cut timber were deemed to be entitled to the 1% rate, $80 cap based on the preferential rate afforded to manufacturing industries and plants.

For several years, North Carolina has worked toward simplifying its sales and use tax statutes in an effort to conform to the Streamlined Sales and Use Tax Agreement. One of the conforming changes the State had to make was to simplify its sales tax rates. Under the Streamlined Sales and Use Tax Agreement, a state must have one rate, with no caps or thresholds, by January 2006. North Carolina had several different rates, including this 1% rate with an $80 cap. In 2001, at the request of North Carolina Citizens for Business and Industry, the General Assembly maintained the preferential tax rate on mill machinery by removing it from the sales tax statutes. By changing the nature of the tax from a sales tax to a privilege tax, the industry kept its preferential rate and the State conformed to the Streamlined Sales and Use Tax Agreement. The change in the law, made in 2001, became effective January 1, 2006.

Thus, as of January 1, 2006, purchases of mill machinery, which includes commercial logging equipment, and mill machinery parts or accessories and manufacturing fuel, are exempt from sales and use tax, but are subject to the new privilege tax. The privilege tax is imposed on the purchaser of qualifying property, and the purchaser is liable for accruing and remitting the tax to the Department of Revenue. Examples of qualifying commercial logging equipment include log skidders, log carts, tree shears, feller bunchers, winches, chain saws, tractors, axes, and mallets when the items are used to cut and transport timber to a wood products manufacturer.

BILL ANALYSIS: This legislative proposal would treat commercial logging machinery and related items the same as farm machinery under the current sales tax laws. First, the bill exempts commercial logging items from the 1%/$80 maximum privilege tax, to which they are currently subject. The bill also creates a new exemption in the sales and use tax statutes for commercial logging machinery, attachments and repair parts, lubricants, and fuel used to operate commercial logging machinery. The language of the exemption tracks the current exemption for farm machinery.

EFFECTIVE DATE: The exemption would become effective for qualifying purchases made on or after July 1, 2006.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 19, 2006

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: 2005-SVz-16 v.3 - Exempt Forestry Mill Machinery from Priv. Tax

FISCAL IMPACT

	Yes (x)	No ( )	No Estimate Available ( )		
	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11
REVENUES:	(2.19)	(2.19)	(2.19)	(2.19)	(2.19)
EXPENDITURES:					
POSITIONS (cumulative):					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: July 1, 2006

BILL SUMMARY: Historically mill machinery, including commercial logging equipment, has been subject to state sales tax at the rate of 1.0%, with an $80 cap per item. Because such special sales tax rates do not conform to the Streamlined Sales Tax Agreement, to which North Carolina is a party, in 2001 the General Assembly chose to move this remove this special treatment from the sales tax statutes, and instead created a special privilege tax of the same amount. This change effectively exempted these purchases of mill machinery from sales tax, but made the purchaser liable for remitting a similar amount of tax under the privilege tax statutes, directly to the Department of Revenue. This change became effective January 1, 2006. The legislation exempts

commercial logging equipment from this new privilege tax, treating it the same as agricultural equipment.

ASSUMPTIONS AND METHODOLOGY: No data specific to loggers or logging operations is available from the North Carolina Department of Revenue. Thus an alternative means of estimating is required.

The North Carolina Forestry Association provides specialized continuing education for logging professionals entitled Pro-Logger. To be a Pro-Logger an individual must participate in 24 hours of baseline training, and attend an additional two classes a year to maintain certification. Such certification is often required to deliver wood to certain wood processing facilities. The Forestry Association reports that approximately 1,600 individuals are currently qualified as North Carolina Pro-Loggers. The Association estimates that one-half of those individuals, or 800 individuals, actually representing logging operations. Using this number as a proxy suggests that there are approximately 800 logging operations in North Carolina.

A February 2006 issue of Texas Logger magazine suggests the following taxable operating costs for a biomass logging facility:

Operating Costs:	
Repair/Maintenance (100% of depreciation):	113, 250
Diesel Fuel (Off highway)	141,039
Large Parts (Tires, etc.)	16,200
Total	270,489

Using this number as a proxy for the operating costs associated with a North Carolina logging facility suggests that exempting these purchases from tax would result in a revenue loss of approximately $2.16 million annually ($270,489 x 800 loggers x 1.0% tax).

The same Texas Logger magazine article suggests that a logging operation requires approximately $755,000 in capital investment. This amount represents purchase of six (6) items: a feller buncher, grapple skidder, whole tree chipper, bulldozer and two service trucks. According to "The Used Connection" web site, the used prices for all these items exceed $8,000. As such, all six items would be taxed at the maximum amount of $80.00 per item, for a total tax on equipment of $480.00. Assuming this equipment is replaced every 15 years suggests that 53 loggers will replace their equipment each year. Thus the annual revenue loss associated with these purchases is $25,440 ($480 x 53 loggers).

The total annual loss associated with this legislation is reflected in the fiscal impact box.

SOURCES OF DATA: North Carolina Forestry Association, Texas Logger magazine.

TECHNICAL CONSIDERATIONS: None

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-LAz-29 [v.4] (4/17)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/18/2006 1:22:21 PM

Short Title: Amend Delinquent Property Tax Collection. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO ENFORCE COLLECTION OF PROPERTY TAXES ON REAL PROPERTY AGAINST THE RECORD OWNER AS OF THE DATE THE TAXES BECOME DELINQUENT AND TO CODIFY THE PRORATION OF TAXES ON REAL PROPERTY.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-273(17) reads as rewritten:

""**§ 105-273. Definitions.**

When used in this Subchapter (unless the context requires a different meaning):

...

(17) "Taxpayer" means any person whose property is subject to ad valorem property taxation by any county or municipality and any person who, under the terms of this Subchapter, has a duty to list property for taxation. For purposes of collecting delinquent ad valorem taxes assessed on real property under G.S. 105-366 through G.S. 105-375, "taxpayer" means the owner of record on the date the taxes become delinquent and any subsequent owner of record of the real property if conveyed after that date."

SECTION 2. G.S. 105-369 reads as rewritten:

"**§ 105-369. Advertisement of tax liens on real property for failure to pay taxes.**

(a) Report of Unpaid Taxes That Are Liens on Real Property. – In February of each year, the tax collector must report to the governing body the total amount of unpaid taxes for the current fiscal year that are liens on real property. A county tax collector's report is due the first Monday in February, and a municipal tax collector's report is due the second Monday in February. Upon receipt of the report, the governing body must order the tax collector to advertise the tax liens. For purposes of this section, district

taxes collected by county tax collectors shall be regarded as county taxes and district taxes collected by municipal tax collectors shall be regarded as municipal taxes.

(b) Repealed by Session Laws 1983 (Regular Session, 1984), c. 1013.

(b1) Notice to Owner. – After the governing body orders the tax collector to advertise the tax liens, the tax collector must send a notice to the ~~listing owner and to the~~ record owner of each affected parcel of property, as determined as of ~~December 31~~January 6 of the fiscal year for which the taxes are ~~due.~~due and to any subsequent record owner The notice must be sent to each owner's last known address by first-class mail at least 30 days before the date the advertisement is to be published. The notice must state the principal amount of unpaid taxes that are a lien on the parcel to be advertised and inform the owner that the names of ~~the listing owner and~~ the record owner as of January 6 and any subsequent record owner will appear in a newspaper advertisement of delinquent taxes if the taxes are not paid before the publication date. Failure to mail the notice required by this section to the correct ~~listing owner or~~ record owner does not affect the validity of the tax lien or of any foreclosure action.

(c) Time and Contents of Advertisement. – A tax collector's failure to comply with this subsection does not affect the validity of the taxes or tax liens. The county tax collector shall advertise county tax liens by posting a notice of the liens at the county courthouse and by publishing each lien at least one time in one or more newspapers having general circulation in the taxing unit. The municipal tax collector shall advertise municipal tax liens by posting a notice of the liens at the city or town hall and by publishing each lien at least one time in one or more newspapers having general circulation in the taxing unit. Advertisements of tax liens shall be made during the period March 1 through June 30. The costs of newspaper advertising shall be paid by the taxing unit. If the taxes of two or more taxing units are collected by the same tax collector, the tax liens of each unit shall be advertised separately unless, under the provisions of a special act or contractual agreement between the taxing units, joint advertisement is permitted.

The posted notice and newspaper advertisement shall set forth the following information:

~~(1) In the case of property that the listing owner has not transferred after January 1 preceding the fiscal year for which the tax liens are advertised, the name of each person to whom is listed real property on which the taxing unit has a lien for unpaid taxes, in alphabetical order.~~

(1a) ~~In the case of property that the listing owner has transferred after January 1 preceding the fiscal year for which the tax liens are advertised, the name of the record owner as of December 31 of each parcel on which the taxing unit has a lien for unpaid taxes, in alphabetical order, followed by a notation that the property was transferred to the record owner and a notation of the name of the listing owner.~~The names of the record owner as of January 6 and any subsequent record owner of each parcel on which the taxing unit has a lien for unpaid taxes, in alphabetical order.

(1b) After the information required by subdivision ~~(1) or~~ (1a) of this subsection for each parcel, a brief description of each parcel of land to which a lien has attached and a statement of the principal amount of the taxes constituting a lien against the parcel.

(2) A statement that the amounts advertised will be increased by interest and costs and that the omission of interest and costs from the amounts advertised will not constitute waiver of the taxing unit's claim for those items.

(3) In the event the list of tax liens has been divided for purposes of advertisement in more than one newspaper, a statement of the names of all newspapers in which advertisements will appear and the dates on which they will be published.

(4) A statement that the taxing unit may foreclose the tax liens and sell the real property subject to the liens in satisfaction of its claim for taxes.

(d) Costs. – Each parcel of real property advertised pursuant to this section shall be assessed an advertising fee to cover the actual cost of the advertisement. Actual advertising costs per parcel shall be determined by the tax collector on any reasonable basis. Advertising costs assessed pursuant to this subsection are taxes.

(e) Payments during Advertising Period. – At any time during the advertisement period, any parcel may be withdrawn from the list by payment of the taxes plus interest that has accrued to the time of payment and a proportionate part of the advertising fee to be determined by the tax collector. Thereafter, the tax collector shall delete that parcel from any subsequent advertisement, but the tax collector is not liable for failure to make the deletion.

(f) Listing and Advertising in Wrong Name. – No tax lien is void because the real property to which the lien attached was listed or advertised in the name of a person other than the person in whose name the property should have been listed for taxation if the property was in other respects correctly described on the abstract or in the advertisement.

(g) Wrongful Advertisement. – Any tax collector or deputy tax collector who willfully advertises any tax lien knowing that the property is not subject to taxation or that the taxes advertised have been paid is guilty of a Class 3 misdemeanor, and shall be required to pay the injured party all damages sustained in consequence."

SECTION 3. Chapter 39 of the General Statutes is amended by adding the following new Article to read:

"**Article 10.**

"Real Property Tax Proration.

"**§ 39-60. Property tax proration on sale of real property.**

Unless otherwise provided by contract, property taxes on the real property being sold shall be prorated between the seller and buyer of the real property on a calendar-year basis."

SECTION 4. Section 3 of this act becomes effective for contracts entered into on or after October 1, 2006. The remainder of this act is effective upon ratification and applies to tax years beginning on or after July 1, 2006.

BILL DRAFT : 2005-LAz-29
Amend Delinquent Property Tax Collection

BILL ANALYSIS

Committee: Revenue Laws
Date: April 17, 2006
Version: Draft

Sponsor:
Analysis by: Martha Walston
Committee Counsel

SUMMARY: *The following changes to the property tax laws relieve the seller of personal liability for property taxes assessed on real property when the seller transfers the property before the taxes become delinquent or when the seller transfers the property before it is annexed by the taxing unit and taxes are imposed by the taxing unit:*

- *Authorizes the tax collector to enforce the remedy of attachment and garnishment against the record owner of real property as of the date the taxes on the real property become delinquent instead of the listing owner of the real property.*
- *Requires the tax collector to send the notice of a tax lien on real property to the record owner of the property as determined as of the date property taxes become delinquent and to any subsequent record owner instead of the listing owner of the property. The advertisement must also state the names of the record owner and any subsequent owner instead of the listing owner.*
- *Amends the definition of "Taxpayer" in the property tax laws to clarify that when collecting delinquent taxes assessed on real property, "taxpayer" means owner of record on the date the taxes become delinquent and any subsequent owner of record of the real property if conveyed after the delinquent date.*
- *Amends Chapter 39 of the General Statutes by adding a new Article that codifies the practice of prorating property taxes on a calendar-year basis when the property is sold.*

CURRENT LAW: Under North Carolina property tax laws, the date of January 1 applies to the following events:

- The date the value of real property is determined for tax purposes.
- The date property is listed in the name of the owner on that date.
- The date a tax lien attaches to the real property.

The owner of the property as of January 1 generally receives a property tax bill in July or August for property taxes owing on the property for the fiscal year that runs from July 1 of the year the property is required to be listed to the following June 30. Taxes become due and payable on September 1, and are payable at face amount if paid before January 6 following the due date. Taxes are delinquent if paid on or after January 6 following the due date and are

subject to interest charges.[1] For example, if a taxpayer lists his or her property on January 1, 2006, then taxes on the property become due on September 1, 2006, for the fiscal year beginning July 1, 2006, and ending June 30, 2007. Taxes on the property are delinquent beginning January 6, 2007.[2]

In February of each year, the tax collector must report to the governing body the total amount of unpaid taxes for the current fiscal year that are liens on real property. After the governing body orders the tax collector to advertise tax liens, the tax collector must send a notice to the record owner of each affected parcel as determined as of December 31 of the fiscal year for which taxes are due. If the property was transferred during the one year period beginning on the listing date preceding the fiscal year in which the taxes become due, then the notice of tax lien on the property must be sent to each listing owner and record owner of the parcel as determined as of December 31 of the fiscal year for which taxes are due. The notice must inform the owners that their names will appear in a newspaper advertisement of delinquent taxes if the taxes are not paid before the publication date. If the listing owner transferred the property after the listing date, the advertisement will state the record owner's name followed by a notation that the property was transferred to the record owner and a notation of the name of the listing owner.

In addition to the remedy of foreclosing on the real property, the taxing unit may also attach and garnish the wages and other compensation, rents, bank deposits, and other intangible personal property of the listing owner of the property. Attachment and garnishment may only be enforced against the listing owner because the pertinent statutes provide that the remedy may be enforced against the taxpayer. Taxpayer is defined in G.S. 105-273(17) as the person whose property is subject to property tax by a county or municipality and any person who has a duty to list property for taxation

BILL ANALYSIS: The draft is an attempt to solve the following problems:

- Seller conveys real property to Buyer on July 8, 2006. After the transfer, Buyer petitions for annexation to the city. On October 2006, seller receives a bill due September 1, 2006 for the partial year annexation. If Seller does not pay this before January 6, 2007, the tax collector can garnish Seller's bank account, because Seller was the owner of the property on the listing date. (January 1 immediately preceding the beginning of the fiscal year to which the annexation becomes effective) G.S. 160A-58.10.
- Seller conveys real property to Buyer in May, 2006. The closing attorney prorates the taxes giving Buyer credit for the months Seller owned the property and directs Buyer to pay the taxes. Buyer does not pay the taxes by January 6, 2007. Seller disregards the notice of delinquent taxes because he had his share of the taxes deducted from his net

[1] For the period January 6 to February 1, interest rate accrues at 2%. For the period February 1 until the principal amount of taxes, the accrued interest, and any penalties are paid, interest accrues at the rate of ¾% a month or fraction thereof.
[2] When real property is acquired after January 1, but prior to July 1, and the property was not subject to taxation on January 1 on account of its exempt status, it is listed for tax by the transferee as of the date of acquisition and is appraised at its true value as of January 1 preceding the date of acquisition. The property is taxed for the fiscal year of the taxing unit beginning on July 1 of the year in which it is acquired.

proceeds at closing and Seller believes his share of taxes was paid at closing. The tax collector has the authority to garnish the wages of Seller.

The draft amends the definition of "Taxpayer" in the property tax laws so that for purposes of collecting delinquent property taxes assessed on real property, the remedies against personal property may only be enforced against the record owner of the real property on the date the taxes become delinquent and against any subsequent record owner of the real property if conveyed after the delinquent date. This means that the tax collector would have the authority to garnish the wages, bank account, or other intangible property of the owner of the property at the time the taxes on that property become delinquent and any subsequent record owner instead of the listing owner of the property.

The draft also codifies the practice of prorating property taxes between the seller and buyer of real property on a calendar-year basis, unless the contract states otherwise.

The draft amends the definition of "Taxpayer" in the property tax laws so that for purposes of collecting delinquent property taxes assessed on real property, the remedies against personal property may only be enforced against the record owner of the real property on the date the taxes become delinquent and against any subsequent record owner of the real property if conveyed after the delinquent date. This means that the tax collector would have the authority to garnish the wages, bank account, or other intangible property of the owner of the property at the time the taxes on that property become delinquent and any subsequent record owner instead of the owner of the property at the time the property was listed.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-LAz-24 [v.11] (3/3)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/19/2006 11:11:32 AM

Short Title: Telephone and Tower Property Tax Appraisal. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO ESTABLISH UNIFORM PROPERTY TAX APPRAISAL FOR ALL TELECOMMUNICATIONS COMPANIES AND TOWER COMPANIES BY PROVIDING FOR SYSTEM APPRAISAL BY THE DEPARTMENT OF REVENUE RATHER THAN LOCAL APPRAISAL.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-333 reads as rewritten:

"**§ 105-333. Definitions.**

The following definitions apply in this Article unless the context requires a different meaning:

(1) Airline company. – A company engaged in the business of transporting passengers and property by aircraft for hire within, into, or from this State.

(2) Bus line company. – A company engaged in the business of transporting passengers and property by motor vehicle for hire over the public highways of this State (but not including a bus line company operating primarily upon the public streets within a single local taxing unit), whether the transportation is within, into, or from this State.

(3) Distributable system property. – All real property and personal property owned or used by a railroad company other than nondistributable system property.

(4) Electric membership corporation. – A company organized, reorganized, or domesticated under Chapter 117 of the General Statutes and engaged in the business of supplying electricity for light, heat, or power to consumers in this State.

(5) Electric power company. – A company engaged in the business of supplying electricity for light, heat, or power to consumers in this State.

(6) Repealed by Session Laws 1973, c. 783, s. 5.

(7) Flight equipment. – Aircraft fully equipped for flying and used in any operation within this State.

(8) Gas company. – A company engaged in the business of supplying artificial or natural gas to, from, within, or through this State through pipe or tubing for light, heat, or power to consumers in this State.

(9) Locally assigned rolling stock. – Rolling stock that is owned or leased by a motor freight carrier company, specifically assigned to a terminal or other premises, and regularly used at the premises to which assigned.

(10) Motor freight carrier company. – A company engaged in the business of transporting property by motor vehicle for hire over the public highways of this State as provided in this subdivision:

a. As to interstate carrier companies domiciled in North Carolina, this term includes carriers who regularly transport property by tractor trailer to or from one or more terminals owned or leased by the carrier outside this State or two or more terminals inside this State. For purposes of appraisal and allocation only, the term also includes a North Carolina interstate carrier that does not have a terminal outside this State but whose operations outside the State are sufficient to require the payment of ad valorem taxes on a portion of the value of the rolling stock of the carrier to taxing units in one or more other states.

b. As to interstate carrier companies domiciled outside this State, this term includes carriers who regularly transport property by tractor trailer to or from one or more terminals owned or leased by the carrier inside this State.

c. As to intrastate carrier companies, this term includes only those carriers that are engaged in the transportation of property by tractor trailer to or from two or more terminals owned or leased by the carrier in this State.

(11) Nondistributable system property. – The following properties owned by a railroad company: land other than right-of-way, depots, machine shops, warehouses, office buildings, other structures, and the contents of the structures listed in this subdivision.

(12) Nonsystem property. – The real and tangible personal property owned by a public service company but not used in its public service activities.

(13) Pipeline company. – A company engaged in the business of transporting natural gas, petroleum products, or other products through

pipelines to, from, within, or through this State, or having control of pipelines for such a purpose.

(14) Public service company. – A railroad company, a pipeline company, a gas company, an electric power company, an electric membership corporation, a ~~telephone~~ telecommunications company, ~~a telegraph company,~~ a bus line company, an airline company, ~~or~~ a motor freight carrier ~~company.~~company, or a tower company. The term also includes any company performing a public service that is regulated by the United States Department of Energy, the United States Department of Transportation, the Federal Communications Commission, the Federal Aviation Agency, or the North Carolina Utilities Commission, except that the term does not include a water company, ~~a radio common carrier company as defined in G.S. 62-119(3),~~ a cable television company, or a radio or television broadcasting company.

(15) Railroad company. – A company engaged in the business of operating a railroad to, from, within or through this State on rights-of-way owned or leased by the company. It also means a company operating a passenger service on the lines of any railroad located wholly or partly in this State.

(16) Rolling stock. – Motor vehicles, railroad locomotives, and railroad cars that are propelled by mechanical or electrical power and used upon the highways or, in the case of railroad vehicles, upon tracks.

(17) System property. – The real property and personal property used by a public service company in its public service activities. The term also includes public service company property under construction on the day as of which property is assessed which when completed will be used by the owner in its public service activities.

~~(18) Telegraph company. – A company engaged in the business of transmitting telegraph messages to, from, within, or through the State.~~

(19) ~~Telephone~~ Telecommunications company. – A company engaged in the business of ~~transmitting telephone messages and conversations to, from, within, or through this State.~~providing telecommunications service as defined in G.S. 105-164.3.

(20) Repealed by Session Laws 1973, c. 783, s. 5. (1939, c. 310, ss. 1600-1605; 1943, c. 634, s. 3; 1965, c. 287, s. 17; 1971, c. 806, s. 1; c. 1121, s. 4; 1973, c. 198; c. 783, ss. 1-5; c. 1180; 1991 (Reg. Sess., 1992), c. 961, s. 1; 1995, c. 350, ss. 1, 2; 1995 (Reg. Sess., 1996), c. 646, s. 18; 1997-23, ss. 6, 7; 1998-98, s. 25.)

(21) Tower company. – A company that owns towers used by a telecommunications company to provide telecommunications service and that is not a telecommunications company.

(22) True value. – Defined in G.S. 105-283."

SECTION 2. G.S. 105-335 reads as rewritten:

"**§ 105-335. Appraisal of property of public service companies.**

(a) Duty to Appraise. – ~~In accordance with the provisions of subsection (b), below, the~~The Department of Revenue ~~shall~~ must appraise for taxation the true value of each public service company ~~(other than bus line, motor freight carrier, and airline companies) as a system (both inside and outside this State). Certain specified properties of bus line, motor freight carrier, and airline companies shall be appraised by the Department in accordance with the provisions of subsection (c), below, and all other properties of such companies shall be listed, appraised, and assessed in the manner prescribed by this Subchapter for the properties of taxpayers other than public service companies~~in accordance with this section.

(b) Property of ~~Public Service Companies Other Than Those Noted in Subsection (c).~~Electric, Gas, Pipeline, and Telecommunications Companies. –

(1) System Property. – Each year, as of January 1, the Department of Revenue ~~shall~~ must appraise at its true value ~~(as defined in G.S. 105-283)~~ the system property used by each public service company both inside and outside this State. Property leased by a public service company shall be included in appraising the value of its system property if necessary to ascertain the true value of the company's system property.

(2) Nonsystem Personal Property. – Each year as of January 1, the Department shall appraise at its true value ~~(as defined in G.S. 105-283)~~ each public service company's nonsystem tangible personal property subject to taxation in this State.

(3) Nonsystem Real Property. – In accordance with the county in which the public service company's nonsystem real property is located and the schedules set out in G.S. 105-286 and 105-287, the Department of Revenue shall appraise at its true value ~~(as defined in G.S. 105-283)~~ each public service company's nonsystem real property subject to taxation in this State.

(c) Property of Bus Line, Motor Freight Carrier, ~~and Airline~~Airline, and Tower Companies. –

(1) Bus Company Rolling Stock. – Each year as of January 1, the Department shall appraise at its true value ~~(as defined in G.S. 105-283)~~ the rolling stock owned or leased by or operated under the control of each bus line company, which bus line company is domiciled in this State or which is regularly engaged in business in this State.

(2) Motor Freight Carrier Company Rolling Stock. – Each year as of January 1, the Department shall appraise at its true value ~~(as defined in G.S. 105-283)~~ the rolling stock owned by a motor freight carrier company or leased by a motor freight carrier company and operated by its employees which motor freight carrier company is domiciled in this State or is regularly engaged in business in this State at a terminal owned or leased by the carrier.

(3) Flight Equipment. – Each year, as of January 1, the Department shall appraise at its true value ~~(as defined in G.S. 105-283)~~ the flight

equipment owned or leased by or operated under the control of each airline company that is domiciled in the State or that is regularly engaged in business at some airport in this State.

(4) Tower Equipment. – Each year, as of January 1, the Department shall appraise at its true value the towers and related site improvements that are owned by each tower company."

SECTION 2. G.S. 105-338 reads as rewritten:

"§ 105-338. Allocation of appraised valuation of system property among local taxing units.

(a) State Board's Duty. – For purposes of taxation by local taxing units in this State, the Department of Revenue shall allocate the valuations of public service company property among the local taxing units in accordance with the provisions of this section.

(b) System Valuation of ~~Companies Other Than Those Noted in Subsection (c).~~Electric, Gas, Pipeline, Railroad, and Telecommunications Companies. –

(1) System Property of Railroad Companies. – The appraised valuation of the distributable system property of a railroad shall be allocated for taxation to the local taxing units in accordance with the ratio of the miles of all the company's tracks in the local taxing unit to the total miles of all the company's tracks in this State, adjusted to reflect density of traffic in the local taxing unit.

(2) System Property of ~~Telephone~~ Telecommunications Companies. –

a. The Department of Revenue shall divide each ~~telephone~~ telecommunications company's system property in this State into the following two classes and shall determine the original cost of that property and the percentage thereof represented by the property in each of the two classes.

– Class 1: Property located in this State that is identified under the applicable uniform system of accounts as central office equipment, ~~large P.B.X. equipment,~~cellular equipment, personal communication service equipment, motor vehicles, tools and work equipment, office furniture and equipment, materials and supplies, and land and buildings (including towers and other structures).

– Class 2: Property located in this State that does not come within Class 1.

The Department of Revenue shall then apply the percentages obtained in accordance with this subdivision to the appraised valuation of the company's system property in this State and thereby derive the proportions of appraised valuation to be allocated as Class 1 and Class 2 valuations to local taxing units in accordance with subdivision (b)(2)b, below.

b. Having made the division required by subdivision (b)(2)a, above, the Department of Revenue shall allocate the appraised

valuation of the properties in each class among the local taxing units of the State as follows:

– Class 1: The appraised valuations of property in this class shall be allocated among the local taxing units in which such property of the company is situated on January 1 in the proportion that the original cost of such property in the taxing unit bears to the original cost of all such property in this State.

– Class 2: The appraised valuations of property in this class shall be allocated among the local taxing units in which the company operates in the proportion that the miles of the company's ~~single aerial wire and single wire in cable (including single tube in coaxial cable)~~transmission wires or cables in the taxing unit bears to the total of such wire miles of the company in this State.

(3) System Property of ~~Other Companies Appraised by the Department of Revenue.~~Electric, Gas, and Pipeline Companies. –

a. The provisions of this subdivision (b)(3) shall govern the allocation of the property of ~~all companies appraised by the Department of Revenue except railroad, telephone, bus line, motor freight carrier, and airline companies.~~electric, gas, and pipeline companies.

b. The appraised valuation of the system property of such a company shall be allocated for taxation to the local taxing units in which the company operates in the proportion that the original cost of the taxable system property in the local taxing unit on January 1 bears to the original cost of all the taxable system property in this State. If in any local taxing unit the company owns system property acquired prior to January 1, 1972, for which the original cost cannot be definitely ascertained, a reasonable estimate of the original cost of that property shall be made by the company, and this estimate shall be used by the Department of Revenue for allocation purposes as if it were the actual original cost of the property.

(c) Property of Bus Line, Motor Freight Carrier, ~~and Airline~~Airline, and Tower Companies. –

(1) The appraised valuation of a bus line company's rolling stock shall be allocated for taxation to each local taxing unit according to the ratio of the company's scheduled miles during the calendar year preceding January 1 in each such unit to the company's total scheduled miles in this State for the same period. In no event, however, shall the State Board make an allocation to a taxing unit if, when computed, the valuation for that taxing unit amounts to less than five hundred dollars ($500.00).

(2) The appraised valuation of the rolling stock (other than locally assigned rolling stock) owned or leased by a motor freight carrier company shall be allocated for taxation to each local taxing unit in which the company has a terminal according to the ratio of the tons of freight handled in the calendar year preceding January 1 at the company's terminals within the taxing unit to the total tons of freight handled by the company in this State in the same period. If a North Carolina interstate motor freight carrier company has no terminal outside this State, but has been required to pay ad valorem tax to one or more taxing units outside this State, there shall be allowed a reduction in the North Carolina valuation measured by the ratio of the rolling stock subject to ad valorem taxation outside the State to all of the carrier's rolling stock.

(3) The appraised valuation of an airline company's flight equipment shall be allocated for taxation to each local taxing unit in which an airport used by the company is situated according to the ratio obtained by averaging the following two ratios: the ratio of the company's ground hours in the taxing unit in the year preceding January 1 to the company's ground hours in the State in the same period, and the ratio of the company's gross revenue in the taxing unit in the year preceding January 1 to the company's gross revenue in the State in the same period.

(4) The appraised valuation of towers and related site improvements owned by a tower company shall be allocated for taxation to each local taxing unit in which the tower company operates according to the ratio of the total tower height of the company's towers located in the taxing unit on January 1 to the total tower height of the company's towers located in the State on the same date."

SECTION 3. This act is effective for taxes imposed for taxable years beginning on or after July 1, 2007.

BILL DRAFT: 2005-LAz-24
Public Service Company Property

BILL ANALYSIS

Committee:	Revenue Laws	**Sponsor:**	
Date:	April 18, 2006	**Analysis by:**	Martha Walston
Version:	Draft		Committee Counsel

SUMMARY: *The draft proposal is a recommendation of the Department of Revenue that would broaden the Department's authority to appraise the property of public service companies for property tax purposes by:*

- *Replacing the definition of "telephone company" with the definition of "telecommunications company". This definition would include wireless companies and paging companies.*
- *Adding a definition of tower company.*
- *Making conforming changes to the appraisal statute and allocation statute.*

The draft also would delete obsolete language and make stylistic changes.

The counties have requested the Department to begin appraising these companies, since many of the counties do not have the capability to determine the true value of the property.

CURRENT LAW: Each year the North Carolina Department of Revenue must appraise, at its true value, the system property[1] used by each public service company (other than bus line, motor freight carrier, and airline companies) both within and without the State. The Department must also appraise the rolling stock[2] of a bus line company or motor freight carrier company, and the flight equipment of an airline company each year.

In determining the true value of public service companies, the Department must consider the following:

- The market value of the company's capital stock and debt.
- The book value of the company's system property as reflected in the books of account kept under the regulations of the appropriate federal or State regulatory agency and what it would cost to replace or reproduce the system property, less a reasonable allowance for depreciation.
- Gross receipts and operation income of the company.
- Any other factor or information that in the judgment of the Board has a bearing on the true value of the company's system property.

[1] System property refers to the real and tangible personal property used by a public service company in its public service activities.

[2] Rolling stock refers to motor vehicles, railroad locomotives, and railroad cars.

If a public service company is operating both inside and outside the State, then the Department must apportion, for taxation in North Carolina, a fair and reasonable share of the value of the company using property, business, and mileage factors.

The Department must allocate the valuations of public service company property among the local taxing units. Each local taxing unit then applies its tax rate to the apportioned valuation just as it does for any other type of property.

BILL ANALYSIS: The draft would authorize the Department of Revenue to appraise wireless companies, paging companies, and tower companies as part of its duty to appraise system property used by public service companies. The counties have requested that the Department of Revenue take over this duty. By replacing the statutory definition of "telephone companies" with a definition of telecommunications companies that provide telecommunications service, the Department would thus pick up wireless companies and paging companies. Telecommunications service would have the same definition as that term does in the Streamlined Sales Tax Agreement. The draft would also pick up tower companies.

In practice most counties use only the cost approach in appraising wireless companies and tower companies, since they do not have the capability to consider other approaches such as the gross receipts and operation income of a company. The determination of the true value of the property of these companies would be more accurately determined by transferring the duty to appraise from the counties to the Department. Also these companies would no longer need to list their property at the county level.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 18, 2006

TO: Revenue Laws Study Committee

FROM: Rodney Bizzell
Fiscal Research Division

RE: 2005-LAz-24 v.7

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:					
NC Local Governments	**See "Assumptions and Methodology"**				
EXPENDITURES:					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: NC Department of Revenue, NC Local Governments

EFFECTIVE DATE: Effective for taxable years beginning on or after July 1, 2007.

BILL SUMMARY:

The draft would authorize the Department of Revenue to appraise wireless companies, paging companies, and tower companies as part of its duty to appraise system property used by public service companies. The counties have requested that the Department of Revenue take over this duty. The definition of "telephone companies" would be replaced with a definition of telecommunications companies that provide telecommunications service, which would include wireless companies and paging companies.

ASSUMPTIONS AND METHODOLOGY:
The NC Department of Revenue uses an appraisal method that differs from the methods currently used by local tax assessors to appraise public service property. This method uses income as a factor in the appraisal process. County assessors do not have the ability to use income in their appraisal process. Because of the differences in appraisal methods, there may be some differences in appraised value of public service company property included in this bill. The bill would also eliminate the need for these companies to list their property at the local level.

SOURCES OF DATA: NC Department of Revenue

TECHNICAL CONSIDERATIONS: None

Service Contracts
Statewide Survey Results

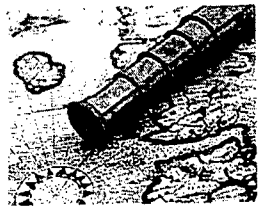
Revenue Laws Study Committee

April 19, 2006

Linda Struyk Millsaps
Economist
Fiscal Research
North Carolina General Assembly

Methodology

- Met with NCCBI Tax Committee, NCCBI Staff, North Carolina Retail Merchants.
- Additional requests to:
  - NC Bankers Association
  - NC Auto Dealers Association
  - NC Technology Association



- Surveys returned directly to Fiscal Research.

Major Retailers

- **While few responses, those who did reply appear representative of their respective industries.**
- **Average potential liability (per chain):**

	Purchases	State Tax	Local Tax	Total Tax
2004	2,600,489	117,022	65,012	182,034
2005	4,096,381	184,337	102,410	286,747
2006	4,962,622	223,318	124,065	347,383

Banking Institutions

- Overall 25 respondents (24%)
- Represent full spectrum of banks, from the state's largest banks to those who are less than 1% of total statewide assets.
- Total assets and deposits represented unknown, but significant.

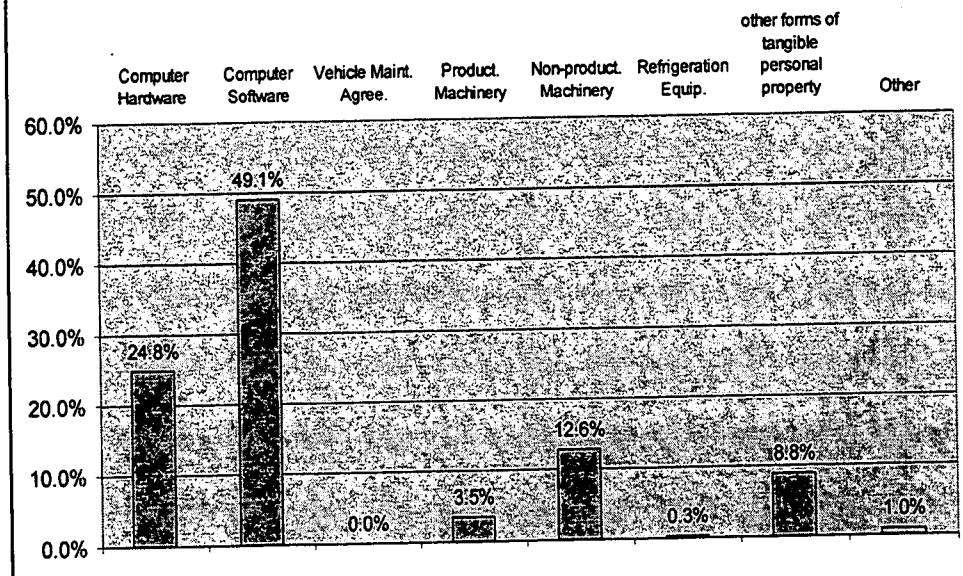


Banks – Nature of Agreements

(All responding banks)

	Comp. Hardware	Comp. Softw.	Vehicle	Prod Mach	Non Prod Mach	Refrig	Other TPP	Other
2004	23.5%	50.0%	0.0%	1.9%	15.0%	0.3%	8.6%	0.9%
2005	25.2%	51.1%	1.3%	3.5%	9.8%	0.2%	8.8%	1.1%
2006	24.8%	49.1%	0.0%	3.5%	12.6%	0.3%	8.8%	1.0%

2006 Bank Contract Distribution



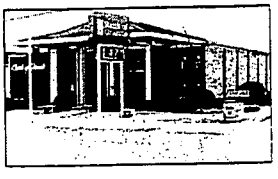
Banks – Expected Future Agreement Growth



Decline	0%
Stay the same	14%
Increase less than 10%	33%
Increase 10% - 25%	48%
Increase more than 25%	5%

Smaller Bank Respondents

- Average Deposits: 425.0 million
- Average Assets: 524.4 million



Potentially Taxable Purchases	$190,868
State Liability	$8,589
Local Liability	$4,772
Total Tax	$13,361

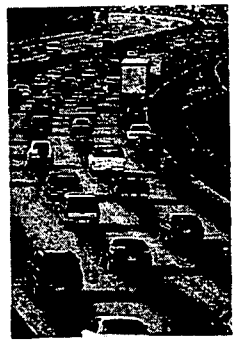
Large Bank Statistics



	Average			
	Base	State Tax	Local Tax	Total Tax
2005	42,181,538	1,898,169	1,054,538	2,952,708
2006	42,559,068	1,915,158	1,063,977	2,979,135

Motor Vehicles

- No specific survey responses
- Association produced an estimate
- New car estimate in line with previous Fiscal Research estimate
  - $236.3 million base
    - $10.6 million state tax
    - $5.9 million local tax
- Used Car Estimate
  - $486.0 million base
    - $21.9 million state tax
    - $12.2 million local tax



Overall

- Major Retailers (per chain)
  - $223,318 state
  - $124,065 local
- Regional and Community Banks
  - $8,589 state
  - $4,772 local
- Large Banks (per bank)
  - $1.9 million state
  - $1.1 million local
- Auto Dealers (total)
  - $32.5 million state
  - $18.1 million local
- Technology Companies
  - Unknown, but exemption for custom software and downloads will substantially limit fiscal impact.



REVENUE LAWS STUDY COMMITTEE
State Legislative Building
Raleigh, North Carolina 27603

Senator John H. Kerr, III, Co-Chair *Representative Paul Luebke, Co-Chair*

April 20, 2006

NOTICE

TO: Members, Revenue Laws Study Committee

FROM: Senator John Kerr, Co-Chair
Representative Paul Luebke, Co-Chair

SUBJECT: Revenue Laws Study Committee Meeting

There will be a meeting of the **Revenue Laws Study Committee** as follows:

DAY:	**Tuesday**
DATE:	**May 2, 2006**
TIME:	**1:00 pm**
LOCATION:	**Room 544, Legislative Office Building**

Please advise DeAnne Mangum, at (919) 733-2405 or e-mail deannem@ncleg.net if you will be unable to attend.

Posted: 04-20-06

REVENUE LAWS STUDY COMMITTEE
Tuesday, May 2, 2006 at 1:00 PM
Room 544, Legislative Office Building

MINUTES

The Revenue Laws Study Committee met at 1:00 PM on May 2, 2006, in Room 544 of the Legislative Office Building. Twelve members of the committee were present. Senator Kerr and Representative Luebke presided.

Sen. Kerr introduced the new member of the staff, Dan Ettefagh, an attorney with the Bill Drafting Division.

Approval of the Minutes.

Rep. Carney motioned for the approval of the April 19, 2006 minutes and the motion carried. A copy of the minutes is attached.

Review of Legislative Recommendations and Proposals.

Video Service Competition Act.
Cindy Avrette, a staff attorney with the Research Division, and Brenna Erford, a fiscal analyst with the Fiscal Research Division, were recognized to explain the bill draft. A copy of the power point presentation is attached. Rep. Carney moved to adopt the draft to be included in the report of recommended bill drafts to the 2006 Session. The motion passed unanimously.

Amend Taxation of Logging Machinery.
Trina Griffin, Research Division staff attorney, was recognized to explain the "Amend Taxation of Logging Machinery" draft proposal. Rep. Hill moved that the draft proposal be recommended to the 2006 General Assembly and the motion passed unanimously.

SSTA Definitions/Sales Tax Payments.
Cindy Avrette, Research Division staff attorney, was recognized to review the bill draft which had been explained in March.

Property Tax Changes.
Martha Walston, Fiscal Research staff attorney, was recognized to summarize the bill draft which had been explained in detail in February.

Amend Delinquent Property Tax Collection.
Martha Walston was recognized to explain the bill draft. Rep. Luebke moved to adopt the draft and include it in the report of recommended bills to the 2006 Session. The motion passed unanimously.

Phone, Tower, Cable Property Tax Appraisal.
Martha Walston was recognized to explain the bill draft. Bob Kaylor, lobbyist for Alltel and Verizon spoke in opposition to the draft. Wade Hargrove, lobbyist for NC Association of Broadcasters and NC Cable Telecommunications Association, spoke in opposition to the draft. Bill Wilkes, Assistant Director of the Property Tax Division, Department of Revenue spoke in favor of the bill and was available to answer questions. Pete Rodda, Forsyth County Tax Administrator, spoke in favor of the bill. Rep. Brubaker motioned to not approve the draft and to remove it from the report. Rep. Luebke requested further information from the Department of Revenue. Rep. Brubaker's motion passed unanimously.

IRC Update.
Canaan Huie, a staff attorney with the Bill Drafting Division, was recognized to summarize the bill draft which had received prior approval at the February 8th meeting.

Additional Personal Income Tax Filing Option.
Martha Walston was recognized to summarize the bill draft which had received approval at the February 8th meeting.

S Corporation Income Tax Adjustments.
Trina Griffin was recognized to review the bill draft which had received approval at the March 1st meeting.

Clarify Gross Premiums Tax.
Cindy Avrette was recognized to review the draft which had been explained at the March meeting. Rodney Bizzell, a fiscal analyst with the Fiscal Research Division, was available to answer questions. Joe Stewart, lobbyist for the Insurance Federation of NC, pointed out both pros and cons in the draft. Wayne Goodwin, Assistant Commissioner of Insurance, spoke in favor of the draft. Rep. Wainwright moved to approve the bill draft and include in the recommendations report to the 2006 Session. The motion passed unanimously.

Franchise Tax Loophole Closing.
Trina Griffin was recognized to the review the bill draft which had been adopted at the March 1st meeting.

Franchise Tax Base Calculations.
Cindy Avrette was recognized to review the bill draft which had been explained at the March 1st meeting.

Expansion of Royalty Reporting Option
Trina Griffin was recognized to summarize the bill draft which had been adopted at the March 1st meeting, but had been altered to delete confusing language at Sen. Clodfelter's request. Rep. Hill moved to approve the draft and include it in the report to the 2006 Session. The motion passed unanimously.

Simplify Electric Franchise Tax Distribution.
Cindy Avrette was recognized to explain the issue which was offered as a committee substitute to Senate Bill 343. Rep. Wainwright recommended its approval and inclusion to the report to the 2006 Session. The motion passed unanimously.

Revenue Laws Technical Changes.
Trina Griffin was recognized to explain the bill draft which had been presented in multiple parts in past meetings and rolled into a single draft. Rep. Hill moved for its approval and the motion passed unanimously.

Approval of the Final Report.
Sen. Kerr moved to approve the Revenue Laws Study Committee's final report to the 2006 Session and the motion passed unanimously.

The meeting adjourned at 2:43 PM.

Senator John H. Kerr, III, Co-Chair
Revenue Laws Study Committee

Representative Paul Luebke, Co-Chair
Revenue Laws Study Committee

DeAnne Mangum, Committee Clerk

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — May 2, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
J STEWART	IFNC
Michael Johnson	Ernst & Young
ANGELA CARTER	UNITED ACTS, RALEIGH, NC
Joseph Coletti	John Locke Foundation
[illegible]	TNC
Shawn Miller	CUCA.
Michael Williams	City of Raleigh, NC.
Jim Rapp	NCTA
Bob Sepe	Action Audits
Catharine Rice	Action Audits
Lisa Beinsler	S.E.C.U.R.E.
Wayne Goodwin	NCDOR

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — May 2, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Carol Tullin	UNC Chapel Hill Comm Studies
Jessica Rapchik	The Peoples Channel 300 A/C Elliot Road
Tina Hartman	The Peoples' Channel Elliott Road, Chapel Hill NC 27514
Chaz Johnston	TPC Elliott Rd Chapel Hill 27514
Lee Mandell	NCLM
Meredith Garwood	Time Warner Cable
Jack Stanley	Time Warner Cable
Bobby White	White's Tire Service
Herb Crenshaw	BellSouth
Renee Boyette	Triangle J Council of Govts PO Box 12276 RTP NC 27709
Jo Anne Sanford	NC Utilities Comm.
Bill Wilson	AARP NC

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — May 2, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
David Duty	Dept. of Revenue
Guy Rudd	DOR
Lennie Collins	DOR
Diane Ellis	DOR
Donna Oldenburg	DOR
Carole Woodward	NC Telecommunications Industry Association
Anna Mitchell	NC DOR
David Ogburn	Verizon
Stan Pace	Verizon
Ed Turlington	BP
Dennis Patterson	OSC

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — May 2, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Jennie New	Kennedy Covington
Shan Mecham	SMC
Mitch Kokai	John Locke Foundation
[illegible]	TPC/UNCCOM Dept.
Jessica Rapchik	The Peoples Channel 300 A/C Elliot Road, Chapel Hill, NC
Jon Paul McClellan	" "
Jeff VAN DYKE	BELL SOUTH
LORI ANN HAER	LAHA
Dorothy Davidge	TCM
Michelle Goryn	Institute for Emerging Issues
Pam Meyer	NCACC

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — May 2, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
MICHAEL CROWELL	LAWYER, RALEIGH
Jeff Mixon	LA, Civitas Inst.
David Baker	NC DOR
Michael Brown	NC DOR
Chad Hinton	Civitas Institute
Kathy Hawley	Progress
Andy Ellen	NC Retail
[illegible]	NCAHA
Steve Woodson	NC Farm Bureau
FRAN PRESTON	NCRMA
[illegible]	SA
Patrick Baffin	ALLEY ASSOC

check Book -

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — May 2, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Butch Gunnells	NCBA
Catherine Rice	Audits, Quest
Robert T. Stepe	Action Audits, LLC
Rebecca Troutman	NCACC
MARK PEAK	BB SMITH
Bill Phillips	TWC
Leslie Bulacan Coman	Capstrat
NICHOLAS LONG JR	NCBA REAL PROPERTY SECTION COUNCIL
Connie Wilson	SSI
THOMAS ADAMS	TIME WARNER CABLE
Wade Hargrove	Brooks Pierce

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — May 2, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Susan Valauri	Nationwide
	JDA: PA
	NMRS
	Public Staff
Horacio Tapia	NCUC
	NC Utilities Commission
Sam J. Ervin, IV	NCUC
Tony Wike	Public Staff
Nat Carpenter	Public Staff
Rob Kaylor	Kaylor Law Firm
John McAlister	Duke Energy

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — May 2, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Drew Wofford	comunity producer at BTN
Pete Rodda	Forsyth Co. Tax Assessor/Collector
Mark Beacon	Beacon Gov't Affairs
Mary Trotter	Brooks Pierce
George Judd	NC BEV
Paul Matthews	Progress Energy
Steve Brewer	Sprint
Marty Bocock	Sprint
Bob Wells	Alliance of N.C. Telcos
Karen Johnson	Smith Anderson
Dwight Allen	Smith Anderson

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — May 2, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
Linda Cheatham	BellSouth- 108 W. [illegible]
Daniel Long	NCUC
Bridget Paschal	NCUC Staff
Lemuel W Hinton	NCUC
John Mattyl	Gov office
C Covey	BPMI
PATRICK BUFFKIN	ALLEY ASSOC, INC
[illegible]	[illegible]
Molly Beadle	self

VISITOR REGISTRATION SHEET

Revenue Laws Study Committee — May 2, 2006

Name of Committee — **Date**

VISITORS: PLEASE SIGN IN BELOW AND RETURN TO COMMITTEE CLERK

NAME	FIRM OR AGENCY AND ADDRESS
JOHN GOODMAN	ALLEY ASSOCIATES
	BOMC ASSO.

House Pages

REVENUE LAWS

Name Of Committee:_____ Date: 5-2-06

1. Name: _____

   County: _____

   Sponsor: _____

2. Name: _____

   County: _____

   Sponsor: _____

3. Name: _____

   County: _____

   Sponsor: _____

4. Name: _____

   County: _____

   Sponsor: _____

5. Name: _____

   County: _____

   Sponsor: _____

Sgt-At-Arms

	SENATE	HOUSE
1. Name:	ERNIE SHERRELL	FRED HINES
2. Name:	RON SPANN	Dusty Rhodes
3. Name:	STAN JOHNSON	MARVIN LEE
4. Name:	JON FITCHETT	Bill Freeman
5. Name:		

REVENUE LAWS STUDY COMMITTEE AGENDA

Sen. John Kerr Rep. Paul Luebke

Tuesday, May 2, 2006
Room 544, Legislative Office Building
1:00 p.m.

I. **Approval of the Minutes from the April 19, 2006, Meeting**

II. **Review of Legislative Recommendations and Proposals**

- **Video Service Competition Act (page 21)**
  Cindy Avrette, Brenna Erford
- **Amend Taxation of Logging Machinery (page 48)**
  Trina Griffin, Linda Millsaps
- **SSTA Definitions/Sales Tax Payments (page 54)**
  Cindy Avrette, Linda Millsaps
- **Property Tax Changes (page 75)**
  Martha Walston, Rodney Bizzell
- **Amend Delinquent Property Tax Collection (page 86)**
  Martha Walston, Rodney Bizzell
- **Phone, Tower, Cable Property Tax Appraisal (page 98)**
  Martha Walston, Rodney Bizzell
- **IRC Update (page 111)**
  Canaan Huie, Linda Millsaps
- **Additional Personal Income Tax Filing Option (page 134)**
  Martha Walston, Linda Millsaps
- **S Corporation Income Tax Adjustments (page 140)**
  Trina Griffin, David Crotts
- **Clarify Gross Premiums Tax (page 147)**
  Cindy Avrette, Rodney Bizzell
- **Franchise Tax Loophole Closing (page 154)**
  Trina Griffin, David Crotts
- **Franchise Tax Base Calculation (page 164)**
  Cindy Avrette, David Crotts
- **Expansion of Royalty Reporting Option (page 173)**
  Trina Griffin, David Crotts

- **Simplify Electric Franchise Tax Distribution (page 183)**
  Cindy Avrette, Rodney Bizzell
- **Revenue Laws Technical Changes (page 187)**
  Trina Griffin

III. **Approval of Final Report**

IV. **Adjournment**

Revenue Laws Study Committee

Estimated Local Tax Distribution For Shared Sales Tax on Video Services

May 2, 2006

Estimated Franchise Fee Revenues for Non-Surveyed and Non-Responding Cities & Counties

Columns 1 and 2 on the following table "Video Services Tax Distribution to Local Governments" give detail on which local governments were surveyed by the North Carolina General Assembly Fiscal Research Division and either the **actual** or **imputed** cable franchise fee collections for that local government (Column 4, Actual & Imputed Cable Franchise Fee Revenues 2004-05). Many local governments who responded to the Fiscal Research survey included actual collections data for FY 2004-05, which is shown in this table. In all cases where actual collections data is available, it has been used. Cable franchise fee revenues for non-surveyed and non-responding local governments that are known or believed to hold current cable franchise agreements have been estimated using the following assumptions:

1. Non-surveyed and non-responding local governments are assumed to assess cable franchise fees at a rate of 5% of gross revenues.

2. Based on survey responses, the following table shows the amount of cable franchise fee that was estimated **per capita** to obtain 2004-05 estimated total franchise fee revenues:

Cities*	**5% per capita**
Less than 1,000 people	$ 11.20
1001-4000 people	$ 8.35
4001-10,000 people	$ 9.40
10,001+ people	$ 8.10
Counties	
4000-25,000 people	$ 3.24
25,001-45,000 people	$ 4.61
45,001-105,000 people	$ 4.81
*The median was used for cities with less than 1,000 people	

These amounts were multiplied by the estimated 2004 population of non-surveyed and non-responding cities to generate an estimated amount of cable franchise fee revenue for 2004-05. In general, estimates for cities tend to more closely approximate actual revenues than estimates for the non-municipal portion of counties. This may be due to the greater variation in the percent of households passed by cable operators in unincorporated areas (counties).

Pursuant to the bill, the actual proportional distribution for local governments will be calculated by the Department of Revenue using certified collections numbers obtaining from local governments. **This document is only intended as an estimate of the actual distribution.** Although every effort has been made to ensure the information presented here is as accurate as possible, imputed franchise fee collections may differ from actual. In addition, some local governments included in this list may not hold a cable franchise agreement or assess franchise fees.

3. For cities, Fiscal Research used certified 2004 municipal population estimates provided by the State Data Center. For counties, State Data Center certified 2004 non-municipal population estimates were used.

Estimated Video Services Tax Distribution to Local Governments

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Aberdeen		U		I			4,060	38,164	0.06%			39,783	1,619
Ahoskie		U		I			4,478	42,093	0.07%			43,879	1,785
Alamance County	S		A				53,731	164,821	0.27%			171,812	6,991
Albemarle		U		I			15,665	126,887	0.20%			132,268	5,382
Alexander County	S		A				33,332	99,765	0.16%			103,996	4,231
Alleghany County	S			I			9,033	29,357	0.05%			30,602	1,245
Alliance		U		I			792	8,870	0.01%			9,247	376
Andrews		U		I			1,845	15,406	0.02%			16,059	653
Angier		U		I			3,855	32,189	0.05%			33,555	1,365
Anson County	S		A				15,146	28,658	0.05%	1	16,000	45,873	17,215
Apex		U		I			25,951	210,203	0.34%			219,119	8,915
Arapahoe		U		I			434	4,861	0.01%			5,067	206
Archdale	S		A				9,369	95,777	0.15%			99,839	4,062
Ashe County	S		A				22,425	-	0.00%			-	-
Asheboro	S		A				22,947	128,777	0.21%			134,239	5,462
Asheville	S		A				73,239	801,623	1.29%	2	32,000	867,623	66,000
Atlantic Beach		U		I			1,791	14,955	0.02%			15,589	634
Aulander	S		A				888	1,989	0.00%			2,073	84
Aurora	S		A				575	4,904	0.01%			5,112	208
Autryville	S		A				201	2,425	0.00%			2,528	103
Avery County	S			I			15,133	49,182	0.08%			51,268	2,086
Ayden		U		I			4,661	43,813	0.07%			45,672	1,858
Badin		U		I			1,971	16,458	0.03%			17,156	698
Bailey		U		I			693	7,762	0.01%			8,091	329
Bakersville		U		I			357	3,998	0.01%			4,168	170
Bald Head Island	S		A				217	19,010	0.03%			19,816	806
Banner Elk	S	U		I			1,035	8,642	0.01%			9,009	367
Bath		U		I			287	3,214	0.01%			3,351	136
Bayboro		U		I			743	8,322	0.01%			8,675	353
Bear Grass		U		I			65	3,640	0.01%			3,794	154
Beaufort County	S			I			31,918	734,114	1.18%			765,250	31,136

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Beaufort		U		I			3,888	162,324	0.26%			169,209	6,885
Beech Mountain		U		I			350	19,600	0.03%			20,431	831
Belhaven	S			I			1,933	16,141	0.03%			16,825	685
Belmont		U		I			8,897	83,632	0.13%			87,179	3,547
Belwood		U		I			1,006	8,400	0.01%			8,756	356
Benson	S		A				3,320	28,524	0.05%			29,734	1,210
Bermuda Run	S			I			1,483	12,383	0.02%			12,908	525
Bertie County	S		A				14,787	13,597	0.02%			14,174	577
Bessemer		U		I			5,337	50,168	0.08%			52,296	2,128
Bethania		U		I			366	4,099	0.01%			4,273	174
Bethel		U		I			1,761	14,704	0.02%			15,328	624
Beulaville		U		I			1,078	9,001	0.01%			9,383	382
Biltmore Forest		U		I			1,475	12,316	0.02%			12,839	522
Biscoe	S		A				1,745	4,463	0.01%			4,652	189
Black Creek		U		I			728	8,154	0.01%			8,499	346
Black Mountain		U		I			7,660	72,004	0.12%			75,058	3,054
Bladen County		U		I			25,334	116,536	0.19%			121,479	4,943
Bladenboro	S		A				1,703	13,029	0.02%			13,582	553
Blowing Rock		U		I			1,430	11,941	0.02%			12,447	506
Bogue		U		I			629	7,045	0.01%			7,344	299
Boiling Spring Lakes	S		A				3,580	21,016	0.03%			21,907	891
Boiling Springs		U		I			3,986	33,283	0.05%			34,695	1,412
Bolivia	S			I			154	1,725	0.00%			1,798	73
Bolton	S			I			487	5,454	0.01%			5,686	231
Boone		U		I			14,120	114,372	0.18%	1	16,000	135,223	20,851
Boonville		U		I			1,144	9,552	0.02%			9,958	405
Bostic		U		I			322	3,606	0.01%			3,759	153
Brevard		U		I			6,795	63,873	0.10%			66,582	2,709
Bridgeton	S		A				309	2,241	0.00%			2,336	95
Broadway		U		I			1,017	8,492	0.01%			8,852	360
Brookford		U		I			430	4,816	0.01%			5,020	204
Brunswick	S			I			1,050	8,768	0.01%			9,139	372
Brunswick County	S			I			51,693	248,126	0.40%			258,650	10,524
Bryson		U		I			1,442	12,041	0.02%			12,551	511

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Buncombe County	S		A		x	0.20	126,011	1,300,179	2.09%	2	32,000	1,387,324	87,145
Bunn	S			I			382	4,278	0.01%			4,460	181
Burgaw		U		I			3,566	29,776	0.05%			31,039	1,263
Burke County	S		A				57,966	260,199	0.42%			271,235	11,036
Burlington	S		A				47,004	368,880	0.59%			384,525	15,645
Burnsville		U		I			1,628	13,594	0.02%			14,170	577
Cabarrus County	S		A				44,812	452,437	0.73%			471,626	19,189
Cajah's Mountain		U		I			2,712	22,645	0.04%			23,606	960
Calabash	S		A				1,346	-	0.00%			-	-
Caldwell County	S			I			39,905	183,563	0.30%	1	16,000	207,349	23,786
Calypso		U		I			432	4,838	0.01%			5,044	205
Camden County	S		A				8,491	45,978	0.07%			47,928	1,950
Cameron	S			I			288	3,226	0.01%			3,362	137
Candor	S			I			838	9,386	0.02%			9,784	398
Canton		U		I			4,122	38,747	0.06%			40,390	1,643
Cape Carteret		U		I			1,298	10,838	0.02%			11,298	460
Carolina Beach	S			I			5,434	51,080	0.08%			53,246	2,166
Carrboro		U		I	x	0.21	17,648	163,949	0.26%			170,902	6,954
Carteret County	S			I			35,853	164,924	0.27%			171,919	6,995
Carthage		U		I			2,169	18,111	0.03%			18,879	768
Cary	S		A				110,028	975,028	1.57%	1	16,000	1,032,382	57,354
Casar		U		I			307	3,438	0.01%			3,584	146
Castalia		U		I			357	3,998	0.01%			4,168	170
Caswell Beach	S		A				443	5,410	0.01%			5,639	229
Caswell County	S		A				21,373	11,391	0.02%			11,874	483
Catawba County	S		A				78,830	573,138	0.92%			597,447	24,309
Cedar Point		U		I			855	9,576	0.02%			9,982	406
Chadbourn	S			I			2,116	17,669	0.03%			18,418	749
Chapel Hill	S		A		x	0.78	51,519	393,993	0.63%	2	32,000	442,704	48,711
Charlotte	S		A		x	0.21	609,185	6,528,881	10.52%	3	48,000	6,853,793	324,912
Chatham County	S		A				44,469	115,000	0.19%			119,878	4,878
Cherokee County	S			I			22,244	72,293	0.12%			75,359	3,066
Cherryville		U		I			5,530	51,982	0.08%			54,187	2,205
Chimney Rock		U		I			181	2,027	0.00%			2,113	86

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
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North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
China Grove		U		I			3,932	32,832	0.05%			34,225	1,393
Chocowinity	S			I			720	8,064	0.01%			8,406	342
Chowan County	S		A				9,412	19,551	0.03%			20,380	829
Claremont		U		I			1,079	9,010	0.01%			9,392	382
Clarkton	S			I			789	8,837	0.01%			9,212	375
Clay County	S		A				9,133	22,377	0.04%			23,326	949
Clayton	S		A				10,879	95,414	0.15%			99,461	4,047
Clemmons		U		I			16,962	137,392	0.22%			143,219	5,827
Cleveland County	S			I			56,376	270,605	0.44%			282,082	11,477
Cleveland		U		I			816	9,139	0.01%			9,527	388
Clinton	S			I			8,657	81,376	0.13%			84,827	3,451
Clyde		U		I			1,386	11,573	0.02%			12,064	491
Coats		U		I			1,977	16,508	0.03%			17,208	700
Cofield		U		I			334	3,741	0.01%			3,899	159
Colerain	S			I			218	2,442	0.00%			2,545	104
Columbia	S						838	9,386	0.02%			9,784	398
Columbus	S			I			1,050	8,768	0.01%			9,139	372
Columbus County	S			I			39,889	183,489	0.30%			191,272	7,782
Concord	S		A				62,291	395,717	0.64%			412,501	16,784
Connelly Springs		U		I			1,904	15,898	0.03%			16,573	674
Conetoe	S						354	6,960	0.01%			7,255	295
Conover		U		I			7,510	70,594	0.11%			73,588	2,994
Conway**	S		A				716	117,446	0.19%			122,427	4,981
Cooleemee		U		I			938	10,506	0.02%			10,951	446
Cornelius	S			I			15,918	128,936	0.21%			134,404	5,469
Cramerton		U		I			3,048	25,451	0.04%			26,530	1,079
Craven County	S		A				37,008	156,000	0.25%			162,616	6,616
Creedmoor		U		I			2,611	21,802	0.04%			22,727	925
Creswell		U		I			264	2,957	0.00%			3,082	125
Crossnore		U		I			301	3,371	0.01%			3,514	143
Cumberland County	S			I			157,660	756,768	1.22%			788,865	32,097
Currituck County	S			I			21,876	71,097	0.11%			74,112	3,015
Dallas	S			I			3,563	29,751	0.05%			31,013	1,262
Danbury		U		I			107	1,198	0.00%			1,249	51

	Detail on Local Governments						Populatio	2004-05 Actual & Imputed		PEG Support		Dis tion	
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Dare County	S			I			16,951	54,921	0.09%	2	32,000	89,251	34,329
Davidson	S		A				8,024	251,339	0.40%			261,999	10,660
Davidson County	S		A				102,023	896,534	1.44%			934,559	38,025
Davie County	S			I			31,122	143,161	0.23%			149,233	6,072
Denton	S			I			1,488	12,425	0.02%			12,952	527
Dillsboro		U		I			236	2,643	0.00%			2,755	112
Dobbins Heights		U		I			903	10,114	0.02%			10,543	429
Dobson	S			I			1,481	12,366	0.02%			12,891	524
Dortches		U		I			826	9,251	0.01%			9,644	392
Dover	S			I			441	4,939	0.01%			5,149	209
Drexel	S			I			1,914	15,982	0.03%			16,660	678
Dublin	S			I			253	2,834	0.00%			2,954	120
Duck		U		I			517	5,790	0.01%			6,036	246
Dunn	S			I			9,712	91,293	0.15%			95,165	3,872
Duplin County	S		A				38,211	20,525	0.03%			21,396	871
Durham	S		A				204,767	1,852,094	2.98%			1,930,648	78,554
Durham County	S		A				31,634	390,638	0.63%			407,206	16,568
East Arcadia		U		I			535	5,992	0.01%			6,246	254
East Bend	S			I			663	7,426	0.01%			7,741	315
East Laurinburg		U		I			291	3,259	0.01%			3,397	138
Eden	S		A				15,840	146,827	0.24%			153,054	6,227
Edenton		U		I			5,059	47,555	0.08%			49,572	2,017
Edgecombe County	S		A				5,031	53,360	0.09%			55,623	2,263
Elizabeth City	S			I			18,249	147,817	0.24%	1	16,000	170,086	22,269
Elizabethtown	S		A				3,729	37,060	0.06%			38,632	1,572
Elk Park		U		I			458	5,130	0.01%			5,347	218
Ellenboro		U		I			473	5,298	0.01%			5,522	225
Ellerbe		U		I			993	11,122	0.02%			11,593	472
Elm		U		I			1,394	11,640	0.02%			12,134	494
Elon	S		A				7,176	59,240	0.10%			61,753	2,513
Emerald Isle		U		I			3,720	31,062	0.05%			32,379	1,317
Enfield		U		I			2,370	19,790	0.03%			20,629	839
Erwin	S		A				4,741	18,509	0.03%			19,294	785
Eureka	S			I			240	2,688	0.00%			2,802	114

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Everetts		U		I			177	1,982	0.00%			2,066	84
Fair Bluff	S			I			1,217	10,162	0.02%			10,593	431
Fairmont		U		I			2,651	22,136	0.04%			23,075	939
Faison		U		I			763	8,546	0.01%			8,908	362
Faith		U		I			703	7,874	0.01%			8,208	334
Falcon		U		I			326	3,651	0.01%			3,806	155
Fallston		U		I			612	6,854	0.01%			7,145	291
Farmville	S		A				4,626	36,076	0.06%			37,606	1,530
Fayetteville	S		A				130,850	1,482,355	2.39%			1,545,227	62,872
Flat Rock		U		I			2,798	23,363	0.04%			24,354	991
Fletcher	S		A				5,088	59,737	0.10%			62,271	2,534
Forest		U		I			7,329	68,893	0.11%			71,815	2,922
Forsyth County	S		A				7,314	715,111	1.15%			745,441	30,330
Fountain	S			I			545	6,104	0.01%			6,363	259
Four Oaks		U		I			1,760	14,696	0.02%			15,319	623
Foxfire Village	S			I			501	5,611	0.01%			5,849	238
Franklin	S			I			3,650	30,478	0.05%			31,770	1,293
Franklin County	S		A				45,626	75,393	0.12%			78,591	3,198
Franklinton		U		I			2,350	19,623	0.03%			20,455	832
Franklinville		U		I			1,333	11,131	0.02%			11,603	472
Fremont		U		I			1,432	11,957	0.02%			12,464	507
Fuquay-Varina		U		I			10,300	83,430	0.13%			86,969	3,539
Gamewell		U		I			3,831	31,989	0.05%			33,346	1,357
Garland	S			I			787	8,814	0.01%			9,188	374
Garner	S			I			21,106	170,959	0.28%			178,210	7,251
Garysburg	S			I			1,232	10,287	0.02%			10,724	436
Gaston	S		A				990	12,299	0.02%			12,821	522
Gaston County	S			I			76,531	367,349	0.59%	1	16,000	398,929	31,581
Gastonia	S		A				68,802	561,221	0.90%			585,024	23,803
Gates County	S		A				10,703	2,283	0.00%			2,380	97
Gatesville		U		I			283	3,170	0.01%			3,304	134
Gibson		U		I			580	6,496	0.01%			6,772	276
Gibsonville	S		A				4,574	41,976	0.07%			43,756	1,780
Glen Alpine		U		I			1,120	9,352	0.02%			9,749	397

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Godwin	S		A				117	1,462	0.00%			1,524	62
Goldsboro	S		A				38,517	275,402	0.44%			287,083	11,681
Goldston	S		A				339	944	0.00%			984	40
Graham		U		I			13,761	111,464	0.18%			116,192	4,728
Graham County	S		A				7,267	98,670	0.16%			102,855	4,185
Grandfather		U		I			78	874	0.00%			911	37
Granite Falls		U		I			4,703	44,208	0.07%			46,083	1,875
Granite Quarry		U		I			2,248	18,771	0.03%			19,567	796
Grantsboro		U		I			828	9,274	0.01%			9,667	393
Granville County	S			I			41,148	189,281	0.30%			197,309	8,028
Greene County	S			I			17,720	57,590	0.09%			60,033	2,443
Greensboro	S		A		x	0.16	233,148	2,533,150	4.08%	1	16,000	2,656,590	123,440
Greenville	S		A				67,499	451,604	0.73%	1	16,000	486,758	35,154
Grifton		U		I			2,356	19,673	0.03%			20,507	834
Grimesland		U		I			441	4,939	0.01%			5,149	209
Grover		U		I			697	7,806	0.01%			8,137	331
Guilford County	S		A				85,555	520,014	0.84%	1	16,000	558,070	38,056
Halifax County	S			I			32,333	148,732	0.24%			155,040	6,308
Halifax		U		I			339	3,797	0.01%			3,958	161
Hamilton		U		I			493	5,522	0.01%			5,756	234
Hamlet		U		I			5,871	55,187	0.09%			57,528	2,341
Harmony		U		I			563	6,306	0.01%			6,573	267
Harnett County	S		A				76,323	169,336	0.27%			176,518	7,182
Harrisburg		U		I			5,238	49,237	0.08%			51,326	2,088
Hassell	S			I			71	795	0.00%			829	34
Havelock	S		A				21,999	107,758	0.17%			112,328	4,570
Haw River	S		A				1,944	13,616	0.02%			14,194	578
Hayesville		U		I			485	5,432	0.01%			5,662	230
Haywood County	S		A				40,332	284,196	0.46%	1	16,000	312,250	28,054
Henderson		U		I			16,445	133,205	0.21%			138,854	5,650
Henderson County	S			I			68,175	327,240	0.53%			341,119	13,879
Hendersonville	S		A				11,893	33,947	0.05%			35,387	1,440
Hertford County	S			I			15,520	50,440	0.08%			52,579	2,139
Hertford		U		I			2,083	17,393	0.03%			18,131	738

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Hickory	S		A				38,973	396,371	0.64%			413,182	16,811
High Point	S		A				90,363	829,394	1.34%			864,571	35,177
High Shoals		U		I			744	8,333	0.01%			8,686	353
Highlands	S		A				941	31,978	0.05%			33,334	1,356
Hildebran		U		I			1,761	14,704	0.02%			15,328	624
Hillsborough		U		I			5,671	53,307	0.09%			55,568	2,261
Hobgood		U		I			395	4,424	0.01%			4,612	188
Hoffman		U		I			652	7,302	0.01%			7,612	310
Hoke County	S			I			34,954	160,788	0.26%			167,608	6,820
Holden Beach	S		A				861	33,310	0.05%			34,723	1,413
Holly Ridge	S			I			843	9,442	0.02%			9,842	400
Holly Springs	S		A				13,362	121,599	0.20%			126,756	5,157
Hookerton		U		I			483	5,410	0.01%			5,639	229
Hope Mills		U		I			12,355	100,076	0.16%			104,320	4,245
Hudson		U		I			3,100	25,885	0.04%			26,983	1,098
Huntersville	S			I			30,664	248,378	0.40%			258,913	10,535
Hyde County	S			I			5,642	18,337	0.03%			19,114	778
Indian Beach		U		I			92	1,030	0.00%			1,074	44
Indian Trail		U		I			16,764	135,788	0.22%			141,548	5,759
Iredell County	S		A				86,894	418,165	0.67%			435,901	17,736
Jackson County	S			I			31,973	147,076	0.24%			153,314	6,238
Jackson	S			I			686	7,683	0.01%			8,009	326
Jacksonville	S		A				73,531	380,125	0.61%			396,247	16,122
Jamestown	S		A				3,258	37,205	0.06%			38,783	1,578
Jamesville	S			I			475	5,074	0.01%			5,289	215
Jefferson	S		A				1,433	10,947	0.02%			11,411	464
Johnston County	S		A				100,346	150,536	0.24%			156,921	6,385
Jonesville		U		I			2,246	18,754	0.03%			19,550	795
Kannapolis	S		A				39,187	287,029	0.46%			299,203	12,174
Kelford		U		I			250	2,800	0.00%			2,919	119
Kenansville		U		I			1,195	9,978	0.02%			10,401	423
Kenly		U		I			1,821	15,205	0.02%			15,850	645
Kernersville		U		I			20,690	167,589	0.27%			174,697	7,108
Kill Devil Hills	S		A				6,613	59,110	0.10%			61,617	2,507

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
King	S		A				6,105	38,034	0.06%			39,647	1,613
Kings Mountain	S			I			10,551	85,463	0.14%			89,088	3,625
Kinston	S		A				23,093	202,815	0.33%			211,418	8,602
Kittrell		U		I			141	1,579	0.00%			1,646	67
Kitty Hawk	S			I			3,399	28,382	0.05%			29,585	1,204
Knightdale	S			I			6,660	62,604	0.10%			65,259	2,655
Kure Beach		U		I			1,857	15,506	0.02%			16,164	658
La Grange		U		I			2,817	23,522	0.04%			24,520	998
Lake Lure	S			I			1,056	8,818	0.01%			9,192	374
Lake Waccamaw		U		I			1,346	11,239	0.02%			11,716	477
Landis		U		I			3,036	25,351	0.04%			26,426	1,075
Lattimore		U		I			437	4,894	0.01%			5,102	208
Laurel Park		U		I			2,127	17,760	0.03%			18,514	753
Laurinberg		U		I			15,961	129,284	0.21%			134,767	5,483
Lawndale		U		I			641	7,179	0.01%			7,484	304
Lee County	S		A				25,298	194,335	0.31%			202,577	8,242
Leland	S			I			4,786	44,988	0.07%			46,897	1,908
Lenoir		U		I			18,479	149,680	0.24%			156,028	6,348
Lenoir County	S		A				31,907	120,109	0.19%			125,203	5,094
Lewiston Woodville	S		A				592	2,495	0.00%			2,601	106
Lewisville		U		I			12,601	102,068	0.16%			106,397	4,329
Lexington	S		A				20,605	162,848	0.26%			169,755	6,907
Liberty	S		A				2,747	16,612	0.03%			17,317	705
Lilesville	S			I			452	5,062	0.01%			5,277	215
Lillington	S		A				3,019	26,269	0.04%			27,383	1,114
Lincoln County	S		A				57,639	276,667	0.45%			288,402	11,734
Lincolnton		U		I			10,431	84,491	0.14%			88,075	3,584
Littleton	S		A				681	12,354	0.02%			12,878	524
Locust		U		I			2,501	20,883	0.03%			21,769	886
Long View		U		I			4,787	44,998	0.07%			46,906	1,909
Louisburg	S		A				3,377	27,388	0.04%			28,550	1,162
Lowell		U		I			2,652	22,144	0.04%			23,083	939
Lucama	S			I			881	9,867	0.02%			10,286	419
Lumber Bridge		U		I			120	1,344	0.00%			1,401	57

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Lumberton		U		I			22,482	182,104	0.29%			189,828	7,724
Macclesfield		U		I			430	4,816	0.01%			5,020	204
Macon County	S		A				27,178	71,794	0.12%			74,839	3,045
Macon		U		I			110	1,232	0.00%			1,284	52
Madison	S		A				2,235	23,622	0.04%			24,624	1,002
Madison County	S			I			16,796	54,587	0.09%			56,902	2,315
Maggie Valley		U		I			1,122	9,369	0.02%			9,766	397
Magnolia		U		I			974	10,909	0.02%			11,371	463
Maiden		U		I			3,285	27,430	0.04%			28,593	1,163
Manteo		U		I			1,123	9,377	0.02%			9,775	398
Marion	S		A				6,175	43,545	0.07%			45,392	1,847
Mars Hill		U		I			1,904	15,898	0.03%			16,573	674
Marshall		U		I			846	9,475	0.02%			9,877	402
Marshville		U		I			2,664	22,244	0.04%			23,188	943
Martin County	S			I			15,309	49,754	0.08%			51,864	2,110
Matthews	S		A				24,879	377,486	0.61%			393,496	16,010
Maxton	S		A				2,527	15,887	0.03%			16,561	674
Mayodan	S		A				2,398	25,471	0.04%			26,551	1,080
Maysville		U		I			991	11,099	0.02%			11,570	471
McAdenville		U		I			597	6,686	0.01%			6,970	284
McDowell County	S			I			36,099	166,055	0.27%			173,098	7,043
Mebane	S		A				7,930	43,881	0.07%			45,742	1,861
Mecklenberg County	S		A		x	2.64	58,021	516,581	0.83%	2	32,000	570,491	53,910
Mesic		U		I			250	2,800	0.00%			2,919	119
Micro	S		A				498	5,941	0.01%			6,193	252
Middleburg		U		I			167	1,870	0.00%			1,950	79
Middlesex	S		A				845	1,893	0.00%			1,973	80
Mills River		U		I			6,038	56,757	0.09%			59,164	2,407
Minnesott Beach		U		I			314	3,517	0.01%			3,666	149
Mint Hill		U		I			17,959	145,468	0.23%			151,638	6,170
Mitchell County		U		I			13,596	44,187	0.07%			46,061	1,874
Mocksville	S		A				4,384	25,629	0.04%			26,716	1,087
Momeyer		U		I			296	3,315	0.01%			3,456	141
Monroe	S		A				31,234	212,628	0.34%			221,646	9,018

	Detail on Local Governments						Populatic	2004-05 Actual & Imputed		PEG Support		Dis tion	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Montgomery County	S		A				18,345	17,643	0.03%			18,391	748
Montreat		U		I			659	7,381	0.01%			7,694	313
Moore County	S		A				43,662	186,848	0.30%			194,773	7,925
Mooresboro		U		I			316	3,539	0.01%			3,689	150
Mooresville		U		I			21,914	177,503	0.29%			185,032	7,529
Morehead		U		I			8,041	75,585	0.12%			78,791	3,206
Morganton	S		A				17,064	145,100	0.23%			151,254	6,154
Morrisville		U		I			12,126	98,221	0.16%			102,386	4,166
Morven	S		A				573	1,044	0.00%			1,088	44
Mount Airy	S		A				8,514	46,798	0.08%			48,783	1,985
Mount Gilead		U		I			1,390	11,607	0.02%			12,099	492
Mount Holly		U		I			9,735	91,509	0.15%			95,390	3,881
Mount Olive		U		I			4,593	43,174	0.07%			45,005	1,831
Mount Pleasant		U		I			1,386	11,573	0.02%			12,064	491
Murfreesboro		U		I			2,278	19,021	0.03%			19,828	807
Murphy	S		A				1,601	11,526	0.02%			12,015	489
Nags Head		U		I			3,094	25,835	0.04%			26,931	1,096
Nash County	S			I			37,368	171,893	0.28%			179,183	7,291
Nashville		U		I			4,656	43,766	0.07%			45,623	1,856
Navassa		U		I			1,600	13,360	0.02%			13,927	567
New Bern	S		A				23,765	228,868	0.37%			238,575	9,707
New Hanover County	S			I			69,692	564,505	0.91%			588,448	23,943
New London		U		I			611	6,843	0.01%			7,133	290
Newland		U		I			707	7,918	0.01%			8,254	336
Newport		U		I			3,608	30,127	0.05%			31,405	1,278
Newton		U		I			12,986	105,187	0.17%			109,648	4,461
Newton Grove		U		I			621	6,955	0.01%			7,250	295
Norlina		U		I			1,100	9,185	0.01%			9,575	390
North Topsail Beach	S			I			846	9,475	0.02%			9,877	402
Northampton County	S		A				15,215	50,588	0.08%			52,734	2,146
Northwest	S			I			746	8,355	0.01%			8,710	354
Norwood		U		I			2,885	24,090	0.04%			25,111	1,022
Oak	S			I			364	4,077	0.01%			4,250	173
Oak Ridge		U	A				4,231	-	0.00%			-	-

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
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North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Oakboro		U		I			1,166	9,736	0.02%			10,149	413
Ocean Isle Beach	S			I			462	5,174	0.01%			5,394	219
Old Fort	S			I			973	10,898	0.02%			11,360	462
Onslow County	S		A				81,494	435,013	0.70%			453,463	18,450
Orange County	S		A				47,413	247,065	0.40%			257,544	10,479
Oriental		U		I			876	9,811	0.02%			10,227	416
Oxford		U		I			8,562	80,483	0.13%			83,896	3,414
Pamlico County	S			I			8,265	26,861	0.04%			28,001	1,139
Pantego	S			I			171	1,915	0.00%			1,996	81
Parkton		U		I			537	6,014	0.01%			6,269	255
Parmele		U		I			279	3,125	0.01%			3,257	133
Pasquotank County	S			I			19,391	63,021	0.10%	1	16,000	81,694	18,673
Patterson Springs		U		I			612	6,854	0.01%			7,145	291
Peachland	S			I			585	6,552	0.01%			6,830	278
Peletier		U		I			521	5,835	0.01%			6,083	247
Pembroke		U		I			2,698	22,528	0.04%			23,484	956
Pender County	S		A				38,933	216,748	0.35%			225,941	9,193
Perquimans County	S			I			9,186	29,855	0.05%			31,121	1,266
Person County	S		A				28,152	69,024	0.11%			71,952	2,928
Pikeville		U		I			714	7,997	0.01%			8,336	339
Pilot Mountain		U		I			1,284	10,721	0.02%			11,176	455
Pine Knoll Shores		U		I			1,574	13,143	0.02%			13,700	557
Pine Level		U		I			1,710	14,279	0.02%			14,884	606
Pinebluff		U		I			1,178	9,836	0.02%			10,253	417
Pinehurst		U		I			10,694	86,621	0.14%			90,295	3,674
Pinetops		U		I			1,359	11,348	0.02%			11,829	481
Pineville		U		I			4,139	18,170	0.03%			18,941	771
Pink Hill	S			I			554	6,205	0.01%			6,468	263
Pitt County	S		A				52,606	281,452	0.45%			293,389	11,937
Pittsboro	S			I			2,376	19,840	0.03%			20,681	841
Plymouth		U		I			3,992	33,333	0.05%			34,747	1,414
Polk County	S		A				15,571	18,878	0.03%			19,679	801
Polkton	S		A				2,582	1,054	0.00%			1,099	45
Polkville		U		I			542	6,070	0.01%			6,328	257

	Detail on Local Governments						Populatic	2004-05 Actual & Imputed		PEG Support		Dis tion	
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Pollocksville		U		I			261	2,923	0.00%			3,047	124
Powellsville	S		A				257	5,271	0.01%			5,495	224
Princeton		U		I			1,178	9,836	0.02%			10,253	417
Princeville		U		I			1,950	16,283	0.03%			16,973	691
Raeford	S		A				3,672	32,736	0.05%			34,124	1,388
Raleigh	S		A		x	0.21	325,213	3,843,102	6.19%	3	48,000	4,054,101	210,999
Ramseur	S		A				1,700	11,358	0.02%			11,840	482
Randleman	S		A				3,989	27,101	0.04%			28,250	1,149
Randolph County	S		A				86,529	217,819	0.35%			227,057	9,238
Ranlo		U		I			2,503	20,900	0.03%			21,786	886
Red Oak		U		I			2,848	23,781	0.04%			24,789	1,009
Red Springs		U		I			3,450	28,808	0.05%			30,029	1,222
Reidsville	S		A				14,626	130,936	0.21%			136,489	5,553
Rennert		U		I			340	3,808	0.01%			3,970	162
Rhodhiss		U		I			897	10,046	0.02%			10,473	426
Rich Square		U		I			888	9,946	0.02%			10,367	422
Richfield		U		I			514	5,757	0.01%			6,001	244
Richlands	S			I			999	11,189	0.02%			11,663	475
Richmond County	S			I			28,491	131,059	0.21%			136,617	5,559
River Bend	S			I			2,938	24,532	0.04%			25,573	1,040
Roanoke Rapids	S		A				16,741	177,383	0.29%			184,906	7,523
Robbins		U		I			1,246	10,404	0.02%			10,845	441
Robbinsville		U		I			738	8,266	0.01%			8,616	351
Robersonville		U		I			1,653	13,803	0.02%			14,388	585
Robeson County	S		A				87,918	246,428	0.40%			256,880	10,452
Rockingham	S			I			9,467	88,990	0.14%			92,764	3,774
Rockingham County	S		A				53,159	208,965	0.34%			217,828	8,863
Rockwell		U		I			2,005	16,742	0.03%			17,452	710
Rocky Mount	S		A				56,309	471,702	0.76%			491,708	20,006
Rolesville		U		I			1,036	8,651	0.01%			9,018	367
Ronda		U		I			475	5,320	0.01%			5,546	226
Roper		U		I			630	7,056	0.01%			7,355	299
Rose Hill		U		I			1,363	11,381	0.02%			11,864	483
Roseboro		U		I			1,350	11,273	0.02%			11,751	478

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
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Rosman		U		I			570	6,384	0.01%			6,655	271
Rowan County	S			I			78,033	374,558	0.60%			390,445	15,886
Rowland	S			I			1,155	9,644	0.02%			10,053	409
Roxboro	S		A				8,833	48,712	0.08%			50,778	2,066
Roxobel	S		A				265	1,195	0.00%			1,246	51
Rural Hall	S		A				2,539	21,738	0.04%			22,660	922
Ruth		U		I			325	3,640	0.01%			3,794	154
Rutherford College		U		I			1,302	10,872	0.02%			11,333	461
Rutherford County	S			I			45,475	218,280	0.35%			227,538	9,258
Rutherfordton	S		A				4,142	34,214	0.06%			35,665	1,451
Salemburg		U		I			480	5,376	0.01%			5,604	228
Salisbury	S			I			28,215	228,542	0.37%			238,235	9,693
Saluda		U		I			575	6,440	0.01%			6,713	273
Sampson County	S			I			50,081	240,389	0.39%	1	16,000	266,585	26,196
Sandy Creek	S			I			267	2,990	0.00%			3,117	127
Sanford		U		I			23,832	193,039	0.31%			201,227	8,187
Saratoga		U		I			387	4,334	0.01%			4,518	184
Sawmills		U		I			5,020	47,188	0.08%			49,189	2,001
Scotland County	S			I			19,062	61,952	0.10%			64,579	2,628
Scotland Neck	S			I			2,268	18,938	0.03%			19,741	803
Seagrove		U		I			251	2,811	0.00%			2,930	119
Selma		U		I			6,685	62,839	0.10%			65,504	2,665
Seven Devils		U		I			138	1,546	0.00%			1,611	66
Severn		U		I			257	2,878	0.00%			3,000	122
Shallotte	S		A				1,704	-	0.00%			-	-
Sharpsburg	S			I			2,512	20,975	0.03%			21,865	890
Shelby		U		I			20,957	169,752	0.27%			176,951	7,200
Siler	S		A				7,773	35,723	0.06%			37,238	1,515
Simpson		U		I			469	5,253	0.01%			5,476	223
Sims		U		I			131	1,467	0.00%			1,529	62
Smithfield		U		I			11,893	96,333	0.16%			100,419	4,086
Snow Hill		U		I			1,564	13,059	0.02%			13,613	554
Southern Pines	S		A				11,573	138,132	0.22%			143,991	5,859
Southern Shores		U		I			2,551	21,301	0.03%			22,204	903

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Southport	S		A				2,595	37,495	0.06%			39,086	1,590
Sparta	S		A				1,814	2,872	0.00%			2,994	122
Spencer Mountain		U		I			50	560	0.00%			584	24
Spencer		U		I			3,384	28,256	0.05%			29,455	1,198
Spindale		U		I			3,917	32,707	0.05%			34,094	1,387
Spring Hope		U		I			1,281	10,696	0.02%			11,150	454
Spring Lake		U		I			8,208	77,155	0.12%			80,428	3,272
Spruce Pine		U		I			2,039	17,026	0.03%			17,748	722
Stallings		U		I			9,163	86,132	0.14%			89,785	3,653
Stanfield		U		I			1,284	10,721	0.02%			11,176	455
Stanley		U		I			3,019	24,756	0.04%			25,806	1,050
Stanly County	S			I			31,086	142,996	0.23%	1	16,000	165,061	22,065
Stantonsburg		U		I			731	8,187	0.01%			8,534	347
Star		U		I			812	9,094	0.01%			9,480	386
Statesville		U		I			24,911	201,779	0.32%			210,337	8,558
Stedman		U		I			673	7,538	0.01%			7,857	320
Stem		U		I			235	2,632	0.00%			2,744	112
Stokes County	S		A				38,818	118,755	0.19%			123,792	5,037
Stokesdale		U		I			3,465	28,933	0.05%			30,160	1,227
Stoneville		U		I			988	11,066	0.02%			11,535	469
Stovall		U		I			386	4,323	0.01%			4,507	183
Summerfield		U		I			7,227	67,934	0.11%			70,815	2,881
Sunset Beach	S		A				1,985	-	0.00%			-	-
Surf City		U		I			1,562	13,043	0.02%			13,596	553
Swain County	S			I			12,028	39,091	0.06%			40,749	1,658
Swansboro	S		A				1,702	10,230	0.02%			10,664	434
Sylva	S			I			2,508	20,942	0.03%			21,830	888
Tabor	S			I			2,570	21,460	0.03%			22,370	910
Tar Heel	S		A				67	514	0.00%			536	22
Tarboro	S		A				10,841	96,249	0.16%			100,331	4,082
Taylorsville	S		A				1,808	34,235	0.06%			35,687	1,452
Taylor		U		I			919	10,293	0.02%			10,729	437
Teachey		U		I			251	2,811	0.00%			2,930	119
Thomasville	S			I			25,749	208,567	0.34%			217,413	8,846

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Tobaccoville		U		I			2,398	20,023	0.03%			20,873	849
Topsail Beach		U		I			518	5,802	0.01%			6,048	246
Transylvania County	S		A				22,349	100	0.00%			104	4
Trent Woods	S		A				4,215	24,000	0.04%			25,018	1,018
Trinity		U		I			6,830	64,202	0.10%			66,925	2,723
Troutman		U		I			1,676	13,995	0.02%			14,588	594
Troy	S		A				4,023	13,511	0.02%			14,084	573
Tryon		U		I			1,775	14,821	0.02%			15,450	629
Turkey		U		I			266	2,979	0.00%			3,106	126
Tyrrell County	S												
Union County	S			I			56,208	269,798	0.43%			281,241	11,443
Unionville		U		I			6,258	58,825	0.09%			61,320	2,495
Valdese		U		I			4,584	43,090	0.07%			44,917	1,828
Vance County	S			I			27,076	124,550	0.20%			129,832	5,283
Vanceboro	S			I			889	9,957	0.02%			10,379	422
Vandemere		U		I			286	3,203	0.01%			3,339	136
Vass	S		A				775	2,781	0.00%			2,899	118
Waco		U		I			328	3,674	0.01%			3,829	156
Wade		U		I			525	5,880	0.01%			6,129	249
Wadesboro	S		A				5,672	27,746	0.04%			28,923	1,177
Wake County	S		A				172,016	1,336,950	2.15%	1	16,000	1,409,655	72,705
Wake Forest	S		A				17,235	179,331	0.29%			186,937	7,606
Walker		U		I			4,532	42,601	0.07%			44,408	1,807
Wallace		U		I			3,514	29,342	0.05%			30,586	1,244
Walnut Cove		U		I			1,523	12,717	0.02%			13,256	539
Walnut Creek	S			I			882	9,878	0.02%			10,297	419
Walstonburg		U		I			231	2,587	0.00%			2,697	110
Warren County	S		A				18,078	7,416	0.01%			7,731	315
Warrenton	S			I			786	8,803	0.01%			9,177	373
Warsaw		U		I			3,092	25,818	0.04%			26,913	1,095
Washington		U		I			9,817	92,280	0.15%			96,194	3,914
Washington County	S		A				8,594	11,794	0.02%			12,294	500
Washington Park	S		A				439	2,769	0.00%			2,886	117
Watauga County	S		A				26,922	149,116	0.24%			155,441	6,325

	Detail on Local Governments						Populatio	2004-05 Actual & Imputed		PEG Support		Dis tion	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Waxhaw		U		I			3,298	27,538	0.04%			28,706	1,168
Wayne County	S		A				68,676	438,185	0.71%			456,770	18,585
Waynesville	S			I			9,536	89,638	0.14%			93,440	3,802
Weaverville		U		I			2,482	20,725	0.03%			21,604	879
Webster		U		I			572	6,406	0.01%			6,678	272
Weddington		U		I			8,006	75,256	0.12%			78,448	3,192
Weldon		U		I			1,349	11,264	0.02%			11,742	478
Wendell		U		I			4,769	44,829	0.07%			46,730	1,901
West Jefferson	S			I			1,096	9,152	0.01%			9,540	388
Whispering Pines	S			I			2,277	19,013	0.03%			19,819	806
Whitakers	S			I			776	8,691	0.01%			9,060	369
White Lake	S		A				586	20,328	0.03%			21,190	862
Whiteville	S		A				5,106	50,281	0.08%	1	16,000	68,414	18,133
Wilkes County	S			I			59,093	283,646	0.46%			295,677	12,030
Wilkesboro		U		I			3,187	26,611	0.04%			27,740	1,129
Williamston	S			I			5,816	54,670	0.09%			56,989	2,319
Wilmington	S		A				94,718	1,230,419	1.98%	2	32,000	1,314,605	84,186
Wilson	S		A				47,441	413,855	0.67%	1	16,000	447,408	33,553
Wilson County	S		A				23,488	68,853	0.11%			71,773	2,920
Windsor	S		A				2,285	-	0.00%			-	-
Winfall		U		I			571	6,395	0.01%			6,666	271
Wingate		U		I			2,779	23,205	0.04%			24,189	984
Winston-Salem	S		A				195,536	1,862,247	3.00%	2	32,000	1,973,231	110,984
Winterville		U		I			6,606	62,096	0.10%			64,730	2,634
Winton		U		I			947	10,606	0.02%			11,056	450
Woodfin		U		I			3,586	29,943	0.05%			31,213	1,270
Woodland		U		I			817	9,150	0.01%			9,538	388
Wrightsville Beach		U		I			2,612	21,810	0.04%			22,735	925
Yadkin County	S		A				30,197	100,675	0.16%			104,945	4,270
Yadkinville	S		A				2,804	32,677	0.05%			34,063	1,386
Yancey		U		I			16,443	133,188	0.21%			138,837	5,649

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Yanceyville	S		A				2,174	15,034	0.02%			15,672	638
Youngsville		U		I			965	10,808	0.02%			11,266	458
Zebulon	S			I			4,458	41,905	0.07%			43,683	1,777
Total	272	300	168	404	7		8,325,774	**$ 62,090,528**		36	**$ 576,000**	**$ 65,300,000**	**$ 3,209,472**

Notes on the tables:

*NC local governments known to assess per subscriber charges include: Buncombe County, Carrboro, Chapel Hill, Charlotte, Greensboro, Mecklenburg County, and Raleigh. Actual per subscriber fee collections for 2004-05 were used for Charlotte, Greensboro, Mecklenburg County, and Raleigh. Collections were estimated for Buncombe County based on estimated number of non-municipal households and estimated percentage of households subscribing to cable. Collections for Carrboro and Chapel Hill were estimated by dividing the actual collections for the two cities combined ($121,240) by their relative population (25% Carrboro, 75% Chapel Hill).

**All rates given in this column are assessed per subscriber per month except for Mecklenburg County, which is assessed per subscriber per year.

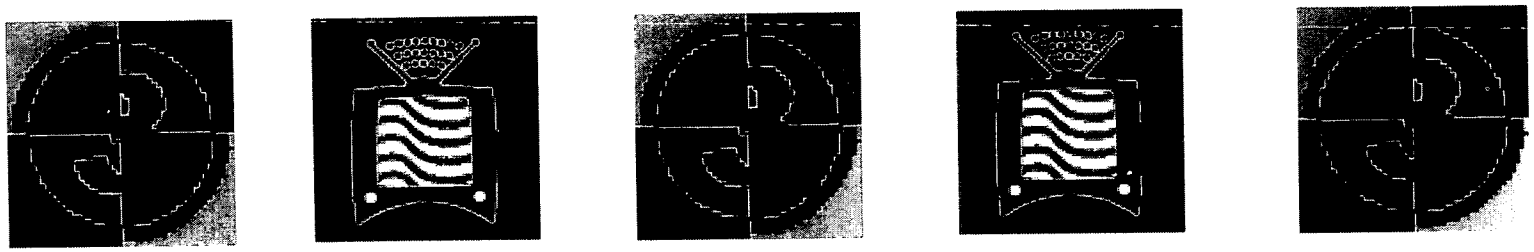
***Revenues given in this column are attributable to cable franchise fee collections and, in the case of local governments who assess per subscriber charges for PEG support, the total amount of those charges for 2004-05.

****This worksheet assumes the total local share of sales tax collections on telecommunications, cable, and satellite television service to be $65.3 million. In accordance with this proposed legislation, $576,000 in PEG support has been deducted from this initial amount ($65.3 million), leaving approximately $64.7 million for the distribution. Local governments with qualifying PEG channels are given an additional $16,000 of sales tax revenue before the distribution is applied. The amount shown in this column for local governments with qualifying PEG channels reflects this payment.

*****The net gain for each local government includes $16,000 PEG support payments per qualifying channel where applicable.

Oak Ridge, Stokesdale, and Summerfield all entered into new franchise agreements and are expected to report franchise fee revenues for 2005-06 although they did not have any collections to report in 2004-05. The estimated franchise fee revenues shown for these three cities were estimated using the same method as other cities in this projection.

Estimated Local Distribution of Shared Sales Tax on Video Services

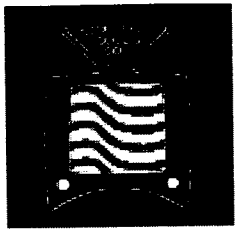


Brenna Erford

Revenue Laws

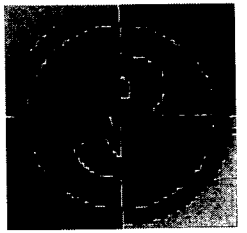
May 2, 2006

Agenda



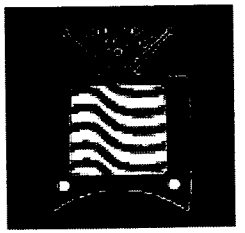
- Changes to revenue provisions since April 19 meeting
  - New percentages, same effect
- Estimated local impact of tax distribution and PEG support
  - *"Estimated Local Tax Distribution for Shared Sales Tax on Video Services"*

Changes since April 19



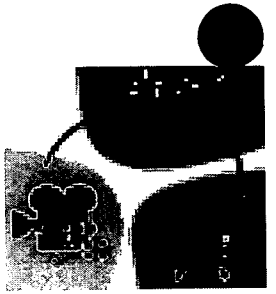
- Percentages
  - 7.23% of total sales tax collections on telecommunications ($28.6 million)
  - 22.61% of total sales tax collections on cable ($20.7 million)
  - 37% of total sales tax collections on satellite ($16.0 million - unchanged from last draft)
- Memo presents detail on base estimates

Local Distribution



- *"Estimated Local Tax Distribution for Shared Sales Tax on Video Services"*
- Provides estimated impact for all local governments believed to have cable franchise agreements
  - List taken from FCC records and cross-checked with State Data Center records
- **All local governments show net gain**

Detail on Local Governments



Estimated Video Services Tax Distribution to Local Governments

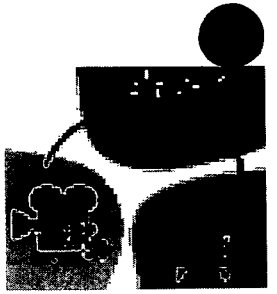
	Detail on Local Governments				Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3	4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Aberdeen		U		I			4,060	38,164	0.06%			39,783	1,619
Ahoskie		U		I			4,478	42,093	0.07%			43,879	1,785
Alamance County	S		A				53,731	164,821	0.27%			171,812	6,991
Raleigh	S		A		x	0.21	325,213	3,843,102	6.19%	3	48,000	4,054,101	210,999

Column 1

Local governments surveyed by Fiscal Research in early 2006 show an "S" in the left column. Local governments that were not surveyed show a "U" in the right column.

This column shows only whether a local government was included in the survey, not whether the local government responded to the survey.

Detail on Local Governments



Estimated Video Services Tax Distribution to Local Governments

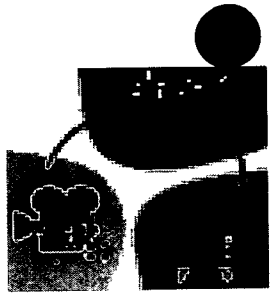
	Detail on Local Governments			Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1	2	3	4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)	Franchise Fee Collections Actual/ Imputed (A/I)	Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
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Raleigh	S	A	x	0.21	325,213	3,843,102	6.19%	3	48,000	4,054,101	210,999

Column 2

Indicates whether the franchise fee amount shown in Column 5 is actual (as reported on the survey or in the local government's 2004-05 CAFR) or estimated (imputed)

Second page of document gives detail on calculation of estimated franchise fee revenues for local governments

Detail on Local Governments



Estimated Video Services Tax Distribution to Local Governments

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?**	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
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Alamance County	S		A				53,731	164,821	0.27%			171,812	6,991
Raleigh	S		A		x	0.21	325,213	3,843,102	6.19%	3	48,000	4,054,101	210,999

Column 3

Local governments that assess per subscriber charges for PEG support are indicated with an “x” in the left column.

The monthly per subscriber charge is shown in the right column.

Local Population Estimates



Estimated Video Services Tax Distribution to Local Governments

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
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Ahoskie		U		I			4,478	42,093	0.07%			43,879	1,785
Alamance County	S		A				53,731	164,821	0.27%			171,812	6,991
Raleigh	S		A		x	0.21	325,213	3,843,102	6.19%	3	48,000	4,054,101	210,999

Column 4

2004 State Data Center estimated municipal population for cities

2004 State Data Center estimated non-municipal population for counties

Used to estimate franchise fee revenues for non-surveyed and non-responding local governments

Estimated Cable Franchise Fees



Estimated Video Services Tax Distribution to Local Governments

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
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Ahoskie		U		I			4,478	42,093	0.07%			43,879	1,785
Alamance County	S		A				53,731	164,821	0.27%			171,812	6,991
Raleigh	S		A		x	0.21	325,213	3,843,102	6.19%	3	48,000	4,054,101	210,999

Column 5

Gives either actual or imputed cable franchise fees for 2004-05 for each local government

If a local government assesses per subscriber fees, the total 2004-05 collection of those fees has been **included** in the amount shown

Estimated Cable Franchise Fees



Estimated Video Services Tax Distribution to Local Governments

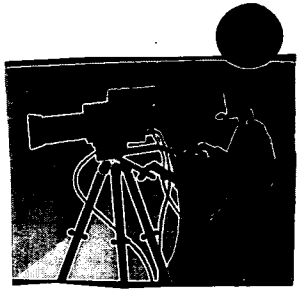
	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
Aberdeen		U		I			4,060	38,164	0.06%			39,783	1,619
Ahoskie		U		I			4,478	42,093	0.07%			43,879	1,785
Alamance County	S		A				53,731	164,821	0.27%			171,812	6,991
Raleigh	S		A		x	0.21	325,213	3,843,102	6.19%	3	48,000	4,054,101	210,999

Column 6

Estimated proportional distribution

Calculated by dividing each local government's total revenue from franchise fees and per subscriber charges by total local government collections ($62.1 million)

PEG Channel Support



Estimated Video Services Tax Distribution to Local Governments

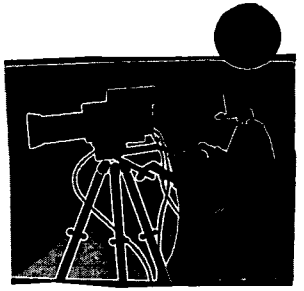
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Column 7

Left side shows the estimated number of PEG channels operated by a local government that qualify for additional pre-distribution funding ($16,000 per channel) under Section 8(b)

Actual number of qualifying channels in NC is not known at this time. Based on available information, this table assumes 33 qualifying channels in NC

PEG Channel Support



Estimated Video Services Tax Distribution to Local Governments

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6		7	8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Governments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
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Alamance County	S		A				[illegible]3,731	164,821	0.27%			171,812	6,991
Raleigh	S		A		x	0.21	325,213	3,843,102	6.19%	3	48,000	4,054,101	210,999

Column 7 (continued)

Estimates the total amount due to a local government for PEG support

Amount provided is $16,000 per qualifying PEG channel for up to 3 PEG channels per local government

Estimated Impact



Estimated Video Services Tax Distribution to Local Governments

	Detail on Local Governments						Population	2004-05 Actual & Imputed		PEG Support		Distribution	
	1		2		3		4	5	6	7		8	9
North Carolina Local Governments with Cable Franchises	Local Gov'ts Surveyed/ Unsurveyed (S/U)		Franchise Fee Collections Actual/ Imputed (A/I)		Assesses Per Subscriber Fee?*	Rate of Per Subscriber Fee**	State Data Center certified population 2004*	Actual & Imputed Cable Franchise Fee Revenues 2004-05***	Estimated Proportional Distribution (Based on % of Total Actual & Imputed Fee Revenues)	Number of Qualified PEG Channels	PEG Support Due to Local Govern-ments	Estimated funds distributed to locals using Proportional Distribution****	Net Gain to Local Governments*****
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Column 8

Estimates total funds that would be distributed to local governments based on Column 6 (Proportional Distribution)

Assumes total $65.3 million for distribution

Total includes $16,000 per PEG channel payment, if applicable

Estimated Impact



Estimated Video Services Tax Distribution to Local Governments

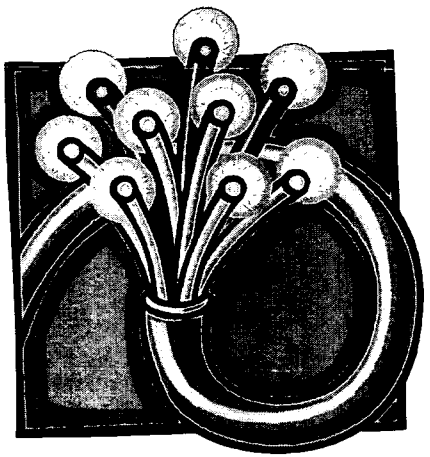
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Column 9

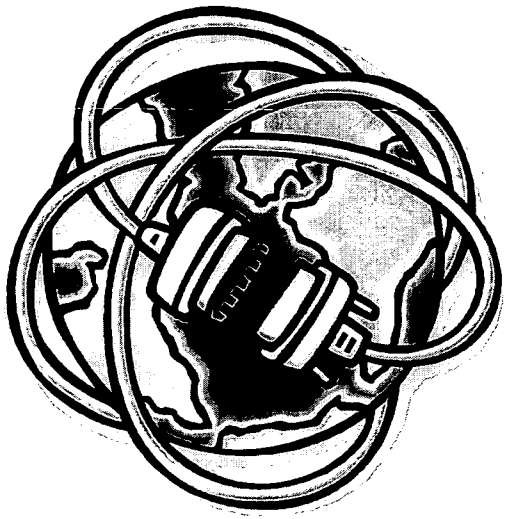
Estimated **net gain to local governments** under proportional distribution & adjustments for PEG support (Column 7)

Calculated as Column 8 (estimated total funds to local government) minus Column 5 (actual or imputed franchise fees and per subscriber charges)

Questions?







REVENUE LAWS STUDY COMMITTEE

DRAFT



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REPORT TO THE 2005 GENERAL ASSEMBLY OF NORTH CAROLINA 2006 SESSION

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C. Disposition of Committee's Recommendations to the 2005 Session
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E. Streamlined Sales Tax Update, Andy Sabol, Director of the Sales and Use Tax Division, Department of Revenue
F. Statewide Survey Regarding Sales Tax on Service Contracts, Linda Millsaps, Fiscal Research Division
G. Recommendation for Electricity Franchise Tax Distribution Formula

* All of the meeting handouts, including Power Point presentations, may be accessed online at the Revenue Laws Study Committee website: http://www.ncleg.net/committees/



REVENUE LAWS STUDY COMMITTEE
State Legislative Building
Raleigh, North Carolina 27603

Senator John H. Kerr, III, Cochair *Representative Paul Luebke, Cochair*

May 2, 2006

TO THE MEMBERS OF THE 2006 GENERAL ASSEMBLY:

The Revenue Laws Study Committee submits to you for your consideration its report pursuant to G.S. 120-70.106.

Respectfully Submitted,

Rep. Paul Luebke, Co-Chair

Sen. John Kerr, Co-Chair

2005-2006

REVENUE LAWS STUDY COMMITTEE

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Cindy Avrette, Staff Attorney
Rodney Bizzell, Fiscal Analyst
David Crotts, Fiscal Analyst
Brenna Erford, Fiscal Analyst
Trina Griffin, Staff Attorney
Y. Canaan Huie, Staff Attorney
Linda Millsaps, Fiscal Analyst
Martha Walston, Staff Attorney

PREFACE

The Revenue Laws Study Committee is established in Article 12L of Chapter 120 of the General Statutes to serve as a permanent legislative commission to review issues relating to taxation and finance. The Committee consists of sixteen members, eight appointed by the President Pro Tempore of the Senate and eight appointed by the Speaker of the House of Representatives. Committee members may be legislators or citizens. The co-chairs for 2005-2006 are Senator John Kerr and Representative Paul Luebke.

G.S. 120-70.106 gives the Revenue Laws Study Committee's study of the revenue laws a very broad scope, stating that the Committee "may review the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable." A copy of Article 12L of Chapter 120 of the General Statutes is included in Appendix A. A committee notebook containing the committee minutes and all information presented to the committee is filed in the Legislative Library.

In 2002, the General Assembly established a permanent subcommittee under the Revenue Laws Study Committee to study and examine the property tax system.[1] The subcommittee consists of eight members, four appointed by the Senate chair of the Revenue Laws Study Committee and four appointed by the House chair of the Committee. The subcommittee may recommend changes in the property tax system to

[1] S.L. 2002-184, s. 8.

the full Committee for its consideration in its final report to the General Assembly. The Property Tax Subcommittee did not meet during the 2005-2006 interim.

Before it was created as a permanent legislative commission, the Revenue Laws Study Committee was a subcommittee of the Legislative Research Commission. It has studied the revenue laws every year since 1977.

COMMITTEE PROCEEDINGS

The Revenue Laws Study Committee met six times after the adjournment of the 2005 Regular Session of the 2005 General Assembly on September 2, 2005. Appendix B contains a copy of the Committee's agenda for each meeting. All of the materials distributed at the meetings may be viewed on the Committee's website: http://www.ncleg.net/committees/. The Committee considered all proposed tax changes in light of general principles of tax policy and as part of an examination of the existing tax structure as a whole.

REVIEW OF THE RECOMMENDATIONS MADE TO THE 2005 GENERAL ASSEMBLY

The 2005 General Assembly enacted five of the Revenue Laws Study Committee's six legislative proposals in whole or in part. Appendix C lists the Committee's recommendations and the action taken on them in 2005. A document entitled "**2005 Finance Law Changes**" summarizes all of the tax legislation enacted in 2005. It is available in the Legislative Library located in the Legislative Office Building.

VIDEO PROGRAMMING SERVICES

The Current Operations and Capital Improvements Appropriations Act of 2005 directed the Revenue Laws Study Committee to study the equity of taxation of providers of cable service, direct-to-home satellite service, satellite digital audio radio service, video programming service, and data service. The Committee spent a considerable amount of time on this issue.

In December the Committee looked at the State's current tax structure on these services. North Carolina began taxing these services when the technologies enabling the services were separate and distinct technologies and the providers of the services were separate and distinct taxpayers. The Committee found that the State taxes these services based upon who provides the service rather than the service itself. Despite the General Assembly's repeated attempts to provide tax equity among these providers, it is debatable whether that has been accomplished:

- Providers of telecommunications services are subject to a 7% State sales tax on its gross revenues. Eighteen and three one-hundredths percent (18.03%) of the tax revenue collected is distributed to the cities. The amount each city receives is based upon a per capita statutory formula.
- Providers of direct-to-home satellite services are subject to a 7% State sales tax. Federal law prohibits local governments from taxing satellite services. The tax revenue is not shared with the local governments.
- Providers of cable television services are subject to a 7% State sales tax with a credit against the tax equal to the amount of local franchise tax paid. Local governments may impose a franchise tax on cable services up to 5% of gross revenues. The amount of tax cities and counties impose varies, as well as the tax base. Each city and county negotiates a franchise agreement with cable providers. The negotiated franchise agreement defines the term 'gross revenues' upon which the tax rate is imposed.
- Providers of satellite digital audio radio services are subject to a 4.5% State sales tax and a 2.5% local sales tax.

The technology that enables these various services has evolved and converged in recent years so that today the same technology used to provide one service is able to provide the other. As a result, industries that use to be separate and distinct today compete against each other to provide customers telecommunications and video programming services. The method of taxation should not provide one provider of a service with a competitive advantage over another. The Committee expressed a goal to establish a method of taxation that applies equally to the same service, regardless of who provides it.

The Committee devoted its January meeting to the providers of telecommunications and video programming services. The Committee asked the providers to describe what type of services they have traditionally offered, what types of services they currently offer, and what types of services they would like to offer in the future. The Committee also asked the providers about any statutory, regulatory, or tax-related obstacles they had encountered as they expanded the types of services they offer or plan to offer and any suggestions they may have as to how the Committee could achieve its goal of taxing the services provided equally.

North Carolina is not alone in grappling with the issue of how to tax and regulate telecommunications and video programming services. Congress as well as other states is considering legislation on this issue. At this time, at least three states have enacted legislation changing the regulation and taxation of telecommunications and video programming services and at least eight other states have legislation pending on the issue. The Committee Chairs instructed the staff to begin meeting with the parties most affected by the issue and to draft legislation addressing the issue for the Committee to consider.

The Revenue Laws Study Committee staff met separately with representatives of the cable industry, the telephone industry, the cable administrators, and the counties and cities. It also held a series of four meetings with the all the affected parties and solicited comments from the parties on numerous occasions. The staff prepared a survey given to all the local governments in the State to determine their franchise fee collections and other nonmonetary contributions received in accordance with their cable franchise agreements. A summary of the survey results may be found in Appendix D.

The Committee Chairs, with the input of two other committee members, provided guidance to the Committee staff as it drafted a proposal for the Committee to consider. They established the following principles:

- Equal taxation of the same service.
- A tax system that is easy to administer.
- A tax and regulatory system that do not impede competition.
- Equal compensation to cities for the use of their public rights-of-way.
- PEG channels service a public purpose and should be supported.

Based upon those principles, they directed the staff to draft a proposal for the Committee to consider that meets the following goals:

- Applies the principles stated above.
- Contains no tax or fee increase.
- Preserves local government revenue stream.
- Promotes competition in the marketplace.
- Promotes deployment of broadband as a basic communication tool.

Legislative Proposal #1, *Video Service Competition Act,* establishes uniform taxes for video programming services and seeks to promote consumer choice. It establishes equal taxation of the same service by applying the State 7% sales tax to all video programming services, repealing the local authority to impose a local franchise tax, and repealing the sales tax credit allowed to cable companies for local franchise tax paid. It preserves the local government revenue stream by distributing part of the sales tax revenues from telecommunications and video programming services to the counties and cities. The distribution formula is based upon the amount of cable franchise tax revenue received in fiscal year 2005-2006 plus any subscriber fees received that year.

Legislative Proposal #1 promotes competition by providing a State franchise process, in lieu of the current locally negotiated franchise agreements. It seeks to ensure competitive neutrality by allowing cable providers to opt-out of existing local agreements when one or more households in the franchise area may be served by both the existing provider and the holder of a State-issued franchise. The proposal specifically prohibits discrimination in the provision of video programming services and declares a violation of this law to be an unfair or deceptive trade practice. The holder of a State-issued franchise must comply with customer service and emergency alert requirements established by the Federal Communications Commission. The proposal designates the Consumer Protection Division of the Attorney General's Office as the State agency to receive customer complaints regarding video programming services.

Legislative Proposal #1 preserves local regulation of public rights-of-way and provides for PEG channel support and growth. In addition to including the per subscriber revenues in the distribution base to local governments, the proposal provides up to $2 million for supplemental PEG support. The proposal provides that existing

franchise agreements will determine the number, service tier placement, and transmission quality required of PEG channels under a State-issued franchise. In the absence of an existing agreement, the number of PEG channels a county or city may have is determined by the area's population. A local entity may acquire additional PEG channels, with the maximum number of channels set at seven. The proposal also requires cable service providers to provide free basic service to local public buildings.

SALES AND USE TAX

The Revenue Laws Study Committee has spent a considerable amount of time over the past several years on the Streamlined Sales Tax Project, which began in March 2000. The Streamlined Sales Tax Project is an effort by states, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The goal of the Project is to achieve sufficient simplification and uniformity to encourage sellers without nexus in states to voluntarily collect use tax in participating states.

In November 2002, the implementing states approved the Streamlined Sales and Use Tax Agreement. The Agreement contains the uniformity and simplification provisions developed by the Project. In July 2005, the Agreement became effective when 18 states representing 28% of the population of states imposing a sales tax were found to be in compliance with the terms of the Agreement. On October 1, 2005, the Streamlined Sales Tax Governing Board, Inc. came into existence. The Governing Board consists of representatives of the member states. It oversees administration of the Agreement. North Carolina is one of the 13 full member states because the General Assembly, upon the recommendation of the Revenue Laws Study Committee, has enacted the necessary changes to North Carolina's sales tax laws to bring it into compliance with the Agreement. Andy Sabol, the Director of the Sales and Use Tax

Division of the Department of Revenue and North Carolina's representative on the Governing Board, gave the Committee an update on the Project. Appendix D contains a copy of his remarks.

The Committee reviewed and adopted two proposals related to sales and use tax, both of which have their origins in the Streamlined Sales and Use Tax Agreement. The first proposal would treat commercial logging machinery the same as farm machinery under the sales tax law by exempting the machinery and related items from the tax. This issue arose as the result of recent legislation that imposed a new privilege tax on mill machinery. For years, State tax law provided a preferential rate of sales and use tax on mill machinery at a rate of 1%, with an $80 maximum tax per article. While there is no specific reference in the sales tax statutes to machinery used in the forestry and logging business, the Department of Revenue has maintained the position that logging firms that had contracts with wood product manufacturers to cut timber were entitled to the 1% rate, $80 cap based on the preferential rate afforded to manufacturing industries and plants.

In order to conform to the Streamlined Sales Tax Agreement, the General Assembly enacted legislation in 2001, which became effective January 1, 2006, that exempts purchases of mill machinery, including commercial logging equipment, from sales and use tax, and, instead, imposes a privilege tax at the same preferential rate. By changing the nature of the tax from a sales tax to a privilege tax, the industry kept its preferential rate and the State conformed to the Streamlined Sales and Use Tax Agreement. Since the privilege tax is imposed on the purchaser of qualifying property, commercial loggers, who had been paying the 1% tax to their vendors, are now liable for accruing and remitting the tax to the Department of Revenue.

The Committee heard testimony from the North Carolina Forestry Association that these commercial logging operations are more like small farming operations as opposed to large-scale manufacturing industries, and that administering the new privilege tax has proven confusing and burdensome. In response to these concerns, the Committee reviewed and adopted Legislative Proposal #2, *Amend Taxation of Logging Machinery,* which exempts commercial logging items from the 1%/$80 maximum privilege tax, to which they are currently subject and creates a new exemption in the sales and use tax statutes for commercial logging machinery, attachments and repair parts, lubricants, and fuel used to operate commercial logging machinery.

The second proposal, Legislative Proposal #3, *SSTA Sales Tax Defn/Sales Tax Payments,* modifies the definitions used in the sales and use tax law that apply to telecommunications services. The changes are made to adopt the definitions in the Streamlined Sales and Use Tax Agreement. The proposal also replaces the semimonthly payment sales tax schedule with a single monthly payment and a prepayment of the next month's liability due on the same day as the monthly payment. The change is made at the request of several large retailers involved in the Streamlined Sales and Use Tax Project. North Carolina is one of only a few states that require payments twice a month.

The Current Operations and Capital Improvements Appropriations Act of 2005 directed the Revenue Laws Study Committee to study the application of sales and use tax to maintenance agreements. The Senate included a provision in Senate Bill 622, 4th edition, to impose the State and local sales tax on maintenance agreements. The House included a similar provision in House Bill 1630, 4th edition. The budget bill indicated an intent of the General Assembly to apply the sales and use tax in some manner to maintenance agreements beginning July 1, 2006. In anticipation of the General

Assembly's need to understand the fiscal ramifications of an expansion of the sales tax base to maintenance agreements, the Committee asked its staff to develop a fiscal analysis of the proposal. Linda Millsaps, with the Fiscal Research Division, worked with the Retail Merchant's Association, the N. C. Bankers Association, and the North Carolina Citizens for Business and Industry to survey their memberships on the revenue implications of a sales tax on maintenance agreements. She also obtained information such a proposal would have on automobile warranty contracts from the Automobile Dealers' Association. Appendix F contains a summary of the data collected from this survey.

PROPERTY TAX

The Revenue Laws Study Committee reviewed and adopted three proposals relating to property tax. Legislative Proposal #4, *Property Tax Changes,* is a recommendation of the Department of Revenue and makes several clarifying changes to the property tax laws. Legislative Proposal #5, *Phone, Tower, & Cable Property Tax Appraisal,* is also a recommendation of the Department of Revenue and broadens the Department's authority to appraise the property of public service companies by including wireless companies, paging companies, cable companies, and tower companies. Legislative Proposal #6, *Amend Delinquent Property Tax Collection,* is a recommendation endorsed by a group of real estate attorneys, county attorneys, and tax collectors.

Legislative Proposal #4, *Property Tax Changes,* makes five clarifying changes recommended by the Department of Revenue. First, it expands the authority to file electronically to include individual personal property. Current law only provides for the electronic filing of business personal property. The proposal would extend the authority to file electronically to personal property such as jet skis, mobile homes, and

boats. Second, the proposal makes a clarifying change to S.L.2005-294 (AN ACT TO CREATE A COMBINED MOTOR VEHICLE REGISTRATION RENEWAL AND PROPERTY TAX COLLECTION SYSTEM), to reflect the intent of the act's sponsors and supporters. This act created a combined system for registration and taxation of motor vehicles to become effective July 1, 2009, or upon the earlier creation of a computer system that allows for the combined payment of registration fees and taxes due on motor vehicles. To cover the cost of the computer system, the act increased the first month's interest on delinquent registered motor vehicle taxes from 2% to 5%. The intent was that 60% of the first month's interest would be transferred to an Account in the Treasurer's Office to implement the computer system. The proposal adds language clarifying this intent. Third, the proposal would give a county board of equalization and review the authority to approve a late application for present-use value appraisal of property if the applicant demonstrates good cause for the delay. Current law allows similar approval for late applications for property tax exemptions or exclusions. Fourth, the proposal would authorize a tax collector to receive tax receipts for assessments that have been or are subsequently appealed to the Property Tax Commission and to send the taxpayer an initial tax bill or notice. The tax collector, however, may not collect the tax or enforce a tax lien until the appeal has been finally adjudicated. Fifth, the proposal, would clarify that the list of items credited to the tax collector in the collector's final settlement with the governing body should include the principal amount of taxes for any assessment appealed to the Property Tax Commission. Current law provides that the final settlement must contain the items to be charged against the tax collector and the items to be allowed as credits for the collector for the preceding fiscal year.

Legislative Proposal #5, *Phone, Tower, & Cable Property Tax Appraisal,* would broaden the Department's authority to appraise the property of public service

companies for property tax purposes by including the property of wireless companies, paging companies, cable companies, and tower companies within the definition of public service company. Under current law, the Department makes a yearly appraisal of public service company property and allocates the valuations among the local taxing units in which the companies do business. In determining the true value of a company's property, the Department considers market value of the company's capital stock and debt, the book value of the company's system property, and the gross receipts and operation income of the company. Since, wireless companies, paging companies, cable companies, and tower companies do not come within the statutory definition of public service company, they are appraised by the local taxing unit in which they are located. Many local taxing units do not have the capability to determine the true value of these companies, and the counties have requested the Department to take over the appraisal of the wireless companies, paging companies, cable companies, and tower companies.

Legislative Proposal #6, *Amend Delinquent Property Tax Collection*, would amend the property tax laws by relieving the seller of personal liability for property taxes assessed on real property when the seller transfers the property before the property becomes delinquent or when the seller transfers the real property before it is annexed by the taxing unit and taxes are imposed by the taxing unit. In effect, the remedies of attachment and garnishment would be enforced against the record owner of the real property on the date the taxes become delinquent instead of the listing owner of the real property. The proposal would also codify the practice of prorating property taxes on a calendar-year basis when real property is sold. This proposal was endorsed by a group of county attorneys, real estate attorneys, and tax collectors.

INCOME TAX

The Committee spent considerable time reviewing several proposals related to income tax, specifically corporate income tax.

North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.[1] The General Assembly determines each year whether to update its reference to the Internal Revenue Code.[2] Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State law previously tracked federal law. Legislative Proposal #7, IRC Update, changes the statutory reference to the Code from January 1, 2005, to January 1, 2006, and makes other conforming changes. Between those dates, Congress enacted four major pieces of federal legislation that made changes to the Internal Revenue Code. This federal legislation includes the Energy Tax Incentive Act of 2005 (P.L. 109-58) signed into law on August 8, 2005, the SAFE Transportation Equity Act of 2005 (P.L. 109-59) signed into law on August 10, 2005, the Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) signed into law on September 23, 2005, and the Gulf Opportunity Zone Act of 2005 (P.L. 109-135) signed into law on December 21, 2005. The changes made in 2005 primarily affect persons impacted by Hurricanes Katrina, Rita, and Wilma, persons who contributed to relief efforts related to those storms, and person involved with various types of energy production or distribution. The proposal also

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[1] North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

[2] The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power."

seeks to conform several other provisions of State tax law to the federal law even though those provisions are dependent upon a reference to the Code.

The Committee considered one individual income tax proposal. Legislative Proposal #8, *Additional Personal Income Tax Filing Option,* is a recommendation of the Department of Revenue and would allow married couples the option of filing a joint return if one spouse is a nonresident with no North Carolina income.

The Committee considered several corporate income tax proposals upon the request of the Department of Revenue. The Committee discussed the corporate tax proposals during its March meeting. It did not receive any opposition to the proposals.

Under current North Carolina law, an individual's pro rata share of S Corporation income attributable to North Carolina is subject to corporate income tax adjustments, while S Corporation income that is not attributable to North Carolina is subject to individual income tax adjustments. Legislative Proposal #9, *S Corp Income Tax Adjustments,* would make an individual's pro rata share of income from an S Corporation subject only to the individual income tax adjustments, rather than being subject to both individual and corporate income tax adjustments. The change in the proposal is more consistent with the tax treatment of an S Corporation generally and would simplify tax form preparation. Consequently, the Department of Revenue believes it may result in a higher degree of compliance with the law.

North Carolina imposes a 1.9% tax rate on the gross premiums of most insurance policies.[3] In addition to the general rate, there is a 1.33% rate applied to the gross premiums on insurance policies that provide fire and lightning coverage. The General Assembly enacted the additional statewide fire and lightning tax in 1959. Although the

[3] Workers' compensation policies are taxed at 2.5%. HMO policies are currently taxed at a rate of 1%; however, effective January 1, 2007, these policies will be taxed at the general rate of 1.9%.

statute does not provide that the tax will apply differently to different types of policies, the Department of Revenue has administered the tax this way. Within the past few years, the Department has been informally advised by both the Department of Insurance and the Attorney General's Office that the statute as written does not provide for assessing the tax against only a percentage of a policy's premium. Rather, without a statutory change, it is their opinion that the tax should be applied to 100% of the premiums of any policy that includes fire and lightning coverage. Legislative Proposal #10, *Clarify Additional Gross Premiums Tax*, would codify the current administrative practice of the Department by setting in statute the percentage of an insurance policy's gross premiums to which the additional tax applies and it would provide that the additional tax would apply to all types of policies.

For the last few years, the Department of Revenue has worked with the Revenue Laws Study Committee to eliminate various loopholes in the application of the franchise tax. Since the franchise tax does not apply to limited liability companies, corporations previously were able to avoid paying franchise tax by transferring assets to a wholly-owned LLC. In 2001, the General Assembly attempted to close this loophole by enacting legislation requiring the attribution of assets transferred to an LLC back to the corporation depending on the corporation's percentage of ownership. The General Assembly enacted legislation again in 2002 and 2004 to tighten the law because corporations were circumventing the attribution rules by interposing other entities between the corporation and the LLC, such as partnerships and business trusts. During the 2005 Session, Senate Bill 540 was introduced to close yet another franchise tax loophole. Under current law, an LLC is treated as a division of its parent. The parent company is then considered to own property in this State and therefore has nexus, making it subject to income and franchise tax, and the constructive ownership

rules apply for attributing the LLC's assets to the parent's franchise tax calculation. However, when an LLC elects to be taxed as a C Corporation, nexus is not conferred on the parent and the attributes of the LLC do not flow to the parent. Therefore, companies currently operating in this State as C Corporations can convert to an LLC, make an election to file as a C Corporation, as they always have, and eliminate their North Carolina franchise tax obligations. Senate Bill 540 attempts to close this loophole by applying the franchise tax to limited liability corporations that elect to be taxed as a C Corporation for federal income tax purposes. The bill passed the Senate, but was not considered by the House. The Department of Revenue requested that the Revenue Laws Study Committee revisit this issue and endorse identical legislation for consideration in the short session. Legislative Proposal #11, Franchise Tax Loophole Closing, is substantially similar to Senate Bill 540. It would apply the corporate franchise tax to limited liability companies that elect to be taxed as a C Corporation for federal income tax purposes. The bill would also provide LLCs that elect to be taxed as a C Corporation a credit for the difference between annual report fees for corporations and LLCs such that those LLCs are paying the lower corporation annual report fee rate.

North Carolina imposes a franchise tax at the rate of $1.50 per $1,000 of the total amount of a corporation's capital base. A corporation's determination of its capital base for purposes of the franchise tax is not the same as the calculation of its capital base for financial reporting purposes. The calculation of its capital base for franchise tax purposes is determined by statute. The statute refers to book value as 'issued and outstanding capital stock, surplus, and undivided profits.' This is similar to net book value with certain adjustments. The principal adjustment is for contingent or deferred liabilities. The statute, a 1996 Department of Revenue Technical Advice Memorandum, and the standards under General Accepted Accounting Practices differ on how to

account for deferred liabilities. Legislative Proposal #12, *Franchise Tax Base Calculation,* would clarify how to treat deferred tax liabilities for franchise tax purposes.

Royalty income received for the use of trademarks, patents, and copyrights in North Carolina *is* taxable and must be reported to North Carolina by an out-of-state corporation receiving this income. However, there is a reporting option currently available to corporations and their related members for royalty payments received for trademark usage that is not available when those payments are for patent or copyright usage. Legislative Proposal #13, *Expansion of Royalty Reporting Option,* would expand the royalty payment reporting option for corporations and their related members to include payments received for the use of patents and copyrights. This proposal would give corporations and their related members that receive royalty payments derived from patent or copyright usage the ability to select which entity, the parent or the holding company, reports the income, just as that option is currently available to those corporations with regard to trademark royalties.

The Committee spent some time looking at real estate investment trusts (REIT). A REIT is a corporation or trust that uses the pooled capital of many investors to purchase and manage real estate. A REIT is subject to federal and State income tax only on the income that is not distributed to its shareholders. The shareholders pay tax on the dividends they receive. However, some taxpayers have avoided paying tax on the dividends they receive from the REIT by forming a company in another state to receive the distributions from the REIT. The income received by that company is not subject to North Carolina tax. The company may then distribute the income to the parent company in North Carolina, but the parent company would not have to pay tax on the

income because of the federal dividends received deduction[4]. The Committee is concerned about this tax avoidance method, but does not have a proposal at this time.

ELECTRICITY FRANCHISE TAX DISTRIBUTION

Cities receive a portion of the franchise tax on electric power companies. The distribution is based upon the gross receipts derived by the power company from sales within a city. This method of distribution imposes unnecessary burdens on the cities, the power companies, and the Department of Revenue and it results in numerous errors in the distribution. The General Assembly, through Senate Bill 343[5], asked the League of Municipalities to recommend a method of distributing this revenue to the cities on the basis of a formula that uses factors such as population and percentage share of prior distributions rather than service inside constantly changing city boundaries. The League, working with the electric power companies, devised a formula for making this distribution. Appendix F details the recommended distribution formula. The Committee recommends that the General Assembly consider a committee substitute for Senate Bill 343[6] that embodies the recommendation of the League.

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[4] 26 U.S.C. 243.

[5] SB 343, AN ACT TO DIRECT THE LEAGUE OF MUNICIPALITIES TO DETERMINE A DIFFERENT METHOD FOR DISTRIBUTING THE FRANCHISE TAX ON ELECTRIC POWER COMPANIES IN ORDER TO SIMPLIFY THE DISTRIBUTION, REDUCE THE ADMINISTRATIVE BURDEN ASSOCIATED WITH THE DISTRIBUTION, AND PREVENT ERRORS IN THE DISTRIBUTION.

[6] SB 343, 2nd edition, is in the House Finance Committee.

COMMITTEE RECOMMENDATIONS AND LEGISLATIVE PROPOSALS

The Revenue Laws Study Committee makes the following 15 recommendations to the 2006 General Assembly. Each proposal is followed by an explanation and, if it has a fiscal impact, a fiscal note or memorandum indicating any anticipated revenue gain or loss resulting from the proposal.

1. Video Services Competition Act
2. Amend Taxation of Logging Machinery
3. SSTA Sales Tax Defn/Sales Tax Payments
4. Property Tax Changes
5. Amend Delinquent Property Tax Collection
6. Phone, Tower, & Cable Property Tax Appraisal
7. IRC Update
8. Additional Personal Income Tax Filing Option
9. S Corp Income Tax Adjustments
10. Clarify Additional Gross Premiums Tax
11. Franchise Tax Loophole Closing
12. Franchise Tax Base Calculation
13. Expansion of Royalty Reporting Option
14. Electricity Franchise Tax Distribution
15. Revenue Laws Technical and Motor Fuel Tax Changes

LEGISLATIVE PROPOSAL #1

VIDEO SERVICES COMPETITION ACT

LEGISLATIVE PROPOSAL #1

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO PROMOTE CONSUMER CHOICE IN VIDEO SERVICE PROVIDERS AND TO ESTABLISH UNIFORM TAXES FOR VIDEO PROGRAMMING SERVICES.

SHORT TITLE: Video Services Competition Act

SPONSORS:

BRIEF OVERVIEW: This bill would promote consumer choice in video service providers and establish uniform taxes for video programming services.

FISCAL IMPACT:

EFFECTIVE DATE: January 1, 2007.

A copy of the proposed legislation, an executive summary bill analysis, and a fiscal memo begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-RBxz-36B [v.7] (03/30)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
5/2/2006 6:42:13 AM

Short Title: Video Service Competition Act. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO PROMOTE CONSUMER CHOICE IN VIDEO SERVICE PROVIDERS AND TO ESTABLISH UNIFORM TAXES FOR VIDEO PROGRAMMING SERVICES.

The General Assembly of North Carolina enacts:

SECTION 1. Chapter 66 of the General Statutes is amended by adding a new Article to read:

"Article 42.

"State Franchise for Cable Television Service.

"**§ 66-350. Definitions.**

The following definitions apply in this Article:

(1) Cable service. – Defined in G.S. 105-164.3.

(2) Cable system. – Defined in 47 U.S.C. 522.

(3) Channel. – A portion of the electromagnetic frequency spectrum that is used in a cable system and is capable of delivering a television channel.

(4) Commission. – The North Carolina Utilities Commission.

(5) Existing agreement. – A local franchise agreement that was awarded under G.S. 153A-137 or G.S. 160A-319 and is in effect on January 1, 2007.

(6) Pass a household. – Make service available to a household, regardless of whether the household subscribes to the service.

(7) PEG channel. – A public, educational, or governmental access channel provided to a county or city.

"**§ 66-351. State franchising authority.**

(a) Authority. – The North Carolina Utilities Commission is designated the exclusive franchising authority in this State for cable service provided over a cable system. This

designation replaces the authorization to counties and cities in former G.S. 153A-137 and G.S. 160A-319 to award a franchise for cable service. This designation is effective January 1, 2007. After this date, a county or city may not award or renew a franchise for cable service.

(b) Award and Scope. – The Commission is considered to have awarded a franchise to a person who files a notice of service under G.S. 66-352. A franchise for cable service authorizes the holder of the franchise to construct and operate a cable system over public rights of way within the area to be served. Chapter 160A of the General Statutes governs the regulation of public rights-of-way by a city.

§ 66-352. Notice and commencement of service.

(a) Notice of Service. – A person who intends to provide cable service over a cable system in an area must file a notice of service with the Commission before providing the service. The notice is effective when it is filed with the Commission. The notice of service must include all of the following:

(1) The applicant's name and principal place of business.

(2) A description and map of the area to be served.

(3) A list of each county and city in which the described service area is located, in whole or in part.

(4) A schedule indicating when service is expected to be offered in part or all of the service area.

(b) Initial Service. – A person who files a notice of service under subsection (a) of this section must begin providing cable service in the service area described in the notice within 120 days after the notice is filed. If cable service does not begin within this period, the notice of service terminates 130 days after it was filed. If cable service begins within this period, the holder of the State-issued franchise must file a report of initial service with the Commission within 10 days after the cable service begins. Cable service begins when it passes one or more households in the described service area. This subsection does not apply to a cable service provider who terminates an existing agreement whose franchise area includes all of the service area described in a notice of service filed by the provider under subsection (a) of this section.

A report of initial service for a service area must include all of the following:

(1) The effective date of a notice of service for that area.

(2) A description and map of the service area.

(3) A statement that cable service has begun in the service area.

(c) Extension. – A person who intends to provide cable service over a cable system in an area that is contiguous with but outside the service area described in a notice of service on file with the Commission must file a notice of service under subsection (a) of this section that includes the proposed area. The initial service requirements in subsection (b) of this section apply to the proposed area. If the map of the area to be served includes any area that is part of the service area of another State-issued franchise, the termination of a notice of service for the proposed area for failure to begin service within the required time does not affect the status of the other State-issued franchise.

(d) Withdrawal. – A person may withdraw a notice of service by filing a notice of withdrawal with the Commission. The notice of withdrawal must be filed at least 90 days before the service is withdrawn.

"**§ 66-353. Annual service report.**

A holder of a State-issued franchise must file an annual service report with the Commission. The report must be filed on or before July 15 of each year. The report must include all of the following:

(1) The effective date of a notice of service for that area.

(2) A description and map of the service area.

(3) The approximate number of households in the service area.

(4) A description and a map of the households passed in the service area as of July 1.

(5) The percentage of households passed in the service area as of July 1.

(6) The percentage of households passed in the service area as of July 1 of any preceding year for which a report was required under this subsection.

(7) A schedule indicating when service is expected to be offered in part or all of the service area, to the extent the schedule differs from one included in the notice of service or in a report previously submitted under this subsection, and an explanation of the reason for the new schedule.

"**§ 66-354. General filing and report requirements.**

A document filed with the Commission under this section must be signed by an officer or general partner of the person submitting the document. Within five days after a person files a document with the Commission under this section, the person must send a copy of the document to any county or city included in the service area described in the document. A document filed under this section is a public record as defined in G.S. 132-1.

A successor in interest to a person who has filed a notice of service is not required to file another notice of service. When a change in ownership occurs, the owner must file a notice of change in ownership with the Commission within 14 days after the change becomes effective.

"**§ 66-355. Effect on existing local franchise agreement.**

(a) Existing Agreement. – This Article does not affect an existing agreement except as follows:

(1) Effective January 1, 2007, gross revenue used to calculate the payment of the franchise tax imposed by G.S. 153A-154 or G.S. 160A-214 does not include gross receipts from cable service subject to sales tax under G.S. 105-164.4. This exclusion does not otherwise affect the calculation of gross revenue and the payment to counties and cities of franchise tax revenue under existing agreements that have not been terminated under subsection (b) of this section.

(2) A cable service provider under an existing agreement may terminate the agreement in accordance with subsection (b) of this section when a

report of initial service filed under G.S. 66-352 indicates that one or more households in the franchise area of the existing agreement are passed by both the cable service provider under the existing agreement and the holder of a State-issued franchise.

(b) Termination. – To terminate an existing agreement, a cable service provider must file a notice of termination with the affected county or city and file a notice of service with the Commission. A termination of an existing agreement becomes effective at the end of a calendar quarter that is at least 30 days after the notice of termination is filed with the affected county or city. A termination of an existing agreement ends the obligations under the agreement as of the effective date of the termination, but does not affect the rights or liabilities of the county or city, a taxpayer, or another person arising under the existing agreement before the effective date of the termination.

"**§ 66-356. Service standards and requirements.**

(a) Discrimination Prohibited. – A person who provides cable service over a cable system may not deny access to the service to any group of potential residential subscribers within the filed service area because of the race or income of the residents. A violation of this subsection is considered an unfair or deceptive act or practice under G.S. 75-1.1.

In determining whether a cable service provider has violated this subsection with respect to a group of potential residential subscribers in a service area, the following factors must be considered:

(1) The length of time since the provider filed the notice of service for the area. If less than a year has elapsed since the notice of service was filed, it is conclusively presumed that a violation has not occurred.

(2) The cost of providing service to the affected group due to distance from facilities, density, or other factors.

(3) Technological impediments to providing service to the affected group.

(4) Inability to obtain access to property required to provide service to the affected group.

(b) FCC Standards. – A person who provides cable service over a cable system must comply with the customer service requirements in 47 C.F.R. § 76.309 and emergency alert requirements established by the Federal Communications Commission. The Consumer Protection Division of the Attorney General's Office is designated as the State agency to receive and respond to customer complaints concerning cable service. The number for the Division must be printed on the customer's bill.

(c) No Build-out. – No build-out requirements apply to a person who provides cable service under a State-issued franchise.

"**§ 66-357. Availability and use of PEG channels.**

(a) Application. – This section applies to a person who provides cable service under a State-issued franchise. It does not apply to a person who provides cable service under an existing agreement.

(b) Local Request. – A county or city must make a written request to a cable service provider for PEG channel capacity. The request must include a statement describing the county's or city's plan to operate and program each channel requested. The cable service

provider must provide the requested PEG channel capacity within 120 days after it receives the written request.

(c) Initial PEG Channels. – If an area is included in both the franchise area of an existing agreement and the service area of a State-issued franchise, the terms of the existing agreement, as of the filing date on the notice of service for the State-issued franchise, determine the required number, service tier placement, and transmission quality of initial PEG channels. The cable service provider must provide the number of PEG channels activated under those terms, giving equivalent service tier placement and transmission quality to those channels. The cable service provider must maintain the same channel designation for a PEG channel unless the service area of the State-issued franchise includes PEG channels that are operated by different counties or cities and those PEG channels have the same channel designation. The expiration of an existing agreement after January 1, 2007, does not affect the requirements in this subsection.

If no existing agreement includes any part of the service area of a State-issued franchise, then the number, service tier placement, and transmission quality of the initial PEG channels a cable service provider must provide depends upon the population of the city in which part or all of the service area is located. If the city's population is at least 50,000, the cable service provider must provide up to three PEG channels on a basic service tier. If the city's population is less than 50,000, a cable service provider must provide up to two PEG channels on a basic service tier. The transmission quality of these PEG channels must be equivalent to those of the closest city covered by an existing agreement.

(d) Additional PEG Channels. – A county or city that does not have seven PEG channels, including the initial PEG channels, is eligible for an additional PEG channel if it meets the programming requirements in this subsection. A county or city that has seven PEG channels is not eligible for an additional channel.

A county or city that meets the programming requirements in this subsection may make a written request under subsection (b) of this section for an additional channel. The additional channel may be provided on any service tier. The transmission quality of the additional channel must be at least equivalent to the transmission quality of the other channels provided.

The PEG channels operated by a county or city must meet the following programming requirements in order for the county or city to obtain an additional channel:

(1) All of the PEG channels must have scheduled programming for at least eighty percent (80%) of the time for at least eight hours a day.

(2) The programming content of each of the PEG channels must not repeat more than fifteen percent (15%) of the programming content on any of the other PEG channels.

(3) No more than fifteen percent (15%) of the programming content on any of the PEG channels may be character-generated programming.

(e) Use of Channels. – If a county or city no longer provides any programming for transmission over a PEG channel it has activated, the channel may be re-programmed at the cable service provider's discretion. A cable service provider must give at least 60

days notice to a county or city before it re-programs a PEG channel that is not used. The cable service provider must restore a previously lost PEG channel within 120 days of the date a county or city certifies to the provider a schedule that demonstrates the channel will be used.

(f) Operation of Channels. – A cable service provider is responsible only for the transmission of a PEG channel. The county or city to which the PEG channel is provided is responsible for the operation and content of the channel. A county or city that provides content to a cable service provider for transmission on a PEG channel is considered to have authorized the provider to transmit the content throughout the provider's service area, regardless of whether part of the service area is outside the boundaries of the county or city.

All programming on a PEG channel must be noncommercial. A cable service provider is not required to transmit content on a PEG channel that is branded with the logo, name, or other identifying marks of another cable service provider.

"**§ 66-358. Transmission of PEG channels.**

(a) Service. – When a cable service provider operating under a State-issued franchise begins providing cable service in an area, the service must include the transmission of PEG channels by one of the following methods:

(1) Interconnection of its cable system on reasonable and competitively neutral terms with any other cable system operated in its franchise or service area. Interconnection may be accomplished by direct cable, microwave link, satellite, or other method of connection.

(2) Transmission of the signal from each PEG channel programmer's origination site.

(b) Signal. – All PEG channel programming must meet the minimum recognized technical standards for the format used. If a PEG channel programmer transmits its signal in a format a cable service provider cannot transmit without altering the transmission signal, then the cable service provider must do one of the following:

(1) Alter the transmission signal to make it compatible with the technology or protocol the cable service provider uses to deliver its cable service.

(2) Provide to the county or city equipment needed to alter the transmission signal to make it compatible with the technology or protocol the cable service provider uses to deliver its cable service.

"**§ 66-359. Service to public building.**

At the written request of a county or city, a cable service provider operating under a State-issued franchise must provide cable service without charge to a public building located within 125 feet of the provider's cable system. The required service is the basic, or lowest-priced, service the provider offers to customers. The terms and conditions that apply to service provided to a retail customer apply to the service provided to the public building. Only one service outlet is required for a building. The cable service provider is not required to provide concealed inside wiring. A public building is a building used as a public school, a charter school, a county or city library, or a function of the county or city."

SECTION 2. G.S. 105-164.3 is amended by adding a new subdivision to read:

"**§ 105-164.3. Definitions.**

The following definitions apply in this Article:

...

(50c) Video programming. – Programming provided by, or generally considered comparable to programming provided by, a television broadcast station, regardless of the method of delivery."

SECTION 3. G.S. 105-164.4(a)(6) reads as rewritten:

"(6) The combined general rate applies to the gross receipts derived from providing ~~any of the following broadcast services~~ video programming to a subscriber in this State. A cable service provider, a direct-to-home satellite service provider, and any other person engaged in the business of providing ~~any of these services~~ video programming is considered a retailer under this ~~Article:~~Article.

~~a. Direct-to-home satellite service.~~

~~b. Cable service.~~"

SECTION 4. G.S. 105-164.4C(d) is recodified as G.S. 105-164.4D with the catchline "Bundled services."

SECTION 5. G.S. 105-164.4D, as recodified by Section 4 of this act, reads as rewritten:

"**§ 105-164.4D. Bundled services.**

~~Bundled Services.~~ When a taxable ~~telecommunications~~ service is bundled with a service that is not taxable, the tax applies to the gross receipts from the taxable service in the bundle as follows:

(1) If the service provider offers all the services in the bundle on an unbundled basis, tax is due on the unbundled price of the taxable service, less the discount resulting from the bundling. The discount for a service as the result of bundling is the proportionate price decrease of the service, determined on the basis of the total unbundled price of all the services in the bundle compared to the bundled price of the services.

(2) If the service provider does not offer one or more of the services in the bundle on an unbundled basis, tax is due on the taxable service based on a reasonable allocation of revenue to that service. If the service provider maintains an account for revenue from a taxable service, the service provider's allocation of revenue to that service for the purpose of determining the tax due on the service must reflect its accounting allocation of revenue to that service."

SECTION 6. The catchline to G.S. 105-164.12B reads as rewritten:

"**§ 105-164.12B. ~~Bundled transactions.~~Tangible personal property bundled with service contract.**"

SECTION 7. G.S. 105-164.44F(a) reads as rewritten:

"(a) Amount. – The Secretary must distribute ~~to the cities~~ part of the taxes imposed by G.S. 105-164.4(a)(4c) on telecommunications service. The Secretary must make the distribution within 75 days after the end of each calendar quarter. The amount the Secretary must distribute is ~~eighteen and three one-hundredths percent (18.03%)~~ the following percentages of the net proceeds of the taxes collected during the ~~quarter,~~ quarter:

(1) Eighteen and three one-hundredths percent (18.03%), minus two million six hundred twenty thousand nine hundred forty-eight dollars ~~($2,620,948).~~($2,620,948), must be distributed to cities in accordance with this section. ~~This~~ The deduction is one-fourth of the annual amount by which the distribution to cities of the gross receipts franchise tax on telephone companies, imposed by former G.S. 105-20, was required to be reduced beginning in fiscal year 1995-96 as a result of the "freeze deduction." ~~The Secretary must distribute the specified percentage of the proceeds, less the "freeze deduction" among the cities in accordance with this section.~~

(2) Seven and twenty-three one-hundredths percent (7.23%) must be distributed to counties and cities as provided in G.S. 105-164.44I."

SECTION 8. Article 5 of Chapter 105 of the General Statutes is amended by adding a new section to read:

"**§ 105-164.44I. Distribution of part of sales tax on video programming service and telecommunications service to counties and cities.**

(a) Distribution. – The Secretary must distribute to the counties and cities part of the taxes imposed by G.S. 105-164.4(a)(4c) on telecommunications service and G.S. 105-164.4(a)(6) on video programming service. The Secretary must make the distribution within 75 days after the end of each calendar quarter. The amount the Secretary must distribute is the sum of the following:

(1) The amount specified in G.S. 105-164.44F(a)(2).

(2) Twenty-two and sixty-one one-hundredths percent (22.61%) of the net proceeds of the taxes collected during the quarter on video programming, other than on direct-to-home satellite service.

(3) Thirty-seven percent (37%) of the net proceeds of the taxes collected during the quarter on direct-to-home satellite service.

(b) Supplemental PEG Support. – The Secretary must include the applicable amount of supplemental PEG channel support in each quarterly distribution to a county or city. The amount to include is one-fourth of sixteen thousand dollars ($16,000) for each qualifying PEG channel operated by the county or city. The amount of money distributed under this subsection may not exceed two million dollars ($2,000,000) in a calendar year. If the amount to be distributed for qualifying PEG channels in a calendar year would otherwise exceed this maximum amount, the Secretary must proportionately reduce the applicable amount distributable for each PEG channel. The amount included under this subsection in a distribution to a county or city is intended to supplement the PEG channel support available in the amount distributed under this section.

A county or city must certify to the Secretary by January 15 of each year the number of qualifying PEG channels it operates. A qualifying PEG channel is one that meets the programming requirements under G.S. 66-357(d). A county or city may not receive PEG channel support for more than three qualifying PEG channels.

The money distributed to a county or city under this subsection must be used by it for the operation and support of PEG channels. For purposes of this subsection, the term "PEG channel" has the same meaning as in G.S. 66-350.

(c) Counties and Cities Without Local Cable Revenue. – The share of a county that did not impose a cable franchise tax under G.S. 153A-154 before January 1, 2007, is one dollar ($1.00) times the most recent annual population estimate for that county. The share of a city that did not impose a cable franchise tax under G.S. 160A-214 before January 1, 2007, is two dollars ($2.00) times the most recent annual population estimate for that city.

(d) Counties and Cities With Local Cable Revenue. – The share of a county or city that imposed a cable franchise tax under either G.S. 153A-154 or G.S. 160A-214 before January 1, 2007, is its proportionate share of the amount to be distributed to all counties and to all cities eligible to receive a distribution under this subsection. The amount to be distributed under this subsection is the amount determined under subsection (a) of this section, minus the amount distributed under subsections (b) and (c) of this section. A county's and city's proportionate share is the amount of cable franchise tax it received under G.S. 153A-154 or G.S. 160A-214 during the 2005-06 fiscal year plus the amount of a subscriber fee imposed during the 2005-06 fiscal year compared to the amount of cable franchise tax revenue and subscriber fee revenue all counties and cities received in that fiscal year. Each county or city that imposed a franchise tax under G.S. 153A-154 or G.S. 160A-214 must certify to the Secretary by January 15, 2007, the amount of cable franchise tax revenue and subscriber fee revenue it received in the 2005-06 fiscal year.

For subsequent fiscal years, the Secretary must multiply the amount of a county's or city's share under this subsection for the preceding year by the percentage change in its population for that fiscal year and add the result to the county's or city's share for the preceding fiscal year to obtain the county's or city's adjusted amount. Each county's or city's proportionate share for that year is its adjusted amount compared to the sum of the adjusted amounts for all counties and cities.

(e) Population Determination. – In making population determinations under this section, the Secretary must use the most recent annual population estimates certified to the Secretary by the State Budget Officer. For purposes of the distributions made under this section, the population of a county is the population of its unincorporated areas plus the population of an ineligible city in the county, as determined under subsection (g) of this section.

(f) Change in City Structure. – The following changes apply when a city alters its corporate structure:

(1) If a city dissolves and is no longer incorporated, the proportional shares of the remaining counties and cities must be recalculated to adjust for the dissolution of that city.

(2) If two or more cities merge or otherwise consolidate, their proportional shares are combined.

(3) If a city divides into two or more cities, the proportional share of the city that divides is allocated among the new cities on a per capita basis.

(g) Ineligible Cities. – An ineligible city is disregarded for all purposes under this section. A city incorporated on or after January 1, 2000, is not eligible for a distribution under this section unless it meets both of the following requirements:

(1) It is eligible to receive funds under G.S. 136-41.2.

(2) A majority of the mileage of its streets is open to the public.

(h) Nature. – The General Assembly finds that the revenue distributed under this section is local revenue, not a State expenditure, for the purpose of Section 5(3) of Article III of the North Carolina Constitution. Therefore, the Governor may not reduce or withhold the distribution."

SECTION 9. G.S. 105-164.21B is repealed.

SECTION 10. G.S. 153A-137 is repealed.

SECTION 11. G.S. 153A-154 is repealed.

SECTION 12. G.S. 160A-211 reads as rewritten:

"**§ 160A-211. Privilege license taxes.**

(a) Authority. – Except as otherwise provided by law, a city shall have power to levy privilege license taxes on all trades, occupations, professions, businesses, and franchises carried on within the city. A city may levy privilege license taxes on the businesses that were formerly taxed by the State under the following sections of Article 2 of Chapter 105 of the General Statutes only to the extent the sections authorized cities to tax the businesses before the sections were repealed:

G.S. 105-36	Amusements – Manufacturing, selling, leasing, or distributing moving picture films.
G.S. 105-36.1	Amusements – Outdoor theatres.
G.S. 105-37	Amusements – Moving pictures – Admission.
G.S. 105-42	Private detectives and investigators.
G.S. 105-45	Collecting agencies.
G.S. 105-46	Undertakers and retail dealers in coffins.
G.S. 105-50	Pawnbrokers.
G.S. 105-51.1	Alarm systems.
G.S. 105-53	Peddlers, itinerant merchants, and specialty market operators.
G.S. 105-54	Contractors and construction companies.
G.S. 105-55	Installing elevators and automatic sprinkler systems.
G.S. 105-61	Hotels, motels, tourist courts and tourist homes.
G.S. 105-62	Restaurants.
G.S. 105-65	Music machines.
G.S. 105-65.1	Merchandising dispensers and weighing machines.
G.S. 105-66.1	Electronic video games.
G.S. 105-74	Pressing clubs, dry cleaning plants, and hat blockers.

G.S. 105-77	Tobacco warehouses.
G.S. 105-80	Firearms dealers and dealers in other weapons.
G.S. 105-85	Laundries.
G.S. 105-86	Outdoor advertising.
G.S. 105-89	Automobiles, wholesale supply dealers, and service stations.
G.S. 105-89.1	Motorcycle dealers.
G.S. 105-90	Emigrant and employment agents.
G.S. 105-91	Plumbers, heating contractors, and electricians.
G.S. 105-97	Manufacturers of ice cream.
G.S. 105-98	Branch or chain stores.
G.S. 105-99	Wholesale distributors of motor fuels.
G.S. 105-102.1	Certain cooperative associations.
G.S. 105-102.5	General business license.

(b) Barbershop and Salon Restriction. – A privilege license tax levied by a city on a barbershop or a beauty salon may not exceed two dollars and fifty cents ($2.50) for each barber, manicurist, cosmetologist, beautician, or other operator employed in the barbershop or beauty salon.

(c) ~~Piped Gas Restriction.~~ Prohibition.– A city may not ~~levy a privilege license tax on a person who is engaged in the business of supplying piped natural gas and is subject to tax under Article 5E of Chapter 105 of the General Statutes.~~ impose a license, franchise, or privilege tax on a person engaged in any of the businesses listed in this subsection. These businesses are subject to a State tax for which the city receives a share of the tax revenue.

(1) Supplying piped natural gas taxed under Article 5E of Chapter 105 of the General Statutes.

(2) Providing telecommunications service taxed under G.S. 105-164.4(a)(4c).

(3) Providing video programming taxed under G.S. 105-164.4(a)(6).

~~(d) Telecommunications Restriction. A city may not impose a license, franchise, or privilege tax on a company taxed under G.S. 105-164.4(a)(4c).~~"

SECTION 13. G.S. 160A-214 is repealed.

SECTION 14. G.S. 160A-319(a) reads as rewritten:

"(a) A city shall have authority to grant upon reasonable terms franchises for ~~the operation within the city of~~ a telephone system and any of the enterprises listed in ~~G.S. 160A-311 and for the operation of telephone systems.~~ G.S. 160A-311, except a cable television system. A franchise granted by a city authorizes the operation of the franchised activity within the city. No franchise shall be granted for a period of more than 60 years, except that a franchise for solid waste collection or disposal systems and facilities shall not be granted for a period of more than 30 ~~years and cable television franchises shall not be granted for a period of more than 20~~ years. Except as otherwise provided by law, when a city operates an enterprise, or upon granting a franchise, a city may by ordinance make it unlawful to operate an enterprise without a franchise."

SECTION 15. An award of a State-issued franchise under Article 42 of Chapter 66 of the General Statutes, as enacted by this act, does not affect a determination of whether video programming provided by the holder of the franchise is considered cable service provided over a cable system under federal law or under a state law that applies substantially the same definitions of "cable service" and "cable system" as federal law.

SECTION 16. If any provision of this act or its application is held invalid, the invalidity does not affect other provisions or applications of this act that can be given effect without the invalid provisions or application, and to this end the provisions of this act are severable.

SECTION 17. The Revenue Laws Study Committee must review the effect Article 42 of Chapter 66, as enacted by this act, has on the following to determine if any changes to the law are needed and must report its findings to the 2009 Session of the North Carolina General Assembly:

(1) Competition in video programming services.

(2) The number of cable service subscribers, the price of cable service by service tier, and the technology used to deliver the service.

(3) The deployment of broadband in the State.

SECTION 18. This act becomes effective January 1, 2007. Sections 7 and 8 of this act apply to the distribution made within 75 days after March 31, 2007, for the quarter starting January 1, 2007.

VIDEO SERVICE COMPETITION ACT

May 2, 2006

Executive Summary

- **Provides equal taxation of same service**
  - Defines video programming to include all programming comparable to television broadcast, regardless of provider
  - Repeals local authority to impose local franchise tax
  - Applies existing 7% State sales tax to video programming service

- **Promotes competition in video programming service**
  - Requires State franchising of cable service providers
  - Repeals local authority to award or renew a local cable franchise, effective January 1, 2007

- **Preserves local government revenue stream**
  - Distributes share of sales tax imposed on video programming to counties and cities
  - Distribution of video programming revenues based on the amount of cable franchise tax received in fiscal year 05-06 PLUS any subscriber revenues received in fiscal year 05-06. Subsequent annual distributions adjusted for population growth

- **Protects PEG Channels**
  - Provides up to $2 million for additional PEG support
  - Includes per subscriber revenue in local government distribution base
  - Sets number, service tier placement, and transmission quality of PEG channels
  - Provides mechanism to acquire additional PEG channels
  - Provides equipment assistance for transmitting PEG channel signals

- **Requires cable service provider to provide free basic service to local public buildings**

- **Preserves local regulation of rights-of-way**

- **Provides competitive neutrality**
  - Existing local franchises cannot be renewed
  - Opt out provision for cable service providers under existing local agreements when one or more households in the franchise area may be served by both the existing provider and the holder of a State-issued franchise

- **Prohibits discrimination**
  - Bill specifically prohibits discrimination of service based on income or race
  - Violation of the law declared an unfair or deceptive trade practice

- **Preserves service standards**
  - Franchisee must comply with customer service standards and emergency alert requirements of FCC

BILL DRAFT 2005-RBxz-36B: Video Service Competition Act

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	May 2, 2006
Introduced by:		**Summary by:**	Cindy Avrette
Version:	Draft		Committee Counsel

SUMMARY: This bill would provide equal taxation of video programming services regardless of how the service is delivered and it would replace locally negotiated franchises of cable service provided over a cable system with a State-issued franchise. The bill would become effective January 1, 2007.

CURRENT LAW: North Carolina began taxing communication services when the technologies enabling the services were separate and distinct technologies and the providers of the services were separate and distinct taxpayers. Over the past several years, the technology used to provide these services has converged so that the line between the services is no longer separate and distinct. The Current Operations and Capital Improvements Appropriations Act of 2005 directed the Revenue Laws Study Committee to study the equity of taxation of providers of cable service, direct-to-home satellite service, satellite digital audio radio service, video programming service, and data service.

The Revenue Laws Study Committee spent a considerable amount of time on this issue.[1] The Committee found that the State taxes these services based upon who provides the service rather than the service itself. Despite the General Assembly's repeated attempts to provide tax equity among these providers, it is debatable whether that has been accomplished:

- The State imposes a 7% State sales tax on telecommunication services and it earmark a percentage of the revenues to cities. The amount each city receives is based upon a per capita statutory formula. State law prohibits counties and cities from imposing local taxes on this service.
- The State imposes a 7% State sales tax on direct-to-home satellite service. Federal law prohibits a local tax on this service and it prohibits local regulation of this service. The tax revenue is not shared with local governments.
- The State imposes a 4.5% State sales tax and a 2.5% local sales tax on digital audio radio service.
- The State imposes a 7% State sales tax on cable services, with a credit equal to the amount of local franchise tax paid on the service. Counties and cities may impose a local franchise tax on this service; the tax may not exceed 5% of gross receipts. Cable service has been subject to local regulation since 1973. The local regulation of cable services varies from county to county and from city to city, depending on the terms of the locally negotiated agreements. The definition of 'gross receipts' may also vary from agreement to agreement. The cable boxes rented to customers is subject to the State and local sales tax. The gross receipts from the rental of these

[1] The Revenue Laws Study Committee staff met separately with representatives of the cable industry, the telephone industry, the cable administrators, and the counties and cities. It also held a series of four meetings with the all the affected parties and solicited comments from the parties on numerous occasions. The staff prepared a survey given to all the local governments in the State to determine their franchise fee collections and other nonmonetary contributions received in accordance with their cable franchise agreements.

boxes may also be included in the company's gross receipts for local franchise tax purposes, depending upon how the term is defined in the local agreement.

The Revenue Laws Study Committee acknowledged that the method of taxation should not provide one provider of a service with a competitive advantage over another. The Committee expressed a goal to establish a method of taxation that applies equally to the same service, regardless of who provides it. The Committee established the following principles:

- Equal taxation of the same service.
- A tax system that is easy to administer.
- A tax and regulatory system that do not impede competition.
- Equal compensation to cities for the use of their public rights-of-way.
- PEG channels service a public purpose and should be supported.

Based upon those principles, it desired a proposal that met the following goals:

- Applies the principles stated above.
- Contains no tax or fee increase.
- Preserves local government revenue stream.
- Promotes competition in the marketplace.
- Promotes deployment of broadband as a basic communication tool.

North Carolina is not alone in grappling with the issue of how to tax and regulate telecommunications and video programming services. Congress as well as other states is considering legislation on this issue. At this time, at least three states have enacted legislation changing the regulation and taxation of telecommunications and video programming services and at least eight other states have legislation pending on the issue.

BILL ANALYSIS: Legislative Proposal #1, *Video Service Competition Act,* establishes uniform taxes for video programming services and seeks to promote consumer choice. It establishes equal taxation of the same service by applying the State 7% sales tax to all video programming services, repealing the local authority to impose a local franchise tax, and repealing the sales tax credit allowed to cable companies for local franchise tax paid. It preserves the local government revenue stream by distributing part of the sales tax revenues from telecommunications and video programming services to the counties and cities. The distribution formula is based upon the amount of cable franchise tax revenue received in fiscal year 2005-2006 plus any subscriber fees received that year.

The proposal promotes competition by providing a State franchise process, in lieu of the current locally negotiated franchise agreements. It seeks to ensure competitive neutrality by allowing cable providers to opt-out of existing local agreements when one or more households in the franchise area may be served by both the existing provider and the holder of a State-issued franchise. The proposal specifically prohibits discrimination in the provision of video programming services and declares a violation of this law to be an unfair or deceptive trade practice. The holder of a State-issued franchise must comply with customer service and emergency alert requirements established by the Federal Communications Commission. The proposal designates the Consumer Protection Division of the Attorney General's Office as the State agency to receive customer complaints regarding video programming services.

The proposal preserves local regulation of public rights-of-way and provides for PEG channel support and growth. In addition to including the per subscriber revenues in the distribution base to local governments, the proposal provides up to $2 million for supplemental PEG support. The proposal provides that existing franchise agreements will determine the number, service tier placement, and

transmission quality required of PEG channels under a State-issued franchise. In the absence of an existing agreement, the number of PEG channels a county or city may have is determined by the area's population. A local entity may acquire additional PEG channels, with the maximum number of channels set at seven. The proposal also requires cable service providers to provide free basic service to local public buildings.

Section-by-section analysis of the proposal:

Section 1 of the proposal replaces the authorization to counties and cities to award a franchise for cable service with a State franchising authority, effective January 1, 2007. The proposal provides that a county or city may not award or renew a franchise for cable service after this date. The proposal designates the North Carolina Utilities Commission as the exclusive franchising authority in the State for cable service provided over a cable system. The terms 'cable service' and 'cable system' are defined by federal law. The proposal would require the franchising of cable service that is required to be franchised under federal law. The proposal does not expand the services that need to be franchised beyond those currently required to be franchised under federal law.

State issued franchise. The State franchise process is one of notice, not regulation. To receive a State-issued franchise, a person must file a notice of service with the Utilities Commission. A person who files a notice of service with the Commission must begin providing cable service within 120 days after the notice is filed. If service is not provided within this period, the notice of service terminates 130 days after it was filed. The notice of service must include the applicant's name and principal place of business, a description and map of the area to be served, a list of each county and city in which the described service area is located, and a schedule indicating when service is expected to be offered in part or all of the service area.

Report of initial service. Once cable service is provided, the holder of a State-issued franchise must file a report of initial service with the Commission. The report of initial service must include the effective date of the notice of service for that area, a description and map of the service area, and a statement that cable service has begun in the service area. The holder of a State-issued franchise must also file an annual service report on or before July 15 of each year. The annual service report must include all of the following: the effective date of a notice of service for that area, a description and map of the service area, the approximate number of households in the service area, a description and map of the households passed in the service area as of July 1, the percentage of households passed in the service area as of July 1, the percentage of households passed in the service area as of July 1 of any preceding year for which a report was required, and a schedule indicating when service is expected to be offered in part or all of the service area, to the extent the schedule differs from one included in the notice of service or in a report previously submitted, and an explanation of the reason for the new schedule.

Existing agreements. The State franchising authority does not affect a local franchise agreement that was awarded by a county or city and is in effect on January 1, 2007, except as follows:

- Effective January 1, 2007, gross revenue used to calculate the payment of a local franchise tax does not include gross receipts from cable service subject to the State sales tax.
- A local franchise agreement may be terminated when a report of initial service indicates that one or more households in the franchise area of the existing agreement are passed by both the cable provider under the existing agreement and the holder of a State-issued franchise.

Termination of existing agreements. To terminate an existing agreement, a cable service provider must file a notice of termination with the affected county or city and file a notice of service with the Utilities Commission. A notice of termination becomes effective at the end of a calendar quarter that is at least 30 days after the notice of termination is filed with the affected county or city. A termination of an existing agreement ends the obligations under the agreement as of the effective date of the termination.

Service standards and requirements. The proposal specifically prohibits discrimination in the provision of the cable service. A violation of the law is considered an unfair and deceptive trade practice. In determining whether a cable service provider has violated the law, the following factors may be considered: the length of time since the provider filed the notice of service for the area, the cost of providing service to an area, technological impediments to providing service to an area, and the inability to obtain access to property required to provide service to an area.

A cable service provider must comply with the customer service requirements and emergency alert requirements established by the Federal Communications Commission. The Consumer Protection Agency of the Attorney General's Office is designated as the State agency to receive and respond to consumer complaints.

PEG channels. The proposal requires a cable service provider operating under a State-issued franchise to include the transmission of PEG channels. A county or city may make a written request for PEG channel capacity and the cable service provider must provide the requested capacity within 120 days after it receives the request. If the area is included in both the franchise area of an existing agreement and the service area of a State-issued franchise, then the terms of the existing agreement as of the filing date of the notice of service determine the number, service tier placement, and transmission quality of the initial PEG channels required under the State-issued franchise. If no existing agreement includes any part of the service area of a State-issued franchise, then the number of PEG channels required under the State-issued franchise depends upon the population of the city in which part or all of the service area is located. If the city's population is at least 50,000, the provider must provide up to three PEG channels. If the city's population is less than 50,000, the provider must provide up to two PEG channels. The PEG channels must be placed on a basic service tier and the transmission quality must be equivalent to those of the closest city covered by an existing agreement.

The maximum number of PEG channels a cable service provider must provide to a county or city is seven. If a county or city does not have seven PEG channels, including the initial PEG channels, it may request additional channels. The additional channels may be provided on any service tier and the transmission quality of the additional channels must be at least equivalent to the transmission quality of the other channels provided. The PEG channels operated by a county or city must meet the following programming requirements in order for the county or city to obtain additional channels:

- All of the PEG channels must have scheduled programming for at least 80% of the time for at least 8 hours a day.
- The programming content of each PEG channel must not repeat more than 15% of the programming content on any of the other PEG channels.
- No more than 15% of the programming content on any PEG channel may be character-generated programming.

A cable service provider is responsible only for the transmission of a PEG channel. A county or city to which the PEG channel is provided is responsible for the operation and content of the channel.

Service to public buildings. At the written request of a county or city, a cable service provider operating under a State-issued franchise must provide cable service without charge to a public building located within 125 feet of the provider's cable system. The required service is the basic, or lowest-priced, service the provider offers to customers. Only one service outlet is required for a building. A public building is a building used as a public school, a charter school, a library, or a function of the county or city.

Sections 2 and 3 of the proposal would apply the State sales tax equally to all video programming services, regardless of who provides the service. Section 2 defines the term 'video programming' to be programming provided by, or generally considered comparable to programming provided by, a television broadcast station, regardless of the method of delivery. The term is broader than 'cable

service provided over a cable system'. It would include cable services offered over private rights-of-way as well as those offered over public rights-of-way. Section 3 imposes the State's 7% sales tax on the gross receipts derived from providing video programming to a subscriber in this State.[2]

Sections 4 through 6 of the proposal would make technical and conforming changes to the provisions governing bundled transactions.

Sections 7 and 8 of the proposal would distribute a share of the sales tax revenues imposed on video programming to counties and cities. The revenue distributed is local revenue, not a State expenditure. Therefore, the Governor may not reduce or withhold the distribution.

Section 7 would increase the amount of the sales tax revenue derived from telecommunication services distributed to cities and counties. Section 8 would distribute the following portion of the gross receipts derived from video programming to counties and cities: 22.61% of the net proceeds collected on video programming, other than on direct-to-home services and 37% of the net proceeds collected on direct-to-home satellite service.[3] The distributions would be made quarterly.

The amount distributed would be allocated as follows:

- An amount, not to exceed $2,000,000 a year, would be distributed as supplement PEG channel support to counties and cities with qualifying PEG channels. The amount per qualifying PEG channel would be $16,000. A county or city could not receive supplemental PEG channel support for more than three PEG channels. The amount distributed to a county or city as supplemental PEG channel support must be used by it for the operation and support of PEG channels.
- The remainder of the revenues to be distributed would be allocated between the counties and cities as follows:
    - The share of a county that did not impose a cable franchise tax before January 1, 2007, would be $1 times the most recent annual population estimate for that county. The population of the county would be the population of its unincorporated areas plus the population of an ineligible city in the county.
    - The share of a city that did not impose a cable franchise tax before January 1, 2007, would be $2 times the most recent annual population estimate for that city.
    - The share of a county or city that did impose a cable franchise tax before January 1, 2007, would be its proportionate share of the remaining amount to be distributed to all counties and cities that imposed a cable franchise tax before January 1, 2007. A county's or city's proportionate share would be the amount of cable franchise tax revenue it received in fiscal year 05-06 plus the amount of a subscriber fee imposed in fiscal year 05-06 compared to the amount of cable franchise tax revenue and subscriber fee revenue all counties and cities received in that fiscal year. For subsequent fiscal years, the amount each county or city receives would be adjusted based upon its percentage change in population.

Section 9 would repeal the credit against the State sales tax on cable services for local franchise tax paid since the local franchise tax is repealed in Section 13.

Section 10 would repeal the county's authority to franchise cable television services.

Section 11 would repeal the county's authority to impose a franchise tax on cable services.

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[2] Although the term video programming includes broadcast services, the provision of these services would not be taxed unless the provider sells the service to subscribers and thus realizes gross receipts from the provision of the services.

[3] This percentage distribution from satellite TV services mirrors the 2.5% local sales tax on satellite radio services.

Section 12 would prohibit a city from imposing a tax on video programming services.

Section 13 would repeal the city's authority to impose a franchise tax on cable services.

Section 14 would repeal the city's authority to franchise cable television services.

Section 15 would provide that an award of a State-issued franchise does not affect a determination of whether video programming provided by the holder of the franchise is considered cable service provided over a cable system under federal law.

Section 16 would provide that the provisions of this act are severable.

Section 17 would direct the Revenue Laws Study Committee to review the effects of this act on competition in video programming services, the number of cable service subscribers, the price of cable service by service tier, the technology used to deliver the service, and the deployment of broadband in the State. The Committee would see if any changes to the law are necessary and would report its findings and recommendations to the 2009 General Assembly.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 19, 2006

TO: Revenue Laws Study Committee

FROM: Brenna Erford
Fiscal Research Division

RE: Consumer Choice in Cable and Uniform Taxation of Video Programming Services

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11
REVENUES:					
General Fund	**No Impact to General Fund**				
Local governments	**Possible net gain up to $3.3 million; see Assumptions & Methodology**				
EXPENDITURES:	**See Assumptions & Methodology**				
POSITIONS (cumulative):	**See Assumptions & Methodology**				

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: NC Department of Revenue, NC Utilities Commission, local governments

EFFECTIVE DATE: January 1, 2007

BILL SUMMARY: The Consumer Choice in Cable and Uniform Taxation of Video Programming Services Act:

- Establishes a statewide video service franchising process;
- Makes changes to the regulatory treatment of existing local cable franchises;
- Eliminates local governments' authority to assess and collect cable franchise fees;

- Replaces local revenues from franchise fees with a new distribution of shared sales tax collections from telecommunications, cable service, and satellite television service;
- Removes the state tax credit for franchise fees paid to local governments;
- Provides for a proportional tax distribution to local governments based on previous revenues from cable, including franchise fees and per subscriber charges;
- Provides for public, educational, and governmental (PEG) channel funding;
- Designates the North Carolina Utilities Commission as the agency responsible for administering statewide video service franchises and consumer complaints.

This bill does not raise taxes on cable service, telecommunications, or home satellite television services. All these services remain subject to the general shared sales tax rate of 7%. However, this bill significantly alters the calculation of the local share of shared sales tax and creates an entirely new distribution method for the local share of shared sales tax collections. The bill does three things that significantly alter the composition of the local share:

- Local governments will no longer be able to assess and collect cable franchise fees. This revenue will be replaced by the local distribution scheme set forth in the bill. Under this proposal, local governments will receive a portion of sales tax collections from cable service equal to 22.61%, an increased portion of the existing telecommunications sales tax, and a share of sales tax collections on satellite television service.
- The tax credit equal to the amount of franchise fees paid to local governments created in 2005 is eliminated.
- Local governments will effectively receive a larger portion of state sales tax collections on telecommunications. This new portion will be equal to 7.23% of total telecommunications sales tax collections, which is equivalent to 22.61% of total sales tax collections for telecommunications less the local share already received pursuant to G.S. 105-164.44F according to Fiscal Research estimates.
- Local governments will be granted a share of sales tax collections from home satellite television service equal to 2.5% of the 7% general sales tax, or approximately 37% of sales tax collections.

ASSUMPTIONS AND METHODOLOGY: Fiscal Research estimates that all North Carolina local governments will be effectively be held harmless by this change, and that some local governments may even see slightly higher revenues. The sum of the local shares of these three industries (approximately $65.3 million) is estimated to slightly exceed actual aggregate local collections of cable franchise fees.

During the 2005 session, cable service, telecommunications, and home satellite television service were brought under the general state sales tax rate of 7%.

Current Law and Estimated Tax Collections by Industry

The chart below shows estimated total sales tax collections for cable service, telecommunications, and home satellite television service for FY 2005-06. These amounts have been adjusted to reflect the 2005 rate changes. The municipal share amount shows the amount received or collected by local governments under current law.

Estimated Sales Tax Collections by Industry and State/Local Share under Current Law			
	2005-06 Adjusted		
	Net collections	State share	Local share*
Telecommunications sales tax	395,714,195	334,850,718	60,863,477
Cable service**	91,350,000	26,100,000	65,250,000
Satellite	43,220,000	43,220,000	N/A
Total, all industries	530,284,195	404,170,718	126,113,477

*Local share reflects 18.03% of total telecommunications sales tax less the "freeze deduction" as required in G.S. 105-164.44F

**Net collections for cable have been estimated from municipal share. The local share ($65.3 million) reflects estimated total cable revenues collected directly by local governments, not by the state.

- For telecommunications, the $60.9 million local share is the 18.03% of telecommunications sales tax less a "freeze distribution" created under G.S. 105-164.44F. This portion of local share is not altered by this legislation.
- For cable service, the local share shown ($65.3 million) is the estimated amount of cable revenues assessed and collected by local governments in 2005. Currently this money is collected directly by local governments, primarily in the form of cable franchise fees. Under federal law, local government units can assess a franchise fee of up to 5% on a locally negotiated definition of gross revenues. This is also the estimated amount of the cable tax credit.
- Sales tax collections from home satellite television service are not currently shared with local governments.

The following sections outline the change in calculation of the local share of cable, telecommunications, and satellite sales tax collections as well as the change in distribution to local governments as it pertains to each industry.

Telecommunications

In 2005, the tax on telecommunications was increased from 6.0% to the general sales tax rate of 7.0%. The change was effective Oct. 1, 2005. Under G.S. 105-164.44F local governments receive a per capita distribution of 18.03% of sales tax collections on telecommunications service less a "freeze deduction" of $2,620,948 on a quarterly basis. This legislation does not alter this portion of the local government share of sales tax on telecommunications. Under this bill, local governments will continue to receive a distribution of total sales tax collections on telecommunications pursuant to G.S. 105-164.44F, plus an additional share of collections equal to 7.23% of gross sales tax collections on telecommunications. This additional share of collections is estimated at $28.6 million based on 2005-06 estimated collections.

Cable Service

Effective January 1, 2006, the general sales tax rate of 7% was applied to cable service, which had previously only been taxed at the local level. Taxpayers also receive an approximate 5% credit against this tax for local cable franchise taxes paid,[1] which is removed by the bill.

At this time, the two months of collections data available for this tax expenditure are not sufficient to estimate the credit's actual cost, so this memo assumes an estimated $65 million for the cost of the cable tax credit.[2] However, survey research conducted by the Fiscal Research Division suggests that the actual amount of cable franchise fees and per subscriber charges collected by North Carolina local governments is approximately $62 million, which suggests that local governments may gain up to $3.3 million in new money from this legislation.

The local share of cable sales tax collections under the distribution established by this bill is estimated at $20.7 million based on 2005-06 estimated collections.

Satellite

The tax on home satellite television service was increased from 5.0% to 7.0% effective Oct. 1, 2005. Currently, all collections of this tax go to the General Fund. Under this legislation, 37% (or 2.5% of the 7.0% general sales tax rate) of satellite tax collections would be shared with local governments.

Based on early Department of Revenue data, satellite tax collections are exhibiting a rapid rate of growth, especially in relation to collections from cable service. This estimate for satellite uses a conservative annual growth rate of 8%.

Fiscal Research estimates that sales tax collections for satellite will be approximately $43.2 million for FY 2005-06. The 37% local share would be $16.0 million based on 2005-06 estimated collections.

Proposed Local Share of Sales Tax Collections by Industry

The chart below illustrates the local share of sales tax collections by industry. **This local share calculation is intended to hold local governments whole with the elimination of local franchise fees and to supply local governments with funds for PEG channel support.** The $65.3 million local share calculated through this distribution equals the estimated 2005 cable franchise fee revenues that would be foregone under this legislation.

[1] Federal law caps local franchise taxes at 5% of gross revenues, suggesting 2% of the 7% state sales tax goes to the state. Fiscal Research Division survey research suggests that not all North Carolina local governments with cable franchises assess franchise fees at the maximum 5% rate, and that the actual value of the tax credit may be somewhat less than 5% of cable's total sales tax liability.

[2] The cost of the cable tax credit was estimated at $65 million in the 2005 Tax Expenditure Report published by the North Carolina Department of Revenue

Proposed Local Share of Sales Tax Collections by Industry	
2005-06 Adjusted	
Industry	Local share
Telecommunications***	28,607,502
Cable	20,654,235
Subtotal	*49,261,737*
Satellite	15,991,400
Total	**65,253,137**

Distribution of Sales Tax to Local Governments

Under this bill, the combined 7.23% of sales tax collections on telecommunications, 22.61% of state sales tax collections on cable service and 37% of sales tax collections on home satellite television service would be distributed to North Carolina local governments on a proportional basis. The proportionate share for each local government is calculated by dividing its actual 2005 revenues from cable services, including actual franchise fee collections and any per subscriber charges for PEG support, by the total of all 2005 local government cable revenues. In subsequent years, the proportionate share for each municipality will be recalculated to reflect per capita growth. The distribution would be effective January 1, 2006.

Based on available data, Fiscal Research believes that under this distribution scheme no municipality will receive less revenue than they would without this legislation, and some may actually realize small gains.

PEG Support

The bill allows local governments that operate PEG channels providing local programming to collect $16,000 per channel, up to 3 channels, per year in the form of four quarterly installments of $4,000. **These funds are to be deducted from the total local share of sales tax collections before the local distribution formula is applied.** The bill caps the amount of annual PEG support to local governments at $2 million. Reliable data on the number of qualifying PEG channels in North Carolina is not available, but based on discussions with public programming interests, this memo assumes there are 33 PEG channels currently operating in North Carolina that would qualify for this funding. In total, the impact of this provision is estimated at $576,000 annually.

Franchise Administration and Consumer Issues

The North Carolina Utilities Commission is named as the agency responsible for administering cable franchises and addressing consumer issues. At this time, the Utilities Commission has not indicated a need for additional staff or appropriations to meet these demands.

Conclusion

The chart below contrasts current law with the proposed tax changes in this bill and illustrates how the total shared sales tax revenue to both the state and local governments is held the same.

Comparison of State and Local Share under Current and Proposed Law						
	(in millions)					
	Current law		**Proposed**		**Change**	
	State	Local	State	Local	State	Local
Telecommunications	334.8	60.9	306.2	89.5	(28.6)	28.6
Cable service	26.1	65.3	70.7	20.7	44.6	(44.6)
Satellite	43.2	-	27.2	16.0	(16.0)	16.0
Total	**404.1**	**126.2**	**404.1**	**126.2**	-	-

SOURCES OF DATA: North Carolina Department of Revenue, North Carolina Fiscal Research Division, North Carolina State Data Center, Federal Communications Commission, U.S. Census Bureau, North Carolina Utilities Commission

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #2

AMEND TAXATION OF LOGGING MACHINERY

LEGISLATIVE PROPOSAL #2

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO TREAT COMMERCIAL LOGGING MACHINERY THE SAME AS FARM MACHINERY UNDER THE SALES TAX.

SHORT TITLE: Amend Taxation of Logging Machinery

SPONSORS:

BRIEF OVERVIEW: This bill would exempt from the 1% privilege tax, with an $80 maximum tax per article, commercial logging machinery, attachments, repair parts for commercial logging machinery, lubricants applied to commercial logging machinery, and fuel to operate commercial logging machinery for use in commercial logging operations.

FISCAL IMPACT: This bill would result in an annual loss to the General Fund of approximately $2.19 million.

EFFECTIVE DATE: This act would become effective July 1, 2006 and applies to items purchased on or after that date.

A copy of the proposed legislation, bill analysis, and fiscal analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-SVz-16A [v.5] (03/01)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/18/2006 3:51:59 PM

Short Title: Amend Taxation of Logging Machinery. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO TREAT COMMERCIAL LOGGING MACHINERY THE SAME AS FARM MACHINERY UNDER THE SALES TAX.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-164.13 is amended by adding a new subdivision to read:

"..

(4f) Sales of the following to a person who is engaged in the commercial logging business:

a. Logging machinery. Logging machinery is machinery used to harvest raw forest products for transport to first market.

b. Attachments and repair parts for logging machinery.

c. Lubricants applied to logging machinery.

d. Fuel used to operate logging machinery.

..."

SECTION 2. Article 5F of Chapter 105 of the General Statutes is amended by adding a new section to read:

"**§ 105-187.53. Commercial logging items.**

This Article does not apply to an item that is exempt from sales and use tax under G.S. 105-164.13(4f)."

SECTION 3. This act does not affect the rights or liabilities of the State, a taxpayer, or another person arising under a statute amended by this act before the effective date of this act, nor does it affect the right to any refund of a tax that accrued under the amended statute before the effective date of its amendment.

SECTION 4. This act becomes effective July 1, 2006 and applies to items purchased on or after that date.

LEGISLATIVE PROPOSAL 2005-SVz-16A: Amend Taxation of Logging Machinery

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	April 19, 2006
Introduced by:		**Summary by:**	Trina Griffin
Version:	Draft 2005-SVz-16A		Committee Counsel

SUMMARY: This legislative proposal would exempt from the 1% privilege tax, with an $80 maximum tax per article, commercial logging machinery, attachments, repair parts for commercial logging machinery, lubricants applied to commercial logging machinery, and fuel to operate commercial logging machinery for use in commercial logging operations, effective for purchases made on or after July 1, 2006.

BACKGROUND & CURRENT LAW: For years, State tax law has provided that the sales and use tax rate on mill machinery is 1%, with an $80 maximum tax per article. There has never been a specific reference in the sales tax statutes to machinery used in the forestry and logging business. However, based on a long-standing interpretation by the Department of Revenue, logging firms that had contracts with wood product manufacturers to cut timber were deemed to be entitled to the 1% rate, $80 cap based on the preferential rate afforded to manufacturing industries and plants.

For several years, North Carolina has worked toward simplifying its sales and use tax statutes in an effort to conform to the Streamlined Sales and Use Tax Agreement. One of the conforming changes the State had to make was to simplify its sales tax rates. Under the Streamlined Sales and Use Tax Agreement, a state must have one rate, with no caps or thresholds, by January 2006. North Carolina had several different rates, including this 1% rate with an $80 cap. In 2001, at the request of North Carolina Citizens for Business and Industry, the General Assembly maintained the preferential tax rate on mill machinery by removing it from the sales tax statutes. By changing the nature of the tax from a sales tax to a privilege tax, the industry kept its preferential rate and the State conformed to the Streamlined Sales and Use Tax Agreement. The change in the law, made in 2001, became effective January 1, 2006.

Thus, as of January 1, 2006, purchases of mill machinery, which includes commercial logging equipment, and mill machinery parts or accessories and manufacturing fuel, are exempt from sales and use tax, but are subject to the new privilege tax. The privilege tax is imposed on the purchaser of qualifying property, and the purchaser is liable for accruing and remitting the tax to the Department of Revenue. Examples of qualifying commercial logging equipment include log skidders, log carts, tree shears, feller bunchers, winches, chain saws, tractors, axes, and mallets when the items are used to cut and transport timber to a wood products manufacturer.

BILL ANALYSIS: This legislative proposal would treat commercial logging machinery and related items the same as farm machinery under the current sales tax laws. First, the bill exempts commercial logging items from the 1%/$80 maximum privilege tax, to which they are currently subject. The bill also creates a new exemption in the sales and use tax statutes for commercial logging machinery, attachments and repair parts, lubricants, and fuel used to operate commercial logging machinery. The language of the exemption tracks the current exemption for farm machinery.

EFFECTIVE DATE: The exemption would become effective for qualifying purchases made on or after July 1, 2006.

2005-SVz-16A-SMSV

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 19, 2006

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: 2005-SVz-16 v.3 - Exempt Forestry Mill Machinery from Priv. Tax

FISCAL IMPACT

	Yes (x)	No ( )	No Estimate Available ( )		
	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11
REVENUES:	(2.19)	(2.19)	(2.19)	(2.19)	(2.19)
EXPENDITURES:					
POSITIONS (cumulative):					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: July 1, 2006

BILL SUMMARY: Historically mill machinery, including commercial logging equipment, has been subject to state sales tax at the rate of 1.0%, with an $80 cap per item. Because such special sales tax rates do not conform to the Streamlined Sales Tax Agreement, to which North Carolina is a party, in 2001 the General Assembly chose to move this remove this special treatment from the sales tax statutes, and instead created a special privilege tax of the same amount. This change effectively exempted these purchases of mill machinery from sales tax, but made the purchaser liable for remitting a similar amount of tax under the privilege tax statutes, directly to the Department of Revenue. This change became

effective January 1, 2006. The legislation exempts commercial logging equipment from this new privilege tax, treating it the same as agricultural equipment.

ASSUMPTIONS AND METHODOLOGY: No data specific to loggers or logging operations is available from the North Carolina Department of Revenue. Thus an alternative means of estimating is required.

The North Carolina Forestry Association provides specialized continuing education for logging professionals entitled Pro-Logger. To be a Pro-Logger an individual must participate in 24 hours of baseline training, and attend an additional two classes a year to maintain certification. Such certification is often required to deliver wood to certain wood processing facilities. The Forestry Association reports that approximately 1,600 individuals are currently qualified as North Carolina Pro-Loggers. The Association estimates that one-half of those individuals, or 800 individuals, actually representing logging operations. Using this number as a proxy suggests that there are approximately 800 logging operations in North Carolina.

A February 2006 issue of Texas Logger magazine suggests the following taxable operating costs for a biomass logging facility:

Operating Costs:	
Repair/Maintenance (100% of depreciation):	113, 250
Diesel Fuel (Off highway)	141,039
Large Parts (Tires, etc.)	16,200
Total	270,489

Using this number as a proxy for the operating costs associated with a North Carolina logging facility suggests that exempting these purchases from tax would result in a revenue loss of approximately $2.16 million annually ($270,489 x 800 loggers x 1.0% tax).

The same Texas Logger magazine article suggests that a logging operation requires approximately $755,000 in capital investment. This amount represents purchase of six (6) items: a feller buncher, grapple skidder, whole tree chipper, bulldozer and two service trucks. According to "The Used Connection" web site, the used prices for all these items exceed $8,000. As such, all six items would be taxed at the maximum amount of $80.00 per item, for a total tax on equipment of $480.00. Assuming this equipment is replaced every 15 years suggests that 53 loggers will replace their equipment each year. Thus the annual revenue loss associated with these purchases is $25,440 ($480 x 53 loggers).

The total annual loss associated with this legislation is reflected in the fiscal impact box.

SOURCES OF DATA: North Carolina Forestry Association, Texas Logger magazine.

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #3

SSTA SALES TAX DEFN/SALES TAX PAYMENTS

LEGISLATIVE PROPOSAL #3

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO INCORPORATE THE STREAMLINED SALES TAX DEFINITIONS CONCERNING TELECOMMUNICATIONS AND TO SIMPLIFY THE TAX PAYMENT REQUIREMENTS FOR SEMIMONTHLY TAXPAYERS.

SHORT TITLE: SSTA Sales Tax Defn/Sales Tax Payments

SPONSORS:

BRIEF OVERVIEW: The bill modifies the definitions used in the sales and use tax law that apply to telecommunications to conform to the definitions adopted in the Streamlined Sales Tax Agreement. It also replaces the semimonthly payment sales tax schedule with a single monthly payment and a prepayment of the next month's liability due on the same day as the monthly payment.

FISCAL IMPACT:

EFFECTIVE DATE: The definitional changes become effective January 1, 2007. The sales tax payment changes become effective October 1, 2007.

A copy of the proposed legislation, bill analysis, and fiscal analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-RBxz-33 [v.7] (02/27)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/19/2006 9:36:11 AM

Short Title: SSTA Sales Tax Defn/Sales Tax Payments. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO INCORPORATE THE STREAMLINED SALES TAX DEFINITIONS CONCERNING TELECOMMUNICATIONS AND TO SIMPLIFY THE TAX PAYMENT REQUIREMENTS FOR SEMIMONTHLY TAXPAYERS.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-164.3 is amended by amending or adding the following definitions to read:

"**§ 105-164.3. Definitions.**

The following definitions apply in this Article:

(01) Ancillary service. – A service associated with or incidental to the provision of a telecommunications service. The term includes detailed communications billing, directory assistance, vertical service, and voice mail service. A vertical service is a service, such as call forwarding, caller ID, three-way calling, and conference bridging, that allows a customer to identify a caller or manage multiple calls and call connections.

...

(27) Prepaid telephone calling service. – Prepaid wireline calling service or prepaid wireless calling service.

(27a) Prepaid Wireline Calling Service. – A right that meets all of the following requirements:

a. Authorizes the exclusive purchase of wireline telecommunications service.

b. Must be paid for in advance.

c. Enables the origination of calls by means of an access number, authorization code, or another similar means, regardless of

whether the access number or authorization code is manually or electronically dialed.

d. Is sold in units or dollars whose number or dollar value declines with use and is known on a continuous basis.

(27b) Prepaid Wireless Calling Service. – A right that meets all of the following requirements:

a. Authorizes the purchase of mobile telecommunications service, either exclusively or in conjunction with other services.

b. Must be paid for in advance.

c. Is sold in units or dollars whose number or dollar value declines with use and is known on a continuous basis.

...

(45a) Streamlined Agreement. – The Streamlined Sales and Use Tax Agreement ~~adopted November 12, 2002,~~ as amended on ~~November 19, 2003, November 16, 2004, and April 16, 2005.~~November, 2005.

...

(48) Telecommunications service. – The electronic transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a point, or between or among ~~points, by or through any electronic, radio, satellite, optical, microwave, or other medium, regardless of the protocol used for the transmission, conveyance, or routing. The term includes mobile telecommunications service and vertical services. Vertical services are switch-based services offered in connection with a telecommunications service, such as call forwarding services, caller ID services, and three-way calling services.~~ points. The term includes any transmission, conveyance, or routing in which a computer processing application is used to act on the form, code, or protocol of the content for purposes of the transmission, conveyance, or routing, regardless of whether it is referred to as voice over Internet protocol or the Federal Communications Commission classifies it as enhanced or valued added. The term does not include the following:

a. Data processing and information services that allow data to be generated, acquired, stored, processed, or retrieved and delivered by an electronic transmission to a customer whose primary purpose for using the service is to obtain the processed data or information.

b. The sale, installation, maintenance, or repair of tangible personal property.

c. Directory advertising and other advertising.

d. Billing and collection services provided to a third party.

e. Internet access service.

f. Radio and television audio and video programming service, regardless of the medium of delivery, and the transmission, conveyance, or routing of the service by the programming service

provider. The term includes cable service and audio and video programming service provided by a mobile telecommunications service provider.

g. Ancillary service.

h. A digital product delivered electronically, including software, music, a ring tone, video, and reading material."

SECTION 2. G.S. 105-164.4(a)(4c) and (4d) read as rewritten:

"**§ 105-164.4. Tax imposed on retailers.**

(a) **(Effective for sales made before July 1, 2007)** A privilege tax is imposed on a retailer at the following percentage rates of the retailer's net taxable sales or gross receipts, as appropriate. The general rate of tax is four and one-half percent (4 1/2%).

(4c) The combined general rate applies to the gross receipts derived from providing telecommunications service and ancillary service. A person who provides telecommunications service or ancillary service is considered a retailer under this Article. ~~Telecommunications service is~~ These services are taxed in accordance with G.S. 105-164.4C.

(4d) The sale or recharge of prepaid telephone calling service is taxable at the general rate of tax. The tax applies regardless of whether tangible personal property, such as a card or a telephone, is transferred. The tax applies to a service that is sold in conjunction with prepaid wireless calling service. Prepaid telephone calling service is taxable at the point of sale instead of at the point of use and is sourced in accordance with G.S. 105-164.4B. Prepaid telephone calling service taxed under this subdivision is not subject to tax as a telecommunications service."

SECTION 3. G.S. 105-164.4B(a)(3) reads as rewritten:

"**§ 105-164.4B. Sourcing principles.**

(a) General Principles. – The following principles apply in determining where to source the sale of a product. These principles apply regardless of the nature of the product.

(1) Over-the-counter. – When a purchaser receives a product at a business location of the seller, the sale is sourced to that business location.

(2) Delivery to specified address. – When a purchaser receives a product at a location specified by the purchaser and the location is not a business location of the seller, the sale is sourced to the location where the purchaser receives the product.

(3) Delivery address unknown. – When a seller of a product does not know the address where a product is received, the sale is sourced to the first address or location listed in this subdivision that is known to the seller:

a. The business or home address of the purchaser.

b. The billing address of the purchaser or, if the product is ~~a~~ prepaid ~~telephone~~ wireless calling ~~service that authorizes the purchase of mobile telecommunications~~ service, the location associated with the mobile telephone number.

c. The address from which tangible personal property was shipped or from which a service was provided."

SECTION 4. G.S. 105-164.4C reads as rewritten:

"**§ 105-164.4C. ~~Tax on telecommunications.~~Telecommunications service and ancillary service.**

(a) General. – The gross receipts derived from providing telecommunications service or ancillary service in this State are taxed at the rate set in G.S. 105-164.4(a)(4c). Telecommunications service is provided in this State if the service is sourced to this State under the sourcing principles set out in subsections (a1) and (a2) of this section. Ancillary service is provided in this State if the telecommunications service to which it is ancillary is provided in this State. The definitions and provisions of the federal Mobile Telecommunications Sourcing Act apply to the sourcing and taxation of mobile telecommunications services.

(a1) General Sourcing Principles. – The following general sourcing principles apply to telecommunications services. If a service falls within one of the exceptions set out in subsection (a2) of this section, the service is sourced in accordance with the exception instead of the general principle.

(1) Flat rate. – A telecommunications service that is not sold on a call-by-call basis is sourced to this State if the place of primary use is in this State.

(2) General call-by-call. – A telecommunications service that is sold on a call-by-call basis and is not a postpaid calling service is sourced to this State in the following circumstances:

a. The call both originates and terminates in this State.

b. The call either originates or terminates in this State and the telecommunications equipment from which the call originates or terminates and to which the call is charged is located in this State. This applies regardless of where the call is billed or paid.

(3) Postpaid. – A postpaid calling service is sourced to the origination point of the telecommunications signal as first identified by either the seller's telecommunications system or, if the system used to transport the signal is not the seller's system, by information the seller receives from its service provider.

(a2) Sourcing Exceptions. – The following telecommunications services and products are sourced in accordance with the principles set out in this subsection:

(1) Mobile. – Mobile telecommunications service is sourced to the place of primary use, unless the service is ~~authorized by a~~ prepaid ~~telephone~~ wireless calling service or is air-to-ground radiotelephone service. Air-to-ground radiotelephone service is a postpaid calling service that is offered by an aircraft common carrier to passengers on its aircraft and enables a telephone call to be made from the aircraft. The sourcing principle in this subdivision applies to a service provided as an adjunct to mobile telecommunications service if the charge for the service is

included within the term "charges for mobile telecommunications services" under the federal Mobile Telecommunications Sourcing Act.

(2) Prepaid. – Prepaid telephone calling service is sourced in accordance with G.S. 105-164.4B.

(3) Private. – Private telecommunications service is sourced in accordance with subsection (e) of this section.

~~(b) Included in Gross Receipts. – Gross receipts derived from telecommunications service include the following:~~

~~(1) Receipts from flat rate service, service provided on a call-by-call basis, mobile telecommunications service, and private telecommunications service.~~

~~(2) Charges for directory assistance, directory listing that is not yellow-page classified listing, call forwarding, call waiting, three-way calling, caller ID, voice mail, and other similar services.~~

~~(3) Customer access line charges billed to subscribers for access to the intrastate or interstate interexchange network.~~

~~(4) Charges billed to a pay telephone provider who uses the telecommunications service to provide pay telephone service.~~

~~(c) Excluded From Gross Receipts. – Gross receipts derived from telecommunications service do not include any of the following:~~

~~(1) Charges for telecommunications services that are a component part of or are integrated into a telecommunications service that is resold. Examples of services that are resold include carrier charges for access to an intrastate or interstate interexchange network, interconnection charges paid by a provider of mobile telecommunications service, and charges for the sale of unbundled network elements. An unbundled network element is a network element, as defined in 47 U.S.C. § 153(29), to which access is provided on an unbundled basis pursuant to 47 U.S.C. § 251(c)(3).~~

~~(2) Telecommunications services that are resold as part of a prepaid telephone calling service.~~

~~(3) 911 charges imposed under G.S. 62A-4 or G.S. 62A-23 and remitted to the Emergency Telephone System Fund under G.S. 62A-7 or the Wireless Fund under G.S. 62A-24.~~

~~(4) Allowable surcharges imposed to recoup assessments for the Universal Service Fund.~~

~~(5) Receipts of a pay telephone provider from the sale of pay telephone service.~~

~~(6) Charges for commercial, cable, mobile, broadcast, or satellite video or audio service unless the service provides two-way communication, other than the customer's interactive communication in connection with the customer's selection or use of the video or audio service.~~

~~(7) Paging service, unless the service provides two-way communication.~~

~~(8) Charges for telephone service made by a hotel, motel, or another entity whose gross receipts are taxable under G.S. 105-164.4(a)(3) when the charges are incidental to the occupancy of the entity's accommodations.~~

~~(9) Receipts from the sale, installation, maintenance, or repair of tangible personal property.~~

~~(10) Directory advertising and yellow page classified listings.~~

(11) Repealed by Session Laws 2005-276, s. 33.7, effective October 1, 2005.

~~(12) Information services. An information service is a service that can generate, acquire, store, transform, process, retrieve, use, or make available information through a communications service. Examples of an information service include an electronic publishing service and a web hosting service.~~

~~(13) Internet access service, electronic mail service, electronic bulletin board service, or similar on-line services.~~

~~(14) Billing and collection services.~~

~~(15) Charges for bad checks or late payments.~~

~~(16) Charges to a State agency or to a local unit of government for the North Carolina Information Highway and other data networks owned or leased by the State or unit of local government.~~

(d) Bundled Services. – When a taxable telecommunications service is bundled with a service that is not taxable, the tax applies to the gross receipts from the taxable service in the bundle as follows:

(1) If the service provider offers all the services in the bundle on an unbundled basis, tax is due on the unbundled price of the taxable service, less the discount resulting from the bundling. The discount for a service as the result of bundling is the proportionate price decrease of the service, determined on the basis of the total unbundled price of all the services in the bundle compared to the bundled price of the services.

(2) If the service provider does not offer one or more of the services in the bundle on an unbundled basis, tax is due on the taxable service based on a reasonable allocation of revenue to that service. If the service provider maintains an account for revenue from a taxable service, the service provider's allocation of revenue to that service for the purpose of determining the tax due on the service must reflect its accounting allocation of revenue to that service.

(e) Private Line. – The gross receipts derived from private telecommunications service are sourced as follows:

(1) If all the customer's channel termination points are located in this State, the service is sourced to this State.

(2) If all the customer's channel termination points are not located in this State and the service is billed on the basis of channel termination

points, the charge for each channel termination point located in this State is sourced to this State.

(3) If all the customer's channel termination points are not located in this State and the service is billed on the basis of channel mileage, the following applies:

a. A charge for a channel segment between two channel termination points located in this State is sourced to this State.

b. Fifty percent (50%) of a charge for a channel segment between a channel termination point located in this State and a channel termination point located in another state is sourced to this State.

(4) If all the customer's channel termination points are not located in this State and the service is not billed on the basis of channel termination points or channel mileage, a percentage of the charge for the service is sourced to this State. The percentage is determined by dividing the number of channel termination points in this State by the total number of channel termination points.

(f) Call Center Cap. The gross receipts tax on telecommunications service that originates outside this State, terminates in this State, and is provided to a call center that has a direct pay permit issued by the Department under G.S. 105-164.27A may not exceed fifty thousand dollars ($50,000) a calendar year. This cap applies separately to each legal entity.

(g) Credit. – A taxpayer who pays a tax legally imposed by another state on a telecommunications service taxable under this section is allowed a credit against the tax imposed in this section.

(h) Definitions. – The following definitions apply in this section:

(01) Ancillary service. – Defined in G.S. 105-164.3.

(1) Call-by-call basis. – A method of charging for a telecommunications service whereby the price of the service is measured by individual calls.

(2) Call center. – Defined in G.S. 105-164.27A.

(3) Mobile telecommunications service. – Defined in G.S. 105-164.3.

(4) Place of primary use. – Defined in G.S. 105-164.3.

(5) Postpaid calling service. – A telecommunications service that is charged on a call-by-call basis and is obtained by making payment at the time of the call either through the use of a credit or payment mechanism, such as a bank card, travel card, credit card, or debit card, or by charging the call to a telephone number that is not associated with the origination or termination of the telecommunications service. A postpaid calling service includes a service that meets all the requirements of a prepaid wireline telephone calling service, except the exclusive use requirement.

(6) Prepaid telephone calling service. – Defined in G.S. 105-164.3.

(7) Private telecommunications service. – Telecommunications service that entitles a subscriber of the service to exclusive or priority use of a communications channel or group of channels.

(8) Telecommunications service. – Defined in G.S. 105-164.3."

SECTION 5. G.S. 105-164.13 is amended by adding the following subdivision to read:

"(54) The following telecommunications services and charges:

a. Telecommunications service that is a component part of or is integrated into a telecommunications service that is resold. This exemption does not apply to service purchased by a pay telephone provider who uses the service to provide pay telephone service. Examples of services that are resold include carrier charges for access to an intrastate or interstate interexchange network, interconnection charges paid by a provider of mobile telecommunications service, and charges for the sale of unbundled network elements. An unbundled network element is a network element, as defined in 47 U.S.C. § 153(29), to which access is provided on an unbundled basis pursuant to 47 U.S.C. § 251(c)(3).

b. Pay telephone service.

c. 911 charges imposed under G.S. 62A-4 or G.S. 62A-23 and remitted to the Emergency Telephone System Fund under G.S. 62A-7 or the Wireless Fund under G.S. 62A-24.

d. Charges for telecommunications service made by a hotel, motel, or another entity whose gross receipts are taxable under G.S. 105-164.4(a)(3) when the charges are incidental to the occupancy of the entity's accommodations.

e. Telecommunications service purchased by a State agency or a unit of local government for the North Carolina Information Highway or another data network owned or leased by the State or unit of local government."

SECTION 6. G.S. 105-164.14(b) and (c) read as rewritten:

"(b) Nonprofit Entities and Hospital Drugs. – A nonprofit entity included in the following list is allowed a semiannual refund of sales and use taxes paid by it under this Article on direct purchases of tangible personal property and services, other than ~~electricity and telecommunications~~ electricity, telecommunications service, and ancillary service, for use in carrying on the work of the nonprofit entity:

(1) Hospitals not operated for profit, including hospitals and medical accommodations operated by an authority created under the Hospital Authorities Law, Article 2 of Chapter 131E of the General Statutes.

(2) Educational institutions not operated for profit.

(3) Churches, orphanages, and other charitable or religious institutions and organizations not operated for profit.

(4) Qualified retirement facilities whose property is excluded from property tax under G.S. 105-278.6A.

Sales and use tax liability indirectly incurred by a nonprofit entity on building materials, supplies, fixtures, and equipment that become a part of or annexed to any building or structure that is owned or leased by the nonprofit entity and is being erected, altered, or repaired for use by the nonprofit entity for carrying on its nonprofit activities is considered a sales or use tax liability incurred on direct purchases by the nonprofit entity.

A hospital that is not allowed a refund under this subsection of sales and use taxes paid on its direct purchases of tangible personal property is allowed a semiannual refund of sales and use taxes paid by it on medicines and drugs purchased for use in carrying out its work.

The refunds allowed under this subsection for certain nonprofit entities and for medicines and drugs purchased by hospitals do not apply to organizations, corporations, and institutions that are owned and controlled by the United States, the State, or a unit of local government, except hospital facilities created under Article 2 of Chapter 131E of the General Statutes and nonprofit hospitals owned and controlled by a unit of local government that elect to receive semiannual refunds under this subsection instead of annual refunds under subsection (c).

A request for a refund must be in writing and must include any information and documentation required by the Secretary. A request for a refund for the first six months of a calendar year is due the following October 15; a request for a refund for the second six months of a calendar year is due the following April 15.

(c) Certain Governmental Entities. – A governmental entity listed in this subsection is allowed an annual refund of sales and use taxes paid by it under this Article on direct purchases of tangible personal property and services, other than ~~electricity and telecommunications~~ electricity, telecommunications service, and ancillary service. Sales and use tax liability indirectly incurred by a governmental entity on building materials, supplies, fixtures, and equipment that become a part of or annexed to any building or structure that is owned or leased by the governmental entity and is being erected, altered, or repaired for use by the governmental entity is considered a sales or use tax liability incurred on direct purchases by the governmental entity for the purpose of this subsection. A request for a refund must be in writing and must include any information and documentation required by the Secretary. A request for a refund is due within six months after the end of the governmental entity's fiscal year. The Secretary shall make an annual report to the Department of Public Instruction and the Fiscal Research Division of the General Assembly by March 1 of the amount of refunds, identified by taxpayer, claimed under subdivisions (2b) and (2c) of this subsection over the preceding year.

This subsection applies only to the following governmental entities:

(1) A county.

(2) A city as defined in G.S. 160A-1.

(2a) A consolidated city-county as defined in G.S. 160B-2.

(2b), (2c) Repealed by Session Laws 2005-276, s. 7.51(a), effective July 1, 2005, and applicable to sales made on or after that date.

(3) A metropolitan sewerage district or a metropolitan water district in this State.
(4) A water and sewer authority created under Chapter 162A of the General Statutes.
(5) A lake authority created by a board of county commissioners pursuant to an act of the General Assembly.
(6) A sanitary district.
(7) A regional solid waste management authority created pursuant to G.S. 153A-421.
(8) An area mental health, developmental disabilities, and substance abuse authority, other than a single-county area authority, established pursuant to Article 4 of Chapter 122C of the General Statutes.
(9) A district health department, or a public health authority created pursuant to Part 1A of Article 2 of Chapter 130A of the General Statutes.
(10) A regional council of governments created pursuant to G.S. 160A-470.
(11) A regional planning and economic development commission or a regional economic development commission created pursuant to Chapter 158 of the General Statutes.
(12) A regional planning commission created pursuant to G.S. 153A-391.
(13) A regional sports authority created pursuant to G.S. 160A-479.
(14) A public transportation authority created pursuant to Article 25 of Chapter 160A of the General Statutes.
(14a) A facility authority created pursuant to Part 4 of Article 20 of Chapter 160A of the General Statutes.
(15) A regional public transportation authority created pursuant to Article 26 of Chapter 160A of the General Statutes, or a regional transportation authority created pursuant to Article 27 of Chapter 160A of the General Statutes.
(16) A local airport authority that was created pursuant to a local act of the General Assembly.
(17) A joint agency created by interlocal agreement pursuant to G.S. 160A-462 to operate a public broadcasting television station.
(18) Repealed by Session Laws 2001-474, s. 7, effective November 29, 2001.
(19) Repealed by Session Laws 2001-474, s. 7, effective November 29, 2001.
(20) A constituent institution of The University of North Carolina, but only with respect to sales and use tax paid by it for tangible personal property or services that are eligible for refund under this subsection acquired by it through the expenditure of contract and grant funds.
(21) The University of North Carolina Health Care System.
(22) A regional natural gas district created pursuant to Article 28 of Chapter 160A of the General Statutes."

SECTION 7. G.S. 105-164.27A(b) reads as rewritten:

"(b) Telecommunications Service. – A direct pay permit for telecommunications service authorizes its holder to purchase telecommunications service and ancillary service without paying tax to the seller and authorizes the seller to not collect any tax on a sale to the permit holder. A person who purchases ~~telecommunications service~~ these services under a direct pay permit must file a return and pay the tax due monthly to the Secretary. A direct pay permit issued under this subsection does not apply to any tax other than the tax on telecommunications service and ancillary service.

A call center that purchases telecommunications service that originates outside this State and terminates in this State may apply to the Secretary for a direct pay permit for telecommunications service and ancillary service. A call center is a business that is primarily engaged in providing support services to customers by telephone to support products or services of the business. A business is primarily engaged in providing support services by telephone if at least sixty percent (60%) of its calls are incoming."

SECTION 8. G.S. 105-164.44F(a) reads as rewritten:

"(a) Amount. – The Secretary must distribute to the cities part of the taxes imposed by G.S. 105-164.4(a)(4c) on telecommunications service and ancillary service. The Secretary must make the distribution within 75 days after the end of each calendar quarter. The amount the Secretary must distribute is eighteen and three one-hundredths percent (18.03%) of the net proceeds of the taxes collected during the quarter, minus two million six hundred twenty thousand nine hundred forty-eight dollars ($2,620,948). This deduction is one-fourth of the annual amount by which the distribution to cities of the gross receipts franchise tax on telephone companies, imposed by former G.S. 105-120, was required to be reduced beginning in fiscal year 1995-96 as a result of the "freeze deduction." The Secretary must distribute the specified percentage of the proceeds, less the "freeze deduction" among the cities in accordance with this section."

SECTION 9. G.S. 105-164.16 reads as rewritten:

"**§ 105-164.16. Returns and payment of taxes.**

(a) General. – Sales and use taxes are payable ~~quarterly, monthly, or semimonthly as specified in this section.~~ when a return is due. A return is due quarterly or monthly as specified in this section. A return must be filed with the Secretary on a form prescribed by the Secretary and in the manner required by the Secretary. A return must be signed by the taxpayer or the taxpayer's agent.

A sales tax return must state the taxpayer's gross sales for the reporting period, the amount and type of sales made in the period that are exempt from tax under G.S. 105-164.13 or are elsewhere excluded from tax, the amount of tax due, and any other information required by the Secretary. A use tax return must state the purchase price of tangible personal property that was purchased or received during the reporting period and is subject to tax under G.S. 105-164.6, the amount of tax due, and any other information required by the Secretary. Returns that do not contain the required information will not be accepted. When an unacceptable return is submitted, the Secretary will require a corrected return to be filed.

(b) Quarterly. – A taxpayer who is consistently liable for less than one hundred dollars ($100.00) a month in State and local sales and use taxes must file a return and

pay the taxes due on a quarterly basis. A quarterly return covers a calendar quarter and is due by the last day of the month following the end of the quarter.

(b1) Monthly. – A taxpayer who is consistently liable for more than one hundred dollars ($100.00) ~~but less than ten thousand dollars ($10,000)~~ a month in State and local sales and use taxes must file a return and pay the taxes due on a monthly basis. A monthly return is due by the 20th day of the month following the calendar month covered by the return.

(b2) ~~Semimonthly.~~ Prepayment. — A taxpayer who is consistently liable for at least ten thousand dollars ($10,000) a month in State and local sales and use taxes must ~~pay the tax twice a month and must file a return on a monthly basis. One semimonthly payment covers the period from the first day of the month through the 15th day of the month. The other semimonthly payment covers the period from the 16th day of the month through the last day of the month. The semimonthly payment for the period that ends on the 15th day of the month is due by the 25th day of that month. The semimonthly payment for the period that ends on the last day of the month is due by the 10th day of the following month.~~

~~A return covers both semimonthly payment periods. The return is due by the 20th day of the month following the month of the payment periods covered by the return. A taxpayer is not subject to interest on or penalties for an underpayment for a semimonthly payment period if the taxpayer timely pays at least ninety five percent (95%) of the lesser of the following and includes the underpayment with the monthly return for those semimonthly payment periods:~~

~~(1) The amount due for each semimonthly payment period.~~

~~(2) The average semimonthly payment for the prior calendar year.~~

make a monthly prepayment of the next month's tax liability. The prepayment is due on the date a monthly return is due. The prepayment must equal at least sixty-five percent (65%) of any of the following:

(1) The amount of tax due for the current month.

(2) The amount of tax due for the same month in the preceding year.

(3) The average monthly amount of tax due in the preceding calendar year.

(b3) Category. – The Secretary must monitor the amount of State and local sales and use taxes paid by a taxpayer or estimate the amount of taxes to be paid by a new taxpayer and must direct each taxpayer to pay tax and file returns ~~in accordance with the appropriate schedule.~~ as required by this section. In determining the amount of taxes due from a taxpayer, the Secretary must consider the total amount due from all places of business owned or operated by the same person as the amount due from that person. A taxpayer must file a return and pay tax in accordance with the Secretary's ~~direction until notified in writing to file and pay under a different schedule.~~direction.

(c) Repealed by Session Laws 2001-427, s. 6(a), effective January 1, 2002, and applicable to taxes levied on or after that date.

(d) **(Effective for taxable years ending before January 1, 2010)** Use Tax on Out-of-State Purchases. – Use tax payable by an individual who purchases tangible personal property outside the State for a nonbusiness purpose is due on an annual basis.

For an individual who is not required to file an individual income tax return under Part 2 of Article 4 of this Chapter, the annual reporting period ends on the last day of the calendar year and a use tax return is due by the following April 15. For an individual who is required to file an individual income tax return, the annual reporting period ends on the last day of the individual's income tax year, and the use tax must be paid on the income tax return as provided in G.S. 105-269.14.

(d) **(Effective for taxable years beginning on or after January 1, 2010)** Use Tax on Out-of-State Purchases. – Notwithstanding subsection (b), an individual who purchases tangible personal property outside the State for a nonbusiness purpose shall file a use tax return on an annual basis. The annual reporting period ends on the last day of the calendar year. The return is due by the due date, including any approved extensions, for filing the individual's income tax return.

SECTION 10. G.S. 105-113(b) reads as rewritten:

(b) Report and Payment. – The tax imposed by this section is payable ~~quarterly, semimonthly,~~ quarterly or monthly as specified in this subsection. A return is due quarterly.

A water company or public sewerage company must pay tax quarterly when filing a return. An electric power company must pay tax in accordance with the schedule ~~that applies to its~~ and requirements that apply to payments of sales and use tax under G.S. 105-164.16 and must file a return quarterly. ~~An electric power company is not subject to interest on or penalties for an underpayment for a semimonthly or monthly payment period if the electric power company timely pays at least ninety-five percent (95%) of the amount due for each semimonthly or monthly payment period and includes the underpayment with the quarterly return for those semimonthly or monthly payment periods.~~

A quarterly return covers a calendar quarter and is due by the last day of the month that follows the quarter covered by the return. A taxpayer must submit a return on a form provided by the Secretary. The return must include the taxpayer's gross receipts from all property it owned or operated during the reporting period in connection with its business taxed under this section. A taxpayer must report its gross receipts on an accrual basis. A return must contain the following information:

(1) The taxpayer's gross receipts for the reporting period from business inside and outside this State, stated separately.

(2) The taxpayer's gross receipts from commodities or services described in subsection (a) that are sold to a vendee subject to the tax levied by this section or to a joint agency established under Chapter 159B of the General Statutes or a city having an ownership share in a project established under that Chapter.

(3) The amount of and price paid by the taxpayer for commodities or services described in subsection (a) that are purchased from others engaged in business in this State and the name of each vendor.

(4) For an electric power company the entity's gross receipts from the sale within each city of the commodities and services described in subsection (a).

- Conforms the definition of "telecommunications service" in (48) to the Streamlined definition and incorporates into the definition the appropriate inclusions and exclusions that are now in G.S. 105-164.4C(b) and (c). (See also the new exemptions in G.S. 105-164.13(54) in Section 5.) As changed, the definition is the same as current law with two exceptions. The first is Universal Service Fund surcharges. These surcharges are part of the sales price and will be subject to tax. The second is paging service. Universal Service Fund surcharges cannot be "carved out" and remain as is because there is no Streamlined "carve out" in sales price or telecommunications service for this. Paging service could be carved out because there is a Streamlined definition for this, but this draft does not include that carve out. The subparts of new (48) match up with current law as follows:

Subpart in (48)	Location in Current Law
a. (info service)	105-164.4C(c)(12) and (13)
b. (sale, etc. of tpp)	105-164.4C(c)(9)
c. (advertising)	105-164.4C(c)(10)
d. (billing)	105-164.4C(c)(14)
e. (Internet)	105-164.4C(c)(13)
f. (cable and radio)	105-164.4C(c)(6)
g. (ancillary)	105-164.4C(b)(2)
h. (digital)	No specific exclusion but not taxed now.

Section 2 changes the tax imposition statute to add the now-separate category of "ancillary service" and to include non-telecommunications services that are sold as part of a prepaid wireless calling service.

Section 3 makes a conforming change to the sourcing statute to apply the new definition of prepaid wireless call service.

Section 4 makes conforming changes to the separate statute on telecommunications to include ancillary service and to apply the new definition of prepaid wireless calling service. The items that were in subsections (b) and (c) are now either part of the definition of telecommunications or are exempt in Section 5.

Section 5 moves to the exemption statute the items that were formerly excluded from the definition of telecommunications and are not intended to be taxed. The items in new (54) were all in G.S. 105-164.4C(c).

Sections 6 through 8 add the now separate category of "ancillary service" in the exemption statute (G.S. 105-164.14), in the direct pay permit statute (G.S. 105-164.27A), and in the local distribution statute (G.S. 105-164.44F).

SIMPLIFY SEMI-MONTHLY SALES TAX PAYMENTS: Taxpayers that are liable for at least $10,000 a month in sales tax, electric utility tax, or piped gas excise tax must pay tax twice a month. For these taxpayers, the month is split into two periods – the first day of the month through the 15th of the month, and the 16th of the month through the end of the month. The tax payment for the 1st through 15th period is due by the 25th of the same month and the tax payment for the 16th through the end of the month is due by the 10th day of the following month. Taxpayers therefore have 10 days after the end of a semimonthly period to make a payment.

In addition to the payments, these taxpayers also file a return. The sales tax return is due monthly by the 20th and the electric utility and piped gas returns are due quarterly by the end of the month after the close of the quarter.

Several large retailers in the Streamlined Sales Tax project asked North Carolina to look at its payment schedule to determine if it could require payments to be made only once a month. North Carolina is one of only a few states that require payments twice a month.

Sections 9 through 11 of the bill replace the semimonthly payment schedule with a single monthly payment and a prepayment of the next month's liability due on the same day as the monthly payment. The result is that taxpayers would have more time to gather data before filing a return and make payments on only one day of the month. Under the bill, the State receives the payment that would otherwise be due on the 25th in the form of a prepayment made on the 20th and it also receives some of the revenue it would have received on the 10th of the following month in the form of the prepayment made on the 20th. The State will experience a slight one-time increase in revenue in the first month that the prepayment schedule takes effect.

The prepayment must equal at least 65% of one of three thresholds:

- The current month's liability.
- The liability for the same month the preceding year.
- The average monthly liability for the past calendar year.

These thresholds are easily determined and eliminate the need for the taxpayer to calculate actual liability for periods of less than a month. The 65% threshold was chosen because it was suggested by the retailers who requested North Carolina to review its law and the prepayment date is about 2/3 of the time in a month. A similar method and threshold are already in place in Florida and Arkansas. Florida sets the prepayment threshold at 60% and Arkansas sets it at 80%.

The bill eliminates the provisions concerning penalty relief for small underpayments because the relief is no longer needed. The relief is provided under current law because the law requires taxpayers to calculate liability for short periods within 10 days after the end of the period. Under the bill, sales tax taxpayers have 20 days after the end of the month to file a return and electric utility and piped gas taxpayers have a full month after the end of a quarter to file a return.

This part of the bill becomes effective October 1, 2007.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 25, 2006

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: 2005-RBxz-33A v. 1 – SSTA Sales Tax Definitions/Sales Tax Payments

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:		**See Assumptions and Methodology**			
EXPENDITURES:		**See Assumptions and Methodology**			
POSITIONS (cumulative):					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: Sections 9 through 11 (semi-monthly filers) becomes effective October 1, 2007. The remainder becomes effective January 1, 2007.

BILL SUMMARY: The legislation makes three changes related to the Streamlined Sales Tax Agreement (SSTA). First, it alters the definition of telecommunications services and adds a definition of "ancillary services" to the sales tax statutes. This change is required to comply with the Streamlined Agreement. Second, the bill changes the sales tax payment schedule for semi-monthly filers. Under existing law the state's largest taxpayers, those who regularly owe at least $10,000 a month is sales taxes, must make sales tax payments twice a month. The first payment is due the 25th of the month and reflects sales made between the 1st and 15th of that month. The second payment reflects sales made after

the 16th day of the month, and is due the 10th day of the following month. The proposal replaces the twice a month payment with a single monthly payment. The new payment, due on the 20th, should reflect sales made in the previous month along with an estimated amount for the current month. The estimated amount is to be 65% of either 1) the current month's liability, 2) the liability for the same month in the previous year, or 3) the average monthly liability for the past calendar year. The taxpayer can choose their method of calculation. Finally, the legislation eliminates statutory provisions to deal with small underpayments; as such a provision is no longer necessary with the proposed pre-payment plan. While these last two changes are related to SSTA, they are not required for compliance with the Agreement.

ASSUMPTIONS AND METHODOLOGY:
Sections 6 – 8 in total, add a new definition of ancillary services, and redefine telecommunications services. All items covered under the new definitions are currently taxed under the existing definition of telecommunications services. While the new definitions create two separate categories – ancillary services and telecommunications services – they are both subject to the general sales tax. As a result, this change is only technical and has no revenue impact.

Sections 9 – 11 alter the sales tax payment schedules for the state's largest retailers. According to the North Carolina Department of Revenue, these retailers represent approximately 68% of total sales tax collections. Because the legislation does not affect the retailer's liability there is no recurring cost or gain associated with the bill. However, the shift from semi-monthly to monthly payments does create a potential one time revenue change. By shifting the payment date for part of the liability from the 25th to the 20th, the state gains five days of interest on the float, creating a small revenue gain. However, because retailers can select which method they will use to calculate their pre-payment, there is a potential for a short term revenue loss, as the state would lose interest on the under-payment. The Department of Revenue indicates that if average pre-payments fall below 60% of actual liabilities, the state could see a small fiscal loss. Given the uncertainty surrounding retailer responses, it is not possible to estimate the potential loss or gain. However, data from the Department indicate that whatever change is seen in either direction would likely be substantially less than $1.0 million.

There may also be some computer programming costs associated with the payment schedule change. However, at this point Fiscal Research cannot determine the exact cost associated with this computer change.

SOURCES OF DATA: North Carolina Department of Revenue.

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #4

PROPERTY TAX CHANGES

LEGISLATIVE PROPOSAL #4

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO MAKE CLARIFYING CHANGES TO THE PROPERTY TAX LAWS.

SHORT TITLE: Property Tax Changes

SPONSORS:

BRIEF OVERVIEW: This bill would make clarifying changes to the property tax laws.

FISCAL IMPACT: No fiscal impact.

EFFECTIVE DATE: When it becomes law.

A copy of the proposed legislation, bill analysis, and fiscal analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-LAz-18 [v.8] (1/24)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/19/2006 11:52:11 AM

Short Title: Property Tax Changes. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO MAKE CLARIFYING CHANGES TO THE PROPERTY TAX LAWS.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-304(a1) reads as rewritten:

"(a1) Electronic Listing. – The board of county commissioners may, by resolution, provide for electronic listing of ~~business~~ personal property in accordance with procedures prescribed by the board. If the board of county commissioners allows electronic listing of ~~business~~ personal property, the assessor must publish this information, including the timetable and procedures for electronic listing, in the notice required by G.S. 105-296(c)."

SECTION 2. G.S. 105-307 reads as rewritten:

"**§ 105-307. Length of listing period; extension; preliminary work.**

(a) Listing Period. – Unless extended as provided in this section, the period during which property is to be listed for taxation each year begins on the first business day of January and ends on January 31.

(b) General Extensions. – The board of county commissioners may, by resolution, extend the time during which property is to be listed for taxation as provided in this subsection. Any action by the board of county commissioners extending the listing period must be recorded in the minutes of the board, and notice of the extensions must be published as required by G.S. 105-296(c). The entire period for listing, including any extension of time granted, is considered the regular listing period for the particular year within the meaning of this Subchapter.

(1) In nonrevaluation years, the listing period may be extended for up to 30 additional days.

(2) In years of octennial appraisal of real property, the listing period may be extended for up to 60 additional days.

(3) If the county has provided for electronic listing of ~~business~~ personal property under G.S. 105-304, the period for electronic listing of business personal property may be extended up to June 1.

(c) Individual Extensions. – The board of county commissioners shall grant individual extensions of time for the listing of real and personal property upon written request and for good cause shown. The request must be filed with the assessor no later than the ending date of the regular listing period. The board may delegate the authority to grant extensions to the assessor. Extensions granted under this subsection shall not extend beyond April 15. If the county has provided for electronic listing of ~~business~~ personal property under G.S. 105-304, the period for electronic listing of business personal property is as provided in subsection (b) of this section.

(d) Preliminary Work. – The assessor may conduct preparatory work before the listing period begins, but may not make a final appraisal of property before the day as of which the value of the property is to be determined under G.S. 105-285."

SECTION 3. G.S. 105-330.10 reads as rewritten:

"**§ 105-330.10. (Effective until July 1, 2009) Disposition of interest.**

Sixty percent (60%) of the first month's interest collected on unpaid taxes pursuant to G.S. 105-330.4 shall be transferred on a monthly basis to the Combined Motor Vehicle and Registration Account created within the Treasurer's Office. The North Carolina Association of County Commissioners shall direct the Treasurer to distribute the funds in the Account to the Division of Motor Vehicles for the purpose of developing and implementing an integrated computer system within the Division of Motor Vehicles that would allow for the combined assessment, billing, and collection of property taxes on motor vehicles and the issuance of registration plates. The Treasurer shall report to the Revenue Laws Study Committee semiannually with the first report due by April 30, 2006. The report shall contain a detailed description of the amount of moneys transferred to the Account and distributed from the Account."

SECTION 4. G.S. 105-277.4 is amended by adding a new subdivision to read:

"(a1) Late Application. – Upon a showing of good cause by the applicant for failure to make a timely application as required by subsection (a) of this section, an application may be approved by the board of equalization and review or, if that board is not in session, by the board of county commissioners. An untimely application approved under this subsection applies only to property taxes levied by the county or municipality in the calendar year in which the untimely application is filed. Decisions of the county board may be appealed to the Property Tax Commission."

SECTION 5. G.S. 105-321(d) is repealed.

SECTION 6. G.S. 105-378 is amended adding a new subsection to read:

"(d) Enforcement and Collection Delayed Pending Appeal. -- When the board of county commissioners or municipal governing body delivers a tax receipt to a tax collector for any assessment that has been or is subsequently appealed to the Property Tax Commission, the tax collector may not seek collection of taxes or enforcement of a tax lien resulting from the assessment until the appeal has been finally adjudicated. The tax collector, however, may send an initial bill or notice to the taxpayer."

SECTION 7. G.S. 105-373(a) reads as rewritten:

"(a) Annual Settlement of Tax Collector. –

(1) Preliminary Report. – After July 1 and before he is charged with taxes for the current fiscal year, the tax collector shall make a sworn report to the governing body of the taxing unit showing:

a. A list of the persons owning real property whose taxes for the preceding fiscal year remain unpaid and the principal amount owed by each person; and

b. A list of the persons not owning real property whose personal property taxes for the preceding fiscal year remain unpaid and the principal amount owed by each person. (To this list the tax collector shall append his statement under oath that he has made diligent efforts to collect the taxes due from the persons listed out of their personal property and by other means available to him for collection, and he shall report such other information concerning these taxpayers as may be of interest to or required by the governing body, including a report of his efforts to make collection outside the taxing unit under the provisions of G.S. 105-364.) The governing body of the taxing unit may publish this list in any newspaper in the taxing unit. The cost of publishing this list shall be paid by the taxing unit.

(2) Insolvents. – Upon receiving the report required by subdivision (a)(1), above the governing body of the taxing unit shall enter upon its minutes the names of persons owing taxes (but who listed no real property) whom it finds to be insolvent, and it shall by resolution designate the list entered in its minutes as the insolvent list to be credited to the tax collector in his settlement.

(3) Settlement for Current Taxes. – After July 1 and before he is charged with taxes for the current fiscal year, the tax collector shall make full settlement with the governing body of the taxing unit for all taxes in his hands for collection for the preceding fiscal year.

a. In the settlement the tax collector shall be charged with:

1. The total amount of all taxes in his hands for collection for the year, including amounts originally charged to him and all amounts subsequently charged on account of discoveries;

2. All penalties, interest, and costs collected by him in connection with taxes for the current year; and

3. All other sums collected by him.

b. The tax collector shall be credited with:

1. All sums representing taxes for the year deposited by him to the credit of the taxing unit or receipted for by a proper official of the unit;

2. Releases duly allowed by the governing body;

3. The principal amount of taxes constituting liens on real property;
4. The principal amount of taxes included in the insolvent list determined in accordance with subdivision (a)(2), above;
5. Discounts allowed by law; ~~and~~
6. Commissions (if any) lawfully payable to the tax collector as ~~compensation.~~compensation; and
7. The principal amount of taxes for any assessment appealed to the Property Tax Commission when the appeal has not been finally adjudicated.

The tax collector shall be liable on his bond for both honesty and faithful performance of duty; for any deficiencies; and, in addition, for all criminal penalties provided by law.

The settlement, together with the action of the governing body with respect thereto, shall be entered in full upon the minutes of the governing body.

(4) Disposition of Tax Receipts after Settlement. – Uncollected taxes allowed as credits in the settlement prescribed in subdivision (a)(3), above, whether represented by tax liens held by the taxing unit or included in the list of insolvents, shall, for purposes of collection, be recharged to the tax collector or charged to some other person designated by the governing body of the taxing unit under statutory authority. The person charged with uncollected taxes shall:
   a. Give bond satisfactory to the governing body;
   b. Receive the tax receipts and tax records representing the uncollected taxes;
   c. Have and exercise all powers and duties conferred or imposed by law upon tax collectors; and
   d. Receive compensation as determined by the governing body."

SECTION 8. This act is effective when it becomes law.

DRAFT 2005-LAz-18: Property Tax Changes

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	April 27, 2006
Introduced by:		**Summary by:**	Martha Walston
Version:	Draft 2005-LAz-18		Committee Counsel

SUMMARY: ***This bill is a recommendation of the Department of Revenue and would make the following clarifying changes to the property tax laws:***

- ***Provides for the electronic filing of both business and individual personal property.***
- ***Amends S.L. 2005-294 (AN ACT TO CREATE A COMBINED MOTOR VEHICLE REGISTRATION RENEWAL AND PROPERTY TAX COLLECTION SYSTEM) to clarify that the first month's interest on past due bills would be transferred to a special account. This change reflects the intent of the bill sponsors and supporters.***
- ***Authorizes a county board of equalization and review to approve a late application for present-use value appraisal of property if the applicant demonstrates good cause for the delay.***
- ***Authorizes a tax collector to receive tax receipts for assessments that have been or are subsequently appealed to the Property Tax Commission and to send the taxpayer an initial tax bill or notice; however, the tax collector may not collect on the tax or enforce a tax lien until the appeal has been finally adjudicated.***
- ***Clarifies that the list of items credited to the tax collector in the final assessment to the governing body of the taxing unit shall include the principal amount of taxes for any assessment appealed to the Property Tax Commission when the appeal has not been finally adjudicated.***

BILL ANALYSIS:

Sections 1 and 2 of the bill provides for the electronic filing of any personal property. Current law allows the board of county commissioners, by resolution, to provide for the electronic listing of business personal property. This language excludes the electronic filing of unlisted automobiles, jet skis, mobile homes, and boats by personal taxpayers. The Department states that there is no reason to limit electronic filing to business personal property.

Current law allows the period for electronic listing of business personal property to be extended to June 1. Section 2 of the bill clarifies that this extension is provided only to business personal property.

Section 3 of the bill makes a clarifying change to legislation that was enacted during the 2005 Session. This change would clarify the intent of the bill's sponsors and supporters. Last Session, the General Assembly ratified House Bill 1779, which creates a combined system for registration and taxation of motor vehicles to become effective July 1, 2009, or upon the earlier creation of a combined registration renewal and tax collection computer system within the Division of Motor Vehicles. Under the new combined system, consumers will receive one statement per registered vehicle, containing both registration fees and the property taxes and vehicle fees due. Payment of the property taxes are a prerequisite to issuance of or renewal for the registration. Property taxes on the vehicle become due on the date a new registration is applied for or at the end of the grace period following the expiration of a

vehicle's current registration. Taxes and registration fees may be collected by the DMV or a DMV agent.

To pay for the new system, the act increased the first month's interest on delinquent registered motor vehicle taxes from 2% to 5%, effective January 1, 2006, and required that 60% of the interest collected on unpaid taxes be transferred on a monthly basis to the Combined Motor Vehicle and Registration Account in the Treasurer's Office. Funds in this Account may only be transferred to the DMV for the purpose of implementing the combined system, at the direction of the North Carolina Association of County Commissioners. The intent of the sponsors to House Bill 1779 and supporters of the bill was that 60% of only the **first month's** interest would be transferred to the Account, not the total interest collected on unpaid taxes. In December, 2005, the North Carolina Department of State Treasurer issued a memorandum directing counties to only remit 60% of the first month's interest to the Treasurer. The memorandum stated that this was the true intent of the bill and that it is anticipated that the language will be corrected during the 2006 Session. The memorandum was sent to all county managers, finance officers, tax administrators, tax assessor, tax collectors, and certified public accountants.

Section 4 of the bill would give a county board of equalization and review the authority to approve a late application for present-use value appraisal of property if the applicant demonstrates good cause for the delay. Under current law, a taxpayer seeking present-use value appraisal of farmland, must file the application within the following time periods:

- An initial application must be filed during the regular listing period of the year for which the benefit of the classification is first claimed, or within 30 days of the date shown on a notice of a change in valuation made pursuant to a county's general reappraisal or horizontal adjustment of real property.
- An application required due to transfer of the land may be submitted at any time during the calendar year but must be submitted within 60 days of the date of the property's transfer.

The bill would allow approval of a late application upon a showing of good cause by the applicant to the board of equalization and review. If the county board of equalization and review is not in session, then the late filing may be approved by the board of county commissioners. Current law allows similar approval for late applications for property tax exemptions or exclusions. (G.S. 105-282.1(a1).)

Sections 5 and 6 of the bill would allow a tax collector to receive tax receipts for assessments that have been appealed or are subsequently appealed to the Property Tax Commission, but would prohibit the tax collector from collecting the tax or enforcing a tax lien resulting from the assessment until the appeal has been finally adjudicated. Pending final adjudication, the tax collector may send an initial tax bill or notice to the taxpayer.

Each year, the county board of commissioners or the municipal governing body directs the tax collector to collect taxes charged in the tax records and receipts. The tax receipt sets out the name and address of the taxpayer, the assessment of the taxpayer's property, the rate of tax levied, and the amount of property taxes and any penalties due. Current law states that no tax receipts are to be delivered to the tax collector for any assessment appealed to the Property Tax Commission until the appeal has been finally adjudicated. In practice, boards of equalization and review often adjourn on June 30th, except to hear appeals filed prior to June 30th. By August 1, however, the tax collector has received the tax receipts. The proposal validates this practice, but clarifies that the tax collector may not seek any remedies for collection of the taxes or enforcement of the tax lien pending final adjudication of appeal from the assessment. The tax collector, however, may send an initial bill or notice to the taxpayer pending final adjudication. By providing notice pending appeal, the taxpayer may choose to avoid the amount of interest that accrues while the appeal is pending. If the taxpayer wins on appeal, the taxpayer receives a refund of any taxes paid plus interests. Finally, the proposal would put a potential buyer of the property on notice of a tax bill, if the property is transferred pending the appeal.

Section 7 of the bill makes clarifying changes to the lists of items credited to the tax collector in the collector's final settlement with the governing body for all taxes in his hands for collection for the preceding fiscal year. Current law provides that the final settlement must contain the items to be charged against the tax collector and the items to be allowed as credits for the collector.[1] The charges and credits should balance. The proposal adds to the lists of credits the principal amount of taxes for any assessment appealed to the Property Tax Commission when the appeal has not been finally adjudicated.

EFFECTIVE DATE: The bill is effective when it becomes law.

2005-LAz-18-SMLA

[1] Charges include the total amount of all taxes placed in the collector's hands for collection for the year, all late-listing penalties and costs collected by the collector, all interests on taxes collected by the collector, and any other sums collected or received by the tax collector. Credits include all sums deposited by the collector to the credit of the taxing unit, releases allowed by the governing body, discounts allowed for early payment of taxes, the principal amount of taxes constituting liens against real property, the principal amount of taxes determined to be insolvent and to be allowed as credits, and any commission the collector is entitled to deduct from amounts collected.

GENERAL ASSEMBLY OF NORTH CAROLINA

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FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: January 8, 2006

TO: Revenue Laws

FROM: Rodney Bizzell
Fiscal Research Division

RE: Property Tax Changes

FISCAL IMPACT

Yes ( ) **No (X)** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:	No Significant Impact				
EXPENDITURES:					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue, North Carolina Local Governments

EFFECTIVE DATE: Becomes effective when law.

BILL SUMMARY:
Sections 1 and 2 of the bill provide for the electronic filing of personal property. Currently, counties are allowed to provide for electronic listing only for business personal property. The Department indicates no reason that this listing mechanism should not be allowed for all personal property. Current law allows the period for electronic listing of business personal property to be extended to June 1. Section 2 of this bill clarifies that this extension is provided only to business personal property.

Section 3 of the bill makes a clarifying change to House Bill 1779, which was enacted during the 2005 Session. The bill creates a combined system for registration and taxation of motor vehicles. The bill increases the first-month interest payments on unpaid vehicle property taxes from 2% to 5% and directs

60% of interest revenue to a special account within the Department of State Treasurer for the purpose of creating a registration renewal and property tax collection computer system within the Division of Motor Vehicles. The intent of the bill, and the practice put into place by the Department of State Treasurer, is to transfer 60% of only the first month of interest on unpaid taxes to the special account. This bill clarifies that the transfer applies to only the month of interest.

Section 4 of the bill would give county boards of equalization and review the authority to approve a late application for present-use value appraisal of property if the applicant demonstrates a good cause for the delay. Current law allows similar approvals for property tax exemptions or exclusions.

Sections 5 and 6 of the bill would allow tax collectors to receive tax receipts for assessments that have been appealed to the Property Tax Commission, but would not allow the collector to collect the tax or enforce a tax lien resulting from the assessment while the appeal is pending. This bill would validate the current practice in which boards of equalization provide tax receipts to collectors by August 1, but clarifies that the collector may not seek remedies for appealed assessments until the appeal is adjudicated.

Section 7 of the bill makes a clarifying change to add taxes appealed to the Property Tax Commission to the list of items credited to the tax collector in the collector's final settlement with the governing body.

ASSUMPTIONS AND METHODOLOGY: All of the proposed changes contained in the bill are administrative or clarifying in nature and would result in no significant fiscal impact.

SOURCES OF DATA: North Carolina Department of Revenue

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #5

AMEND DELINQUENT PROPERTY TAX COLLECTION

LEGISLATIVE PROPOSAL #9

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO MAKE CORPORATE INCOME TAX ADJUSTMENTS INAPPLICABLE TO S CORPORATIONS.

SHORT TITLE: S Corp Income Tax Adjustments

SPONSORS:

BRIEF OVERVIEW: This proposal would make corporate income tax adjustments inapplicable to S Corporations.

FISCAL IMPACT: Negligible fiscal impact.

EFFECTIVE DATE: This proposal would become effective with the 2006 taxable year.

A copy of the proposed legislation, bill analysis, and fiscal analysis begin on the next page.

LEGISLATIVE PROPOSAL #9

S CORP INCOME TAX ADJUSTMENTS

believes the number of taxpayers involved would be small. Because this legislation gives the couple the option of choosing to file joint or separate returns, it would be reasonable to assume there are some circumstances were the taxpayer may benefit financially from a specific filing status, and would select that status. As such, there is a potential revenue loss.

SOURCES OF DATA: North Carolina Department of Revenue.

TECHNICAL CONSIDERATIONS: None

GENERAL ASSEMBLY OF NORTH CAROLINA

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FISCAL ANALYSIS MEMORANDUM

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DATE: February 6, 2006

TO: Revenue Laws

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: Additional Personal Income Tax Filing Option

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:			Potential Minimal loss		
EXPENDITURES:					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: For taxable years beginning on or after January 1, 2006.

BILL SUMMARY: Under North Carolina law, a married couple that files a joint federal return must file a joint state return if both are residents or have North Carolina income. However, if one spouse is a non-resident and has no North Carolina income, the other spouse must file a separate return with the State. The proposed legislation would allow such a couple the option of filing a joint North Carolina return. This is a recommendation of the North Carolina Department of Revenue.

ASSUMPTIONS AND METHODOLOGY: Currently no data is available about the number of returns this change would impact or the likely amount of revenue affected. However, the Department

DRAFT 2005-LAz-20:
Additional Personal Income Tax Filing Option

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	April 28, 2006
Introduced by:		**Summary by:**	Martha Walston Committee Counsel
Version:	Draft 2005-LAz-20		

SUMMARY: This bill is a recommendation of the Department of Revenue and would allow married couples the option of filing a joint return if one spouse is a nonresident with no North Carolina income.

BILL ANALYSIS: Under current law, a married couple who file a federal joint return are required to file a North Carolina joint return if each spouse is either a resident or has North Carolina income. If one spouse is a nonresident and has no North Carolina income, that spouse is not subject to North Carolina income tax and the other spouse must file a separate return. The current law is based on the fact that North Carolina has no jurisdiction to tax a person who is not a resident and does not have income from North Carolina sources. The current law makes filing more complicated because the couple must recompute their income separately in order to file a North Carolina return.

The bill would allow a married couple the option of filing jointly if they file a federal joint return and if one spouse is a nonresident with no income from North Carolina. Because North Carolina does not have jurisdiction over the nonresident spouse, the bill does not require a joint return.[1] It merely gives a couple a joint return option so that they may choose to file jointly, for example if doing so would simplify their tax preparation or reduce their North Carolina taxes. This option would also allow North Carolina residents to file jointly in Georgia and South Carolina. Currently, these two states do not allow nonresident joint filing for residents of states that do not allow joint filings for Georgia and South Carolina residents.

EFFECTIVE DATE: The bill is effective for taxable years beginning on or after January 1, 2006.

2005-LAz-20-SMLA

[1] A New York court found that a provision, which required married nonresidents to file a joint nonresident tax return in New York if they filed a joint federal return, was unconstitutional. The court explained that the provision exposed a nonresident spouse with no New York connections to civil and criminal liability in New York by virtue of that spouse's signature on the State tax return.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-LAz-20 [v.3] (1/31)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/6/2006 11:26:08 AM

Short Title: Additional Personal Income Tax Filing Option.	(Public)
Sponsors: Unknown.	
Referred to:	

A BILL TO BE ENTITLED

AN ACT TO ALLOW AN ADDITIONAL JOINT FILING OPTION FOR INDIVIDUAL INCOME TAXES.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-162(e) reads as rewritten:

"(e) Joint Returns. – A husband and wife ~~shall file a single income tax return jointly if (i) their~~whose federal taxable income is determined on a joint federal return ~~and (ii) both spouses are residents of this State or both spouses have~~shall file a single income tax return jointly if each spouse either is a resident of this State or has North Carolina taxable ~~income.~~income, and may file a single income tax return jointly if one spouse is not a resident and has no North Carolina taxable income. Except as otherwise provided in this Part, a wife and husband filing jointly are treated as one taxpayer for the purpose of determining the tax imposed by this Part. A husband and wife filing jointly are jointly and severally liable for the tax imposed by this Part reduced by the sum of all credits allowable including tax payments made by or on behalf of the husband and wife. However, if a spouse has been relieved of liability for federal tax attributable to a substantial understatement by the other spouse pursuant to section 6015 of the Code, that spouse is not liable for the corresponding tax imposed by this Part attributable to the same substantial understatement by the other spouse. A wife and husband filing jointly have expressly agreed that if the amount of the payments made by them with respect to the taxes for which they are liable, including withheld and estimated taxes, exceeds the total of the taxes due, refund of the excess may be made payable to both spouses jointly or, if either is deceased, to the survivor alone."

SECTION 2. This act is effective for taxable years beginning on or after January 1, 2006.

LEGISLATIVE PROPOSAL #8

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO ALLOW AN ADDITIONAL JOINT FILING OPTION FOR INDIVIDUAL INCOME TAXES.

SHORT TITLE: Additional Personal Income Tax Filing Option

SPONSORS:

BRIEF OVERVIEW: This bill would allow married couples the option of filing a joint return if one spouse is a nonresident with no North Carolina income.

FISCAL IMPACT: Potential minimal loss.

EFFECTIVE DATE: The bill is effective for taxable years beginning on or after January 1, 2006.

A copy of the proposed legislation, bill analysis, and fiscal analysis begin on the next page.

LEGISLATIVE PROPOSAL #8

ADDITIONAL PERSONAL INCOME TAX FILING OPTION

Research estimates a 2006-07 loss associated with this change of $142,000. In 2007-08 that number drops to $53,000.

Most of the remaining changes related specifically to residents, former residents, and property owners in the Gulf Region. Clearly most of the victims of Hurricanes Katrina and Rita were relocated to areas closer to the gulf than North Carolina. However, the North Carolina Department of Public Instruction indicates that approximately 1,462 students entered the North Carolina school system as a result of the hurricanes. Thus, at least some form residents relocated to the state. To the extent they take advantage of the new special tax changes the State will see a loss. However, given the limited number of families involved, the potential loss is expected to be relatively insignificant.

GO Act: While this Act makes numerous tax law changes, most are related specifically to the Gulf area. Based on data provided by the Joint Committee on Taxation, it appears that the only change that will have a measurable fiscal impact on North Carolina is the temporary suspension of limitation on qualified corporate charitable contributions for Hurricanes Rita and Wilma relief efforts. The Joint Committee estimates that in 2006 this change will result in a $85 million loss for the federal government. Using the state's portion of Gross Domestic Product as a proxy for North Carolina's portion of the revenue loss, and adjusting for base differences, suggests a potential revenue loss for the state of $34,000. This is a one time loss, as it relates only to contributions made between August 28, 2005 and December 31, 2005. Any other revenue affects related to this legislation are expected to be negligible.

While the above outlines the IRC update conformity issues, the legislation also addresses several other tax issues.

Credit for Child Care: Under current law taxpayers can receive both a federal and state credit for work related child care expenses. For many years, the amount of expenses that could be considered when calculating the credit was the same at both the state and federal level. In 2003 the federal government increased the cap on those qualifying expenses from $2,400 to $3,000 ($4,800 to $6,000 if there is more than one qualifying individual in the household). At that time the state did not conform to this change. The legislation would bring state caps in line with the federal caps. According to the Policy Analysis and Statistics Division of the North Carolina Department of Revenue (formerly Tax Research), the annual cost of such a change is approximately $5.0 million.

Other: The legislation also addresses several other tax issues. First, the bill reduces the period of time in which a taxpayer must report a federal change from two years to six months. This change is expected to ease processing at the North Carolina Department of Revenue, but will have no revenue side implications. Second, the bill alters the tax filing date for nonresident aliens. Specifically, it conforms the State filing deadlines to the federal filing deadlines for nonresident aliens and would ease compliance for those taxpayers. No revenue impact is expected as a result of this change.

SOURCES OF DATA: Joint Committee on Taxation, Internal Revenue Service, North Carolina Department of Revenue, and the North Carolina Department of Public Instruction.

TECHNICAL CONSIDERATIONS: None

millions

Commercial Building Property	FY 06-07	FY 07-08	FY 08-09	FY 09-10	FY 10-11
JCT Estimate of Federal change	-81	-141	-48	6	5
Federal Tax Base Change (34%)	-238.235	-414.706	-141.176	17.64706	14.70588
NC Portion of Federal Collections	0.53%	0.53%	0.53%	0.53%	0.53%
NC Base Change	-1.26265	-2.19794	-0.74824	0.093529	0.077941
Corporate Estimate	-0.08712	0.000437	0.000437	0.000437	0.000437
Individual Estimate	-0.10417	-1.09875	-0.3739	0.046983	0.039189
Average	-0.09565	-0.54916	-0.18673	0.02371	0.019813

- Depreciation, Amortization, and Other Changes: The federal legislation creates more favorable depreciation and amortization schedules for a number of large purchases including air pollution control facilities for coal-fired plants, certain electric power purchases. The JCT has developed a series of estimates related to these changes. However, because these investments are highly concentrated, based on the individual business decisions of a limited number of companies, and are not linked to any particular state or national ratio, no exact fiscal estimate is possible on these portions of the legislation.

SAFE Act: Although the Act makes a substantial number of changes at the federal level, the changes do not impact North Carolina taxable income. As such, there is no state impact associated with this legislation.

Katrina Act: The federal legislation defines both a "Hurricane Katrina Disaster Area" and a "core disaster area" and provides additional tax advantages for individual who live in those areas, own property in those areas, or make certain charitable contributions to relief efforts in those areas.

While all of these changes could have a revenue impact, the largest potential fiscal impact will likely come from the changes related to charitable contributions. Under federal law the deduction allowed for charitable contributions is limited for certain types of taxpayers, certain types of property donated, and the type of organization receiving the donation. Generally cash contributions are deductible in the amount contributed, "capital gain property" is deductible at fair market value, other appreciated property donations are deductible at the donor's base in property, and depreciated property is deductible at fair market value. In addition, the tax value of the donation can not exceed a certain proportion of their adjusted gross income. The Katrina Act provides several exceptions to these limitations on charitable contribution deductions. The Joint Committee on Taxation estimates a 2006 cost associate with this change of $819.0 nationwide. Using North Carolina's proportion of charitable contributions at the federal level as a proxy suggests conforming on this change will result in a one time loss to the General Fund of $5.89 million. In addition, their were numerous changes related to the cost of assisting with the relief effort including a change in the standard deductible mileage rate, mileage reimbursements to volunteers, enhanced deductions for contributions of food and book inventories, and an increased personal exemption for housing victims of the hurricanes. Based on data from the Joint Committee on Taxation, North Carolina's portion of federal taxes, and the average North Carolina tax rate, Fiscal

taxpayer has to file an amended return after to reflect changes or corrections in their federal return upon which their state return is based. Currently taxpayers have two years after the change to file an amended return. The legislation shorts this period to six months. This provision applies to all state taxes which are based on federal returns including estate, income, and gift taxes. The legislation also conforms state nonresident alien return due dates to similar federal dates. Finally, the legislation conforms the state amounts associated with the child care credit and certain employment related expense credits to those allowed under federal law.

ASSUMPTIONS AND METHODOLOGY: The legislation makes numerous changes to the state's tax law.

IRC Update: Section 1 of the bill updates the reference to the federal code from January 1, 2005 to January 1, 2006. This has the effect of including the changes associated with four pieces of federal legislation: the Energy Tax Incentive Act of 2005 (Energy Act), the Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005 (SAFE Act), the Katrina Emergency Tax Relief Act of 2005 (Katrina Act), and the Gulf Opportunity Zone Act of 2005 (GO Act). While these bills included numerous tax changes, only some flow through to the state return. The items with a likely fiscal impact are addressed below.

Energy Act: The Energy Act created a variety of incentives to purchase energy efficient vehicles, facilities, and home improvement items. Because many of these incentives are in the form of credits, they do not effective North Carolina taxable income. As such, they produce no revenue gain or loss. However, there are three items in the bill that do create a potential loss for the state.

- Alternative Fuel Vehicles: The Energy Act eliminated the existing deduction for clean-fuel vehicles and certain refueling property, and replaced it with a tax credit. Because federal tax credits do not affect North Carolina taxable income, the credit has no impact on state revenues, while eliminating the deduction would actually create a revenue gain. The Joint Committee on Taxation estimates a national loss in 2006 of $8.0 million from this change. Data from the Bureau of Economic Analysis and Economy.com suggest that North Carolina will be approximately 2.85% of US auto sales. Using this percent as a proxy for alternative fuel vehicle sales suggests a state revenue gain $225,000 in 2006. In future years the change will be less than $100,000.
- Electric Transmission Assets: Under previous federal law, a taxpayer could recognize a qualified gain from a qualifying electric transmission transition if that transaction was completed before January 1, 2007. The Energy Act extends that date to January 1, 2008. Conforming to the Code will also extend this date to 2008. The Joint Committee on Taxation estimates a national 2006 loss of $105 million, and a 2007 loss of $237 million. However, because of the limited information available concerning the distribution of these assets and transitions, no North Carolina estimate is possible on this portion of the bill.
- Energy Efficient Commercial Buildings Property Deduction: The Act allows taxpayers to claim a deduction (as opposed to depreciation or amortization) for costs associated with energy efficient commercial building property placed into service between January 1, 2006 and January 1, 2008. The estimated state revenue change as a result of the proposal is outlined below. It assumes an average federal tax rate of 34% and uses North Carolina's portion of federal corporate tax payments as a proxy for North Carolina's portion of the loss. In addition, because this can be used by both individuals and corporations, the average loss is used as a proxy for the actual loss.

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 26, 2006

TO: Revenue Laws Study Committee

FROM: Linda Struyk Millsaps
Fiscal Research Division

RE: 2005-LYxz-284 – IRC Update

FISCAL IMPACT (millions)

	Yes (x)	No ( )	No Estimate Available ( )		
	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:	(5.1)	(5.1)	(5.0)	(5.0)	(5.0)
EXPENDITURES:					
POSITIONS (cumulative):					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: Sections 1, 2, and 10 are effective when law. Sections 3, 4, 5, and 6 become effective July 1, 2006 and apply to federal determinations made on or after that date. Sections 7, 8, and 9 are effective for taxable years beginning on or after January 1, 2006.

BILL SUMMARY: Generally North Carolina tracks federal law as it relates to income tax provisions. However, because of constitutional limitations the General Assembly must proactively decide each year to update its reference to the Internal Revenue Code (IRC). Updating the reference date for the code effectively allows the state to track recent changes in federal tax law. The legislation changes the reference date in the North Carolina statutes from January 1, 2005 to January 1, 2006, effectively including several recent federal tax law changes. In addition, the bill shortens the amount of time a

little as 90 days to as much as two years. This provision becomes effective July 1, 2006, and applies to federal determinations made on or after that date.

FILING PERIOD FOR NONRESIDENT ALIENS.

Section 6072(c) of the Code requires a nonresident alien to file an income tax return on or before the fifteenth day of the sixth month following the close of the taxable year (June 15th for taxpayer whose taxable year is the calendar year). Under current State law, nonresident alien corporate taxpayers must file a State return by the fifteenth day of the third month following the close of the taxable year (March 15th for a calendar year taxpayer) and nonresident alien individual taxpayers must file a State return by the fifteenth day of the fourth month following the close of the taxable year (April 15th for a calendar year taxpayer). Thus, under current State law a nonresident alien is required to file a State income tax return before the federal tax return is due. This provision would conform the State filing deadlines to the federal filing deadlines for nonresident aliens and would ease compliance burdens on those taxpayers. These provisions become effective for taxable years beginning on or after January 1, 2006.

CREDIT FOR CHILD-CARE AND CERTAIN EMPLOYMENT-RELATED EXPENSES.

Current State law allows a credit to a taxpayer who is eligible for the federal credit for child-care and employment-related expenses. The amount of the credit is based on a percentage of those expenses up to a certain amount. For the State credit, the amount of expenses that may be taken into consideration when computing the credit are capped at $2,400 when there is one qualifying individual in the household and $4,800 when there is more than one qualifying individual in the household. Until 2003, these limits were the same as those at the federal. In 2003, the federal limits increased to $3,000 and $6,000 respectively. This provision would conform the State limits to the federal limits. This provision also clarifies that the amount of expenses used in calculating the credit may not include any amount excluded from gross income. This provision becomes effective for taxable years beginning on or after January 1, 2006.

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deduction may not exceed a taxpayer's taxable income from the active conduct of a trade or business.

This act increases the maximum section 179 deduction for qualified GO Zone property by the lesser of $100,000 or the amount of property placed into service in the GO Zone. In addition it increases the total investment limitation by the lesser of $600,000 or the amount of property placed into service in the GO Zone. The increased amounts apply to property acquired on or after August 25, 2005, and placed into service before January 1, 2008. "Qualified GO Zone property" must satisfy all of the following conditions: 1) It must be depreciable modified accelerated cost recovery systems (MACRS) recovery property with a recovery period of 20 years or less; 2) Substantially all use of the property must be in the active conduct of a trade or business of the taxpayer in the GO Zone; 3) The original use of the property in the GO Zone must commence with the taxpayer on or after August 25, 2005; 4) The property must be purchased on or after August 25, 2005; 5) No written binding contract for the purchase of the property may be in effect before August 25, 2005; and 6) The property must be placed in service before January 1, 2008. The term does not include property used in connection with a private or commercial golf course, a country club, a massage parlor, a hot tub facility, a suntan facility, a liquor store, or a gambling or animal racing property.

- *Deduction for demolition and clean-up costs.* Under general law, demolition costs are capitalized and added to the basis of the land on which the demolished building was located. The tax treatment of debris removal costs depends on the nature of the costs incurred. Debris removal costs that are in the nature of replacement must be capitalized and added to the basis of the property damaged. Other times, debris removal costs may be used to show a decrease in the fair market value of property which could be used to determine the amount of a casualty loss. This act allows a taxpayer to claim a current deduction for 50% of any qualified Gulf Opportunity Zone clean-up costs paid between August 25, 2005, and January 1, 2008. For the purposes of this provision, a "qualified Gulf Opportunity Zone clean-up cost" is an amount paid for the removal of debris, or the demolition of structures, on real property located in the GO Zone if the real property is either held by the taxpayer for use in a trade or business or is inventory in the hands of the taxpayer.

- *Environmental remediation costs.* Under previous law, a taxpayer may elect to deduct, rather than capitalize, certain environmental remediation expenditures incurred in connection with property used in a trade or business for the production of income. This provision expired for expenditures incurred after December 31, 2005. This act extends the expiration date for that provision until December 31, 2007 for qualified environmental remediation expenditures incurred in connection with a qualified site in the GO Zone. In addition, expenditures incurred on or after August 25, 2005, with respect to petroleum products in the GO Zone are included in the deduction.

FEDERAL DETERMINATIONS:

This bill would reduce the period of time in which a taxpayer must report a federal change from two years to six months. When the federal government corrects or otherwise determines the amount of an estate, gift, or income that is subject to tax, the taxpayer must file a State return that reflects that change. This is so because the State estate, gift, and income taxes are, to varying degrees, based on amounts determined with respect to federal law. The Multistate Tax Commission has adopted a model uniform statute for reporting federal changes. That model uniform statute requires a taxpayer to report those changes within six months. The model statute is intended to bring uniformity to this area among the states. Currently there is a great deal of variety with some states requiring changes to be reported in as

January 1, 2006 and may not exceed $600 for any month in which lodging is furnished. For the purposes of this provision, a "qualified employee" is an individual who on August 28, 2005, had a principal residence in the GO Zone and who performs substantially all of his or her employment services in the GO Zone for a qualified employer. For the purposes of this provision, a "qualified employer" is an employer with a trade or business located in the GO Zone.

Depreciation and expensing.

- *Bonus depreciation for Gulf Opportunity Zone property.* In 2002 and 2003, Congress acted to allow for bonus depreciation (either 30% or 50% depending on when the property was purchased) for property that was purchased after September 10, 2001. In order to qualify for the bonus depreciation, the property had to have been placed into service before January 1, 2005. For certain transportation property, noncommercial aircraft, or property with a long production period, the property must have been placed into service before January 1, 2006.

  This act allows a taxpayer to claim an additional first-year depreciation allowance equal to 50% of the adjusted basis of qualified Gulf Opportunity Zone property acquired on or after August 25, 2005, and placed into service before January 1, 2008 (the sunset date is January 1, 2009, for nonresidential real property and residential rental property). "Qualified Gulf Opportunity Zone property must satisfy all of the following conditions: 1) It must be depreciable modified accelerated cost recovery systems (MACRS) recovery property with a recovery period of 20 years or less, MACRS water utility property, qualified leasehold improvement property, off-the-shelf computer software, residential rental property, or nonresidential real property; 2) Substantially all use of the property must be in the active conduct of a trade or business of the taxpayer in the GO Zone; 3) The original use of the property in the GO Zone must commence with the taxpayer on or after August 25, 2005; 4) The property must be purchased on or after August 25, 2005; 5) No written binding contract for the purchase of the property may be in effect before August 25, 2005; and 6) The property must be placed in service before January 1, 2008 (January 1, 2009 for nonresidential real property and residential rental property). The term does not include property that is 1) mandatory alternative depreciation system (ADS) property; 2) tax-exempt bond-financed property; 3) qualified revitalization buildings or rehabilitation expenditures for which a deduction under section 1400I of the Code is claimed; or 4) property used in connection with a private or commercial golf course, a country club, a massage parlor, a hot tub facility, a suntan facility, a liquor store, or a gambling or animal racing property.

  In addition, this act allows the Secretary to extend the placed-in-service date for noncommercial aircraft and property with longer production periods for up to one year. This extension is granted on a case-by-case basis and may only be granted if the delay in placing the property into service was caused by one of the three hurricanes and the property is placed in service in the GO Zone, the Rita GO Zone, or the Wilma GO Zone.

- *Increase in limits on section 179 deductions.* Certain taxpayers may elect to claim a section 179 expense deduction on the cost of qualifying property rather than depreciating the property over time. For the 2003 through 2007 tax years, the maximum amount of the deduction is limited to $100,000, indexed for inflation.[7] This limitation is increased by $35,000 for property that is placed in service in the New York Liberty Zone, an empowerment zone, or a renewal community. The amount of the section 179 deduction is reduced to the extent that the total amount of property placed into service exceeds an investment threshold, currently set at $400,000, indexed for inflation.[8] The section 179

[7] The adjusted dollar limitation is $105,000 for 2005 and $108,000 for 2006.

[8] The adjusted investment limitation is $420,000 for 2005 and $430,000 for 2006.

that an individual is not taken into account by more than one taxpayer with respect to the same benefit.

Gulf Opportunity Zone Act of 2005 (P.L. 109-135) (GO Act)

The Gulf Opportunity Zone Act of 2005 expanded upon the relief offered in the Katrina Emergency Tax Relief Act of 2005. In some instances, this expansion meant extending the additional benefits allowed under the Katrina Act to taxpayers affected by Hurricanes Rita or Wilma. In other cases, the expansion created new tax benefits for taxpayers in one or more of the disaster areas. The act also made numerous technical corrections.

General Provisions. First, the GO Zone Act added several new definitions. First, the "Gulf Opportunity Zone" or "GO Zone" is a subset of the Hurricane Katrina disaster area that has been determined by the President to warrant individual or individual and public assistance from the federal government and is the same as the "core disaster area" under the Katrina Act. The "Hurricane Rita disaster area" means an area with respect to which the President has declared a major disaster before October 6, 2005, with respect to Hurricane Rita. The "Hurricane Wilma disaster area" means an area with respect to which the President has declared a major disaster before November 14, 2005, with respect to Hurricane Wilma. The "Rita GO Zone" and "Wilma GO Zone" are, respectively, the portions of the Hurricane Rita disaster area and Hurricane Wilma disaster area that have been determined by the President to warrant individual or individual and public assistance from the federal government.

Extensions of Hurricane Katrina benefits. The GO Zone Act extended some of the benefits of the Katrina Act to areas affected by Hurricanes Rita and Wilma. The following changes fall into this category.

- *Retirement plans.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical to those discussed under the Katrina Act with some timing differences related to the different dates of the three storms.
- *Casualty losses.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical to that discussed under the Katrina Act with some timing differences related to the different dates of the three storms.
- *Secretarial authority to make adjustments.* The specific provisions discussed under the Katrina Act were repealed and replaced with more general provisions relating to all of the hurricanes. The provisions under this act were substantively identical to those discussed under the Katrina Act with some timing differences related to the different dates of the three storms.
- *Mortgage revenue bonds.* The first-time homebuyer requirement is eliminated for residences in the Rita GO Zone or the Wilma GO Zone. In addition, the increased maximum amount of a qualified home improvement loan is applied to residences in the Rita GO Zone and the Wilma GO Zone.

Housing relief for Hurricane Katrina. As discussed above, the Katrina Act provided some relief to individuals who provided housing for Hurricane Katrina evacuees. In this act, Congress provided further tax relief relating to housing expenditures. Employer-provided housing is generally included in income as a form of compensation. An exception to this general rule exists when an employee is required to accept the lodging on business premises as a condition of employment. This act provides that a qualified employee's gross income does not include the value of any in-kind lodging furnished to the employee, the employee's spouse, or the employee's dependents by or on behalf of the qualified employer. The exclusion applies only to lodging furnished during the six-month period beginning

certain military personnel, the time period for performing certain acts (such as filing returns, paying taxes, bringing suit) is automatically suspended. In the case of a Presidentially declared disaster or terroristic or military action, the Secretary has the authority to prescribe a period of up to one year in which the time period for the same actions is suspended. This act requires the Secretary to suspend those time periods at least until February 28, 2006, for taxpayers determined to have been affected by the Presidentially declared disaster relating to Hurricane Katrina. In addition, this act adds employment and excise taxes to the list of taxes for which the Secretary may extend filing and payment time periods.

- *Special rules for mortgage revenue bonds.* A qualified mortgage bond is a type of private activity bonds for which interest is excluded from gross income. Qualified mortgage bonds are issued to make mortgage loans to qualified mortgagors for the purchase, improvement, or rehabilitation of owner-occupied residences and to finance qualified home improvement loans. There are several limitations on qualified mortgage bonds, including income limitations for homebuyers, purchase price limitations, and a the requirement that the mortgagor be a "first-time homebuyer" – one that did not have any ownership interest in a primary residence for the previous three years. The first-time home buyer requirement does not apply to targeted area residences – one that is located in an area of chronic economic distress or a census tract in which at least 70% of the families have an income that is 80% or less of the statewide median income. A qualified home improvement loan may not exceed $15,000.

  This act eliminates the first-time homebuyer requirement with respect to qualified Hurricane Katrina recovery residences. A "qualified Hurricane Katrina recovery residence" is one that is financed before January 1, 2008, and is either 1) located in the core disaster area or 2) the mortgagor of which owned a principal residence in the Hurricane Katrina disaster area that was rendered uninhabitable by Hurricane Katrina and the residence financed is in the same state as the previous residence.

  The act also increases the maximum amount of a qualified home improvement loan to $150,000 for residences located in the Hurricane Katrina disaster area to the extent that the loan is for repair of damage caused by Hurricane Katrina.

- *Extension of replacement period for nonrecognition of gain.* A taxpayer generally realizes gain to the extent the sales price of property exceeds the taxpayer's basis in the property. The realized gain is subject to taxation unless it is deferred or not recognized under some special provision. Gain realized by a taxpayer from an involuntary conversion of property is deferred to the extent the taxpayer replaces the property within the applicable period. The applicable period begins when property is converted and ends two years after the close of the first taxable year in which the gain is realized.

  This act extends the applicable period from two years to five years for property that is located within the Hurricane Katrina disaster area that is compulsorily or involuntarily converted after August 25, 2005, by reason of Hurricane Katrina. Substantially all of the use of the replacement property must be in this area for this provision to apply.

- *Secretarial authority to make adjustments regarding taxpayer and dependency status for taxpayers affected by Hurricane Katrina.* This provision allows the Secretary of the Treasury to make adjustments to the tax laws to ensure that taxpayers do not lose eligibility for credits or deductions or experience a change in filing status due to temporary relocations caused by Hurricane Katrina. An example of such an adjustment would be allowing a parent to claim a personal exemption for a child even if the child did not satisfy the residency requirement as a result of a relocation due to Hurricane Katrina. Any adjustment must ensure

– food intended for human consumption that meets all quality and labeling standards imposed by federal, state, and local laws even though the food may not be readily marketable for any number of reasons.

- *Charitable deduction for contribution of book inventories.* A taxpayer's deduction for charitable contributions of inventory is generally limited to the lesser of the taxpayer's basis in the inventory (usually cost) or the fair market value of the inventory. For certain contributions of inventory, a C corporation may claim an enhanced deduction equal to the lesser of 1) basis plus one-half on the item's appreciation or 2) two times basis. To be eligible for the enhanced deduction, the contributed property must generally be inventory of the corporation, contributed to a charitable organization described in section 501(c)(3) of the Code, and the donee must 1) use the property consistent with the donee's exempt purpose only for the care of the ill, the needy, or infants, 2) not transfer the property in exchange for money, other property, or services, and 3) provide the taxpayer with a written statement attesting to the proper use of the property.

  This act extends the enhanced deduction for C corporations to qualified book contributions. A "qualified book contribution" is a charitable contribution of books to a public school that provides elementary education or secondary education and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils in attendance at the place where its education activities are regularly carried on.

Miscellaneous Provisions.

- *Exclusion for certain cancellations of indebtedness by reason of Hurricane Katrina.* Gross income includes income that is realized by a debtor for the discharge of indebtedness, subject to certain exceptions. This act provides that the gross income of a qualified individual does not include any amount which would otherwise by includible in gross income by reason of a discharge of nonbusiness debt if the indebtedness is discharged by an applicable entity. The relief allowed under this provision does not apply to any indebtedness to the extent that real property outside of the Hurricane Katrina disaster area serves as security for the debts. For the purposes of this provision, a "qualified individual" is any natural person whose principal place of abode on August 25, 2005, was located 1) in the core disaster area or 2) in the Hurricane Katrina disaster area and the person suffered economic loss as a result of Hurricane Katrina. An "applicable entity" includes the following: a financial institution; a credit union; a corporation that is a direct or indirect subsidiary of a financial institution or credit union and as such is subject to regulation by federal or state agencies; the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the National Credit Union Administration, and certain other federal executive agencies; an executive, judicial, or legislative agency; and any other organization the for whom the lending of money is a significant trade or business.

- *Suspension of certain limitations on personal casualty losses.* A taxpayer may generally claim a deduction for any loss sustained during the taxable year for which he is not compensated by insurance or otherwise. For individuals, the loss must be incurred in a trade or business or consist of property loss attributable to casualty or theft. Losses are deductible only if they exceed $100 per casualty or theft and total casualty and theft losses exceed 10% of the taxpayer's adjusted gross income. This act removes the $100 and 10% limitations on casualty and theft losses to the extent those losses are in the Hurricane Katrina disaster area on or after August 25, 2005, and are attributable to Hurricane Katrina.

- *Required exercise of IRS administrative authority.* In general, the Secretary of the Treasury may grant reasonable extensions of time to taxpayers to perform certain acts. In addition, for

purposes of this provision, a "Hurricane Katrina displaced individual" is a person 1) whose principal place of abode on August 28, 2005, was in the Hurricane Katrina disaster area, 2) who was displaced from the abode, 3) who is provided housing free of charge in the taxpayer's principal place residence for a period of 60 consecutive days that ends in the taxable year in which the exemption is claimed, and 4) is not the spouse or dependent of the taxpayer. For a person whose principal place of abode on August 28, 2005, was outside of the core disaster area, the person's abode must have been damaged by Hurricane Katrina or the person must have been evacuated from the abode by reason of Hurricane Katrina.

- *Increase in standard mileage rate for charitable use of vehicles.* In determining the amount of the charitable contribution deduction when a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer may either deduct actual operating expenditures or use the charitable standard mileage rate. The charitable standard mileage rate, 14 cents per mile, is significantly less than the business standard mileage rate[6]. The charitable rate is less than the business rate because it is meant to offset direct operating expenses, such as gas, only and not other expenses, such as a depreciation, insurance, or general maintenance.

  This act allows a taxpayer who uses a vehicle in providing donated service to charity for Hurricane Katrina relief only to compute the charitable mileage deduction at a rate equal to 70% of the business standard mileage rate, rounded to the next highest cent, on the date of the contribution. In the alternative, the taxpayer may continue to use actual operating expenditures to determine the amount of the deduction.

- *Mileage reimbursement to charitable volunteers excluded from gross income.* Volunteer drivers who are reimbursed for mileage expenses have taxable income to the extent that the reimbursement exceeds deductible expenses computed using either direct expenses or the charitable standard mileage rate. Under this act, reimbursement for mileage expenses by a charitable organization described in section 170(c) of the Code to a volunteer for the costs of using a passenger vehicle for Hurricane Katrina relief only are not included in income to the extent that the reimbursement does not exceed the amount that would be allowed using the business standard mileage rate. A taxpayer may not claim a deduction or credit for amounts excluded under this provision.

- *Charitable deduction for contribution of food inventories.* A taxpayer's deduction for charitable contributions of inventory is generally limited to the lesser of the taxpayer's basis in the inventory (usually cost) or the fair market value of the inventory. For certain contributions of inventory, a C corporation may claim an enhanced deduction equal to the lesser of 1) basis plus one-half on the item's appreciation or 2) two times basis. To be eligible for the enhanced deduction, the contributed property must generally be inventory of the corporation, contributed to a charitable organization described in section 501(c)(3) of the Code, and the donee must 1) use the property consistent with the donee's exempt purpose only for the care of the ill, the needy, or infants, 2) not transfer the property in exchange for money, other property, or services, and 3) provide the taxpayer with a written statement attesting to the proper use of the property.

  This act allows the enhanced deduction to any taxpayer engaged in a trade or business that makes a donation of food inventory. For taxpayers other than C corporations, the total deduction for contributions of food inventory may not exceed 10% of the taxpayer's income from all business entities from which a contribution of food inventory is made. The enhanced deduction is available only for food that qualifies as "apparently wholesome food,"

[6] For expenses incurred between January 1, 2005, and September 1, 2005, the standard business mileage rate was 40.5 cents per mile. For expenses incurred between September 1, 2005, and January 1, 2006, the standard business mileage rate was 48.5 cents per mile.

private foundations other than private non-operating foundations, and certain governmental units) are deductible up to 50% of the contribution base. Contributions of this type of property to nonoperating private foundations and certain other organizations are deductible up to 30% of the contribution base. Contributions of appreciated capital gain property to an organization described in section 170(b)(1)(A) of the Code are generally deductible up to 30% of the contribution base. A taxpayer may elect to bring all of these contributions of appreciated capital gain property under the 50% limitation by reducing the amount of the deduction by the amount of the appreciation of the property. Contributions of appreciated capital gains property to a private nonoperating foundation are deductible up to 20% of the contribution base. For corporations, charitable contributions are deductible up to 10% of the corporations taxable income computed without regard to net operating loss or capital loss carrybacks. For both individuals and corporations, excess charitable contributions may be carried forward for up to five years.

There is also an overall limitation on most itemized deductions for individuals. The total amount of otherwise allowable itemized deductions is reduced by three percent of the amount of the taxpayer adjusted gross income in excess of a certain threshold. However, the otherwise allowed deductions may not be reduced by more than 80%. This reduction is reduced to two percent for the 2006 and 2007 taxable years and to one percent for the 2008 and 2009 taxable years, is repealed for the 2010 taxable year, and is reinstated for the 2011 taxable year.

This act provides several exceptions to the limitations on charitable contribution deductions. For individuals, the deduction for qualified contributions is allowed up to the amount by which the taxpayer's contribution base exceeds the taxpayer's deductions for other charitable contributions. In most cases, this means that an individual may deduct charitable contributions up to 100% of the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. For corporations, the deduction for a qualified contribution is allowed up to amount by which the corporation's taxable income exceeds the deduction for other charitable contributions. For the purposes of these provisions, a "qualified contribution" is a cash contribution that is made between August 28, 2005, and December 31, 2005, to an organization described in section 170(b)(1)(A) of the Code. The term does not include a contribution of noncash property or one that is for the establishment or maintenance of a segregated fund or account with respect to which the donor reasonably expects to have advisory privileges with respect to the fund or account because of his status as donor. In the case of a corporation, the contribution must be for relief efforts related to Hurricane Katrina in order to be a qualified contribution.

In addition, for individuals the charitable deduction contribution, up to the amount of qualified contributions, is not treated as an itemized deduction and is not subject to the reduction for higher-income taxpayers.

- *Additional exemption for housing Hurricane Katrina displaced individuals.* In the aftermath of Hurricane Katrina, hundreds of thousands of residents of the affected areas were displaced. During this time of displacement, many individuals opened their homes to those who had been displaced. Generally, individuals are allowed personal exemptions in computing taxable income. Personal exemptions are allowed for the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. Personal exemptions are phased out for higher-income taxpayers.

  This act allowed a taxpayer an additional $500 exemption for each Hurricane Katrina displaced individual of the taxpayer, up to a maximum additional exemption of $2,000. The additional exemption is not subject to the phase out for higher-income taxpayers. For the

between August 25, 2005, and February 28, 2006. Because it is treated as a roll-over, that portion will not be included in income or subject to the 10% early withdrawal tax.

- *Loans from qualified plans for relief relating to Hurricane Katrina.* An individual is allowed to borrow from an qualified employer plan in which the individual participates provided the loan satisfies certain conditions. Generally, a loan from a qualified employer plan is treated as a taxable distribution of plan benefits. A loan is not treated as a tax distribution of benefits to the extent that the loan, when added to the outstanding balance of all other loans to the individual from all plans maintained by the employer, does not exceed the lesser of 1) $50,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or 2) the greater of $10,000 or one half the individual's accrued benefit under the plan. For this exception to apply, the loan must have a repayment period of five years or less, must be amortized in level payments, and must have payments due at least quarterly.

  This act provides special rules in the case of a loan from a qualified plan to a qualified individual. For the purposes of this provision, a "qualified individual" is one whose principal place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss because of Hurricane Katrina. Under this provision, the loan limit discussed above is increased to the lesser of 1) $100,000 reduced by the excess of the highest outstanding balance of loans from such plans during the one-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made or 2) the greater of $10,000 or the individual's accrued benefit under the plan.

  In addition, this act provides that in the case of a qualified individual with an outstanding loan from a qualified plan on or after August 25, 2005, if the due date for any repayment with respect to the loan occurs during the period from August 25, 2005, to December 31, 2006, the due date is delayed for one year.

Charitable Giving Incentives. In the wake of Hurricane Katrina, people from around the nation rushed to the aid of people in the affected areas with unprecedented amounts of charitable giving. As part of this act, Congress further encouraged and rewarded charitable giving.

- *Temporary suspension of limitations on charitable contributions.* In general, the income tax deduction allowed for charitable contributions is subject to limitations based on the type of taxpayer, the property contributed, and the donee organization. Subject to certain limitations, discussed further below, the following general rules apply: 1) Contributions of cash are deductible in the amount contributed; 2) Contributions of capital gain property[4] to a qualified charity are deductible at fair market value; 3) Contributions of other appreciated property are deductible at the donor's basis in the property; and 4) Contributions of depreciated property are deductible at the fair market value of the property.

  Most contributions are subject to percentage limitations. For individuals, the amount deductible is limited to a percentage of the taxpayer's contribution base[5]. The percentage varies depending on the type of donee organization and the type of property contributed. Contributions by an individual of property other than appreciated capital gain property to a charitable organization described in section 170(b)(1)(A) of the Code (public charities,

[4] "Capital gain property" means any capital asset or property used in the taxpayer's trade or business the sale which at its fair market value, at the time of contribution, would have resulted in a gain that would have been a long-term capital gain.
[5] The "contribution base" is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback.

General Provisions. The act contains definitions of several key phrases that are used throughout the act. Under the act, "Hurricane Katrina disaster area" means an area with respect to which a major disaster has been declared by the President before September 14, 2005, with respect to Hurricane Katrina. The states of Alabama, Florida, Louisiana, and Mississippi comprise the Hurricane Katrina disaster area. The act also defines the term "core disaster area." The core disaster area is a subset of the Hurricane Katrina disaster area that has been determined by the President to warrant individual or individual and public assistance from the federal government. The core disaster area covers certain counties and parishes in Alabama, Louisiana, and Mississippi.

Retirement Funds. The act contains a number of special rules related to retirement funds for people who lived in the Hurricane Katrina disaster area or the core disaster area. Generally, these provisions allow for a more liberal use of retirement funds for emergency needs than would otherwise be allowed without subjecting the taxpayer to some sort of penalty or disincentive. These provisions include the following:

- *Tax favored withdrawals from retirement plans for relief relating to Hurricane Katrina.* Generally, a withdrawal from a qualified retirement plan, a tax-sheltered annuity, an IRA, or an eligible deferred compensation plan maintained by a state or local government is included in taxable income in the year in which it is made. In addition, a distribution that is received before death, disability, or the age of 59 ½ is generally subject to a 10% early withdrawal tax. Some distributions are known as eligible rollover distributions and are not included in taxable income or subject to the 10% penalty tax. These distributions must be rolled over into another qualified retirement account within 60 days.

  This act provides an exception to the 10% early withdrawal tax in the case of a qualified Hurricane Katrina distribution[3] from a qualified retirement plan, tax-sheltered annuity, or IRA. In addition, any amount required to be included in income as a result of a qualified Hurricane Katrina distribution is included in income in installments over the three-year period beginning with the year in which the distribution is made rather than entirely within the year that the distribution is made. Finally, any amount of a qualified Hurricane Katrina distribution that is recontributed to an eligible retirement account within the three-year period is treated as a roll-over distribution and is not included in income.

- *Recontribution of withdrawals for home purchases cancelled due to Hurricane Katrina.* There is an exception to the 10% early withdrawal tax discussed above in the case of a qualified first-time homebuyer distribution from an eligible retirement account. A qualified first-time homebuyer distribution is one that does not exceed $10,000 and that is used within 120 days of the distribution for the purchase or construction of a principal residence of a first-time homebuyer. If the distribution is not used for the purchase of the home within 120 days or is not rolled over into an eligible retirement account within 60 days, the distribution is included in income and is subject to the 10% early withdrawal tax.

  This act allows a taxpayer that received a qualified distribution from a retirement account to recontribute that amount to an eligible retirement account without penalty. For the purposes of this provision, a "qualified distribution" is a distribution that was received after February 28, 2005, and before August 29, 2005, and that was to be used to purchase or construct a principal residence in the Hurricane Katrina disaster area, but the residence is not purchased or constructed because of Hurricane Katrina. Any portion of a qualified distribution may be contributed to an eligible retirement account and treated as a roll-over if it is recontributed

[3] A "qualified Hurricane Katrina distribution" is a distribution made from an eligible retirement plan on or after August 25, 2005, and before January 1, 2007, to an individual whose primary place of abode on August 28, 2005, is located in the Hurricane Katrina disaster area and who has sustained an economic loss due to Hurricane Katrina. The total amount of qualified Hurricane Katrina distributions to a taxpayer from all accounts may not exceed $100,000.

natural gas depreciation lines placed in service between April 11, 2005, and January 1, 2011, to be depreciated over a 15-year period.

- *Depreciation of natural gas gathering pipelines.* Prior to the enactment of this act, there was a disagreement among the courts as to what asset class natural gas gathering pipelines owned by a nonproducer belonged. The IRS maintained, and this position was supported by the Tax Court, that these pipelines belonged to an asset class subject to depreciation over 15 years. The Courts of Appeals in the Sixth, Eighth, and Tenth Circuits, however, held that these pipelines belonged to an asset class subject to depreciation over 7 years. There was agreement that natural gas gathering pipelines owned by a producer were part of the asset class subject to depreciation over 7 years. This act clarifies that all natural gas gathering pipelines, regardless of ownership, are subject to depreciation over 7 years. This provision applies to natural gas gathering pipelines placed in service after April 11, 2005.

- *Geological and geophysical costs amortized over two years.* Geological and geophysical costs are those incurred for the purpose of accumulating data that serves as the basis for the decision about acquisition or retention of mineral rights by taxpayers in the business of exploring for minerals (including gas and oil). Courts have held these costs to be capital in nature and allocable to the property acquired or retained. If no property was acquired or retained, the costs were treated as a capital loss. This act provides that these costs, when incurred in the United States for oil or gas exploration, shall be amortized ratably over a 24-month period beginning on the mid-point of the taxable year in which the costs were incurred. The act does not affect the treatment of costs incurred outside of the United States or with respect to exploration for minerals other than oil or gas.

- *84-month amortization of air pollution control facilities.* Current law allows taxpayers to amortize a certified pollution control facility used in connection with a plant that was in operation before January 1, 1976, over a 60-month period. For certified pollution control facilities placed in service after April 11, 2005, this act eliminates the requirement that the property be used in connection with a plant that was in operation before 1976 if the plant is an electric generation plant that is primarily coal fired. For property that satisfies this criteria, the amortization period is 84-months. The act does not lengthen the amortization period for property that was covered by previous law, it provides a favored, though not as generously favored, method of depreciation for another class of property.

Safe, Accountable, Flexible, Efficient Transportation Equity Act of 2005 (P.L. 109-59) (hereinafter SAFE Act)

Although this act makes numerous tax changes at the federal level, these changes have little to no direct impact at the State level

Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) (hereinafter Katrina Act)

2005 was a record-setting year on the meteorological front. Not only did the year see a record number of named storms (27) and a record number of hurricanes (14), the year also included the costliest Atlantic hurricane on record and one of the deadliest, Hurricane Katrina. Hurricane Katrina made landfall along the Gulf Coast on August 29, 2005, as a Category 4 storm. Hurricane Katrina resulted in the deaths of more than 1,400 people and caused over $80 billion in property damage.

In the aftermath of Hurricane Katrina, Congress took action to assist taxpayers in the affected region. On September 21, 2005, Congress passed the Katrina Emergency Tax Relief Act of 2005, which was signed into law by President Bush on September 23, 2005. The act is collection of tax relief provisions for individuals and businesses. Below, the key provisions of this act that could have an impact on State revenues are summarized.

amortizable property that is installed in a commercial building that meets certain standards for energy efficiency; 2) The property is installed as part of the interior lighting, heating, cooling, ventilation, or hot water systems or the building envelope; and 3) The property is installed as part of a plan to reduce the total annual energy costs of the building with respect to the interior lighting, heating, cooling, ventilation, and hot water systems by at least 50% as compared to a similar building that meets certain minimum standards for energy efficiency. The IRS is required to issue regulations relating to eligibility for a partial deduction and to the transfer of a deduction from a public entity (like the State) to the person responsible for designing the property.

- *Recapture of section 197 amortization.* Generally, property subject to amortization under section 197 of the Code is intangible property that is purchased and held by a taxpayer in the course of a business. Section 197 property includes goodwill, covenants not to compete, patents, copyrights, trademarks and certain licenses. The cost of section 197 property is recoverable over fifteen years using straight-line depreciation. Under general rules, gain on the sale of depreciable property must be recaptured as ordinary income to the extent of depreciation deductions previously claimed. Under general rules, the recapture amount is computed separately for each piece of property. This act provides that if multiple pieces of section 197 property are sold or disposed of in a single transaction or series of transactions, then the taxpayer must compute the recapture as if all of the property were a single asset. The effect of this change is to maximize the amount of income treated as recapture, and thus as ordinary income, and the lessen the amount treated as a capital gain, which is taxed at a lower rate.

- *Depreciation of electric transmission property.* Generally, under the modified accelerated cost recovery system (MACRS) assets used in the transmission and distribution of electricity for sale have a 20-year recovery period. This act allows the costs of certain electric transmission property placed into service after April 11, 2005, to be recovered over 15 years instead of 20.

- *Expensing liquid fuel refineries.* Under previous law, petroleum refining assets were depreciated over a 10-year recovery period using the double declining balance method. Petroleum refining assets are assets used for distillation, fractionation, and catalytic cracking of crude petroleum into gasoline and other petroleum products. This acts allows a taxpayer to make an election to expense 50% of the cost of qualified refinery property in the year in which the property is placed into service. "Qualified refinery property" includes any portion of a qualified refinery that satisfies the following conditions: 1) The original use of the property commences with the taxpayer; 2) The property is placed in service between August 8, 2005, and January 1, 2012; 3) The property satisfies certain production capacity requirements; 4) The property satisfies all applicable environmental laws in effect when it is placed into service; 5) No written binding contract for the construction of the property was in effect on or before June 14, 2005; and 6) The construction of the property is subject to a written binding contract entered into before January 1, 2008. A "qualified refinery" is one that is located in the United States and that is designed to serve the primary purpose of processing liquid fuel from crude oil or qualified fuels (including shale and tar sands and coal seams). The expensing election is not available with respect to a refinery that is used primarily as a topping plant, asphalt plant, lube oil facility, crude or product terminal, or blending facility.

- *Depreciation of natural gas distribution lines.* Under previous law, natural gas distribution lines installed by a gas company were depreciated over a 20-year period. This act allows

Between January 1, 2005, and January 1, 2006, there were four major pieces of federal legislation that made changes to the Internal Revenue Code. This federal legislation includes the Energy Tax Incentive Act of 2005 (P.L. 109-58) signed into law on August 8, 2005, the SAFE Transportation Equity Act of 2005 (P.L. 109-59) signed into law on August 10, 2005, the Katrina Emergency Tax Relief Act of 2005 (P.L. 109-73) signed into law on September 23, 2005, and the Gulf Opportunity Zone Act of 2005 (P.L. 109-135) signed into law on December 21, 2005.

Energy Tax Incentive Act of 2005 (P.L. 109-58) (hereinafter Energy Act)

Many of the changes made in this act involve tax credits for various activities. Because they are tax credits, these provisions do not have a direct impact at the State level. There are, however, several provisions that could have an impact at the State level, most of which involve the depreciation, amortization, or expensing of certain items.

- *Elimination of deduction for clean-fuel vehicles.* Under previous law, a taxpayer was allowed a deduction for the purchase of a qualified clean-fuel vehicle. A "qualified clean-fuel vehicle" is any motor vehicle that may be propelled by a clean-burning fuel such as natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, electricity, or any other fuel at least 85% of which is methanol, ethanol, or other alcohol or ether. The maximum amount of the deduction varied depending on the type of vehicle purchased. The deduction began to be phased out in 2004, and was set to be eliminated after the 2006 taxable year. This act moves up the phase-out so that the deduction is eliminated after the 2005 taxable year. In place of the deduction, this act creates a new federal credit for alternative fuel motor vehicles.

- *Tax deferral for gains on electric transmission assets.* Under current law, a taxpayer may elect to recognize qualified gain from a qualifying electric transmission transaction over an eight-year period. In order for a transaction to be a "qualifying electric transmission transaction" numerous conditions must be satisfied, one of which is that the transaction must be completed before January 1, 2007. This act extends that date by one year to January 1, 2008.

- *Deduction for nuclear decommissioning costs.* Utilities that own or operate a nuclear power plant are required by law to decommission the plant at the end of its useful life. A utility may elect to deduct contributions it makes to a nuclear decommissioning reserve fund established to help pay the costs associated with the eventual decommissioning. For previous tax years, contributions to such a reserve fund were limited to the lesser of the amount of nuclear decommission costs allocable to the fund that is included in the taxpayer's cost of services for ratemaking purposes for the taxable year and the ruling amount. The "ruling amount" is a schedule obtained from the IRS that specifies the annual payments that must be made into the fund to cover of the amount of the decommission costs allocable to the fund over its existence. This act eliminates the "lesser of" test for taxable years beginning on or after January 1, 2006, and instead limits the deduction to the ruling amount.

- *Energy efficient commercial buildings property deduction.* Despite the fact that large commercial buildings use approximately one-fourth of the electrical energy consumed in the nation, there is currently no federal tax incentive to encourage the use of energy-efficient property in the construction or renovation of commercial buildings. This act allows taxpayers to claim a deduction (as opposed to depreciation or amortization) with respect to costs associated with energy-efficient commercial building property placed into service between January 1, 2006, and January 1, 2008. The maximum amount that may be deducted is $1.80 per square foot of the building, less any amount deducted under this provision with respect to the same building in previous tax years. In order to qualify for the deduction, the following conditions must be satisfied: 1) The costs must be associated with depreciable or

DRAFT 2005-LYxz-284: IRC Update

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	February 8, 2006
Introduced by:		**Summary by:**	Y. Canaan Huie
Version:	Draft 2005-LYxz-284		Committee Counsel

SUMMARY: This bill would update the reference to the Internal Revenue Code used in defining and determining certain State tax provisions. In addition the bill would shorten the time span in which a taxpayer would have to file an amended estate, income, or gift tax return when the federal government corrects or otherwise determines the amount on which the tax is based. The bill also conforms the filing date for income tax returns for a nonresident alien to the federal dates. Finally, the bill would conform the amounts for the credit for child care and certain employment-related expenses to the amounts allowed for the corresponding federal credit.

CURRENT LAW: Currently the reference date for the Internal Revenue Code is January 1, 2005.

When the federal government corrects or otherwise determines the amount on which an estate, income, or gift tax is based, the taxpayer must file a State return within 2 years that reflects that change.

Nonresidents aliens are currently required to file State income tax returns before their federal returns are due.

Currently, the credit for child care and certain employment-related expenses may not be based on expenses in excess of $2,400 if the household includes one qualifying individual or $4,800 if the household includes more than one qualifying individual.

BILL ANALYSIS:

IRC UPDATE

North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.[1] The General Assembly determines each year whether to update its reference to the Internal Revenue Code.[2] Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State law tracks federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. This bill would change the reference date from January 1, 2005, to January 1, 2006, effective when the bill become law.

[1] North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

[2] The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power."

Secretary of Revenue shall determine from all available evidence the taxpayer's correct tax liability for the taxable year. As used in this section, the term 'all available evidence' means evidence of any kind that becomes available to the Secretary from any source, whether or not the evidence was considered in the federal correction or determination.

The Secretary shall assess and collect any additional tax due from the taxpayer as provided in Article 9 of this Chapter. The Secretary shall refund any overpayment of tax as provided in Article 9 of this Chapter. A taxpayer who fails to comply with this section is subject to the penalties in G.S. 105-236 and forfeits the right to any refund due by reason of the determination."

SECTION 7. G.S. 105-130.17 is amended by adding a new subsection to read:

"(g) A corporation that files a federal return pursuant to section 6072(c) of the Code shall file its return on or before the fifteenth day of the sixth month following the close of its income year"

SECTION 8. G.S. 105-155(a) reads as rewritten:

"(a) ~~Where and When to File.~~Return. – An income tax return shall be filed ~~as prescribed by the Secretary~~ at the place and in the form prescribed by the Secretary. The income tax return of every taxpayer reporting on a calendar year basis ~~shall be filed~~is due on or before the fifteenth day of April in each ~~year, and the~~year. The income tax return of every taxpayer reporting on a fiscal year basis ~~shall be filed~~is due on or before the fifteenth day of the fourth month following the close of the fiscal year. These dates do not apply to a nonresident alien whose federal income tax return is due at a later date under section 6072(c) of the Code. The return of a nonresident alien affected by that Code section is due on or before the fifteenth day of the sixth month following the close of the taxable year. An information return shall be filed at the times prescribed by the Secretary. A taxpayer may ask the Secretary for an extension of time to file a return under G.S. 105-263."

SECTION 9. G.S. 105-151.11(b) reads as rewritten:

"(b) Employment Related Expenses. – The amount of employment-related expenses for which a credit may be claimed may not exceed ~~two thousand four hundred dollars ($2,400)~~three thousand dollars ($3,000) if the taxpayer's household includes one qualifying individual, as defined in section 21(b)(1) of the Code, and may not exceed ~~four thousand eight hundred dollars ($4,800)~~ six thousand dollars ($6,000) if the taxpayer's household includes more than one qualifying individual. The amount of employment-related expenses for which a credit may be claimed is reduced by the amount of employer-provided dependent care assistance excluded from gross income."

SECTION 10. Sections 1, 2, and 10 of this act are effective when they become law. Sections 3 through 6 of this act become effective July 1, 2006, and apply to federal determinations made on or after that date. Sections 7 through 9 of this act are effective for taxable years beginning on or after January 1, 2006.

transfer must, within ~~two years~~six months after being notified of the correction or final determination by the federal government, file a tax return with the Secretary reflecting the correct amount of tax payable under this Article.

The Secretary must assess and collect any additional tax due as provided in Article 9 of this Chapter and must refund any overpayment of tax as provided in Article 9 of this Chapter. A person who fails to report a federal correction or determination in accordance with this section forfeits the right to any refund due by reason of the determination."

SECTION 4. G.S. 105-130.20 reads as rewritten:

"**§ 105-130.20. Federal corrections.**

If a taxpayer's federal taxable income is corrected or otherwise determined by the federal government, the taxpayer must, within ~~two years~~six months after being notified of the correction or final determination by the federal government, file an income tax return with the Secretary reflecting the corrected or determined taxable income. The Secretary shall determine from all available evidence the taxpayer's correct tax liability for the income year. As used in this section, the term 'all available evidence' means evidence of any kind that becomes available to the Secretary from any source, whether or not the evidence was considered in the federal correction or determination.

The Secretary shall assess and collect any additional tax due from the taxpayer as provided in Article 9 of this Chapter. The Secretary shall refund any overpayment of tax as provided in Article 9 of this Chapter. A taxpayer that fails to comply with this section is subject to the penalties in G.S. 105-236 and forfeits its rights to any refund due by reason of the determination."

SECTION 5. G.S. 105-159 reads as rewritten:

"**§ 105-159. Federal corrections.**

If a taxpayer's federal taxable income is corrected or otherwise determined by the federal government, the taxpayer must, within ~~two years~~ six months after being notified of the correction or final determination by the federal government, file an income tax return with the Secretary reflecting the corrected or determined taxable income. The Secretary shall determine from all available evidence the taxpayer's correct tax liability for the taxable year. As used in this section, the term 'all available evidence' means evidence of any kind that becomes available to the Secretary from any source, whether or not the evidence was considered in the federal correction or determination.

The Secretary shall assess and collect any additional tax due from the taxpayer as provided in Article 9 of this Chapter. The Secretary shall refund any overpayment of tax as provided in Article 9 of this Chapter. A taxpayer who fails to comply with this section is subject to the penalties in G.S. 105-236 and forfeits the right to any refund due by reason of the determination."

SECTION 6. G.S. 105-197.1 reads as rewritten:

"**§ 105-197.1. Federal corrections.**

If the amount of a taxpayer's net gifts is corrected or otherwise determined by the federal government, the taxpayer must, within ~~two years~~ six months after being notified of the correction or final determination by the federal government, file a gift tax return with the Secretary of Revenue reflecting the corrected or determined net gifts. The

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-LYxz-284 [v.4] (1/20)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
5/2/2006 9:55:53 AM

Short Title: IRC Update. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO UPDATE THE REFERENCE TO THE INTERNAL REVENUE CODE USED IN DEFINING AND DETERMINING CERTAIN STATE TAX PROVISIONS AND TO MAKE OTHER CHANGES TO MORE CLOSELY CONFORM TO FEDERAL TAX LAW.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-228.90(b)(1b) reads as rewritten:

"(b) Definitions. – The following definitions apply in this Article:

...

(1b) Code. – The Internal Revenue Code as enacted as of January 1, ~~2005,~~2006, including any provisions enacted as of that date which become effective either before or after that date."

SECTION 2. Notwithstanding Section 1 of this act, any amendments to the Internal Revenue Code enacted after January 1, 2005, that increase North Carolina taxable income for the 2005 taxable year become effective for taxable years beginning on or after January 1, 2006.

SECTION 3. G.S. 105-32.8 reads as rewritten:

"**§ 105-32.8. Federal determination that changes the amount of tax payable to the State.**

If the federal government corrects or otherwise determines the gross estate tax imposed under section 2001 of the Code or the amount of the maximum state death tax credit allowed an estate under section 2011 of the Code, the personal representative must, within ~~two years~~ six months after being notified of the correction or final determination by the federal government, file an estate tax return with the Secretary reflecting the correct amount of tax payable under this Article. If the federal government corrects or otherwise determines the amount of the maximum state generation-skipping transfer tax credit allowed under section 2604 of the Code, the person who made the

LEGISLATIVE PROPOSAL #7

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2006 REGULAR SESSION OF THE 2006 GENERAL ASSEMBLY

AN ACT TO UPDATE THE REFERENCE TO THE INTERNAL REVENUE CODE USED IN DEFINING AND DETERMINING CERTAIN STATE TAX PROVISIONS.

SHORT TITLE: IRC Update

SPONSORS:

BRIEF OVERVIEW: This proposal would update the reference to the Internal Revenue Code used in defining and determining certain State tax provisions. In addition the proposal would shorten the time span in which a taxpayer would have to file an amended estate, income, or gift tax return when the federal government corrects or otherwise determines the amount on which the tax is based. The proposal would also conform the filing date for income tax returns for a nonresident alien to the federal dates. Finally, the bill would conform the amounts for the credit for child care and certain employment-related expenses to the amounts allowed for the corresponding federal credit.

FISCAL IMPACT:

EFFECTIVE DATE: Different portions of the proposal would become effective when it became law, on July 1, 2006, or for taxable years beginning on or after January 1, 2006

A copy of the proposed legislation, bill analysis, and fiscal analysis begin on the next page.

LEGISLATIVE PROPOSAL #7

IRC UPDATE

ASSUMPTIONS AND METHODOLOGY:
The NC Department of Revenue uses an appraisal method that uses income as a factor in appraising public service company property. County assessors utilize the cost approach, which does not use income as a factor. Because of the differences in appraisal methods, there may be some differences in appraised value of public service company property included in this bill, however the amount of the impact cannot be determined until the appraisals are conducted.

SOURCES OF DATA: NC Department of Revenue

TECHNICAL CONSIDERATIONS: None

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 18, 2006

TO: Revenue Laws Study Committee

FROM: Rodney Bizzell
Fiscal Research Division

RE: 2005-LAz-31 v.3 - Phone, Tower and Cable Property Tax Appraisal

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES: NC Local Governments	See "Assumptions and Methodology"				
EXPENDITURES:					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: NC Department of Revenue, NC Local Governments

EFFECTIVE DATE: Effective for taxable years beginning on or after July 1, 2007.

BILL SUMMARY:
This bill would authorize the Department of Revenue to appraise wireless companies, paging companies, tower companies and cable companies as part of its duty to appraise system property used by public service companies and to allocate its value to the appropriate local taxing units. The bill would eliminate the need for these companies to list their property at the local level. The definition of "telephone companies" would be replaced with a definition of telecommunications companies that provide telecommunications service, which would include wireless companies and paging companies. The bill adds definitions for "tower company" and "cable company."

The Department must allocate the valuations of public service company property among the local taxing units. Each local taxing unit then applies its tax rate to the apportioned valuation just as it does for any other type of property.

BILL ANALYSIS: The draft would authorize the Department of Revenue to appraise wireless companies, paging companies, cable companies, and tower companies as part of its duty to appraise system property used by public service companies. The counties have requested that the Department of Revenue take over this duty. By replacing the statutory definition of "telephone companies" with a definition of telecommunications companies that provide telecommunications service, the Department would thus pick up wireless companies and paging companies. Telecommunications service would have the same definition as that term does in the Streamlined Sales Tax Agreement. The draft would also pick up cable companies and tower companies.

In practice most counties use only the cost approach in appraising wireless companies, cable companies, and tower companies, since they do not have the capability to consider other approaches such as the gross receipts and operation income of a company. The determination of the true value of the property of these companies would be more accurately determined by transferring the duty to appraise from the counties to the Department. Also these companies would no longer need to list their property at the county level.

EFFECTIVE DATE: The bill is effective for taxes imposed for taxable years beginning on or after July 1, 2007.

2005-LAz-31 SMLA

DRAFT 2005-LAz-31:
Phone, Tower, & Cable Property Tax Appraisal

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	April 27, 2006
Introduced by:		**Summary by:**	Martha Walston Committee Counsel
Version:	Draft 2005-LAz-31		

SUMMARY: ***The draft proposal is a recommendation of the Department of Revenue that would broaden the Department's authority to appraise the property of public service companies for property tax purposes by:***

- ***Replacing the definition of "telephone company" with the definition of "telecommunications company". This definition would include wireless companies and paging companies.***
- ***Adding definitions for "tower company" and "cable company" and including these companies in the definition of public service companies appraised by the Department of Revenue.***
- ***Making conforming changes to the appraisal statute and allocation statute.***

The draft also would delete obsolete language and make stylistic changes.

Counties have requested the Department to begin appraising these companies, since many of the counties do not have the capability to determine the true value of the companies' property.

CURRENT LAW: Each year the North Carolina Department of Revenue must appraise, at its true value, the system property[1] used by each public service company (other than bus line, motor freight carrier, and airline companies) both within and without the State. The Department must also appraise the rolling stock[2] of a bus line company or motor freight carrier company, and the flight equipment of an airline company each year.

In determining the true value of public service companies, the Department must consider the following:

- The market value of the company's capital stock and debt.
- The book value of the company's system property as reflected in the books of account kept under the regulations of the appropriate federal or State regulatory agency and what it would cost to replace or reproduce the system property, less a reasonable allowance for depreciation.
- Gross receipts and operation income of the company.
- Any other factor or information that in the judgment of the Department has a bearing on the true value of the company's system property.

If a public service company is operating both inside and outside the State, then the Department must apportion, for taxation in North Carolina, a fair and reasonable share of the value of the company using property, business, and mileage factors.

[1] System property refers to the real and tangible personal property used by a public service company in its public service activities.

[2] Rolling stock refers to motor vehicles, railroad locomotives, and railroad cars.

Board make an allocation to a taxing unit if, when computed, the valuation for that taxing unit amounts to less than five hundred dollars ($500.00).

(2) The appraised valuation of the rolling stock (other than locally assigned rolling stock) owned or leased by a motor freight carrier company shall be allocated for taxation to each local taxing unit in which the company has a terminal according to the ratio of the tons of freight handled in the calendar year preceding January 1 at the company's terminals within the taxing unit to the total tons of freight handled by the company in this State in the same period. If a North Carolina interstate motor freight carrier company has no terminal outside this State, but has been required to pay ad valorem tax to one or more taxing units outside this State, there shall be allowed a reduction in the North Carolina valuation measured by the ratio of the rolling stock subject to ad valorem taxation outside the State to all of the carrier's rolling stock.

(3) The appraised valuation of an airline company's flight equipment shall be allocated for taxation to each local taxing unit in which an airport used by the company is situated according to the ratio obtained by averaging the following two ratios: the ratio of the company's ground hours in the taxing unit in the year preceding January 1 to the company's ground hours in the State in the same period, and the ratio of the company's gross revenue in the taxing unit in the year preceding January 1 to the company's gross revenue in the State in the same period.

(4) The appraised valuation of towers and related site improvements owned by a tower company shall be allocated for taxation to each local taxing unit in which the tower company operates according to the ratio of the total tower height of the company's towers located in the taxing unit on January 1 to the total tower height of the company's towers located in the State on the same date."

SECTION 3. This act is effective for taxes imposed for taxable years beginning on or after July 1, 2007.

to be allocated as Class 1 and Class 2 valuations to local taxing units in accordance with subdivision (b)(2)b, below.

b. Having made the division required by subdivision (b)(2)a, above, the Department of Revenue shall allocate the appraised valuation of the properties in each class among the local taxing units of the State as follows:

– Class 1: The appraised valuations of property in this class shall be allocated among the local taxing units in which such property of the company is situated on January 1 in the proportion that the original cost of such property in the taxing unit bears to the original cost of all such property in this State.

– Class 2: The appraised valuations of property in this class shall be allocated among the local taxing units in which the company operates in the proportion that the miles of the company's ~~single aerial wire and single wire in cable (including single tube in coaxial cable)~~transmission wires or cables in the taxing unit bears to the company's total of ~~such~~ wire or cable miles ~~of the company~~ in this State.

(3) System Property of ~~Other Companies Appraised by the Department of Revenue.~~Electric, Gas, and Pipeline Companies. –

a. The provisions of this subdivision (b)(3) shall govern the allocation of the property of ~~all companies appraised by the Department of Revenue except railroad, telephone, bus line, motor freight carrier, and airline companies.~~electric, gas, and pipeline companies.

b. The appraised valuation of the system property of such a company shall be allocated for taxation to the local taxing units in which the company operates in the proportion that the original cost of the taxable system property in the local taxing unit on January 1 bears to the original cost of all the taxable system property in this State. If in any local taxing unit the company owns system property acquired prior to January 1, 1972, for which the original cost cannot be definitely ascertained, a reasonable estimate of the original cost of that property shall be made by the company, and this estimate shall be used by the Department of Revenue for allocation purposes as if it were the actual original cost of the property.

(c) Property of Bus Line, Motor Freight Carrier, ~~and Airline~~Airline, and Tower Companies. –

(1) The appraised valuation of a bus line company's rolling stock shall be allocated for taxation to each local taxing unit according to the ratio of the company's scheduled miles during the calendar year preceding January 1 in each such unit to the company's total scheduled miles in this State for the same period. In no event, however, shall the State

(3) Flight Equipment. – Each year, as of January 1, the Department shall appraise at its true value ~~(as defined in G.S. 105-283)~~ the flight equipment owned or leased by or operated under the control of each airline company that is domiciled in the State or that is regularly engaged in business at some airport in this State.

(4) Tower Equipment. – Each year, as of January 1, the Department shall appraise at its true value the towers and related site improvements owned by each tower company."

SECTION 2. G.S. 105-338 reads as rewritten:

"**§ 105-338. Allocation of appraised valuation of system property among local taxing units.**

(a) State Board's Duty. – For purposes of taxation by local taxing units in this State, the Department of Revenue shall allocate the valuations of public service company property among the local taxing units in accordance with the provisions of this section.

(b) System Valuation of ~~Companies Other Than Those Noted in Subsection (c).~~Electric, Gas, Pipeline, Railroad, Telecommunications, and Cable Companies. –

(1) System Property of Railroad Companies. – The appraised valuation of the distributable system property of a railroad shall be allocated for taxation to the local taxing units in accordance with the ratio of the miles of all the company's tracks in the local taxing unit to the total miles of all the company's tracks in this State, adjusted to reflect density of traffic in the local taxing unit.

(2) System Property of ~~Telephone~~ Telecommunications and Cable Companies. –

a. The Department of Revenue shall divide ~~each telephone company's~~the system property of each telecommunications company and cable company in this State into the following two classes and shall determine the original cost of that property and the percentage thereof represented by the property in each of the two classes.

– Class 1: Property located in this State that is identified under the applicable uniform system of accounts as central office equipment, ~~large P.B.X. equipment,~~cellular equipment, personal communication service equipment, motor vehicles, tools and work equipment, office furniture and equipment, materials and supplies, and land and buildings (including towers and other structures).

– Class 2: Property located in this State that does not come within Class 1.

The Department of Revenue shall then apply the percentages obtained in accordance with this subdivision to the appraised valuation of the company's system property in this State and thereby derive the proportions of appraised valuation

SECTION 2. G.S. 105-335 reads as rewritten:

"**§ 105-335. Appraisal of property of public service companies.**

(a) Duty to Appraise. – ~~In accordance with the provisions of subsection (b), below, the~~The Department of Revenue ~~shall~~ must appraise for taxation the true value of each public service company ~~(other than bus line, motor freight carrier, and airline companies) as a system (both inside and outside this State). Certain specified properties of bus line, motor freight carrier, and airline companies shall be appraised by the Department in accordance with the provisions of subsection (c), below, and all other properties of such companies shall be listed, appraised, and assessed in the manner prescribed by this Subchapter for the properties of taxpayers other than public service companies.~~in accordance with this section.

(b) Property of ~~Public Service Companies Other Than Those Noted in Subsection (c).~~Electric, Gas, Pipeline, Telecommunications, and Cable Companies. –

(1) System Property. – Each year, as of January 1, the Department of Revenue ~~shall~~ must appraise at its true value ~~(as defined in G.S. 105-283)~~ the system property used by each public service company both inside and outside this State. Property leased by a public service company shall be included in appraising the value of its system property if necessary to ascertain the true value of the company's system property.

(2) Nonsystem Personal Property. – Each year as of January 1, the Department shall appraise at its true value ~~(as defined in G.S. 105-283)~~ each public service company's nonsystem tangible personal property subject to taxation in this State.

(3) Nonsystem Real Property. – In accordance with the county in which the public service company's nonsystem real property is located and the schedules set out in G.S. 105-286 and 105-287, the Department of Revenue shall appraise at its true value ~~(as defined in G.S. 105-283)~~ each public service company's nonsystem real property subject to taxation in this State.

(c) Property of Bus Line, Motor Freight Carrier, ~~and Airline~~Airline, and Tower Companies. –

(1) Bus Company Rolling Stock. – Each year as of January 1, the Department shall appraise at its true value ~~(as defined in G.S. 105-283)~~ the rolling stock owned or leased by or operated under the control of each bus line company, which bus line company is domiciled in this State or which is regularly engaged in business in this State.

(2) Motor Freight Carrier Company Rolling Stock. – Each year as of January 1, the Department shall appraise at its true value ~~(as defined in G.S. 105-283)~~ the rolling stock owned by a motor freight carrier company or leased by a motor freight carrier company and operated by its employees which motor freight carrier company is domiciled in this State or is regularly engaged in business in this State at a terminal owned or leased by the carrier.

(13) Pipeline company. – A company engaged in the business of transporting natural gas, petroleum products, or other products through pipelines to, from, within, or through this State, or having control of pipelines for such a purpose.

(14) Public service company. – A railroad company, a pipeline company, a gas company, an electric power company, an electric membership corporation, a ~~telephone~~ telecommunications company, a cable company, ~~a telegraph company,~~ a bus line company, an airline company, ~~or~~ a motor freight carrier ~~company.~~company, or a tower company. The term also includes any company performing a public service that is regulated by the United States Department of Energy, the United States Department of Transportation, the Federal Communications Commission, the Federal Aviation Agency, or the North Carolina Utilities Commission, except that the term does not include a water ~~company, a radio common carrier company as defined in G.S. 62-119(3), a cable television company,~~company or a radio or television broadcasting company.

(15) Railroad company. – A company engaged in the business of operating a railroad to, from, within or through this State on rights-of-way owned or leased by the company. It also means a company operating a passenger service on the lines of any railroad located wholly or partly in this State.

(16) Rolling stock. – Motor vehicles, railroad locomotives, and railroad cars that are propelled by mechanical or electrical power and used upon the highways or, in the case of railroad vehicles, upon tracks.

(17) System property. – The real property and personal property used by a public service company in its public service activities. The term also includes public service company property under construction on the day as of which property is assessed which when completed will be used by the owner in its public service activities.

~~(18) Telegraph company. – A company engaged in the business of transmitting telegraph messages to, from, within, or through the State.~~

(19) ~~Telephone~~ Telecommunications company. – A company engaged in the business of ~~transmitting telephone messages and conversations to, from, within, or through this State.~~providing telecommunications service, as defined in G.S. 105-164.3.

(20) Repealed by Session Laws 1973, c. 783, s. 5. (1939, c. 310, ss. 1600-1605; 1943, c. 634, s. 3; 1965, c. 287, s. 17; 1971, c. 806, s. 1; c. 1121, s. 4; 1973, c. 198; c. 783, ss. 1-5; c. 1180; 1991 (Reg. Sess., 1992), c. 961, s. 1; 1995, c. 350, ss. 1, 2; 1995 (Reg. Sess., 1996), c. 646, s. 18; 1997-23, ss. 6, 7; 1998-98, s. 25.)

(21) Tower company. – A company engaged in the business of owning towers that are used to provide telecommunications service.

(22) True value. – Defined in G.S. 105-283."

Statutes and engaged in the business of supplying electricity for light, heat, or power to consumers in this State.

(5) Electric power company. – A company engaged in the business of supplying electricity for light, heat, or power to consumers in this State.

(6) Repealed by Session Laws 1973, c. 783, s. 5.

(7) Flight equipment. – Aircraft fully equipped for flying and used in any operation within this State.

(8) Gas company. – A company engaged in the business of supplying artificial or natural gas to, from, within, or through this State through pipe or tubing for light, heat, or power to consumers in this State.

(9) Locally assigned rolling stock. – Rolling stock that is owned or leased by a motor freight carrier company, specifically assigned to a terminal or other premises, and regularly used at the premises to which assigned.

(10) Motor freight carrier company. – A company engaged in the business of transporting property by motor vehicle for hire over the public highways of this State as provided in this subdivision:

a. As to interstate carrier companies domiciled in North Carolina, this term includes carriers who regularly transport property by tractor trailer to or from one or more terminals owned or leased by the carrier outside this State or two or more terminals inside this State. For purposes of appraisal and allocation only, the term also includes a North Carolina interstate carrier that does not have a terminal outside this State but whose operations outside the State are sufficient to require the payment of ad valorem taxes on a portion of the value of the rolling stock of the carrier to taxing units in one or more other states.

b. As to interstate carrier companies domiciled outside this State, this term includes carriers who regularly transport property by tractor trailer to or from one or more terminals owned or leased by the carrier inside this State.

c. As to intrastate carrier companies, this term includes only those carriers that are engaged in the transportation of property by tractor trailer to or from two or more terminals owned or leased by the carrier in this State.

(11) Nondistributable system property. – The following properties owned by a railroad company: land other than right-of-way, depots, machine shops, warehouses, office buildings, other structures, and the contents of the structures listed in this subdivision.

(12) Nonsystem property. – The real and tangible personal property owned by a public service company but not used in its public service activities.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-LAz-31 [v.3] (4/24)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/27/2006 10:32:18 AM

Short Title: Phone, Tower, & Cable Property Tax Appraisal. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO ESTABLISH UNIFORM PROPERTY TAX APPRAISAL FOR TELECOMMUNICATIONS COMPANIES, CABLE COMPANIES, AND TOWER COMPANIES BY PROVIDING FOR SYSTEM APPRAISAL BY THE DEPARTMENT OF REVENUE RATHER THAN LOCAL APPRAISAL.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-333 reads as rewritten:

"**§ 105-333. Definitions.**

The following definitions apply in this Article unless the context requires a different meaning:

(1) Airline company. – A company engaged in the business of transporting passengers and property by aircraft for hire within, into, or from this State.

(2) Bus line company. – A company engaged in the business of transporting passengers and property by motor vehicle for hire over the public highways of this State (but not including a bus line company operating primarily upon the public streets within a single local taxing unit), whether the transportation is within, into, or from this State.

(2a) Cable company. - A company engaged in the business of providing cable service as defined in G.S. 105-164.3, over a cable system, as defined in 47.U.S.C. 522.

(3) Distributable system property. – All real property and personal property owned or used by a railroad company other than nondistributable system property.

(4) Electric membership corporation. – A company organized, reorganized, or domesticated under Chapter 117 of the General

LEGISLATIVE PROPOSAL #6

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO ESTABLISH UNIFORM PROPERTY TAX APPRAISAL FOR TELECOMMUNICATIONS COMPANIES, CABLE COMPANIES, AND TOWER COMPANIES BY PROVIDING FOR SYSTEM APPRAISAL BY THE DEPARTMENT OF REVENUE RATHER THAN LOCAL APPRAISAL.

SHORT TITLE: Phone, Tower, & Cable Property Tax Appraisal

SPONSORS:

BRIEF OVERVIEW: The bill broadens the Department's authority to appraise the property of public service companies for property tax purposes by including wireless, paging, tower, and cable companies in the definition of public service company.

FISCAL IMPACT: There would be no impact on the General Fund. The impact to the local governments cannot be determined.

EFFECTIVE DATE: Effective for taxes imposed for taxable years beginning on or after July 1, 2007.

A copy of the proposed legislation, bill analysis, and fiscal analysis begin on the next page.

LEGISLATIVE PROPOSAL #6

PHONE, TOWER, & CABLE PROPERTY TAX APPRAISAL

- Requires the tax collector to send the notice of a tax lien on real property to the record owner of the property as determined as of the date property taxes become delinquent and to any subsequent record owner instead of the listing owner of the property. The advertisement must also state the names of the record owner and any subsequent owner instead of the listing owner.
- Amends the definition of "Taxpayer" in the property tax laws to clarify that when collecting delinquent taxes assessed on real property, "taxpayer" means owner of record on the date the taxes become delinquent and any subsequent owner of record of the real property if conveyed after the delinquent date.
- Amends Chapter 39 of the General Statutes by adding a new Article that codifies the practice of prorating property taxes on a calendar-year basis when the property is sold.

ASSUMPTIONS AND METHODOLOGY:
The bill corrects the problems that occur when an owner sells property after the listing date, and the property taxes later become delinquent under the new owner. Current law allows the tax assessor to use remedies of attachment and wage garnishment against the listing owner. This bill allows tax assessors to use these tax collection remedies against owner of record as opposed to the listing owner. The bill does not change the types of remedies available to assessors and is not projected to significantly impact revenue collection.

SOURCES OF DATA: NC Department of Revenue

TECHNICAL CONSIDERATIONS: None

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: May 2, 2006

TO: Revenue Laws Study Committee

FROM: Rodney Bizzell
Fiscal Research Division

RE: 2005-LAz-29 v4 – Amend Delinquent Property Tax Collection

FISCAL IMPACT

Yes () **No (X)** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES: **Local Governments**	**"See Assumptions and Methodology"**				

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: NC Local Governments

EFFECTIVE DATE: Section 5 of this act becomes effective for contracts entered into on or after October 1, 2006. The remainder of this act is effective upon ratification and applies to tax years beginning on or after July 1, 2006.

BILL SUMMARY:
This bill makes the following changes to the property tax laws to relieve the seller of personal liability for property taxes assessed on real property when the seller transfers the property before the taxes become delinquent or when the seller transfers the property before it is annexed by the taxing unit and taxes are imposed by the taxing unit:

- Authorizes the tax collector to enforce the remedy of attachment and garnishment against the record owner of real property as of the date the taxes on the real property become delinquent instead of the listing owner of the real property.

would not set out the name of the listing owner, unless the listing owner and owner of record on the delinquent date is the same person.

The draft also codifies the practice of prorating property taxes between the seller and buyer of real property on a calendar-year basis, unless the contract states otherwise.

EFFECTIVE DATE: The draft is effective for taxes imposed for taxable years beginning on or after July 1, 2006, except that section 5 of the draft becomes effective for contracts entered into on or after October 1, 2006.

2005-LAz-29-SMLA

2006, for the fiscal year beginning July 1, 2006, and ending June 30, 2007. Taxes on the property are delinquent beginning January 6, 2007.[2]

In February of each year, the tax collector must report to the governing body the total amount of unpaid taxes for the current fiscal year that are liens on real property. After the governing body orders the tax collector to advertise tax liens, the tax collector must send a notice to the record owner of each affected parcel as determined as of December 31 of the fiscal year for which taxes are due. If the property was transferred during the one year period beginning on the listing date preceding the fiscal year in which the taxes become due, then the notice of tax lien on the property must be sent to each listing owner and record owner of the parcel as determined as of December 31 of the fiscal year for which taxes are due. The notice must inform the owners that their names will appear in a newspaper advertisement of delinquent taxes if the taxes are not paid before the publication date. If the listing owner transferred the property after the listing date, the advertisement will state the record owner's name followed by a notation that the property was transferred to the record owner and a notation of the name of the listing owner.

In addition to the remedy of foreclosing on the real property, the taxing unit may also attach and garnish the wages and other compensation, rents, bank deposits, and other intangible personal property of the listing owner of the property. Attachment and garnishment may only be enforced against the listing owner because the pertinent statutes provide that the remedy may be enforced against the taxpayer. Taxpayer is defined in G.S. 105-273(17) as the person whose property is subject to property tax by a county or municipality and any person who has a duty to list property for taxation.

BILL ANALYSIS: The draft is an attempt to solve the following problems:

- Seller conveys real property to Buyer on July 8, 2006. After the transfer, Buyer petitions for annexation to the city. On October 2006, seller receives a bill due September 1, 2006 for the partial year annexation. If Seller does not pay this before January 6, 2007, the tax collector can garnish Seller's bank account, because Seller was the owner of the property on the listing date. (January 1 immediately preceding the beginning of the fiscal year to which the annexation becomes effective) G.S. 160A-58.10.

- Seller conveys real property to Buyer in May, 2006. The closing attorney prorates the taxes giving Buyer credit for the months Seller owned the property and directs Buyer to pay the taxes. Buyer does not pay the taxes by January 6, 2007. Seller disregards the notice of delinquent taxes because he had his share of the taxes deducted from his net proceeds at closing and Seller believes his share of taxes was paid at closing. The tax collector has the authority to garnish the wages of Seller.

The draft amends the definition of "Taxpayer" in the property tax laws so that for purposes of collecting delinquent property taxes assessed on real property, the remedies against personal property may only be enforced against the record owner of the real property on the date the taxes become delinquent and against any subsequent record owner of the real property if conveyed after the delinquent date. This means that the tax collector would have the authority to garnish the wages, bank account, or other intangible property of the owner of the property at the time the taxes on that property become delinquent and any subsequent record owner instead of the listing owner of the property.

The draft provides that the notice of the tax lien would be sent to the record owner of the real property as of the date the taxes became delinquent instead of the listing owner. The advertisement of the tax lien

[2] When real property is acquired after January 1, but prior to July 1, and the property was not subject to taxation on January 1 on account of its exempt status, it is listed for tax by the transferee as of the date of acquisition and is appraised at its true value as of January 1 preceding the date of acquisition. The property is taxed for the fiscal year of the taxing unit beginning on July 1 of the year in which it is acquired.

BILL DRAFT: 2005-LAz-29:
Amend Delinquent Property Tax Collection

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	April 27, 2006
Introduced by:		**Summary by:**	Martha Walston
Version:	Draft 2005-LAz-29		Committee Counsel

SUMMARY: ***The following changes to the property tax laws relieve the seller of personal liability for property taxes assessed on real property when the seller transfers the property before the taxes become delinquent or when the seller transfers the property before it is annexed by the taxing unit and taxes are imposed by the taxing unit:***

- ***Authorizes the tax collector to enforce the remedy of attachment and garnishment against the record owner of real property as of the date the taxes on the real property become delinquent instead of the listing owner of the real property.***
- ***Requires the tax collector to send the notice of a tax lien on real property to the record owner of the property as determined as of the date property taxes become delinquent instead of the listing owner of the property. The advertisement must also state the name of the record owner instead of the listing owner.***
- ***Amends the definition of "Taxpayer" in the property tax laws to clarify that when collecting delinquent taxes assessed on real property, "taxpayer" means owner of record on the date the taxes become delinquent and any subsequent owner of record of the real property if conveyed after the delinquent date.***

The bill also amends Chapter 39 of the General Statutes by adding a new Article that codifies the practice of prorating property taxes on a calendar-year basis when the property is sold, unless the parties' contract states otherwise.

CURRENT LAW: Under North Carolina property tax laws, the date of January 1 applies to the following events:

- The date the value of real property is determined for tax purposes.
- The date property is listed in the name of the owner on that date.
- The date a tax lien attaches to the real property.

The owner of the property as of January 1 generally receives a property tax bill in July or August for property taxes owing on the property for the fiscal year that runs from July 1 of the year the property is required to be listed to the following June 30. Taxes become due and payable on September 1, and are payable at face amount if paid before January 6 following the due date. Taxes are delinquent if paid on or after January 6 following the due date and are subject to interest charges.[1] For example, if a taxpayer lists his or her property on January 1, 2006, then taxes on the property become due on September 1,

[1] For the period January 6 to February 1, interest rate accrues at 2%. For the period February 1 until the principal amount of taxes, the accrued interest, and any penalties are paid, interest accrues at the rate of ¾% a month or fraction thereof.

SECTION 6. Section 5 of this act becomes effective for contracts entered into on or after October 1, 2006. The remainder of this act is effective for taxes imposed for taxable years beginning on or after July 1, 2006.

shall be made parties and served with summons in the same manner as in other civil actions.

Persons who have disappeared or who cannot be located and persons whose names and whereabouts are unknown, and all possible heirs or assignees of such persons, may be served by publication; and such persons, their heirs, and assignees may be designated by general description or by fictitious names in such an action."

SECTION 4. G.S. 105-375(c) reads as rewritten:

"(c) Notice Listing Taxpayer and Others. – The tax collector filing the certificate provided for in subsection (b), above, shall, at least 30 days prior to docketing the judgment, send a registered or certified letter, return receipt requested, to the ~~listing taxpayer at his~~owner of record as of the date the taxes became delinquent at the owner's last known address, and to all lienholders of record who have a lien against the ~~listing taxpayer~~owner of record or against any subsequent owner of the property (including any liens referred to in the conveyance of the property to the ~~listing taxpayer~~owner of record or to the subsequent owner of the property), stating that the judgment will be docketed and the execution will be issued thereon in the manner provided by law. ~~A notice stating that the judgment will be docketed and that execution will be issued thereon shall also be mailed by certified or registered mail, return receipt requested, to the current owner of the property (if different from the listing owner) if: (i) a deed or other instrument transferring title to and containing the name of the current owner was recorded in the office of the register of deeds or filed or docketed in the office of the clerk of superior court after January 1 of the first year in which the property was listed in the name of the listing owner, and (ii) the tax collector can obtain the current owner's mailing address through the exercise of due diligence.~~ If within 10 days following the mailing of said letters of notice, a return receipt has not been received by the tax collector indicating receipt of the letter, then the tax collector shall have a notice published in a newspaper of general circulation in said county once a week for two consecutive weeks directed to, and naming, all unnotified lienholders and the ~~listing taxpayer~~owner of record that a judgment will be docketed against the ~~listing taxpayer.~~owner of record. The notice shall contain the proposed date of such docketing, that execution will issue thereon as provided by law, a brief description of the real property affected, and notice that the lien may be paid off prior to judgment being entered. All costs of mailing and publication, plus a charge of fifty dollars ($50.00) to defray administrative costs, shall be added to the amount of taxes that are a lien on the real property and shall be paid by the taxpayer to the taxing unit at the time the taxes are collected or the property is sold."

SECTION 5. Chapter 39 of the General Statutes is amended by adding the following new Article to read:

"**Article 10.**

"Real Property Tax Proration.

"**§ 39-60. Property tax proration on sale of real property.**

Unless otherwise provided by contract, property taxes on the real property being sold shall be prorated between the seller and buyer of the real property on a calendar-year basis."

(1b) After the information required by subdivision ~~(1) or~~ (1a) of this subsection for each parcel, a brief description of each parcel of land to which a lien has attached and a statement of the principal amount of the taxes constituting a lien against the parcel.

(2) A statement that the amounts advertised will be increased by interest and costs and that the omission of interest and costs from the amounts advertised will not constitute waiver of the taxing unit's claim for those items.

(3) In the event the list of tax liens has been divided for purposes of advertisement in more than one newspaper, a statement of the names of all newspapers in which advertisements will appear and the dates on which they will be published.

(4) A statement that the taxing unit may foreclose the tax liens and sell the real property subject to the liens in satisfaction of its claim for taxes.

(d) Costs. – Each parcel of real property advertised pursuant to this section shall be assessed an advertising fee to cover the actual cost of the advertisement. Actual advertising costs per parcel shall be determined by the tax collector on any reasonable basis. Advertising costs assessed pursuant to this subsection are taxes.

(e) Payments during Advertising Period. – At any time during the advertisement period, any parcel may be withdrawn from the list by payment of the taxes plus interest that has accrued to the time of payment and a proportionate part of the advertising fee to be determined by the tax collector. Thereafter, the tax collector shall delete that parcel from any subsequent advertisement, but the tax collector is not liable for failure to make the deletion.

(f) Listing and Advertising in Wrong Name. – No tax lien is void because the real property to which the lien attached was listed or advertised in the name of a person other than the person in whose name the property should have been listed for taxation if the property was in other respects correctly described on the abstract or in the advertisement.

(g) Wrongful Advertisement. – Any tax collector or deputy tax collector who willfully advertises any tax lien knowing that the property is not subject to taxation or that the taxes advertised have been paid is guilty of a Class 3 misdemeanor, and shall be required to pay the injured party all damages sustained in consequence."

SECTION 3. G.S. 105-374(c) reads as rewritten:

"(c) Parties; Summonses. – The ~~listing taxpayer~~owner of record as of the date the taxes became delinquent and spouse (if any), ~~the current owner,~~any subsequent owner, all other taxing units having tax liens, all other lienholders of record, and all persons who would be entitled to be made parties to a court action (in which no deficiency judgment is sought) to foreclose a mortgage on such property, shall be made parties and served with summonses in the manner provided by G.S. 1A-1, Rule 4.

The fact that the ~~listing taxpayer~~owner of record, any subsequent owner, or any other defendant is a minor, is incompetent, or is under any other disability shall not prevent or delay the tax lien sale or the foreclosure of the tax lien; and all such persons

taxes collected by county tax collectors shall be regarded as county taxes and district taxes collected by municipal tax collectors shall be regarded as municipal taxes.

(b) Repealed by Session Laws 1983 (Regular Session, 1984), c. 1013.

(b1) Notice to Owner. – After the governing body orders the tax collector to advertise the tax liens, the tax collector must send a notice to the ~~listing owner and to the~~ record owner of each affected parcel of property, as determined as of ~~December 31 of the fiscal year for which the taxes are due.~~the date the taxes became delinquent. The notice must be sent to each owner's last known address by first-class mail at least 30 days before the date the advertisement is to be published. The notice must state the principal amount of unpaid taxes that are a lien on the parcel to be advertised and inform the owner that the ~~names~~ name of ~~the listing owner and~~ the record owner as of the date the taxes became delinquent will appear in a newspaper advertisement of delinquent taxes if the taxes are not paid before the publication date. Failure to mail the notice required by this section to the correct ~~listing owner or~~ record owner does not affect the validity of the tax lien or of any foreclosure action.

(c) Time and Contents of Advertisement. – A tax collector's failure to comply with this subsection does not affect the validity of the taxes or tax liens. The county tax collector shall advertise county tax liens by posting a notice of the liens at the county courthouse and by publishing each lien at least one time in one or more newspapers having general circulation in the taxing unit. The municipal tax collector shall advertise municipal tax liens by posting a notice of the liens at the city or town hall and by publishing each lien at least one time in one or more newspapers having general circulation in the taxing unit. Advertisements of tax liens shall be made during the period March 1 through June 30. The costs of newspaper advertising shall be paid by the taxing unit. If the taxes of two or more taxing units are collected by the same tax collector, the tax liens of each unit shall be advertised separately unless, under the provisions of a special act or contractual agreement between the taxing units, joint advertisement is permitted.

The posted notice and newspaper advertisement shall set forth the following information:

~~(1) In the case of property that the listing owner has not transferred after January 1 preceding the fiscal year for which the tax liens are advertised, the name of each person to whom is listed real property on which the taxing unit has a lien for unpaid taxes, in alphabetical order.~~

(1a) ~~In the case of property that the listing owner has transferred after January 1 preceding the fiscal year for which the tax liens are advertised, the name of the record owner as of December 31 of each parcel on which the taxing unit has a lien for unpaid taxes, in alphabetical order, followed by a notation that the property was transferred to the record owner and a notation of the name of the listing owner.~~The name of the record owner as of the date the taxes became delinquent for each parcel on which the taxing unit has a lien for unpaid taxes, in alphabetical order.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-LAz-29 [v.9] (4/17)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/27/2006 12:43:09 PM

Short Title: Amend Delinquent Property Tax Collection. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO ENFORCE COLLECTION OF PROPERTY TAXES ON REAL PROPERTY AGAINST THE RECORD OWNER AS OF THE DATE THE TAXES BECOME DELINQUENT AND TO CODIFY THE PRORATION OF TAXES ON REAL PROPERTY.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-273(17) reads as rewritten:

""**§ 105-273. Definitions.**

When used in this Subchapter (unless the context requires a different meaning):

...

(17) "Taxpayer" means any person whose property is subject to ad valorem property taxation by any county or municipality and any person who, under the terms of this Subchapter, has a duty to list property for taxation. For purposes of collecting delinquent ad valorem taxes assessed on real property under G.S. 105-366 through G.S. 105-375, "taxpayer" means the owner of record on the date the taxes become delinquent and any subsequent owner of record of the real property if conveyed after that date."

SECTION 2. G.S. 105-369 reads as rewritten:

"**§ 105-369. Advertisement of tax liens on real property for failure to pay taxes.**

(a) Report of Unpaid Taxes That Are Liens on Real Property. – In February of each year, the tax collector must report to the governing body the total amount of unpaid taxes for the current fiscal year that are liens on real property. A county tax collector's report is due the first Monday in February, and a municipal tax collector's report is due the second Monday in February. Upon receipt of the report, the governing body must order the tax collector to advertise the tax liens. For purposes of this section, district

LEGISLATIVE PROPOSAL #5

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO ENFORCE COLLECTION OF PROPERTY TAXES ON REAL PROPERTY AGAINST THE RECORD OWNER AS OF THE DATE THE TAXES BECOME DELINQUENT AND TO CODIFY THE PRORATION OF TAXES ON REAL PROPERTY.

SHORT TITLE: Amend Delinquent Property Tax Collection

SPONSORS:

BRIEF OVERVIEW: This bill makes changes to the property tax laws to relieve the seller of personal liability for property taxes assessed on real property when the seller transfers the property before the taxes become delinquent or when the seller transfers the property before it is annexed by the taxing unit and taxes are imposed by the taxing unit. the bill also codifies the practice of prorating property on a calendar-year basis when the property is sold, unless the terms of the contract provide otherwise.

FISCAL IMPACT: No fiscal impact.

EFFECTIVE DATE: This bill is effective for taxes imposed for taxable years beginning on or after July 1, 2006, except that section 5 of the bill becomes effective for contracts entered into on or after October 1, 2006.

A copy of the proposed legislation, bill analysis, and fiscal analysis begin on the next page.

LEGISLATIVE PROPOSAL #10

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY.

AN ACT TO CLARIFY THE APPLICATION OF THE ADDITIONAL GROSS PREMIUMS TAXES ON FIRE AND LIGHTNING COVERAGE AND TO INCLUDE ALL POLICIES.

SHORT TITLE: Clarify Additional Gross Premiums Tax

SPONSORS:

BRIEF OVERVIEW: The bill would specify the percentage of an insurance policy's gross premiums to which the additional gross premiums tax on fire and lightning coverage applies and it would provide that the additional tax would apply to all types of policies that insure against fire and lightning loss.

FISCAL IMPACT:

EFFECTIVE DATE: The clarifying changes would become effective January 1, 2006. The elimination of the exemption for marine and automobile policies would become effective January 1, 2007.

A copy of the proposed legislation and bill analysis begin on the next page.

LEGISLATIVE PROPOSAL #10

CLARIFY ADDITIONAL GROSS PREMIUMS TAX

generally and would simplify tax form preparation. Consequently, it may result in a higher degree of compliance with the law.

ASSUMPTIONS AND METHODOLOGY: The Department of Revenue indicates that the proposal would have a negligible revenue impact because many of the adjustments are duplicated in both individual and corporate income tax law and that some of the adjustments under the corporate income tax that are not under the individual income tax are not applicable to S corporation income tax. Thus, the change has limited application

SOURCES OF DATA: North Carolina Department of Revenue.

TECHNICAL CONSIDERATIONS: None

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 25, 2006

TO: Revenue Laws

FROM: Dave Crotts
Fiscal Research Division

RE: Draft 2005-SVxz-11 (v.5) (S Corporation Income Tax Adjustments)

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:	See "Assumptions and Methodology"				
EXPENDITURES:					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: Tax years beginning on or after January 1, 2006.

BILL SUMMARY: A C Corporation cannot be a shareholder of an S Corporation. All S shareholders must be individuals or trusts, which means that the taxpayer is subject to the individual income tax. However, current law results in an individual's pro rata share of S Corporation income attributable to North Carolina being subject to corporate income tax adjustments, while S Corporation income not attributable to North Carolina is subject to individual income tax adjustments. The proposal would make an individual's pro rata share of income from an S Corporation subject only to the individual income tax adjustments, rather than being subject to both individual and corporate income tax adjustments. This approach would be more consistent with the tax treatment of an S Corporation

treatment of an S Corporation generally and would simplify tax form preparation. Consequently, it may result in a higher degree of compliance with the law.

EFFECTIVE DATE: This act would become effective for taxable years beginning on or after January 1, 2006.

BACKGROUND: Of the approximately 20 states that tax S Corporation income at the shareholder level, 18 of those states use the individual law to make adjustments. Louisiana applies corporate adjustments. North Carolina is the only state that uses both.

2005-SVxz-11

LEGISLATIVE PROPOSAL 2005-SVxz-11: S Corp. Income Tax Adjustments

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	March 1, 2006
Introduced by:		**Summary by:**	Trina Griffin Committee Counsel
Version:	Draft 2005-SVxz-11		

SUMMARY: ***This legislative proposal would make corporate income tax adjustments inapplicable to S Corporations, effective beginning with the 2006 taxable year.***

CURRENT LAW: An S Corporation is a corporation that has elected to have the corporation's income pass through to the shareholders. Thus, the business profits are taxed at individual tax rates. An S Corporation election allows the shareholders to preserve the benefit of limited liability for the corporate form while at the same time being treated as partners for federal income tax purposes. The S Corporation itself does not pay any income tax, but an S Corporation is required to file an informational return with the IRS, similar to a partnership tax return, to inform the IRS of each shareholder's ownership interest in the S corporation. To be eligible for S Corporation status, a corporation must meet all of the following requirements:

- The corporation may have no more than 75 shareholders.
- The corporation may have only one class of stock, although different voting rights among shareholders are allowed.
- All shareholders must be individuals or trusts.
- The corporation must be formed in the United States.
- No shareholder may be a non-resident alien.
- The corporation may not be an insurance company or a domestic international sales corporation.

A C Corporation, on the other hand, assumes a separate legal and tax life distinct from its shareholders. A corporation pays taxes at its own corporate income tax rates and files its own corporate tax forms each year. C Corporations may choose to retain their profits and earnings as part of their operating capital, or they may choose to distribute some or all of their profits and earnings as dividends paid to shareholders. Dividends paid to shareholders are essentially taxed twice. They are taxed once at the corporate level and again at the individual level.

As noted above, C Corporations cannot be shareholders of an S Corporation. All shareholders must be individuals or trusts. Trusts, and obviously individuals, are subject to tax using the individual income tax rates. Thus, the tax imposed on the income of an S Corporation is an individual income tax, not a corporate tax. However, current law results in an individual's pro rata share of S Corporation income attributable to North Carolina being subject to corporate income tax adjustments, while S Corporation income not attributable to North Carolina is subject to individual income tax adjustments.

BILL ANALYSIS: This bill would make an individual's pro rata share of income from an S Corporation subject only to the individual income tax adjustments, rather than being subject to both individual and corporate income tax adjustments. This approach would be more consistent with the tax

GENERAL ASSEMBLY OF NORTH CAROLINA
SESSION 2005

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BILL DRAFT 2005-SVxz-11 [v.5] (02/13)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/28/2006 3:00:15 PM

Short Title: S Corp Income Tax Adjustments. (Public)

Sponsors:

Referred to:

A BILL TO BE ENTITLED

AN ACT TO MAKE CORPORATE INCOME TAX ADJUSTMENTS INAPPLICABLE TO S CORPORATIONS.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-131.2 reads as rewritten:

"**§ 105-131.2. Adjustment and characterization of income.**

(a) Adjustment. – ~~The pro rata share of each shareholder in the income attributable to the State of an S Corporation shall be adjusted as provided in G.S. 105-130.5. The pro rata share of each resident shareholder in the income not attributable to the State of an S Corporation shall be adjusted as provided in G.S. 105-134.6(b), (c), and (d).~~Each shareholder's pro rata share of an S Corporation's income is subject to the adjustments provided in G.S. 105-134.6.

(b) Repealed by Session Laws 1989, c. 728, s. 1.35.

(c) Characterization of Income. – S Corporation items of income, loss, deduction, and credit taken into account by a shareholder pursuant to G.S. 105-131.1(b) ~~shall be~~ are characterized as though received or incurred by the S Corporation and not its shareholder."

SECTION 2. G.S. 105-134.6(a) reads as rewritten:

"(a) S Corporations. – ~~The pro rata share of each shareholder in the income attributable to the State of an S Corporation shall be adjusted as provided in G.S. 105-130.5. The pro rata share of each resident shareholder in the income not attributable to the State of an S Corporation shall be~~ Each shareholder's pro rata share of an S Corporation's income is subject to the adjustments provided in ~~subsections (b), (c), and (d) of~~ this section."

SECTION 3. This act is effective for tax years beginning on or after January 1, 2006.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-RBxz-30 [v.11] (02/23)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
5/2/2006 9:01:35 AM

Short Title: Clarify Additional Gross Premiums Tax. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO CLARIFY THE APPLICATION OF THE ADDITIONAL GROSS PREMIUMS TAXES ON FIRE AND LIGHTNING COVERAGE AND TO APPLY THE ADDITIONAL TAX TO ALL POLICIES THAT PROVIDE FIRE AND LIGHTNING COVERAGE.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-228.5(d)(3) reads as rewritten:

"(d) Tax Rates; Disposition. –

...

(3) Additional Statewide Fire and Lightning Rate. – An additional tax ~~shall be applied to gross premiums on contracts of insurance applicable to fire and lightning coverage, except in the case of marine and automobile policies,~~ at the rate of one and thirty-three hundredths percent ~~(1.33%).~~(1.33%) applies to gross premiums on insurance contracts that provide fire and lightning coverage, except in the case of marine and automobile policies. The tax is a percentage of the gross premiums from the contracts, determined in accordance with the table in this subdivision. Twenty-five percent (25%) of the net proceeds of this additional tax shall be deposited in the Volunteer Fire Department Fund established in Article 87 of Chapter 58 of the General Statutes. The remaining net proceeds shall be credited to the General Fund.

Type of Insurance Contract	Taxable Percentage
Fire Loss	100%
Commercial Multiple Peril	
Non-liability portion	100%
Liability portion	0%
Homeowner's	50%

Farm Owner's	35%."

SECTION 2. G.S. 105-228.5(d)(4) reads as rewritten:

"(d) Tax Rates; Disposition. –

...

(4) Additional Local Fire and Lightning Rate. – An additional tax ~~shall be applied to gross premiums on contracts of insurance applicable to fire and lightning coverage within fire districts~~ at the rate of one-half of one percent ~~(½ of 1%)~~.(0.5%) applies to gross premiums on insurance contracts that provide fire and lightning coverage within a fire district. The tax is a percentage of the gross premiums from the contracts, determined in accordance with the table in subdivision (3) of this subsection. The net proceeds shall be credited to the Department of Insurance for disbursement pursuant to G.S. 58-84-25."

SECTION 3. G.S. 105-228.5(d)(3), as amended by Section 1 of this act, reads as rewritten:

"(d) Tax Rates; Disposition. –

...

(3) Additional Statewide Fire and Lightning Rate. – An additional tax at the rate of one and thirty-three hundredths percent (1.33%) applies to gross premiums on insurance contracts that provide fire and lightning ~~coverage, except in the case of marine and automobile policies.~~ coverage. The tax is a percentage of the gross premiums from the contracts, determined in accordance with the table in this subdivision. Twenty-five percent (25%) of the net proceeds of this additional tax shall be deposited in the Volunteer Fire Department Fund established in Article 87 of Chapter 58 of the General Statutes. The remaining net proceeds shall be credited to the General Fund.

Type of Insurance Contract	**Taxable Percentage**
Fire Loss	100%
Commercial Multiple Peril	
Non-liability portion	100%
Liability portion	0%
Homeowner's	50%
Farm Owner's	35%
Marine	20%
Automobile	10%
Other	10%."

SECTION 4. Sections 1 and 2 of this act are effective for taxable years beginning on or after January 1, 2006. Section 3 of this act is effective for taxable years beginning on or after January 1, 2007. The remainder of this act is effective when it becomes law.

BILL DRAFT 2005-RBxz-30: Clarify Additional Gross Premiums Tax

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	May 2, 2006
Introduced by:		**Summary by:**	Cindy Avrette Committee Counsel
Version:	Draft		

SUMMARY: Draft Proposal 2005-RBxz-30 would specify the percentage of an insurance policy's gross premiums to which the additional gross premiums tax on fire and lightning coverage applies and it would provide that the additional tax would apply to all types of policies that insure against fire and lightning loss.

BILL ANALYSIS: North Carolina imposes a 1.9% tax rate on the gross premiums of most insurance policies.[1] In addition to the general rate, there is a 1.33% rate applied to the gross premiums on insurance policies that provide fire and lightning coverage. The statute specifically excludes marine and automobile policies from this additional tax. Twenty-five percent of the net proceeds of this additional tax are credited to the Volunteer Fire Department Fund[2] and the remainder is credited to the General Fund. There is also a 0.5% rate applied to gross premiums on insurance policies that provide fire and lightning coverage within fire districts. The statute does not provide any exceptions from this tax. The net proceeds of this tax are credited to the Department of Insurance.[3]

The General Assembly enacted the additional statewide fire and lightning tax in 1959. Although the statute does not provide that the tax will apply differently to different types of policies, the Department has administered the tax this way. The additional tax has been imposed on 100% of premiums from insurance that covers only fire losses and on a percentage of premiums from insurance that covers multiple risks. The percentages applied are neither statutory nor imposed by administrative rule. Within the past few years, the Department has been informally advised by both the Department of Insurance and the Attorney General's Office that the statute as written does not provide for assessing the tax against only a percentage of a policy's premium. Rather, without a statutory change, it is their opinion that the tax should be applied to 100% of the premiums of any policy that includes fire and lightning coverage.

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[1] Workers' compensation policies are taxed at 2.5%. HMO policies are currently taxed at a rate of 1%; however, effective January 1, 2007, these policies will be taxed at the general rate of 1.9%.

[2] Funds in the Volunteer Fire Department Fund provide matching grants to volunteer fire departments to purchase equipment and make capital improvements. In 2005, the Department received 567 applications for grants requesting matching funds of $6,577,455. The available monies in the Fund totaled only $4,369,976. The Department approved 500 applications totaling $4,365,489.

[3] Three percent (3%) of the tax proceeds are credited to the State Firemen's Association for general purposes. Two percent (2%) of the proceeds are used by the Department of Insurance for the purpose of administering the disbursement. The remaining funds are allocated among the fire districts in proportion to the amount of business done in the district and used by the local district for firemen's local relief purposes. *See Article 84 of Chapter 58 of the General Statutes.*

Section 1 of this bill draft would codify the current administrative practice of the Department by setting in statute the percentage of an insurance policy's gross premiums to which the additional tax applies. It would provide that policies covering fire loss would be taxable at 100%. It would set by statute the taxable percentages for the following types of policies:

Type of Insurance Policy	Taxable Percentage
• Non-liability portion of a Commercial Multiple Peril policy	100%
• Homeowner's Policy	50%
• Farm Owner's Policy	35%
• Marine Policy	20%
• Automobile Policy	10%
• Other types of policies that provide fire and lightning coverage	10%

The percentages in the draft proposal for CMP policies, homeowner's policies, and farm owner's policies reflect the percentages currently used by the Department of Revenue through administrative practice. The Revenue Laws Study Committee asked the Department of Insurance, working with the insurance industry, to review the percentages to verify that they accurately reflect the fire and lightning loss experience for these different types of policies. The Department anticipates that it needs an additional two weeks to gather the applicable data and determine the accurate percentages. The proposal, if adopted, would need to be amended in the Finance Committee to change the taxable percentages.

It appears 21 other states impose a gross premiums tax on policies covering fire losses. Of those states, seven provide for the taxable percentage statutorily – of those two use 100% for all policies that include fire and lightning coverage and five have a range of percentages for different types of coverage.[4] Florida sets its taxable percentages through administrative rule. At least ten states provide taxable percentages on tax forms without statutory support or administrative rule[5] and Montana instructs taxpayers to use their own experience to determine the percentage of their premiums subject to the additional tax.

Section 2 of the bill provides that the taxable percentages applicable for the statewide fire and lightning tax would also apply to the local fire and lightning tax rate.

Section 3 would eliminate the current exemption for marine and automobile policies from the additional statewide fire and lightning rate. North Carolina is the only state that imposes

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[4] Arkansas, Georgia, Kansas, Mississippi, Oregon, Tennessee, and Virginia. Arkansas and Virginia tax all policy premiums at 100%.

[5] Kentucky, Louisiana, Maine, Minnesota, Nebraska, Ohio, South Carolina, South Dakota, West Virginia, and Wisconsin. One other state, Indiana, provides percentages on the tax form, but it could not verify its authority for the percentages used.

an additional statewide fire and lightning tax that excludes premiums from marine and automobile coverage from the taxable premiums base. The local fire and lightning tax does not exclude these policies. The bill draft provides that the taxable percentage for a marine policy would be 20% and the taxable percentage for all other types of policies would be 10%.

Sections 1 and 2 of the bill would become effective for taxable years beginning on or after January 1, 2006. Section 3 would become effective for taxable years beginning on or after January 1, 2007.

LEGISLATIVE PROPOSAL #11

FRANCHISE TAX LOOPHOLE CLOSING

LEGISLATIVE PROPOSAL #11

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO APPLY THE FRANCHISE TAX TO CERTAIN LIMITED LIABILITY COMPANIES AND TO PROVIDE A CREDIT FOR ADDITIONAL ANNUAL REPORT FEES PAID BY LIMITED LIABILITY COMPANIES SUBJECT TO FRANCHISE TAX.

SHORT TITLE: Franchise Tax Loophole Closing

SPONSORS:

BRIEF OVERVIEW: This proposal would apply the corporate franchise tax to limited liability companies that elect to be taxed as a C Corporation for federal income tax purposes.

FISCAL IMPACT: No fiscal impact.

EFFECTIVE DATE: For taxable years beginning on or after January 1, 2007.

A copy of the proposed legislation, bill analysis, and fiscal analysis begin on the next page

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

U D

BILL DRAFT 2005-SVxz-12 [v.2] (02/15)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
2/28/2006 2:51:12 PM

Short Title: Franchise Tax Loophole Closing. (Public)

Sponsors:

Referred to:

A BILL TO BE ENTITLED

AN ACT TO APPLY THE FRANCHISE TAX TO CERTAIN LIMITED LIABILITY COMPANIES AND TO PROVIDE A CREDIT FOR ADDITIONAL ANNUAL REPORT FEES PAID BY LIMITED LIABILITY COMPANIES SUBJECT TO FRANCHISE TAX.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-114(b) reads as rewritten:

"(b) Definitions. – The following definitions apply in this Article:

(1) City. – Defined in G.S. 105-228.90.

(1a) Code. – Defined in G.S. 105-228.90.

(2) Corporation. – A domestic corporation, a foreign corporation, an electric membership corporation organized under Chapter 117 of the General Statutes or doing business in this State, or an association that is organized for pecuniary gain, has capital stock represented by shares, whether with or without par value, and has privileges not possessed by individuals or partnerships. The term includes a mutual or capital stock savings and loan association or building and loan association chartered under the laws of any state or of the United States. The term includes a limited liability company that elects to be taxed as a C Corporation under the Code, but does not otherwise include a limited liability company.

(3) Doing business. – Each and every act, power, or privilege exercised or enjoyed in this State, as an incident to, or by virtue of the powers and privileges granted by the laws of this State.

(4) Income year. – Defined in G.S. 105-130.2(5)."

SECTION 2. G.S. 105-114.1 reads as rewritten:

"**§ 105-114.1. Limited liability companies.**

(a) Definitions. – The following definitions apply in this section:

(1) Affiliated group. – Defined in section 1504 of the Code.

(2) Capital interest. – The right under a limited liability company's governing law to receive a percentage of the company's assets upon dissolution after payments to creditors.

(3) Entity. – A person that is not a human being.

(4) Governing law. – A limited liability company's governing law is determined under G.S. 57C-6-05 or G.S. 57C-7-01, as applicable.

(5) Noncorporate limited liability company. – A limited liability company that does not elect to be taxed as a C Corporation under the Code.

(b) Controlled Companies. – If a corporation or an affiliated group of corporations owns more than fifty percent (50%) of the capital interests in a noncorporate limited liability company, the corporation or group of corporations must include in its three tax bases pursuant to G.S. 105-122 the same percentage of (i) the noncorporate limited liability company's capital stock, surplus, and undivided profits; (ii) fifty-five percent (55%) of the noncorporate limited liability company's appraised ad valorem tax value of property; and (iii) the noncorporate limited liability company's actual investment in tangible property in this State, as appropriate.

(c) Constructive Ownership. – Ownership of the capital interests in a noncorporate limited liability company is determined by reference to the constructive ownership rules for partnerships, estates, and trusts in section 318(a)(2)(A) and (B) of the Code with the following modifications:

(1) The term "capital interest" is substituted for "stock" each place it appears.

(2) A noncorporate limited liability company and any noncorporate entity other than a partnership, estate, or trust is treated as a partnership.

(3) The operating rule of section 318(a)(5) of the Code applies without regard to section 318(a)(5)(C).

(d) No Double Inclusion. – If a corporation is required to include a percentage of a noncorporate limited liability company's assets in its tax bases under this Article pursuant to subsection (b) of this section, its investment in the noncorporate limited liability company is not included in its computation of capital stock base under G.S. 105-122(b).

(e) Affiliated Group. – If the owner of the capital interests in a noncorporate limited liability company is an affiliated group of corporations, the percentage to be included pursuant to subsection (b) of this section by each group member that is doing business in this State is determined by multiplying the capital interests in the noncorporate limited liability company owned by the affiliated group by a fraction. The numerator of the fraction is the capital interests in the noncorporate limited liability company owned by the group member, and the denominator of the fraction is the capital interests in the noncorporate limited liability company owned by all group members that are doing business in this State.

(f) Exemption. – This section does not apply to assets owned by a noncorporate limited liability company if the total book value of the noncorporate limited liability

company's assets never exceeded one hundred fifty thousand dollars ($150,000) during its taxable year.

(g) Timing. – Ownership of the capital interests in a noncorporate limited liability company is determined as of the last day of its taxable year. The adjustments pursuant to subsections (b) and (d) of this section must be made to the owner's next following return filed under this Article. If a noncorporate limited liability company and a corporation or an affiliated group of corporations have engaged in a pattern of transferring assets between them with the result that each did not own the capital interests on the last day of its taxable year, the ownership of the capital interests in the noncorporate limited liability company must be determined as of the last day of the corporation or group of corporations' taxable year.

(h) Penalty. – A taxpayer who, because of fraud with intent to evade tax, underpays the tax under this Article on assets attributable to it under this section is guilty of a Class H felony in accordance with G.S. 105-236(7)."

SECTION 3. Article 3 of Chapter 105 is amended by adding a new section to read:

"**§ 105-122.1. Credit for additional annual report fees paid by limited liability companies subject to franchise tax.**

A limited liability company subject to tax under this Article is allowed a credit against the tax imposed by this Article equal to the difference between the annual report fee for corporations under G.S. 55-1-22 and the annual report fee for limited liability companies under G.S. 57C-1-22(a). The credit allowed by this section may not exceed the amount of tax imposed by this Article for the taxable year reduced by the sum of all credits allowed, except payments of tax made by or on behalf of the taxpayer."

SECTION 4. This act is effective for taxable years beginning on or after January 1, 2007.

LEGISLATIVE PROPOSAL 2005-SVxz-12: Franchise Tax Loophole Closing

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	March 1, 2006
Introduced by:		**Summary by:**	Trina Griffin Committee Counsel
Version:	Draft 2005-SVxz-12		

SUMMARY: This legislative proposal would apply the corporate franchise tax to limited liability companies that elect to be taxed as a C Corporation for federal income tax purposes. The bill would also provide LLCs that elect to be taxed as a C Corporation a credit for the difference between annual report fees for corporations and LLCs such that those LLCs are paying the lower corporation annual report fee rate. This proposal is substantially similar to Senate Bill 540, introduced last session, which has passed the Senate.

CURRENT LAW: Under North Carolina law, limited liability companies[1] (LLCs) are not subject to the franchise tax. In 1997, the North Carolina law regarding LLCs was changed to allow for a single-member LLC. This change had the unintended consequence of allowing a corporation subject to North Carolina franchise tax to set up an LLC and transfer assets to the LLC in a tax-free transfer. The assets then held by the LLC would not be subject to the franchise tax. Thus, the corporation could avoid a significant portion of its franchise tax liability by transferring assets into a wholly owned LLC without affecting its income tax liability. This loophole was the first of a number of loopholes that gave rise to a series of legislative changes enacted over the last five years attempting to close those loopholes.[2]

Under current law, the franchise tax now extends to all LLC assets that a corporation controls through trusts and other entities, with some limitation. Specifically, a corporation (or an affiliated group of corporations) must own more than 50% of the capital interests in a limited liability company for the attribution rules to apply, and LLCs whose assets do not exceed $150,000 are exempt.

The concept of control is determined by tracing ownership of the capital interests in the LLC's assets. A capital interest is the right to receive some or all of the assets under the LLC's governing law if the LLC was dissolved. Ownership of the capital interests in an LLC is traced, using the principles of constructive ownership, through any noncorporate entities. The chain of constructive ownership can run through layers of noncorporate entities but not through individuals. The franchise tax is payable by the corporation or affiliated group of corporations to which ownership of the capital interests is traced. Ownership of capital interests in an LLC is determined as of the last day of the LLC's tax year. If an LLC and a corporation engage in a pattern of trading assets back and forth so that neither owns them on its respective trigger date, the Secretary may require the determination to be made as of the last day of the corporation's tax year. If the capital interests in an LLC are owned by an affiliated group of corporations, the value of the assets is allocated among the members of the group for franchise tax purposes so that there will not be double taxation of any assets. The allocation is in proportion to each affiliate's ownership interest.

[1] A limited liability company is a business entity that is essentially a hybrid of a partnership and a corporation. Like a corporation, an LLC limits the liability of its owners. Like a partnership, an LLC is usually not subject to entity-level taxation.

[2] See the BACKGROUND section of this summary for a detailed description of recent legislative changes regarding the franchise tax loophole.

BILL ANALYSIS: This legislative proposal is virtually identical to Senate Bill 540, which was introduced during the 2005 session and passed the Senate. The Department has requested that the Revenue Laws Study Committee revisit this issue and would encourage the General Assembly to address it during the short session.

The bill would apply the corporate franchise tax to limited liability companies that elect to be taxed as a C Corporation. It also makes conforming changes to G.S. 105-114.1 regarding the attribution of certain LLC assets to controlling corporations for franchise tax purposes.

This bill originated as the result of at least one request for a private letter ruling from a major accounting firm. Based on this request, the Department of Revenue identified another scenario that could result in a corporation's avoidance of paying franchise tax. This scenario would involve a corporation headquartered in North Carolina, but whose parent company is domiciled outside North Carolina. In addition, the parent's only contact with North Carolina is its ownership of the corporation. This corporation, which already files as a C Corporation for federal tax purposes, could convert to an LLC but make an election to continue being taxed as a C Corporation and avoid franchise tax because the parent has no nexus with this State and thus the "constructive ownership" attribution rules do not apply.

Current law provides that an LLC may be disregarded and treated as a division of its parent. The parent company is then considered to own property in this State and therefore has nexus, making it subject to income and franchise tax, and the constructive ownership rules apply for attributing the LLC's assets to the parent's franchise tax calculation. However, when an LLC elects to be taxed as a C Corporation, nexus is not conferred on the parent and the attributes of the LLC do not flow to the parent. Therefore, companies currently operating in this State as C Corporations could convert to an LLC, make an election to file as a C Corporation, as they always have, and eliminate their North Carolina franchise tax obligations.

Under this bill, LLCs that elect to be taxed as a C Corporation would be subject to franchise tax. LLCs that do not elect to be taxed as a C Corporation would be considered "noncorporate LLCs" and would be subject to the attribution rules in G.S. 105-114.1 for franchise tax purposes.

The bill also provides LLCs that elect to be taxed as a C Corporation a nonrefundable credit for the difference between the annual report fee for corporations, which is $20.00, and the annual report fee for limited liability companies, which is $200.

EFFECTIVE DATE: This bill would become effective for taxable years beginning on or after January 1, 2007.

BACKGROUND:

Franchise Tax Generally – The State franchise tax is among the oldest taxes in North Carolina. It is a tax on S Corporations and C Corporations for the privilege of doing business in the State. The tax rate is $1.50 per $1,000 of value of the greatest of (1) apportioned net book value of the corporation; (2) 55% of appraised value of real and tangible personal property in NC; or (3) total actual investment in tangible property in NC.

The Department of Revenue, in its 2003 reports to the Revenue Laws Study Committee, noted that there exists a general franchise tax inequity because the imposition of the tax depends on the type of entity. The Governor's Commission to Modernize State Finances recommended that the State impose the franchise tax on all types of business entities, not just on traditional corporations. The Commission recommended that the revenues generated from this base broadening could be used to establish a minimum net worth threshold for payment of the tax.

Franchise Tax Loophole History – In 2001, the General Assembly enacted S.L. 2001-327 to close a loophole whereby a corporation, subject to North Carolina franchise tax, could set up a single-member LLC, transfer assets to the LLC in a tax-free transfer, and avoid paying taxes on the transferred assets

since LLCs are not subject to the franchise tax. The 2001 legislation tried to address the problem by requiring a corporation to pay tax on assets owned by the LLC if the corporation, including its affiliated corporations, indirectly owned[3] at least 70% of the LLC's assets. Unfortunately, tax planners found that the tax could still be avoided by using an additional paper transaction. If the corporation interposed a partnership between itself and the LLC holding its assets, then technically the 2001 legislation would not apply and the assets would continue to escape franchise tax.

In 2002, the General Assembly enacted S.L. 2002-126 to tighten the 2001 law. The 2002 legislation required attribution through "related members" (other entities and individuals) who may partner with one or more corporate entities to own the LLC that will hold the corporate assets. "Related members" is a defined term and includes shareholders, partnerships, etc. If a corporation and its related members together indirectly own at least 70% of an LLC's assets, the 2002 legislation provides that each corporation pays franchise tax on its relative share of the LLC's assets. The relative share is calculated after excluding those related members that are not corporations. Thus, the entire assets are subject to franchise tax, with the tax burden shared proportionally by the corporations that are involved in the ownership scheme.

After the 2002 legislation was enacted, it became apparent that it not only failed to close the loophole but also extended the franchise tax to situations that did not involve corporate control of LLC assets. The loophole remained open because there are additional paper transactions that can be interposed between the corporation and the LLC in order to circumvent the attribution of the LLC's assets to the corporation. For example, control may be passed through a business trust.[4]

In 2004, the General Assembly enacted S.L. 2004-74 to address these issues by providing that for purposes of determining ownership of an LLC's assets, any membership interest of a business trust would be attributed to the owners of the beneficial interest in the business trust, according to their interests in the trust, and the trust itself would be disregarded as a separate entity. In addition, the legislation limited the tax to only those assets that a corporation controls, it reduced the minimum threshold of LLC asset ownership from 70% or more to more than 50%, and it exempted small LLCs.

2005-SVxz-12-SMSV

[3] Indirect ownership of an LLC's assets is determined based on who is entitled to receive those assets upon dissolution of the LLC.

[4] A business trust is not considered a related member, as that term is defined in G.S. 105-130.7A, because it would be the corporation, not the shareholders, that would form the trust.

GENERAL ASSEMBLY OF NORTH CAROLINA

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FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 25, 2006

TO: Revenue Laws Study Committee

FROM: David Crotts
Fiscal Research Division

RE: Proposal 2005-SVxz-12 (Franchise Tax Loophole Closing)

FISCAL IMPACT

Yes (x) **No ( )** **No Estimate Available (x)**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:					
EXPENDITURES:					
POSITIONS (cumulative):					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: The franchise tax is administered by the Department of Revenue. The enactment of the bill is not expected to affect the Department's budget requirements.

EFFECTIVE DATE: Tax years beginning on or after January 1, 2007.

ISSUE BACKGROUND: Under North Carolina law, limited liability companies (LLCs) are not subject to the franchise tax. In 1997 single-member LLCs were authorized in North Carolina. This allowed a corporation the opportunity to set up an LLC and transfer assets to the LLC in a tax-free transfer. The assets then held by the LLC would not be subject to the franchise tax.

The 2001 General Assembly attempted to correct this situation by requiring a corporation to pay tax on assets owned by the LLC if the corporation, including its affiliated corporations, indirectly owned at least 70% of the LLC's assets. However, tax planners found that the tax could still be avoided by using an additional paper transaction. For example, if the corporation interposed a partnership between itself and the LLC holding its assets, the assets would continue to escape the franchise tax.

In 2002, the General Assembly addressed this issue by including "related members" (other entities and individuals) who may partner with one or more corporate entities to own the LLC to which the corporate assets are transferred. If a corporation and its related members together indirectly own at least 70% of an LLC's assets, each corporation would pay the franchise tax on its relative share of the LLC's assets.

After the enactment of the 2002 session change, it was discovered that there are other paper transactions that can be interposed between the corporation and the LLC to avoid the franchise tax. One example is a business trust. The tax does not apply in this situation because the trust is not considered a "related member". In addition, the 2002 legislation also had the effect of extending the tax to situations that did not involve corporate control of LLC assets.

The 2004 General Assembly attempted to address these issues by providing that for purposes of determining the ownership of an LLC's assets, any membership interest of a business trust would be attributed to the owners of the beneficial interest in the business trust, according to their interests in the trust, and the trust itself would be disregarded as a separate entity. In addition, the 2002 bill limits the tax to only those assets that a corporation controls and exempts small LLC's.

BILL SUMMARY: (1) Applies the corporate franchise tax to limited liability companies (LLCs) that elect to be taxed as a C corporation for federal income tax purposes; (2) provides these corporations are eligible for a nonrefundable credit equal to the difference between the annual report fee for corporations ($20) and the same fee for LLC's ($200); (3) makes conforming changes regarding attribution of certain LLC assets to controlling corporations for franchise tax purposes.

ASSUMPTIONS AND METHODOLOGY: Discussions with the Department of Revenue indicate that the practical effect of the legislation is to address another potential method of avoiding franchise tax liability by corporate structuring arrangements. The concern arose as a result of a request from a major accounting firm for a private letter ruling. The tax planning scenario would involve a corporation headquartered in North Carolina, but whose parent company is domiciled outside the State. In addition, the parent's only contact with North Carolina is its ownership of the corporation. This corporation, which already files as a C-corporation for federal tax purposes, could convert to an LLC but make an election to continue being taxed as a C-corporation and avoid franchise tax because the parent has no nexus (tax situs) with this State. Thus, the "constructive ownership" attribution rules do not apply.

The Department has no data on whether any companies have already established such arrangements. However, the request for a private letter ruling suggests that one or more accounting firms were contemplating the use of such a tax sheltering vehicle. With the passage of time since the legislation was originally proposed, it is possible that the activity level of this tax planning tool has accelerated.

SOURCES OF DATA: Discussions with Department of Revenue

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #12

FRANCHISE TAX BASE CALCULATION

LEGISLATIVE PROPOSAL #12

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO CLARIFY THE TREATMENT OF DEFERRED TAX ASSETS IN THE COMPUTATION OF THE FRANCHISE TAX CAPITAL BASE.

SHORT TITLE: Franchise Tax Base Calculation

SPONSORS:

BRIEF OVERVIEW: The bill clarifies the treatment of deferred tax assets in the computation of the franchise tax capital base.

FISCAL IMPACT:

EFFECTIVE DATE: The bill becomes effective when it becomes law.

A copy of the proposed legislation, bill analysis, and fiscal analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-RBz-31 [v.7] (02/24)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/19/2006 7:34:52 AM

Short Title: Franchise Tax Base Calculation. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO CLARIFY THE TREATMENT OF DEFERRED TAX ASSETS IN THE COMPUTATION OF THE FRANCHISE TAX CAPITAL BASE.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-122(b) reads as rewritten:

"(b) Determination of Capital Base. -- ~~Every such~~ A corporation taxed under this section shall determine the total amount of its issued and outstanding capital stock, ~~surplus~~ surplus, and undivided ~~profits; no reservation or allocation~~ profits. No reservation or allocation from surplus or undivided profits ~~shall be~~ is allowed ~~other than for~~ except as provided below:

(1) Definite ~~definite~~ and accrued legal ~~liabilities, except as herein provided;~~liabilities.

(2) ~~taxes~~ Taxes accrued, dividends ~~declared~~ declared, and reserves for depreciation of tangible assets as permitted for income tax ~~purposes shall be treated as deductible liabilities. There shall also be treated as a deductible liability reserves for the entire cost~~ purposes.

(3) When including deferred tax liabilities, a corporation may reduce the amount included in its base by netting against that amount deferred tax assets. The reduction may not decrease deferred tax liabilities below zero (0).

(4) Reserves for the cost of any air-cleaning device or sewage or waste treatment plant, including waste lagoons, and pollution abatement equipment purchased or constructed and installed which reduces the amount of air or water pollution resulting from the emission of air contaminants or the discharge of sewage and industrial wastes or other polluting materials or substances into the outdoor atmosphere or streams, lakes, or rivers, upon condition that the corporation claiming

such deductible liability shall furnish to the Secretary a certificate from the Department of Environment and Natural Resources or from a local air pollution control program for air-cleaning devices located in an area where the Environmental Management Commission has certified a local air pollution control program pursuant to G.S. 143-215.112 certifying that the Environmental Management Commission or local air pollution control program has found as a fact that the air-cleaning device, waste treatment plant or pollution abatement equipment purchased or constructed and installed as above described has actually been constructed and installed and that such plant or equipment complies with the requirements of the Environmental Management Commission or local air pollution control program with respect to such devices, plants or equipment, that such device, plant or equipment is being effectively operated in accordance with the terms and conditions set forth in the permit, certificate of approval, or other document of approval issued by the Environmental Management Commission or local air pollution control program and that the primary purpose thereof is to reduce air or water pollution resulting from the emission of air contaminants or the discharge of sewage and waste and not merely incidental to other purposes and functions.

(5) ~~The~~ Reserves for the cost of purchasing and installing equipment or constructing facilities for the purpose of recycling or resource recovering of or from solid waste or for the purpose of reducing the volume of hazardous waste generated shall be treated as deductible for the purposes of this section upon condition that the corporation claiming such deductible liability shall furnish to the Secretary a certificate from the Department of Environment and Natural Resources certifying that the Department of Environment and Natural Resources has found as a fact that the equipment or facility has actually been purchased, installed or constructed, that it is in conformance with all rules and regulations of the Department of Environment and Natural Resources, and the recycling or resource recovering is the primary purpose of the facility or equipment.

(6) ~~The~~ Reserves for the cost of constructing facilities of any private or public utility built for the purpose of providing sewer service to residential and outlying areas shall be treated as deductible for the purposes of this section; the deductible liability allowed by this section shall apply only with respect to such pollution abatement plants or equipment constructed or installed on or after January 1, 1955.

(7) ~~Treasury stock shall not be considered in computing the capital stock, surplus and undivided profits as the basis for franchise tax, but shall be excluded proportionately from said capital stock, surplus and undivided profits as the case may be upon the basis and to the extent of the cost thereof.~~ The cost of treasury stock.

(8) In the case of an international banking facility, the capital base shall be reduced by the excess of the amount as of the end of the taxable year of all assets of an international banking facility which are employed outside the United States over liabilities of the international banking facility owed to foreign persons. For purposes of such reduction, foreign persons shall have the same meaning as defined in G.S. 105-130.5(b)(13)d.

Every corporation doing business in this State which is a parent, subsidiary, or affiliate of another corporation shall add to its capital stock, ~~surplus~~ surplus, and undivided profits all indebtedness owed to a parent, ~~subsidiary~~ subsidiary, or affiliated corporation as a part of its capital used in its business and as a part of the base for franchise tax under this section. ~~The term "indebtedness" as used in this paragraph includes all loans, credits, goods, supplies, or other capital of whatsoever nature furnished by a parent, subsidiary, or affiliated corporation, other than indebtedness endorsed, guaranteed, or otherwise supported by one of these corporations. The terms "parent," "subsidiary," and "affiliate" as used in this paragraph shall have the meaning specified in G.S. 105-130.6.~~ If any part of the capital of the creditor corporation is capital borrowed from a source other than a parent, ~~subsidiary~~ subsidiary, or affiliate, the debtor corporation, which is required under this ~~paragraph~~ subsection to include in its tax base the amount of debt by reason of being a parent, subsidiary, or affiliate of the ~~said~~ creditor corporation, may deduct from the debt ~~thus~~ included a proportionate part determined on the basis of the ratio of ~~such~~ the borrowed capital ~~as above specified~~ of the creditor corporation to the total assets of the ~~said~~ creditor corporation. If ~~Further, in case~~ the creditor corporation ~~as above specified~~ is also taxable under the provisions of this section, ~~such~~ the creditor corporation ~~shall be~~ is allowed to deduct from the total of its capital, ~~surplus~~ surplus, and undivided profits the amount of any debt owed to it by a parent, subsidiary or affiliated corporation to the extent that ~~such~~ the debt has been included in the tax base of ~~said~~ the parent, ~~subsidiary~~ subsidiary, or affiliated debtor corporation reporting for taxation under the provisions of this section.

The following definitions apply in this subsection:

(1) Affiliate. – The same meaning as specified in G.S. 105-130.6.

(2) Indebtedness. – All loans, credits, goods, supplies, or other capital of whatsoever nature furnished by a parent, subsidiary, or affiliated corporation, other than indebtedness endorsed, guaranteed, or otherwise supported by one of these corporations

(3) Parent. – The same meaning as specified in G.S. 105-130.6.

(4) Subsidiary. – The same meaning as specified in G.S. 105-130.6."

SECTION 2. This act is effective when it becomes law.

BILL DRAFT 2005-RBxz-31: Franchise Tax Base Calculation

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	May 2, 2006
Introduced by:		**Summary by:**	Cindy Avrette Committee Counsel
Version:	Draft		

SUMMARY: Draft Proposal 2005-RBz-31 seeks to clarify the treatment of deferred tax assets in the computation of the franchise tax capital base. The bill would become effective when it becomes law.

BILL ANALYSIS: North Carolina imposes a franchise tax at the rate of $1.50 per $1,000 of the total amount of a corporation's capital stock, surplus, and undivided profits (hereinafter referred to as the corporation's capital base). The corporation's capital base may not be less than 55% of the appraised value of all the real and tangible personal property owned by the corporation in the State nor less than its total actual investment in tangible property in the State.

Most public corporations compute their capital base for financial reporting purposes. Public corporations must comply with the requirements of the Financial Accounting Standards Board (FASB) when reporting the results of their operations and financial positions. Under FASB, corporations are required to accrue certain liabilities and the related deferred tax assets which are applicable to those accrued liabilities in order to accurately reflect the financial position of the corporation.

A corporation's determination of its capital base for purposes of the franchise tax is not the same as the calculation of its capital base for financial reporting purposes. The calculation of its capital base for franchise tax purposes is determined by G.S. 105-122(b), not by the requirements of FASB. The statute refers to book value as 'issued and outstanding capital stock, surplus, and undivided profits.' This is similar to net book value with certain adjustments. The principal adjustment is for contingent or deferred liabilities.

Deferred tax assets and deferred tax liabilities are accounts carried on the books of a corporation for financial reporting purposes. They represent timing differences in the recognition of income and deductions for income tax purposes and for financial accounting purposes. Deferred tax liability typically arises where income has been recognized on the corporation's books but not for tax purposes. For example, where a gain is reflected on the books but reported for tax purposes on the installment basis.

- Under FASB, deferred tax liabilities are recognized as liabilities for accounting purposes.
- Deferred liabilities are not recognized for franchise tax purposes because they are not 'definite and accrued'. Therefore, deferred tax liabilities must be added back to a corporation's capital base for franchise tax purposes.
- Frequently, a taxpayer that has a deferred liability will also have a deferred tax asset. The issue is whether the deferred liability that must be added-back can be reduced by the amount of the deferred tax asset. In 1996, the Department of Revenue issued a TAM (technical advice memorandum) that permitted the netting of deferred liability accounts and deferred tax asset accounts. The TAM provided that the deferred tax asset account had to be clearly identified with the deferred tax liability account and the deferred tax asset could not reduce the related deferred liability below zero (0).

The statute, the 1996 TAM, and GAAP differ on how to account for deferred tax assets. The purpose of this bill is to determine how deferred tax assets should be treated for franchise tax purposes and to state that treatment clearly in the statute.

The franchise tax statute begins the calculation of a corporation's franchise tax capital base with the '*total amount of its issued stock, surplus, and undivided profit*'. The statute provides that '*no reservation or allocation from surplus or undivided profits shall be allowed other than for definite and accrued legal liabilities, except as herein provided: taxes accrued, dividends declared and reserves for depreciation of tangible assets as permitted for income tax purposes shall be treated as deductible liabilities.*'

In 1992, FASB Statement No. 109 established financial accounting and reporting standards for the effects of income taxes that result from an enterprise's activities during the current and preceding years. The statement resulted in deferred tax assets being separately stated from deferred tax liabilities. When the two accounts were netted, a smaller net tax liability account was added-back to the franchise tax base. When the accounts had to be separately stated, the Department did not permit the netting of the two accounts. This resulted in the add-back of the deferred tax liability unreduced by the amount of the deferred tax asset.

Taxpayers having deferred tax asset accounts contended that they should be allowed to reduce their capital stock bases by the balances in those accounts. Since the asset and liability accounts are reciprocal concepts, they argued that it was inequitable to include a deferred tax liability in the capital stock base without decreasing it by the deferred tax asset.

In response to taxpayer concerns, the Department of Revenue issued TAM-CF-96-1 in August of 1996. The TAM appears to contradict the plain meaning of the statute because it permits the deferred liability accounts to be reduced by deferred tax asset accounts.[1] In explaining the change, the TAM states that a more equitable and consistent position is to recognize that net worth is incorrectly stated when the total amount of a deferred liability is included without a netting adjustment for the deferred tax benefit resulting directly from such liability. The TAM provides that the inclusion of a deferred liability in the computation of the net worth base should permit an offset or adjustment for the deferred tax asset required to be computed under the accounting standards without regard to how the deferred tax asset is reflected on the financial statement.

The FASB change in 1992 concerned the accounting for income taxes. Arguably, the TAM written in 1996 attempted to address the accounting changes precipitated by that FASB change. The wording of the TAM, however, refers to deferred liabilities as a whole instead of just deferred tax liabilities. Any deferred liability may create a corresponding deferred tax asset. Taxpayers contend that the TAM permits them to reduce the amount of any deferred liability required to be added back to its net book value for franchise tax purposes by the amount of a deferred tax asset. Examples of the types of contingent and deferred liabilities that have been reduced include post retirement benefits, loan loss reserves, credit card reserves, and litigation reserves.

This draft proposal would change the law to allow deferred tax liabilities to be reduced by their corresponding deferred tax assets.

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[1] The TAM became effective for tax years ending on or after July 1, 1996.

GENERAL ASSEMBLY OF NORTH CAROLINA

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FISCAL ANALYSIS MEMORANDUM

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DATE: May 1, 2006

TO: Revenue Laws Study Commission

FROM: Dave Crotts
Fiscal Research Division

RE: Proposal 2005-RBz-31 (v.7):
Franchise Tax Calculation

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:	See "Assumptions and Methodology"				
EXPENDITURES:					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: When the bill becomes law.

BILL SUMMARY: Since August 1, 1996 the Department of Revenue has been allowing taxpayers, when calculating their franchise tax base, to reduce, but not below zero, a deferred liability by the deferred tax asset amount that resulted when the deferred liability was required under financial accounting standards. The current management of the Department of Revenue feels that the Department did not have the statutory authority to make such a ruling in 1996 and some taxpayers are challenging some of the specifics of the ruling. The proposal attempts to clarify the issue by allowing deferred tax liabilities to be reduced by their corresponding tax assets, but not below zero.

ASSUMPTIONS AND METHODOLOGY: Discussions with the Department of Revenue indicate that the impact of the change will be fairly small.

SOURCES OF DATA: North Carolina Department of Revenue.

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #13

EXPANSION OF ROYALTY REPORTING OPTION

LEGISLATIVE PROPOSAL #13

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO EXPAND THE ROYALTY INCOME REPORTING OPTION TO INCLUDE ADDITIONAL TYPES OF INTANGIBLE PROPERTY.

SHORT TITLE: Expansion of Royalty Reporting Option

SPONSORS:

BRIEF OVERVIEW: This proposal would expand the reporting option available to corporations and their related members with regard to reporting the receipt of royalty payments by including payments for patents and copyrights.

FISCAL IMPACT:

EFFECTIVE DATE: For taxable years beginning on or after January 1, 2006.

A copy of the proposed legislation, bill analysis, and fiscal analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-SVz-13 [v.7] (02/15)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/19/2006 9:15:55 AM

Short Title: Expansion of Royalty Reporting Option. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO EXPAND THE ROYALTY INCOME REPORTING OPTION TO INCLUDE ADDITIONAL TYPES OF INTANGIBLE PROPERTY.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-130.7A reads as rewritten:

"**§ 105-130.7A. Royalty income reporting option.**

(a) Purpose. – Royalty payments received for the use of ~~trademarks~~ intangible property in this State are income derived from doing business in this State. This section provides taxpayers with an option concerning the method by which these royalties can be reported for taxation when the recipient and the payer are related members. As provided in this section, these royalty payments can be either (i) deducted by the payer and included in the income of the recipient, or (ii) added back to the income of the payer and excluded from the income of the recipient.

(b) Definitions. – The following definitions apply in this section:

(1) Component member. – Defined in section 1563(b) of the Code.

(1a) Intangible property. – Copyrights, patents, and trademarks.

(2) North Carolina royalty. – An amount charged that is for, related to, or in connection with the use in this State of ~~a trademark.~~ intangible property. The term includes royalty and technical fees, licensing fees, and other similar charges.

(3) Own. – To own directly, indirectly, beneficially, or constructively. The attribution rules of section 318 of the Code apply in determining ownership under this section.

(4) Related entity. – Any of the following:

a. A stockholder who is an individual, or a member of the stockholder's family enumerated in section 318 of the Code, if the stockholder and the members of the stockholder's family

own in the aggregate at least eighty percent (80%) of the value of the taxpayer's outstanding stock.

b. A stockholder, or a stockholder's partnership, limited liability company, estate, trust, or corporation, if the stockholder and the stockholder's partnerships, limited liability companies, estates, trusts, and corporations own in the aggregate at least fifty percent (50%) of the value of the taxpayer's outstanding stock.

c. A corporation, or a party related to the corporation in a manner that would require an attribution of stock from the corporation to the party or from the party to the corporation under the attribution rules of section 318 of the Code, if the taxpayer owns at least eighty percent (80%) of the value of the corporation's outstanding stock.

(5) Related member. – A person that, with respect to the taxpayer during any part of the taxable year, is one or more of the following:

a. A related entity.

b. A component member.

c. A person to or from whom there would be attribution of stock ownership in accordance with section 1563(e) of the Code if the phrase "5 percent or more" were replaced by "twenty percent (20%) or more" each place it appears in that section.

(6) Royalty payment. – Either of the following:

a. Expenses, losses, and costs paid, accrued, or incurred for North Carolina royalties, to the extent the amounts are allowed as deductions or costs in determining taxable income before operating loss deduction and special deductions for the taxable year under the Code.

b. Amounts directly or indirectly allowed as deductions under section 163 of the Code, to the extent the amounts are paid, accrued, or incurred for a time price differential charged for the late payment of any expenses, losses, or costs described in this subdivision.

(7) Trademark. – A trademark, trade name, service mark, or other similar type of intangible asset.

(8) Use. – Use of ~~a trademark~~ intangible property includes direct or indirect maintenance, management, ownership, sale, exchange, or disposition of the ~~trademark.~~intangible property.

(c) Election. – For the purpose of computing its State net income, a taxpayer must add royalty payments made to, or in connection with transactions with, a related member during the taxable year. This addition is not required for an amount of royalty payments that meets either of the following conditions:

(1) The related member includes the amount as income on a return filed under this Part for the same taxable year that the amount is deducted

by the taxpayer, and the related member does not elect to deduct the amount pursuant to G.S. 105-130.5(b)(20).

(2) The taxpayer can establish that the related member during the same taxable year directly or indirectly paid, accrued, or incurred the amount to a person who is not a related member.

(d) Indirect Transactions. – For the purpose of this section, an indirect transaction or relationship has the same effect as if it were direct."

SECTION 2. This act is effective for taxable years beginning on or after January 1, 2006.

LEGISLATIVE PROPOSAL 2005-SVz-13: Expansion of Royalty Reporting Option

BILL ANALYSIS

Committee:	Revenue Laws Study Committee	**Date:**	April 19, 2006
Introduced by:		**Summary by:**	Trina Griffin
Version:	Draft 2005-SVz-13		Committee Counsel

SUMMARY: ***This legislative proposal expands the reporting option available to corporations and their related members with regard to reporting the receipt of royalty payments by including payments for patents and copyrights.***

BACKGROUND[1] & CURRENT LAW: In recent years, intellectual property has become an enormously valuable intangible corporate asset due to the rapid change in science and technology coupled with expanding legal protections and increasing commercial success based on innovation. As intellectual property becomes a more important corporate asset, many companies with large intellectual property portfolios search for ways to maximize revenues, such as licensing those assets. Income derived from licensing intellectual property is subject to federal and state taxation as ordinary income. Given this, many companies have also developed tax strategies to minimize state taxation of royalty income.

Under one such strategy, a company with a large intellectual property portfolio forms a wholly-owned subsidiary to hold its intellectual property assets in a state that does not tax royalty income received from licensing intellectual property assets. The parent company transfers all of its intellectual property assets to the subsidiary in exchange for ownership of stock in the subsidiary. The subsidiary then licenses the intellectual property assets back to the parent company in exchange for royalties. If the parent corporation is late paying these royalties, it also owes the subsidiary late fees. The parent corporation deducts against its state income tax the royalties and late fees it owes the subsidiary. The subsidiary likely pays little or no tax on these receipts to the state in which it was formed because the receipts are either exempt or apportioned away from that state. Moreover, the subsidiary's receipts are paid back to the parent corporation in the form of deductible dividends. As a result of this arrangement, the parent corporation ends up paying little or no state tax on these profits even though it may generate substantial profits from its retail or manufacturing activities in a state. Recognizing this transfer and license-back arrangement as a tax avoidance strategy, many states have enacted laws attempting to reach this income for taxation.

In North Carolina, every C Corporation "doing business" in this State is subject to corporate income and franchise taxes.[2] Some corporations have argued that an out-of-state investment company's receipt of royalty income from the use of trademarks in this State does not constitute "doing business" in North Carolina and, therefore, the investment company is not subject to North Carolina income or franchise tax on the royalties.

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[1] Much of this information is drawn from Xuan-Thao N. Nguyen, "Holding Intellectual Property," 38 State Tax Notes 699 (November 21, 2005).

[2] See G.S. 105-130.3 and G.S. 105-122.

However, in *A&F Trademark, Inc. v. Tolson* the North Carolina Court of Appeals upheld the State's position on the taxation of royalty income received by an out-of-state investment company for the use of trademarks in this State. The Court ruled that the out-of-state taxpayers who hold trademarks used in North Carolina were doing business in North Carolina. Therefore, under current law, an out-of-state holding company receiving royalty payments for the use of trademarks, patents, or copyrights in North Carolina is subject to both North Carolina income and franchise taxes.

In 2001, the General Assembly enacted G.S. 105-130.7A to enhance corporate compliance with taxes on trademark income. This statute did not change what was already considered taxable but merely enhanced compliance with the State tax on income generated from using trademarks and added a reporting option to the income tax statute.

Specifically, G.S. 105-130.7A restates that a company's receipts from royalty payments for the use of trademarks in North Carolina are income from doing business in North Carolina. Then it provides adjustments to assure full and fair accountability of this income in relationship to where it is actually earned. In cases where the recipient of the North Carolina royalty income is unrelated to the payer, the recipient is required to pay tax on the income to North Carolina. In cases where the recipient and the payer are related, they have an option on how the income is reported to North Carolina. Either the payer can deduct the North Carolina royalty payments on its North Carolina return and the recipient can include them on its North Carolina return, or the payer can add them to its North Carolina income and the recipient can deduct them on its North Carolina return.[3]

This provision solves the problem as it relates to trademarks and trade names, but does not address other types of intellectual property, such as patents[4] and copyrights.[5]

BILL ANALYSIS: This legislative proposal would expand the royalty payment reporting option for corporations and their related members to include payments received for use of patents and copyrights.

This proposal does not change or expand what is already taxable in North Carolina. Royalty income received for the use of trademarks, patents, and copyrights in North Carolina *is* taxable and must be reported to North Carolina by an out-of-state corporation receiving this income. However, there is a reporting option currently available to corporations and their related members for royalty payments received for trademark usage that is not available when those payments are for patent or copyright usage.

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[3] See *Geoffrey, Inc. v. South Carolina Tax Com'n*, 437 S.E.2d 13 SC, 1993, cert. denied by U.S. Supreme Court, 114 S.Ct. 50 (1993). The South Carolina Supreme Court held that (1) royalty income of a foreign corporation, obtained from trademark licenses issued to an affiliate, could be taxed without violating due process clause and (2) tax could be imposed without violating interstate commerce clause.

[4] A patent for an invention is the grant of a property right to the inventor that gives the inventor the right to exclude others from making, using, offering for sale, selling or importing the invention for a specified period of time.

[5] Copyright is a form of protection provided under federal law to the authors of original works of authorship, including literary, dramatic, musical, artistic, and certain other intellectual works, both published and unpublished.

This proposal would give corporations and their related members that receive royalty payments derived from patent or copyright usage the ability to select which entity, the parent or the holding company, reports the income, just as that option is currently available to those corporations with regard to trademark royalties. That is, the payer has the option of deducting the payments on its North Carolina return and the recipient can include them on its North Carolina return, or the payer can add them to its North Carolina return and the recipient can deduct them on its North Carolina return.

EFFECTIVE DATE: This act would become effective for taxable years beginning on or after January 1, 2006.

2005-SVz-13

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

[This confidential fiscal memorandum is a fiscal analysis of a draft bill, amendment, committee substitute, or conference committee report that has not been formally introduced or adopted on the chamber floor or in committee. This is not an official fiscal note. If upon introduction of the bill you determine that a formal fiscal note is needed, please make a fiscal note request to the Fiscal Research Division, and one will be provided under the rules of the House and the Senate.]

DATE: April 25, 2006

TO: Revenue Laws

FROM: Dave Crotts
Fiscal Research Division

RE: Draft 2005-SVz-13 (v.6) (Expansion of Royalty Reporting Option)

FISCAL IMPACT

Yes (X) **No ( )** **No Estimate Available ( )**

	FY 2005-06	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10
REVENUES:			See "Assumptions and Methodology"		
EXPENDITURES:					

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: North Carolina Department of Revenue.

EFFECTIVE DATE: Tax years beginning on or after January 1, 2006.

BILL SUMMARY .The 2001 General Assembly enacted legislation that eliminated the tax planning strategy of shifting trademark royalty income to another state in order to avoid the North Carolina income tax. The proposal would extend the 2001 treatment to royalty income patents and copyrights.

ASSUMPTIONS AND METHODOLOGY: A discussion with the Department of Revenue indicates that the enactment of the bill could have a positive impact on General Fund tax revenue but the magnitude of this amount is not known. One factor limiting the impact of the proposal is that fact that in the wake of the **A & F Trademark** case, some affected taxpayers may be in compliance. Another issue

is the fact that the proposal applies to patent and copyright royalty income only. In general, any revenue gain would be smaller than the receipts from the 2001 act affecting trademark income. During the 2001 discussion the estimated fiscal impact from the trademark provision was $20 million per year.

SOURCES OF DATA: North Carolina Department of Revenue.

TECHNICAL CONSIDERATIONS:

LEGISLATIVE RECOMMENDATION #14

ELECTRICITY FRANCHISE TAX DISTRIBUTION

LEGISLATIVE RECOMMENDATION #14

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

CONSIDER A COMMITTEE SUBSTITUTE FOR SENATE BILL 343 THAT WOULD SIMPLIFY THE ELECTRICITY FRANCHISE TAX DISTRIBUTION

SHORT TITLE: Electricity Franchise Tax Distribution (Senate Bill 343, 2nd Edition). The bill is currently in the House Finance Committee.

SPONSORS: Sen. Hoyle

BRIEF OVERVIEW: Senate Bill 343, 2nd edition, finds that the current distribution to cities under G.S. 105-116.1 of part of the franchise tax on electric power companies imposes unnecessary administrative burdens on the cities, the power companies, and the Department of Revenue and results in numerous errors in the distribution. The bill directed the League of Municipalities to recommend a method of distributing this revenue to the cities on the basis of a formula that uses factors such as population and percentage share of prior distributions rather than service inside constantly changing city boundaries. The League's recommendation is contained in Appendix G. The Revenue Laws Study Committee recommends that the General Assembly consider a committee substitute for Senate Bill 343 that embodies the League's recommendation.

FISCAL IMPACT: No impact.

EFFECTIVE DATE: January 1, 2008

A copy of the fiscal analysis memorandum begins on the next page .

GENERAL ASSEMBLY OF NORTH CAROLINA

Session 2005

FISCAL ANALYSIS MEMORANDUM

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DATE: May 2, 2006

TO: Revenue Laws Study Committee

FROM: Rodney Bizzell
Fiscal Research Division

RE: Electric Utility Franchise Distribution

FISCAL IMPACT

Yes ( ) **No (X)** **No Estimate Available ( )**

	FY 2006-07	FY 2007-08	FY 2008-09	FY 2009-10	FY 2010-11
REVENUES:					
General Fund	"See Assumptions and Methodology"				
Local Governments	"See Assumptions and Methodology"				

PRINCIPAL DEPARTMENT(S) & PROGRAM(S) AFFECTED: NC Department of Revenue, NC Local Governments

EFFECTIVE DATE: January 1, 2008

BILL SUMMARY:
This bill would change the method by which the municipal share of the electric utility franchise tax is distributed to municipalities. A 3.22% tax rate is applied to gross receipts resulting from the sale of power and light in the state. An amount equal to a tax of 3.09% of revenues derived from within a legally incorporated municipality is distributed to the municipality. This method of distribution requires tracking municipal boundaries to determine the correct distribution amount. This bill provides an alternate distribution methodology that does not require tracking municipal annexations.

ASSUMPTIONS AND METHODOLOGY:
The proposed bill divides the distribution into four parts. The first part uses data from the most recent four distribution quarters, under current law, to calculate a base municipal statewide distribution amount and distribute it quarterly to each city. The second part of the distribution is calculated by using the cumulative growth in the municipal share of the statewide population from a base year as a proxy to create a separate fund to be distributed annually to cities based on their proportionate share of the cumulative absolute population. A third part of the distribution is used to determine the growth in the municipal share of gross revenue resulting from major existing and new commercial/industrial/institutional customers and expansions. This portion of the distribution would be distributed to cities annually based on their proportionate share of the revenues produced by the major new commercial/industrial customers. A final part of the distribution provides extra electric utility franchise tax distributions to municipalities that experience seasonal growth in electricity consumption due to tourism-based changes in population as opposed to changes in permanent population. It is calculated by using the increase in the water consumption in gallons (as a surrogate for electricity) in "seasonal population towns" to create a separate fund to be distributed annually to seasonal population towns as an adjustment factor.

The final calculation details of the formulas for the parts of the distribution would be worked out by League of Municipalities and Department of Revenue staff. By May 1, 2007, the Department of Revenue will provide to the League of Municipalities and appropriate legislative staff the results of test runs of the formulas showing city-by-city distributions to allow for any needed legislative changes before a proposed effective date of January 1, 2008. The distribution change is not expected to result in any significant fiscal impact.

SOURCES OF DATA: NC Department of Revenue, NC League of Municipalities

TECHNICAL CONSIDERATIONS: None

LEGISLATIVE PROPOSAL #15

REVENUE LAWS TECHNICAL AND MOTOR FUEL TAX CHANGES

LEGISLATIVE PROPOSAL #15

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE TO THE 2006 REGULAR SESSION OF THE 2005 GENERAL ASSEMBLY

AN ACT TO MAKE TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES TO THE REVENUE LAWS AND RELATED STATUTES AND TO IMPROVE THE COLLECTION AND ADMINISTRATION OF THE MOTOR FUEL TAX.

SHORT TITLE: Revenue Laws Technical and Motor Fuel Tax Changes

SPONSORS:

BRIEF OVERVIEW: Makes technical and clarifying changes to the revenue laws and related statutes and makes changes in the motor fuel tax laws to improve collection and administrative efforts.

FISCAL IMPACT:

EFFECTIVE DATE: Except as otherwise noted in the bill, the proposal would become effective when it becomes law.

A copy of the proposed legislation and bill analysis begin on the next page.

GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 2005

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BILL DRAFT 2005-SVz-10 [v.11] (01/24)

(THIS IS A DRAFT AND IS NOT READY FOR INTRODUCTION)
4/27/2006 4:33:02 PM

Short Title: Revenue Laws Tech. & Motor Fuel Tax Changes. (Public)

Sponsors: .

Referred to:

A BILL TO BE ENTITLED

AN ACT TO MAKE TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES TO THE REVENUE LAWS AND RELATED STATUTES AND TO IMPROVE THE COLLECTION AND ADMINISTRATION OF THE MOTOR FUEL TAX.

The General Assembly of North Carolina enacts:

SECTION 1. G.S. 105-113.82(a) reads as rewritten:

"**§ 105-113.82. Distribution of part of beer and wine taxes.**

(a) Amount, Method. – The Secretary shall distribute annually the following percentages of the net amount of excise taxes collected on the sale of malt beverages and wine during the preceding 12-month period ending March 31, less the amount of the net proceeds credited to the Department of ~~Agriculture and Consumer Services~~ Commerce under G.S. 105-113.81A, to the counties and cities in which the retail sale of these beverages is authorized in the entire county or city:

(1) Of the tax on malt beverages levied under G.S. 105-113.80(a), twenty-three and three-fourths percent (23¾%);

(2) Of the tax on unfortified wine levied under G.S. 105-113.80(b), sixty-two percent (62%); and

(3) Of the tax on fortified wine levied under G.S. 105-113.80(b), twenty-two percent (22%).

If malt beverages, unfortified wine, or fortified wine may be licensed to be sold at retail in both a county and a city located in the county, both the county and city shall receive a portion of the amount distributed, that portion to be determined on the basis of population. If one of these beverages may be licensed to be sold at retail in a city located in a county in which the sale of the beverage is otherwise prohibited, only the city shall receive a portion of the amount distributed, that portion to be determined on

the basis of population. The amounts distributed under subdivisions (1), (2), and (3) shall be computed separately."

SECTION 2. G.S. 105-122(d) reads as rewritten:

"(d) After determining the proportion of its total capital stock, surplus and undivided profits as set out in subsection (c) of this section, which amount ~~so determined~~ shall ~~in no case~~ not be less than fifty-five percent (55%) of the appraised value as determined for ad valorem taxation of all the real and tangible personal property in this State of each ~~such~~ corporation ~~plus the total appraised value of intangible property returned for taxation of intangible personal property as herein specified~~ nor less than its total actual investment in tangible property in this State, every corporation taxed under this section shall annually pay to the Secretary of Revenue, at the time the report and statement are due, a franchise or privilege ~~tax, which is hereby levied~~ tax at the rate of one dollar and fifty cents ($1.50) per one thousand dollars ($1,000) of the total amount of capital stock, surplus and undivided profits as ~~herein provided.~~ provided in this section. The tax imposed in this section shall ~~in no case~~ not be less than thirty-five dollars ($35.00) and shall be for the privilege of carrying on, doing business, and/or the continuance of articles of incorporation or domestication of each ~~such~~ corporation in this State. Appraised value of tangible property including real estate ~~shall be~~ is the ad valorem valuation for the calendar year next preceding the due date of the franchise tax return. ~~Appraised value of intangible property shall be the total gross valuation required to be reported for intangible tax purposes on April 15 coincident with or next preceding the due date of the franchise tax return.~~ The term "total actual investment in tangible property" as used in this section ~~shall be construed to mean~~ means the total original purchase price or consideration to the reporting taxpayer of its tangible properties, including real estate, in this State plus additions and improvements thereto less reserve for depreciation as permitted for income tax purposes, and also less any indebtedness incurred and existing by virtue of the purchase of any real estate and any permanent improvements made thereon. In computing "total actual investment in tangible personal property" there shall also be deducted reserves for the entire cost of any air-cleaning device or sewage or waste treatment plant, including waste lagoons, and pollution abatement equipment purchased or constructed and installed which reduces the amount of air or water pollution resulting from the emission of air contaminants or the discharge of sewage and industrial wastes or other polluting materials or substances into the outdoor atmosphere or into streams, lakes, or rivers, upon condition that the corporation claiming ~~such~~ this deduction shall furnish to the Secretary a certificate from the Department of Environment and Natural Resources or from a local air pollution control program for air-cleaning devices located in an area where the Environmental Management Commission has certified a local air pollution control program pursuant to G.S. 143-215.112 certifying that said Department or local air pollution control program has found as a fact that the air-cleaning device, waste treatment plant or pollution abatement equipment purchased or constructed and installed as above described has actually been constructed and installed and that ~~such~~ the device, plant or equipment complies with the requirements of the Environmental Management Commission or local air pollution control program with respect to ~~such~~ the devices,

plants or equipment, that ~~such~~ the device, plant or equipment is being effectively operated in accordance with the terms and conditions set forth in the permit, certificate of approval, or other document of approval issued by the Environmental Management Commission or local air pollution control program and that the primary purpose ~~thereof~~ is to reduce air or water pollution resulting from the emission of air contaminants or the discharge of sewage and waste and not merely incidental to other purposes and functions. The cost of constructing facilities of any private or public utility built for the purpose of providing sewer service to residential and outlying areas ~~shall be~~ is treated as deductible for the purposes of this section; the deductible liability allowed by this section shall apply only with respect to ~~such~~ pollution abatement plants or equipment constructed or installed on or after January 1, 1955."

SECTION 3.(a) G.S. 105-130.2 reads as rewritten:

"...

(4a) Gross income. – Defined in section 61 of the Code.

~~(4a)~~(4b) Income year. – The calendar year or the fiscal year upon the basis of which the net income is computed under this Part. If no fiscal year has been established, the income year is the calendar year. In the case of a return made for a fractional part of a year under the provisions of this Part or under rules adopted by the Secretary, the income year is the period for which the return is made.

..."

SECTION 3.(b) G.S. 105-114(b)(4) reads as rewritten:

"(4) Income year. – Defined in G.S. ~~105-130.2(5).~~105-130.2(4b)."

SECTION 4.(a) G.S. 105-130.47(a) reads as rewritten:

"(a) Definitions. – The following definitions apply in this section:

(1) Highly compensated individual. – An individual who receives compensation in excess of one million dollars ($1,000,000) for services with respect to a single production.

(2) Live sporting event. – A scheduled sporting competition, game, or race that is not originated by a production company, but originated solely by an amateur, collegiate, or professional organization, institution, or association for live or tape-delayed television or satellite broadcast. A live sporting event shall not include commercial advertising, an episodic television series, a television pilot, music video, motion picture, or documentary production where any sporting events are presented through archived historical footage or similar footage depicting earlier live sporting events that originated more than thirty days before the time of such usage.

(3) Production company. – Defined in G.S. 105-164.3.

(4) Qualifying expenses. – The sum of the total amount spent in this State for the following by a production company in connection with a production:

a. Goods and services leased or purchased by the production company. For goods with a purchase price of twenty-five

thousand dollars ($25,000) or more, the amount included in qualifying expenses is the purchase price less the fair market value of the good at the time the production is completed.

b. Compensation and wages paid by the production company, other than amounts paid to a highly compensated individual, either directly or indirectly, on which ~~the production company remitted~~ withholding payments are remitted to the Department of Revenue under Article 4A of this Chapter."

SECTION 4.(b) G.S. 105-151.29(a) reads as rewritten:

"(a) Definitions. – The following definitions apply in this section:

(1) Highly compensated individual. – An individual who receives compensation in excess of one million dollars ($1,000,000) for services with respect to a single production.

(2) Live sporting event. – A scheduled sporting competition, game, or race that is not originated by a production company, but originated solely by an amateur, collegiate, or professional organization, institution, or association for live or tape-delayed television or satellite broadcast. A live sporting event shall not include commercial advertising, an episodic television series, a television pilot, music video, motion picture, or documentary production where any sporting events are presented through archived historical footage or similar footage depicting earlier live sporting events that originated more than thirty days before the time of such usage.

(3) Production company. – Defined in G.S. 105-164.3.

(4) Qualifying expenses. – The sum of the total amount spent in this State for the following by a production company in connection with a production:

a. Goods and services leased or purchased by the production company. For goods with a purchase price of twenty-five thousand dollars ($25,000) or more, the amount included in qualifying expenses is the purchase price less the fair market value of the good at the time the production is completed.

b. Compensation and wages paid by the production company, other than amounts paid to a highly compensated individual, either directly or indirectly, on which ~~the production company remitted~~ withholding payments are remitted to the Department of Revenue under Article 4A of this Chapter."

SECTION 4.(c) G.S. 105-259(b) reads as rewritten:

"(b) Disclosure Prohibited. – An officer, an employee, or an agent of the State who has access to tax information in the course of service to or employment by the State may not disclose the information to any other person unless the disclosure is made for one of the following purposes:

~~(32) To provide the report required under G.S. 105-164.14(c) to the Department of Public Instruction and the Fiscal Research Division of the General Assembly.~~

. . .

(36) To furnish to a taxpayer claiming a credit under G.S. 105-130.47 or G.S. 105-151.29 information from a third party to the extent the information was used by the Secretary to adjust the amount of the credit claimed by the taxpayer."

SECTION 5.(a) G.S. 105-164.3(49) reads as rewritten:

"(49) Use. – Means and includes the exercise of any right or power or dominion whatsoever over tangible personal property or over any service subject to tax under this Article by a purchaser thereof and includes, but is not limited to, any withdrawal from storage, distribution, installation, affixation to real or personal property, or exhaustion or consumption of tangible personal property or any service subject to tax under this Article by the owner or purchaser thereof, but does not include the sale of tangible personal property or of any service subject to tax under this Article in the regular course of business."

SECTION 5.(b) G.S. 105-164.16(a) reads as rewritten:

"(a) General. – Sales and use taxes are payable quarterly, monthly, or semimonthly as specified in this section. A return is due quarterly or monthly as specified in this section. A return must be filed with the Secretary on a form prescribed by the Secretary and in the manner required by the Secretary. A return must be signed by the taxpayer or the taxpayer's agent.

A sales tax return must state the taxpayer's gross sales for the reporting period, the amount and type of sales made in the period that are exempt from tax under G.S. 105-164.13 or are elsewhere excluded from tax, the amount of tax due, and any other information required by the Secretary. A use tax return must state the purchase price of tangible personal property or services sourced to this State that ~~was~~ were purchased or received during the reporting period and ~~is~~ are subject to tax under G.S. 105-164.6, the amount of tax due, and any other information required by the Secretary. Returns that do not contain the required information will not be accepted. When an unacceptable return is submitted, the Secretary will require a corrected return to be filed."

SECTION 6. G.S. 105-164.6(c) reads as rewritten:

"(c) Credit. – A credit is allowed against the tax imposed by this section for the following:

(1) The amount of sales or use tax paid on the item to this State. Payment of sales or use tax to this State on an item by a retailer extinguishes the liability of a purchaser for the tax imposed under this section.

(2) The amount of sales or use tax paid on the item to another state. If the amount of tax paid to the other state is less than the amount of tax imposed by this section, the difference is payable to this State. The

credit allowed by this subdivision does not apply to tax paid to a state that does not grant a similar credit for sales or use taxes paid in North Carolina."

SECTION 7. G.S. 105-164.7 reads as rewritten:

"**§ 105-164.7. Sales tax part of purchase price.**

Every retailer subject to the tax levied in G.S. 105-164.4 shall at the time of selling or delivering or taking an order for the sale or delivery of taxable tangible personal property or a taxable service, or collecting the sales price, add to the sales price the amount of tax due. The tax constitutes a part of the purchase price, is a debt from the purchaser to the retailer until paid, and is recoverable at law in the same manner as other debts. The tax must be stated and charged separately from the sales price, shown separately on the retailer's sales records, and paid by the purchaser to the retailer as trustee for and on account of the State. The retailer is liable for the collection of the tax and for its payment to the Secretary. The retailer's failure to charge the tax to or to collect the tax from the purchaser does not affect this liability. It is the intent of this Article that the tax be added to the sales price of tangible personal property and services when sold at retail and be borne and passed on to the customer, instead of being borne by the retailer."

SECTION 8.(a) G.S. 105-164.13(1a) reads as rewritten:

"(1a) Sales of the following to a farmer, as defined in subdivision (1) of this section:

a. A container ~~sold to a farmer, as defined in subdivision (1) of this section,~~ used for a purpose set out in ~~that~~ subdivision (1) of this section or in packaging and transporting the farmer's product for sale.

b. A grain, feed, or soybean storage facility, and parts and accessories attached to the facility."

SECTION 8.(b) G.S. 105-164.13(4e) is repealed.

SECTION 9. G.S. 105-164.14(k) reads as rewritten:

"(k) Reports. – The Department of Revenue shall publish by May 1 of each year the following information itemized by taxpayer for the 12-month period ending the preceding December 31:

(1) The number of taxpayers claiming a refund allowed in subsections (a1), (g), (h), (i), ~~and (j)~~(j), and (*l*) of this section.

(2) The total amount of purchases with respect to which refunds were claimed.

(3) The total cost to the General Fund of the refunds claimed."

SECTION 10. G.S. 105-164.15A reads as rewritten:

"**§ 105-164.15A. Effective date of rate changes for services.**

The effective date of a rate change for a service taxable under this Article is administered as follows:

(1) For a rate increase, the new rate applies to the first billing period that starts on or after the effective date. For a service billed after it is provided, the first billing period starts on the effective date. For a

service billed before it is provided, the first billing period starts on the first day of the month after the effective date.

(2) For a rate decrease, the new rate applies to bills rendered on or after the effective date."

SECTION 11. G.S. 105-187.52 reads as rewritten:

"**§ 105-187.52. Administration.**

(a) Administration. – The privilege taxes imposed by this Article are in addition to the State use tax. Except as otherwise provided in this Article, the collection and administration of these taxes is the same as the State use tax imposed by Article 5 of this Chapter.

(b) Credit. – A credit is allowed against the tax imposed by this Article for the amount of a sales or use tax, privilege or excise tax, or substantially equivalent tax paid to another state. The credit allowed by this subsection does not apply to tax paid to another state that does not grant a similar credit for the privilege tax paid in North Carolina."

SECTION 12.(a) G.S. 105-233 and G.S. 105-234 are repealed.

SECTION 12.(b) G.S. 105-236 reads as rewritten:

"**§ 105-236. ~~Penalties.~~Penalties; situs of violations; penalty disposition.**

(a) Penalties. – ~~Penalties assessed by the Secretary under this Subchapter are assessed as an additional tax. The clear proceeds of any civil penalties levied pursuant to subdivisions (3), (4), (5)a., and (6) of this section shall be remitted to the Civil Penalty and Forfeiture Fund in accordance with G.S. 115C-457.2. Except as otherwise provided by law, and subject to the provisions of G.S. 105-237, the following penalties shall be applicable:~~The following civil penalties and criminal offenses apply:

(1) Penalty for Bad Checks. – When the bank upon which any uncertified check tendered to the Department of Revenue in payment of any obligation due to the Department returns the check because of insufficient funds or the nonexistence of an account of the drawer, the Secretary shall assess a penalty equal to ten percent (10%) of the check, subject to a minimum of one dollar ($1.00) and a maximum of one thousand dollars ($1,000). This penalty does not apply if the Secretary finds that, when the check was presented for payment, the drawer of the check had sufficient funds in an account at a financial institution ~~in this State~~ to pay the check and, by inadvertence, the drawer of the check failed to draw the check on the account that had sufficient funds.

. . .

~~(11) Any violation of Subchapter I, V, or VIII of this Chapter or of Article 3 of Chapter 119 of the General Statutes is considered an act committed in part at the office of the Secretary in Raleigh. The certificate of the Secretary that a tax has not been paid, a return has not been filed, or information has not been supplied, as required by law, is prima facie evidence that the tax has not been paid, the return has not been filed, or the information has not been supplied.~~

(12) Repealed by Session Laws 1991, c. 45, s. 27.

(b) Situs. – Violation of a tax law is considered an act committed in part at the office of the Secretary in Raleigh. The certificate of the Secretary that a tax has not been paid, a return has not been filed, or information has not been supplied, as required by law, is prima facie evidence that the tax has not been paid, the return has not been filed, or the information has not been supplied.

(c) Penalty Disposition. – Civil penalties assessed by the Secretary are assessed as an additional tax. The clear proceeds of civil penalties assesses by the Secretary must be credited to the Civil Penalty and Forfeiture Fund, established in G.S. 115C-457.1."

SECTION 12.(c) G.S. 105-449.48 and G.S. 105-449.127 are repealed.

SECTION 12.(d) G.S. 105-449.49 reads as rewritten:

"**§ 105-449.49. Temporary permits.**

(a) Issuance. – Upon application to the Secretary and payment of a fee of fifty dollars ($50.00), a motor carrier may obtain a temporary permit authorizing the carrier to operate a vehicle in the State for three days without registering the vehicle in accordance with G.S. ~~105-449.47 for not more than three days.~~ 105-449.47. A motor carrier to whom a temporary permit has been issued may elect not to report its operation of the vehicle during the three-day period. Fees collected under this subsection are credited to the Highway Fund.

(b) Refusal. – The Secretary may refuse to issue a temporary permit to any of the following:

(1) A motor carrier whose registration has been withheld or revoked.

(2) A motor carrier who the Secretary determines is evading payment of tax through the successive purchase of temporary permits."

SECTION 13.(a) G.S. 105-449.65(b) reads as rewritten:

"(b) Multiple Activity. – A person who is engaged in more than one activity for which a license is required must have a separate license for each activity, unless this subsection provides otherwise. A person who is licensed as a supplier is considered to have a license as a distributor. A person who is licensed as an occasional importer or a tank wagon importer is not required to obtain a separate license as a distributor unless the importer is also purchasing motor fuel, at the terminal rack, from an elective or permissive supplier who is authorized to collect and remit the tax to the State. A person who is licensed as a distributor is not required to obtain a separate license as an importer if the distributor acquires fuel for import only from an elective supplier or a permissive supplier and is not required to obtain a separate license as an exporter. A person who is licensed as a distributor or a blender ~~is not required to obtain a separate license~~ and who transports fuel is considered to be licensed as a motor fuel ~~transporter if the distributor or blender does not transport motor fuel for others for hire.~~transporter."

SECTION 13.(b) G.S. 105-449.101 reads as rewritten:

"**§ 105-449.101. Motor fuel transporter to file informational return showing deliveries of ~~imported or exported~~ motor fuel.**

(a) Requirement. – A motor fuel transporter ~~that imports motor fuel into this State or exports motor fuel from this State~~ must file a monthly informational return with the Secretary that shows motor fuel ~~received or delivered for import or export~~

transported in this State by the transporter during the month. ~~This requirement does not apply to a distributor that is not required to be licensed as a motor fuel transporter.~~

(b) Content. – The return required by this section is due ~~by the 25th day of the month following the month covered by the return.~~ on the same date as a monthly return due under G.S. 105-449.90. The return must contain the following information and any other information required by the Secretary:

(1) The name and address of each person from whom the transporter received motor fuel outside the State for delivery in the State, the amount of motor fuel received, the date the motor fuel was received, and the destination state of the fuel.

(2) The name and address of each person from whom the transporter received motor fuel in the State for delivery outside the State, the amount of motor fuel delivered, the date the motor fuel was delivered, and the destination state of the fuel.

(3) The name and address of each person from whom the transporter received motor fuel in the State for delivery in the State, the amount of motor fuel received, the date the motor fuel was received, and the destination state of the fuel."

SECTION 14.(a) G.S. 105-449.60 is amended by adding a new subdivision to read:

"**§ 105-449.60. Definitions.**

The following definitions apply in this Article:

...

(10a) Exempt card or code. – A credit card or an access code that enables the person to whom the card or code is issued to buy motor fuel at retail without paying the motor fuel excise tax on the fuel."

SECTION 14.(b) G.S. 105-449.88A reads as rewritten:

"**§ 105-449.88A. Liability for tax due on motor fuel designated as exempt by the use of cards or codes.**

~~(a) Exempt Cards at Rack. When a licensed distributor or licensed importer removes motor fuel from a terminal by means of an exempt card or exempt access code issued by the supplier, the distributor or importer represents that the fuel removed will be resold to a governmental unit that is exempt from the tax. A supplier may rely on this representation. A licensed distributor or licensed importer that does not resell motor fuel removed from a terminal by means of an exempt card or exempt access code to an exempt governmental unit is liable for any tax due on the fuel.~~

(b) Exempt ~~Cards at Retail.~~ Card or Code. ~~An "exempt card or code" is a credit card or an access code that enables the person to whom the card or code is issued to buy motor fuel at retail without paying the motor fuel excise tax on the fuel.~~ An entity that issues an exempt card or code has a duty to determine if the person to whom it is issued is exempt from the motor fuel excise tax. An entity that issues an exempt card or code to a person who is not exempt from tax is liable for tax due on motor fuel the person purchases at retail by use of the exempt card or code. If a supplier authorizes another entity to issue an exempt card or code to a person who is not exempt from tax, the

supplier and the entity that issued the card are jointly and severally liable for tax due on motor fuel the person purchases at retail by use of the exempt card or code.

(c) Card Holder. – A person to whom an exempt card or ~~exempt access card~~ code is issued ~~for use at a terminal or at retail~~ is liable for any tax due on fuel purchased with the card or code for a purpose that is not exempt. A person who misuses an exempt card or code by purchasing fuel with the card or code for a purpose that is not exempt is liable for the tax due on the fuel."

SECTION 14.(c) G..S. 105-449.90(c) is repealed.

SECTION 14.(d) G.S. 105-449.93 reads as rewritten:

"**§ 105-449.93. ~~Exempt sale deduction and percentage~~ Percentage discount for licensed distributors and some licensed importers.**

~~(a) Deduction. – A license holder listed below may deduct from the amount of tax otherwise payable to a supplier the amount calculated on motor fuel the license holder received from the supplier and resold to a governmental unit whose purchases of motor fuel are exempt from the tax under G.S. 105-449.88 if, when removing the fuel, the license holder used an access card or code specified by the supplier to notify the supplier of the license holder's intent to resell the fuel in an exempt sale:~~

~~(1) A licensed distributor.~~

~~(2) A licensed importer that removed the motor fuel from a terminal rack of a permissive or an elective supplier.~~

(b) Percentage Discount. – A licensed distributor that pays the tax due a supplier by the date the supplier must pay the tax to the State may deduct from the amount due a discount of one percent (1%) of the amount of tax payable. A licensed importer that removes motor fuel from a terminal rack of a permissive or an elective supplier and that pays the tax due the supplier by the date the supplier must pay the tax to the State may deduct from the amount due a discount of the same amount allowed a licensed distributor. The discount covers the expense of furnishing a bond and losses due to shrinkage or evaporation. A supplier may not directly or indirectly deny this discount to a licensed distributor or licensed importer that pays the tax due the supplier by the date the supplier must pay the tax to the State."

SECTION 14.(e) G.S. 105-449.94 is repealed.

SECTION 14.(f) G.S. 105-449.97(d) reads as rewritten:

"(d) Taxes Paid on Exempt Retail Sales. – When filing a return, a supplier that issues or authorizes the issuance of an exempt card or ~~an exempt access~~ code to a person that enables the person to buy motor fuel ~~at retail~~ without paying tax on the fuel may deduct the amount of excise tax imposed on fuel purchased with the exempt ~~retail~~ card or code. The amount of excise tax imposed on fuel purchased ~~at retail~~ with an exempt ~~retail~~ card or code is the amount that was imposed on the fuel when it was delivered to the retailer of the fuel."

SECTION 14.(g) G.S. 105-449.105A(a) reads as rewritten:

"(a) Refund. – A distributor who sells kerosene to any of the following may obtain a refund for the excise tax the distributor paid on the kerosene, less the amount of any discount allowed on the kerosene under G.S. 105-449.93:

(1) The end user of the kerosene, if the distributor dispenses the kerosene into a storage facility of the end user that contains fuel used only for one of the following purposes and the storage facility is installed in a manner that makes use of the fuel for any other purpose improbable:
a. Heating.
b. Drying crops.
c. A manufacturing process.

(2) A retailer of kerosene, if the distributor dispenses the kerosene into a storage facility that meets both of the following conditions:
a. It is marked with the phrase "Undyed, Untaxed Kerosene, Nontaxable Use Only" or a similar phrase that clearly indicates that the fuel is not to be used to operate a highway vehicle.
b. It either has a dispensing device that is not suitable for use in fueling a highway vehicle or is kept locked by the retailer and must be unlocked by the retailer for each sale of kerosene.

(3) An airport, if the distributor dispenses the kerosene into a storage facility that contains fuel used only for fueling airplanes and that meets at least one of the following conditions:
a. It is marked with the phrase "Undyed, Untaxed Kerosene, Nontaxable Use Only" or a similar phrase that clearly indicates that the fuel is not to be used to operate a highway vehicle.
b. It has a dispensing device that is not suitable for use in fueling a highway vehicle."

SECTION 15.(a) G.S. 105-449.100 reads as rewritten:

"**§ 105-449.100. Terminal operator to file informational return showing changes in amount of motor fuel at the terminal.**

A terminal operator must file a monthly informational return with the Secretary that shows the amount of motor fuel received or removed from the terminal during the month. The return is due ~~by the 25th day of the month following the month covered by the return.~~ on the same date as a monthly return due under G.S. 105-449.90. The return must contain the following information and any other information required by the Secretary:

(1) The number of gallons of motor fuel received in inventory at the terminal during the month and each position holder for the fuel.
(2) The number of gallons of motor fuel removed from inventory at the terminal during the month and, for each removal, the position holder for the fuel and the destination state of the fuel.
(3) The number of gallons of motor fuel gained or lost at the terminal during the month."

SECTION 15.(b) G.S. 105-449.102(a) reads as rewritten:

"(a) Return. – A distributor that exports motor fuel from a bulk plant located in this State must file a monthly return with the Secretary that shows the exports. The return is due ~~by the 25th day of the month following the month covered by the return.~~

on the same date as a monthly return due under G.S. 105-449.90. The return serves as a claim for refund by the distributor for tax paid to this State on the exported motor fuel."

SECTION 15.(c) G.S. 105-449.137(b) reads as rewritten:

"(b) Payment. – The tax imposed by this Article is payable when a return is due. A return is due ~~monthly within 25 days after the end of each month.~~ on the same date as a monthly return due under G.S. 105-449.90. A monthly return covers liabilities that accrue in the calendar month preceding the date the return is due. A return must be filed with the Secretary and must be in the form and contain the information required by the Secretary."

SECTION 15.(d) G.S. 119-18(a) reads as rewritten:

"(a) Tax. – An inspection tax of one fourth of one cent (1/4 of 1¢) per gallon is levied upon all of the fuel listed in this subsection regardless of whether the fuel is exempt from the per-gallon excise tax imposed by Article 36C or 36D of Chapter 105 of the General Statutes. The inspection tax on motor fuel is due and payable to the Secretary of Revenue at the same time that the per gallon excise tax on motor fuel is due and payable under Article 36C of Chapter 105 of the General Statutes. The inspection tax on alternative fuel is due and payable to the Secretary of Revenue at the same time that the excise tax on alternative fuel is due and payable under Article 36D of Chapter 105 of the General Statutes. The inspection tax on kerosene is payable monthly to the Secretary by a supplier that is licensed under Part 2 of Article 36C of Chapter 105 of the General Statutes and by a kerosene supplier. A monthly report is due ~~by the 22nd of each month~~ on the same date as a monthly return due under G.S. 105-449.90 and applies to kerosene sold during the preceding month by a supplier licensed under that Part and to kerosene received during the preceding month by a kerosene supplier. A kerosene terminal operator must file a return in accordance with the provisions of ~~G.S. 105-449.100.~~G.S. 105-449.90.

(1) Motor fuel.

(2) Alternative fuel used to operate a highway vehicle.

(3) Kerosene."

SECTION 16.(a) G.S. 105-449.106(c) reads as rewritten:

"(c) Special Mobile Equipment. – A person who purchases and uses motor fuel to operate special mobile equipment off-highway may receive a quarterly refund, for the excise tax paid during the preceding quarter, at a rate equal to the flat cents-per-gallon rate plus the variable cents-per-gallon rate in effect during the quarter for which the refund is claimed, less the amount of sales and use tax or privilege tax due on the fuel under this Chapter, as determined in accordance with G.S. 105-449.107(c). An application for a refund must be made in accordance with this Part."

SECTION 16.(b) G.S. 105-449.107 reads as rewritten:

"**§ 105-449.107. Annual refunds for off-highway use and use by certain vehicles with power attachments.**

(a) Off-Highway. – A person who purchases and uses motor fuel for a purpose other than to operate a licensed highway vehicle may receive an annual refund for the excise tax the person paid on fuel used during the preceding calendar year. The amount of refund allowed is the amount of the flat cents-per-gallon rate in effect during the year

for which the refund is claimed plus the average of the two variable cents-per-gallon rates in effect during that year, less the amount of sales and use tax or privilege tax due on the fuel under this Chapter. An application for a refund allowed under this section must be made in accordance with this Part.

(b) Certain Vehicles. – A person who purchases and uses motor fuel in one of the vehicles listed below may receive an annual refund for the amount of fuel consumed by the vehicle:

(1) A concrete mixing vehicle.
(2) A solid waste compacting vehicle.
(3) A bulk feed vehicle that delivers feed to poultry or livestock and uses a power takeoff to unload the feed.
(4) A vehicle that delivers lime or fertilizer in bulk to farms and uses a power takeoff to unload the lime or fertilizer.
(5) A tank wagon that delivers alternative fuel, as defined in G.S. 105-449.130, or motor fuel or another type of liquid fuel into storage tanks and uses a power takeoff to make the delivery.
(6) A commercial vehicle that delivers and spreads mulch, soils, composts, sand, sawdust, and similar materials and that uses a power takeoff to unload, blow, and spread the materials.
(7) A commercial vehicle that uses a power takeoff to remove and dispose of septage and for which an annual fee is required to be paid to the Department of Environment and Natural Resources under G.S. 130A-291.1.
(8) A sweeper.

The amount of refund allowed is thirty-three and one-third percent (33 1/3%) of the following: the sum of the flat cents-per-gallon rate in effect during the year for which the refund is claimed and the average of the two variable cents-per-gallon rates in effect during that year, less the amount of sales and use tax or privilege tax due on the fuel under this Chapter. An application for a refund allowed under this section must be made in accordance with this Part. This refund is allowed for the amount of fuel consumed by the vehicle in its mixing, compacting, or unloading operations, as distinguished from propelling the vehicle, which amount is considered to be one-third of the amount of fuel consumed by the vehicle.

(c) Sales Tax Amount. – Article 5 of this Chapter determines the amount of sales and use tax to be deducted under this section from a motor fuel excise tax refund. Article 5F of this Chapter determines the amount of privilege tax to be deducted under this section from a motor fuel excise tax refund. The sales price and the cost price of motor fuel to be used in determining the amount to deduct is the average of the wholesale prices used under G.S. 105-449.80 to determine the excise tax rates in effect for the two six-month periods of the year for which the refund is claimed."

SECTION 17. G.S. 105-449.120(a)(3a) is repealed.

SECTION 18. The caption of G.S. 105-249.2 reads as rewritten:

"**§ 105-249.2. Due date extended and penalties waived for certain military personnel or ~~individuals~~ persons affected by a presidentially declared disaster.**"

SECTION 19. The caption of G.S. 143B-437.71 reads as rewritten:

"**§ 143B-437.71. One North Carolina Fund established as a ~~nonreverting account.~~special revenue fund.**"

SECTION 20.(a) G.S. 153A-155(d) reads as rewritten:

"(d) Administration. – The taxing county shall administer a room occupancy tax it levies. A room occupancy tax is due and payable to the county finance officer in monthly installments on or before the ~~15th~~20th day of the month following the month in which the tax accrues. Every person, firm, corporation, or association liable for the tax shall, on or before the 20th day of each month, prepare and render a return on a form prescribed by the taxing county. The return shall state the total gross receipts derived in the preceding month from rentals upon which the tax is levied. A room occupancy tax return filed with the county finance officer is not a public record and may not be disclosed except in accordance with G.S. 153A-148.1 or G.S. 160A-208.1."

SECTION 20.(b) G.S. 160A-215(d) reads as rewritten:

"(d) Administration. – The taxing city shall administer a room occupancy tax it levies. A room occupancy tax is due and payable to the city finance officer in monthly installments on or before the ~~15th~~20th day of the month following the month in which the tax accrues. Every person, firm, corporation, or association liable for the tax shall, on or before the 20th day of each month, prepare and render a return on a form prescribed by the taxing city. The return shall state the total gross receipts derived in the preceding month from rentals upon which the tax is levied. A room occupancy tax return filed with the city finance officer is not a public record and may not be disclosed except in accordance with G.S. 153A-148.1 or G.S. 160A-208.1."

SECTION 21. G.S. 160A-49(f2) reads as rewritten:

"(f2) Effective Date of Annexation for Certain Property. – Annexation of property subject to annexation under subsection (f1) of this section shall become effective:

(1) Upon the effective date of the annexation ordinance, the property is considered part of the city only (i) for the purpose of establishing city boundaries for additional annexations pursuant to this Article and (ii) for the exercise of city authority pursuant to Article 19 of this Chapter.

(2) For all other purposes, the annexation becomes effective as to each tract of such property or part thereof on the last day of the month in which that tract or part thereof becomes ineligible for classification pursuant to ~~G.S. 105-227.4~~ G.S. 105-277.4 or no longer meets the requirements of subdivision (f1)(2) of this section. Until annexation of a tract or a part of a tract becomes effective pursuant to this subdivision, the tract or part of a tract is not subject to taxation by the city under Article 12 of Chapter 105 of the General Statutes nor is the tract or part of a tract entitled to services provided by the city."

SECTION 22. The introductory language for Section 59.2 of S.L. 2005-435 reads as rewritten:

"**SECTION 59.2.(a)** ~~G.S. 105-114.1(a4)~~ G.S. 105-114(a4) reads as rewritten:"

SECTION 23. The introductory language of Section 4 of S.L. 2005-413 reads as rewritten:

"**SECTION 4.** ~~G.S. 105-129.15(7) reads~~ Subdivisions (6) and (7) of G.S. 105-129.15 read as rewritten:"

SECTION 24. Section 1(a) of S.L. 2005-261 reads as rewritten:

"**SECTION 1.(a)** Authority; Vote. – If the majority of those voting on the question pursuant to this section vote for the levy of the tax, the Monroe City Council may, by ordinance, levy a prepared food and beverages tax of up to one percent (1%) of the sales price of prepared food and beverages sold within the City of Monroe at retail for consumption on or off the premises by a retailer subject to sales tax under G.S. ~~105-164(a)(1).~~105-164.4(a)(1). This tax is in addition to State and local sales tax.

The Monroe City Council may direct the county board of elections to submit to the qualified voters of the city during any election held in 2006 the question of whether to levy a local prepared food and beverages tax of one percent (1%) as provided in this section. The election must be held on a date jointly agreed upon by the board of elections and city council and held in accordance with Chapter 163 of the General Statutes. The question to be used in the voting systems and ballots shall be:

"[ ] FOR [ ] AGAINST

One percent (1%) local prepared food and beverages tax, in addition to the current local sales and use taxes, to be used for the Civic Center Project for the City of Monroe."

SECTION 25. Section 4 is effective for taxable years beginning on or after January 1, 2006. Sections 13, 14, 15, and 17 of this act become effective January 1, 2007, and apply to motor fuel purchased on or after that date. An exempt card or code will not be valid for sales of motor fuel at the terminal rack on or after January 1, 2007. The remainder of this act is effective when it becomes law.

BILL DRAFT 2005-SVz-10: Revenue Laws Technical & Motor Fuels Tax Changes

BILL ANALYSIS

Committee: Revenue Laws Study Committee
Introduced by:
Version: Draft

Date: April 27, 2006
Summary by: Trina Griffin
Committee Counsel

SUMMARY: ***This bill draft makes several technical, clarifying, and administrative changes to the revenue laws and related statutes and to the motor fuels tax laws to improve collection and administration.***

Sections 1, 2, 7, 19, 21, 22, 23, and 24 are technical changes. Sections 3, 5, 6, 8, 12, and 18 are clarifying changes. Sections 4, 9, 10, 11, and 20 make administrative changes. Sections 13 through 17 are changes to the motor fuel tax laws designed to improve collection and administrative efforts.

BILL ANALYSIS: This bill draft makes the following changes:

Section	Explanation
1	Corrects a departmental reference since S.L. 2005-380 transferred the NC Grape Growers Council from the Department of Agriculture and Consumer Services to the Department of Commerce.
2	Removes obsolete language and makes other stylistic changes. This statutory subsection makes two obsolete references to including the appraised value of intangible property in the appraised value base. This language became obsolete with the repeal of the intangibles tax effective for tax years beginning on or after January 1, 1995. The Department of Revenue does not require intangible property to be included in the appraised value base.
3(a) & (b)	Defines the term "gross income" in the corporate income tax law by reference to section 61 of the Code, which is the same definition that is currently found in the individual income tax law. Section 20(b) is a conforming change.
4	Section 4 relates to the new film incentives tax credit enacted last year. Subsections (a) and (b) make clarifying changes to the film incentives in both the corporate and individual provisions. First, the term "highly compensated individual" is limited to individuals who are compensated for services and does not include individuals who may sell goods in excess of the one-million-dollar limitation. Second, the exclusion of amounts paid to highly compensated individuals is clarified so that it is clear that the exclusion applies whether the individual is paid directly by the production or by an unrelated third-party. It is not uncommon for a production company to contract with a separate entity for the services of actors or other professionals involved in a production. Third, the statutes are amended so that withholdings must be remitted in order for compensation to qualify as a qualifying expenses, but that withholding does not necessarily have to be performed by the production company. Subsection (c) makes two changes to the confidentiality statute, one of which is related to the film incentives tax credit. It adds a new subdivision (36), which allows the Department of Revenue to provide to a production company claiming a film production

	credit information from a third party to the extent the information was used by the Department to adjust the amount of the credit claimed by the production company. It also repeals subdivision (32), which allows the Department of Revenue to provide to Department of Public Instruction and the Fiscal Research Division reports regarding sales and use tax refunds received by school administrative units. This provision was enacted last year. However, Section 32(b) of S.L. 2005-435 amended the definition of tax information to exclude governmental agency refunds. Therefore, an exception is not needed in the confidentiality statute since the information is no longer confidential tax information.
5(a) & (b)	In 2005, the General Assembly made the use tax applicable to services sourced to this State. Section 21(a) is a conforming change which amends the definition of "use" to include services. Section 21(b) is a conforming change to the statute regarding use tax returns.
6	Corrects an inadvertent omission. In last year's budget bill, there was a rewrite of this statutory section on use tax. A credit should be allowed for both sales and use tax paid to another state, but the revised statute only provides a credit for sales tax paid. There was no intent to change the application of the tax and so, this section adds the phrase "or use" back into the statute.
7	Makes a grammatical change to the statute.
8(a) & (b)	Clarifies that the exemption from sales tax for sales of grain, feed, or soybean storage facilities and accessories only applies to sales made to farmers. This was one of the items previously subject to the 1%, $80 maximum rate of tax. The 1% rate was imposed on sales to farmers of grain, feed, or soybean storage facilities and accessories. Last year, to conform to the Streamlined Agreement, the General Assembly exempted these items from sales tax. However, the new exemption language did not limit the exemption to farmers.
9	Last year, a sales and use tax refund was authorized for the purchase of fuel by interstate passenger air carriers and by motorsports racing team or sanctioning body. Under current law, the Department of Revenue is required annually to publish the number of taxpayers claiming certain sales and use tax refunds. This section would add these categories of refunds to the reporting requirement.
10	Clarifies the effective date for a rate increase with regard to prepayments of service. In 2005, the General Assembly enacted G.S. 105-164.15A, which addresses the effective date for rate increases and decreases to taxable services, but the statute does not specifically address prepayments of service.
11	Provides a credit against the privilege tax for sales and use tax, or a similar type of tax, paid to another state. Currently, there is no specific provision for credits in the newly enacted Article 5F.
12(a) & (b)	Section 12 makes changes to various penalty statutes. **Section 12(a)** repeals two misdemeanor statutes relating to the willful failure to comply with the tax laws and aiding and abetting in the violation of the tax laws. These violations are covered by G.S. 105-236(9) and therefore are unnecessary. Section 12(b) reorganizes the penalties statute and makes some technical and clarifying changes. It divides the former statutory section into three subsections: subsection (a) lists the various penalties available to the Department of Revenue for violations of the

	tax laws; subsection (b) is a recodification of the principle previously set out in subdivision (11), which states that a violation of a tax law is considered an act committed in part at the office of the Secretary in Raleigh; and subsection (c) restates language previously found at the beginning of the statute directing the disposition of the penalty proceeds to the Civil Penalty and Forfeiture Fund. This subsection also deletes an obsolete requirement to avoid the penalty for a bad check, which states that a person had sufficient funds in a bank account "in this State." Since the Department does not follow this requirement, it is being deleted. Section 12(c) repeals G.S. 105-449.127, which provides that civil penalties assessed for violation of the motor fuels tax laws be credited to the Highway Fund. G.S. 105-449.48 provides that fees collected for the issuance of temporary permits for motor carriers and all civil penalties collected for violations of the motor carrier laws be credited to the Highway Fund. **Section 12(d)** repeals this statute and moves the fee disposition language to G.S. 105-449.49. The repeal of these two statutes redirects from the Highway Fund to the Civil Penalty and Forfeiture Fund civil penalty proceeds collected under these two articles as required by *North Carolina School Boards Assn. v. Moore*. In July of 2005, the North Carolina Supreme Court held in *North Carolina School Boards Assn. v. Moore* that the penalties assessed under Chapter 105 are imposed as a monetary payment for a taxpayer's noncompliance with a mandate of the Revenue Act, that they are punitive in nature, and, as such, they are subject to Article IX, Section 7 of the NC Constitution requiring those funds be remitted to the Civil Penalty and Forfeiture Fund for use by the schools.
13(a) & (b)	Section 13 would give the Department the ability to cross match all motor fuel to ensure compliance with the motor fuel tax laws. Under current law, the Department may cross-match information regarding fuel entering the State and fuel leaving the State, but it cannot cross-match information regarding the intrastate movement of motor fuel. The Department has a new fuel tracking system that will better enable it to monitor the movement of fuel. The Department expects the system to be operational by the last quarter of this fiscal year. Section 15 makes the statutory changes necessary to enable the Department to review intrastate movements of fuel by providing that anyone who transports fuel must be licensed as a transporter and that all transporters must file informational returns on all movements of motor fuel. Section 13(a) provides that all people who transport motor fuel will be licensed as a motor fuel transporter. Under current law, a person licensed as a distributor or blender is considered to be licensed as a motor fuel transporter if the person transports the fuel for other for hire. This section would remove the exception for persons who transport their own fuel so that any distributor or blender who transports fuel – whether for hire or for their own use – would also be considered licensed as a transporter. Section 13(b) provides that a transporter must file an informational return showing deliveries of motor fuel. Under current law, only interstate movements of fuel must be reported on a monthly informational return. The change in this section of the bill would

	require such a return for all deliveries of fuel.
14	Section 14 would provide that all motor fuel leaving the terminal rack would be subject to the motor fuel excise tax. The Department requested this change to reduce the areas of evasion and inadvertent duplicate refunds. Under current law, a licensed distributor or importer may remove fuel from a terminal without paying the tax if the person has an exempt card issued by the supplier. This section would remove the ability of distributors and importers to use exempt cards at the terminal rack. Instead, they would be able to obtain a monthly refund on any sales of fuel to exempt entities.[1] This change would conform North Carolina's law to the laws of the surrounding states who do not allow untaxed gasoline or undyed fuel to leave their terminals without the imposition of the tax. Section 14(a) puts the definition of 'exempt card or code' in the definitional statute for the motor fuel article. Section 14(b) repeals the portion of the statute that allows fuel to be removed from the terminal without paying the tax. Section 14(c) removes the deduction a licensed distributor or importer may make for tax exempt fuel taken from the terminal rack because the ability to obtain the fuel without paying the tax is repealed in section 14(b). Section 14(d) repeals the statute requiring a licensed distributor or importer who obtains fuel at the terminal rack with an exempt card to file a quarterly reconciling return. Section 14(e) makes conforming changes. Section 14(f) provides a monthly refund procedure for a distributor who sells diesel fuel to an airport. A refund procedure already exists for sales of motor fuel to the other listed exempt entities.
15	Section 13(b) and section 15 would establish a common due date for all motor fuel tax due and informational returns. Under current law, most of the monthly tax returns are due on the 22nd day of the month following the month covered by the return. Informational returns are due on the 25th day of the month following the month covered by the return. These sections provide that all monthly returns are due on the 22nd day of the month following the month covered by the return.
16	Adds a reference to the privilege tax imposed under Article 5F, which was enacted last year, with regard to refunds of motor fuels tax allowed for nonhighway use of a vehicle. A refund of motor fuels tax allowed for the nonhighway use of a vehicle is to be reduced by the amount of sales and use tax owed based on the method set out in G.S. 105-449.107. Prior to January 1, 2006, the amount of sales tax due was based on either the general State and local rates of tax of the 1% rate imposed on sales of fuel to farmers and manufacturers. Effective January 1, 2006, sales of fuel to farmers and manufacturers are subject to the new 1% privilege tax. Currently, these two statutes refer only to the sales and use taxes levied in Article 5.
17	Section 17 would remove the misdemeanor for taxpayers failing to pay the destination state taxes collected to that state. This provision was put into the law when North Carolina first moved to tax-at-the-rack. Today, all of the surrounding states have destination state tax laws. North Carolina does not collect and remit the taxes to those states, therefore this misdemeanor is no longer needed.
18	Amends the caption of G.S. 105-249.2 by replacing the word "individuals" with the word "persons." This statute provides, in part, that no penalties may be assessed for any period in which the time for filing a federal return or for paying a federal tax is extended

[1] G.S. 105-449.88 exempts the following entities from the motor fuel excise tax if it is sold to them for their use: the federal government, the State, local boards of education, charter schools, community colleges, counties, municipalities, and airports.

	because of a presidentially declared disaster. The relief provided by this statute is applied by the Department of Revenue equally to all tax entities, including businesses, and not just individuals.
19	Amends the caption of the statute to reflect what the statute actually provides. G.S. 143B-437.71(a) states, "The One North Carolina Fund is established as a special revenue fund in the Department of Commerce."
20	Section 20(a) and (b) conform the date an occupancy tax return is due to the date that the occupancy taxes are due.
21	Corrects an incorrect statutory reference.
22	Corrects an incorrect statutory reference.
23	Corrects introductory language from a 2005 session law.
24	Corrects an incorrect statutory reference within a local session law.

EFFECTIVE DATE: Section 4 is effective for taxable years beginning on or after January 1, 2006. Sections 13, 14, 15, and 17 of this act become effective January 1, 2007, and apply to motor fuel purchased on or after that date. An exempt card or code will not be valid for sales of motor fuel at the terminal rack on or after January 1, 2007. The remainder of this act is effective when it becomes law.

APPENDIX A

AUTHORIZING LEGISLATION
ARTICLE 12L OF CHAPTER 120
OF THE
GENERAL STATUTES

ARTICLE 12L

Revenue Laws Study Committee

§ 120-70.105. Creation and membership of the Revenue Laws Study Committee.

(a) Membership. -- The Revenue Laws Study Committee is established. The Committee consists of 16 members as follows:

(1) Eight members appointed by the President Pro Tempore of the Senate; the persons appointed may be members of the Senate or public members.

(2) Eight members appointed by the Speaker of the House of Representatives; the persons appointed may be members of the House of Representatives or public members.

(b) Terms. -- Terms on the Committee are for two years and begin on January 15 of each odd-numbered year, except the terms of the initial members, which begin on appointment. Legislative members may complete a term of service on the Committee even if they do not seek reelection or are not reelected to the General Assembly, but resignation or removal from service in the General Assembly constitutes resignation or removal from service on the Committee.

A member continues to serve until a successor is appointed. A vacancy shall be filled within 30 days by the officer who made the original appointment. (1997-483, s. 14.1; 1998-98, s. 39.)

§ 120-70.106. Purpose and powers of Committee.

(a) The Revenue Laws Study Committee may:

(1) Study the revenue laws of North Carolina and the administration of those laws.

(2) Review the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable.

(3) Call upon the Department of Revenue to cooperate with it in the study of the revenue laws.

(4) Report to the General Assembly at the beginning of each regular session concerning its determinations of needed changes in the State's revenue laws.

These powers, which are enumerated by way of illustration, shall be liberally construed to provide for the maximum review by the Committee of all revenue law matters in this State.

(b) The Committee may make interim reports to the General Assembly on matters for which it may report to a regular session of the General Assembly. A report to the General Assembly may contain any legislation needed to implement a recommendation of the Committee. When a recommendation of the Committee, if enacted, would result in an increase or decrease in State revenues, the report of the Committee must include an estimate of the amount of the increase or decrease. (1997-483, s. 14.1.)

§ 120-70.107. Organization of Committee.

(a) The President Pro Tempore of the Senate and the Speaker of the House of Representatives shall each designate a cochair of the Revenue Laws Study Committee. The Committee shall meet upon the joint call of the cochairs.

(b) A quorum of the Committee is nine members. No action may be taken except by a majority vote at a meeting at which a quorum is present. While in the discharge of its official duties, the Committee has the powers of a joint committee under G.S. 120-19 and G.S. 120-19.1 through G.S. 120-19.4.

(c) The Committee shall be funded by the Legislative Services Commission from appropriations made to the General Assembly for that purpose. Members of the Committee receive subsistence and travel expenses as provided in G.S. 120-3.1 and G.S. 138-5. The Committee may contract for consultants or hire employees in accordance with G.S. 120-32.02. Upon approval of the Legislative Services Commission, the Legislative Services Officer shall assign professional staff to assist the Committee in its work. Upon the direction of the Legislative Services Commission, the Supervisors of Clerks of the Senate and of the House of Representatives shall assign clerical staff to the Committee. The expenses for clerical employees shall be borne by the Committee. (1997-483, s. 14.1.)

APPENDIX B

MEETING AGENDAS

REVENUE LAWS STUDY COMMITTEE

Rep. Paul Luebke Sen. John Kerr

Monday, December 12, 2005
Room 544, Legislative Office Building
1:00 p.m.

I. Welcome and Introductions

II. 2005 Finance Law Changes
Cindy Avrette, Research Division

III. Taxation of Communication Services

- **Past and Current North Carolina Tax Treatment**
  Cindy Avrette, Research Division
- **Convergence of the Industries**
  Brenna Erford, Fiscal Research Division

IV. Expansion of the Sales Tax Base – Maintenance Agreements
Linda Millsaps, Fiscal Research Division

V. Adjournment
Next Meeting: January 11, 2006 at 1:00 pm

REVENUE LAWS STUDY COMMITTEE

Sen. John Kerr Rep. Paul Luebke

Wednesday, January 11, 2006
Room 544, Legislative Office Building
1:00 p.m.

I. Approval of the Minutes from the December 12, 2005, Meeting

II. Taxation of Communication Services

- **Review of Current State Tax Treatment**
  Cindy Avrette, Legal Analyst, Research Division
- **Comments from Interested Parties**
  - *Bruce Yancey, Director of State and Local Taxes, BellSouth*
  - *Alan Ciamporcero, President, Southeast Region Public Affairs, Policy, & Communications, Verizon*
  - *Robert Wells, Executive Director, The Alliance of North Carolina Independent Telephone Companies*
  - *Randy Fraser, Vice President Government Affairs – NC, Time Warner Cable*
  - *Tom Adams, President of the NC Cable Telecommunications Association and President, Raleigh Division, Time Warner Cable*
  - *Ross Lieberman, Director of Government Relations, Echo-Star*
  - *Lee Mandell, Director of Information Technology and Research, NC League of Municipalities*
  - *Paul Meyer, Assistant General Counsel, NC Association of County Commissioners*

III. Adjournment

Next Meeting: February 8, 2006 at 1:00 pm

REVENUE LAWS STUDY COMMITTEE

Sen. John Kerr Rep. Paul Luebke

Wednesday, February 8, 2006
Room 544, Legislative Office Building
1:00 p.m.

I. **Approval of the Minutes from the January 11, 2005, Meeting**

II. **Synopsis of the Institute of Emerging Issues Forum on 'Financing the Future'**

Sabra Faires, Senate Tax Counsel and member of IEI workgroup on 'Bridging the Gap'

III. **Streamlined Sales Tax Update**

Andy Sabol, Director of the Sales & Use Tax Division, Department of Revenue

IV. **Additional Personal Income Tax Filing Option: Draft Proposal, Summary, and Fiscal Memorandum**

Martha Walston, Fiscal Research Division
Linda Millsaps, Fiscal Research Division

V. **IRC Update: Draft Proposal, Summary, and Fiscal Memorandum**
Canaan Huie, Bill Drafting Division
Linda Millsaps, Fiscal Research Division

VI. **Property Tax Changes: Draft Proposal, Summary, and Fiscal Memorandum**

Martha Walston, Fiscal Research Division
Rodney Bizzell, Fiscal Research Division

VII. **Revenue Laws Technical Changes: Draft Proposal and Summary**

Trina Griffin, Research Division

VIII. **2005 Biennial Tax Expenditure Report**

Karl Knapp, Director of the Tax Research Division, Department of Revenue

IX. **Adjournment**

Next Meeting: March 1, 2006, in Room 544 LOB at 1:00 pm

REVENUE LAWS STUDY COMMITTEE AGENDA

Sen. John Kerr Rep. Paul Luebke

Wednesday, March 1, 2006
Room 544, Legislative Office Building
1:00 p.m.

I. Approval of the Minutes from the February 8, 2006, Meeting

II. Revenue Laws Technical Changes: Draft Proposal and Summary

Continuation of the draft from previous meeting – Provisions to improve the collection and administration of the motor fuel tax.

Cindy Avrette, Research Division

III. Streamlined Sales Tax Definitions: Draft Proposal and Summary

Sabra Faires, Senate Tax Counsel

IV. S Corp Income Tax Adjustments: Draft Proposal and Summary

Trina Griffin, Research Division

V. Clarify Additional Gross Premiums Tax: Draft Proposal and Summary

Cindy Avrette, Research Division

VI. Franchise Tax Loophole Closing: Draft Proposal and Summary

Trina Griffin, Research Division

VII. Franchise Tax Base Calculation: Draft Proposal and Summary

Cindy Avrette, Research Division

VIII. Expansion of Royalty Reporting Option: Draft Proposal and Summary

Trina Griffin, Research Division

IX. Real Estate Investment Trusts

Cindy Avrette, Research Division

X. **Taxation of Communications Services**

- **Review of Current Tax Treatment** – Cindy Avrette, Research Division
- **Review of Current NC Market** – Brenna Erford, Fiscal Research Division
- **Review of Current Legislation in other States** – Sabra Faires, Senate Tax Counsel

XI. **Adjournment**

Next Meeting: April 5, 2006, in Room 544 LOB at 1:00 pm

REVENUE LAWS STUDY COMMITTEE AGENDA

Sen. John Kerr Rep. Paul Luebke

Wednesday, April 19, 2006
Room 544, Legislative Office Building
1:00 p.m.

I. **Approval of the Minutes from the March 1, 2006, Meeting**

II. **Draft Proposal: Video Services Competition Act**

- **Overview of the Issue and Presentation of Draft Proposal**
  Cindy Avrette, Research Division
  Brenna Erford, Fiscal Research Division
- **Public Comments**

III. **Draft Proposal: Amend Taxation of Logging Machinery**
Trina Griffin, Research Division
Linda Millsaps, Fiscal Research Division

IV. **Draft Proposal: Amend Delinquent Property Tax Collection**
Martha Walston, Fiscal Research Division
Walker Reagan, Research Division

V. **Draft Proposal: Public Service Company Property**
Martha Walston, Fiscal Research Division

VI. **Status Report:**

- **Electricity Franchise Tax Distribution**
- **Real Estate Investment Trust**

VII. **Expansion of Sales Tax Base to include Maintenance Agreements**
Linda Millsaps

VIII. **Corporate Tax Issues, Continued from March 1, 2006, Meeting**

- **Draft Proposal: Franchise Tax Base Calculation**
  Cindy Avrette, Research Division
  David Crotts, Fiscal Research Division
- **Draft Proposal: Clarify Additional Gross Premiums Tax**
  Cindy Avrette, Research Division
  Rodney Bizzell, Fiscal Research Division
- **Draft Proposal: Franchise Tax Loophole Closing**
  Trina Griffin, Research Division
  David Crotts, Fiscal Research Division

- **Draft Proposal: S Corporation Income Tax Adjustments**
  Trina Griffin, Research Division
  David Crotts, Fiscal Research Division

- **Draft Proposal: Expansion of Royalty Reporting Option**
  Trina Griffin, Research Division
  David Crotts, Fiscal Research Division

IX. **Draft Proposal: Property Tax Changes**
(Continuation of draft from February 8, 2006 Meeting)
Martha Walston, Fiscal Research Division

X. **Draft Proposal: Streamlined Sales Tax Changes**
(Continuation of draft from March 1, 2006 Meeting)
Cindy Avrette, Research Division
Linda Millsaps, Fiscal Research Division

XI. **Draft Proposal: Revenue Laws Technical Changes**
(Continuation of draft from previous meetings)
Trina Griffin, Research Division

XII. **Adjournment: Next meeting May 2, *2006, in Room 544 LOB at 1:00 pm***

APPENDIX C

DISPOSITION OF COMMITTEE'S RECOMMENDATIONS TO THE 2005 SESSION OF THE GENERAL ASSEMBLY

STATUS OF BILLS RECOMMENDED BY THE REVENUE LAWS STUDY COMMITTEE - 2005 REGULAR SESSION

SHORT TITLE	SENATE SPONSORS	HOUSE SPONSORS	BILL #	FINAL STATUS
Increase Disabled Vet Property Tax Exclusion		Brubaker	HB 139	Not enacted
IRC Update	Kerr		SB 146	Original bill not enacted. The provisions were put into SB 622, which was **enacted, S.L. 2005-276** (see Sec. 35).
Motor Fuel Tax Changes		Luebke	HB 105	**Enacted** **SL 2005-435**
Property Tax Changes		Brubaker	HB 116	**Enacted*** **SL 2005-313**
Revenue Laws Technical Changes	Hartsell		SB 159	Original bill not enacted. The provisions were put into HB 105, which was **enacted, S.L. 2005-435** (see Part II.).
Streamlined Sales Tax Changes	Kerr		SB 145	Original bill not enacted. The provisions were put into SB 622, which was **enacted, S.L. 2005-276** (see Sec. 33).

JAC/04-25-2006

* Bills were modified prior to enactment.

APPENDIX D

CABLE FRANCHISE SURVEY
BRENNA ERFORD, FISCAL RESEARCH DIVISION

Summary of Cable Franchise Survey

The following statistics are taken from a survey of 272 North Carolina local governments regarding their franchise fee collections and other nonmonetary contributions received in accordance with their cable franchise agreement or agreements. The survey was conducted by the North Carolina General Assembly Fiscal Research Division. A total of 161 local governments responded to the survey.

Type of Respondent	Number surveyed	Number responded	Percent
Municipalities	172	109	63.4%
Counties	100	52	52.0%

The municipality-to-county ratio in the following survey data is:

Type of respondent	Number of respondents	Percent of total
Cities or towns	109	67.7%
Counties	52	32.3%
Total	161	100%

The purpose of this document is to summarize the survey's findings. The survey requested actual franchise fee collections for fiscal years 2004 and 2005. This data is reported separately in Appendix A.

Franchise Agreements & Fees

- One hundred and fourteen survey respondents (70.8%) negotiated their current franchise agreement or agreements independent of other local governments.[1]
- The majority of responding local governments (75.8%) assess franchise fees at the rate of 5% of gross revenues. (Please see Appendix B for detail on the assessment of franchise fees.)

Network Infrastructure and Other Equipment

- Twenty respondents (12.4%) indicated they receive some network infrastructure from their cable operator or operators.[2]
- Twenty-one respondents (13.1%) indicated they receive equipment for PEG programming from their cable operator or operators. In addition, four respondents (2.5%) indicated they receive some computer hardware or software related to PEG

[1] 24.2% of survey respondents negotiated their current franchise agreement or agreements in partnership with other local governments (5% did not respond to this question).

[2] 57.8% indicated that they do not receive any network infrastructure from their cable operator (29.8% did not respond)

programming. Four respondents (2.5%) also indicated they receive a PEG studio from their cable operator.[3]

- Eleven respondents (6.8%) indicated they receive some other form of capital from their cable operators.

Public, Educational, and Governmental (PEG) Channels

- More than half (50.9%) of respondents indicated they receive PEG channels from their cable operator.[4]
- The number of channels provided by cable operators ranged from 1 to 6 per local government. The chart below shows that the majority of local governments receiving PEG channels are allotted 3 or less by their cable operator.

Number of PEG channels provided	Number of responding local governments	Percent of total
1	44	57.9%
2	12	15.8%
3	11	14.5%
4	5	6.6%
5	1	1.3%
6	3	3.9%
Total	***76***	***100%***

- Twenty-eight survey respondents indicated how many of their allotted PEG channels are currently in use. Their responses ranged from all in use (100%) to none (0%). Unfortunately, too few respondents offered data on how many PEGs are currently in use to generalize these findings to North Carolina local governments in general.[5]

Broadband Internet Service

- Only seven respondents (4.3%) indicated they receive broadband internet service from their cable operator as part of their franchise agreement. Most of those who receive service indicated that it is provided in the public schools.[6]

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[3] 55% of respondents indicated they do not receive any PEG-related equipment from their cable operator (31.9% did not respond). 42.2% of respondents indicated they do not receive computer hardware or software (55.3% did not respond), and 41.6% indicated they do not receive a PEG studio (55.9% did not respond).

[4] 29.2% indicated they do not receive PEG channels (19.9% did not respond).

[5] Twenty-seven local governments indicated how many of their allotted PEG channels are in use, but eight of the 27 are urban centers that have both a higher number of PEG channels than their less urban counterparts and also tend to utilize them differently. For example, the city of Raleigh has been allocated 5 PEG channels, but currently only uses 3, or 60%. In contrast, the cities of Elkin and Davidson each receive 1 PEG channel, which they indicated is used (100%). Using averages regardless of population size would result in overestimation of PEG use by urban areas and underestimation of their use in more rural areas.

[6] A few (less than five) respondents indicated they receive a "VPN discount" equal to 20% off the retail price of broadband service. These responses were not included in the broadband totals for the survey since they were understood to constitute something other than the provision of broadband service *free of charge*.

Basic Cable Service

- Seventy-one respondents (44.1%) receive basic cable service free of charge in some or all government-owned buildings.[7] Of those local governments that receive basic cable service:
    - Forty-one respondents (25.5%) receive free basic cable service in all government-owned buildings[8]
    - Fifty-six respondents (34.8%) receive free basic cable service in all administrative buildings[9]
    - Forty-six respondents (28.6%) receive free basic cable service in all public schools[10]
    - Thirty-six respondents (22.4%) receive free basic cable service in all public libraries[11]

Competition

- Although this survey was not designed to study competition within the cable industry in North Carolina, respondents were asked to indicate if they held more than one current cable franchise agreement with separate operators.
    - Twenty-four local governments surveyed (14.9% of respondents) hold cable franchise agreements with more than one cable operator in their area
    - One hundred and thirty-two local government surveyed (82.0%) hold only one cable franchise with one cable operator
    - Five local governments (3.1%) did not respond to the question
- Respondents were also asked to estimate what percent of households in their franchise area are able to obtain cable television service from more than one cable operator. Out of the twenty-four local governments with multiple franchises, twenty (or 83.3%) responded to this question.
    - Of those twenty local governments, eleven (or 45.8%) indicated that the multiple cable operators in their area do not serve the same areas, so in effect the "overlap" of cable operators' service areas was 0.0%.
    - The remaining thirteen local governments (or 54.2%) indicated that 1.0% to 60.0% of households in their area have access to service from more than one cable operator.

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[7] 26.7% do not receive basic cable service free of charge (29.2% did not respond).
[8] 74.5% did not respond.
[9] For purposes of this survey, "administrative buildings" include city halls, town administrative buildings, public utilities facilities, and police and fire departments (65.2% did not respond).
[10] 71.4% did not respond
[11] 77.6% did not respond

APPENDIX E

STREAMLINED SALES TAX UPDATE
ANDY SABOL, DIRECTOR OF SALES AND USE TAX
DEPARTMENT OF REVENUE

STREAMLINED SALES TAX UPDATE
February 2006

The Streamlined Sales Tax Project began in March 2000 as an effort by states, with input from local governments and the private sector, to simplify and modernize sales and use tax collection and administration. The goal of the representatives working on this Project is to achieve sufficient uniformity and simplification so as to encourage sellers without nexus in states to voluntarily collect sales or use tax in participating states. Currently, forty-three states and the District of Columbia have by legislative or executive action authorized participation in Project.

In November 2002, the Streamlined Sales and Use Tax Agreement was approved by the states. The Agreement contains the uniformity and simplification provisions developed by the Project. The Agreement has been amended several times over the last three years to adopt items that the Project participants continued to address. The Agreement itself was to become effective when at least ten (10) states representing twenty percent (20%) of the population of all states that impose a sales tax were determined to be in compliance with the provisions of the Agreement.

Over the last few years, states, including North Carolina, have enacted provisions to bring themselves into compliance with the Agreement. 2005 was a significant year in that in July 2005, eighteen states representing over twenty-eight percent (28%) of the population of states imposing sales tax were determined to be in substantial compliance with the Streamlined Agreement and became either full or associate member states. Full member states are states that were determined presently to be in substantial compliance with the provisions of the Streamlined Agreement. Associate member states are states that have taken action to amend their laws to come into compliance but have future effective dates. On October 1, 2005, the Streamlined Sales Tax Governing Board, Inc., consisting of representatives of the member states, came into existence. The Governing Board will oversee administration of the Agreement including matters such as interpretations of the Agreement, admittance of new members, and oversight of contracts and technology.

Since 2001, legislation has been enacted in each session to bring North Carolina laws into compliance with the provisions of the Streamlined Agreement and North Carolina was admitted as a full member state. There are currently thirteen full member states and six associate member states as Nevada was admitted as a member state as of January 1, 2006. As the states continue to address matters brought before them, there will be future amendments to the Agreement that will require amendments to our law. With most amendments states are being given at least two legislative sessions to address the issues and our Department has been working with General Assembly staff on changes to the Agreement made in April 2005 that will need to be enacted by January 1, 2008 in order for our State to remain in compliance. We look forward to continuing to work with members and staff and want to express our appreciation for all that has been accomplished to date.

The Governing Board is overseeing the implementation of several technology initiatives that will ease the burden of sellers for collection and remittance of sales and use tax. On October 1, 2005, a central registration system was activated on the Governing Board's website. This allows a multistate seller to complete a single electronic registration form and become registered to collect sales and use tax in all the member states. The member states download the registration information and incorporate the data into their own registration systems. To date, 479 sellers have registered through the central site with 27 of these being new sellers signifying that they will collect tax in North Carolina and with 67 being sellers already registered and collecting tax. Over $110,000 has been collected from the new sellers since activation of the system. In addition to these new sellers, we have estimated that we are collecting over $1.5 million annually from several sellers that came forward prior to the formation of the Governing Board who indicated that the reason for beginning to voluntarily collect tax was the progress that the states had made through the Streamlined Project efforts.

Another major initiative is the finalizing of contracts with third party service providers that will perform the administrative sales tax collection and remittance functions for sellers. Under this model, states have agreed to compensate the service providers for the services that they provide to sellers thus significantly easing the burden of collecting tax in states in which a seller is not located. The member states have been working for months on reviewing the tax computation software developed by the service providers and other functions necessary for the proper collection and remittance of tax. Four firms are currently being evaluated and it is hoped that the Governing Board will enter into contracts with at least two of the firms over the next few months. Once a service provider is available, it is anticipated the number of voluntary sellers will significantly increase.

All forty-three participating states and the District of Columbia, along with local government representatives, continue to work on remaining issues undertaken by the Streamlined Project through a State and Local Advisory Council. Private industry representatives have also formed an advisory body as recognized in the Streamlined Agreement. These bodies will be consulted and assigned projects by the Governing Board as new issues are brought forward, as deemed appropriate. Only the states that compose the Governing Board have the authority to vote on amendments to the Streamlined Agreement and entry of new members. It is anticipated that at least two more states, Vermont and Washington, will petition for membership in 2006 and that more states will choose to give serious consideration to making law changes necessary to become members now that the Agreement is effective and sellers are coming forward.

Members of our Department continue to represent the State and are delegates to the State and Local Advisory Council and the Governing Board. Our staff will continue to work with the appropriate parties to explain any new measures that come forth and to help formulate any legislation necessary to keep North Carolina in compliance. Federal legislation has once again been introduced in Congress that would require remote sellers to collect tax in those states that have adopted the uniformity and simplification provisions of the Streamlined Agreement. If this legislation is eventually enacted, our State should find itself in position to benefit accordingly.

Thank you for the opportunity to present this update. My staff and I will be glad to provide any additional information. 2005 was an important year in this process although there continues to be important work ahead. Once again, the support of members of the General Assembly and their staff have given is appreciated and we look forward to future discussions.

Submitted by: Andy Sabol, Director
Sales and Use Tax Division
North Carolina Department of Revenue

APPENDIX F

STATEWIDE SURVEY REGARDING SALES TAX ON SERVICE CONTRACTS, LINDA MILLSAPS, FISCAL RESEARCH DIVISION

APPENDIX G

RECOMMENDATION FOR ELECTRICITY FRANCHISE TAX DISTRIBUTION FORMULA, LEAGUE OF MUNICIPALITIES

Electric Utility Franchise Tax Distribution Issues and Proposed Process

Assumptions and Goals:

1. Electric utilities should only have to report total statewide gross receipts and major customer information to DoR. Utilities would no longer be required to track annexations except for large industrial/commercial/Institutional billing meters. Utilities would only need to provide an annual report to the state providing commercial/industrial/Institutional large billing meter revenue by municipality. Utilities would not need to provide any other detail on a monthly or quarterly basis other than total revenues subject to gross receipts tax and related gross receipts tax payment on the those revenues.
2. Data to make annual adjustments should be readily available and timely
3. Population-based data (natural growth, mergers, incorporations & un-incorporations, and annexations) and other sources (ones that do not involve utility companies calculating gross receipts from "service inside constantly changing city boundaries") should be the only data DoR needs to make annual adjustments
4. The proportion of the statewide electric utility franchise tax revenues that goes to municipalities should continue to grow, as it does under current law
5. Individual cities should be able to get additional electric utility tax revenues based on their growth, without penalizing municipalities without growth, as they can under current law
6. Calculated negative distribution amounts are not allowed and will be rounded up to zero.
7. The current criteria for determining whether municipalities are eligible to receive electric utility tax revenues will remain in place

Overview of Process:

The distribution process has four parts, creating four separate pots of money that are distributed through four different formulas.

The first pot uses data from the most recent four distribution quarters, under current law, to calculate a base municipal statewide distribution amount and distribute it quarterly to each city.

A second, "municipal share growth," pot is calculated by using the cumulative growth in the municipal share of the statewide population from a base year as a proxy to create a separate fund to be distributed annually to cities based on their proportionate share of the cumulative absolute population growth from the same base year.

A third pot is calculated by using gross revenue data from electric utilities about major existing and new commercial/industrial/institutional customers and expansions (those meeting a pre-determined threshold size of annual electricity consumption) to create a separate fund to be distributed to cities annually based on their proportionate share of the revenues produced by the major new commercial/industrial customers.

A final pot provides extra electric utility franchise tax distributions to municipalities that experience seasonal growth in electricity consumption due to tourism-based changes in population as opposed to changes in permanent population. It is calculated by using the increase in the water consumption in gallons (as a surrogate for electricity) in "seasonal population towns" to create a separate fund to be distributed annually to seasonal population towns as an adjustment factor.

The final calculation details of the formulas for the four pots of funds would be worked out by League of Municipalities and DoR staff. By May 1, 2007, DoR will provide to the League of Municipalities and appropriate legislative staff the results of test runs of the formulas showing city-by-city distributions to allow for any needed legislative changes before a proposed effective date of January 1, 2008. Reasonable one-time, re-programming costs for DoR could be deducted from the first new quarterly distribution in the same manner as the continuing costs of collection.

Proposed Process and Issues

Pot 1, Base Municipal Statewide Distribution:

1. *Municipal base share of total statewide Electric Utility Franchise Tax collections* (use the municipal collection percentage for the most recent year available [currently estimated to be about 58%] to calculate the base municipal share each quarter; this percentage will remain fixed)
2. *Individual municipality share of base distribution* (use each municipality's past proportional share of each quarterly distribution, averaged over the last 3 years, after adjustment for holdback and hold harmless but before adjustment for cost of collection and error corrections, and then apply those percentages to the base municipal share amount each quarter; these percentages will remain fixed)

Pot 2, Municipal Share Growth Distribution:

1. *Growth in municipal share of total statewide electric utility tax collections* (use the cumulative percentage growth in the certified municipal proportion of the statewide population from the most recent base year [the municipal population proportion has grown from 49.75% in 1996 to 52.25% in 2003 = 5.03%] as a proxy to calculate quarterly municipal share growth percentages [the municipal share proportion has grown from 53.11% in FY97-98 to 57.92% in FY04-05 = 9.06%], which are then applied to the base municipal collection percentage to calculate the percent of the quarterly total statewide electric utility tax collections going into the municipal share growth pot [58% * 5.03% = 2.92%])
2. *Growth in individual municipality electric utility tax collections from the impact of natural population growth and annexations on each municipality's share of the distribution* (use cumulative absolute growth in certified individual municipal populations from the base year annually to distribute, only to growing municipalities, the pot of money created by the adjustment by calculating individual municipality population growth as a percentage of statewide municipal population growth)

Pot 3, Major Customer Growth Distribution:

1. *Growth in individual municipality electric utility tax collections from the impact of growth in electricity use by major commercial/industrial customers on each municipality* (utilities would provide annual information to the state that would show large commercial/industrial/ institutional billing meter revenue by municipality to create a separate fund, calculated by multiplying annual growth by city by 3.09%,). A commercial/industrial/institutional billing meter is considered to be large if the annual electric revenue for financial reporting purposes from the billing meter is more than $200,000 for the year.

1. [For purposes of implementation and reporting of utility gross receipts tax proceeds for major electric customers, "customer" shall be defined as an individual electric billing meter with actual annual revenue in excess of $200,000 in the prior calendar year. Revenue shall consider all tariff charges, but shall exclude any applicable sales taxes or other miscellaneous charges such as outdoor lighting, additional facilities, non-regulated services or other fees that might be included on the electric bill. "Customer" shall include any industrial or commercial entity located on a single premise receiving an electric bill that is not classified as Public Administration by the Standard Industrial Classification Manual published by the United States Government. A billing meter revenue could include multiple meters all serving a single corporate entity on a single premise that are simultaneous metered and totalized and billed through a single rate schedule. This definition would also exclude multiple unmetered locations, such as traffic signals or outdoor street lighting, that are consolidated and billed in a single mailing.]

2. Distribute annually to those cities with major electric customers, based on the taxes generated by each city's increased revenues produced by the growth in electricity used by major new commercial/industrial/institutional customers

Pot 4, Seasonal Population Towns Growth Distribution:

1. *Growth in individual seasonal population town electric utility tax collections from the impact of future increases in non-resident populations on each seasonal population town's share of the distribution* (use an index of relevant and readily available data (e.g., taxable real property per capita, tourism expenditures per capita, population, occupancy tax) to identify seasonal population towns in the base year. [This index is forthcoming from the League of Municipalities.] Update the list of seasonal population towns with new data every five years.
2. Calculate seasonal population towns' aggregate share of the total municipal distribution in the base year to establish a percentage which will be used in following years to create a seasonal population towns' distribution base. Recalculate this percentage every five years.
3. The rate of cumulative change in seasonal population towns' water consumption (based on annual water consumption data supplied by each seasonal population town) is used as a proxy for change in electricity consumption. The rate of change in seasonal population towns' water consumption is applied to the seasonal population towns' distribution base to establish the seasonal population towns' distribution amount. This distribution amount is allocated annually to the individual seasonal

population towns relative to their contribution to the cumulative change in water consumption.

Other Adjustments and Issues:

1. *Holdback amounts* (currently fixed at $19,308,392/year; subtract off the top of the base municipal share amount in equal quarterly totals, before distribution calculations)
2. *Cost of collection* (currently $75,000/year; subtract off the top of the base municipal share amount in equal quarterly amounts, before distribution calculations)
3. *Hold harmless amounts* (currently fixed at $265,066/year for 24 cities; adjusted for by using quarterly post-hold harmless adjustment distribution percentages)
4. *Error corrections* (adjusted for by using quarterly pre-error correction adjustment distribution percentages)
5. *New incorporations, mergers, & un-incorporations that have no franchise tax distribution history* (follow current procedures for handling new incorporations, etc., within the telecommunications tax)
6. *Unified city/county governments that have no franchise tax distribution history [e.g., Currituck County]* (follow current procedures for handling new incorporations within the telecommunications tax)
7. *Towns with current $0 distributions* (If a local act that provides alternative electric utility tax revenues to a city is repealed or if any other circumstances that prevent a city from currently getting electric utility franchise tax revenues change, then follow current procedures for handling new incorporations within the telecommunications tax; possibly affects 11 small towns)

Pros:

1. Eliminates the need for electric utilities to calculate gross receipts from "service inside constantly changing city boundaries" except for easily identified major customers
2. Eliminates distribution errors due to utility or municipality reporting mistakes, thereby reducing the administrative burden on DoR for error correction and the negative impact on cities
3. Provides for all municipalities to share in the natural growth of electric franchise tax
4. Provides for recurring increases in overall municipal share of statewide electric utility franchise tax revenues
5. Captures population and non-population growth in electric utility taxes.
6. Provides for growing municipalities to realize additional utility tax revenues <u>without</u> penalizing non-growing municipalities, since the funding for the growth comes from the State share of tax collections
7. Reduces the variability of revenues to individual municipalities; while the economy and the weather will still be major factors determining electric franchise tax revenues, they now will only affect the statewide municipal amount, and not the distribution to <u>individual</u> cities and towns; this softens the blow to individual municipalities that would otherwise absorb the <u>full</u> impact of a localized loss of electric gross receipts

Cons:

1. While providing a reasonable approximation, this process does not exactly adjust individual municipal shares of overall municipal statewide electric utility franchise tax revenues for the impact of electric gross receipts growth specifically through commercial and industrial customers, abnormally large annexations, or growth in seasonal visitors/residents but not year-round population
2. Certified municipal population estimates are sometimes inaccurate; however, they are the current basis for the distribution Powell Bill, sales tax, and beer and wine revenues
3. While the overall trend is towards an increasing proportion of statewide population to be municipal, there will be some years in which the growth will be negative

Statewide Distribution Examples for All Four Pots of Utility Tax Revenues

Pot 1: Base Municipal Share of Total Statewide Collections Based on Past Distributions

Year	State Total Collections (1)	Municipal Share % (2)	Municipal Share $ (3)	Holdback and Cost (4)	Municipal Distribution (5)
FY04-05 (base)	$259,926,056	57.92%	$150,549,172	$19,383,392	$131,165,780
FY05-06 (est)	$267,723,838	57.92%	$155,065,647	$19,383,392	$135,682,255
FY06-07 (est)	$270,401,076	57.92%	$156,616,303	$19,383,392	$137,232,911
FY07-08 (est)	$275,809,098	57.92%	$159,748,629	$19,383,392	$140,365,237
FY08-09 (est)	$273,051,007	57.92%	$158,151,143	$19,383,392	$138,767,751
FY09-10 (est)	$289,434,067	57.92%	$167,640,212	$19,383,392	$148,256,820
	(Formulas: 1x2=3; 3-4=5)				

Pot 2: Additional Municipal Share of Total Statewide Collections Based on Cumulative Population Growth

Year	State Total Collections (1)	Municipal Share % (2)	Cumulative Population Growth (3)	Municipal Growth Share % (4)	Municipal Growth Distribution (5)
FY04-05 (base)	$259,926,056	57.92%	0.00%	0.00%	$0
FY05-06 (est)	$267,723,838	57.92%	1.32%	0.77%	$2,052,804
FY06-07 (est)	$270,401,076	57.92%	3.88%	2.25%	$6,071,376
FY07-08 (est)	$275,809,098	57.92%	4.29%	2.48%	$6,850,334
FY08-09 (est)	$273,051,007	57.92%	5.79%	3.35%	$9,158,883
FY09-10 (est)	$289,434,067	57.92%	4.91%	2.84%	$8,225,445
	(Formulas: 2x3=4; 1x4=5)				

Pot 3: Additional Municipal Share Based on Major Municipal Commercial/Industrial Customer Growth

Year	Statewide Major Municipal Customer Sales (+$200k/Yr)	Annual (5%) Major Municipal Customer Sales Growth (1)	Municipal Electric Tax Rate (2)	Municipal Growth Distribution (3)
FY04-05 (base)	$823,418,660	$0	3.09%	$0
FY05-06 (est)	$864,589,593	$41,170,933	3.09%	$1,272,182
FY06-07 (est)	$907,819,073	$43,229,480	3.09%	$1,335,791
FY07-08 (est)	$953,210,026	$45,390,954	3.09%	$1,402,580
FY08-09 (est)	$1,000,870,528	$47,660,501	3.09%	$1,472,709
FY09-10 (est)	$1,050,914,054	$50,043,526	3.09%	$1,546,345
	(Formula: 1x2=3)			

Pot 4: Additional Municipal Share Based on Seasonal Population Growth

Year	Statewide Municipal Distribution (1)	Seasonal Population Share (2)	Seasonal Population Distribution Base (3)	Calculated Seasonal Population Δ H20 Consumption (4)	Seasonal Population Growth Distribution (5)
FY04-05 (base)	$131,165,780	4.76%	$6,243,491	n/a	n/a
FY05-06 (est)	$135,682,255	4.76%	$6,458,475	3.10%	$200,213
FY06-07 (est)	$137,232,911	4.76%	$6,532,287	2.70%	$176,372
FY07-08 (est)	$140,365,237	4.76%	$6,681,385	3.20%	$213,804
FY08-09 (est)	$138,767,751	4.76%	$6,605,345	2.50%	$165,134
FY09-10 (est)	$148,256,820	4.76%	$7,057,025	3.30%	$232,882
	(Formulas: 1x2=3; 3x4=5)				

REVENUE LAWS STUDY COMMITTEE



REPORT TO THE 2005 GENERAL ASSEMBLY OF NORTH CAROLINA 2006 SESSION

MEMORANDUM IN SUPPORT
OF
LOCAL GOVERNMENT CABLE FRANCHISING

1. **Only through Local Government Cable Franchising can competition without discrimination be achieved;**
   - The future economic survival of North Carolina's local communities depends on the widespread and rapid deployment of affordable broadband infrastructures.
   - Local governments have a vested interest in ensuring meaningful competition and the deployment of broadband and video service in their communities.
   - Broadband video deployment cannot be based on the income level of a local community, its neighborhoods or its citizens.
   - Federal law requires local governments to ensure that "cable systems are responsive to the needs and interests of the *local* community" and that these essential services are not offered on a discriminatory basis due to income.
   - Only through local cable franchising – which allows local government enforcement of build out requirements and construction schedules – can all North Carolina communities be assured the promise of wider deployment of broadband video services.
   - State preemption of local cable franchising will remove local government's ability to enforce these requirements and will lead to only the wealthiest communities, neighborhoods and citizens being served.

2. **Only through Local Government Cable Franchising can PEG channel capacity, financial support, and local programming be preserved:**
   - Congress granted local governments the right to: (1) require Public, Education and Government channels (PEG) to respond to the needs and interests of their local residents; (2) require financial support as necessary to develop these channels; and; (3) enforce – through penalties – noncompliance with these requirements.
   - Current local cable franchises include PEG provisions based on the local characteristics and needs of their citizens.
   - Local governments are held directly accountable – and hear directly from their constituents – when these channels go dark.
   - This system of direct accountability to the local citizen works.
   - State preemption of local cable franchising – and the elimination of local government's authority to enforce these requirements – will result in the slow demise of this valuable community resource.

3. **Only through Local Government Cable Franchising can cable consumers be adequately protected:**
   - Current local cable franchises include consumer protection provisions, which meet or exceed federal guidelines. Under this system, local cable subscribers call their local officials when cable problems are not resolved.
   - Only local governments currently have the staff, the inspectors and local cable franchise enforcement authority to resolve cable subscriber problems quickly.

Town of Clyde

MEMORANDUM IN SUPPORT OF LOCAL GOVERNMENT CABLE FRANCHISING

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   - Only local governments currently have the staff, the inspectors and local cable franchise enforcement authority to resolve cable subscriber problems quickly.

- The State Public Utility Commission is not staffed to respond to cable complaints from the 1.839 million cable subscribers in North Carolina.
- State preemption of local cable franchising will eliminate local government's ability to enforce cable consumer protections.

4. **Only through Local Government Cable Franchising can cable franchise fees be uniformly distributed to local governments:**
   - Current local cable franchises require cable providers to pay rent for the use of public rights-of-way in the form of cable franchise fees and permit local financial audits to ensure that the amounts paid are correct.
   - Local cable franchise fees directly reflect the gross revenues generated from households in each local community.
   - State preemption and "equal distribution" of local franchise fees cannot replace this exacting method.

5. **Local Government Cable Franchising must be preserved to ensure the public safety of local rights-of-way.**
   - Local cable franchises validate local police powers to monitor and enforce the use public rights-of-way to ensure the public's safety.
   - Local rights-of-way represent the most fundamental economic development asset of a community.
   - Local officials are held directly accountable by their citizens when public rights-of-way become dangerous or misused.
   - This system of direct accountability to local citizens must not be subverted.

Therefore, the undersigned, on behalf of the City/Town of Clyde **, fully supports all efforts to block attempts by telecommunications companies to subvert local cable franchising authority through state preemption.**

Sincerely,

John Welch

Mayor/City, County, Town Manager, Chairman

cc: Lee Mandell
Andrew Romanet, Jr.
NCLM
P.O. Box 3069
Raleigh, NC 27602-3069

Continued...

Paul A. Meyer
NACC
215 N. Dawson Street
Raleigh, NC 27603

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705

Sen. Daniel Gray Clodfelter
100 N. Tryon Street
Charlotte, NC 28202-4003

Sen. Walter H. Dalton
560 N. Main Street
Rutherfordton, NC 28139

Sen. Fletcher Lee Hartsell Jr.
P.O. Box 368
Concord, NC 28026-0368

Sen. David W. Hoyle
P.O. Box 2494
Gastonia, NC 28053

Sen. Hugh Webster
208 Shadowbrook Drive
Burlington, NC 27215

Mr. Leonard W. Jones
300 North 35th Street
Morehead City, NC 28577

Mr. J. Micah Pate, lll
615 Oberlin Road
Raleigh, NC 27605

Rep. Harold J. Brubaker
138 Scarboro Street
Asheboro, NC 27203

Rep. Becky Carney
P.O. Box 32873
Charlotte, NC 28232

Rep. Walter Greene Church Sr.
P.O. Box 760
Valdese, NC 28690

Rep. Dewey Lewis Hill
P.O. Box 723
Whiteville, NC 28472

Rep. Daniel Francis McComas
P.O. Box 2274
Wilmington, NC 28402

Rep. William L. Wainwright
P.O. Box 33
Havelock, NC 28532

Rep. W. A. Wilkins
210 Fair Oaks Drive
Roxboro, NC 27574

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Commmittee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925

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   - Only through local cable franchising – which allows local government enforcement of build out requirements and construction schedules – can all North Carolina communities be assured the promise of wider deployment of broadband video services.
   - State preemption in other states has led to only the wealthiest communities, neighborhoods and citizens being served with broadband video.

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   - Current local cable franchises include PEG provisions based on the local characteristics and needs of their citizens.
   - Local governments are held directly accountable to – and hear directly from – their constituents when these channels go dark.
   - This system of direct accountability to the local citizen works.
   - State preemption in other states has led to the slow demise of this valuable local PEG programming.

3. **Only through Local Government Cable Franchising can cable consumers be adequately protected:**
   - Current local cable franchises include consumer protection provisions and allow local cable subscribers to call their local officials when cable problems are not resolved.
   - Only local governments currently have the staff, the inspectors and local cable franchise enforcement authority to resolve cable subscriber problems quickly.
   - The State Public Utility Commission is not staffed to respond to cable complaints from the 1.839 million cable subscribers in North Carolina.
   - State preemption of local cable franchising in other states has eliminated local government's ability to enforce cable consumer protections.

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   - Current local cable franchises require cable providers to pay rent for the use of public rights-of-way in the form of cable franchise fees and permit local financial audits to ensure that the amounts paid are correct.
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   - Local officials are held directly accountable by their citizens when public rights-of-way become dangerous or misused.
   - This system of direct accountability to local citizens must not be subverted.

Therefore, the undersigned, on behalf of the City/Town of Havelock **, fully supports all efforts to block attempts by telecommunications companies to subvert local cable franchising authority through state preemption.**

Sincerely,

Mayor/City/County, Town Manager, Chairman

cc:
S. Ellis Hankins
Lee Mandell
Andrew Romanet, Jr.
NCLM
P.O. Box 3069
Raleigh, NC 27602-3069
Fax: 919-733-9519

Paul A. Meyer
James Blackburn, III
NCACC
215 N. Dawson Street
Raleigh, NC 27603
Fax: 919-733-1065

Continued....

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616
Office Fax: (919)733-5815
Business Fax: (919)734-4215

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705
Office Fax: (919)733-3113

Sen. Daniel Gray Clodfelter
100 N. Tryon Street
Charlotte, NC 28202-4003
Office Fax: (919)715-5815
Business Fax: (704)378-2041

Sen. Walter H. Dalton
560 N. Main Street
Rutherfordton, NC 28139
Business Fax: (828)286-8229

Sen. Fletcher Lee Hartsell Jr.
P.O. Box 368
Concord, NC 28026-0368
Office Fax: (919)733-7223
Business Fax: (704)788-8058

Sen. David W. Hoyle
P.O. Box 2494
Gastonia, NC 28053
Office Fax: (919)829-5579
Business Fax: (704)864-7468

Sen. Hugh Webster
208 Shadowbrook Drive
Burlington, NC 27215
Office Fax: (919)754-3289

Mr. Leonard W. Jones
300 North 35th Street
Morehead City, NC 28577
Business Fax: (919)733-3113

Mr. J. Micah Pate, III, CPA
615 Oberlin Road, Ste. 200
Raleigh, NC 27605
Business Fax: (919)836-9288

Rep. Harold J. Brubaker
138 Scarboro Street
Asheboro, NC 27203
Business Fax: (336)629-2603

Rep. Becky Carney
P.O. Box 32873
Charlotte, NC 28232
Business Fax: (828)874-2831

Rep. Walter Greene Church Sr.
P.O. Box 760
Valdese, NC 28690
Office Fax: (704)332-8339

Rep. Dewey Lewis Hill
P.O. Box 723
Whiteville, NC 28472
Business Fax: (910)642-7004

Rep. Daniel Francis McComas
P.O. Box 2274
Wilmington, NC 28402
Business Fax: (910)343-8003

Rep. William L. Wainwright
P.O. Box 33
Havelock, NC 28532
Office Fax: (252)672-4075
Business Fax: (252)672-4075

Rep. W. A. Wilkins
210 Fair Oaks Drive
Roxboro, NC 27574
Office Fax: (919)715-0850

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Committee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919) 733-3113 or (919)-715-5815

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)715-5460

Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)715-3589

Sabra J. Faires
Senate Tax Counsel
330 Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)733-8740

RANDOLPH VOLLER
Mayor

DA[redacted]B. HUGHES, P.E.
Town Manager

PAUL S. MESSICK, JR.
Town Attorney

P.O. Box 759 - 635 East Street
PITTSBORO. N.C. 27312

TOWN OF



BOARD OF COMMISSIONERS

GENE BROOKS
MAX G. COTTEN
PAMELA BALDWIN
CHRIS WALKER
CLINTON E. BRYAN, JR

TELEPHONE
(919) 542-4621
FAX (919) 542-7109

February 10, 2006

Leigh Horner,
Regulatory and Issues Management
Sprint - Corporate Headquarters
2001 Edmund Halley Drive
Reston, VA 20191

Dear Ms. Horner:

The Town of Pittsboro believes that having access to advanced telecommunications services is not only essential to the future economic development of our community, but is a quality-of-life necessity. We also believe having choice in broadband providers will ensure more consumer responsive customer service and lower rates. For these reasons, we have always supported telecommunications competition in our local market.

It has come to our attention that Sprint believes that local governments are hindering the deployment of competitive cable providers. In light of the fact that your Company has not approached our community to deploy its network, we are extending this invitation to you to consider deploying your most advanced service network in our community.

In extending this invitation, we commit to working with your company on an *expedited* basis to generate an agreement that provides the necessary access to our streets and easements. We also commit to cooperate and assist your Company in the physical act of constructing or upgrading your infrastructure, as we recognize that speed-to-market is a critical element in deciding which communities are selected for investment.

We look forward to hearing from you with all due haste.

Sincerely,

TOWN OF PITTSBORO

Randolph Voller
Mayor

cc: rboyette@tjcog.org

Sen. John Hosea Kerr lll, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616

Sen. Daniel Gray Clodfelter
100 N. Tryon Street
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P.O. Box 368
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Mr. J. Micah Pate, lll
615 Oberlin Road
Raleigh, NC 27605

Rep. Paul Luebke , Co-Chair
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1507 Oakland Avenue
Durham, NC 27705

Rep. Harold J. Brubaker
138 Scarboro Street
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Rep. Becky Carney
PO Box 32873
Charlotte, NC 28232

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PO Box 760
Valdese, NC 28690

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P.O. Box 723
Whiteville, NC 28472

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P.O. Box 2274
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P.O. Box 33
Havelock, NC 28532

Rep. W. A. Wilkins
210 Fair Oaks Drive
Roxboro, NC 27574

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Committee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925

RANDOLPH VOLLER
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DAVID B. HUGHES, P.E.
Town Manager

PAUL S. MESSICK, JR.
Town Attorney

P.O. Box 759 - 635 East Street
PITTSBORO, N.C. 27312

TOWN OF



BOARD OF COMMISSIONERS

GENE BROOKS
MAX G. COTTEN
PAMELA BALDWIN
CHRIS WALKER
CLINTON E. BRYAN, JR

TELEPHONE
(919) 542-4621
FAX (919) 542-7109

February 10, 2006

Mr. Alan Ciamporcero
President, SE Region
Verizon
P.O. Box 110
FLTC0005
Tampa, FL 33601

Dear Mr. Ciamporcero:

The Town Of Pittsboro believes that having access to advanced telecommunications services is not only essential to the future economic development of our community, but is a quality-of-life necessity. We also believe having choice in broadband providers will ensure more consumer responsive customer service and lower rates. For these reasons, we have always supported telecommunications competition in our local market.

It has come to our attention that Verizon recently testified at the North Carolina State Legislature's Revenue Laws Study Committee that local governments are hindering the deployment of competitive cable providers. In light of the fact that your company has not approached our community to deploy its network, we are extending this invitation to you to consider deploying your most advanced service network in our community.

In extending this invitation, we commit to working with your company on an *expedited* basis to generate an agreement that provides the necessary access to our streets and easements. We also commit to cooperate and assist your Company in the physical act of constructing or upgrading your infrastructure, as we recognize that speed-to-market is a critical element in deciding which communities are selected for investment.

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Mayor

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Goldsboro, NC 27533-1616

Sen. Daniel Gray Clodfelter
100 N. Tryon Street
Charlotte, NC 28202-4003

Sen. Walter H. Dalton
560 N. Main Street
Rutherfordton, NC 28139

Sen. Fletcher Lee Hartsell Jr.
P.O. Box 368
Concord, NC 28026-0368

Sen. David W. Hoyle
P.O. Box 2494
Gastonia, NC 28053

Sen. Hugh Webster
208 Shadowbrook Drive
Burlington, NC 27215

Mr. Leonard W. Jones
300 North 35th Street
Morehead City, NC 28577

Mr. J. Micah Pate, lll
615 Oberlin Road
Raleigh, NC 27605

Rep. Paul Luebke , Co-Chair
Revenue Laws Study Committee
1507 Oakland Avenue
Durham, NC 27705

Rep. Harold J. Brubaker
138 Scarboro Street
Asheboro, NC 27203

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P.O. Box 32873
Charlotte, NC 28232

Rep. Walter Greene Church Sr.
P.O. Box 760
Valdese, NC 28690

Rep. Dewey Lewis Hill
P.O. Box 723
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P.O. Box 2274
Wilmington, NC 28402

Rep. William L. Wainwright
P.O. Box 33
Havelock, NC 28532

Rep. W. A. Wilkins
210 Fair Oaks Drive
Roxboro, NC 27574

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Committee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925

RANDOLPH VOLLER
Mayor

DAVID B. HUGHES, P.E.
Town Manager

PAUL S. MESSICK, JR.
Town Attorney

P.O. Box 759 - 635 East Street
PITTSBORO. N.C. 27312

TOWN OF



BOARD OF COMMISSIONERS

GENE BROOKS
MAX G. COTTEN
PAMELA BALDWIN
CHRIS WALKER
CLINTON E. BRYAN, JR

TELEPHONE
(919) 542-4621
FAX (919) 542-7109

February 10, 2006

Mr. C. Duane Ackerman
Chairman, CEO
Bell South Corporation
1155 Peachtree Street, N.E.
Atlanta, Georgia 30309

Dear Mr. Ackerman:

The Town of Pittsboro believes that having access to advanced telecommunications services is not only essential to the future economic development of our community, but is a quality-of-life necessity. We also believe having choice in broadband providers will ensure more consumer responsive customer service and lower rates. For these reasons, we have always supported telecommunications competition in our local market.

It has come to our attention that Bell South recently testified at the North Carolina State Legislature's Revenue Laws Study Committee that local governments are hindering the deployment of competitive cable providers. In light of the fact that your company has not approached our community to deploy its network, we are extending this invitation to you to consider deploying your most advanced service network in our community.

In extending this invitation, we commit to working with your company on an *expedited* basis to generate an agreement that provides the necessary access to our streets and easements. We also commit to cooperate and assist your Company in the physical act of constructing or upgrading your infrastructure, as we recognize that speed-to-market is a critical element in deciding which communities are selected for investment.

We look forward to hearing from you with all due haste.

Sincerely,

TOWN OF PITTSBORO

Randolph Voller
Mayor
Town/City Manager/Mayor/Chairperson

cc: rboyette@tjcog.org

Sen. John Hosea Kerr lll, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616

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Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925

BELLSOUTH

BellSouth Telecommunications, Inc.
Post Office Box 30188
Charlotte, NC 28230-0188

Krista S. Tillman
President – North Carolina

704 417-8797

February 11, 2006

Mr. Bill Greene
Town Administrator
1101 Main Street
Andrews, NC 28901

Dear Mr. Greene:

Thank you for your recent letter expressing interest in BellSouth and our advanced services.

We agree that advanced communications systems and services contribute to economic growth while enhancing overall quality of life. BellSouth has invested heavily in building a state-of-the-art network to serve NC customers. Currently, we are evaluating plans to use that network to deploy cable television in areas we now serve. Unfortunately, BellSouth does not serve Andrews.

BellSouth witness Bruce Yancey shared with the Revenue Laws Study Committee our belief that the decades-old local franchising process is a hurdle to competitive entry. We know this first hand. In the past 10 years BellSouth has negotiated 20 cable franchises in the Southeast. On average, negotiations required 11 months. At least one took three years.

Moreover, BellSouth is not alone in recognizing the hurdles facing would be Cable TV competitors. No less than the Federal Communications Commission has noted that the "local franchise process is, perhaps, the most important policy-relevant barrier to competitive entry in local cable markets."

Because of your interest in advanced communications services, I hope you will consider supporting the move to a statewide cable franchise. According to a report by the Phoenix Group, which I've attached, streamlined cable franchising will drive broadband deployment in low income and rural areas. This is a very promising study.

Verizon, which I understand serves the Andrews area, has witnessed first hand the benefits of a streamlined process in Texas. Since that legislature adopted a statewide franchise system this past October, 12 companies have filed to invest and serve 112 markets, many of them small cities or rural communities. Hopefully, policymakers will make a similar decision to generate this same investment and competitive consumer benefit in North Carolina.

Thank you again for your interest.

Sincerely,

Krista Tillman

Krista Tillman

Attachment

CC: Senator John Kerr III

Senator Daniel Clodfelter

Senator Walter Dalton

Senator Fletcher Hartsell

Senator David Hoyle

Senator Hugh Webster

Mr. Leonard Jones

Mr. J. Micah Pate. III

Representative Paul Luebke

Representative Harold Brubaker

Representative Becky Carney

Representative Walter Church

Representative Dewey L. Hill

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Representative W.A. Wilkins

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Committee Clerk
Revenue Laws Study Committee

Ms. Cindy Avrette
Research Division

Ms. Martha Walston
Fiscal research Division

Diana Aycock

From: Evelyn Hartsell (Sen. Kerr) [Kerrla@ncleg.net]
Sent: Monday, February 13, 2006 10:23 AM
To: John Kerr
Subject: FW: Final versions of cable letter & survey

Attachments: CABLE FRANCHISE SURVEY.doc; CABLE FRANCHISE LETTER.doc

CABLE FRANCHISE SURVEY.doc CABLE FRANCHISE LETTER.doc

Evelyn S. Hartsell
Legislative Assistant
Senator John H. Kerr, III
919-733-5621

> *-----Original Message-----*
> *From: Cindy Avrette (Research)*
> *Sent: Friday, February 10, 2006 4:34 PM*
> *To: Rep. Paul Luebke; Sen. John Kerr; kerr@warrenkerr.com; Paul Luebke (Outside Email)*
> *Cc: Brenna Erford (Fiscal Research)*
> *Subject: FW: Final versions of cable letter & survey*
>
> *As part of our effort to gather facts around the issue of*
> *communication services, Brenna devised a survey that is being sent to*
> *all the cities and counties in the State. DeAnne mailed the letter and*
> *survey today. I have attached the survey and letter for you to see. We*
> *hope to have their responses by March 1st.*
>
> *Please call either Brenna or myself if you have any questions. Thanks!*
>
> _____
> *From: Brenna Erford (Fiscal Research)*
> *Sent: Tuesday, February 07, 2006 11:25 AM*
> *To: DeAnne Mangum (Finance CA)*
> *Cc: Sabra Faires (Pres Pro Tem's Office); Linda Millsaps (Fiscal Research); Cindy Avrette (Research)*
> *Subject: Final versions of cable letter & survey*

> *Here are the final versions.*

>

> <<*CABLE FRANCHISE SURVEY.doc*>> <<*CABLE FRANCHISE LETTER.doc*>>

North Carolina General Assembly
Revenue Laws Study Committee

Cable Franchise Questionnaire

1. Please indicate whether you have enclosed hard copies of your local franchise ordinances or if they are available online.

   ___ I have enclosed hard copies of all local ordinances pertaining to our cable franchise.

   ___ All franchise-related ordinances may be accessed online at the following URL:

   _____

2. Did your local government negotiate its own franchise, or was your franchise negotiated in partnership with other local governments in your area? If so, please indicate which local governments comprised that partnership.

   _____

   _____

   _____

3. Please enter your total franchise fee collections from the following fiscal years:

   2003-04 _____

   2004-05 _____

4. Please enter your current franchise fee rate: _____

5. What percentage of homes in your cable franchise area have ***access*** to cable service? (Please disregard whether they are subscribers or not.)

   _____

6. For each of the following categories, please indicate the type and amount of all in-kind contributions to your local government received as part of your current franchise agreement. If you did not receive any of the types of in-kind contributions listed, write "not applicable" on that line. Please indicate any other types of capital received in the "Other" line.

6a. Capital (network infrastructure/wiring, equipment)

Description (Type)	*Locations*	*Amount/Number*
Network infrastructure (wiring, cable)		(Total, in feet or miles)
Equipment		
Other		

6b. Services (example: public, educational, and government channels; broadband service)

Description (Type)	*Locations*	*Amount/Number*
Public, educational, and government channels		(Number of channels)

Description (Type)	*Locations*	*Amount/Number*
Other		

6c. Other in-kind contributions (continued on next page)

Description (Type)	*Locations*	*Amount/Number*
Other		

7. Do you have a cable franchise agreement with more than one cable operator in your area?

___ Yes (Go to question 7a.)

___ No (Skip to question 8.)

7a. Please indicate which cable operators are authorized to provide cable service in your area, the percentage of homes they are able to serve, and the percentage of homes in your area that could be served by more than one cable operator.

	Name of operator	*Percentage of homes served by operator*	*Total percent of homes served by **more than one** operator*
Incumbent cable operator			(One response)
Overbuilder			
Overbuilder			

8. What is the current price of basic cable service in your area? _____

9. What is the term of your current franchise agreement?

_____

_____

10. When does your current franchise agreement expire?

_____

_____

Please return this form in the enclosed self-addressed stamped envelope by March 1, 2006. Please feel free to contact Brenna Erford at (919) 733-4910, or at brennae@ncleg.net, if you have any questions. Thank you for your assistance.

Dear ___ ,

As ordered in S.L. 2005-276, Section 33.32, the Revenue Laws Study Committee of the North Carolina General Assembly is studying the equity of taxation of providers of cable service, direct-to-home satellite service, satellite digital audio radio service, video programming service, and data service. In light of technological change and industry convergence in communications, the committee has requested information on cable franchises to assist in better understanding how these complex changes in the communications market will impact local and state revenues. The committee requests your submission of the following information:

1. A copy of all local ordinances pertaining to the cable franchise in your area. If you have both an enacting ordinance as well as a franchise agreement, please provide a copy of both. If your ordinances are available online, please provide a URL where they can be accessed and all applicable citations in lieu of a hard copy.
2. Whether your local government negotiated its franchise agreement or agreements independently or in partnership with other municipalities and/or the county in which you are located.
3. Your total franchise fee revenues from fiscal years 2003-04 and 2004-05.
4. Your current franchise fee rate.
5. The percentage of homes in your franchise service area with access to cable service.
6. Detail on all in-kind contributions (in the form of capital, services, or other contributions) your local government received as part of your current franchise agreement.
7. If more than one cable operator is authorized to do business in your area, detail on the extent to which each company has been granted a franchise to overbuild the other.
8. The current rate charged for basic cable service by your local cable operator.
9. The term of your current franchise agreement.
10. The expiration date of your current franchise agreement.

You have been sent a link to a survey website containing these questions, and a hard copy of the survey has been enclosed with this letter for your convenience. We would appreciate your online response by March 1, 2006. If you are unable to answer the survey online, please complete the enclosed form and return it to the North Carolina General Assembly in the enclosed self-addressed stamped envelope by March 1, 2006.

Thank you for your assistance.

Sincerely,



Brenna Erford
Research Assistant
North Carolina General Assembly
Fiscal Research Division
(919) 733-4910
brennae@ncleg.net

BARRY JACOBS, CHAIR
STEPHEN H. HALKIOTIS, VICE-CHAIR
OSES CAREY, JR
LERIE P. FOUSHEE
LICE M. GORDON

ORANGE COUNTY BOARD OF COMMISSIONERS
POST OFFICE BOX 8181
200 SOUTH CAMERON STREET
HILLSBOROUGH, NORTH CAROLINA 27278

February 13, 2006

Mr. Alan Ciamporcero
President, SE Region
Verizon
P.O. Box 110
FLTC0005
Tampa, FL 33601

Dear Mr. Ciamporcero:

Orange County believes that having access to advanced telecommunications services is not only essential to the future economic development of our community, but has become a quality-of-life necessity. We also believe having choice in broadband providers will help improve customer response and lower rates. For these reasons, we have always supported telecommunications competition in our local market.

We learned that Verizon recently testified before the North Carolina State Legislature's Revenue Laws Study Committee and strongly implied that local governments through their franchising regulations are hindering the deployment of competitive cable providers. Our county takes particular issue with such a contention, since we have no record of being approached by Verizon to deploy a cable network. We wholeheartedly extend an invitation to consider deploying your most advanced service network in our community.

In doing so we commit to working with your company with all deliberate speed to generate a franchising agreement that provides necessary access to roads and easements. We recognize that speed-to-market is a critical element in deciding which communities to select for investment.

Feel free to contact me, or Assistant County Manager Gwen Harvey at 919 245 2307, for further information. We look forward to hearing from you as soon as possible.

Sincerely yours,

Barry Jacobs
Chair

cc: Sen. John Hosea Kerr III, Co-Chair
evenue Laws Study Committee

P.O. Box 1616
Goldsboro, NC 27533-1616

[redacted]n. Daniel Gray Clodfelter
[redacted]00 N. Tryon Street
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Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Commmittee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925

Renee Boyette
Member Services Director
Triangle J Council of Governments
POB 12276
Research Triangle Park, NC 27709

BOCC

Michael Patrick, Chair, Cable Advisory Committee

Gwen Harvey, ACM

BARRY JACOBS, CHAIR
STEPHEN H. HALKIOTIS, VICE-CHAIR
OSES CAREY, JR
ALERIE P. FOUSHEE
ALICE M. GORDON

ORANGE COUNTY BOARD OF COMMISSIONERS
POST OFFICE BOX 8181
200 SOUTH CAMERON STREET
HILLSBOROUGH, NORTH CAROLINA 27278

February 13, 2006

Mr. C. Duane Ackerman
Chairman, CEO
Bell South Corporation
1155 Peachtree Street, N.E.
Atlanta, Georgia 30309

Dear Mr. Ackerman:

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Sincerely,

Barry Jacobs
Chair

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BOCC

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Gwen Harvey, ACM

MAYOR
JERRY B. McLAMB

COMMISSIONERS
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WILL T. CHANDLER
JACK R. LITTLETON
CASANDRA P. STACK
WILLIAM W. MASSENGILL, JR.
RAY G. SMITH

TOWN OF BENSON
P.O. BOX 69
303 EAST CHURCH STREET
NORTH CAROLINA
27504
(919) 894-3553
FAX (919) 894-1283

TOWN MANAGER
KEITH R. LANGDON

TOWN CLERK
CONNIE M. SORRELL

FINANCE OFFICER
DONNA M. HONEYCUTT

TOWN ATTORNEY
DONALD A. PARKER

February 14, 2006

Mr. C. Duane Ackerman
Chairman, CEO
Bell South Corporation
1155 Peachtree Street, N.E.
Atlanta, Georgia 30309

Dear Mr. Ackerman:

The Town of Benson believes that having access to advanced telecommunications services is not only essential to the future economic development of our community, but is a quality-of-life necessity. We also believe having choice in broadband providers will ensure more consumer responsive customer service and lower rates. For these reasons, we have always supported telecommunications competition in our local market.

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We look forward to hearing from you with all due haste.

Sincerely,
Jerry B. McLamb
Jerry B. McLamb, Mayor

cc: rboyette@tjcog.org
Copy list attached

MAYOR
JERRY B. McLAMB

COMMISSIONERS
FREDERICK D. NELSON, JR.
WILL T. CHANDLER
JACK R. LITTLETON
CASANDRA P. STACK
WILLIAM W. MASSENGILL, JR.
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TOWN CLERK
CONNIE M. SORRELL

FINANCE OFFICER
DONNA M. HONEYCUTT

TOWN ATTORNEY
DONALD A. PARKER

February 14, 2006

Mr. Alan Ciamporcero
President, SE Region
Verizon
P.O. Box 110
FLTC0005
Tampa, FL 33601

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Sincerely,

Jerry B. McLamb

Jerry B. McLamb, Mayor
cc: rboyette@tjcog.org
Copy list attached

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TOWN CLERK
CONNIE M. SORRELL

FINANCE OFFICER
DONNA M. HONEYCUTT

TOWN ATTORNEY
DONALD A. PARKER

February 14, 2006

Leigh Horner,
Regulatory and Issues Management
Sprint - Corporate Headquarters
2001 Edmund Halley Drive
Reston, VA 20191

Dear Ms. Horner:

The **Town of Benson** believes that having access to advanced telecommunications services is not only essential to the future economic development of our community, but is a quality-of-life necessity. We also believe having choice in broadband providers will ensure more consumer responsive customer service and lower rates. For these reasons, we have always supported telecommunications competition in our local market.

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Sincerely,

Jerry McLamb
Mayor
Town of Benson

cc: rboyette@tjcog.org
Copy list attached

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616

(continued)
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100 N. Tryon Street
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Havelock, NC 28532

Rep. W. A. Wilkins
210 Fair Oaks Drive
Roxboro, NC 27574

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Commmittee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
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Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
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GEORGE F. GOOSMANN
MAYOR

TOWN OF BILTMORE FOREST

CHARLES W. GRIMES
GLENN E. KELLY
DORIS LOOMIS
COMMISSIONERS

NELSON E. SMITH
TOWN ADMINISTRATOR

February 14, 2006

Mr. Alan Ciamporcero
President, SE Region
Verizon
P.O. Box 110
FLTC0005
Tampa, FL 33601

Dear Mr. Ciamporcero:

The **Town/ of Biltmore Forest** believes that having access to advanced telecommunications services is not only essential to the future economic development of our community, but is a quality-of-life necessity. We also believe having choice in broadband providers will ensure more consumer responsive customer service and lower rates. For these reasons, we have always supported telecommunications competition in our local market.

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We look forward to hearing from you with all due haste.

Sincerely,

George F. Goosmann, III
Mayor

cc: Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616

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February 14, 2006

Mr. C. Duane Ackerman
Chairman, CEO
Bell South Corporation
1155 Peachtree Street, N.E.
Atlanta, Georgia 30309

Dear Mr. Yancey:

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PO BOX 5352 · BILTMORE FOREST · NORTH CAROLINA 28813
PHONE (828) 274-0824 FAX (828) 274-8131 EMAIL BILTMOREFOREST@ CHARTER.NET
WWW.TOWNOFBILTMOREFOREST.COM

TOWN OF CARRBORO

NORTH CAROLINA

WWW.TOWNOFCARRBORO.ORG

Leigh Horner,
Regulatory and Issues Management
Sprint - Corporate Headquarters
2001 Edmund Halley Drive
Reston, VA 20191

Dear Ms. Horner: February 14, 2006

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Sincerely,

Steve Stewart, Town Manager

cc: rboyette@tjcog.org

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Charlotte, NC 28202-4003

Sen. Walter H. Dalton
560 N. Main Street
Rutherfordton, NC 28139

Sen. Fletcher Lee Hartsell Jr.
P.O. Box 368
Concord, NC 28026-0368

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Mr. C. Duane Ackerman
Chairman, CEO
Bell South Corporation
1155 Peachtree Street, N.E.
Atlanta, Georgia 30309

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Mr. Alan Ciamporcero
President, SE Region
Verizon
P.O. Box 110
FLTC0005
Tampa, FL 33601

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cc: rboyette@tjcog.org

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TOWN OF MORRISVILLE
P.O. Box 166
Morrisville, NC 27560
919.463.6200

February 14, 2006

Mr. Alan Ciamporcero
President, SE Region
Verizon
P.O. Box 110
FLTC0005
Tampa, FL 33601

Dear Mr. Ciamporcero:

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Sincerely,

John A. Whitson
Town Manager

TOWN OF MORRISVILLE
P.O. Box 166
Morrisville, NC 27560
919.463.6200

February 14, 2006

Leigh Horner,
Regulatory and Issues Management
Sprint - Corporate Headquarters
2001 Edmund Halley Drive
Reston, VA 20191

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Morrisville, NC 27560
919.463.6200

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Chairman, CEO
Bell South Corporation
1155 Peachtree Street, N.E.
Atlanta, Georgia 30309

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John A. Whitson
Town Manager

cc: rboyette@tjcog.org

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Goldsboro, NC 27533-1616

Sen. Daniel Gray Clodfelter
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Peter T. Connet, City Manager
Debra W. Holmes, Town Clerk
[redacted] and Personnel Director
[redacted] Andrews, Administrative Secretary

Telephone: 919.934.2116

SMITHFIELD
NORTH CAROLINA

350 East Market Street
Post Office Box 761
Smithfield, NC 27577

Fax: 919.989.8937

February 15, 2006

Leigh Horner,
Regulatory and Issues Management
Sprint - Corporate Headquarters
2001 Edmund Halley Drive
Reston, VA 20191

Dear Ms. Horner:

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Whiteville, NC 28472

Rep. Daniel Francis McComas
P.O. Box 2274
Wilmington, NC 28402

Rep. William L. Wainwright
P.O. Box 33
Havelock, NC 28532

Rep. W. A. Wilkins
210 Fair Oaks Drive
Roxboro, NC 27574

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Committee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925

County of Pender
www.pender-county.com

Board of Commissioners
Stephen C. Holland, Chairman
F.D. Rivenbark, Vice-Chairman
Eugene B. Meadows
Bill Moore
J. David Williams

John Bauer, County Manager
Paul Parker, Asst. County Manager
Glenda Pridgen, Executive Secretary
Melinda Knoerzer, Administrative Assistant

County Manager's Office
Post Office Box 5
807 South Walker Street
Burgaw, NC 28425

Telephone: (910) 259-1200
Facsimile: (910) 259-1402

February 16, 2006

Brenna Erford
Research Assistant, Fiscal Research Division
North Carolina General Assembly
Revenue Laws Study Committee
State Legislative Building
Raleigh, NC 27603

Dear Ms. Erford:

I am writing to you today on behalf of Pender County, North Carolina about concerns we have with the BellSouth initiative to gain a statewide cable television franchise.

The major telephone companies in the United States (SBC, Verizon and BellSouth) have all publicly stated that the franchising process is simply too hard and too time consuming for them to undertake in order for them to compete and that they need universal franchising relief. They have publicly stated that the franchising process is a barrier to entry. At the same time each of these companies are making these statements, they have all begun negotiating franchises with local franchising authorities (LFA).

The proposed statewide franchise will lower the franchise fees cities and counties currently collect; remove any build out requirements; do not provide for any named entity to enforce customer service and technical standards and gives away our public rights-of-ways. We cannot support this legislation and see no reason why the State should be considering it.

LFA's have not withheld any franchises to bona-fide competitors. In fact, since the 1996 Act, cities and counties across the nation have opened their arms to any entity that will compete with both telephone and cable companies. And the proof is in the franchises awarded. SBC, Verizon and BellSouth have all been awarded franchises to do business and in many cases have been slow to roll out services after securing franchises. For instance, in the case of BellSouth, they have at least nineteen cable television franchises in communities in Georgia, Florida and Tennessee, yet BellSouth has not built out those areas and done virtually no construction since the year 2000. In September of 2005, a representative of BellSouth wrote to one Georgia community "at this time we do not have any active plans to expand our existing cable facilities..." It would appear the barrier to entry is the cost of construction, not the securing of franchises.

The Federal Communications Commission ("FCC") has issued a Notice of Proposed Rulemaking ("NPRM") (MB Docket 05-311) in which it makes a number of assumptions and asserts that franchising of cable services by local governments may be an unreasonable barrier to entry for new telecom video providers. To this end the FCC is seeking comment from local government (and others) on "what can be done to ensure that local franchising authorities (LFAs) do not *unreasonably refuse* to award cable franchises to competitive entrants.
It seems to me that the BellSouth initiative is in conflict with the intentions of the FCC at this juncture. Pender County respectively disagrees with the intentions of this legislation, the assumptions contained in it and the need for it altogether. We would recommend that the North Carolina legislature allow the FCC to conduct its NPRM and let the experts determine if in fact there is a barrier to entry for any entity wishing to utilize the local authority's ROW. For our part, we intend to introduce the notion of allowing local governments to also provide telecom services.

The use of public rights of ways by the local Cable TV and telephone providers is a tremendous benefit to the local "for profit" private companies. These providers use the rights-of-ways with immediate clear access to their facilities. Their trucks often block lanes of travel and limit the full use of the streets by the public. Their facilities, poles and down-guys place restraints on full utilization of traffic facilities. We understand that these services are beneficial to our citizens but a portion of the maintenance of these rights-of-ways should be reimbursed to the Cities by the "for profit" companies to cover a small portion of the maintenance cost.

Not withstanding the FCC's NPRM, Title VI of the Communications Act has governed cable television for 20 years. In creating this policy Congress ensured that crucial social obligations would be met. These obligations are comparable to those placed on other video programming providers, such as broadcasting and satellite television or any other communications provider.

Title VI is largely a success, is technology-neutral, and respects federalism. Title VI preserves the authority of local government, but does not mandate economic regulation at the local level. Through the franchise process each locality's elected leaders are able to determine what is in the best interests of their community.

While no one can deny that cable TV needs more competition, this is not the way to usher it in. The 1996 Act laid out three very specific ways that phone companies could enter the video business and BellSouth tried them all. Acquiring local franchises were not and are not a barrier to phone entry into the video business.

Local Governments Support Broadband Deployment, Competition, and Fairness.

- In less than 10 years, cable high-speed broadband service, with a Title VI franchise, has been made available to 91% of all homes passed by cable. Over 60% of all broadband subscribers today receive their service via a Title VI franchised network.
- SC cities, towns and counties welcome competitive choice in video, voice and data on broadband networks that is fair so as to benefit all consumers.
- Local government believes like services should be treated alike.

All Cable/Video providers need a Cable Franchise, which is a license to use the Public Right of Way (PROW).

A telephone franchise does not confer the right to provide cable/video services, nor does a cable franchise confer the right to provide telecommunications services.

- Public rights-of-way (PROW) are constitutionally protected tangible, limited, and valuable real estate to which the federal government cannot grant access.
- Private entities using public property for private profit should pay fair and reasonable rents.

Franchises document the requirement to serve, protect public safety, preserve property rights, meet capacity needs, and require set-asides of capacity and support for public, education, governmental channels.

Local permission is not difficult to acquire and will not require years of negotiations.

- The franchising process is open and quick for those companies that do not seek to use the process to cherry pick or seek to obtain an advantage over their competitors.
- An RBOC could achieve 25% penetration of cabled homes within their service area by obtaining approximately a dozen franchises, not the 10,000 quoted. New York City alone provides access to more cable homes than Verizon seeks to serve in its first year.

Although the local franchising system protects important goals, this does not mean it cannot be streamlined. Local government stands ready to engage with state and federal legislators as it considers changes and reforms to the existing system consistent with our mutual goals of promoting competition for all our citizens.

Thank you for your continued support of local government in North Carolina. I will be happy to discuss this matter with you personally if necessary and look forward to responding to any questions you might have.

Respectfully,

John Bauer
County Manager

TOWN OF ST. JAMES

February 17, 2006

Mr. C. Duane Ackerman
Chairman, CEO
Bell South Corporation
1155 Peachtree Street, N.E.
Atlanta, Georgia 30309

Dear Mr. Yancey:

The Town Council of the Town of St. James, North Carolina, believes that having access to advanced telecommunications services is not only essential to the future economic development of our community, but is a quality-of-life necessity. We also believe having choice in broadband providers will ensure more consumer responsive customer service and lower rates. For these reasons, we have always supported telecommunications competition in our local market.

It has come to our attention that Bell South recently testified at the North Carolina State Legislature's Revenue Laws Study Committee that local governments are hindering the deployment of competitive cable providers. In light of the fact that your company has not approached our community to deploy its network, we are extending this invitation to you to consider deploying your most advanced service network in our community.

In extending this invitation, we commit to working with your company on an *expedited* basis to generate an agreement that provides the necessary access to our streets and easements. We also commit to cooperate and assist your Company in the physical act of constructing or upgrading your infrastructure, as we recognize that speed-to-market is a critical element in deciding which communities are selected for investment.

We look forward to hearing from you with all due haste.

Sincerely,

Shelley Lesher

Shelley Lesher
Mayor

3628 St. James Drive Southport, N.C. 28461
Phone 253-4730 Fax 253-4732 E-mail tosj@atmc.net

cc: SECURE@nc.rr.com

Sen. John Hosea Kerr lll, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616

Sen. Daniel Gray Clodfelter
100 N. Tryon Street
Charlotte, NC 28202-4003

Sen. Walter H. Dalton
560 N. Main Street
Rutherfordton, NC 28139

Sen. Fletcher Lee Hartsell Jr.
P.O. Box 368
Concord, NC 28026-0368

Sen. David W. Hoyle
P.O. Box 2494
Gastonia, NC 28053

Sen. Hugh Webster
208 Shadowbrook Drive
Burlington, NC 27215

Mr. Leonard W. Jones
300 North 35th Street
Morehead City, NC 28577

Mr. J. Micah Pate, lll
615 Oberlin Road
Raleigh, NC 27605

Rep. Paul Luebke , Co-Chair
Revenue Laws Study Committee
1507 Oakland Avenue
Durham, NC 27705

Rep. Harold J. Brubaker
138 Scarboro Street
Asheboro, NC 27203

Rep. Becky Carney
P.O. Box 32873
Charlotte, NC 28232

Rep. Walter Greene Church Sr.

P.O. Box 760
Valdese, NC 28690

Rep. Dewey Lewis Hill
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Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925

TOWN OF ST. JAMES

February 17, 2006

Mr. Alan Ciamporcero
President, SE Region
Verizon
P.O. Box 110
FLTC0005
Tampa, FL 33601

Dear Mr. Ciamporcero:

The Town Council of the Town of St. James, North Carolina, believes that having access to advanced telecommunications services is not only essential to the future economic development of our community, but is a quality-of-life necessity. We also believe having choice in broadband providers will ensure more consumer responsive customer service and lower rates. For these reasons, we have always supported telecommunications competition in our local market.

It has come to our attention that Verizon recently testified at the North Carolina State Legislature's Revenue Laws Study Committee that local governments are hindering the deployment of competitive cable providers. In light of the fact that your company has not approached our community to deploy its network, we are extending this invitation to you to consider deploying your most advanced service network in our community.

In extending this invitation, we commit to working with your company on an *expedited* basis to generate an agreement that provides the necessary access to our streets and easements. We also commit to cooperate and assist your Company in the physical act of constructing or upgrading your infrastructure, as we recognize that speed-to-market is a critical element in deciding which communities are selected for investment.

We look forward to hearing from you with all due haste.

Sincerely,

Shelley Lesher

Shelley Lesher
Mayor

3628 St. James Drive Southport, N.C. 28461
Phone 253-4730 Fax 253-4732 E-mail tosj@atmc.net

cc: SECURE@nc.rr.com

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(continued)
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Bill Clark
Mayor

Joel Macon
Councilman

Jerry Johnson
Councilman

Alan Gilbert
Mayor Pro Tem

Pat Efird
Councilwoman

Bob Nicholl
Interim Town Manager

TOWN OF CAROLINA BEACH
1121 N. Lake Park Boulevard
Carolina Beach, North Carolina 28428
910 458 2994
FAX 910 458 2997
Bill.clark@carolinabeach.org

February 20, 2006

Brenna Erford
Research Assistant, Fiscal Research Division
NC General Assembly
619 LOB
300 N. Salisbury St.
Raleigh, NC 27603

Revenue Committee:

I am writing to you today on behalf of the Town of Carolina Beach, North Carolina about concerns we have with the BellSouth initiative to gain a statewide cable television franchise.

The major telephone companies in the United States (SBC, Verizon and BellSouth) have all publicly stated that the franchising process is simply too hard and too time consuming for them to undertake in order for the them to complete and that they need universal franchising relief. They have publicly stated that the franchising process is a barrier to entry. At the same time each of these companies are making these statements, they have begun negotiating franchises with local franchising authorities (LFA).

The proposed statewide franchise will lower the franchise fees towns and counties currently collect; remove any build out requirements; do not provide for any named entity to enforce customer service and technical standards and gives away our public rights-of-ways. We cannot support this legislation and see no reason why the State should be considering it.

LFA's have not withheld any franchises to bona-fide competitors. In fact, since the 1996 Act, cities and counties across the nation have opened their arms to any entity that will compete with both telephone and cable companies. And the proof is in the franchises awarded. SBC, Verizon and BellSouth have all been awarded franchises to do business and in many cases have been slow to roll out services after securing franchises. For instance, in the case of BellSouth, they have at least nineteen cable television franchises in communities in Georgia, Florida and Tennessee, yet BellSouth has not built out those areas and done virtually no construction since the year 2000. In September of 2005, a representative of BellSouth wrote to one Georgia community "at this time we do not have any active plans to expand our existing cable facilities..." It would appear the barrier to entry is the cost of construction, not the securing of franchises.

The Federal Communications Commission ("FCC") has issued a Notice of Proposed Rulemaking ("NPRM") (MB Docket 05-311) in which it makes a number of assumptions and asserts that franchising of cable services by local governments may be an unreasonable barrier to entry for new telecom video providers. To This end the FCC is seeking comment from local government (and others) on "what can be done to ensure the local franchising authorities (LFA's) do not *unreasonably refuse* to award cable franchises to competitive entrants"[1]

All initial comments to the proceeding are due by February 13, 2006, with replies due March 14, 2006. It seems to me that the BellSouth initiative is in conflict with the intentions of the FCC at this juncture. The Town of Carolina Beach respectively disagrees with the intentions of this legislation, the assumptions contained in it and the need for it altogether. We would recommend that the North Carolina legislature allow the FCC to conduct its NPRM and let the experts determine if in fact there is a barrier to entry for any entity wishing to utilize the local authority's ROW. For our part, we intend to introduce the notion of allowing local governments to also provide telecom services.

The Town has the obligation to maintain streets and rights-of-ways for the use of our citizens. The use of these same rights-of-ways by the local Cable TV and telephone providers is a tremendous benefit to the local "for profit" private companies. These providers use the rights-of-ways with immediate clear access to their facilities. Their trucks often block lanes of travel and limit the full use of the streets by the public. Their facilities, poles and down-guys place restraints on full utilization of traffic facilities. We understand that these services are beneficial to our citizens but a portion of the maintenance of these rights-of-ways should be reimbursed to the Town by the "for profit" companies to cover a small portion of the maintenance cost.

Not withstanding the FCC's NPRM, Title VI of the Communications Act has governed cable television for 20 years. In creating this policy Congress ensured that crucial social obligations would be met. These obligations are comparable to those placed on other video programming providers, such as broadcasting and satellite television or any other communications provider.

Title VI is largely a success, is technology-neutral, and respects federalism. Title VI preserves the authority of local government, but does not mandate economic regulation at the local level. Through the franchise process each locality's elected leaders are able to determine what is in the best interests of their community.

While no one can deny that cable TV needs more competition, this is not the way to usher it in. The 1996 Act laid out three very specific ways that phone companies could enter the video business and BellSouth tried them all. Acquiring local franchises were not and are not a barrier to phone entry into the video business.

However allowing BellSouth or any other phone company to utilize the rights-of-ways without proper local oversight, management and compensation is simply wrong. Many local governments have two, three and four local cable companies operating in their communities. The locals are charged with entering into fair and similar franchises with all operators and cannot and should not be taken out of the process. Who will regulate the local operations? The FCC certainly will not and the state PSC does not have the manpower, resources or knowledge to do so.

Local North Carolina government welcomes the long-awaited entry of the traditional telephone company into the video marketplace, albeit almost ten years after Congress passed landmark legislation to ease their competitive entry. Still, absent obtaining a local franchise for service within their service territory, as first required by the Congress in 1984 and affirmed in 1992 and 1996, Telco-cable competition will not be fair, nor will consumers be the beneficiaries of this new potential for competitive choice and service choice.

Local Governments Support Broadband Deployment, Competition, and Fairness.

- In less than 10 years, cable high-speed broadband service, with a Title VI franchise, has been made available to 91% of all homes passed by cable. Over 60% of all broadband subscribers today receive their service via a Title VI franchised network.
- SC cities, towns and counties welcome competitive choice in video, voice and data on broadband networks that is fair so as to benefit all consumers.
- Local government believes like services should be treated alike.

All Cable/Video providers need a Cable Franchise, which is a license to use the Public Right of Way (PROW). A telephone franchise does not confer the right to provide cable/video services, nor does a cable franchise confer the right to provide telecommunications services.

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Franchises document the requirement to serve, protect public safety, preserve property rights, meet capacity needs, and require set-asides of capacity and support for public, education, governmental channels.

Local permission is not difficult to acquire and will not require years of negotiations.

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- An RBOC could achieve 25% penetration of cabled homes within their service area by obtaining approximately a dozen franchises, not the 10,000 quoted. New York City alone provides access to more cable homes than Verizon seeks to serve in its first year.

Although the local franchising system protects important goals, this does not mean it cannot be streamlined. Local government stands ready to engage with state and federal legislators as it considers changes and reforms to the existing system consistent with our mutual goals of promoting competition for all our citizens.

Thank you for your continued support of local government in North Carolina. I will be happy to discuss this matter with you personally if necessary and look forward to responding to any questions you might have.

Sincerely

WB Clark

Bill Clark, Mayor
Town of Carolina Beach

DeAnne Mangum (Finance CA)

From: Brenna Erford (Fiscal Research)
Sent: Tuesday, February 28, 2006 11:17 AM
To: DeAnne Mangum (Finance CA)
Subject: FW: Mecklenburg County Survey Response 02-24-06
Attachments: 1982 Vision Cable Franchise.pdf

From: Johnson, Geraldine M. [mailto:gmjohnson@ci.charlotte.nc.us]
Sent: Tuesday, February 28, 2006 11:13 AM
To: Brenna Erford (Fiscal Research)
Cc: Boris, Doris
Subject: Mecklenburg County Survey Response 02-24-06

Brenna,

Please note that the response for Mecklenburg County, NC to the survey's section on infrastructure may not be as complete as it should be.

Due to the wording of the section, the term "received" resulted in a response that the Charlotte-Mecklenburg Office of Cable & Franchise Management (OCFM) views as incomplete. The Franchise Agreement between Mecklenburg County and Time Warner (attached) contains infrastructure requirements that are not included in the response that requested infrastructure that has been "received". Mecklenburg County is now in legal proceedings to secure what Time Warner was supposed to give the County under the section that includes I-Net requirements.

This document will be put on the website: http://cabletv.charmeck.org. Click on regulations.

Geraldine M. Johnson
Cable Monitoring Specialist
Office of Cable & Franchise Management (OCFM)
600 East Fourth Street - 9th Floor
Charlotte, NC 28202

Phone: 704.336.8567 Fax: 704.632.8271
Cable TV Web Page: http://cabletv.charmeck.org

MEMORANDUM

TO: **Members of the Revenue Laws Study Commission**

FROM: **Bill Wilson, Associate State Director – Advocacy**
Mary Bethel, Associate State Director – Advocacy

SUBJECT: **Video Franchise Legislation**

DATE: **March 14, 2006**

AARP North Carolina currently does not have a policy position on allowing the telephone companies the ability to obtain video franchises. However, if the legislature decides to override local control of video franchises in favor of establishing a state or national franchise process, then that legislation should also adopt explicit provisions that ensure consumers maintain the benefits and protections they received under the local franchising process.

At a minimum, these provisions should:

- ensure access to local channels for public access programming;
- prevent economic redlining and generally ensuring that all providers make their service available in all neighborhoods;
- establish customer service standards and enforcement mechanisms;
- ensure local authorities have the authority to manage the disruption caused by installing and maintaining infrastructure in city streets and public rights of way, and
- ensure video service providers provide compensation in the form of franchise fees for the benefit of using public property and rights of way.

We encourage the Revenue Laws Study Commission to consider these factors in drafting any legislation on video franchises.

Action Audits, LLC

March 15, 2006

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705

Re: Texas Cable Law is Not a Success

Dear Senator Kerr and Representative Luebke:

At the January 11, 2006 meeting of the Revenue Laws Study Committee, a representative of Verizon, Alan Ciamporcero, testified that local cable franchising in North Carolina is a barrier to entry for competitive services. He advocated that North Carolina follow the lead created by the State of Texas, who eliminated all local cable franchising protections in September 2005 and replaced it with a state PUC certificate, granted in 14 days. This, Mr. Ciamporcero asserts, "has been great" for Texas consumers because it has lead to immediate competition, with "several new companies" entering the video business, and "price competition" and "better quality service spreading quickly" throughout the state. Texas consumers, he states, "have been the winners."

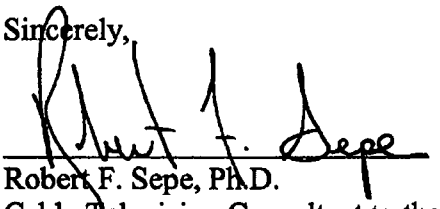
We write to tell you the Texas cable law is not a success and Texas consumers have been the losers. The law has not stimulated competition through numerous companies appearing throughout the state. Only four new companies have applied state franchises, and they will serve about 1% of all the communities in Texas - those being the wealthiest communities. The remaining 12 who now hold state franchises are existing cable operators who already had a local franchise. Ironically, the law does not require any cable systems to ever be built.

The law has eliminated consumer protection for Texas cable subscribers. The Texas PUC is sending cable complaints back to local governments, although the law removes local authority to enforce any consumer protections. The law has not led to lower cable rates in Texas. Incumbent cable operators have raised their rates or kept them the same. The law has not led to higher quality cable programming services. The law has resulted in the reduction or slow extinction of PEG access channels. The law has not stimulated thousands of new jobs and high investment in Texas. Verizon states that its ultimate goal is to serve 400,000 households in Texas - that's 5.4% of the total occupied households in Texas. AT&T has a pilot ("controlled deployment") in San Antonio and

states it will begin deploying television service sometime in the first half of 2008. AT&T also reports it will eliminate 23,000 jobs by the end of 2009.

It would be a tragedy for North Carolina cable consumers to become subject to a Texas like law that pretends to establish competition between video providers and deceives the consumer with the implied benefits therein.

Sincerely,



Robert F. Sepe, PhD.
Cable Television Consultant to the Triangle J Council of Governments

attachment: FACT VERSUS FICTION: THE TEXAS CABLE LAW

cc: Renee Boyette, TJCOG
Charles Archer, NCLM
Doris Boris, President, SEATOA
Revenue Laws Study Committee

FACT VERSUS FICTION: THE TEXAS CABLE LAW

FACT **The State Law has not led nor will lead to rampant competition throughout Texas.**

Careful examination of the applications granted by the Texas PUC as of February 22, 2006 reveals that, despite the complete elimination of local cable franchises, 16 video providers have been granted state franchises, covering only 116 of the more than 5,700 unique communities in Texas.[1] That's about 2% of the local communities in Texas, or 8% of its incorporated places. Yet, a more careful review of these applications reveal that about 1% of the communities in Texas will potentially experience competition. This is because the existence of a statewide franchise does not indicate a competitive provider. The law allows incumbent cable operators to opt into a statewide franchise when their existing local franchises expire, as could non-incumbent cable operators who serve fewer than 40% of the households in their communities. Seventy-five percent (75%) of the state franchise applicants, (12 out of the 16) are existing cable operators. Only four new companies have arrived on the scene (two small companies, Verizon and AT&T (formerly-SBC). These new companies will only be offering competitive service to 47 communities (or portions of communities) out of more than 5,700 communities in the state. This is less about 1% of all the communities in Texas, or about 4% of the incorporated places. This is not rampant cable competition throughout Texas.

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[1]Counting communities in Texas is difficult. According to FallingRain Genomics, there are 5,700 uniquely mapped communities. (www.fallingrain.com/world/US/48 (FallingRain Genomics, Inc, an MIT-associated mapping company based in California). The 2000 U.S. Census reports 1,174 incorporated places. The Texas Municipal League reports currently about 1,210 incorporated places. Yet neither include the unincorporated areas of the counties. A significant percentage of the Texas population lives outside of incorporated places. (8.15 million households in Texas, 5.68 million households in incorporated places). Also, a statewide cable franchise application does not ensure that an entire community is served. A number of applicants specify an interest to serve only "a portion" of the listed community. For example, Verizon, is only serving its traditional telephone service areas which do not fall along municipal borders.

FACT: **The State law sanctions economic discrimination - it eliminated full deployment requirements, provisions which ensure all households have access to cable and broadband services offered by all wireline providers.**

Of the four "new" operators who have entered the video business in Texas, trade press have reported that AT&T and Verizon put the greatest pressure on state legislators.[2] Currently, Verizon has applied for statewide franchises to serve only 22 communities (or portions therein) in the entire state. The average median household income in these communities is $82,425. AT&T has applied for statewide franchises to serve just 21 communities where the average median income is $52,337. This compares with the average median income in Texas which is $39,927.[3] Clearly only wealthier communities will experience competition. Even in communities where state franchisees chose to offer competitive service, they can pick and chose the areas where they build. A service area can be defined to include only affluent households. The Company is then prohibited from discriminating in that service area based on income. The State law removed a standard provision in local cable franchises that requires the cable operator to serve the entire community regardless of wealth.

FACT: **The State law has not led to a reduction in cable rates; cable rates have either increased or stayed the same.**

A quick review by the Texas Chapter of NATOA, shows that Texas cable rates in communities served by companies with state-wide franchises has either increased or stayed the same. Contrary to expectation, cable rates have not declined as a result of the Texas state law.[4]

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[2]For example, SBC had an army of 123 lobbyists reporting up to $6.8 million in fees. "200 SBC representatives were [sic] on the floor of the House to help its 150 elected members make their decision.." A Texas Tale: State -Issued Cable Franchising comes to the Lone Star State," by Don Knight, Assistant City Attorney, Dallas, Tax, in *NATOA Journal of Municipal Telecommunications Policy*, Winter 2005 at page 14.

[3]The average median income in North Carolina is $39,184.

[4]See attached chart produced by Margaret Somereve, President of Texas NATOA (TATOA), February 10, 2006.

FACT: **The State law is not good for consumers - it has eliminated cable subscriber consumer protections.**

Federal law provided local Texas cable franchising authorities broad discretion to enforce cable consumer service standards which meet or exceed the FCC guidelines. If a Texas cable subscriber had any problem with their cable service - from poor installation to incorrect billing - they could call their local franchising authority who typically knew how to get the problem fixed quickly. In recent testimony before the FCC, a Commissioner from the Texas PUC admitted that the Texas PUC now sends cable consumer complaints back to local governments (or to the FCC).[5] But the Texas law eliminated the ability of Texas local governments to enforce any customer service standards. Local communities are unable to act on any customer calls sent their way by the Texas PUC. Texas cable consumers are the losers.

FACT: **The State law has facilitated the demise of local public, education and government channels - leading to a decline in local program content.**

Sharon King, the President and CEO of Dallas Community Television testified before the FCC on February 10, 2006, that passage of the Texas cable legislation provided the means for Time Warner to eliminate financial support and equipment for San Antonio's public access channel. As a result, programming on the public access channel ceased, whereupon Time Warner repossessed the channel. Ms. King also reported her operating budget for Dallas was cut more than 22%, simply due to "the atmosphere" surrounding the legislation.[6]

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[5]Audio link of FCC meeting: www.fcc.gov/realaudio/mt021006.ram. See also www.fcc.gov/realaudio/presentations/2006/021006/smitherman.pdf where a Texas PUC Commissioner states complaints are being referred back to local governments. In February 2006, Action Audits staff contacted the Texas PUC regarding a cable bill problem. She was put on hold for 45 minutes and then told to contact her local government.

[6]FCC Public Hearing on Status of Competition for the Delivery of Video Programming, Keller, Texas, February 10, 2006. Testimony of Sharon King, Alliance for Community Media., MB Docket No. 05-255 at page 2: www.fcc.gov/realaudio/presentations/2006/021006/king.pdf.

FACT: **The State law has not created thousands of new jobs and massive new investments in Texas.**

Texas State Representative Phil King, a champion of the Texas cable bill, announced that he expected over 13,000 permanent jobs and $2 billion in new investment as a direct result of passage of the Texas cable law.[7] Yet the Texas law does not require a statewide franchisee to build any cable system. AT&T has not built any competitive cable systems in Texas. It has a "pilot" (controlled deployment) of its "Project Lightspeed" in San Antonio Texas. Verizon has begun providing its FIOS service to portions of fourteen communities in Texas – four in which it had local cable franchises.[8] Verizon states it will ultimately provide service to 400,000 households in Texas.[9] This represents only 5.4% of the occupied homes in Texas. AT&T recently has announced its intention to eliminate 13,000 jobs as a result of its merger with SBC and will eliminate another 10,000 jobs when it merges with Bell South.[10] This is not a company that is creating new jobs.[11]

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[7]Www.lightreading.com/document.asp?doc_id=81842.

[8]See www.fcc.gov/realaudio/presentations/2006/021006/oconnell.pdf at page 7.

[9]Www.verizon.com/news (January 5, 2006 Press Release: More Verizon Customers in North Texas Get Competitive Choice).

[10]"AT&T to cut 20,000 Jobs After Merger," by James Doran, Wall Street Correspondent, March 7, 2006 at business.timesonline.co.uk/article/0,,13129-2072868,00.html.

[11]"Before AT&T announced its plans to buy BellSouth, the phone giant said it planned to offer its own tv service to 18 million homes by the first half of 2008." "Some experts are skeptical that the company will be able to move ahead with a broad rollout later this year." (*AT&T Deal is Another Worry for Cable,* Wall Street Journal, March 7, 2006, pg A10); "[Cable operators] point out that for months, if not years, [AT&T's] management's attention will likely be focused on integrating the two companies." (AT&T & Bell South), *id., front page.* Of note, the Texas law removes any government authority from reviewing or denying any future transfers of ownership of Texas cable systems, preventing any government authority from evaluating the public interest purpose of future cable mergers. State franchises also have no termination date.

CABLE RATES IN TEXAS

	2005 Basic	2006 Basic	% Change	2005 Standard	2006 Standard	% Change
ALLEN						
Comcast	13.12	13.12	0%	44.50	44.50	0%
Grande	10.00			34.00		
AUSTIN						
Time Warner	10.50	10.50	0%	48.53	50.85	5%
Grande	11.50	11.50	0%	43.50	46.00	6%
CARROLLTON						
Comcast	14.99	14.99	0%	42.50	42.50	0%
Verizon		12.95			39.95	
FORT WORTH						
Charter	15.05	17.05	13%	45.99	46.99	2%
One Source Basic	10.95	10.95	0%	29.95	29.95	0%
Verizon		12.95			39.95	
IRVING						
Comcast	10.02	10.02	0%	44.50	44.50	0%
Verizon		12.95			39.95	
KELLER						
Charter	15.05	19.05	27%	46.99	48.99	4%
One Source Basic		10.95			29.95	
Verizon		12.95			39.95	
ROUND ROCK						
Time Warner	10.50	10.50	0%	48.19	50.85	6%
Grande	10.50	11.50	10%	41.00	43.50	6%
SAN ANTONIO						
Time Warner	12.15	12.75	5%	46.40	48.85	5%
Grande		12.50		47.00	46.00	-2%
SOUTHLAKE						
Charter	17.05	19.05	12%	46.99	48.99	4%
Verizon		12.95			34.95	
WACO						
Time Warner	8.45	10.50	24%	29.95	35.95	20%
Grande	9.00	10.00	11%	33.00	37.50	14%

MIDLAND						
Cox		14.54			41.99	
Grande					41.00	
ABILENE						
Cox	15.48	16.68	8%	41.99	43.65	4%
ADDISON						
Comcast	15.60	14.99	-4%	38.99	42.50	9%
CEDAR HILL						
Comcast		13.74			38.75	
DENTON						
Charter	12.78	19.05	49%	46.99	48.99	4%
FARMERS BRANCH						
Comcast	14.20	14.20	0%	42.50	42.50	0%
GRAND PRAIRIE						
Comcast	14.99	14.99	0%	44.50	44.50	0%
HOUSTON						
Time Warner	13.60	15.50	14%	40.99	42.99	5%
HURST						
Charter	17.05	19.05	12%	46.99	48.99	4%
LEWISVILLE						
Comcast	10.38	10.38	0%	41.50	44.50	7%
MESQUITE						
Comcast	14.17	14.17	0%	44.50	44.50	0%
N. RICHLAND HILLS						
Charter	17.05	19.05	12%	46.99	48.99	4%
RICHARDSON						
Comcast	12.39	12.39	0%	44.50	44.50	0%
VICTORIA						
Cox	15.39	16.22	5%	38.99	41.09	5%

[redacted] Statewide Franchises

Source: TATOA

BELLSOUTH

March 28, 2006

BellSouth Telecommunications, Inc.
128 West Hargett Street
Raleigh, NC 27601

Jeff Van Dyke
Executive Director-Governmental Affairs

919 821-6016

TO: Members, NC Revenue Laws Committee
Staff, Revenue Laws Committee

From: Jeff Van Dyke, BellSouth

RE: Local Government Letter Writing Campaign

I'm writing in regard to the local government letters currently directed at BellSouth that are being copied to the Revenue Laws Committee members.

Krista Tillman, BellSouth President for NC Operations, is responding appropriately to our local government friends; however, to save a few trees, we are not copying the committee on our reply to these identical, template-based letters.

The campaign appears to be coordinated by outside consultants to the local Cable TV franchising process who have a direct financial interest in maintaining the status quo.

BellSouth has experience with the local cable franchising process. In the past 10 years, we have negotiated 20 Cable TV franchises in the Southeast. The process is time-consuming, with many opportunities for delay. Negotiations averaged 10 months. One took three years. Another took "only" nine months, but a lawsuit by the Cable TV industry delayed entry for several years. Ironically, one of the NC cities that wrote us recently with an offer of a "timely and expedited" process just spent four years renegotiating a franchise agreement.

We have talked informally with some NC local governments and reviewed existing franchise agreements. These contracts are appropriate for existing companies with a dominant 70% market share, but they represent a serious economic hurdle for new competitors who are forced to make considerable financial risk with no guarantee of return.

BellSouth isn't alone is its concern about the impact of the local franchising process on Cable TV competition. I have attached several articles from the national debate.

Ten years ago, the NC General Assembly enacted legislation sponsored by Sen. David Hoyle that updated the rules in the telecom marketplace, adopting a free entry approach to encourage new competitors, like cable companies, to enter the telecom market. It was a huge success.

BellSouth believes the legislature should adopt the very same free entry policy to encourage new competitors, like telephone companies, to enter the Cable TV market. We think this can be done through state Cable TV franchise legislation, while protecting local government franchise revenue, rights-of-way authority and Public Education and Government channels.

With cable rates increasing 86 percent in 10 years, NC consumers deserve landline competitive choices. A state franchise is the way to speed those choices to your constituents.

Here Comes Your 19th Telecom Meltdown

By Holman W. Jenkins Jr. The Wall Street Journal
Date: August 10, 2005, Section: Business World

In a long-ago conversation about some particularly gruesome, self-defeating policy out of Washington, a famous CEO blurted out in an interview: "It's like we were an idiot country!"

CEOs didn't say such things on the record then, and they don't now. But a few telephone execs might be tempted. You don't know it yet, but you want your IPTV -- short for Internet protocol television. It's the only live hope for getting this country wired with high-capacity broadband the way our economic competitors Japan and South Korea are wired.

Well, forget about it. Sure, IPTV would fulfill the promise of access to all the world's video, liberated from the dictates of program schedulers, manageable from whatever TV, cell phone or computer might be at hand, even when far from home.

And yes, not only is there a large pool of capital available to bring you this nirvana, but a motive. America's Baby Bells still produce billions in cash flow from their obsolescing voice networks and IPTV is the only business proposition on the horizon that might rescue them from a strategic cul-de-sac.

You'd be forgiven also for thinking the regulatory ducks are finally in a row after a decade of court fights. Not quite. The **Federal Communications Commission** has worked hard to free up networks to deliver bits that arrive as Web pages, email, movie downloads, etc. Where the **FCC** has lost its nerve is failing to extend the same freedom to bits that arrive looking like what you're used to getting from a TV broadcaster. Result: IPTV is in danger of being euthanized in its crib by 33,000 franchise boards in every hamlet in the country, which insist that because it looks like cable TV it must be treated like cable TV.

That means running the same gantlet of local permissions to deliver TV that cable ran 30 years ago, a process that can take months or years for each town.

Only lately has this nightmare come into focus, and the two Bells that have made the most noise about Internet television, **Verizon** and **SBC**, are taking different tacks. **Verizon**, which is spending $2 billion to run fiber right up to three million homes this year, figures it needs to cut deals with 200 boards immediately and 10,000 to cover its territory by 2010. By midyear, it had reached agreement with just six.

SBC bravely says it will stick to its plan to roll out service to 18 million homes by 2007 without seeking franchise agreements, even if that means getting sued by 2,200 towns and cities. But **SBC** is a publicly traded company and must live in the real world. Says executive and lawyer Bruce Byrd: "We're not going to just build if all we see is greater and greater opposition to us spending this money."

Now you know why the air is suddenly rushing out of the IPTV balloon. Some even predict it will be 10 or 15 years before Americans get Internet television, which by then will likely have become a universal standard around the globe.

Lawyers for the phone companies have good reason for arguing that cable rules shouldn't apply to the Internet, but no help is coming from the feds. **FCC** Chairman Kevin Martin has publicly sympathized, but agency lawyers are telling him his authority to address the matter is "legally" dicey -- read politically dicey, because of the specter of 33,000 screaming mayors and town councils.

Sen. John Ensign, with the backing of heavyweights John McCain and Ted Stevens, has proposed legislation to preempt the local franchise boards, though it will go likely nowhere without the backing of the powerful cable industry. Never mind that the cable guys' own phone efforts are exempt from old-style phone regulation. Behind the scenes, they're doing all they can to "throw sand in the gears," in the words of a Cox cable executive, of the Bells' TV forays.

Cabledom's new best friends are the nation's mayors, joined by self-styled consumer activists and even AARP, who insist local control is necessary to preserve our democracy. Why? The Bells might deliver super broadband to affluent neighborhoods first, thereby inflicting "digital redlining" (a phrase they learned from cable lobbyists) on poor neighborhoods.

This argument has the merit of being complete drivel. We'd have no wireless phones, no TV, no cars, indeed, no telephones, if businesses couldn't invest to offer their innovations to early adopters and high rollers. The Bells are building "networks" -- the whole idea is to create an infrastructure in which adding new customers will be much cheaper than reaching the first customers.

Besides, the opponents should ask themselves what happens when the Bells are cherry-picked to death, leaving only the poor to bear the cost of maintaining the old phone networks.

We lag the world in broadband because of a decade-long fight to beat back the pathological urges of 50 state phone regulators. Anybody who doubts ultrafast broadband is now threatened by teensy bureaucrats in thousands of towns and cities might take a gander at what cable already endures to maintain what is currently its local monopolies. Adelphia just renewed its franchise with Boynton Beach, Fla. -- at the cost of a $200,000 "donation" to city hall for TV equipment.

Even when such negotiations go smoothly, they are frequently subject to votes or lawsuits that can slow up the process by months or years.

Not for the first time in the Internet age, many are asking: "Where's the Bush administration?" The White House talks often enough about the urgency of getting America wired for broadband, yet has been AWOL in most regulatory fights so far.

Sooner or later, Wall Street is bound to begin noticing just how precarious is the future of the four big bells -- which includes **BellSouth** and **Qwest** -- notwithstanding their combined market cap of $230 billion. Their residential voice business is being eaten alive, with no salvation in sight -- except for IPTV.

Mr. Jenkins edits "Political Diary," the editorial page's daily e-mail newsletter with commentary, analysis and gossip on Washington, D.C. and state politics. With John Fund. Subscribe at www.politicaldiary

Mehlman and Irving: On telecom, Texas is set to bring on competition

Bruce Mehlman and Larry Irving, SPECIAL TO THE AMERICAN-STATESMAN

Wednesday, August 31, 2005

They say the mark of true genius is the ability to hold two contradictory ideas in one's mind at the same time. By this measure, Washington, D.C., is one of the smartest towns on earth, and no group is more brilliant than the lobbying armies of the cable industry giants.

For the past year, cable's top guns have argued that their high-speed data service, whether offering voice video or data, should be exempt from the traditional regulations burdening identical high-speed services offered over phone lines. Cable correctly and successfully convinced the Federal Communications Commission, the Bush administration and the U.S. Supreme Court that the legacy regulations would impede investment, innovation and competition in the new networks and services.

Yet these same multibillion dollar corporations now argue strenuously to preserve other burdensome regulations — most noticeably, archaic local franchising rules — that are impeding other, identical high-speed services.

From the perspective of customers, there is no difference. Consumers want the highest quality services at the lowest possible prices, whether in voice, video or data. And the proven path to get there is through robust competition in the marketplace.

The good news is that new technologies — specifically broadband Internet — are bringing new opportunities for increased competition. Cable companies are getting into the telephone business to compete for voice traffic. Wireless companies are diving into data services to compete for Internet users. And traditional telephone players are trying to expand their broadband-based offerings to deliver more choices, more voices and better prices to video consumers.

This increased video competition is very much needed. Since 1996, cable rates have increased 45 percent, or nearly three times the rate of inflation. Internet-delivered video offerings — Internet Protocol Television (IPTV,) as it's called — should bring the same downward pressure on these prices as competitive alternatives are doing in voice telephony and broadband access.

IPTV also promises to spur innovation in programming — delivering interactive television and integrated voice-video-data educational materials, for example — while

IPTV will accelerate broadband deployment and adoption, useful at a time when our nation ranks 16th in the world in broadband uptake.

The bad news is that, right now, government stands in the way. In addition to the formidable challenge of taking on incumbents that held government-sanctioned monopolies for years, local governments across the country insist that new entrants who wish to offer consumers more choices in video need to cut deals with over 30,000 local franchising agencies, each of whom wants its cut and conditions.

While this might have made sense when cable companies were the only game in town, it makes no sense today, particularly for businesses that already pay local taxes and have relationships with the local authorities, such as the phone companies. It should be clear to objective observers that IP-enabled services such as IPTV are free from such legacy regulations, but absent federal clarification, the cable giants and many local tax collectors will argue otherwise.

Some states are not waiting for Washington and are taking this challenge head on. Texas appears likely to emerge as a national leader. During a special session this summer, both the Texas House and Senate passed bills that would allow telephone companies to get a single state franchise rather than negotiate with hundreds of municipalities. The overwhelming support for the bill received in the Senate (24-3 approval) and House (144-1) shows that bringing competition to the cable industry is a powerful and compelling idea. The bill is now awaiting Gov. Rick Perry's signature.

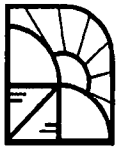
That's a great start from the Lone Star State, although policy-makers have a strong argument that even a single state franchise isn't needed. Telecom companies already have statewide franchising authority for their telecom services, including broadband Internet services. If bits and bytes are already franchised, it's hard to argue that just because those bits and bytes end up as video, an additional franchise is needed.

In Washington, the news is encouraging as well. In late July, Nevada Sen. John Ensign introduced a communications reform bill that would eliminate the franchise requirement for video service providers — cable as well as new entrants — to obtain franchises.

This forward-leaning legislation would create a consistent and predictable regulatory regime that would encourage innovation, investment and broadband deployment.

Policy-makers love to talk up the benefits of competition, broadband and innovation. With Texas already taking the deregulatory high-ground, lawmakers in Congress now have the opportunity to match the state with national action. These are encouraging signs that every voter should be watching closely.

Irving was assistant secretary of commerce under President Clinton, and Mehlman was former assistant secretary of commerce under President George W. Bush. They now serve as the co-directors of the Internet Innovation Alliance.



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PHOENIX CENTER POLICY BULLETIN NO. 13

George S. Ford, PhD
Thomas M. Koutsky, J.D.

January 2006

"IN DELAY THERE IS NO PLENTY":*
THE CONSUMER WELFARE COST OF FRANCHISE REFORM DELAY

"You may delay, but time will not, and lost time is never found again."

Benjamin Franklin, *Poor Richard's Almanac* (1748)

Abstract: Traditional phone carriers have announced ambitious multi-billion dollar plans to bulk up their networks with fiber in order to deliver a range of new services, including multi-channel video in competition with video incumbents. This competition promises to benefit consumers through lower prices, enhanced services and expanded choices from both incumbents and new entrants. Actual market entry, however, faces a significant barrier in the form of local franchise requirements that are delaying entry and could postpone competition for a substantial period of time. For that reason, public policymakers are being urged to speed the delivery of new services to consumers by reforming the franchise process.

This POLICY PAPER seeks to assist policymakers by measuring the impact of delayed entry on consumers. Drawing on existing data that shows cable prices are about 15 percent lower in the face of wireline video competition, we find that a one-year delay in entry because of franchise requirements would cost American consumers $8.2 billion. The toll on consumers cumulates as reform is deferred so that four years of delay would cost consumers almost $30 billion in unrecoverable losses. These estimated losses may be understated, as we assume a 15 percent price decline, which is consistent with GAO analysis. A recent survey by Bank of America found substantially greater price declines, on the order of 28-42 percent, as the result of new wireline video competition from traditional telecommunications carriers.

* William Shakespeare, *Twelfth Night*.

PHOENIX CENTER FOR ADVANCED LEGAL & ECONOMIC PUBLIC POLICY STUDIES
5335 Wisconsin Avenue, NW, Suite 440
Washington, D.C. 20015
Tel: (+1) (202) 274-0235 Fax: (+1) (202) 244-8257//9342 e-Fax: (+1) (202) 318-4909
www.phoenix-center.org

I. Introduction

American consumers stand at the cusp of significant savings from increased competition for video program distribution. Incumbent local telephone companies like AT&T and Verizon, as well as smaller telephone companies in more-rural markets, have announced plans to upgrade their networks to fiber-rich, broadband platforms that will support a number of services, including multichannel video services. If successful, this broadband network deployment promises to deliver innovative services while saving American households billions of dollars in cable rates.

Because video competition and entry will increase consumer surplus, any factor that *delays* that entry will cause a significant loss of consumer welfare. We have shown in other research that the local franchising process raises the costs of entry and causes considerable delay in the construction of these new, multi-service broadband networks. As the FCC has noted, the local franchise process is perhaps "the most important policy relevant barrier to competitive entry in local cable markets."[1]

This POLICY BULLETIN estimates that delaying video entry by one year would cost American consumers $8.2 billion in consumer welfare from video services alone, and these losses increase with each year of delay. As discussed below, since we do not consider the consumer welfare of improvements and price reductions for jointly provided broadband and telephone services,[2] our estimate is conservative.

As we demonstrated in PHOENIX CENTER POLICY BULLETIN NO. 12,[3] there is little doubt that when consumers have a choice of multiple wireline providers of video services, prices drop rapidly and significantly. Study after study - from a variety of sources including the FCC, the

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1 *In re Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992, Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming*, 9 FCC Rcd 7442, Appendix H at ¶ 375 (1994) (hereinafter "Appendix H")(emphasis supplied).

2 PHOENIX CENTER PUBLIC POLICY PAPER NO. 23 discusses the important link between the availability of video services is crucial to the business case for constructing a broadband network in low-income areas. Delay in video entry will cause significant delay in broadband services in low-income areas, and the consumer welfare loss of that situation is likely to be significant. George S. Ford, Thomas M. Koutsky and Lawrence J. Spiwak, *The Impact of Video Service Regulation on the Construction of Broadband Networks to Low-Income Households*, PHOENIX CENTER POLICY PAPER NO. 23 (September 2005) (available at: http://www.phoenix-center.org/pcpp/PCPP23Final.pdf).

3 George S. Ford and Thomas M. Koutsky, *Franchise Fee Revenues After Video Competition: The "Competition Dividend" for Local Governments*, PHOENIX CENTER POLICY BULLETIN NO. 12 (November 2005) (available at: http://www.phoenix-center.org/PolicyBulletin/PCPB12Final.pdf).

Government Accountability Office,[4] academics,[5] and even the incumbent cable industry itself[6] – has shown that price decreases of 15% or more are common in markets with direct, head-to-head cable competition.[7] Recent colloquial evidence confirms this trend, and also shows that price-cutting by incumbents is often limited to areas where this wireline video competition is present, while prices remain high in adjacent areas.[8] A recent survey by Bank of America revealed that in areas where Verizon was rolling out its fiber-to-the-home FiOS service with a multichannel video offering, incumbent cable companies have responded with "not actively advertised" video service price cuts of 28-42% that are offered only in areas where FiOS video service is available.[9]

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[4] *See Direct Broadcast Satellite Subscribership Has Grown Rapidly, but Varies across Different Types of Markets, Report to the Subcommittee on Antitrust, Competition Policy and Consumer Rights,* Committee on the Judiciary, U.S. Senate, US Government Accountability Office, GAO-05-257 (2005).

[5] *See, e.g.,* J. Merline, *How to Get Better TV at Lower Prices.* CONSUMERS RESEARCH 10-17 (1990); S. Levin and J. Meisel, *Cable Television and Competition: Theory, Evidence, and Policy,* 15 TELECOMMUNICATIONS POLICY 519-528 (1991); T. W. Hazlett, *Competition vs. Franchise Monopoly in Cable Television,* 4 CONTEMPORARY POLICY ISSUES 80-97 (1986); W. H. Emmons and R. A. Prager, *The Effects of Market Structure and Ownership on Prices and Service offerings in the U.S. Cable Television Industry,* 28 RAND JOURNAL OF ECONOMICS 732-50 (1997); R. O. Beil, P. Dazzio, R. Ekelund, and J. Jackson, *Competition and the Pricing of Cable Television Services,* 5 JOURNAL OF REGULATORY ECONOMICS 401-415 (1993); R. Beard, G. Ford, R. C. Hill, and R. Saba, *Fragmented Duopoly: A Conceptual and Empirical Investigation,* 78 JOURNAL OF BUSINESS 2377-2396 (2005).

[6] *See* Kagan World Media, *Survey of Incumbent Cable Operators in Overbuild Communities* (January 2003), attached to Reply Comments of NCTA in FCC Docket No. 04-227 (August 8, 2004). In its comments before the FCC in Docket No. 04-227, the NCTA acknowledged that it had commissioned this Kagan study, but the NCTA downplayed the results, noting that while the Kagan survey found lower prices in areas with two wireline cable systems, "overbuilds were rare in any event . . . In the rare circumstances in which exist, incumbent cable operators cannot afford to ignore such wireline competition." NCTA Reply Comments in FCC Docket No. MB 04-27 (August 8, 2004) at 10.

[7] In our estimation methodology, we measure "price" as average revenue per customer.

[8] In Kutztown, Pennsylvania, the incumbent cable provider, Service Electric, in 2004 dropped its prices over 25% where it faced wireline competition from a new fiber network. But that price cut only applied where the new network was built – a newspaper reported that the price for the same service rose from $25.60/month to $36.05/month only three blocks away, where service from the new fiber entrant was unavailable. Jeanne Bonner, *Kutztown Cable Price War Pits Borough vs. Company,* THE (KUTZTOWN, PA) MORNING CALL (March 28, 2004) at AA1-AA2; *see also* Jerri Stroud, *Verizon Fires First Shot in battle with Charter for TV customers,"* ST. LOUIS POST-DISPATCH (Sept. 24, 2005) (noting break-out of price competition in Keller, Texas after telephone company video entry).

[9] Bank of America Equity Research, *Battle for the Bundle: Consumer Wireline Services Pricing,* (January 23, 2006) at 10 (surveying prices in Herndon, VA, Keller, TX, and Temple Terrace, FL). Bank of America states that "such pricing is not actively advertised. Without specifically calling and mentioning FiOS, a consumer would be unaware this pricing existed." Incumbent cable firms also offer discounts of 21-29% for "triple play" bundles of voice, video and broadband services in the three FiOS video areas.

PHOENIX CENTER FOR ADVANCED LEGAL & ECONOMIC PUBLIC POLICY STUDIES
5335 Wisconsin Avenue, NW, Suite 440
Washington, D.C. 20015
Tel: (+1) (202) 274-0235 Fax: (+1) (202) 244-8257//9342 e-Fax: (+1) (202) 318-4909
www.phoenix-center.org

Several bills pending before Congress would eliminate or reform this process and would take other pro-competitive actions that will foster video entry, such as needed improvements in program access rules. Unfortunately, given the various constituencies opposed to franchise reform, efforts to bog down the reform process are well underway.[10] As our analysis shows, policymakers must resist such procrastination efforts, because any such delay or failure to reform the local franchise process would cost American consumers billions of dollars - some $8.2 billion for one year alone. Moreover, this consumer welfare loss can never be recovered. New video entrants are already beginning to face pressure and concerns from investors regarding their ability to enter the video market quickly enough to succeed.[11] Policymakers need to keep the cost of delay - and the risk of failure - in mind in deciding whether video franchise reform should be a priority in the current debate over rewriting the Telecommunications Act of 1996.

II. Analytical Framework

There is no question that the local franchise process and other barriers delay video entry and raise costs. The local franchise process forces new entrants to negotiate contracts with thousands of local authorities, meet certain rigorous (and sometimes unreasonable) "build-out" requirements or construction schedules, and contribute support to institutional networks and governmental cable channels.[12] Moreover, the ability of vertically-integrated cable companies to lock-up access to key programming, such as regional sports networks, also stands in the way of competitive video entry.[13]

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[10] *See, e.g.*, Jonathan Make and Anne Veigle, *Franchise Rule Delay Seen*, COMMUNICATIONS DAILY (December 9, 2005).

[11] *See, e.g., S&P Cuts Verizon Credit Rating*, WALL STREET JOURNAL ONLINE NEWS ROUNDUP (January 13, 2006) at page A6.

[12] *See* George S. Ford, Thomas M. Koutsky and Lawrence J. Spiwak, *The Consumer Welfare Cost of Cable "Build-out" Rules*, PHOENIX CENTER POLICY PAPER NO. 22 (Addendum, July 2005) (available at: http://www.phoenix-center.org/pcpp/PCPP22Final.pdf) and to be reprinted as *The Economics of Build-out Rules in Cable Television*, HASTINGS COMMUNICATIONS AND ENTERTAINMENT (COMM/ENT) LAW JOURNAL (forthcoming Winter 2006). These requirements can sometimes border on the absurd. For example, Verizon has applied for a cable franchise in Sudbury, Massachusetts, a town of only 5504 households. After reviewing the franchise application for several months, it was recently reported that the town intends to ask Verizon to pay approximately $100,000 per year directly to the city - on top of franchise fee taxes - for the privilege of offering competitive video services. This amounts to a tithe of $45 per customer subscribing household customer each and every year (assuming symmetric duopoly with 80% aggregate penetration). *See* Stacey Hart, *Verizon Close to Cable Deal: Draft License Agreement Would Give Sudbury Extra $100K, Local Programs*, METROWEST DAILY NEWS (January 22, 2006).

[13] *See, e.g.*, James W. Olson and Lawrence J. Spiwak, *Can Short-Term Limits on Strategic Vertical Restraints Improve Long-Term Cable Industry Market Performance?* 13 CARDOZO ARTS & ENT. L.J. 283 (1995) (available at:

(Footnote Continued....)

We can estimate the losses in consumer surplus from a delay in enacting meaningful franchise reform by comparing the consumer surplus that one would reasonably expect if entry occurs now versus the consumer surplus one would expect if entry occurs at some point in the future. We can then apply a discount factor to these two flows of consumer surplus gains from price competition and the difference between the two flows will measure the harm to consumers from delay. This estimation method is illustrated in Figure 1.

Figure 1. Loss Calculation

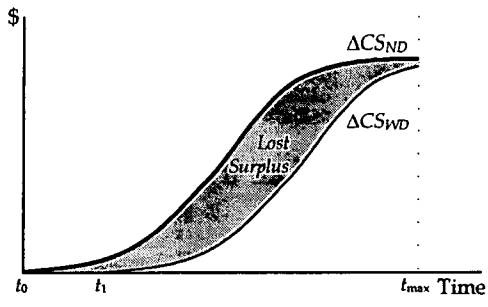


Figure 1 assumes that a new entrant is ready, willing and able to enter the market at t_0 (time zero), but construction occurs over time. For our purposes, if no franchising barrier existed, then the entrant would immediately begin construction of its network and providing services over time (the horizontal axis) as the network were constructed. Consumers would benefit from this entry through lower prices, and this benefit is measured on the vertical axis. The result is a change in consumer surplus S-curve - over time, consumer welfare increases the larger the network becomes.[14] Figure 1 demonstrates graphically what is intuitive - when a new

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http://www.phoenix-enter.org/library/prog_access.doc). Indeed, as noted in PHOENIX CENTER POLICY PAPER NO. 21, in some cases, blocking an entrant's access to programming is product differentiation through sabotage. Impeding access to existing programming does not increase the amount of programming available to consumers and thus has no effect on absolute quality. Rather, the restriction merely alters the relative qualities of the incumbent and entrant in favor of the incumbent. George S. Ford, Thomas M. Koutsky and Lawrence J. Spiwak, *Competition After Unbundling: Entry, Industry Structure and Convergence,* PHOENIX CENTER POLICY PAPER NO. 21 (July 2005) at n. 68 (available at: http://www.phoenix-center.org/pcpp/PCPP21Final.pdf).

[14] The S-Curve (or Gompertz curve) is the most common methodology to model the diffusion of new products and the growth of new firms (and other phenomena of interest). *See, e.g.,* J. P. Martino, TECHNOLOGICAL FORECASTING FOR DECISION MAKING, 2 ed. (1983); J.J. Van Duijin, THE LONG WAVE IN ECONOMIC LIFE (1983); D. Miller, THE ICARUS PARADOX (1990); H. B. Stewart, RECOLLECTING THE FUTURE (1989); R. Foster and S. Kaplan, CREATIVE DESTRUCTION (2001).

provider begins construction, the consumer welfare benefits from that entry (from lower prices and better services) increases as that network is built over time. A delay in entry pushes these consumer welfare benefits into the future and, given the time value of money, a delay in entry adversely affects consumer welfare.

Of course, the rate in which a network is built is affected by the franchising process. ΔCS_{ND} represents the change in consumer surplus that would apply if the entrant faced no delay (no delay, or "ND") in entering. ΔCS_{WD} (with delay, or "WD") is the change in consumer welfare that applies if entry is delayed until a particular period of time (t_1). We assume that once entry is open, entry occurs at the same rate in the "delay" as in the "no delay" scenario. In other words, ΔCS_{WD} is simply ΔCS_{ND} shifted to the right by the number of years of delay.[15] In the figure, we see that the two curves become close together at t_{max}, since at t_{max} nearly every house is passed under either the delay or no delay scenarios. How close the two curves are depends on the length of delay and t_{max}.

This temporal reduction in consumer surplus caused by the delay is the difference between the areas under the two curves, which is the lightly shaded region between ΔCS_{ND} and ΔCS_{WD}, labeled "Lost Surplus". Importantly, the lost surplus from delay is lost forever and cannot be "made up for" in the future. As founding father Benjamin Franklin observed: "You may delay, but time will not, and lost time is never found again."[16]

For example, if a household pays $120 more for cable service in 2007 than it would have paid if new wireline video entry had occurred that year instead of in 2008, that household will never get that $120 back, even if it enjoys lower prices in 2008 (and beyond). As a result, even if ΔCS_{ND} and ΔCS_{WD} approach convergence (which never happens), the area labeled "Lost Surplus" never disappears, and the size of that area represents the lost consumer surplus from delay.

In this BULLETIN, we attempt to compute the size of this area. In so doing, we assume a linear demand curve. As price falls due to increased competition, aggregate video penetration rises as inferred by an elasticity assumption. Consumer surplus is

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15 Indeed, if today is a uniquely propitious time to begin competitive video deployment (say, because customers are choosing their "triple play" provider), then delay to market may yield an entry rate that progresses much more sluggishly from its take-off point than undelayed entry. Many claim that we are at just such a moment in time in the communications industry. An analysis of the impact delay would have on the prospects of success would require a separate analysis. In this BULLETIN, we conservatively focus solely on delay, with no effect on the rate of entry after the delay has ended.

16 POOR RICHARD'S ALMANAC (1748).

$$\Delta CS_t = \Delta P\left(Q_{0,t} + \Delta Q_t / 2\right) \quad (1)$$

where ΔCS_t is the change in consumer surplus in period t, ΔP is the change in price, $Q_{0,t}$ is the quantity without entry in period t, and ΔQ_t is the change in quantity in period t resulting from competitive entry (computed using the assumed elasticity). Eq. (1) is the standard formulation of consumer surplus changes from a price changes with linear demand.[17] Note that all consumer surplus changes are based on price decreases alone. We do not take into account quality or service improvements, thereby leading to conservative estimates of the consumer welfare loss.

In computing Eq. (1), we assume that there is no uniform pricing constraint, an assumption consistent with federal law.[18] In other words, prices are lower in the segments where wireline video competition exists and, consequently, consumer surplus increases only for consumers in the overbuild segments of cable markets. This assumption is also consistent with the colloquial evidence cited above about incumbent cable company price responses to new entry.[19] Since lower prices only occur in the overbuild areas, we need to estimate the percentage of homes in these overbuild areas over time. The formula we use is:

$$h_t / H_t = Le^{-be^{kt}} \quad (2)$$

where h is homes-passed by the entrant, H is total homes, L is the terminal penetration rate, e is the base of natural logarithms, b and k are parameters, and t is time. Eq. (2) gives us the S-shaped curve. We select parameter values $b = 4.3$ and $k = -0.27$ since these values produce the familiar S-shape curve and because they imply a 33% build-out of the terminal penetration L by the fifth year and 75% by the tenth year (regardless of L). These values seem sensible, and we provide sensitivity analysis on these assumptions.[20]

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17 *See, e.g.*, R. B. Ekelund Jr. and R. D. Tollison, ECONOMICS 4th (1994), at Ch. 5.

18 Cable systems subject to effective competition in a geographic area specifically exempted from the uniform geographic rate requirement of Section 623(d) of the Communications Act and can lower rates only in areas where competition is present. 47 U.S. § 623(d).

19 *Supra* nn. 8 & 9.

20 Sanford C. Berstein & Co. telecom analyst Craig Moffett predicts "by 2010, close to 40% of U.S. households might be able to get TV service from their local phone companies." P. Grant, *Getting Your MTV From the Phone Company*, WALL STREET JOURNAL (September 21, 2005) at D1. Our assumption is only 33% of households, so we this parameterization is probably conservative. Further, the deployment schedule in Equation (2) is for the nation. Obviously, some companies will have a more aggressive rollout schedule.

Once we have the ability to calculate consumer surplus at any point in time, the aggregate consumer surplus represented by the "Lost Surplus" area is simply the present value of the flow of these consumer surpluses over the time horizon. Without a delay of entry, consumer surplus increases in the first year (t_0). With delay to t_1, the consumer surplus gains do not occur until year t_1. Specifically, the computations are

$$\Delta CS_{ND} = \int_{t_0}^{t_{max}} \Delta CS(t) \cdot f(t) dt \quad (3)$$

$$\Delta CS_{WD} = \int_{t_1}^{t_{max}} \Delta CS(t) \cdot f(t) dt \quad (4)$$

where $\Delta CS(t)$ is computed as in Eq. (1), $f(t)$ is the discount factor for time t, and t_{max} is identical for both. Lost consumer surplus is simply $\Delta CS_{WD} - \Delta CS_{ND}$.

III. Estimation Details

The framework above allows us to estimate the lost consumer surplus over virtually any time horizon with a variety of network deployment schedules or price competition. To make a particular estimate, we need to make a number of assumptions. We employ a 25-year horizon (t_{max}) with a discount rate of 5.25% (used to compute f).[21] In t_0, which represents the present, we utilize current cable industry estimates of 110 million television households, of which 90% subscribe to multichannel video service.[22] We assume exogenous household growth (*e.g.*, population growth) of 1.7% annually.[23]

For the benchmark case, we assume that terrestrial overbuilding eventually occurs for 90% of television homes (at the end of the 25-year horizon). The own-price elasticity of the linear demand curve is 1.5 (in absolute value), which is at the lower end of published estimates of

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[21] The discount rate is the government recommended discount rate for social projects. *See* OMB Circular No. A-94, APPENDIX C (Revised January 2006) (http://www.whitehouse.gov/OMB/circulars/a094/a94_appx-c.html) (average of the 20 and 30 recommended rates). The rate is a nominal rate. If a real discount rate is used, the lost surplus would increase. We use the nominal rate so that our estimates are conservative. Sensitivity analysis indicates that every one percentage point reduction in the discount rate increase the consumer surplus loss by about 10%.

[22] Industry Overview, Statistics & Resources, www.ncta.com.

[23] Based on the average annual growth rate of U.S. Households from *USA Statistics in Brief, Households and Housing*, www.census.gov (years 2000 through 2004).

demand elasticities for cable service.[24] We make this assumption so that our estimates are conservative, since a larger elasticity of demand would increase the lost surplus. Most of the consumer surplus gains are from infra-marginal consumers (not new customers), however, so the elasticity assumption does not have a sizeable influence on the estimated surplus changes.[25] We assume average monthly revenue per household of $50, and a price cut from competition of 15%.[26]

IV. Results

With our framework and benchmark assumptions in hand, we can estimate the lost consumer surplus from a delay in franchise reform. We find that the present value of this consumer welfare loss is quite significant - $8.2 billion dollars for one year of delay, or nearly $75 dollars for each American household. Four years of delay would cost consumers nearly $30 billion, or about $270 dollars per household. Moreover, a rigorous sensitivity analysis suggests that our findings are robust to a wide range of assumptions. Policy makers must consider this significant cost of delay in deciding whether it should act on pro-entry video policies, such as franchise reform and program access policies.

To calculate this estimate, we need to make a number of "benchmark" assumptions. Table 1 summarizes the results of the estimation methodology under the benchmark assumptions. We have calculated the lost surplus for a number of different "delay" scenarios. To calculate these

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[24] Economic theory indicates the profit maximizing markup is $(p - c)/p = 1/e$, where e is the own-price elasticity of demand. In the cable industry, markups over programming costs, which represent the vast majority of the incremental cost of a subscriber, are around 0.65, implying an own-price elasticity of about 1.54. *See, e.g.*, Comcast 2004 Form 10-K (Video Revenue (12096), Programming Costs (3909), Price-Cost Margin = 0.67, Implied Elasticity 1.48) and Charter/Renaissance 2004 Form 10-K (Video Revenue (83934), Programming Costs (30874), Price-Cost Margin = 0.63, Implied Elasticity = 1.58). Programming costs are not the only incremental cost, however, so the 1.5 elasticity implied by these calculations is a lower bound.

[25] For example, in the benchmark simulation results in Table 1, *infra*, the one-year consumer welfare loss falls from $8.2 billion to $7.3 billion if the elasticity is set at zero.

[26] Price is based on reported average revenue per video subscriber by Comcast (2004 Form 10-K) and Charter/Renaissance (1004 Form 10-K). For the competitive price cut, *see Direct Broadcast Satellite Subscribership Has Grown Rapidly, but Varies across Different Types of Markets, Report to the Subcommittee on Antitrust, Competition Policy and Consumer Rights,* Committee on the Judiciary, U.S. Senate, US Government Accountability Office, GAO-05-257 (2005) ("GAO 2005 Study") at Appendix III, Table 3. The coefficient on a terrestrial overbuild is -0.1694, and the percentage change in price is measured as exp(-0.1694) - 1 = 15.6%.

estimates, we made a number of "benchmark" assumptions that we discuss in more detail below.[27]

Table 1. Consumer Surplus Reduction from Delayed Entry

Benchmark Assumptions

Years Delay	Consumer Surplus with No Delay	Consumer Surplus With Delay	Lost Surplus
1	$93.2B	$85.0B	$8.2B
2	$93.2B	$77.3B	$15.9B
3	$93.2B	$70.1B	$23.1B
4	$93.2B	$63.3B	$29.9B
5	$93.2B	$56.9B	$36.3B

As shown in Table 1, surplus losses are substantial. Just one year of delay reduces the present value of consumer surplus by $8.2 billion dollars, whereas three years of delay increases that loss to $23.1 billion. A five-year stall on video entry reduces consumer surplus by $36.3 billion.

Moreover, these losses are *unrecoverable*. If a household pays more for video service in 2007 because policymakers have delayed franchise reform for one year, then that money is *lost forever*, even if policymakers finally remove the barrier to entry and entry occurs in 2008.

Calculating these estimates requires us to make a number of assumptions regarding video penetration levels, price responses and new-entrant network construction. In the following paragraphs, we describe and analyze the sensitivity of these calculations to changes in these assumptions (for example, lower penetration levels, lower price responses, *etc.*).[28] This sensitivity analysis underscores and reinforces the robustness of our finding – under a number of scenarios, consumers will lose billions of dollars from even one year's delay in entry.

A. *Video and Satellite Penetration*

In our benchmark case, we assumed that 90% of households subscribed to video service, either cable or satellite. We based this assumption on statistics provided by the National Cable Television Association ("NCTA"). We note that this 90% includes both cable and satellite video

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[27] We assume: (a) 110 million households; (b) 1.7% annual growth rate in households; (c) 90% video penetration rate; (d) for the overlap S-Curve, $L = 0.90$, $b = 4.3$ and $k = -0.27$; (e) $50 average revenue per month; (f) 15% price cut; (g) 1.5 demand elasticity; and (h) 5.25% discount rate.

[28] We do not provide sensitivity analysis for those assumptions based on census and industry statistics such as household growth, the discount rate, and so forth.

services, but there is good evidence that price competition between wireline and satellite video providers is not as intense as that between two wireline providers.[29] We can estimate a lower bound to the surplus gains by assuming that wireline providers do not compete at all with satellite providers. This assumption is an extreme and unrealistic one, but is useful in providing an absolute lower bound to the consumer surplus loss (as it relates to video penetration). To evaluate the consumer surplus effects under the assumption that terrestrial entry competes only with wireline video customers (and not satellite operators), we can adjust the 90% assumption down to 66.3% (essentially subtracting DBS subscriber levels from the "market"). Adjusting this video penetration assumption has approximately a 26% reducing effect on the estimates of lost surplus. Thus, there is about a 1.1% change in surplus loss for every percentage point change in the video penetration rate (26% reduction in loss for a 23.7 percentage point reduction in penetration). Of course, the assumption that wireline competition has no effect on satellite video industry is unrealistic and contradicts empirical evidence showing that competition among terrestrial video providers substantially reduces the market share of satellite providers.[30] Nevertheless, even if the impact of satellite services is ignored completely, the estimated surplus loss is significant - over $6 billion for one year's delay.

B. *Extent of New Network Construction (Overlap)*

We assume that new entrants will ultimately build to 90% of cable households - in other words, we estimate that 90% of homes have access to two terrestrial multichannel video operators. Of course, reaching that level of network construction by a new entrant takes time.[31] The percentage effect of changes in the overlap rate is approximately symmetric. Increasing overlap to 100% increases the surplus loss by about 10%, and decreasing overlap to 80% decreases surplus loss by about 10%. Thus, for every percentage point change in the overlap rate, consumer surplus loss changes by about 1% (in the same direction).

C. *Price Competition*

Reducing the competitive price cut following entry reduces surplus loss. We assumed a 15% price cut based on the (*ceteris paribus*) econometric estimates by the GAO in the most recent study of wireline video competition. There is every reason to expect similar, near-immediate price cuts from telephone company entry, as the 2005 GAO Study looked at 113 markets in

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29 GAO 2005 Study, *supra* 26.

30 *Id.*

31 Equation (2) can be used to determine the level of "overbuild overlap" for any year *t*.

which cable faces wireline video competition to arrive at its estimate of a 15% price cut.[32] This benchmark assumption may well be conservative - a January 2006 Bank of America survey of three areas where Verizon has rolled out FiOS video service revealed video service price cuts by incumbent cable operators Cox, Charter and BrightHouse of 42.8%, 28.6%, and 37.8%, respectively. By altering the assumed price cut, we find that a one-percentage point change in the assumed price cut changes the surplus loss from the benchmark case by about 7%.

D. *Rate of Network Construction*

Equation (2) determines the rate at the new network is constructed. The formula has two parameters, *b* and *k*, which we assumed had values of 4.3 and -0.27, respectively. These values produced the familiar S-shape curve with 33% build-out of the terminal penetration by the fifth year and 75% by the tenth year, which is more conservative than some analysts' predictions.[33]

Interestingly, if we slow the growth rate of deployment by the new entrant (*e.g.*, "flattening" the S-curve in Figure 1), then the loss in consumer welfare from delay does not decrease significantly. Instead of 33% in five years and 75% in ten years, if we assume that the new entrant builds out to 20% at five years and 66% at 10 years, the consumer welfare loss is only reduced by about 5%. Alternately, if the deployment rates are 50% in five years and 90% in 10 years, the consumer surplus loss increases by 9% relative to the benchmark assumptions.

This finding has important implications for policymakers. Within reasonable bounds, the extent of consumer welfare loss caused by a delay in franchise reform *is not significantly impacted by the rate of network construction that the new video entrant chooses to undertake.*[34] Consumers will lose from any delay in reform, even in areas in which telephone company entry is not on the immediate horizon.

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[32] Many of the econometric studies of overbuild competition were conducted during periods where uniform pricing rules were common. Thus, the competitive price cuts from these studies are tempered relative to a world without uniform pricing rules, since overlap of rival systems was rarely complete. As shown in Beard *et al.* (2005), *supra* n. 5, if system overlap is taken into account, then the price cuts for 100% overlaps (which would be equivalent to the absence of a uniform pricing rule) are much larger than 15 percent.

[33] P. Grant, *supra* n. 20.

[34] It is primarily discounting that creates the sensitivity to the growth assumption. Slower growth pushes gains out into the future. If the discount rate were 0, there would be very little difference in the estimated loss based on this variation in the growth assumption.

E. *Time Horizon*

We sum the discounted lost consumer surplus over 25 years. This long period is necessary to avoid, as much as possible, large differences between ΔCS_{ND} and ΔCS_{WD} in the final year of the simulation.[35] Note, however, that as the number of years increases where entry is delayed, the difference between the two measures of consumer surplus rises. As a result, *the longer entry is delayed by policy decisions, the longer it takes for consumers to enjoy the full benefits of competitive entry.* If the horizon is reduced to 20 years, then the surplus loss falls by about 5%. Alternately, if we increase the horizon to 30 years, then the surplus loss increases by about 4%.

V. Conclusion

There is no question that cable rates decrease considerably in locations where consumers enjoy direct, wireline video competition. Local telephone companies are beginning to invest significant capital into new, fiber-rich broadband networks capable of providing new video competition and lower rates. But there is a growing recognition that the local franchise process is, at best, delaying that new entry, and at worse, frustrating entry altogether. The delay costs consumers money - but how much?

In this BULLETIN, we estimate that the consumer welfare cost of delaying video competition is significant - $8.2 billion for one year of delay and $29.9 billion for four years of delay. This estimate is conservative because it does not take into account potential consumer welfare gains that would result from increased availability of broadband networks that more liberal video entry policies would promote. These consumer welfare losses comprise an important cost of the current regulatory framework, which permits local governments to dictate the pace of deployment of new, next-generation interstate broadband networks.

The rewrite of the Telecommunications Act of 1996 involves a number of complicated policy issues that might lead to calls for further consideration or delay. But policymakers considering video franchise reform need to understand the impact that delayed reform will have on their constituents. Every day of delay is another day of higher cable rates. In making decisions about whether video franchise reform should be a priority, policymakers need to take into account that cost of delay.

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[35] With large differences at the end of the time horizon, computing a terminal value is an appropriate remedy. We do not compute a terminal value, so our estimates are conservative in this regard.

DeAnne Mangum (Finance CA)

From: SECURE [SECURE@nc.rr.com]
Sent: Monday, April 03, 2006 1:08 PM
To: SECURE
Subject: RE: Stop N.C. Preemption of Local cable franchising - send attached.
Attachments: MEMORANDUM_IN_SUPPORT-3-31-06-Final with faxes.rtf

Here is a final attachment with fax numbers for ease of use.

Lisa Beimler
S.E.C.U.R.E.
"Helping local governments fight back"
P.O. Box 25608
Raleigh, NC 27611-5608
(202)465-4749

-----Original Message-----
From: SECURE [mailto:SECURE@nc.rr.com]
Sent: Monday, April 03, 2006 12:37 PM
To: SECURE
Subject: Stop N.C. Preemption of Local cable franchising - send attached.

Contact: Bob Sepe
Action Audits, LLC
Phone: 919-467-5392
Email: rsepe@nc.rr.com

S.E.C.U.R.E.
PO Box 25608
Raleigh, NC 27611-5608
Voice: 202-465-4749

Southeastern Coalition To Uphold Local Government Rights-of-Way Enforcement

SECURE ALERT

NC Revenue Laws Study Committee Continues to Prepare Anti-Local Government Cable Bill

(BUT LOCAL GOVERNMENTS PUSH BACK)

- PLEASE SEND COMMITTEE ATTACHED MEMORANDUM REJECTING STATE PREEMPTION

April 3, 2006 – North Carolina Local Elected officials are pushing back as they alert the N.C. Revenue Laws Study Committee that State preemption of local cable franchising will lead to North Carolina's poorer, rural and minority communities being left behind in the deployment of broadband video. Bell South and Verizon have asked the State to preempt local cable franchising, claiming local governments have been a barrier to entry to video competition in North Carolina. But the telcos have not approached any North Carolina communities and now demand that they not be required to build one foot of competitive plant under proposed state preemption. Telcos will roll out competition only where they chose -- to the wealthy communities in North Carolina. This is a strategy to eliminate both the last vestige of local consumer protection and public policy obligations to serve North Carolina's less-wealthy communities.

"Half of North Carolina consists of rural and low-income communities," stated Bob Sepe, a co-founder of S.E.C.U.R.E. "The experience in Texas has shown us what such a law will mean for North Carolina. Verizon is only building in Texas communities with an average median income of $82,000, while the average median income in Texas, just like in North Carolina, is about $39,000." He added, "Our communities have lost their textile base, their tobacco and manufacturing base and now the State is contemplating denying them the broadband video? Cable incumbents will be demanding state preemption on the telcos' heels, and then will pull out of lower-income communities to match the telco competition in wealthy North Carolina areas. Lower- income and minority consumers will be the losers."

ACTION STEPS→

- Send the attached **Memorandum in Support of Local Cable Franchising** to the Revenue Laws Study Committee Members, whose faxes and addresses are on the memo, and reject state preemption of local cable franchising authority.
- Attend in full force the next Revenue Laws Committee Meeting, now scheduled to take place Wednesday, **April 19th, 2006 at 1:00 p.m. (NEW DATE!)** when the draft legislation is slated to be introduced.

Join SECURE to safeguard your community's broadband future. It is time for local governments to remind their State Legislators and Washington just who they are. Call 202-465-4749 for details. SECURE participants invest $1,000 annually to protect local regulatory authority and revenues.

*SECURE is associated with Action Audits, LLC.

For Immediate Release April 3, 2006.

Lisa Beimler
S.E.C.U.R.E.
"Helping local governments fight back"
P.O. Box 25608
Raleigh, NC 27611-5608
(202)465-4749

MEMORANDUM IN SUPPORT
OF
LOCAL GOVERNMENT CABLE FRANCHISING

1. **Only through Local Government Cable Franchising can competition, without discrimination, be achieved.**
   - The future economic survival of North Carolina's local communities depends on the widespread and rapid deployment of affordable broadband infrastructures.
   - Local governments have a vested interest in ensuring meaningful competition and the deployment of broadband and video service in their communities.
   - Broadband video deployment should not be based on the income level of a local community, its neighborhoods or its –citizens.
   - Only through local cable franchising – which allows local government enforcement of build out requirements and construction schedules – can all North Carolina communities be assured the promise of wider deployment of broadband video services.
   - State preemption in other states has led to only the wealthiest communities, neighborhoods and citizens being served with broadband video.

2. **Only through Local Government Cable Franchising can PEG channel capacity, financial support, and local programming be preserved:**
   - Congress granted local governments the right to: (1) require Public, Education and Government channels (PEG) to respond to the needs and interests of their local residents; (2) require financial support to develop these channels; and; (3) enforce – through penalties – -noncompliance with these requirements.
   - Current local cable franchises include PEG provisions based on the local characteristics and needs of their citizens.
   - Local governments are held directly accountable to – and hear directly from – their constituents when these channels go dark.
   - This system of direct accountability to the local citizen works.
   - State preemption in other states has led to the slow demise of this valuable local PEG programming.

3. **Only through Local Government Cable Franchising can cable consumers be adequately protected:**
   - Current local cable franchises include consumer protection provisions and allow local cable subscribers to call their local officials when cable problems are not resolved.
   - Only local governments currently have the staff, the inspectors and local cable franchise enforcement authority to resolve cable subscriber problems quickly.
   - The State Public Utility Commission is not staffed to respond to cable complaints from the 1.839 million cable subscribers in North Carolina.
   - State preemption of local cable franchising in other states has eliminated local government's ability to enforce cable consumer protections.

4. **Only through Local Government Cable Franchising can cable franchise fees be uniformly distributed to local governments:**
   - Current local cable franchises require cable providers to pay rent for the use of public rights-of-way in the form of cable franchise fees and permit local financial audits to ensure that the amounts paid are correct.
   - Local cable franchise fees directly reflect the gross revenues generated from households located in each local community.
   - State preemption and "equal distribution" of local franchise fees cannot replace this exacting method.

5. **Local Government Cable Franchising must be preserved to ensure the public safety of local rights-of-way.**
   - Local cable franchises validate local police powers to monitor and enforce the use of public rights-of-way to ensure the public's safety.
   - Local rights-of-way represent the most fundamental economic development asset of a community.
   - Local officials are held directly accountable by their citizens when public rights-of-way become dangerous or misused.
   - This system of direct accountability to local citizens must not be subverted.

Therefore, the undersigned, on behalf of the City/Town of_____, fully supports all efforts to block attempts by telecommunications companies to subvert local cable franchising authority through state preemption.

Sincerely,

Mayor/City, County, Town Manager, Chairman

cc:
S. Ellis Hankins
Lee Mandell
Andrew Romanet, Jr.
NCLM
P.O. Box 3069
Raleigh, NC 27602-3069
Fax: 919-733-9519

Paul A. Meyer
James Blackburn, III
NCACC
215 N. Dawson Street
Raleigh, NC 27603
Fax: 919-733-1065

Continued....

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616
Office Fax: (919)733-5815
Business Fax: (919)734-4215

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705
Office Fax: (919)733-3113

Sen. Daniel Gray Clodfelter
100 N. Tryon Street
Charlotte, NC 28202-4003
Office Fax: (919)715-5815
Business Fax: (704)378-2041

Sen. Walter H. Dalton
560 N. Main Street
Rutherfordton, NC 28139
Business Fax: (828)286-8229

Sen. Fletcher Lee Hartsell Jr.
P.O. Box 368
Concord, NC 28026-0368
Office Fax: (919)733-7223
Business Fax: (704)788-8058

Sen. David W. Hoyle
P.O. Box 2494
Gastonia, NC 28053
Office Fax: (919)829-5579
Business Fax: (704)864-7468

Sen. Hugh Webster
208 Shadowbrook Drive
Burlington, NC 27215
Office Fax: (919)754-3289

Mr. Leonard W. Jones
300 North 35th Street
Morehead City, NC 28577
Business Fax: (919)733-3113

Mr. J. Micah Pate, III, CPA
615 Oberlin Road, Ste. 200
Raleigh, NC 27605
Business Fax: (919)836-9288

Rep. Harold J. Brubaker
138 Scarboro Street
Asheboro, NC 27203
Business Fax: (336)629-2603

Rep. Becky Carney
P.O. Box 32873
Charlotte, NC 28232
Business Fax: (828)874-2831

Rep. Walter Greene Church Sr.
P.O. Box 760
Valdese, NC 28690
Office Fax: (704)332-8339

Rep. Dewey Lewis Hill
P.O. Box 723
Whiteville, NC 28472
Business Fax: (910)642-7004

Rep. Daniel Francis McComas
P.O. Box 2274
Wilmington, NC 28402
Business Fax: (910)343-8003

Rep. William L. Wainwright
P.O. Box 33
Havelock, NC 28532
Office Fax: (252)672-4075
Business Fax: (252)672-4075

Rep. W. A. Wilkins
210 Fair Oaks Drive
Roxboro, NC 27574
Office Fax: (919)715-0850

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Committee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919) 733-3113 or (919)-715-5815

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)715-5460

Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)715-3589

Sabra J. Faires
Senate Tax Counsel
330 Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)733-8740

DeAnne Mangum (Finance CA)

From: Sandy Bostic [sbostic@NCLM.ORG]

Sent: Friday, April 07, 2006 9:16 AM

To: Rep. Paul Luebke; Sen. John Kerr; Rep. Harold "Bru" Brubaker; Rep. Becky Carney; Rep. Walter Church; Rep. Dewey Hill; Rep. Danny McComas; Rep. William Wainwright; Rep. Winkie Wilkins; Sen. Daniel Clodfelter; Sen. Walter Dalton; Sen. Fletcher Hartsell, Jr.; Sen. David Hoyle; Sen. Hugh Webster; Cindy Avrette (Research); Martha Walston (Fiscal Research); DeAnne Mangum (Finance CA); Rep. Alma Adams; Rep. Bernard Allen; Rep. Larry Bell; Rep. Linda Coleman; Rep. Pete Cunningham; Rep. Beverly Earle; Rep. Jean Farmer-Butterfield; Rep. Edward Jones; Rep. Howard Hunter; Rep. Earl Jones; Rep. Marvin Lucas; Rep. Mary McAllister; Rep. Mickey Michaux, Jr.; Rep. Paul Miller; Rep. Earline W. Parmon; Rep. Garland Pierce; Rep. Larry Womble; Rep. Tom Wright; Sen. Charlie Dannelly; Sen. Katie Dorsett; Sen. Malcolm Graham; Sen. Robert Lee Holloman; Sen. Jeanne Lucas; Sen. Vernon Malone; Sen. Larry Shaw

Subject: Fair Video Service (Letter also sent by regular mail)

April 6, 2006

The Honorable John H. Kerr, III
Senate Co-Chair, Revenue Laws Study Committee
P. O. Box 1616
Goldsboro, NC 27533-1616

The Honorable Paul Luebke
House Co-Chair, Revenue Laws Study Committee
1507 Oakland Avenue
Durham, NC 27705

Re: Fair Video Service

Dear Senator Kerr and Representative Luebke:

We write on behalf of the membership of North Carolina Black Elected Municipal Officials (NCBEMO) to express serious concerns about draft legislation regarding video services that will be considered by the Revenue Laws Study Committee on April 19, and possibly by the General Assembly this year.

We support additional competition in the communications marketplace, which could bring lower prices, improved quality and new services. Competition must be extended broadly, however, to as many communities and neighborhoods as possible, to benefit people of all races and income levels.

We see very little in this legislation that will actually foster increased competition, and certainly not fair competition with widespread public benefit. As drafted, it will allow new providers of video services to leave behind many minority and disadvantaged communities and neighborhoods, and that might be the result. North Carolina law should not authorize or allow that.

The non-discrimination or redlining provisions in this draft legislation fall far short of what is necessary to protect the public interest. The General Assembly should not apply non-discrimination provisions just within a number of small areas or neighborhoods that a provider might select to serve, but rather throughout the jurisdictional area of municipalities or counties. As members of the Congressional Black Caucus recently wrote to the chairman and ranking member of the House committee that is considering

video franchising legislation in Washington, "a rule that confines the non-discrimination provision only to areas chosen by a provider is like telling a bank that anti-redlining provisions will only apply to lending for New York's 5th Avenue," or other higher income areas.

Most existing municipal cable franchises in North Carolina require the cable company to serve every neighborhood in every developed part of town. We should not throw out that public interest requirement.

Our NCBEMO membership endorses the following principles for fairness along with the entire membership of the North Carolina League of Municipalities:

- The benefits of video competition should not be enjoyed by just a privileged few—phone companies should not be allowed to cherry pick and provide video service only in the neighborhoods they view as most desirable;
- City taxpayers own those street rights-of-way, and their elected representatives need to retain authority to regulate use (digging, placement of fiber optics and cable, repair of pavement and traffic control);
- Franchise fees, in part, are compensation for private use of the publicly-owned right-of-way, and should not be eliminated or reduced;
- If phone companies enter the video business, then they have some community obligations and should provide public, educational and government access channels and reasonable operating support, just like cable companies; and
- The city should be able to enforce the FCC video customer service standards, just as under current law (see the city hall phone number for complaints at the bottom of many cable bills).

We will appreciate your support.

Respectfully,

James E. Mitchell, Jr.
President, NC Black Elected Municipal Officials
Council Member, City of Charlotte
Member, National League of Cities Board of Directors

Joycelyn V. Johnson
Past President, NC Black Elected Municipal Officials
Council Member, City of Winston-Salem
Immediate Past President, NC League of Municipalities

Darryl Moss
Past President, NC Black Elected Municipal Officials
Mayor, City of Creedmoor
Member, NC League of Municipalities Board of Directors

cc: Members of Revenue Laws Study Committee
Members of the Legislative Black Caucus

Box Contents
Studies & Nonstanding Committees
Item #25896
2005 Biennium

Box 5

1. *(cont.)* 2005 – 2006 Revenue Laws Study Committee (***Handouts & Reports)***
2. 2005-2008 Interim Revenue Laws Study Committee
3. 2005-2006 Joint Legislative Transportation Oversight Committee
4. 2006 House Study Committee on Abandoned Cemeteries
5. 2006-2008 Agriculture & Forestry Awareness Study Commission

TOWN OF

RANDOLPH VOLLER
Mayor

D[redacted]B. HUGHES, P.E.
Town Manager

PAUL S. MESSICK, JR.
Town Attorney

P.O. Box 759 - 635 East Street
PITTSBORO. N.C. 27312

BOARD OF COMMISSIONERS

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CHRIS WALKER
CLINTON E. BRYAN, JR

TELEPHONE
(919) 542-4621
FAX (919) 542-7109

April 6, 2006

MEMORANDUM IN SUPPORT OF LOCAL GOVERNMENT CABLE FRANCHISING

1. **Only through Local Government Cable Franchising can competition, without discrimination, be achieved.**
   - The future economic survival of North Carolina's local communities depends on the widespread and rapid deployment of affordable broadband infrastructures.
   - Local governments have a vested interest in ensuring meaningful competition and the deployment of broadband and video service in their communities.
   - Broadband video deployment should not be based on the income level of a local community, its neighborhoods or its citizens.
   - Only through local cable franchising – which allows local government enforcement of build out requirements and construction schedules – can all North Carolina communities be assured the promise of wider deployment of broadband video services.
   - State preemption in other states has led to only the wealthiest communities, neighborhoods and citizens being served with broadband video.

2. **Only through Local Government Cable Franchising can PEG channel capacity, financial support, and local programming be preserved:**
   - Congress granted local governments the right to: (1) require Public, Education and Government channels (PEG) to respond to the needs and interests of their local residents; (2) require financial support to develop these channels; and; (3) enforce – through penalties – noncompliance with these requirements.
   - Current local cable franchises include PEG provisions based on the local characteristics and needs of their citizens.
   - Local governments are held directly accountable to – and hear directly from – their constituents when these channels go dark.
   - This system of direct accountability to the local citizen works.
   - State preemption in other states has led to the slow demise of this valuable local PEG programming.

3. **Only through Local Government Cable Franchising can cable consumers be adequately protected:**

- Current local cable franchises include consumer protection provisions and allow local cable subscribers to call their local officials when cable problems are not resolved.
- Only local governments currently have the staff, the inspectors and local cable franchise enforcement authority to resolve cable subscriber problems quickly.
- The State Public Utility Commission is not staffed to respond to cable complaints from the 1.839 million cable subscribers in North Carolina.
- State preemption of local cable franchising in other states has eliminated local government's ability to enforce cable consumer protections.

4. **Only through Local Government Cable Franchising can cable franchise fees be uniformly distributed to local governments:**
   - Current local cable franchises require cable providers to pay rent for the use of public rights-of-way in the form of cable franchise fees and permit local financial audits to ensure that the amounts paid are correct.
   - Local cable franchise fees directly reflect the gross revenues generated from households located in each local community.
   - State preemption and "equal distribution" of local franchise fees cannot replace this exacting method.

5. **Local Government Cable Franchising must be preserved to ensure the public safety of local rights-of-way.**
   - Local cable franchises validate local police powers to monitor and enforce the use of public rights-of-way to ensure the public's safety.
   - Local rights-of-way represent the most fundamental economic development asset of a community.
   - Local officials are held directly accountable by their citizens when public rights-of-way become dangerous or misused.
   - This system of direct accountability to local citizens must not be subverted.

Therefore, the undersigned, on behalf of the Town of Pittsboro, fully supports all efforts to block attempts by telecommunications companies to subvert local cable franchising authority through state preemption.

Sincerely,

TOWN OF PITTSBORO

Samuel W. Misenheimer
Interim Town Manager

cc: S. Ellis Hankins
Lee Mandell

Mr. Leonard W. Jones
300 North 35th Street
Morehead City, NC 28577
Mr. J. Micah Pate, III, CPA
615 Oberlin Road, Ste. 200
Raleigh, NC 27605

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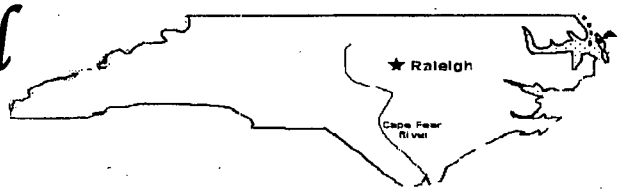
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Rep. W. A. Wilkins
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Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Committee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
Raleigh, NC 27603-5925

North Carolina Black Elected Municipal Officials



The 21st Century

NCBEMO

Reshaping the Future, Honoring the Past

Mailing Address:
NCBEMO
P. O. Box 3069
Raleigh, NC 27602-3069
www.ncbemo.org

President
Councilman James Mitchell
Charlotte, North Carolina
(704) 398-9480

1st Vice-President
Rodney Locks
Brevard, North Carolina

2nd Vice-President
T. Diane B.-Smalls
Greensboro, North Carolina

Secretary
Councilman Robert Massey
Fayetteville, North Carolina

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Historian
Alderwoman Z. Ann Hoyle
Hickory, North Carolina

SCHOLARSHIP CHAIRPERSON
Councilwoman Mildred Council
Greenville, North Carolina

DISTRICT REPRESENTATIVES
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#2 Alderman Robert Raynor
#3 Mayor Perry Dixon
#4 Commissioner Ora Truzy
#5 Mayor Warnie Bishop
#6
#7 Mayor Pro-Tem Donnie Olds
#8 Councilwoman Delores Chambers
#9
#10 Commissioner Franklin Campbell
#11 Councilman Carl Evans
#12 Mayor Pro-Tem Rodney Locks

April 6, 2006

The Honorable John H. Kerr, III
Senate Co-Chair, Revenue Laws Study Committee
P. O. Box 1616
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The Honorable Paul Luebke
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1507 Oakland Avenue
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Re: Fair Video Service

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We will appreciate your support.

Respectfully,

James E. Mitchell, Jr.

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Mayor, City of Creedmoor
Member, NC League of Municipalities Board of Directors

cc: Members of Revenue Laws Study Committee
Members of the Legislative Black Caucus

NORTH CAROLINA TELECOMMUNICATIONS INDUSTRY ASSOCIATION

April 10, 2006

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Committee
Room 329, Legislative Office Building
Raleigh, North Carolina 27603-5925

Dear Ms. Mangum:

Enclosed is a copy of an editorial that was published in *The News and Observer* regarding statewide video competition in North Carolina.

The telecommunications industry in North Carolina would like to see the franchise approval process expedited and simplified. Under the current local cable franchising process, video competition is stifled and consumers are denied choice and lower rates.

Local telephone companies all have a strong presence in their respective communities and have supported these communities' needs generously over the years. These companies have and will continue to provide excellent service quality to their voice and broadband customers. This will not change with the addition of video offerings.

We believe the best deal any local government can make for its residents is to quickly create the climate for competition to exist in the cable television market and for residents to experience better prices and value as a result.

If we can be of service to you as you serve to support the Revenue Laws Study Committee, please feel free to call on us.

Sincerely,

Carole M. Woodward
President / CEO

Enclosure (1)

5910 CLYDE RHYNE DRIVE • SANFORD, NC 27330 • PHONE: 919-708-7464 • FAX: 919-708-5226
www.nctia.org

Point of View

'STATEWIDE VIDEO COMPETITION' GOOD FOR NORTH CAROLINA

Do not adjust your TV sets – the blurring of the lines between television service and telephone service is intentional.

Today, cable companies are offering customers telephone service to go with their TV and Internet offerings and telephone companies are adding video to their product mix. A high-speed array of new technologies promises to bring lively competition, better service and better value to North Carolina's residents. And it could all start to happen very quickly, if we can move past an arduous, archaic, municipality-by-municipality franchise process and move into a more streamlined state-issued franchising system.

Texas has state-issued cable television franchising, as does Virginia and Indiana The concerns being expressed by some about a similar proposal for North Carolina makes one think of the classic Shakespearean play, "Much Ado About Nothing." Perhaps the best way to allay these fears is to actually look at the **facts** involved with proposals made by a number of the state's telecommunications carriers thus far to the Revenue Laws Study Committee in North Carolina.

The objective of the proposals made by the telecommunications industry in North Carolina is to expedite and simplify the franchise approval process in the interest of bringing long-overdue competition and choice to captive cable customers. The Federal Communications Commission has found that in markets where a cable service competitor exists, prices are on average 15-20 percent lower. And a Phoenix Center study issued in February concludes that delaying franchise reform in North Carolina even one year will cost consumers $288 million in rates they can never recover without competition – an average per household of $94. These costs get even higher with each year competition is delayed. The best deal any municipality can make for its residents is to quickly create the climate for competition to exist in the cable television market and for residents to experience better prices and value as a result.

Let's look at some of the specific concerns being aired about the proposal:

Service. Local telephone companies all have a strong presence in their respective communities and currently provide excellent service quality to their voice and broadband customers. This will not change with the addition of video offerings. More importantly, the best protection for good service comes from the creation of competition for all communications services.

Public, educational and governmental access (PEG) channels. The telecommunications industry is proposing that all cable systems provide capacity for PEG channels and ensure availability of PEG channel content to all providers. The industry is not opposed to franchise fees to support PEG, but does believe there is a negative consequence to consumers from additional cash demands placed on video service

providers. In a competitive marketplace, those cash demands are passed back to consumers in the form of additional fees – in effect, hidden taxes - to offset the cost to the service provider.

Control of municipal rights-of-way and access to same. The proposals preserve the right of state and local governments to manage public rights-of-way. As for access to rights-of-way, the local telephone companies have had access to municipal rights-of-way in North Carolina for decades. The local phone companies should not have to duplicate these efforts simply because their new or existing communications network can also support a video service. In support of competitive parity, North Carolina's telecommunications industry is not opposed to paying a video franchise fee similar to what the cable industry pays now. Municipalities may then use that revenue as they wish, whether it be for access, PEG or some other program of choice.

Cherry-picking. This is another way of suggesting that new video competitors would "redline" consumers, a practice that Federal Law directly prohibits and also provides for enforcement action if the law is violated. Local telephone companies have never discriminated when providing their voice and data services. Unfortunately, opponents are using unfounded accusations of redlining in an attempt to obscure the benefits of competition to consumers. The "cherry-picking" argument is a red herring. The reality is that subscription rates for video services correlate little with income and local telephone companies entering the video market will compete for as many customers as possible. Simply put, a video competitor will go where the subscribing customers are located.

Under the current local cable franchising scheme, video competition is stifled and consumers are denied choice and lower rates. The proposals from the telecommunications industry are good for consumers and good for North Carolina. Let's focus on the real issue - competition in the cable TV market leads to lowers rates and North Carolina consumers deserve lower rates, sooner rather than later.

Carole M. Woodward
President / CEO
North Carolina Telecommunications Industry Association, Inc

5910 Clyde Rhyne Drive
Sanford, NC 27330
Phone: 919-708-7464
Email: woodward@nctia.org

RESOLUTION IN SUPPORT OF VIDEO COMPETITION EVERYWHERE

WHEREAS, it is the mission of Alexander County to preserve and protect the rights of all its citizens; and

WHEREAS, the existing federal and local video franchising rules have resulted in a $100 billion investment in advanced telecommunications services nationwide and formed the basis for a national policy of broadband; and

WHEREAS, public policies that encourage the deployment of broadband everywhere could result in a $500 billion boost to the economy and 1.2 million jobs at a time when municipal budgets and economic opportunities are lean; and

WHEREAS, the local franchising authority strongly supports the anti-discrimination provisions of the 1984 Cable Act that have ensured against a 19th century world of digital haves and have-nots and ensured that Americans of all incomes, races, and backgrounds can have equal access to television and broadband service as the information and communication that it provides becomes more essential in our daily lives; and

WHEREAS, because this bipartisan anti-discrimination provision has been effective in ensuring the robust build-out of broadband networks, and in protecting against cherry picking of communities, the provision should be preserved by Congress and the States applied both to existing video service providers and new entrants into the video marketplace; and

WHEREAS, some telecommunications companies that now seek to enter the video marketplace are attempting to gain competitive advantage through federal and state preemption of local authority and are seeking to undermine the anti-discrimination and build-out requirements that have been a bipartisan cornerstone of our telecommunications laws for decades; and

WHEREAS, the local franchising authority wants to encourage competition for telephone, broadband, and video services, recognize that competition for such services is growing rapidly, and ensure that these new competitive services are available to all its citizens; and

WHEREAS, new entrants into the video marketplace face no unreasonable barriers to entry as federal law expressly provides that video franchises are not exclusive and municipalities have franchised numerous second video providers throughout the country; and

WHEREAS, excluding local elected officials from the franchise process as some telecommunications carriers suggest would be harmful to residents who use local franchise rules to ensure that video services are provided to everyone and that public safety and other community needs are met; and

WHEREAS, local franchising authority agrees that government policies should not determine winners and losers in the marketplace and thus the rules governing local franchises, including rules regarding the build-out of networks, should apply to all video providers equally; and

WHEREAS, the 109th United States Congress is currently considering various legislative proposals that would drastically limit or abolish the important role of local government franchising and the non-discrimination provisions of the 1984 Cable Act; and

WHEREAS, a number of states are considering various legislative proposals that would also limit or abolish the important role of local government in franchising, protecting the interests of all its citizens and the non-discrimination provisions of the 1984 Cable Act and promoting competition.

NOW, THEREFORE, BE IT RESOLVED that the local franchising authority urges Congress to reject the intentions of such legislative proposals, including S. 1349 and H.R. 3146, the "Video Choice Act of 2005"; and

BE IT FURTHER RESOLVED that the local franchising authority urges state legislatures to reject legislative proposals that limit or abolish the role of local government franchising and the ability of local governments to protect all its citizens, impose build-out requirements that will ensure that the non-discrimination provisions of the 1984 Cable Act are met, and promote competition for all its citizens; and

BE IT FURTHER RESOLVED the local franchising authority supports legislation which would promote competition in broadband and video services for everyone, recognizes and preserves local community needs, preserves local control over franchising, and prohibits redlining and other discriminatory practices; and

BE IT FURTHER RESOLVED that in enacting new legislation, Congress and all states should ensure that the current anti-discrimination provisions in the 1984 Cable Act are preserved, and should ensure that any and all new entrants abide by the same standards that current multichannel video providers live by; and

BE IT FURTHER RESOLVED that any new legislation with respect to existing multichannel video service providers, enacted by Congress and/or any state, should permit local franchising authorities to require all new entrants in the video marketplace to offer their broadband and video services to consumers within their service territory on a non-discriminatory basis, just as the law permits them to do so today.

Adopted this the 10th day of April 2006.

Larry G. Yoder, Chairman

ATTEST:

Jamie M. Starnes, Clerk to the Board

Town of Chapel Hill
Manager's Office
405 Martin Luther King Jr Blvd
Chapel Hill, NC 27514

Voice: (919) 968-2743 Fax: (919) 969-2063
www.townofchapelhill.org

TO: DeAnne Mangum

DATE: April 12, 2006

LOCATION: Committee Clerk, Revenue Laws Study Committee

FAX NO.: 919-733-3113

FROM: Kevin Foy

This fax contains 2 pages including this cover page. If this document is incomplete or illegible, please contact our office at the voice phone number above and we will be happy to resubmit the information.

Notes:

April 12, 2006

Memorandum in Support of Local Government Cable Franchising

Telephone companies are pressing for legislation in North Carolina that would dramatically change the way in which local governments work with cable companies. We express our commitment to maintaining local control and safeguarding the interests of our citizens.

- **Public Access Fees:** Our citizens cherish civic involvement. Chapel Hill's public, education and government channels reflect the local characteristics and needs of its citizens. In addition to franchise fees, our cable agreement provides for a special pass-through fee that generates about $117,000 a year to support public access programming. Loss of these funds threatens a valuable community resource that provides information and inspiration through homegrown programs.

- **Universal Access:** Our community believes that all citizens, regardless of economic status, should be treated equally. This is why our cable franchise requires that the cable company provide the same service to all households, not only so-called "high value" customers willing to spend more on telephone, internet and video services. When local governments enforce buildout requirements, communities are assured the promise of wider deployment of broadband video services.

- **Fair Payment:** Our local cable franchise requires the cable provider to pay rent for the use of public rights-of-way. The fees we receive are generated from Chapel Hill households. "Equal distribution" on a statewide basis cannot replace this method.

- **Consumer Protection:** State preemption of local cable franchising eliminates local government's ability to enforce cable consumer protections. Our cable provider maintains a local office with regular office hours and is expected to be responsive to customers. Local cable subscribers call their local officials when cable problems are not resolved.

- **Safe Use and Maintenance:** Our citizens expect that community property and interests will be safeguarded. The cable operator here must follow permit and bonding requirements made of contractors working within the Town's rights-of-way.

We urge you to allow the local community which owns the public right-of-way to determine the best use of the community's property. Please help us maintain our local cable franchising authority.

Sincerely,

K.C.F

Mayor Kevin C. Foy

www.townofchapelhill.org
405 Martin Luther King Jr. Blvd., Chapel Hill, NC 27514-5705
phone (919) 968-2743 *fax* (919) 967-8406

City of Gastonia

Office of The Mayor

"A Commitment to Excellence"

April 12, 2006

MEMORANDUM IN SUPPORT
OF
LOCAL GOVERNMENT CABLE FRANCHISING

1. **Only through Local Government Cable Franchising can competition without discrimination be achieved:**
   - The future economic survival of North Carolina's local communities depends on the widespread and rapid deployment of affordable broadband infrastructures.
   - Local governments have a vested interest in ensuring meaningful competition and the deployment of broadband and video service in their communities.
   - Broadband video deployment cannot be based on the income level of a local community, its neighborhoods or its citizens.
   - Federal law requires local governments to ensure that "cable systems are responsive to the needs and interests of the *local* community" and that these essential services are not offered on a discriminatory basis due to income.
   - Only through local cable franchising – which allows local government enforcement of build out requirements and construction schedules – can all North Carolina communities be assured the promise of wider deployment of broadband video services.
   - State preemption of local cable franchising will remove local government's ability to enforce these requirements and will lead to only the wealthiest communities, neighborhoods and citizens being served.

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   - Congress granted local governments the right to: (1) require Public, Education and Government channels (PEG) to respond to the needs and interests of their local residents; (2) require financial support as necessary to develop these channels; and; (3) enforce – through penalties – noncompliance with these requirements.
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   - Local governments are held directly accountable – and hear directly from their constituents – when these channels go dark.
   - This system of direct accountability to the local citizen works.
   - State preemption of local cable franchising – and the elimination of local government's authority to enforce these requirements – will result in the slow demise of this valuable community resource.

Post Office Box 1748 • Gastonia, North Carolina 28053-1748 • Phone: (704) 866-6720 • Fax: (704) 854-6607
Email: mayor@cityofgastonia.com

3. **Only through Local Government Cable Franchising can cable consumers be adequately protected:**
   - Current local cable franchises include consumer protection provisions, which meet or exceed federal guidelines. Under this system, local cable subscribers call their local officials when cable problems are not resolved.
   - Only local governments currently have the staff, the inspectors and local cable franchise enforcement authority to resolve cable subscriber problems quickly.
   - The State Public Utility Commission is not staffed to respond to cable complaints from the 1.839 million cable subscribers in North Carolina.
   - State preemption of local cable franchising will eliminate local government's ability to enforce cable consumer protections.

4. **Only through Local Government Cable Franchising can cable franchise fees be uniformly distributed to local governments:**
   - Current local cable franchises require cable providers to pay rent for the use of public rights-of-way in the form of cable franchise fees and permit local financial audits to ensure that the amounts paid are correct.
   - Local cable franchise fees directly reflect the gross revenues generated from households in each local community.
   - State preemption and "equal distribution" of local franchise fees cannot replace this exacting method.

5. **Local Government Cable Franchising must be preserved to ensure the public safety of local rights-of-way.**
   - Local cable franchises validate local police powers to monitor and enforce the use public rights-of-way to ensure the public's safety.
   - Local rights-of-way represent the most fundamental economic development asset of a community.
   - Local officials are held directly accountable by their citizens when public rights-of-way become dangerous or misused.
   - This system of direct accountability to local citizens must not be subverted.

Therefore, the undersigned, on behalf of the City of Gastonia, fully supports all efforts to block attempts by telecommunications companies to subvert local cable franchising authority through state preemption.

Sincerely,

Jennifer T. Stultz, Mayor
City of Gastonia, NC

Edward C. Munn, City Manager
City of Gastonia, NC

C: Lee Mandell
Andrew Romanet, Jr.
NCLM
P.O. Box 3069
Raleigh, NC 27602-3069

Paul A. Meyer
NACC
215 N. Dawson Street
Raleigh, NC 27603

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705

Sen. Daniel Gray Clodfelter
100 N. Tryon Street
Charlotte, NC 28202-4003

Sen. Walter H. Dalton
560 N. Main Street
Rutherfordton, NC 28139

Sen. Fletcher Lee Hartsell Jr.
P.O. Box 368
Concord, NC 28026-0368

Sen. David W. Hoyle
P.O. Box 2494
Gastonia, NC 28053

Sen. Hugh Webster
208 Shadowbrook Drive
Burlington, NC 27215

Mr. Leonard W. Jones
300 North 35th Street
Morehead City, NC 28577

Mr. J. Micah Pate, III
615 Oberlin Road
Raleigh, NC 27605

Rep. Harold J. Brubaker
138 Scarboro Street
Asheboro, NC 27203

Rep. Becky Carney
P.O. Box 32873
Charlotte, NC 28232

Rep. Walter Greene Church Sr.
P.O. Box 760
Valdese, NC 28690

Rep. Dewey Lewis Hill
P.O. Box 723
Whiteville, NC 28472

Rep. Daniel Francis McComas
P.O. Box 2274
Wilmington, NC 28402

Rep. William L. Wainwright
P.O. Box 33
Havelock, NC 28532

Rep. W. A. Wilkins
210 Fair Oaks Drive
Roxboro, NC 27574

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Committee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
Raleigh, NC 27603-5925

Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925

MEMORANDUM IN SUPPORT OF LOCAL GOVERNMENT CABLE FRANCHISING

1. **Only through Local Government Cable Franchising can competition, without discrimination, be achieved.**
   - The future economic survival of North Carolina's local communities depends on the widespread and rapid deployment of affordable broadband infrastructures.
   - Local governments have a vested interest in ensuring meaningful competition and the deployment of broadband and video service in their communities.
   - Broadband video deployment should not be based on the income level of a local community, its neighborhoods or its –citizens.
   - Only through local cable franchising – which allows local government enforcement of build out requirements and construction schedules – can all North Carolina communities be assured the promise of wider deployment of broadband video services.
   - State preemption in other states has led to only the wealthiest communities, neighborhoods and citizens being served with broadband video.

2. **Only through Local Government Cable Franchising can PEG channel capacity, financial support, and local programming be preserved:**
   - Congress granted local governments the right to: (1) require Public, Education and Government channels (PEG) to respond to the needs and interests of their local residents; (2) require financial support to develop these channels; and; (3) enforce – through penalties – -noncompliance with these requirements.
   - Current local cable franchises include PEG provisions based on the local characteristics and needs of their citizens.
   - Local governments are held directly accountable to – and hear directly from – their constituents when these channels go dark.
   - This system of direct accountability to the local citizen works.
   - State preemption in other states has led to the slow demise of this valuable local PEG programming.

3. **Only through Local Government Cable Franchising can cable consumers be adequately protected:**
   - Current local cable franchises include consumer protection provisions and allow local cable subscribers to call their local officials when cable problems are not resolved.
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   - The State Public Utility Commission is not staffed to respond to cable complaints from the 1.839 million cable subscribers in North Carolina.
   - State preemption of local cable franchising in other states has eliminated local government's ability to enforce cable consumer protections.

Post-it® Fax Note 7671	Date 4-13-06	# of pages ▶ 2
To DeAnne Maglin	From	
Co./Dept.	Co.	
Phone #	Phone #	
Fax #	Fax #	

Only through Local Government Cable Franchising can cable franchise fees be uniformly distributed to local governments:

- Current local cable franchises require cable providers to pay rent for the use of public rights-of-way in the form of cable franchise fees and permit local financial audits to ensure that the amounts paid are correct.
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- Local cable franchises validate local police powers to monitor and enforce the use of public rights-of-way to ensure the public's safety.
- Local rights-of-way represent the most fundamental economic development asset of a community.
- Local officials are held directly accountable by their citizens when public rights-of-way become dangerous or misused.
- This system of direct accountability to local citizens must not be subverted.

Therefore, the undersigned, on behalf of the ~~City~~/Town of TOPSAIL BEACH **, fully supports all efforts to block attempts by telecommunications companies to subvert local cable franchising authority through state preemption.**

Sincerely,

TOWN MANAGER

Mayor/City, County, Town Manager, Chairman

cc:
S. Ellis Hankins
Lee Mandell
Andrew Romanet, Jr.
NCLM
P.O. Box 3069
Raleigh, NC 27602-3069
Fax: 919-733-9519

Paul A. Meyer
James Blackburn, III
NCACC
215 N. Dawson Street
Raleigh, NC 27603
Fax: 919-733-1065

Continued....

MAYOR
JERRY B. McLAMB

COMMISSIONERS
FREDERICK D. NELSON, JR.
WILL T. CHANDLER
JACK R. LITTLETON
CASANDRA P. STACK
WILLIAM W. MASSENGILL, JR.
RAY G. SMITH

TOWN OF BENSON
P.O. BOX 69
303 EAST CHURCH STREET
NORTH CAROLINA
27504
(919) 894-3553
FAX (919) 894-1283

TOWN MANAGER
KEITH R. LANGDON

TOWN CLERK
CONNIE M. SORRELL

FINANCE OFFICER
DONNA M. HONEYCUTT

TOWN ATTORNEY
DONALD A. PARKER

Memorandum

To: Honorable Legislator
N.C. General Assembly

From: Jerry B. McLamb, Mayor

Date: April 17, 2006

Re: Support of Local Government Cable Franchising

Enclosed you will find copy of a memorandum in support of Local Government Cable Franchising and a carbon copy list.

On our behalf, please support all efforts to block attempts by telecommunications companies to subvert local cable franchising authority through state preemption.

Thank you in advance for your time and consideration in this matter.

Attachments

Cc: file

MAYOR
JERRY B. McLAMB

COMMISSIONERS
FREDERICK D. NELSON, JR.
WILL T. CHANDLER
JACK R. LITTLETON
CASANDRA P. STACK
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   - This system of direct accountability to local citizens must not be subverted.

Therefore, the undersigned, on behalf of the City/Town of Benson, fully supports all efforts to block attempts by telecommunications companies to subvert local cable franchising authority through state preemption.

Sincerely,

Jerry B. McLamb

cc:
S. Ellis Hankins
Lee Mandell
Andrew Romanet, Jr.
NCLM
P.O. Box 3069
Raleigh, NC 27602-3069
Fax: 919-733-9519

Paul A. Meyer
James Blackburn, III
NCACC
215 N. Dawson Street
Raleigh, NC 27603
Fax: 919-733-1065

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616
Office Fax: (919)733-5815
Business Fax: (919)734-4215

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705
Office Fax: (919)733-3113

Sen. Daniel Gray Clodfelter
100 N. Tryon Street
Charlotte, NC 28202-4003
Office Fax: (919)715-5815
Business Fax: (704)378-2041

Sen. Walter H. Dalton
560 N. Main Street
Rutherfordton, NC 28139
Business Fax: (828)286-8229

Sen. Fletcher Lee Hartsell Jr.
P.O. Box 368
Concord, NC 28026-0368
Office Fax: (919)733-7223
Business Fax: (704)788-8058

Sen. David W. Hoyle
P.O. Box 2494
Gastonia, NC 28053
Office Fax: (919)829-5579
Business Fax: (704)864-7468

Sen. Hugh Webster
208 Shadowbrook Drive
Burlington, NC 27215
Office Fax: (919)754-3289

Mr. Leonard W. Jones
300 North 35th Street
Morehead City, NC 28577
Business Fax: (919)733-3113

Mr. J. Micah Pate, III, CPA
615 Oberlin Road, Ste. 200
Raleigh, NC 27605
Business Fax: (919)836-9288

Representative James H. Langdon, Jr.
10176 NC 50 Hwy. North
Angier, NC 27501
919-550-8366
2005-2006 Session

Senator Fred Smith
311 Athletic Club Boulevard
Clayton, NC 27520
2005-2006 Session

TOWN OF CARRBORO
301 West Main Street
Carrboro, North Carolina 27510

FAX (919) 918-4456

DATE: April 19, 2006

TO: Sabra J. Faires

FAX: 919-733-8740

FROM: Mayor Mark Chilton

MESSAGE: see attached letter

Number of pages (including cover sheet): 2

Please call (919) 918-7310 if there are any problems, questions or concerns regarding this transmission.

TOWN OF CARRBORO
NORTH CAROLINA
WWW.TOWNOFCARRBORO.ORG

April 18, 2006

To Whom It May Concern:

I am writing on behalf of the Town of Carrboro. We are strongly opposed to any effort to pre-empt our cable franchising authority. We believe that all video signal providers should be treated the same and they should all be required to provide service to our entire town through a franchised agreement.

The Town of Carrboro fully supports all efforts to block attempts by telecommunications companies to subvert local cable franchising authority through state preemptions.

Sincerely,

Mark Chilton
Mayor

DeAnne Mangum (Finance CA)

From: LocusNo1@aol.com

Sent: Sunday, April 23, 2006 4:24 PM

To: kerr@warrenkerr.com; DeAnne Mangum (Finance CA); Rep. Marian McLawhorn

Subject: Check out Bill Tracking - 2006 session > Legislation

Bill Tracking - 2006 session > Legislation If you scroll down you will see the Virginia Franchise Bill as passed by both houses. Please pay particular attention to the provisions for PEG channels. This Bill reads very professionally, not at all like the bad bill presented to you on behalf of Verizon. There are proper protections and funding for PEG channels. Please note that the Virginia statute requires the use of the Federal Communications Act definition of PEG channels in paragraph 611 of the amended Federal act of 1934 and not the poorly worded definition of the bill presented to you (page 1). The Virginia bill is very clear on percentages of revenue to be used to support the PEG channels in the public interest. Franchise fees are not "hidden taxes on consumers" but a measure of public service to all as a counter to the monopolistic power of the cable owners. Your bill should be held until the Congress has taken action and not rushed through a short session. There is too much at stake here. Frank Schenck, Greenville

DeAnne Mangum (Finance CA)

From: LocusNo1@aol.com
Sent: Sunday, April 23, 2006 11:15 PM
To: kerr@warrenkerr.com; DeAnne Mangum (Finance CA)
Subject: Check out Nutmeg Network Gets Statewide Ride - 6/13/2005 - Multichannel News

Nutmeg Network Gets Statewide Ride - 6/13/2005 - Multichannel News - CA607840 Connecticut, why not North Carolina? Frank Schenck

Reed Business Information

Multichannel NEWS™

Nutmeg Network Gets Statewide Ride

By Linda Haugsted 6/13/2005

Connecticut legislators and the state's cable operators have reached an unprecedented commitment for statewide basic-tier carriage of Connecticut Network, or CT-N, a government-affairs network.

In this story:
LAWMAKERS
INTERESTED
CHARTER MUST ADD

The pressure on operators to universally carry the network was intense. CT-N and state Attorney General Richard Blumenthal filed as intervenors in a refranchising docket for Cox Communications Inc. before the state's Department of Public Utility Control, arguing that new agreements for the 10 towns it serves should include a requirement to carry CT-N on basic.

That signaled the desire to set a precedent that would apply to other operators at refranchising.

LAWMAKERS INTERESTED

Also, state officials threatened legislation to compel carriage of the 6-year-old-network, which televises sessions of the state's General Assembly and other public-affairs issues around the clock.

What apparently triggered the heightened attention was talk by some operators of moving CT-N from its current analog slot to a more costly digital tier. Now, only 37% of CT-N viewers can watch the 24/7 coverage on basic cable; 40% have to pay for more digital channels for access and 20% of approximately 1 million cable homes only see CT-N part time, if at all, said network CEO Paul Giguere.

In the Cox docket, CT-N and the attorney general argued that the public-affairs network met the definition of a government network with mandated carriage. Cox attorneys countered that each local franchising authority would have to establish that the network meets that definition.

Attempts by other states to mandate carriage of a government channel have been struck down in court, the company also noted in its response.

But faced with bipartisan support for CT-N carriage, New England Cable Telecommunications Association vice president Bill Durand sat down and negotiated individual agreements for the state's cable companies.

By Jan. 1, 2007, companies including Comcast Corp., Adelphia Communications Inc., Cox, Cablevision Systems Corp., Tele-Media Corp. and Charter Communications Inc. will set aside a basic-channel slot for CT-N.

CHARTER MUST ADD

For some companies, this will mean moving the channel from digital, but in Charter's case, it must add the network for the first time, according to legislators. Giguere added that about 85% of the state's systems would place CT-N on its dedicated basic or expanded-basic channel slot by January 2006.

"This has been one of our top goals," he said of the basic channel placement.

CT-N carriage has been the only consensus issue this legislative session, said state Sen. John Fonfara (D-Hartford), chairman of the General Assembly's Energy and Technology Committee. At the announcement of the agreements on June 1, committee co-chair Rep. Steve Fontana (D-North Haven) added, "Our overreaching goal is to provide a common threshold to statewide access."

<<< Back | Print

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DeAnne Mangum (Finance CA)

From: LocusNo1@aol.com
Sent: Sunday, April 23, 2006 11:41 PM
To: kerr@warrenkerr.com; Rep. Marian McLawhorn; DeAnne Mangum (Finance CA)
Subject: Check out CONNECTICUT NETWORK (CT-N): CT's STATE PUBLIC AFFAIRS NETWORK, Hart

CONNECTICUT NETWORK (CT-N): CT's STATE PUBLIC AFFAIRS NETWORK, Hartford, Bridgeport, New Haven, Waterbury

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CT-N

Monday April 24,20

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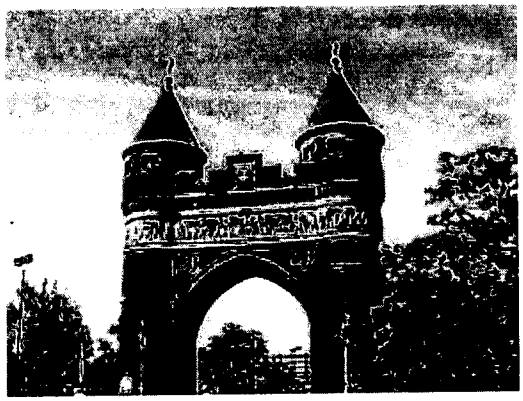
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"Knowledge will forever govern ignorance. And people who mean to be their own governors, must arm themselves with the power which knowledge gives."

James Madison

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Connecticut Network
Capitol Place, Suite #605
21 Oak Street
Hartford, CT 06106

E-mail paul.giguere@cga.ct.gov
Telephone: 860.246.1553
Fax: 860.246.1547

Email: Webmaster About This Site
Employee Login

DeAnne Mangum (Finance CA)

From: SECURE [SECURE@nc.rr.com]
Sent: Monday, April 24, 2006 10:35 AM
To: SECURE
Subject: N.C. Revenue Committee Cable Bill hurts local communities - Please send attached and attend May 2nd meeting
Attachments: Quick_bullets_of_3rd_Draft_Cable_Bill_problems Letter.doc

Contact: Bob Sepe
Action Audits, LLC
Phone: 919-467-5392
Email: rsepe@nc.rr.com

S.E.C.U.R.E.
PO Box 25608
Raleigh, NC 27611-5608
Voice: 202-465-4749

Southeastern Coalition To Uphold Local Government Rights-of-Way Enforcement

Local Elected officials must tell N.C. Revenue Committee
Cable Bill hurts local communities

-PLEASE SEND THE ATTACHED LETTER TO COMMITTEE MEMBERS TO OPPOSE STATE PREEMPTION.

April 24, 2006 – Local officials must continue to alert the Revenue Laws Study Committee members that local cable franchising is not a barrier to cable competition when the Committee contemplates introducing its Cable Bill again on May 2nd. Committee members remain in doubt, even as numerous local community representatives pushed back and testified at Wednesday's hearing that the Committee's bill is bad for North Carolina.

On Wednesday, April 19th, the N.C. Revenues Law Study Committee faced a standing-room-only crowd as it discussed legislation that claims to "Promote Consumer Choice in Cable Television Providers," but drastically removes consumer accountability and abandons rural areas and lower-income consumers instead. More than 30 representatives spoke in support or in opposition to the bill, including representatives from The Peoples Channel, Elon University, NAACP, AARP, Charlotte-Mecklenburg, NATOA, Bell South, Freedom Works, Time Warner, SEATOA, and SECURE, among others.

Freedom works, a front group (sock puppet) for the telephone industry, provided a handful of citizens who testified in favor of the bill, but these voices were more than matched by local government officials who pointed out that "one home passed" does not constitute competition in an entire community. These officials urged Committee members to abandon this ruse, which will harm North Carolina local governments and consumers, by deregulating current cable monopolists without a hint of competition.

Committee members asked Committee staff how the bill would actually promote competition. Cindy Avrette, Research Division staff for the committee, answered that the bill has no specific incentives to stimulate competition but that "the hope is" that removing local cable franchising to the state level will ease the way for new competitors in the cable market.

Committee members and local government representatives also expressed concern over the complicated compensation plan that would replace local cable franchise fees. Avrette admitted the formulas for the redistribution of tax revenues were largely extrapolated without certified numbers or auditing.

ACTION STEPS
→PLEASE ASK A LOCAL ELECTED OFFICIAL TO SIGN AND SEND THE ATTACHED LETTER TO COMMITTEE MEMBERS IN OPPOSITION OF THIS BILL.
→**ATTEND THE MAY 2nd meeting** – 1:00 PM – 544 Legislative Office Building to repeat that local

cable franchising is not a barrier to competition.

Join SECURE to safeguard your community's broadband future. It is time for local governments to let Washington know just who they are. Call 202-465-4749 for details. SECURE participants invest $1,000 annually to protect local regulatory authority and revenues.

*SECURE is associated with Action Audits, LLC.

For Immediate Release, April 24, 2006.

Lisa Beimler
S.E.C.U.R.E.
"Helping local governments fight back"
P.O. Box 25608
Raleigh, NC 27611-5608
(202)465-4749

April 24, 2006

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616
Office Fax: (919)733-5815
Business Fax: (919)734-4215

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705
Office Fax: (919)733-3113

Dear Sen. Kerr and Rep. Luebke :
The Revenue Study Laws Committee has been working on legislation called "AN ACT to promote consumer choice in cable television providers and to establish uniform taxes for video programming services." On behalf of the [**County/Town/City of ____**], I am asking you to oppose this bill, which is an unprecedented usurpation of local government authority.

The third version of the draft bill continues to fail to stimulate competition, while decimating consumer protections for local cable subscribers, removing PEG channel and I-NET funding, and eliminating franchise fees used to pay for community service, like police and fire. This bill is not good public policy for North Carolina.

- **The Bill does not achieve real competition.** New cable operators are state franchised and relieved of all local public interest obligations without any commitment to build competitive cable systems. Current cable operators are relieved of all local franchising public interest obligations as soon as their franchises expire, without any evidence of competition. AT&T (perspective owner of Bell South) would be immediately exempt from all state and local franchising requirements.

- **The Bill Abandons low wealth, low density and rural areas.** The Bill allows new state franchised cable providers to define their own service areas and serve only the wealthier neighborhoods. The bill fails to provide penalties if service discrimination occurs due to income. Half of North Carolina communities consist of low wealth, rural communities. They will be bypassed by these new providers, yet their cable operators will likely raise their rates to offset discounts offered in competition-rich, wealthier communities. As soon as a local franchise expires, without one speck of competition, the bill allows current cable operators to terminate broadband cable service in lower income, rural communities to maximize resources for fighting competition in high-wealth service areas. Lower income communities will become digital have-nots.

- **The Bill eliminates cable consumer protections**
  State franchised operators are relieved of local consumer protections that are more severe than the FCC's. Cable consumers of state-franchised cable systems must call the State Public Utility Commission regarding cable complaints. The Commission is given no additional staff or enforcement authority to handle potential calls from North Carolina's 1.89 million cable consumers. Current cable operators can abandon all local government consumer obligations as soon as their franchise expires, or when a state franchised cable company passes only one home with cable plant

in its self-defined service area (such as a three-block neighborhood) or simply if a state –franchised operator fails to file a Notice of Service with the PUC on time. There are no penalties for falsifying these NOS reports. No provision exists for the renewal of local cable franchising if competitors abandon their service areas and "competition" disappears.

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- **The Bill does not keep Local Government Whole**. The measure eliminates local cable franchise fees (currently used to cover community services like police and fire), and attempts to redistribute new state video programming and telecom taxes, based on a complicated formula, with no indication that local governments are kept whole.

Thank you for honoring your commitment to North Carolina's local governments and local communities.

Sincerely,

Chairman/Mayor

Cc: S. Ellis Hankins
Lee Mandell
Andrew Romanet, Jr.
Charles Archer
NCLM
P.O. Box 3069
Raleigh, NC 27602-3069
Fax: 919-733-9519

Paul A. Meyer
James Blackburn, III
NCACC
215 N. Dawson Street
Raleigh, NC 27603
Fax: 919-733-1065

Sen. Daniel Gray Clodfelter
100 N. Tryon Street
Charlotte, NC 28202-4003
Office Fax: (919)715-5815, Business Fax: (704)378-2041

Sen. Walter H. Dalton
560 N. Main Street
Rutherfordton, NC 28139
Business Fax: (828)286-8229

Sen. Fletcher Lee Hartsell Jr.
P.O. Box 368
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P.O. Box 2494
Gastonia, NC 28053
Office Fax: (919)829-5579, Business Fax: (704)864-7468

Sen. Hugh Webster
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Raleigh, NC 27603-5925
Fax: (919)733-8740

Norman R. Johnson, Mayor
350 East Market Street
Box 761
Smithfield, NC 27577

SMITHFIELD
NORTH CAROLINA

Telephone: 919.934.2116
Fax: 919.989.8927

April 24, 2006

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616
Office Fax: (919)733-5815
Business Fax: (919)734-4215

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705
Office Fax: (919)733-3113

Dear Sen. Kerr and Rep. Luebke :
The Revenue Study Laws Committee has been working on legislation called "AN ACT to promote consumer choice in cable television providers and to establish uniform taxes for video programming services." On behalf of the Town of Smithfield, I am asking you to oppose this bill, which is an unprecedented usurpation of local government authority.

The third version of the draft bill continues to fail to stimulate competition, while decimating consumer protections for local cable subscribers, removing PEG channel and I-NET funding, and eliminating franchise fees used to pay for community service, like police and fire. This bill is not good public policy for North Carolina.

- **The Bill does not achieve real competition.** New cable operators are state franchised and relieved of all local public interest obligations without any commitment to build competitive cable systems. Current cable operators are relieved of all local franchising public interest obligations as soon as their franchises expire, without any evidence of competition. AT&T (perspective owner of Bell South) would be immediately exempt from all state and local franchising requirements.

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Thank you for honoring your commitment to North Carolina's local governments and local communities.

Sincerely,

Norman R. Johnson
Mayor

Cc: S. Ellis Hankins
Lee Mandell
Andrew Romanet, Jr.
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NCLM
P.O. Box 3069
Raleigh, NC 27602-3069
Fax: 919-733-9519

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James Blackburn, III
NCACC
215 N. Dawson Street
Raleigh, NC 27603
Fax: 919-733-1065

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100 N. Tryon Street
Charlotte, NC 28202-4003
Office Fax: (919)715-5815, Business Fax: (704)378-2041
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TOWN OF ZEBULON

THE TOWN OF *FRIENDLY* PEOPLE

Mayor
ROBERT MATHENY
Town Manager
RICHARD HARDIN
Town Attorney
ANDY GAY

Commissioners
DALE BECK
DON BUMGARNER
BEVERLY WALL CLARK
ROY COLLINS
CURTIS STRICKLAND

April 24, 2006

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616
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Business Fax: (919)734-4215

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705
Office Fax: (919)733-3113

Dear Sen. Kerr and Rep. Luebke:

The Revenue Study Laws Committee has been working on legislation called "AN ACT to promote consumer choice in cable television providers and to establish uniform taxes for video programming services." On behalf of the Town of Zebulon, I am asking you to oppose this bill, which is an unprecedented usurpation of local government authority.

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- **The Bill does not achieve real competition.** New cable operators are state franchised and relieved of all local public interest obligations without any commitment to build competitive cable systems. Current cable operators are relieved of all local franchising public interest obligations as soon as their franchises expire, without any evidence of competition. AT&T (perspective owner of Bell South) would be immediately exempt from all state and local franchising requirements.

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Sincerely,

Robert S. Matheny
Mayor

Cc: S. Ellis Hankins
Lee Mandell
Andrew Romanet, Jr.
Charles Archer
NCLM
P.O. Box 3069
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Fax: (919)733-8740

DeAnne Mangum (Finance CA)

From: LocusNo1@aol.com
Sent: Tuesday, April 25, 2006 2:15 PM
To: DeAnne Mangum (Finance CA)
Subject: Check out Cable-style TV regulation proposal could change service, rates

Cable-style TV regulation proposal could change service, rates Where did the state come up with $16,000/year for operating costs? Is that a misprint from $160,000, as the "shoestring $140,000" for Chapel Hill implies?
Frank Schenck

TOWN OF RIVER BEND
45 Shoreline Drive, River Bend, NC 28562-8970
Phone (252)638-3870 Fax (252)638-2580
E-Mail: mail@riverbendnc.org
www.riverbendnc.org

April 25, 2006

Senator John Hosea Kerr, III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616

Dear Senator Kerr:

The Revenue Study Laws Committee has been working on legislation called "AN ACT to promote consumer choice in cable television providers and to establish uniform taxes for video programming services." On behalf of the Town of River Bend, I am asking you to oppose this bill, which is an unprecedented usurpation of local government authority.

The third version of the draft bill still fails to stimulate competition, while decimating consumer protections for local cable subscribers, removing PEG channel and I-NET funding, and eliminating franchise fees used to pay for community service, like police and fire. This bill is not good public policy for North Carolina.

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Thank you for honoring your commitment to North Carolina's local governments and local communities.

Sincerely:

John R. Kirkland
Mayor

cc: S. Ellis Hankins
Lee Mandell
Andrew Romanet, Jr.
Charles Archer
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James Blackburn, III
Sen. Daniel Gray Clodfelter

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Sen. Fletcher Lee Hartsell Jr.
Sen. David W. Hoyle
Sen. Hugh Webster
Mr. Leonard W. Jones
Mr. J. Micah Pate, III, CPA
Rep. Harold J. Brubaker
Rep. Becky Carney
Rep. Walter Greene Church, Sr.
River Bend Council Members
Senator Pete Bland
Representative Alice Underhill
Representative William Wainwright

TOWN OF RIVER BEND
45 Shoreline Drive, River Bend, NC 28562-8970
Phone (252)638-3870 Fax (252)638-2580
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April 25, 2006

Representative Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705

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Thank you for honoring your commitment to North Carolina's local governments and local communities.

Sincerely:

John R. Kirkland
Mayor

cc: S. Ellis Hankins
Lee Mandell
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Sen. Daniel Gray Clodfelter

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Sen. Fletcher Lee Hartsell Jr.
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Mr. Leonard W. Jones
Mr. J. Micah Pate, III, CPA
Rep. Harold J. Brubaker
Rep. Becky Carney
Rep. Walter Greene Church, Sr.
River Bend Council Members
Senator Pete Bland
Representative Alice Underhill
Representative William Wainwright

Office of the City Manager
City of Greensboro

GREENSBORO

April 26, 2006

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616
Office Fax: (919)733-5815
Business Fax: (919)734-4215

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705
Office Fax: (919)733-3113

Dear Sen. Kerr and Rep. Luebke:

The City of Greensboro continues to oppose the draft legislation from the Revenue Laws Study Committee entitled, "An Act to Promote Consumer Choice in Cable Television Providers and To Establish Uniform Taxes for Video Programming Services."

A. Under current franchising law, local governments consider past performance history, among other factors, in making the decision to award a franchise.

- **The draft bill provides for automatic award of franchise on the filing of a token notice containing little more than name, address and proposed service area; the provider's reputation and record of past performance, quality of service, type of service and experience play no role in the award of a state franchise.** Thus, the draft bill does not permit any level of "background check" and exposes North Carolina residents to rampant opportunities to be exploited by unknown/untested entities.

B. Under current franchising law, Greensboro promotes closing the digital divide by enforcing franchise provisions that require availability and build-out through the entire franchise area, as that area is determined by the local franchising authority, based upon a subscriber per cable mile density test.

- **The draft bill will actually stymie broadband deployment across our State.** It permits new cable and video providers to enter the most profitable, densely populated and/or affluent markets, likely engaging the incumbent cable franchisees in price wars that *will bring about higher charges* for the incumbents' customers located outside the cherry-picked markets, i.e., higher prices for residents in rural, less populated and economically disadvantaged communities and markets. This result will occur because the new entrants will not enter (or bring competition to) the less profitable markets, leaving them subject to the monopoly power of the incumbent cable company who will be pressured to recover the profits by raising prices in the areas outside the cherry-picked markets. Subscribers in these less profitable areas will have fewer protections from monopoly power, because the draft bill allows incumbent cable companies to escape public

interest obligations upon expiration or early termination of their existing local franchise agreements.

- **The draft bill permits termination of existing cable franchises whenever a new state franchised provider simply files its annual report after the date it is due or just fails to file it for any reason**—without regard for whether the provider is still offering service or is providing any level of competition at all.
- **The draft bill does not reinstate local franchising or any increased scrutiny on the incumbent cable company should new entrants abandon state-issued franchises for any reason, *e.g.*, bankruptcy, new business strategy, unlawful discrimination etc.**

C. Under current law, Greensboro regulates and monitors the performance of the cable franchisee and **enforces** the public interest provisions of the franchise through discussion, renewal negotiations, performance bond requirements and liquidated damages.

- **The draft bill imposes no penalties or consequences when its provisions are violated by the service providers.**

D. Under current law, Greensboro does not permit discriminatory provision of service that leaves areas of the City on the stranded side of the digital divide.

- **The draft bill purports to prohibit discrimination based on income, but contains no provisions to enforce the prohibition.** Moreover, no retail provider actually imposes an express income test; it is all too easy to offer numerous income-neutral reasons for non-availability of service which nonetheless have the impact of denying service to low income and economically disadvantaged areas. In addition, the discrimination which is likely to leave low income areas out will occur in determining the service area of the franchise—a determination the draft bill leaves to the complete discretions of the provider without any regard to race, income, or population density.

E. Under current law, Greensboro enforces public access channel and funding obligations on franchises.

- **While attempting to preserve current PEG channel and funding levels, the draft bill contains no enforcement provisions or tools to obtain compliance should providers skirt these obligations.**

F. Greensboro's current cable franchisee has agreed to pay the City 5% of gross annual revenues and to provide certain benefits to the City at either no cost or reduced costs.

- **The draft bill will not leave local governments whole.** The bill eliminates local cable franchise fees (currently used to cover community services like police and fire), and attempts to redistribute new state video programming and telecom taxes, based on a complicated formula, leaving the actual amount received by individual local government units some what a mystery.
- **The draft bill actually leaves localities with greater expenses.** Cable companies currently make significant funding contributions toward the operation costs of the public access channels. The draft bill relieves providers of any such commitment and transfers the costs of PEG channel operation to city and county government. Moreover, under current franchise agreements, cable companies have agreed to construct and maintain institutional network, linking specified government buildings for training, meeting, and data and voice exchange purposes, and to provide INET to additional facilities at actual cost. Because the draft bill will relieve providers

from such INET commitments, local government will now have to meet significant additional data costs.

G. FINALLY AND OF GREAT IMPORTANCE, under current law, Greensboro decides which providers are permitted in its rights-of-way and under what terms and conditions.

- **The draft bill infringes on local government's property rights by determining that any person filing a perfunctory notice of service is permitted to operate a cable system in the City's rights-of-way.**
- **The draft bill is unclear on whether, with the loss of its franchising authority, the City will be permitted to charge a fair rental based on value for use and occupancy of its rights-of-way, and whether the state franchise holders can be charged by the City for damage to City-owned rights-of-way and/or for damage to the property and business of other legal occupants of City rights-of-way.**

Thank you for carefully considering the concerns we have raised, before moving forward with the draft bill.

Sincerely,

Mitchell Johnson

Mitchell Johnson, City Manager

Cc:

S. Ellis Hankins
Lee Mandell
Andrew Romanet, Jr.
Charles Archer
Paul A. Meyer
James Blackburn, III
Sen. Daniel Gray Clodfelter
Sen. Walter H. Dalton
Sen. Fletcher Lee Hartsell Jr.
Sen. David W. Hoyle
Sen. Hugh Webster
Mr. Leonard W. Jones
Mr. J. Micah Pate, III, CPA
Rep. Harold J. Brubaker
Rep. Becky Carney
Rep. Walter Greene Church Sr.
Rep. Dewey Lewis Hill
Rep. Daniel Francis McComas
Rep. William L. Wainwright
Rep. W. A. Wilkins
Ms. DeAnne Mangum
Ms. Cindy Avrette
Ms. Martha Walston
Sabra J. Faires
Sen. Phil Berger
Sen. Stan Bingham
Sen. Katie G. Dorsett
Sen. Kay R. Hagan
Rep. Alma Adams
Rep. John M. Blust
Rep. Mary Price Taylor Harrison
Rep. Maggie Jeffus
Rep. Earl Jones
Rep. Laura I. Wiley

Town of Garner

Post Office Box 446 • Garner, North Carolina 27529
Phone 919-772-4688 • FAX 919-662-8874

April 26, 2006

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616
Office Fax: (919)733-5815
Business Fax: (919)734-4215

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705
Office Fax: (919)733-3113

Dear Sen. Kerr and Rep. Luebke:

The Revenue Study Laws Committee has been working on legislation called "AN ACT to promote consumer choice in cable television providers and to establish uniform taxes for video programming services." On behalf of the Town of Garner, I am asking you to oppose this bill, which is an unprecedented usurpation of local government authority.

The third version of the draft bill continues to fail to stimulate competition, while decimating consumer protections for local cable subscribers, removing PEG channel and I-NET funding, and eliminating franchise fees used to pay for community service, like police and fire. This bill is not good public policy for North Carolina.

- **The Bill does not achieve real competition.** New cable operators are state franchised and relieved of all local public interest obligations without any commitment to build competitive cable systems. Current cable operators are relieved of all local franchising public interest obligations as soon as their franchises expire, without any evidence of competition. AT&T (perspective owner of Bell South) would be immediately exempt from all state and local franchising requirements.

- **The Bill Abandons low wealth, low density and rural areas.** The Bill allows new state franchised cable providers to define their own service areas and serve only the wealthier neighborhoods. The bill fails to provide penalties if service discrimination occurs due to income. Half of North Carolina communities consist of low wealth, rural communities. They will be bypassed by these new providers, yet their cable operators will likely raise their rates to offset discounts offered in competition-rich, wealthier communities. As soon as a local franchise expires, without one speck of competition, the bill allows current cable operators to terminate broadband cable service in lower income, rural communities to maximize resources for fighting competition in high-wealth service areas. Lower income communities will become digital have-nots.

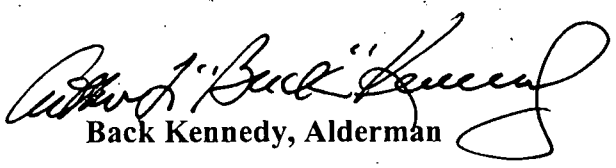
- **The Bill eliminates cable consumer protections**
  State franchised operators are relieved of local consumer protections that are more severe than the FCC's. Cable consumers of state-franchised cable systems must call the State Public Utility Commission regarding cable complaints. The Commission is given no additional staff or enforcement authority to handle potential calls from North Carolina's 1.89 million cable consumers. Current cable operators can abandon all local government consumer obligations as soon as their franchise expires, or when a state franchised cable company passes only one home with cable plant in its self-defined service area (such as a three-block neighborhood) or simply if a state –franchised operator fails to file a Notice of Service with the PUC on time. There are no penalties for falsifying these NOS reports. No provision exists for the renewal of local cable franchising if competitors abandon their service areas and "competition" disappears.

- **The Bill does not preserve PEG channels or I-NETs.** The Bill attempts to hold incumbent cable operators to current local public, educational and government channel and funding obligations, but provides the State no enforcement authority if these terms are not met. The Bill relieves state franchised operators of these obligations in communities where there are no current PEG channels, penalizing slow-start communities who have current local franchise rights to obtain funding and such channels in the future. The bill only provides them $16,000, enough for little more than one digital camera, per year in PEG resources. New cable operators are relieved of Institutional network obligations, which save public institutions thousands of dollars in data costs every year. Current cable operators can abandon I-NET obligations as soon as their franchises expires, burdening local governments with hundreds of thousands of dollars now saved in data network costs.

- **The Bill does not keep Local Government Whole**. The measure eliminates local cable franchise fees (currently used to cover community services like police and fire), and attempts to redistribute new state video programming and telecom taxes, based on a complicated formula, with no indication that local governments are kept whole.

Thank you for honoring your commitment to North Carolina's local governments and local communities.

Sincerely,



Back Kennedy, Alderman

Cc: S. Ellis Hankins
Lee Mandell
Andrew Romanet, Jr.
Charles Archer
NCLM
P.O. Box 3069
Raleigh, NC 27602-3069
Fax: 919-733-9519

Paul A. Meyer
James Blackburn, III
NCACC
215 N. Dawson Street
Raleigh, NC 27603
Fax: 919-733-1065

Sen. Daniel Gray Clodfelter
100 N. Tryon Street
Charlotte, NC 28202-4003
Office Fax: (919)715-5815, Business Fax: (704)378-2041
Sen. Walter H. Dalton
560 N. Main Street
Rutherfordton, NC 28139
Business Fax: (828)286-8229

Sen. Fletcher Lee Hartsell Jr.
P.O. Box 368
Concord, NC 28026-0368
Office Fax: (919)733-7223, Business Fax: (704)788-8058

Sen. David W. Hoyle
P.O. Box 2494
Gastonia, NC 28053
Office Fax: (919)829-5579, Business Fax: (704)864-7468

Sen. Hugh Webster
208 Shadowbrook Drive
Burlington, NC 27215
Office Fax: (919)754-3289

Mr. Leonard W. Jones
300 North 35th Street
Morehead City, NC 28577
Business Fax: (919)733-3113

Mr. J. Micah Pate, III, CPA
615 Oberlin Road, Ste. 200
Raleigh, NC 27605
Business Fax: (919)836-9288

Rep. Harold J. Brubaker
138 Scarboro Street
Asheboro, NC 27203
Business Fax: (336)629-2603

Rep. Becky Carney
P.O. Box 32873
Charlotte, NC 28232
Business Fax: (828)874-2831

Rep. Walter Greene Church Sr.
P.O. Box 760
Valdese, NC 28690
Office Fax: (704)332-8339

Rep. Dewey Lewis Hill
P.O. Box 723
Whiteville, NC 28472
Business Fax: (910)642-7004

Rep. Daniel Francis McComas
P.O. Box 2274
Wilmington, NC 28402
Business Fax: (910)343-8003

Rep. William L. Wainwright
P.O. Box 33
Havelock, NC 28532
Office Fax: (252)672-4075, Business Fax: (252)672-4075

Rep. W. A. Wilkins
210 Fair Oaks Drive
Roxboro, NC 27574
Office Fax: (919)715-0850

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Committee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919) 733-3113 or (919)-715-5815

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)715-5460

Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)715-3589

Sabra J. Faires
Senate Tax Counsel
330 Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)733-8740

TOWN OF MURFREESBORO

FACSIMILE TRANSMISSION TO:

FAX#: 919-733-3113 919 715 5815

ATTN: MS. DE ANNE MANGUM

COMPANY OR DEPARTMENT:

FROM: MAYOR JOHNSON

SUBJECT: CABLE

TOTAL # OF PAGES (Including Cover Sheet) 6

COMMENTS:

If you do not receive all pages or if transmission is illegible, please call the following numbers: (252) 398-5904 Town Office or (252) 398-4888 Public Works Office.

Operator: M. Eubanks Date 5-2-06

P.O. Box 6 - 105 East Broad Street - Murfreesboro, N.C. 27855-0006
Phone: (252) 398-5904 - Fax: (252) 398-5973 Email: townofmurfreesboro@gate811.net

TOWN OF MURFREESBORO

May 1, 2006

Sen. John Hosea Kerr III, Co-Chair
Revenue Laws Study Committee
P.O. Box 1616
Goldsboro, NC 27533-1616
Office Fax: (919)733-5815
Business Fax: (919)734-4215
(Phone: 919-733-5621)

Rep. Paul Luebke, Co-Chair
Revenue Law Study Committee
1507 Oakland Avenue
Durham, NC 27705
Office Fax: (919)733-3113
(Phone: 919-733-7663)

Dear Sen. Kerr and Rep. Luebke :
The Revenue Study Laws Committee has been working on legislation called "AN ACT to promote consumer choice in cable television providers and to establish uniform taxes for video programming services." On behalf of the Town of Murfreesboro, I am asking you to oppose this bill, which is an unprecedented usurpation of local government authority.

The third version of the draft bill still fails to stimulate competition, while decimating consumer protections for local cable subscribers, removing PEG channel and I-NET funding, and eliminating franchise fees used to pay for community service, like police and fire. This bill is not good public policy for North Carolina.

- **The Bill does not achieve real competition**. New cable operators are state franchised and relieved of all local public interest obligations without any commitment to build competitive cable systems. Current cable operators are relieved of all local franchising public interest obligations as soon as their franchises expire, without any evidence of competition. AT&T (perspective owner of Bell South) would be immediately exempt from all state and local franchising requirements.

- **The Bill Abandons low wealth, low density and rural areas.** The Bill allows new state franchised cable providers to define their own service areas and serve only the wealthier neighborhoods. The bill fails to provide penalties if service discrimination occurs due to income. Half of North Carolina communities consist of low wealth, rural communities. They will be bypassed by these new providers, yet their cable operators will likely raise their rates to offset discounts offered in competition-rich, wealthier communities. As soon as a local franchise expires, without one speck of competition, the bill allows current cable operators to terminate broadband cable service in lower income, rural communities to maximize resources for fighting competition in high-wealth service areas. Lower income communities will become digital have-nots.

P.O. Box 6 • 105 East Broad Street • Murfreesboro, NC 27855-0006
Phone: 252-398-5904 • Fax: 252-398-5973
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- **The Bill eliminates cable consumer protections**
  State franchised operators are relieved of local consumer protections that are more severe than the FCC's. Cable consumers of state-franchised cable systems must call the State Public Utility Commission regarding cable complaints. The Commission is given no additional staff or enforcement authority to handle potential calls from North Carolina's 1.89 million cable consumers. Current cable operators can abandon all local government consumer obligations as soon as their franchise expires, or when a state franchised cable company passes only one home with cable plant in its self-defined service area (such as a three-block neighborhood) or simply if a state –franchised

  operator fails to file a Notice of Service with the PUC on time. There are no penalties for falsifying these NOS reports. No provision exists for the renewal of local cable franchising if competitors abandon their service areas and "competition" disappears.

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- **The Bill does not keep Local Government Whole**. The measure eliminates local cable franchise fees (currently used to cover community services like police and fire), and attempts to redistribute new state video programming and telecom taxes, based on uncertified numbers, with no indication that local governments are kept whole.

Thank you for honoring your commitment to North Carolina's local governments and local communities.

Sincerely,

Lynn Johnson

Lynn Johnson, Mayor

Cc: S. Ellis Hankins
Lee Mandell
Andrew Romanet, Jr.
Charles Archer
NCLM
P.O. Box 3069
Raleigh, NC 27602-3069
Fax: 919-733-9519

James Blackburn, III
NCACC
215 N. Dawson Street
Raleigh, NC 27603
Fax: 919-733-1065

Sen. Daniel Gray Clodfelter
100 N. Tryon Street
Charlotte, NC 28202-4003
Office Fax: (919)715-5815, Business Fax: (704)378-2041
(Phone: 919-715-8331)

Sen. Walter H. Dalton
560 N. Main Street
Rutherfordton, NC 28139
Business Fax: (828)286-8229
(Phone: 919-715-3038)

Sen. Fletcher Lee Hartsell Jr.
P.O. Box 368
Concord, NC 28026-0368
Office Fax: (919)733-7223, Business Fax: (704)788-8058
(Phone: 919-733-7223

Sen. David W. Hoyle
P.O. Box 2494
Gastonia, NC 28053
Office Fax: (919)829-5579, Business Fax: (704)864-7468
(Phone - 919-733-5734)

Sen. Hugh Webster
208 Shadowbrook Drive
Burlington, NC 27215
Office Fax: (919)754-3289
(Phone: 919-715-0706)

Mr. Leonard W. Jones
300 North 35th Street
Morehead City, NC 28577
Business Fax: (919)733-3113
(Phone - 252-247-4625)

Mr. J. Micah Pate, III, CPA
615 Oberlin Road, Ste. 200
Raleigh, NC 27605
Business Fax: (919)836-9288

Rep. Harold J. Brubaker
138 Scarboro Street
Asheboro, NC 27203
Business Fax: (336)629-2603
(Phone: 919-715-4946)

Rep. Becky Carney
P.O. Box 32873
Charlotte, NC 28232
Business Fax: (828)874-2831
(Phone: 919-733-5827)

Rep. Walter Greene Church Sr.
P.O. Box 760
Valdese, NC 28690
Office Fax: (704)332-8339
(Phone: 919-733-5805)

Rep. Dewey Lewis Hill
P.O. Box 723
Whiteville, NC 28472
Business Fax: (910)642-7004
(Phone: 919-733-5830)

Rep. Daniel Francis McComas
P.O. Box 2274
Wilmington, NC 28402
Business Fax: (910)343-8003
(Phone: 919-733-5786)

Rep. William L. Wainwright
P.O. Box 33
Havelock, NC 28532
Office Fax: (252)672-4075, Business Fax: (252)672-4075
(Phone: 919-733-5995)

Rep. W. A. Wilkins
210 Fair Oaks Drive
Roxboro, NC 27574
Office Fax: (919)715-0850
(Phone: 919-715-0850)

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Committee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919) 733-3113 or (919)-715-5815
(Phone: 919-733-2405)

Ms. Cindy Avrette
Research Division
Room 545, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)715-5460 (Phone: 919-733-2578)

Ms. Martha Walston
Fiscal Research Division
Room 643, Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)715-2589
(Phone: 919-733-4910)

Sabra J. Faires
Senate Tax Counsel
330 Legislative Office Building
Raleigh, NC 27603-5925
Fax: (919)733-8740
(Phone: (919)733-2284)

DeAnne Mangum (Finance CA)

From: SECURE [SECURE@nc.rr.com]
Sent: Wednesday, May 03, 2006 1:00 PM
To: SECURE
Subject: Both General Assembly and Congress move to eliminate local video franchising authority - Press release and information from NC League of Municipalities
Attachments: video franchising 2.doc

Both General Assembly and Congress move to eliminate local video franchising authority

General Assembly Revenue Laws Committee recommends video franchising bill that does not guarantee broad competition

The General Assembly's Revenue Laws Committee today voted to recommend legislation that will allow telephone companies and cable companies to obtain state franchises instead of local franchises to provide video programming. The legislation eliminates important consumer protections and does not guarantee real competition in the video programming markets.

"Under this legislation, a telephone or cable company obtaining a state franchise has no obligation to serve an entire community; it can pick only certain neighborhoods and leave the others with no service and no competition," said NCLM Executive Director S. Ellis Hankins. He said that municipal officials oppose the legislation as now written.

Right now, a cable or telephone company must obtain a local franchise from a municipality or county in order to offer service in that jurisdiction. Local franchises typically have build-out provisions that specify that all of the city or county must be served within a specific time if the area meets certain density requirements. Under the legislation recommended by the Revenue Laws Committee, a telephone company can apply for a state franchise for an area and there are no build-out requirements.

Cable companies with existing local franchises will be able to opt out of their franchises as soon as another company with a state franchise offers service to just one customer in their franchise area.

"That's hypothetical competition, not actual competition," said Hankins, adding that the legislation then gives cable companies the opportunity to redraw their areas of service when applying for a state franchise.

"So a cable operator could decide to no longer offer service in some neighborhoods, perhaps those with lower profit margins, and consumers could do nothing," said Hankins.

Cable operators whose local franchises expire after Jan. 1, 2007 would not have to seek renewal of their franchise, but could apply for the state franchise.

"BellSouth maintains that local franchises are an impediment to competition. It then points out that Lexington is the only N.C. city with competition and says consumers benefit from lower rates in Lexington because of this. But in the example they cite, both the cable company and the telephone company have local franchise agreements granted by the city," said Hankins "If real competition can exist under local franchises, why does BellSouth want to change the rules?"

Another loss in the proposed legislation concerns public, educational and governmental channels. Currently local

franchises spell out how many of these channels must be provided by the operator and what support –direct and indirect – the cable operator must provide. The recommended legislation keeps requirements for some public, educational and governmental channels, but places unreasonable restrictions on the channels and does not require any in-kind support from franchise-holders, such as equipment or studio space.

"The General Assembly can enact legislation that encourages real competition and protects the public interest. This bill needs vast improvement before it accomplishes either of those goals," said Hankins.

At the federal level

ISSUE: The Communications, Opportunity, Promotion, and Enhancement Act of 2006 (COPE / Barton-Rush) Bill "federalizes" local government video/cable franchising, limits the benefits of broadband-video competition to a few well-to-do neighborhoods, and undermines the ability of local governments to protect consumers and manage public rights-of-way.

The bill strips local governments of their authority to franchise the use of their rights-of-way for video/cable services and gives that authority to the Federal Communications Commission (FCC) in Washington, D.C. The FCC has never had the authority to regulate local public rights-of-way and has no expertise concerning local streets, sidewalks, public safety or traffic patterns.

The bill gives the FCC the authority to oversee and second-guess all local rights-of-way management practices and all customer service issues. Incidents occurring in local rights-of-way are public safety concerns and must be addressed immediately and locally. This bill completely ignores the reality that the FCC is not able to respond in a timely manner to these rights-of-way concerns. The FCC does not and never will have the resources to handle all customer complaints nationwide, and local governments are best situated to respond to their residents' complaints.

The bill allows providers of the broadband-video service, through the national franchise, to use the public rights-of-way in a community, but pick and choose which neighborhoods they wish to serve while bypassing all others completely. The bill would even allow broadband/video providers to avoid maintaining or upgrading facilities in poorer neighborhoods while affluent neighborhoods receive cutting-edge services and lower prices.

STATUS: A House floor vote was expected this week but seems to have been delayed. This provides some time for action.

ACTION NEEDED: Contact your Representatives and ask that they "VOTE NO", on the Communications, Opportunity, Promotion, and Enhancement Act of 2006 (COPE / Barton-Rush) Bill!

Use all communication methods:

PHONE dial the Capitol switchboard at 202/224-3121 and ask for your member's office, FAX and EMAIL your representative and ask that they "VOTE NO on COPE!"

Lisa Beimler
S.E.C.U.R.E.
"Helping local governments fight back"
P.O. Box 25608
Raleigh, NC 27611-5608
(202)465-4749

NORTH CAROLINA nclm. LEAGUE OF MUNICIPALITIES

ALBERT COATES LOCAL GOVERNMENT CENTER
POST OFFICE BOX 3069
RALEIGH, NORTH CAROLINA 27602-3069
215 NORTH DAWSON STREET (27603)

PHONE: (919) 715-4000
FAX: (919) 733-9519
WWW.NCLM.ORG

PROMOTING EXCELLENCE IN MUNICIPAL GOVERNMENT

Contact: Margot Christensen
Public Affairs Director
(919) 715-3931

Revenue Laws Committee recommends video franchising bill that does not guarantee broad competition

Raleigh, NC, May 2, 2006...The General Assembly's Revenue Laws Committee today recommended legislation that will allow telephone companies and cable companies to obtain state franchises instead of local franchises to provide video programming. The legislation eliminates important consumer protections and does not guarantee real competition in the video programming markets.

"Under this legislation, a telephone or cable company obtaining a state franchise has no obligation to serve an entire community; it can pick only certain neighborhoods and leave the others with no service and no competition," said NCLM Executive Director S. Ellis Hankins. He said that municipal officials oppose the legislation as now written.

Right now, a cable or telephone company must obtain a local franchise from a municipality or county in order to offer service in that jurisdiction. Local franchises typically have build-out provisions that specify that all of the city or county must be served within a specific time if the area meets certain density requirements. Under the legislation recommended by the Revenue Laws Committee, a telephone company can apply for a state franchise for an area and there are no build-out requirements.

Cable companies with existing local franchises will be able to opt out of their franchises as soon as another company with a state franchise offers service to just one customer in their franchise area.

"That's hypothetical competition, not actual competition," said Hankins, adding that the legislation then gives cable companies the opportunity to redraw their areas of service when applying for a state franchise.

"So a cable operator could decide to no longer offer service in some neighborhoods, perhaps those with lower profit margins, and consumers could do nothing," said Hankins.

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"BellSouth maintains that local franchises are an impediment to competition. It then points out that Lexington is the only N.C. city with competition and says consumers benefit from lower rates in Lexington because of this. But in the example they cite, both the cable company and the telephone company have local franchise agreements granted by the city," said Hankins "If real competition can exist under local franchises, why does BellSouth want to change the rules?"

-more-

Another loss in the proposed legislation concerns public, educational and governmental channels. Currently local franchises spell out how many of these channels must be provided by the operator and what support –direct and indirect – the cable operator must provide. The recommended legislation keeps requirements for some public, educational and governmental channels, but places unreasonable restrictions on the channels and does not require any in-kind support from franchise-holders, such as equipment or studio space.

"The General Assembly can enact legislation that encourages real competition and protects the public interest. This bill needs vast improvement before it accomplishes either of those goals," said Hankins.

DeAnne Mangum (Finance CA)

From: LocusNo1@aol.com
Sent: Saturday, May 06, 2006 8:13 PM
To: DeAnne Mangum (Finance CA)
Subject: Check out 1995-2005: Section 6 - Near-term Reform

1995-2005: Section 6 - Near-term Reform Interesting reading. Are you going to kill PEG channels? No news is bad news. Frank Schenck, Greenville

NEAR-TERM REFORM FOR PUBLIC SERVICE IN CABLE TELEVISION

Cable television, like the computer, has great potential for innovative video growth and change. Trying now to develop policies for the future is futile, because so much depends on dynamic technological and market factors that cannot be predicted. On a more modest scale, however, cable has its own public service scheme, which--like broadcasting's--is flawed in implementation. So the issue once more is whether, and if so, what steps should be taken to implement that scheme more effectively during the next decade. After a description of the scheme, its constitutionality will be reviewed in light of the recent Supreme Court ruling in Turner v FCC; and possible reform will be discussed.

The Basic Cable Regulatory Approach

The 1984 Cable Act established the present regulatory approach to cable, subject to certain refinements in 1992 legislation. Because cable has such great capacity, with increased capacity coming on-stream through fiber and compression techniques, Congress bypassed behavioral regulation of content and focused instead on a content-neutral, access-based structure (see CBS v DNC, cited earlier). Section 624 of the 1984 Cable Act provides that no government body shall "impose requirements regarding the provision or content of cable service, except as expressly provided in this title"(subsection (f)(1)), and subsection (a) specifies that the franchising authority "may not establish requirements for video programming or other information services."67

Because the act was designed to promote the public interest by explicitly diversifying the sources of information over cable (the Associated Press principle), it requires systems of 36 channels or more to set aside 10 to 15 percent of capacity for commercial leased channel access (section 612), and it permits the franchising authority to designate channels for public, educational, and governmental access (PEG) use, with facilities support (sections 611, 624(b)(1)). The cable operator is to exercise no editorial control over the leased or PEG channels (sections 611(e); 612(c)(2)).68

The House report on the 1984 act included the following rationale for the PEG provisions:

> One of the greatest challenges over the years in establishing communications policy has been assuring access to the electronic media by people other than the licensees or owners of those media. The development of cable television, with its abundance of channels, can provide the public and program providers the meaningful access that, up until now, has been difficult to obtain. A requirement of reasonable third-party access to cable systems will mean a wide diversity of information sources for the public--the fundamental goal of the First Amendment--without the need to regulate the content of programming provided over cable. Almost all recent franchise agreements provide for access by local governments, schools, and non-profit and community groups over so-called "PEG" (public, educational, and governmental) channels. Public access channels are often the video equivalent of the speaker's soap box or the electronic parallel to the printed leaflet. They provide groups and individuals who generally have not had access to the electronic media with the opportunity to become sources of information in the electronic marketplace of ideas.

PEG channels also contribute to an informed citizenry by bringing local schools into the home, and by showing the public local government at work. H.R. 4103 continues the policy of allowing cities to specify in cable franchises that channel capacity and other facilities be devoted to such use.69

The PEG channels thus further two of the purposes of the Cable Act: they ensure that cable systems are responsive to the needs and interests of the local community, and they ensure that such systems provide the widest possible diversity of information sources and services to the public.70

Constitutionality of the Access Approach The district court has upheld the constitutionality of the access provisions, although the case is being appealed (see footnote 74. In the interim, the Supreme Court has shed considerable light on cable's standing under the First Amendment in Turner v FCC, the must-carry case, and the access provisions appear to be constitutional under Turner.

Although the Court rejected the contention that cable has the same reduced standing under the First Amendment as a broadcaster, it also rejected cable's contention that it is entitled to the strict scrutiny protection accorded the print medium in Tornillo.71 The heart of the Court's ruling is that the must-carry provisions are content-neutral and "are justified by special characteristics of the cable medium: the bottleneck monopoly power exercised by cable operators and the dangers this power poses." The Court therefore declined to use "the most exacting level of First Amendment scrutiny," and agreed with the district court that the "appropriate standard by which to evaluate the constitutionality of must-carry is the intermediate level of scrutiny applicable to content-neutral restrictions that impose an incidental burden on speech." This is the O'Brien standard, which holds that a content-neutral regulation will be sustained if "it furthers an important or substantial governmental interest; if the governmental interest is unrelated to the suppression of free expression; and if the incidental restriction is no greater than is essential to the furtherance of that interest." 72

The largest issue as to the constitutionality of the access provisions would appear to be whether they are content-neutral and thus come under the O'Brien test. The leased access requirement is clearly content-neutral. The PEG channels present a closer case in this regard. It can be argued that the government's purpose is different from and inconsistent with the suppression of free expression because cable is free to present any material it wishes; that the public access channel and the government channel are really wide-open channels for local expression. Thus, the government channel is a local C-SPAN operation that, in addition to covering government proceedings, affords opportunities to interest groups or concerned citizens to discuss issues. However, in a limited channel environment, the government is here preferring local cable programming over national programming (e.g., C-SPAN). The most difficult case is the educational channel, which, in addition to educational programming, typically presents school board meetings and public discussions of education issues.73

These access provisions clearly meet the other O'Brien tests: they serve an important government purpose, and the restrictions do not exceed what is essential to further the government's interest. Leased access, tailored to the larger systems, is limited to 10 to 15 percent of capacity. PEG usually involves only a few channels, and if either the PEG or leased access channels are not used, they are available to the cable operation for its own purposes. Cable capacity is increasing rapidly, so the burden of these requirements should be reduced in the future. Finally, it is significant that the dissent in the district court's decision in Turner v FCC relied heavily upon a characterization of the leased channel provision as narrowly tailored to carry out the government's purpose.74

In light of cable's rapidly increasing channel capacity and telco's large-scale entry into video programming delivery, at some point, channel capacity on both cable and telco will become a readily available commodity. The problem will not be one of access, but of financial support for the PEG channels (see discussion in the following section). The government can obtain funds from a franchise fee based on the value of cable's or telco's use of the public rights-of-way and can devote a portion of these funds to lease (and support) PEG channels. In this way, all constitutional issues are put to rest.75

The Reform Needed Professor Patricia Aufderheide of The American University has described the

effectiveness of the PEG channels in bringing local issues to the fore and sparking strong voter reaction; fostering summer reading programs through the educational channel; and greatly increasing public contact with local officials. Public access channels can serve as safety valves for individual expression and contribute markedly to the community goals that are essential to the functions of democracy. The problems stemming from such open access represent the price of a true marketplace of ideas. Furthermore, Aufderheide points out that when the Ku Klux Klan began to use these channels, their programs spurred civil libertarians and minorities to employ the access service for their own purposes--practices that continue today (see footnote 73).

Two major flaws impair the PEG channels. The first and most obvious is that the 1984 act does not require such channels. Consequently, PEG channels are found in only a relatively small percentage of cable operations: 16.5 percent of systems have public access, 12.9 percent have educational access, and 10.7 percent have government access.76 In light of the great contribution that these channels could make to the democratic process, Congress should specify a minimum allocation of three channels for PEG purposes with additional channels if the franchising authority establishes that there is a need.

Second, if the locality requires the PEG channel, PEG operations require reasonable financial support if they are to carry out their important missions. The 1984 act did not mandate such support, moving instead in the opposite direction.

In 1972, the FCC found that franchise fees were legitimate if used to fund local government cable regulation or projects like the PEG channel; however, such fees should not tax cable subscribers unreasonably or thwart the goal of robust nationwide cable television. During the bidding war for the franchises, fees as high as 36 percent had been offered to bribe local governments. The FCC therefore adopted a rule limiting fees to 3 percent, permitting an additional 2 percent if a showing were made as to need for some local cable-related purpose, such as support for PEG operations.77

That was how the matter stood when Congress originated the legislation leading to the 1984 act. The cities generally opposed the deregulatory thrust of the act, but they were offered what cable industry representatives have called the $800 million bribe: the act maintains the 5 percent ceiling on franchise fees, but stipulates that the use of funds derived from such fees may not be regulated (section 622(i)). Because the cities were no longer required to use the funds for cable-related regulatory purposes, including implementing the PEG channels, the funds could simply vanish into city coffers to pay for everything from pensions to potholes.

Some cities continue to fund the PEG channels adequately, but generally, as Aufderheide notes, the PEG channel operations have been on a starvation diet.78 Before the bill was enacted, Congress was warned of this danger in a letter from Chairman Timothy Wirth to the House Energy and Commerce Committee, dated February 15, 1974, in which Wirth proposed that 1 to 2 percent of the fee should be used for PEG funding:

> This proposal will assure that cable viewers are provided the true diversity of program offerings that cable systems are capable of delivering. Dark, unprogrammed access channels provide no diversity at all. . . . What has been overlooked in the drive to increase the number of channels devoted to alternative programming is that delivery systems and channel capacity alone by no means insure that alternative programming itself w ill be developed. It is not realistic to expect that quality, non-commercial programming for distribution over public and educational access channels will be developed without a meaningful commitment of resources to do just that.

Congress should remedy this flaw by requiring that two percent of the franchise fee be dedicated to supporting the PEG channels. The rest could be used to cover the cost of cable regulation (probably less than one percent) or any other local purpose.79 Surely this is reasonable; after all, the five percent fee is a tax directed at the cable subscriber and thus should be used, to some significant extent, for cable public service.80

In connection with PEG channels, Congress should also prod the local public television stations to fill any void that may occur or to assist local groups as much as possible with developing and operating the channels. Quality Time? (see footnote 59) noted the "modest and declining" number of local programs on local stations (on page 19), and later quoted directly from the report of the First Carnegie Commission (on pages 20-21):

> "Public Television programming can deepen a sense of community in local life. It should show us our community as it really is. It should be a forum for debate and controversy. It should bring into the home meetings . . . where major public decisions are hammered out, occasions where people of the community express their hopes, their protests, their enthusiasms, and their will. It should provide a voice for groups in the community that may otherwise be unheard." The Task force agrees with this statement. Moreover, the Task Force believes that one role in particular should be of paramount importance to all public stations: They should be a vital force in involving and engaging the public in local, statewide, and national civic affairs. In this regard, it is noteworthy that very few communities have yet made good use of the . . . PEG channels. . . . The cable industry is rightly proud of its sponsorship of the national C-SPAN channels, but there are still very few local C-SPAN-type operations in this country, despite the obvious need for coverage of town meetings, city councils, school boards, open meetings with officials and elected representatives, and other civic activities. The educational channels present a different, but equally worthwhile challenge. Public television stations (through use of their studios, equipment, and personnel) could play an important role in activating these channels for community groups, educational institutions, and cable initiatives, including continuing education. A percentage of the cable franchise fee . . . should be mandated to support these essential civic, educational, and local public services.

Congress should require the CPB, with the assistance of the Public Broadcasting System, to define the potential contributions of local public television stations in this regard and to file annual progress reports for the next five years. In some communities, no intervention by the local public station may be needed. Others may afford ample opportunity for the station to serve as a catalyst by working with local groups and making its considerable station resources available. The stations' over-the-air contribution might increase, because some of the programming produced for the PEG channels could be edited and replayed over the stations' facilities. Because the situation varies with each community, there should be no mandated entry for the local stations, but rather only a reminder of their civic obligation and potential opportunity, with periodic reports, to bring "sunshine" to the area.

◀ Contents ▶

DeAnne Mangum (Finance CA)

From: LocusNo1@aol.com
Sent: Sunday, May 07, 2006 5:29 PM
To: DeAnne Mangum (Finance CA); Cindy Avrette (Research)
Subject: Check out http://cbo.gov/ftpdocs/71xx/doc7182/hr5252.pdf

http://cbo.gov/ftpdocs/71xx/doc7182/hr5252.pdf CBO makes it clear that the only losers financially are the franchisors, municipalities and counties. The winneres: Telephone and Cable Companies. Frank Schenck, Greenville

May 11, 2006

Ms. DeAnne Mangum
Committee Clerk
Revenue Laws Study Commmittee
Room 329, Legislative Office Building
Raleigh, NC 27603-5925

Dear Ms. Mangum:

The City of Raleigh, NC understands that the Revenue Laws Study Committee of the North Carolina General Assembly has passed out of committee proposed legislation that would eliminate local cable franchises in favor of a state-wide video franchise. It would also eliminate essential consumer and municipal benefits and protections. *The City of Raleigh does not support that goal.*

The City of Raleigh *does* support and encourage competition between cable and telecommunications providers. Assuring that our citizens have access to competitive advanced telecommunications services at the lowest rates possible is a quality of life issue to which we are fully committed.

Unfortunately, *the proposed legislation will not provide or encourage competition, nor will it result in lower cable rates.* We believe that the best way in which to assure that all of our citizens enjoy equitable access to competitive advanced telecommunications services, and fair treatment for all concerned, is through the current local cable franchising process that has served us all so well to date.

Without the protections provided by local cable franchises, residents of low income and rural areas will not receive competitive Broadband services. Telcos have repeatedly assured stockholders and the investment community that they will "cherry-pick" by focusing only on acquiring "high value" Broadband service customers and will not provide service to "low value" customers and areas. Even today they continue to refuse to provide plain old telephone service (POTS) in rural areas without participation in a special federally mandated financing fund.

Two major telephone companies also recently announced that they will not compete with lower rates. At a conference held on April 27, 2006 in Vienna, VA, Verizon announced that they will price their service *"competitively, but not at a discount"* since it is *"worth somewhat more than cable."* AT&T agreed that lower customer rates would not apply, stating that *"our business plan is not built around price cuts"* and calling their IPTV *"a high end service."*

We are very disappointed that local telephone companies have repeatedly shown an unwillingness to compete on a level playing field. Bell South has twice

refused our offer of a local cable franchise since the restrictions against telephone companies entering the video market were removed in 1996. Verizon also recently declined our offer.

While we do feel that retention of the current franchising process would best meet the needs of all involved, it is essential that any proposed changes in the franchising process address and resolve the following issues:

1. **ASSURE ACCESS WITHOUT DISCRIMINATION**
   - The continued growth and well-being of each community requires that every member have equitable access to Broadband and other related services.
     - Broadband deployment cannot be based on the income level of a local community.
     - Franchise areas should serve a recognized municipality or county.

     All providers must continue to be required to make service available to entire designated Franchise areas on a strictly enforced time table, without "cherry-picking" wealthy communities.
   - Federal law requires local governments to ensure that "*cable systems are responsive to the needs and interests of the **local** community*"
     - Local cable franchising allows local government to enforce build-out requirements and schedules. It assures that all North Carolina communities and rural areas will be included in the deployment of broadband video services.
     - State pre-emption will remove local government's ability to enforce requirements.
2. **EQUITABLE AND FAIR DISTRIBUTION OF CABLE FRANCHISE FEES**
   - Current local cable franchises require cable providers to pay rent (franchise fees) for the use of public rights-of-way directly to a municipality or county, and permit local financial audits to ensure that the amounts paid are correct.
   - Local cable franchise fees accurately reflect the gross revenues generated from households in each local community, without going through unnecessary bureaucratic layers or financial formulations.
3. **PRESERVATION OF LOCAL AUTHORITY OVER LOCAL PUBLIC RIGHTS-OF-WAY**
   - Local PROW are the most fundamental development asset of a community.
   - Local cable franchises validate local police powers to monitor and enforce the use public rights-of-way (PROW) to ensure the public's safety.
   - Local officials are held directly accountable by their citizens. This system of direct accountability to local citizens works well and should not be abandoned or adulterated.
4. **APPROPRIATE SUPPORT FOR PEG CHANNELS, FACILITIES AND OPERATIONS**

- Congress granted local governments the right to require: 1) PEG channels to respond to the needs and interests of local residents; 2) Financial support necessary to operate and develop the channels; 3) Compliance with these requirements through penalties.
- Adequate provisions to support and encourage this valuable community resource must be retained. The elimination of local government authority to enforce current requirements will adversely affect this valuable community resource.

5. ADEQUATE PROTECTION OF CABLE CONSUMERS RIGHTS

- Current local cable franchises recognize federal consumer protection provisions and provide for enforcement of the protections. State preemption of local cable franchising will eliminate current cable consumer protections and channels for resolution and would, therefore, be bad public policy.
- Complaints from the 1.839 million cable subscribers in North Carolina are usually customer service related matters; such as missed appointments, small damages, failure to fulfill promises, poor product quality and other similar failures with which state agencies have no specific experience or training.
- Only local governments have the experienced staff, inspectors and local cable franchise enforcement authority to resolve cable subscriber problems quickly and appropriately.

The City of Raleigh recognizes and supports the benefits of the local franchising process and urges the members of the North Carolina General Assembly to also recognize and support those benefits. We request that you retain and preserve local cable franchising and the benefits it provides to consumers and local governments.

Sincerely,

Mayor

City Manager

DeAnne Mangum (Finance CA)

From: LocusNo1@aol.com
Sent: Tuesday, May 09, 2006 4:15 PM
To: DeAnne Mangum (Finance CA)
Subject: Check out Key bill will be done in secret | ajc.com

Key bill will be done in secret | ajc.com The way they do legislation in Washington. FKS

PRINTTHIS

ajc.com
The Atlanta Journal-Constitution

Key bill will be done in secret

By MARILYN GEEWAX
The Atlanta Journal-Constitution
Published on: 05/07/06

WASHINGTON — The House and Senate are preparing to vote on telecommunications legislation that could affect every American who surfs the Internet, watches cable TV or uses a phone.

But consumers shouldn't waste much time watching the floor debates on C-SPAN. The lawmakers themselves admit their goal is not to pass definitive legislation in public in the coming weeks.

Instead, they want the House and Senate to pass separate bills, regardless of how different they may be. The final version would be negotiated, largely in private, by about a dozen senators and representatives on a conference committee.

The Senate just needs to pass "anything to get us into conference," where the real decisions will be made, House telecommunications subcommittee Chairman Fred Upton (R-Mich.) said Tuesday at a telecom forum hosted by National Journal's Technology Daily.

"It's not supposed to work like this," said Celia Wexler, vice president for advocacy for Common Cause, a government watchdog group. "It's appalling that you can hear a member [of Congress] say that in public."

Watchdog groups say that while most conference negotiations are closed to public view, lobbyists continue to influence the members and their staffers, sometimes even supplying language that ends up as the law of the land.

In the case of telecom, the groups say, so many persuasive and well-financed lobbyists are involved that they may battle to a standstill, leaving Congress flush with campaign contributions but unable to agree on a final bill before adjournment.

"We're going to do all we can to put the citizens back into the process," Wexler said.

That won't be easy. The evolving telecom legislation is following a well-worn path that Congress often uses to craft spending, tax and other bills outside public view.

Though Congress has held numerous public hearings on telecom issues over the past year, details of legislation have been largely worked out in private. Several senators and their staffers have complained, off the record, that the process has been closed even to them.

To some, Congress' handling of an issue known as "network neutrality" illustrates the process.

Consumer advocates say that unless Congress spells out tough rules to ensure that providers of high-speed Internet service treat all Web sites and services in a neutral way, cable and phone companies will make content providers pay fees for quick downloads of their sites and services.

For example, if Yahoo paid such a fee, its search engine might work faster than Google's. Net neutrality proponents say that would forever change the free and open nature of the Internet, making it more like cable TV service where large companies choose what subscribers can see.

Senate Commerce Committee Chairman Ted Stevens (R-Alaska) recently revealed his 135-page draft bill after months of behind-the-scenes work. The committee is scheduled to consider the bill June 8, and the full Senate may vote on it before the August recess.

Stevens' legislation does little to preserve network neutrality. It calls only for federal regulators to prepare annual reports on the delivery of Internet services.

The House telecom bill, expected to win approval this week, does have some provisions for protecting network neutrality.

But Wexler, of Common Cause, fears that no matter what legislation passes in public, the neutrality protections will be stripped out in the conference committee.

Key Republican lawmakers "want a bill that will be as weak as possible" in terms of protecting consumers, Wexler said.

In her "nightmare scenario," the House-Senate conferees would kill neutrality protections and vote on final legislation after the November election, during a lame-duck session of the expiring 109th Congress. Without having to worry about angering voters, "the unholy child that would emerge" could be very favorable to industry, she said.

But network neutrality isn't the only major issue in the telecom bill.

Others are allowing national franchising for video services, expanding fees for the telephone Universal Service Fund, opening unused broadcast spectrum for unlicensed wireless equipment, establishing a broadcast "flag" to protect digital content from Internet piracy, and allowing municipalities to offer high-speed Internet access.

Capitol Hill experts say that how Congress resolves these issues could have an enormous impact on corporate earnings. As a result, the lobbying is so intense that "they could checkmate each other," said Wayne Crews, a technology policy analyst for the Competitive Enterprise Institute, a research group that supports free enterprise.

Scott Cleland, chief executive of the consulting firm Precursor Group, agreed that final legislation might not pass this year.

"Legislation is always hard to pass, but especially in an election year" when Congress allows itself plenty of time for campaigning, he said.

"There is less floor time, and less motivation to cooperate" because some lawmakers prefer having an issue left unresolved so they can condemn their opponent's position, he said.

Paul Glenchur, who tracks telecom regulations for the Stanford Washington Research Group, said an unresolved issue can also help candidates raise campaign funds. "There are a lot of deep-pocket industries that take an interest in this legislation," he noted.

For example, Federal Election Commission data show that through the first quarter of 2006, House Energy and Commerce Committee Chairman Joe Barton (R-Texas) received $10,000 in political action committee contributions for the 2005-2006 election cycle from AT&T, the National Cable and Telecommunications Association and MCI, now part of Verizon Communications.

The telecom legislation also might die this year because Democrats see a chance to reclaim the majority of seats. If Democrats could get control of committee chairmanships, they could shape legislation more to their liking, so they have little incentive to act in 2006.

"If there is a real strong sense that a shift [to Democrats] could happen, then that could trickle into people's thinking about the legislation," Glenchur said.

Find this article at:
http://www.ajc.com/services/content/business/stories/0507biztelecom.html

☐ Check the box to include the list of links referenced in the article.

DeAnne Mangum (Finance CA)

From: LocusNo1@aol.com
Sent: Wednesday, May 10, 2006 9:20 AM
To: rsepe@nc.rr.com; DeAnne Mangum (Finance CA)
Subject: Check out Policy Council - BellSouth - BellSouth Endorses A La Carte Programm

Policy Council - BellSouth - BellSouth Endorses A La Carte Programming Model Hooray! FKS

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BellSouth Endorses A La Carte Programming Model

For immediate release
December 09, 2005

BELLSOUTH®

WASHINGTON -- BellSouth today weighed in on the debate over customer choice in video programming, supporting the idea of offering consumers a la carte and family-tier pricing plans.

BellSouth agrees with the position recently expressed by Federal Communications Commission Chairman Kevin Martin and some Members of Congress that these offerings would provide customers more control in deciding the types of programming they choose to allow into their homes.

The following statement may be attributed to Herschel Abbott, BellSouth vice president governmental affairs.

> "Internet Protocol TV (IPTV), which can be delivered over phone lines, fundamentally is about offering consumers competitive choice in video programming. Currently, one of the most significant business obstacles new competitive entrants face in offering innovative technologies like IPTV is the existing local franchising process and lack of a streamlined franchising framework.
>
> "But as we contemplate the future of our video business, we are fully supportive of Chairman Martin's call for a la carte and family friendly programming tiers. IPTV holds much promise for the consumer and greater programming options is just one example of how consumers will benefit by having choice in video service providers. As long as content can be acquired in a manner that allows flexibility, we would look forward to meeting the needs of our customers with even more choice through a la carte and family-tiered offerings."

###

For more information contact:

Bill McCloskey, BellSouth
bill.mccloskey@bellsouth.com
(202) 463-4129

Last modified January 18, 2006, 02:13 PM.

DeAnne Mangum (Finance CA)

From: Catherine Lazorko [clazorko@townofchapelhill.org]
Sent: Friday, May 12, 2006 3:57 PM
To: Cindy Avrette (Research)
Cc: DeAnne Mangum (Finance CA); Martha Walston (Fiscal Research)
Subject: Opposition to Proposed State Cable Legislation
Attachments: response_luebke_may06.doc; response_kerr_may06.doc

Forwarded on behalf of W. Calvin Horton.

Catherine Lazorko
Town Information Officer
Town of Chapel Hill
405 Martin Luther King Jr. Blvd.
Chapel Hill, NC 27514-5705
++++++++++++++++++
Phone: 919/968-2893
Cell: 919/215-TOWN
Fax: 919/969-2063
clazorko@townofchapelhill.org
www.townofchapelhill.org

April 18, 2006

The Honorable John H. Kerr
Cochair, Revenue Laws Study Committee
North Carolina General Assembly
526 Legislative Office Building
Raleigh, NC 27603-5925

Dear Senator Kerr:

We write to express our opposition to proposed statewide cable television legislation. The draft bill from the NC Revenue Commission would result in a substantial loss for citizens of Chapel Hill, and grant unjustified benefits to telecommunications companies. Consider some of our potential losses:

- **Loss of Authority:** We lose authority over our community's public rights of way. Municipalities set procedures, standards and criteria to safeguard public interests in the use of this public property for other utilities, but we will lose oversight for cable services.

- **Loss of Revenue:** Our cable franchise currently generates about $500,000 a year through a 5 percent franchise tax. In addition, we receive $117,000 to operate our public access station through special pass-through fees. We lose authority to negotiate an agreement that supports values unique to our community, including support for community broadcasting.

- **Loss of Public Access:** Loss of our supplemental fees threatens the stability of our public access station and its outreach in engaging our citizens in the life and culture of Chapel Hill.

- **Loss of Channels:** Chapel Hill has negotiated 4 PEG channels and currently employs 3 of those channels. We would lose one, being restricted to "up to 3" under the proposed bill. Even our existing 3 channels would be threatened under the "substantially utilized" rule that forbids repeat programming on a PEG channel. It is routine practice of government channels to repeat announcements and meetings as a service to citizens.

- **Loss of Customer Service:** Residents would lose their ability to visit their cable provider's local offices, as it will not be required that cable providers keep regular office hours.

- **Loss of Local Oversight:** Citizens will lose the ability to call local officials when cable problems are not resolved.

- **Loss of Free Service to Public Facilities:** Town buildings, schools and libraries may lose free cable service as the bill does not require cable providers to provide them free service.

The proposed legislation is damaging to communities like ours throughout North Carolina.

Sincerely,
W. Calvin Horton, Town Manager

www.townofchapelhill.org
405 Martin Luther King Jr. Blvd., Chapel Hill, NC 27514-5705
phone (919) 968-2743 *fax* (919) 967-8406

May 12, 2006

The Honorable Paul Luebke
Cochair, Revenue Laws Study Committee
North Carolina General Assembly
529 Legislative Office Building
Raleigh, NC 27603-5925

Dear Representative Luebke:

We write to express our opposition to proposed statewide cable television legislation. The draft bill from the NC Revenue Commission would result in a substantial loss for citizens of Chapel Hill, grant unjustified benefits to telecommunications companies. Consider some of our potential losses:

- **Loss of Authority:** We lose authority over our community's public rights of way. Municipalities set procedures, standards and criteria to safeguard public interests in the use of this public property for other utilities, but we will lose oversight for cable services.

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Sincerely,

W. Calvin Horton, Town Manager

www.townofchapelhill.org
405 Martin Luther King Jr. Blvd., Chapel Hill, NC 27514-5705
phone (919) 968-2743 *fax* (919) 967-8406

DeAnne Mangum (Finance CA)

From: LocusNo1@aol.com

Sent: Tuesday, May 16, 2006 5:13 PM

To: Cindy Avrette (Research); DeAnne Mangum (Finance CA); kerr@warrenkerr.com; Rep. Marian McLawhorn

Subject: Check out http://www.dpuc.state.ct.us/DPUCINFO.nsf/d0d0a3ad025c3fc085256b4300

http://www.dpuc.state.ct.us/DPUCINFO.nsf/d0d0a3ad025c3fc085256b43005ad70d/2f15d694c6ccca04852564f70(OpenDocument 48 Public Access Channels and studios because the Department of Public Utilities requires it in all their franchises. Why not North Carolina? Frank Schenck

DeAnne Mangum (Finance CA)

From: SECURE [SECURE@nc.rr.com]
Sent: Friday, May 19, 2006 12:08 PM
To: SECURE
Subject: Good Mountain Xpress article on Cable vs. Community in NC - Link to mountainx.com

Cable vs. community

Proposed state law could undercut local media services

by Lisa Watters

A bill that's slated to be introduced during the N.C. General Assembly's current short session is being touted as a boon to both cable-service providers and their customers. But opponents say the law could undermine funding for local access stations and local government data networks. And with the bill on the fast track, according to Rep. **Bruce Goforth**, there may not be a lot of time to resolve those concerns.

Supporters of the bill – titled An Act to Promote Consumer Choice in Video Service Providers and to Establish Uniform Taxes for Video Programming Services – say it would lower costs for cable customers. "The proposed changes ... [are] really pro-consumer. Competition has proven to improve the quality of service," said **Larry Spooner**, area director for external affairs at Bellsouth (which along with Verizon has been a strong proponent of the bill). "We certainly think the consumers will benefit from having an additional land-line-based provider of video services in the state."

But public statements by both Verizon and AT&T seem to indicate that they have no intention of undercutting current cable rates, according to a letter the city of Raleigh sent to the legislative committee considering the bill.

And a draft version obtained by *Xpress* reveals that it would establish a statewide cable franchise, replacing the individual franchises granted by local communities across North Carolina. This would eliminate local governments' ability to leverage those agreements to negotiate additional funding and media services, such as support for public-access channels and local-government networks.

At press time, the bill had just been approved by the Revenue Laws Study Committee and was said to be on its way to the Finance Committee. Goforth said he hadn't seen the bill yet and therefore couldn't comment on it.

A taxing situation

"Over the past several years, the technology used to provide [communication services] has converged so that the line between the services is no longer separate and distinct," the draft legislation states.

For example, cable companies now offer Internet access and have begun to offer telephone service using VoIP (or "voice over Internet protocol"). Meanwhile, phone companies are eager to offer TV service over their land lines.

The bill also emphasizes that it "will establish a method of taxation that applies equally to the same service, regardless of who provides it." But the draft bill doesn't explain why those tax concerns should pertain to locally negotiated agreements, and the wording appears to fundamentally change the way the government treats payments from service providers – with potentially significant repercussions for state residents.

In the past, cable-service providers have paid local communities franchise fees in exchange for the privilege of using public rights of way. In the bill, however, the payments these providers would now make to the state are called "sales taxes." The bill also fails to explain why telephone companies couldn't simply work out their own franchise deals with local communities to offer cable service, except to say that this new system would be "easy to administer ... [would not] impede competition ... [would provide] equal taxation of the same service ... [and] equal compensation to cities for the use of their public [rights of way]."

Curbing local funding

Supporters of the bill maintain that local communities won't lose out, because they'll receive a proportional share of the sales tax, based on their previous revenues from cable-service providers, including both franchise fees and subscriber charges.

But the bill places limits on the additional funding and services that local communities have been able to negotiate with cable-service providers for such operations as public-, education- and government-access channels (collectively known as PEG) and local-government data networks (I-NETs). Proponents of such services often emphasize the value of the training in digital media that these operations provide communities.

For example, the bill would give each local government $16,000 per channel for up to three PEG channels, for a maximum payout of $48,000. (Communities with larger populations might qualify for more channels but no additional funding.) But both Asheville and Buncombe County are getting much more than that under their current cable-franchise agreements. Both local governments received $340,000 start-up grants plus annual funding allotments for their PEG channels (roughly $48,000 for Asheville and $80,000 for Buncombe County).

And while proponents of the bill say it will benefit communities that now get nothing, at least one local media expert disagrees. "Sixteen thousand dollars is a meaningless sum, because it barely covers the purchase of a single camera," notes **Wally Bowen**, executive director of the nonprofit Mountain Area Information Network in Asheville. "You just can't launch a public-access or education-access or government-access operation with a single camera," says Bowen, who was active in the push to obtain more support for such services during the last round of city and county franchise negotiations.

The bill also mandates free basic-cable service to public buildings within 125 feet of the provider's cable system, but that's a benefit already provided under local franchise agreements. Meanwhile, the draft legislation makes no allowance for I-NETs that would connect public entities to one another. In 2002, for example, Buncombe County negotiated with Charter for a 10 megabit Internet link for the county schools valued at $1.1 million over the 12-year franchise term.

"There is no provision in the bill as it stands to protect existing I-NET benefits or to allow communities in the future to negotiate for these benefits," notes Bowen. "In just one fell swoop, [the bill] cuts out the local government's authority over public rights of way and ... [their] ability to negotiate for these benefits."

Meanwhile, a letter opposing the legislation, signed by both the mayor and city manager of Raleigh, states: "Two major telephone companies also recently announced that they will not compete with lower rates. At a conference held on April 27, 2006, in Vienna, Va., Verizon announced that they will price their service 'competitively, but not at a discount.' ... AT&T agreed that lower customer rates would not apply, stating that 'our business plan is not built around price cuts' and calling their IPTV 'a high-end service.'"

Bowen says he's also worried about how reduced funding for PEG and I-NET operations will affect the state's fledgling digital-media economy, especially in smaller cities and rural communities.

"What's so critical about this is that PEG channels and I-NET ... and [their funding] are all integral parts of boosting and building our digital-media economy," he points out. "And here the Legislature is about to cut the legs out from under that. They just haven't connected the dots."

For a closer look at the draft of the bill, visit www.ncleg.net/committeeinfo/revenuelaws /meetingdocument_/may22006_/handouts_/default.htm. For additional information, visit www.urtv.org.

Lisa Beimler
S.E.C.U.R.E.
"Helping local governments fight back"
P.O. Box 25608
Raleigh, NC 27611-5608
(202)465-4749

DeAnne Mangum (Finance CA)

From: SECURE [SECURE@nc.rr.com]
Sent: Wednesday, May 24, 2006 10:58 AM
To: SECURE
Subject: NC Cable Bill: URGENT - NC Local Officials Must Contact State Reps.
Attachments: NC House Finance Committee.xls; NC Senate Commerce Committee.xls

Contact: Bob Sepe
Action Audits, LLC
Phone: 919-467-5392
Email: rsepe@nc.rr.com

S.E.C.U.R.E.
PO Box 25608
Raleigh, NC 27611-5608
Voice: 202-465-4749

*S*outheastern *C*oalition To
*U*phold *L*ocal *G*overnment
*R*ights-of-Way *E*nforcement

NORTH CAROLINA'S PROPOSED VIDEO SERVICE COMPETITION ACT WILL NOT CREATE BROADBAND VIDEO COMPETITION

-BUT IT WILL HURT CABLE CONSUMERS AND LOCAL NORTH CAROLINA COMMUNITIES

May 24, 2006 - **It is urgent that local elected officials contact your State Representatives ASAP.** The Video Service Competition Act (S.B. 1559; H.R. 2047) – recently introduced in the House Finance and Senate Commerce Committees – does not create broadband video competition. **BUT IT DOES ELIMINATE ALL LOCAL GOVERNMENT CABLE CONSUMER PROTECTIONS AND VALUABLE PUBLIC RESOURCES AND FUNDING.**

Our State representatives are saying they are being overwhelmed by lobbyists from the telecommunications industry to pass this legislation. Our State representatives are saying they are not hearing from local elected officials at all. Our State representatives have been told the local government problems with this Bill have been "worked out".

This legislation will deregulate the monopoly cable industry without any evidence of competition, it will eliminate local public, educational and government channels and no-cost institutional networks used by local police and fire officials, and it will eliminate cable franchise fees, while redistributing these funds through the State at lesser amounts.

It is urgent that you contact members of the House Finance Committee and the Senate Commerce Committee and tell them **"Do not Vote For This Bill -- It will hurt North Carolina cable consumers and local communities."** Phone numbers for state reps. and talking points follow:

THE LEGISLATION DOES NOT CREATE COMPETITION IN VIDEO PROGRAMMING SERVICES, BUT INSTEAD

- Defines competition as just one home "passed" (not even served) somewhere in the community, by a state-franchised cable provider;
- Relieves incumbent cable operators of all local franchise and consumer obligations as soon as the current franchise expires, without any presence of video competition;
- Eliminates all local cable franchising requirements and consumer protections

including those in existing contractual agreements;
- Fails to re-establish local franchising if the state franchised operator terminates service in the community.

THE LEGISLATION DOES NOT PROTECT CABLE CONSUMERS, BUT INSTEAD
- Removes all local consumer protections and replaces them with weak federal standards and no State enforcement authority;
- Restricts cable subscribers with complaints to calling the Attorney General's office.

THE LEGISLATION DOES NOT PROTECT LOCAL RIGHT OF WAY AUTHORITY, BUT INSTEAD
- Removes all local authority for issuing video franchises;
- Permits all cable service providers with a State-issued franchise to operate within local rights-of-way;
- Permits cable service providers to secure a State-issued franchise without requiring any financial or technical certification;
- Permits cable service providers to arbitrarily set their own "service area" whether it is one street or an entire county.

THE LEGISLATION DOES NOT PROHIBIT SERVICE DISCRIMINATION, BUT INSTEAD
- Promotes service discrimination by permitting cable service providers to cherry pick "service areas" and abandon low wealth, low density and rural North Carolina communities;
- Permits service discrimination by race or income for one year;
- Permits service discrimination if the cable service provider claims it is too "costly" or "technologically infeasibility" to provide service to an affected group.

THE LEGISLATION DOES NOT PROTECT PEG CHANNELS OR INSTITUTIONAL NETWORKS, BUT INSTEAD
- Limits the number of PEG channels available to communities,
- Reduces PEG channel funding to $16,000 per channel – for up to three channels only and only for operational support;
- Makes currently-dedicated PEG funding discretionary;
- Eliminates Institutional Network obligations once the current cable franchise expires, or if a company applies for a State cable franchise.

DOES NOT KEEP LOCAL GOVERNMENTS FINANCIALLY "WHOLE", BUT INSTEAD
- Eliminates local cable franchise fees and sends all these as "taxes" to the State;
- Implements a new video tax structure and freezes State tax re-distribution to local governments at 2006 levels;
- Eliminates no and/or low-cost Institutional Network data services currently being used for local police, fire and other public services.

Join SECURE to safeguard your community's broadband future. It is time for local governments to let Washington know just who they are. Call 202-465-4749 for details. SECURE participants invest $1,000 annually to protect local regulatory authority and revenues.

*SECURE is aasociated with Action Audits, LLC.

For Immediate Release 2 p.m. EDT, May 24, 2006.

Lisa Beimler
S.E.C.U.R.E.
"Helping local governments fight back"
P.O. Box 25608
Raleigh, NC 27611-5608
(202)465-4749

DeAnne Mangum (Finance CA)

From: Connie Ledoux Book [cbook@elon.edu]
Sent: Thursday, June 01, 2006 4:44 PM
To: Cindy Avrette (Research)
Cc: mtrathen@brookspierce.com; Jo Anne Sanford; Joyner, Lorinzo; ricecb@yahoo.com; biwilson@aarp.org; robert.gruber@ncmail.net; a.page@mindspring.com; dharris@ptcog.org; Andy Sabol; anna.mitchell@dornc.com; doris.boris@ci.charlotte.nc.us; rsepe@nc.rr.com; michael.williams@ci.raleigh.nc.us; johnston@thepeopleschannel.org; Brenna Erford (Fiscal Research); Linda Millsaps (Fiscal Research); Sabra Faires (Pres Pro Tem's Office); kerr@ncuc.net; aromanet@nclm.org; dsimpson@smithlaw.com; debra.derr@bellsouth.com; dallen@smithlaw.com; eturlington@brookspierce.com; j.vandyke@bellsouth.com; lmandell@nclm.org; mprak@brookspierce.com; martin.h.bocock@sprint.com; paul.meyer@ncacc.org; randy.fraser@twcable.com; robertwells@mindspring.com; everett.james@chartercom.com; stan.pace@verizon.com; steven.k.brewer@sprint.com; tom.adams@twcable.com; whargrove@brookspierce.com; tcoley@bellsouth.net; beverly.hughes@smithmoorelaw.com; bscoggins@kennedycovington.com; locusno1@aol.com; lcoman@capstrat.com; steve.skinner@cingular.com; Bennink, Bob; jstein@ncdoj.com; Rep. Paul Luebke; Rep. Becky Carney; Rep. William Wainwright; Sen. John Kerr; Sen. Daniel Clodfelter; DeAnne Mangum (Finance CA); Jason Cannon (House Finance)
Subject: HB 2047 and SB 1559: Video Services Competition Act

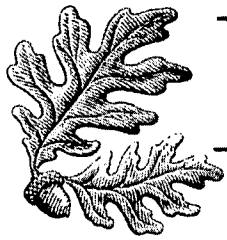
Attachments: housefinanceremarks.doc



housefinanceremarks.doc (520 K...

Per the request of Representative Martha Alexander, I've attached my comments on the proposed state cable franchise.
Thank you.

--
Connie Ledoux Book, Ph.D.
Associate Dean and Associate Professor
Elon University
School of Communications
CBX 2850
Elon, NC 27244
cbook@elon.edu
(336)278-5661
FAX (336) 278-5734



ELON UNIVERSITY

SCHOOL OF COMMUNICATIONS

June 1, 2006

Connie Ledoux Book, Ph.D.
Associate Dean and Associate Professor
School of Communications
Elon University
cbook@elon.edu, 336-278-5661

Remarks to the House Finance Committee

Good Morning. My name is Connie Book. I'm the Associate Dean in the School of Communications at Elon University. I have never worked for a telephone company or a cable company, but in the world of academics have had the luxury of spending my time studying cable franchising. While this Bill seems simple enough on the surface, it is actually complex, not only because of the arguments stakeholders are making—but because of our passionate relationship with television. In North Carolina the average person watches TV 3 hours a day, 21 hours a week. Besides work and sleep, there's nothing we do more.

The complexity of cable franchising has resulted in more than 50 city and county employees administrating cable franchises in the state of North Carolina alone. I recently conducted a national assessment of these local government workers and found that they spend most of their time on issues of franchise compliance and handling consumer complaints. The Secretary of State needs to be prepared. I anticipate a significant State staff if this legislation is passed and if in fact the telephone companies deliver on their promise of competition. I hope someone in this room has seen a five-year business plan from BellSouth or Verizon. Keep in mind that if this legislation passes it dismantles a local franchising system on the promise of competition, the Bill doesn't require the telephone companies to compete, only makes it easier and who knows if and when they will deliver. I say that because nothing, absolutely nothing, stops them from competing today. They have just refused to do so because the profit margins weren't right.

But here's the white elephant in the room--the real work will come when the existing local cable franchises convert to the new state franchises. I don't know how many of these local franchise agreements you've reviewed as part of writing this Bill, but as you know hundreds of voices are involved in that process and the end result is local cable franchise agreements tailored to the unique needs of the community. While the telephone companies have described this process as *onerous*, I disagree. Local franchising results in cable television and telecommunications services responsive to the community. Across our State, local cable franchises have created provisions that provide a host of services beyond PEG channels, such as, a secure and private channel for fire and police training, the network infrastructure to program street lights and requirements that the cable operator have a local office. These are just three examples among *hundreds*, none of which are addressed by this Bill.

If this committee chooses to move forward with this Bill, it's a mistake. This Bill will end a process that is working, for one that won't work and in the end the State will have been seduced by a promise of competition and increased telecom taxes that won't pan out.

That said, if you choose to move forward with this Bill there are three serious flaws that you have power to easily correct today and I ask that you consider doing this.

1. The first is the absence of a "reopener" that would allow the State and force the cable provider to come back to the table and make correction as the State franchising process unfolds. The way the Bill reads now, the State doesn't have an opportunity to come back and address failing provisions—in fact the term of the franchise looks like its 60 years, who does business with anyone for 60 years without an option to opt out or change the nature of the contract? This can be corrected by adding two sentences, one that says if the cable provider is non-compliant with any aspect of this Bill, it automatically creates an opportunity to reopen discussion for both parties. The other is by establishing a review process. This most recent draft has one in place for 2009, a reopener should be established at that point and then again every 7 years. The State of Connecticut uses this window on its State cable franchising process and as part of its review works with local governments to ascertain the effectiveness of the cable franchising process and conducts community audits of PEG and customer service. The Secretary of State will frankly need some muscle, to make sure what this Bill does require is being met. $250 a day for non-compliance, is nothing to this industry. In fact, several cable and telephone attorneys in this room have already billed that since the meeting started at 8:30. A reopener will be considered more cautiously by the providers.

2. The two remaining flaws that can be fixed today are perhaps more complex, but as easily corrected--so I hope you will stay with me on this. There are three sections of this Bill that provide provisions for PEG channels. The PEG channels get a lot of attention because they are important and they are probably the most visible element of the local franchising process. Currently, a PEG channel on the basic tier of cable uses less than 1% of the total capacity of the cable system. That's the way the industry thinks about these channels—what capacity of my system should I have to give over to local communities for use of the public rights-of-way. This Bill should reflect that approach to a cable system, a portion of its system to provide for public interest requirements. The federal government is now using this approach and has set 5% as the mark. Five percent of a cable system should be used to meet public interest requirements. Remember, local cable franchise agreements provide a lot more than just PEG channels.

Let's go back to that white elephant, the one where the existing local cable franchise, converts to the new state franchise, and play out a scenario that will happen if this Bill passes in its current form and Bellsouth decides to compete. Let's imagine we are the City of Greensboro. We negotiated with the cable company a franchise agreement that provides for an Institutional Network. That network runs our street lights, our water monitoring system, e-mail, Internet in our public schools, some telephone service and is maintained and operated by the cable provider. Bellsouth rolls out service and the cable company (within 30 days according to the new Senate version of this Bill) converts to the state franchise. Immediately, the Institutional Network is no longer required. The cable company, lowers its bill to compete with BellSouth who set up shop for $3 less a month than the cable company was charging because their overhead is lower, remember they didn't have to buildout their system. Sounds good right--$3 less a month, $36 a year—competition is working. So the cable company, now earning less per household, sits down and reviews their bottom line. That Institutional Network they once provided the City as part of the local franchise agreement, becomes by necessity a billable item. The cable company puts a value on it, a dollar figure. In communities that lease that network service from the cable company or telephone company of similar size to Greensboro, pay more than $2 million dollars annually. The City has to have this service and that money comes out of the local tax base. That's just one city, one example. That white elephant will be repeated in every market where so called competition exists. That new tax burden

2850 CAMPUS BOX ELON, NORTH CAROLINA 27244 336.278.5724 FAX 336.278.5734 www.elon.edu

on *every* person and cable competition only benefiting the select, wealthy pockets of neighborhoods where the telephone company has decided the profit margin is right.

So what can you do today to protect the people from that scenario? Require that cable companies and telephone companies provide 5% of their system to meet public interest requirements and let cities and counties define that 5%. Perhaps its PEG channels, perhaps its network services, perhaps it's a fire and police training system. That five percent then can be flexible, versatile and adaptable as technology changes. One sentence by you today to amend this Bill can bring this forward thinking to the people of North Carolina.

3. The last flaw is as simple to correct. The PEG channel programming requirements need to be struck from this Bill. The 80% activity requirement and repeat no more than 15% is simply posturing by whoever suggested it was needed in this Bill. The programming model of many cable networks is built around repeat programming, reruns and syndication. Headline News repeats its programming every 30 minutes, the Weather Channel every 20 minutes and the TV Guide Channel repeats continuously. When the cable industry adopts a model of no repeats then we can all climb aboard. Repeats capture different audiences at different times of day and the cable industry continues to use it because it is effective. Therefore, so should PEG programmers. Please make part of your work today to strike these requirements.

In closing, I'd like to repeat that this legislation is a mistake, local cable franchising works. That said if you choose to proceed I hope that you will consider as part of your work today, the correction of these three flaws.

Thank you for your patience with my remarks.

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Franchise Agreements in NC

Piedmont Triad Council of Governments – Alamance, Caswell, Davidson, Guilford, Montgomery, Randolph, and Rockingham

Sample Cable Enabling Ordinance

- 19) Franchise does not mean or include any license or permit required for the privilege of transacting and carrying on a business within the county
- 21) Franchise fee means the percentage, as specified by the county, of the Franchisee's Gross Annual Revenues from all sources payable in exchange for the rights granted pursuant to this Ordinance and the Franchise Agreement
- 25) Gross Annual Revenues – all receipts from providing Cable Services including subscriber fees, pay cable fees, installation and reconnection fees, leased channel fees, converter rentals, and advertising revenues, but does not include taxes or copyright fees on services furnished by Grantee
- Franchise – to construct, operate, and maintain cable system on public rights of way
- 7-16 Franchise Fees
    - A. Because the county finds public ways to be valuable property rights and administration of the ordinance imposes on the county additional regulatory responsibilities and expense, grantee to pay franchise fee
    - B. Fee is in addition to other tax now or hereafter to be paid

Sample Franchise Agreement

- Section 5. Franchise Fees and Performance Bond. Time Warner shall pay to the County for use of its streets, public palces, and other facilities, as well as the maintenance, improvements, and supervision thereof, an annual franchise fee of 3% of the gross subscriber revenue. This payment shall be in addition to any other tax or payment owed to the County by Tine Warner
- Upon acceptance of agreement, Time Warner to make lump sum grant payment to county of $200,000 to be used to support access activities
- Service w/in 18 months when density of at least 20 residential dwelling units per cable plant mile. In areas with less than 20 residential units per cable mile, Time Warner shall offer a cost-sharing arrangement and every person contributing shall waive all ownership interests in the line extension
- 3 PEG Channels – one public, one educational, and one government, wiring at schools, and up to 3 additional channels

CABLE TELEVISION ORDINANCE

FOR THE

COUNTY OF , NORTH CAROLINA

Sample Cable Enabling Ordinance

Piedmont Triad Council of Governments

www.ptcog.org/cable

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Be it ordained that the County Cable Television Ordinance is adopted as follows:

COUNTY CABLE TELEVISION ORDINANCE

Sec. 7-1. PURPOSE.

County finds that the development of cable television Systems has the potential of having great benefit and impact upon the people in the unincorporated areas of County. Because of the complex and rapidly changing technology associated with cable television, the County further finds that the public convenience, safety and general welfare can best be served by establishing regulatory powers which should be vested in the County or such persons as the County shall designate. It is the intent of this Ordinance and subsequent amendments to provide for and specify the means to advance and protect the public interest in these matters, and any Franchise issued pursuant to this Ordinance shall be deemed to include this finding as an integral part thereof.

Further, it is recognized that cable television Systems have the capacity to provide entertainment and information services to the County's residents, and may have the capacity to provide a variety of broad band, interactive communications services to institutions and individuals.

For these purposes, the following goals underlie the regulations contained herein:

1) Cable television services should be provided to the maximum number of County residents at the most reasonable cost.
2) The System should be capable of accommodating both the present and reasonably foreseeable future State-of-The-Art cable television needs of the County.
3) The Systems authorized by this Ordinance shall be responsive to the needs and interests of the local community, and shall provide the widest possible diversity of information sources and services to the public.
4) Each of the goals enumerated in 1) - 3) above shall be sought taking into account the costs and benefits to the residents of County.

Sec. 7-2. TITLE OF ORDINANCE.

This Ordinance shall be known and may be cited as " County's Cable Television Ordinance," and it shall become a part of the ordinances of the County.

This Ordinance shall take effect and be in force from and after its adoption for the grant of any new franchise or renewal of any franchise existing at the time of adoption.

All ordinances or parts of ordinances in conflict with the provisions of this Ordinance are hereby repealed, specifically Chapter 7, Sections 7-1 through 7-93 of the County Code.

This Ordinance shall be governed by and subject to the Communications Act of 1934, as amended, including any future amendments relating to telecommunications and cable television communications, and other applicable laws.

Sec. 7-3. DEFINITIONS.

For the purpose of this Ordinance the following terms, phrases, words and their derivations shall have the meaning given herein unless otherwise defined by Federal or State law. When not inconsistent with the context, words used in the present tense include the future; words in the plural number include the singular number. The word "shall" is mandatory and "may" is permissive. Words not defined shall be given their common and ordinary meaning.

1) ADDITIONAL SERVICE means any cable service other than Basic Service provided over the System.

2) ACCESS CHANNELS means any channels on the System provided herein by the operator for access use by the County, its agencies, and citizens, in accordance with the Cable Act

3) BASIC SERVICE means a separately available tier to which subscription is required for access to any other tier of service. Basic Service tier shall, at a minimum, consist of the following: all signals carried in fulfillment of the Cable Act, Sections 614 and 615; any public, educational, and governmental access programming required in this Ordinance or the Franchise; any signal of any television broadcast station that is provided by the cable operator to any Subscriber, except a signal which is secondarily transmitted by a satellite carrier beyond the local service area of such station. Additional signals may be added to the basic tier by the Grantee.

4) CABLE ACT, see Communications Policy Act below.

5) CABLE SERVICE means the one-way transmission to subscribers of Video Programming or Other Programming Service, together with subscriber interaction, if any, which is required for selection or use of such Video programming or Other Programming Service.

6) CABLECAST SIGNAL means a nonbroadcast signal that originates within the facilities of the System.

7) CHANNEL means a 6 Megahertz (Mhz) frequency band, which is capable of carrying either one standard video signal, a number of audio, digital or other nonvideo signals or some combination of such signals. One channel of high definition television may utilize more than 6 Mhz.

8) COMMERCIAL SUBSCRIBER means a Subscriber who receives a service in a place of business where the service may be utilized in connection with a business, trade or profession.

9) BOARD means the County Board of Commissioners.

10) COMMUNICATIONS POLICY ACT or CABLE ACT means the Cable Communications Policy Act of 1984 and the Telecommunications Consumer Protection and Competition Act of 1992 as they may be amended or succeeded.

11) CONVERTER means an electronic device which converts signals to a frequency not susceptible to interference within the television receiver of a Subscriber, and any channel selector which permits a Subscriber to view all signals delivered at designated converter dial locations at the set.

12) COUNTY means the County of , North Carolina, a political subdivision of the State of North Carolina.

13) DISCRETE CHANNEL shall mean a channel which can only be received by the person and/or institution intended to receive signals on such channel.

14) DOWNSTREAM SIGNAL means a signal originating from or provided by System to a Subscriber terminal or other terminal including video, audio, or digital signals or any other type of data or information for either programs or other uses such as security alert services, etc.

15) DROP shall mean a coaxial, fiber, or other connection from Feeder cable to the Subscriber/user residence or place of business.

16) EDUCATIONAL ACCESS CHANNEL means any channel designated for educational access use, in accordance with the Cable Act.

17) FAIR MARKET VALUE means the price that a willing buyer would pay to a willing seller for a going concern based on the System valuation prevailing in the industry at the time.

18) FCC means the Federal Communications Commission and any legally appointed successor.

19) FRANCHISE means the nonexclusive rights granted pursuant to this Ordinance to construct, operate and maintain a System along the Public Rights-Of-Way within all or a specified area in the County. Any such authorization, in whatever form granted, shall not mean or include any license or permit required for the privilege of transacting and carrying on a business within the County as required by other ordinances and laws of the County, State or Federal governments.

20) FRANCHISE AREA means the entire County for which a Franchise is granted under the authority of this Ordinance. If not otherwise stated in the Franchise, the Franchise areas shall be the entire County, excluding all territory within the corporate limits of any municipality within the County or any territories thereafter annexed by the municipalities.

21) FRANCHISE FEE means the percentage, as specified by the County, of the Franchisee's Gross Annual Revenues from all sources payable (as permitted by the Cable Act) in exchange for the rights granted pursuant to this Ordinance and the Franchise agreement.

22) FRANCHISEE or GRANTEE means the natural person(s), partnership(s), domestic and foreign corporation(s), association(s), joint venture(s), or organization(s) of any kind which has been legally granted a Franchise by the County and its lawful successor, transferee or assignee.

23) GOVERNMENT ACCESS CHANNEL means any channel specifically designated or dedicated for government access use, in accordance with the Cable Act

24) GRANTOR means County as represented by the Board acting within the scope of its jurisdiction.

25) GROSS ANNUAL REVENUES means all receipts received directly or indirectly by the Grantee, from providing Cable Services within the County, including, but not limited to, basic Subscriber and additional service monthly Fees, pay cable Fees, installation and reconnection Fees, leased channel Fees, converter rentals, and advertising revenues; provided, however, that this shall not include any taxes or copyright Fees on services furnished by the Grantee.

26) HEADEND means the electronic control center of the System including components that amplify, filter, and convert incoming broadcast and other television and electronic signals for distribution over the cable System.

27) INSTALLATION shall mean the connection of the System from the drop cable to Subscribers' terminals.

28) MONITORING means observing a communications signal, or the absence of a signal, where the observer is not a party to the communication, whether the signal is observed by visual or electronic means, for any purpose whatsoever.

29) NARROWCASTING shall mean the ability to distribute cable programming to a particular segment or segments of the cable Subscribers.

30) PERSON means an individual, partnership, association, organization, corporation or any lawful successor or transferee of said individual, partnership, association, organization or corporation.

31) PLANT MILE means a linear mile of cable as measured on the street or easement from pole to pole or pedestal to pedestal.

32) PUBLIC ACCESS CHANNEL means any channel designated or dedicated for access use by the general public or noncommercial organizations, in accordance with the Cable Act, which is made available for use without charge, on a nondiscriminatory basis, in accordance with the rules and regulations specified in the Franchise and over which Grantee has no editorial control.

33) PUBLIC WAY or PUBLIC RIGHTS-OF-WAY means the surface, the air space above the surface, and the area below the surface of any public street, highway, lane, path, alley, sidewalk, boulevard, drive, bridge, tunnel, park, parkways, waterways, utility easements or other public right-of-way now or hereafter held by the County which shall entitle the County and the Grantee to the use thereof for the purpose of installing and maintaining the System. No reference herein, or in any Franchise, to the "public way" shall be deemed to be a representation or guarantee by the County that its title to any property is sufficient to permit its use for such purpose, and the Grantee shall, by its use of such terms, be deemed to gain only such rights to use property in the County as the County may have the undisputed right and power to give or as granted by Federal or State law.

34) REASONABLE NOTICE shall be written notice addressed to the Grantee at its principal office within the County or such other office as the Grantee has designated to the County as the address to which notice shall be transmitted to it, which notice shall be certified and postmarked not less than seven (7) business days prior to that day in which the party giving such notice shall commence any action which requires the giving of notice. In computing said seven (7) days, holidays recognized by the County shall be excluded.

35) RESIDENT means any person residing in the County as otherwise defined by applicable law.

36) RESIDENTIAL SUBSCRIBER means a Subscriber who receives a service in an individual dwelling unit where the service is not to be utilized in connection with a business, trade, or profession.

37) SALE shall include any sale, exchange, barter or offer for sale.

38) SCHOOL means any state accredited public or nonprofit educational institution including primary and secondary schools, colleges and universities, both public and private.

39) SERVICE AREA means the entire geographic area within the Franchise territory.

40) STATE means the State of North Carolina.

41) STATE-OF-THE-ART means that the Franchisee shall construct, install and maintain its System in a manner which will continue to enable it to add new services and associated equipment as they are developed, available and when economically feasible and marketable to subscribers to the reasonable satisfaction of the Franchisee.

42) SYSTEM, also referred to as "System," means a facility, consisting of a set of closed transmission paths and associated signal generation, reception, and control equipment that is designed to provide Cable Service which includes Video Programming and which is provided to multiple Subscribers within a community, but such term does not include any of the following: (a) a facility that serves only to retransmit the television signals of one or more television broadcast stations; (b) a facility that serves only Subscribers in one or more multiple dwelling units under common ownership, control, or management, unless such facility or facilities uses any public rights-of-way; (c) a facility of a common carrier which is subject in whole or in part to the provision of Title II of the Cable Act, except that such facility shall be considered a cable System to the extent that such facility is used in the transmission of video programming directly to Subscribers; or (d) any facilities of any electric utility used solely for operating its electric utility Systems.

43) TRANSFER means the disposal by the Grantee, directly or indirectly, by gift, assignment, voluntary sale, assets acquisition, merger, consolidation, or otherwise, of fifty percent (50%) or more at one time of the ownership or controlling interest in the System, or fifty percent (50%) cumulatively over the term of the Franchise of such interest to a corporation, partnership, limited partnership, trust or association, or person or group of persons acting in concert.

44) TRUNK LINE means the major distribution cable used in cable communications, which divides into Feeder lines which are tapped for service to Subscribers.

(44) UPSTREAM SIGNAL means a signal originating from a Subscriber terminal to another point in the System including video, audio, or digital signals or any other type of data or information for either programs or other uses such as security alert services, etc.

(45) USER means a person or organization utilizing channel or equipment and facilities for purpose of producing and/or transmission of material, as contrasted with receipt thereof in a Subscriber capacity.

Sec. 7-4. GRANT OF FRANCHISE

A. Grant. In the event that County shall grant to the Grantee a nonexclusive, revocable for cause Franchise to construct, operate, and maintain a System within the County said Franchise shall constitute both a right and an obligation to provide the services of a System as regulated by the provisions of this Ordinance and the Franchise.
B. Event of Conflict. The Franchise shall be granted under the terms and conditions contained herein, consistent with and subject to all applicable statutory requirements. In the event of conflict between the terms and conditions of this Ordinance, the Franchise, or the terms and conditions on which the County can grant a Franchise, statutory requirements shall control.
C. Generally Applicable Ordinances. Any Franchise granted by the County is hereby made subject to the general ordinance provisions now in effect and hereafter made effective. Nothing in the Franchise shall be deemed to waive the requirements of the various codes and ordinances of the County or other applicable law regarding permits, Fees to be paid, or manner of construction.

Sec. 7-5 USE OF PUBLIC RIGHTS OF WAY.

Insofar as permitted by law and for the purpose of operating and maintaining a System in the County, the Grantee may erect, install, construct, repair, replace, reconstruct and retain in, on, over, under, upon, across and along the public ways within the County such wires, cables, conductors, ducts, conduits, vaults, manholes, amplifiers, appliances, pedestals, attachments and other property and equipment as are necessary to the operation of the Systems, provided, however, that Grantee complies with all design, construction, safety, and performance provisions contained in this Ordinance, the Franchise agreement, and other applicable local ordinances.

Sec. 7-6. USE OF GRANTEE FACILITIES.

No poles shall be erected by the Grantee without prior approval of the County which shall not be unreasonably withheld, with regard to location, height, type and any other pertinent aspect. However, no location of any pole of the Grantee shall be a vested right and such poles shall be removed or modified by the Grantee at its own expense whenever the County reasonably determines that the public convenience would be enhanced thereby. Grantee shall utilize existing poles and conduits, where possible. The County shall have the right, during the life of the Franchise, to install and maintain free of charge upon the poles owned by the Grantee, any wire and pole fixtures that do not unreasonably interfere with the Cable System operations of the Grantee; provided the County shall at all times indemnify and hold Grantee harmless against any and all claims which might arise as a result of the County's use.

Sec. 7-7. FRANCHISE REQUIRED.

No System shall be allowed to occupy or use the streets of the County or be allowed to operate in the County without a Franchise.

Sec. 7-8. TERM OF FRANCHISE.

The term of any Franchise granted pursuant to this Ordinance shall be stated in the Franchise.

Sec. 7-9. FRANCHISE NONEXCLUSIVE.

The Franchise discussed herein is nonexclusive. The County specifically reserves the right to grant at any time such additional Franchises for a System it deems appropriate.

Sec. 7-10. TIME IS OF THE ESSENCE.

Whenever this ordinance or an agreement shall set forth any time for an act to be performed by or on behalf of the Grantee, such time shall be deemed of the essence and any failure of the Grantee to perform within the time allotted shall always be sufficient grounds for the County to invoke an appropriate penalty including possible revocation of the Franchise.

Sec. 7-11. LAW GOVERNS.

In any controversy or dispute under this Ordinance, the law of the State of North Carolina shall apply and venue shall be in state or federal court for County, North Carolina.

Sec. 7-12. SEVERABILITY.

If any section, subsection, sentence, clause, phrase or portion of this Ordinance or the Franchise is for any reason held invalid or unconstitutional by any court of competent jurisdiction, or by any Federal, State, or Local statute or regulation, such portion shall be deemed a separate, distinct and independent provision and such holding shall not affect the validity of the remaining portions thereof.

Sec. 7-13. TRANSFER OF OWNERSHIP OR CONTROL.

A. Transfer of Franchise. Any Franchise granted hereunder cannot in any event be sold, Transferred, leased, assigned or disposed of, including but not limited to, by force or voluntary sale, merger, consolidation, receivership or other means without the prior consent of the County, which shall not be unreasonably withheld.
B. Transfer Threshold. The Grantee shall promptly notify the County of any actual or proposed change in or Transfer of, or acquisition by any other party of, control of the Grantee. The word "control" as used herein is not limited to major stockholders but includes actual working control in

whatever manner exercised. A rebuttable presumption that a transfer of control has occurred shall arise upon the disposal by the Grantee, directly or indirectly, by gift, assignment, voluntary sale, merger, consolidation or otherwise, of fifty percent (50%) or more, at one time, of the ownership or controlling interest in the System, or fifty percent (50%) cumulatively over the term of the Franchise of such interest to a corporation, partnership, limited partnership, trust or association, or person or group of persons acting in concert. The County shall exercise its power to approve a transfer of ownership or control in a manner consistent with Section 617 of the Communications Act (47 U.S.C. 537)

C. Process. Every Transfer, sale, lease, assignment or disposition of, including but not limited to, by force or voluntary sale, merger, consolidation, receivership or other means or acquisition of control of the Grantee shall make the Franchise subject to cancellation unless and until the County shall have consented thereto, which consent will not be unreasonably withheld. For the purpose of determining whether it shall consent to such Transfer, sale, lease, assignment or disposition of, including but not limited to, by force or voluntary sale, merger, consolidation, receivership or other means or acquisition of control of the Grantee the County may inquire into the legal, financial, character, technical and other public interest qualifications of the prospective controlling party, and the Grantee shall assist the County in any such inquiry. Failure to provide all information reasonably requested by the County as part of said inquiry may be grounds for denial of the proposed Transfer, sale, lease, assignment or disposition of, including but not limited to, by force or voluntary sale, merger, consolidation, receivership or other means or acquisition of control of the Grantee. If the County finds that such transfer, after considering the legal, financial, character, technical, and other public interest qualifications of the applicant, is satisfactory, the County will transfer and assign the rights and obligations of such Franchise as in the public interest. The consent of the County to such transfer shall not be unreasonably withheld.

D. Assumption of Control. The County agrees that any financial institution having a pledge of the Franchise or its assets for the advancement of money for the construction and/or operation of the System shall have the right to notify the County that it or its designee satisfactory to the County will take control and operate the System. Further, said financial institution shall also submit a plan for such operation that will insure continued service and compliance with all Franchise obligations during the term the financial institution exercises control over the System. The financial institution shall not exercise control over the System for a period exceeding one year, unless extended by the County at its discretion and during said period of time it shall have the right to petition for transfer of the Franchise to another Grantee.

E. Regulation of Transfer. The consent or approval of the County to any transfer of the Grantee shall not constitute a waiver or release of the rights of the County in and to the streets, rights-of-way, or areas appurtenant thereto, and any Transfer shall, by its terms, be expressly subject to the terms and conditions of this Ordinance and the Franchise.

F. Construction Requirement. In the absence of extraordinary circumstances, the County will not approve any Transfer or assignment of the Franchise prior to completion of construction of the proposed initial System.

G. Signatory Requirement. Any approval by the County of Transfer shall be contingent upon the prospective controlling party becoming a signatory to the Franchise.

H. Exceptions. Notwithstanding anything to the contrary no such consent shall be required for any transfer to any person controlling, controlled by or under the same common control of the Grantee so long as the Grantee continues to guarantee the performance, under the terms of the Ordinance and the Franchise Agreement, of the Transferee

Sec. 7-14. FRANCHISE RENEWAL.

The Grantee shall own the System, but shall have no right to use of Public Rights-of-Way upon the completion of the Franchise term. The County shall grant or deny renewal of the Franchise of a Grantee in accordance with Section 626 of the Communications Act (47 U.S.C. 546) or other applicable law.

Sec. 7-15. POLICE POWERS.

A. Acknowledgments. In accepting the Franchise, the Grantee acknowledges that its rights hereunder are subject to the police power of the County to adopt and enforce general ordinances necessary to the safety and welfare of the public, and it agrees to comply with all applicable general laws and ordinances enacted by the County pursuant to such power.

B. Conflict. Any conflict between the provisions of this Ordinance or the Franchise and any other present or future lawful exercise of the County's general police powers shall be resolved in favor of the latter, except that any such exercise that is not of general application in the jurisdiction or applies exclusively to Grantee or Systems which contains provisions inconsistent with this Ordinance shall prevail only if, upon such exercise, the County finds an emergency exists constituting a danger to health, safety, property or general welfare and such exercise is mandated by law.

Sec. 7-16. FRANCHISE FEES.

A. Because the County finds that:

1) The public ways of the County and State to be used by the Grantee in the operation of its System within the boundaries of the Franchise area are valuable public properties acquired and maintained at great expense to its taxpayers, and

2) The grant to the Grantee to the said public ways is a valuable property right without which the Grantee would be required to invest substantial capital in right-of-way costs and acquisitions, and

3) The administration of this Ordinance or the Franchise imposes upon the County additional regulatory responsibility and expense, a Grantee of any Franchise hereunder shall pay to the County a Franchise Fee in an amount as designated in the Franchise Agreement. The County reserves the right to change the Franchise Fee as stated in the Franchise Agreement, by adopting an ordinance establishing the new Franchise Fee rate and allowing reasonable notice to the Grantee for administration of the change. This Franchise Fee payment shall be in addition to any other Fee and commence as of the effective date of the Franchise. The County shall be furnished a statement of said payment by the Vice President for Finance of the Grantee, reflecting the total amounts of Gross Annual Revenues and computations for the period covered by the payment.

B. Franchise Fee in addition to Other Tax. This payment shall be in addition to any other tax or payment of general applicability owed by the Grantee to the Governments or other taxing jurisdiction. Payment of the Franchise Fee made by Grantee to the County shall be in addition to any and all taxes of general applicability which are now or may be required hereafter to be paid by any Federal, State, or Local law.

C. Acceptance by the County. No acceptance of any payment by the County shall be construed as a release or as an accord and satisfaction of any claim the County may have for further or additional sums payable as a Franchise Fee under this Ordinance or for the performance of any other obligation of the Grantee.

D. Failure to Make Required Payment. In the event that any Franchise payment or recomputed amount is not made on or before the dates specified herein, Grantee shall pay as additional compensation an interest charge, computed from such due date, at the annual rate equal to the commercial prime interest rate of the County's primary depository bank plus 3% during the period that such unpaid amount is owed.

E. Quarterly Payments. The Franchise Fee and any other costs, charges, or damages assessed shall be payable quarterly to the County. The Grantee shall file a complete and accurate verified statement of all Gross Annual Revenue within the Franchise area during the period for which said quarterly payment is made, and said payment shall be made to the County not later than forty-five (45) days after the expiration of each calendar quarter. Quarterly computation dates are the last day in the months of March, June, September and December.

F. Audits. The County shall have the right to inspect the Grantee's income records and the right to audit and to recompute any amounts determined to be payable under this Ordinance. Audits shall be at the expense of the Grantee if the additional amount due is greater than two percent (2%) of the amount paid. Any additional amount due to the County as a result of the audit shall

be paid within thirty (30) days following written notice to the Grantee by the County which notice shall include a copy of the audit report.

Sec. 7-17. FORFEITURE OR REVOCATION.

A. Grounds for Revocation. The County reserves the right to revoke any Franchise granted hereunder and rescind all rights and privileges associated with the Franchise in accordance with the Communications Act and with the procedures set forth herein in the following circumstances, each of which represents a default and breach under the Ordinance and the Franchise grant:

1) If the Grantee shall default in the performance of any of the material obligations under this Ordinance or under such documents, contracts and other terms and provisions entered into by and between the County and the Grantee, including timely payment of any amounts owed.
2) If the Grantee shall fail to provide or maintain in full force and effect the liability and indemnification coverage or the performance bond as required herein.
3) If the Grantee shall violate any orders or rulings of any regulatory body having jurisdiction over the Grantee relative to this Ordinance or the Franchise and after notice thereof, shall continue the violation and not remedy the same within sixty (60) days.
4) If the Grantee practices any fraud or engages in any unfair or deceptive act or practice with regard to the County or Subscribers under the laws of the State.
5) The Grantee's construction schedule is delayed later than the schedule contained in the Franchise or beyond any extended date set by the County.
6) The Grantee becomes insolvent, unable or unwilling to pay its debts or is adjudged bankrupt.
7) The Grantee fails to restore service after ninety-six (96) consecutive hours of interrupted service, except when written approval of such interruption is obtained from the County.
8) The Grantee misrepresents a material fact in the application for or negotiation of the Franchise or any extension or renewal thereof.
9) The Grantee ceases to provide cable services for any reason that is within the control of the Grantee over the System.

B. Effect of Circumstances Beyond Control of Grantee. The Grantee shall not be declared at fault or be subject to any sanction under any provision of this Ordinance in any case, in which performance of any such provision is prevented or delayed due to an Act of God for reasons beyond the Grantee's control. A fault shall not be deemed to be beyond the Grantee's control if committed by a corporation or other business entity in which the Grantee holds a controlling interest, whether held directly or indirectly.

C. Court Order. Grantor and Grantee will abide by the terms of any stay order issued by a court of competent jurisdiction.

D. Procedure Prior to Revocation.

1) The County shall make written demand that the Grantee comply with any such material requirement, limitation, term condition, rule or regulation or correct any action deemed cause for revocation. If the failure, refusal or neglect of the Grantee continues for a period of thirty (30) days following such written demand, the County shall place its request for termination of the Franchise upon a regular Board meeting agenda. The County shall cause to be mailed by certified mail to such Grantee at least ten (10) days prior to the date of such Board meeting, a written notice of this intent to request such termination and the reason therefor, and the time and place of the meeting, notice of which shall be published by the Clerk to the Board of Commissioners at least once, ten (10) days before such meeting in a newspaper of general circulation within the County.

2) The Board shall hear any persons interested therein, and shall determine in its discretion, whether or not any failure, refusal or neglect by the Grantee was with just cause.

3) If such failure, refusal or neglect by the Grantee was with just cause, as reasonably defined by the County, the Board shall direct the Grantee to comply within such time and manner and upon such terms and conditions as are reasonable.

4) If the Board shall determine such failure, refusal, or neglect by the Grantee was without just cause, then the Board shall, by resolution, declare that the Franchise of the Grantee shall be terminated and bond forfeited either conditionally or unconditionally.

5) If the Revocation of the Franchise depends upon a finding of fact, such finding of fact shall be made by the County only after an administrative hearing, providing the Grantee with a full and fair opportunity to be heard, including without limitations the right to introduce evidence, the right to production of evidence and to question witnesses. A transcript shall be made of such hearings. The Grantee shall have the right to appeal any such administrative decision to a court of competent jurisdiction.

E. Disposition of Facilities. In the event a Franchise is revoked or otherwise terminated, the County may, in its sole discretion, do any of the following:

1) Purchase the System under the procedures set forth in this Ordinance, at a Fair Market Price.

2) Effect a Transfer of the System to another Person.

3) Order the removal of the System facilities required by public necessity from the County within a reasonable period of time as determined by the County or require the original Grantee to maintain and operate its System for a period of six (6) months or until such further time as is mutually agreed upon.

F. Restoration of Property. In removing its System, or part thereof, the Grantee shall refill, at its own expense, any excavation that shall be made by it and shall leave all Public Ways and places in as good a condition or better as that existing prior to the Grantee's removal of its System without affecting the electrical or telephone cable, wires, or attachments. The County may inspect and approve the condition of the Public Ways and cables, wires, attachments, and poles after removal. The liability, indemnity, insurance and performance bond as provided herein shall continue in full force and effect during the period of removal and until the Grantee has fully complied with the terms and conditions of, this Ordinance and the Franchise.

G. Restoration by County: Reimbursement of Costs. In the event of a failure by the Grantee to complete any restoration work required by the County within the time as may be established by the County and to the satisfaction of the County, the County may, following reasonable notice to the Grantee, cause such work to be done and the Grantee shall reimburse the County the cost thereof within thirty (30) days after receipt of an itemized list of such cost, or the County may at its option recover such costs through the performance bond provided by Grantee. The County shall be permitted to seek legal and equitable relief to enforce the provisions of this Section.

H. Extended Operation. Upon either the denial of renewal or revocation of a Franchise, the County may require the Grantee to continue to operate the System for a period of six (6) months from the date of such denial or revocation, or until such time beyond six (6) months as is mutually agreed upon. The Grantee shall, as trustee for its successor in interest, continue to operate the System under the terms and conditions of this Ordinance and the Franchise. The County shall be permitted to seek legal and equitable relief to enforce the provisions of this Section.

Sec. 7-18. RECEIVERSHIP AND FORECLOSURE.

A. Termination by Insolvency. The Franchise granted hereunder shall, at the option of the County, cease and terminate one hundred twenty (120) days after the appointment of a receiver or receivers or trustee or trustees to take over and conduct the business of the Grantee whether in a receivership, reorganization, bankruptcy or other action or proceeding unless such receivership or trusteeship shall have been vacated prior to the expiration of said one hundred twenty (120) days, or unless:

1) Such receivers or trustees shall have, within one hundred twenty (120) days after their election or appointment, fully complied with all the terms and provisions of this Ordinance and the Franchise granted pursuant hereto, and the receivers or trustees within said one hundred twenty (120) days shall have remedied all defaults under the Franchise; and

2) Such receivers, or trustees shall, within said one hundred twenty (120) days, execute an agreement duly approved by the Court having jurisdiction in the premises, whereby such receivers or trustees assume and agree to be bound by each and every term, provision and condition of the Franchise herein granted.

B. Termination by Judicial Action. In the case of a foreclosure or other judicial sale of the plant, property and equipment of the Grantee or any part thereof, including or excluding the Franchise, the County may serve notice of termination upon the Grantee and the successful bidder at such sale, in which event the Franchise and all rights and privileges of the Grantee granted hereunder shall cease and terminate thirty (30) days after service of such notice, unless:

1) The County shall have approved the transfer of the Franchise as provided by this Ordinance, and

2) Such successful bidder shall have covenanted and agreed with the County to assume and be bound by every term, provision, and conditions of the Franchise herein granted.

Sec. 7-19. EQUAL OPPORTUNITY POLICY.

Equal opportunity employment shall be afforded by the Grantee to all qualified persons, and no person shall be discriminated against in employment because of race, color, religion, age, national origin, sex, or handicap. Grantee shall comply with all equal opportunity provisions enacted by Federal, State and local authorities, and in particular Section 634 of the Communications Act (47 U.S.C. 554), as well as all such provisions contained in this Ordinance and the Franchise.

Sec. 7-20. NOTICES.

All notices from Grantee to the County pursuant to this Ordinance and the Franchise shall be to the County Manager or his/her designee. Grantee shall maintain with the County, throughout the term of the Franchise, an address for service of notices by mail which address shall be noted in the Franchise Agreement.

Sec. 7-21. FAILURE OF COUNTY TO ENFORCE THIS FRANCHISE, NO WAIVER OF THE TERMS THEREOF.

The Grantee shall not be excused from complying with any of the terms and conditions of this Ordinance or the Franchise by any failure of the County upon any one or more occasions to insist upon or to seek compliance with any such terms or conditions.

Sec. 7-22. RIGHTS RESERVED TO THE GRANTOR.

A. Right of Inspection of Records. The County shall have the right to inspect all books, records, reports, maps, plans, financial statements, and other like materials of the Grantee, at any time during normal business hours, when necessary to ascertain the Grantee's compliance with this Ordinance, the Franchise and all applicable laws.

B. Right of Inspection of Construction. The County shall have the right to inspect all construction or installation work performed subject to the provisions of the Franchise and to make such tests as it shall find necessary to ensure compliance with the terms of this Ordinance and all applicable laws.

C. Right of Inspection of Property. At all reasonable times, Grantee shall permit examination by any duly authorized representative of the County of the System, together with any appurtenant property of Grantee situated within or without the County when necessary to ascertain the Grantee's compliance with this Ordinance, the Franchise and all applicable laws.

D. Right of Intervention. The County shall have the right of intervention in any suit or proceeding to which the Grantee is party, and the Grantee shall not oppose such intervention by the County.

Sec. 7-23. NO RECOURSE AGAINST THE GRANTOR.

Except when seeking equitable relief, the Grantee shall have no recourse whatsoever against the County or its officials, boards, commissions, agents, or employees for any loss, cost, expense or damage arising out of any provision or requirements of the Franchise or because of the enforcement of this Ordinance or the Franchise.

Sec. 7-24. PENALTIES.

Failure to comply with the provisions of this ordinance shall subject the Grantee to all penalties provided by law and as enumerated in the Franchise Agreement.

Sec. 7-25. REGULATORY AUTHORITY.

A. The County shall exercise appropriate regulatory authority under the provisions of this Ordinance, the Communications Act, and all applicable law. This authority shall be vested in the County Board of Commissioners and administered through the County Manager or his/her designee in order to provide day-to-day administration and enforcement of the provisions of this Ordinance and any Franchise granted hereunder, and to carry out the County's responsibilities with regard to cable television.

B. Notwithstanding any other provisions of this Ordinance to the contrary, the Grantee shall at all times comply with all laws and regulations of the local, state and federal government. In the event that any actions of the state or federal government or any agency thereof, or any court of competent jurisdiction upon final adjudication, substantially reduce in any way the power or authority of the County under this Ordinance or the Franchise, or if in compliance with any local, state, or federal law or regulation, the Grantee finds conflict with the terms of this Ordinance, the Franchise, or any law or regulation of the County, then as soon as possible following knowledge thereof, the Grantee shall notify the County of the point of conflict believed to exist between such law or regulation and the laws or regulations of the County, this Ordinance and the Franchise. The County or the Grantee may notify the other party that it wishes to renegotiate those provisions which are affected in any way by such modification in regulations or other statutory authority. Thereafter, the Grantee and the County shall negotiate in good faith in the development of alternate provisions which shall fairly restore the County to the maximum level of authority and power permitted by law.

C. The County reserves the right to exercise the maximum plenary (full) authority, as may at any time be lawfully permissible, to regulate the System, the Franchise and the Grantee. Should applicable legislative, judicial or regulatory authorities at any time permit regulation not presently permitted to the County, the County may, following good faith negotiations, engage in any such additional regulation as may then be permissible, whether or not contemplated by this Ordinance or the Franchise, including without limitation, regulation regarding Franchise Fees, taxes, programming, rates charged to Subscribers and users, consumer protection, or any other similar or dissimilar matter. The County shall have the right to modify any of the provisions to such reasonable extent as may be necessary to carry out the full intent and purpose of this Ordinance and the Franchise in accordance with Federal and State law, provided, however, no modifications shall increase the obligation of the Grantee or limit the rights of the Grantee hereunder.

Sec. 7-26. SUPERVISION OF THE FRANCHISE.

A. The County shall have the following regulatory responsibility:

1) Administration and enforcement of the provisions of this Ordinance and any Franchise granted hereunder to the full extent necessary to assure compliance with the Ordinance and the Franchise Agreement.
2) Award, renewal, extension or termination of a Franchise pursuant to the provisions of this Ordinance, the Franchise, and other applicable law.
3) Consent prior to Transfer of any Franchise granted hereunder.
4) Performance evaluation of the Grantee.
5) Rate and service regulation, if applicable.

B. The County also reserves the right to perform the following functions:
1) Develop objectives and coordinate activities related to the operation of Government Access Channels.
2) Approve procedures and standards for Public, Educational and Government access operations and services, including the use of dedicated channels and sharing of public facilities.
3) Coordinate plans for expansion, interconnection and growth of cable services.
4) Analyze the possibility of integrating cable communications with other County, State or regional Cable Television networks.
5) Formulate and recommend long-range Cable Television policy for the County, and determine the County's view of the future cable-related needs and interests of the community.
6) Provide the administrative effort necessary for the conduct of performance evaluations, and any other activities required for the administration of the Franchise.
7) Monitor Grantee's process for handling citizen complaints and periodically inspect and analyze the records related to such complaints.
8) Receive applications for rate increases, if applicable, and provide staff assistance in the analysis and recommendations thereto.
9) Monitor Grantee's adherence to operational standards, service requirements and line extension policies.
10) Assure compliance with applicable laws and ordinances.
11) Arrange tests and analysis of equipment and performance, as needed to insure compliance with this Ordinance and the Franchise.
12) Assure continuity in service.
13) Receive for examination all data and reports required by this Ordinance.

C. Cable TV Advisory Committee. The County may in its discretion establish a cable advisory committee. The duties of this committee may be reposed in an existing committee The responsibilities of the Committee shall include, but not be limited to, the following:
1) Monitor and advise the Board and County administration on the provisions of this Ordinance and related ordinances.
2) Serve as an advisory body for the Public, Educational, and Governmental Access channels of cable television and any institutional programming that may be developed.
3) Advise the County government of objectives to be obtained in the County's System based upon its continued evaluation of the County's cable television Franchise, cable technology, and the future cable-related needs and interests of the community.
4) Prepare an annual report to the Board.
5) Cooperate with the County and the Grantee in fulfilling its responsibilities herein.

D. Interconnectivity. Upon the request of the County, the Grantee shall interconnect its System, for the purpose of sharing Public, Education or Government Access Channels with any other like cable television facility operating in the County. The Grantee further agrees that it will bear its share of the cost of any interconnection. Such costs will be allocated between and among the Systems being interconnected in an equitable manner. The Grantee may not construct any physical facilities to provide an interconnection with other cable communications or data Systems until the plans for such interconnection have been approved by the Board.

Sec. 7-27. RATES AND CHARGES.

A. Schedule Filings. Grantee shall file with the County schedules which shall describe all services offered, all rates and charges of any kind, and all terms and conditions relating thereto. Grantee shall notify County and Subscribers in writing at least thirty (30) days prior to the implementation of any change in services offered, rate charges, or terms and conditions related thereto, as may be required by law.

B. Nondiscriminatory Rates. To the extent required by applicable Federal or State Law, Grantee shall establish rates that are nondiscriminatory within the same general class of Subscribers which must be applied fairly and uniformly to all Subscribers in the Franchise area for all services. Nothing contained herein shall prohibit the Grantee from offering (i) discounts to commercial and multiple family dwelling Subscribers billed on a bulk basis; (ii) promotional discounts; (iii) reduced installation rates for Subscribers who have multiple services; or (iv) discounts for senior citizens and/or low income residents. To the extent required by federal, state, or local law or regulation, Grantee's charges and rates for all services shall be itemized on Subscriber's monthly bills.

C. County Regulation. To the extent that Federal or State law or regulation, and in particular Section 626 of the Communications Act (47 U.S.C. 543) and the regulations of the FCC, may now, or as the same may hereafter be amended to, authorize the County to regulate the rates for any particular service tiers, service packages, equipment, or any other services provided by Grantee, the County shall have the right to exercise rate regulation to the full extent authorized by law, or to refrain from exercising such regulation for any period of time, at the sole discretion of the County.

D. Ability to Petition. If applicable, the County shall have the right to petition the FCC or other appropriate agency or organization to obtain rate regulation authority or to petition the federal body to review or regulate rates in the County.

Sec. 7-28. PERFORMANCE EVALUATIONS.

A. Performance Evaluations. The County and the Grantee may, at the discretion of the County, hold scheduled performance evaluation sessions. All such evaluation sessions shall be open to the public, to the extent required by law.

B. Special evaluation sessions shall be held at any time during the term of the Franchise at the request of the County.

C. Notice of Public Hearings on Performance. All evaluation sessions before the Board shall be open to the public and announced once in a newspaper of general circulation and announced for five consecutive days on the Government Access Channel.

D. Items for Review. Topics which may be discussed at any scheduled or special evaluation session may include, but not be limited to, System performance and construction, Grantee compliance with this Ordinance and the Franchise, customer service and complaint response, Subscriber privacy, services provided, programming offered, service rate structures, Franchise Fees, penalties, free or discounted services, applications of new technologies, judicial and FCC filings, and line extensions.

E. Cooperation. During the review and evaluation by the County, the Grantee shall fully cooperate with the County and shall provide such information and documents as the County may need to reasonably perform its review.

Sec. 7-29. PERFORMANCE BOND.

A. Performance Bond. Upon the effective date of the Franchise, the Grantee shall obtain and maintain during the entire term of the Franchise and any extensions and renewals thereof, at its cost and expense, and file with the County, a corporate surety bond in an amount no less than $50,000 and as specified in the Franchise Agreement to guarantee the faithful performance of the Grantee of all its obligations provided under this Ordinance and the Franchise. Failure to timely obtain, file and maintain said bond shall constitute a substantial violation within the meaning of this Section.

B. Conditions. The performance bond shall provide the following conditions:

1) There shall be recoverable by the County jointly and severally from the principal and surety, any and all fines and liquidated damages due to the County and any and all damages, losses, costs, and expenses suffered or incurred by the County resulting from the failure of the Grantee to: faithfully comply with the provisions of this Ordinance and the Franchise; comply with all orders, permits and directives of any County agency or body having jurisdiction over its acts or defaults; pay Fees due to the County; pay any claims, liens or taxes due the County which arise by reason of the construction, operation, maintenance or repair of the cable System. Such losses, costs and expenses shall include, but not be limited to, attorney's Fees and other associated expenses.

2) The total amount of the bond shall be forfeited in favor of the County in the event:
   a) The Grantee abandons the cable System at any time during the term of the Franchise or any extension thereto; or
   b) The Grantee Transfers the Franchise without the express written consent of the County.

C. Reduction of Bond. Upon written application by the Grantee, the County may, at its sole option, permit the amount of the bond to be reduced or waive the requirements for a performance bond subject to the following conditions: Reductions granted or denied upon application by the Grantee shall be without prejudice to the Grantee's subsequent applications or to the County's right to require the full bond without notice at any time thereafter. However, no application for reduction shall be made by the Grantee within one (1) year of any prior application for reduction of within the first five (5) years of the franchise.

D. Use of Performance Bond. Prior to drawing upon the performance bond for the purposes described in this Section, the County shall notify the Grantee in writing by certified or registered mail, return receipt requested, that payment is due and the Grantee shall make a full and complete payment. If the Grantee does not make the payment within ten (10) days from the mailing of the notice, the County may withdraw the amount thereof, with interest and penalties, from the performance bond.

E. Notification. Within three (3) days of a withdrawal from the performance bond, the County shall send to the Grantee, by certified mail, return receipt requested, written notification of the amount, date and purpose of such withdrawal.

F. Replenishment of Performance Bond. No later than thirty (30) days after mailing to the Grantee by certified mail notification as described in G above of a withdrawal pursuant to paragraph F above, the Grantee shall replenish the performance bond in an amount equal to the amount so withdrawn. Failure to make timely replenishment of such amount to the performance bond may constitute a substantial violation of this Ordinance.

G. Non-Renewal, Alteration, or Cancellation of Performance Bond. The performance bond required herein shall be in a form satisfactory to the County and shall require thirty (30) days written notice of any non-renewal, alteration or cancellation to both the County and the Grantee. The Grantee shall, in the event of any such cancellation notice, obtain, pay all premiums for, and file with the County, written evidence of the issuance of replacement bond or policies within thirty (30) days following receipt by the County or the Grantee of any notice of cancellation, and failure to do so constitutes a substantial violation of this Ordinance.

H. Inflation. To offset the effects of inflation the amounts of the bond provided for herein, shall be increased by the annual rate of inflation at the end of every three (3) year period of the Franchise, applicable to the next three (3) year period, upon the request of the County.

Sec. 7-30. LIABILITY AND INSURANCE.

A. Certificate of Insurance. Prior to commencement of construction, but in no event later than sixty (60) days after the effective date of the Franchise and thereafter, continuously maintain insurance as defined by this Section and shall throughout the duration of the Franchise and any extensions or renewals thereof, the Grantee shall furnish to the County, certificates of insurance, approved by the County, for all types of insurance required under this Section. Failure to furnish said certificates of insurance in a timely manner shall constitute a violation of this Ordinance.

B. Filing. Any insurance policy or certificate thereof obtained by the Grantee in compliance with this Section shall be filed and maintained with the County Manager or his/her designee during the term of the Franchise, and may be changed from time to time to reflect changing liability limits and/or to compensate for inflation. Grantee shall immediately advise the County of any litigation that may develop that would affect this insurance.

C. No Limit of Liability. Neither the provisions of this Section nor any damages recovered by the County hereunder, shall be construed to or limit the liability of the Grantee under any Franchise issued hereunder or for damages.

D. Enforcement. All insurance policies maintained pursuant to this Ordinance or the Franchise shall contain the following, or a comparable, endorsement:

"It is hereby understood and agreed that this insurance policy may not be canceled by the insurance company nor the intention not to renew be stated by the insurance company until thirty (30) days after receipt by the County Manager, by registered or certified mail, of a written notice of such intention to cancel or not to renew."

E. Hold Harmless Clause. All contractual liability insurance policies maintained pursuant to this Ordinance or the Franchise shall include the following hold harmless clause:

"The Grantee agrees to indemnify, save harmless and defend the County, its officials, agents, servants, and employees, and each of them against and hold it and them harmless from any and all lawsuits, claims, demands, liabilities, losses and expenses, including court costs and reasonable attorney's Fees, for or on account of any injury to any person, or any death at any time resulting from such injury, or any damage to any property, which may arise or which may be alleged to have arisen out of or in connection with the work covered by the Franchise and performed or caused to be performed. The foregoing indemnity shall apply except if such injury, death or damage is caused by the negligence or other fault of the County, its agents, servants, or employees, or any other person indemnified hereunder."

F. State Institution. All insurance policies provided under the provisions of this Ordinance or the Franchise shall be written by companies authorized to do business in the State and approved by the State's Commissioner of Insurance.

G. Named Insured. At any time during the term of the Franchise, the County may request and the Grantee shall comply with such request, to name the County as an additional named insured for all insurance policies written under the provisions of this Ordinance or the Franchise.

H. Inflation. To offset the effects of inflation and to reflect changing liability limits, all of the coverages, limits, and amounts of the insurance provided for herein will be increased at the end of every three (3) year period of the Franchise at the annual rate of inflation, applicable to the next three year period, upon the request of the County.

I. General Liability Insurance. The Grantee shall maintain, and by its acceptance of any Franchise granted hereunder specifically agree that it will maintain throughout the term of the Franchise, general liability insurance insuring the Grantee in the minimum of:

1) $2,000,000 for property damage per occurrence;
2) $2,000,000 for property damage aggregate;
3) $4,000,000 for personal bodily injury or death to any one person; and
4) $5,000,000 bodily injury or death aggregate per single accident or occurrence.

J. Policy Inclusions. Such general liability insurance must include, at a minimum, coverage for all of the following: comprehensive form, premises, operations, explosion and collapse hazard, underground hazard, products/completed operations hazard, contractual insurance, broad form property damage, and personal injury.

K. Automobile Liability Insurance. The Grantee shall maintain throughout the term of the Franchise, automobile liability insurance for owned, non-owned, or rented vehicles used by Grantee, its, agents, officials, or employees in the minimum amount of:

1) $1,000,000 for bodily injury and consequent death per occurrence;
2) $1,000,000 for bodily injury and consequent death to any one person.
3) $500,000 for property damage per occurrence.

L. Worker's Compensation and Employer's Liability Insurance. The Grantee shall maintain throughout the term of the Franchise, Worker's Compensation and employer's liability, valid in the State, in the minimum amount of:

1) Statutory limit for Worker's Compensation.
2) $100,000 for employer's liability.

Sec. 7-31. INDEMNIFICATION.

A. Grantee shall, at its sole cost and expense, fully indemnify, defend and hold harmless the County, its officers, boards and commissions, and County employees against any and all claims, suits, actions, liability and judgments for damages (including but not limited to costs and expenses for reasonable legal Fees and disbursements and liabilities assumed by the County in connection therewith):

1) To persons or property, in any way arising out of or through the acts or omissions of Grantee, its servants, agents or employees, or to which Grantee's negligence shall in any way contribute unless caused solely by negligence or other fault of the County, its agents, servants or employees, or any other person indemnified hereunder.
2) Arising out of any claim for invasion of the right of privacy, for defamation of any person, firm or corporation, or the violation or infringement of any copyright, trademark, trade name, service mark or patent, or of any other right of any person, firm or corporation (excluding claims arising out of or relating to County programming).
3) Arising out of Grantee's failure to comply with the provisions of any federal, State, or local statute, ordinances, or regulation applicable to Grantee in its business hereunder.

B. The foregoing indemnity is conditioned upon the following:

The County shall give Grantee reasonable notice of the making of any claim or the commencement of any action, suit or other proceeding covered by the provisions of this Section. Nothing herein shall be deemed to prevent the County from cooperating with Grantee and participating in the defense of any litigation by its own counsel at its sole cost and expense. No recovery by the County of any sum by reason of the liquidated damages required by this Ordinance shall be subject to litigation by the Company, except that any sum so received by the County shall be deducted from any recovery which the County might have against the Company under the terms of this Section.

Sec. 7-32. AUTHORITY TO CONSTRUCT.

A. Authorization to Commence Construction and Application Procedures. Within thirty (30) days of the acceptance by the Grantee of an initial Franchise, the Grantee shall apply for any needed contracts for use of poles. Within thirty (30) days after completion of the make-ready survey identifying the routes of the System facility, the Grantee shall apply for all additional licenses from the State, County, or other necessary parties, such as the railroads for crossing under or over their property. In any event, all necessary applications for permits, licenses, certificates and authorizations shall be applied for in a timely fashion so that such filing and processing shall not interfere with or cause delay with the construction scheduled as outlined in the Franchise. Failure to make such timely application and timely filing shall constitute a substantial violation of this Ordinance.

B. Power to Contract. Upon grant of the Franchise and in order to construct, operate and maintain a cable System in the County, the Grantee may enter into contracts with any public utility companies or any other owner or lessee of any poles or underground areas located within

the County; obtain right-of-way permits from appropriate County, State, City, and Federal officials necessary to cross or otherwise use highways or roads under their respective jurisdiction; obtain permission from the Federal Aviation Administration to erect and maintain antennas; and obtain whatever other permits a County, City, State or Federal agency may require.

Sec. 7-33. CONSTRUCTION AND TECHNICAL STANDARDS.

A. Compliance with Construction and Technical Standards. Grantee shall construct, install, operate and maintain its System in a manner consistent with all laws, ordinances, construction standards, governmental requirements and FCC technical standards. The Grantee, through the System, shall provide uniform, strong signals which are free from any significant distortion and interference. The System shall be designed, constructed, operated and maintained for 24-hours-a-day continuous operation. The System shall produce, for reception on Subscribers' receivers which are in good working order, either monochrome or color pictures (providing the receiver is color capable) which are free from any significant interference or distortion which would cause any material degradation of video or audio quality.

B. System Design. Any System operating within the County shall at a minimum meet the following :

1) The System will be spaced to permit a minimum operation, which shall be stated in the Franchise Agreement and will be capable of utilizing State-of-The-Art technology.

2) The System will utilize converters which will make the System adaptable for the development of future services.

C. Poles. Grantee will comply with the existing permitting process for use of the Public Ways.

D. Contractor Qualifications. Any contractor or subcontractor proposed for work of construction, installation, operation, maintenance, and repair of System equipment must be properly licensed under laws of the State, and all local ordinances.

E. System Equipment. The System erected by the Grantee within the County shall be so located as to cause minimum interference with the proper use of the Public Ways, and to cause minimum interference with the rights and reasonable convenience of property owners who adjoin any of the said streets, alleys or other Public Ways. No pole or other fixtures placed in any public ways by the Grantee shall be placed in such a manner as to interfere with normal travel on such public way.

F. Maps. The County does not guarantee the accuracy of any maps showing the horizontal or vertical location of existing substructures. In public rights-of-way, where necessary, the location shall be verified by excavation. Grantee may make use of ULOCO or some other utilities location service and at Grantee's expense.

G. Quality of Construction. Construction, installation, operation, and maintenance of the System shall be performed in an orderly and workmanlike manner, in accordance with then current technological standards. All cables and wires shall be installed, where possible, parallel with electric and telephone lines. Multiple cable configurations shall be arranged in parallel and bundled with due respect for engineering considerations.

H. Construction Standards. Grantee shall at all times comply with: (1) National Electrical Safety Code (National Bureau of Standards); (2) National Electrical Code (National Bureau of Fire Underwriters); (3) Bell System Code of Pole Line Construction; (4) applicable FCC or other Federal, State and local regulations; and standards as set forth in the Franchise.

I. Non-interference. In any event, the System shall not endanger or interfere with the safety of persons or property in the Franchise area or other areas where the Grantee may have equipment located.

J. Antennas. Any antenna structure used in the System shall comply with construction, marking, and lighting of antenna structure standards as required by Federal and State law or regulation.

K. OSHA. All worker facilities, conditions, and procedures that are used during construction, installation, operation, and maintenance of the cable System shall comply with the standards of the Occupational Safety and Health Administration.

L. Standby Power. The Grantee shall maintain equipment capable of providing standby power for a minimum of twenty-four (24) hours for the headend.

Sec. 7-34. SYSTEM CONSTRUCTION SCHEDULE.

The Franchise shall specify the construction schedule. Failure to comply with the construction schedule shall constitute a breech of the Franchise and this ordinance.

Sec. 7-35. EXTENSION OF SERVICE.

The Grantee shall provide service to all dwelling units where there are an average of twenty (20) homes per mile. In such cases where residential density does not meet the requirement, consideration will be made for line extensions based on a cost share basis as may be specified in the Franchise Agreement. The Grantee may not otherwise discriminate against low income or low density areas. For good cause, the Grantee may request and the County Manager may grant reasonable extension of time.

Sec. 7-36. USE OF STREETS.

A. Underground Installation. All installations shall be underground in those areas of the County where public utilities providing telephone and electric service are underground at the time of installation. In areas of the County where either telephone or electric utility facilities are above ground at the time of installation, Grantee may install its service above ground, provided that at such time as those facilities are required to be placed underground by the County or are placed underground, the Grantee shall likewise place its services underground without direct additional cost to the County or to the individual Subscribers so served within the County. Where not otherwise required to be placed underground by this Ordinance or the Franchise, the Grantee's System shall be located underground at the request of the adjacent property owner, provided that the excess cost over the aerial location shall be borne by the property owner making the request.

B. Approvals. Prior to construction or alteration, Grantee will obtain all required construction permits.

C. Interference with Persons, Improvements, Public and Private Property and Utilities. The System shall be located, erected and maintained so that such facilities shall:

1) Not endanger or interfere with the health, safety or lives or persons;
2) Not interfere with any improvements the County, City or State may deem proper to make;
3) Not interfere with the free and proper use of Public Ways except to the minimum extent possible during actual construction or repair;
4) Not interfere with the rights and reasonable convenience of private property owners, except to the minimum extent possible during actual construction or repair; and
5) Not obstruct, hinder or interfere with any gas, electric, water or telephone facilities, easements, property rights, or other utilities facilities' easements located within the County.

D. Restoration to Prior Condition. In case of any disturbance of pavement, sidewalk, driveway or other surfacing, the Grantee shall, at its own cost and expense and in a manner approved by the County, replace and restore all paving, sidewalk, driveway, landscaping, or surface of any street or alley disturbed, consistent with the practices of local utilities. Such restoration shall be undertaken within no more than 10 business days after the damage is incurred and shall be completed as soon as possible thereafter. Such closing shall be at the expense of the Grantee.

E. Private Property. Grantee shall be subject to all laws, ordinances or regulations regarding private property or regulations regarding private property in the course of constructing, installing, operating or maintaining the System. Grantee shall promptly repair or replace all private property, both real and personal, damaged or destroyed as a result of the construction, installation, operating, or maintenance of the System at its sole cost and expense.

F. Relocation of the Facilities. In the event that at any time during the period of the Franchise, the County or State shall lawfully elect to alter, or change, the grade of any street, alley or other public ways, the Grantee, upon reasonable notice by the proper authority, shall remove or

relocate as necessary its poles, wires, cables, underground conduits, manholes and other fixtures at its own cost and expense.

G. Cooperation with Building Movers. The Grantee shall, on the request of any person holding a building moving permit issued by the County, temporarily raise or lower its wire to permit the moving of buildings. The expense of such temporary removal, raising or lowering of wires shall be paid by the person requesting the same, and the Grantee shall have the authority to require such payment in advance. The Grantee shall be given not less than fifteen (15) working days' advance notice to arrange for such temporary wire changes.

H. Tree Trimming. The Grantee shall have the authority, except when in conflict with existing County ordinances, or other applicable law, to trim any trees upon and overhanging public right-of-way so as to prevent the branches of such trees from coming in contact with System facilities, except that at the option of the County, such trimming may be done by it, or under its supervision and direction, at the expense of the Grantee.

I. Easements. All necessary easements over and under private property shall be arranged for by the Grantee.

Sec. 7-37. CONSTRUCTION REPORTING REQUIREMENTS.

A. Progress Report. Within thirty (30) days of the granting of an initial Franchise Agreement pursuant to this Ordinance, the Grantee shall provide the County with a written progress report detailing initial construction work completed to date. Such report shall include a description of the progress in applying for any necessary agreements, licenses, or certifications and any other information the County Manager may deem necessary. The content and format of the report will be determined by the County Manager and may be modified at his/her discretion.

B. Time Frame for Reports. Such written progress reports shall be submitted to the County Manager's office on a monthly basis throughout the entire construction process. The County Manager or his/her designee may require more frequent reporting, if he/she determines it is necessary to better monitor the Grantee's progress.

C. Subscriber Information. Prior to the commencement of initial System construction, the Grantee shall produce an informational document to be distributed to all residents of the area to be under construction, which shall describe the activity that will be taking place.

Sec. 7-38. TESTS AND PERFORMANCE MONITORING.

A. Tests. All testing of the System shall be done in accordance with the rules and regulations of the FCC. In addition, the County, in its discretion may require other testing and reports as it determines to be necessary to protect the interests of the citizens of the County and when necessary to ascertain Grantee's compliance with this Ordinance and the Franchise Agreement.

B. FCC Reports. A copy of any performance test reports required by the FCC shall be submitted to the County upon request and with reasonable notice.

C. Complaints. Whenever there have been similar complaints made or when there exists other evidence, which, in the reasonable judgment of the County, casts doubt on the reliability or quality of the Grantee's System, the County shall have the right and authority to compel the Grantee to test, analyze, and report on the performance of its System. The County may require additional tests, full or partial repeat tests, different test procedures, or tests involving a specific Subscriber's terminal. Reports on such tests shall be delivered to the County no later than fourteen (14) days after the County formally notifies the Grantee and shall include the following information: the nature of the complaints which precipitated the special tests; what System component was tested; the equipment used, and procedures employed in said testing; the results of such tests; and methods by which said complaints were resolved. Said tests and analyses shall be supervised by an engineer who shall sign all records of the special tests and forward same to the County with a report interpreting the results of the tests and recommending what actions should be taken by the County. All such tests shall be at the expense of the Grantee.

D. Consultants. The County shall have the right, at its expense, to employ or contract with qualified consultants and attorneys if necessary or desirable, to assist in the administration of this, or any other section of this Ordinance or the Franchise.

Sec. 7-39. GENERAL SERVICE STANDARDS.

The County reserves the right to enforce all relevant service rules and regulations as set forth by federal, state, and local governments. These rules and regulations include, but are not limited to, FCC Customer Service Regulations, as hereafter amended by the FCC, and the County's Rate and Service Regulation Ordinance, as hereafter amended by the County from time to time.

Sec. 7-40. SERVICES TO SUBSCRIBERS AND USERS.

A. Service. Concurrently with the activation of the System in the County, the Grantee shall provide all services to Subscribers as described herein and as specified in the Franchise Agreement at rates detailed in the rate schedule.

1) The System shall carry the broad categories of programming and services listed in the Franchise. Should the Grantee desire to change the selection of programs or services offered on any of its tiers, it shall maintain the mix, quality and level of services provided over the System. Any such change in programs or services offered shall comply with the conditions and procedures contained in the Franchise, and shall be reported to the County at least thirty (30) days prior to the proposed implementation. The Grantee shall use its good faith efforts to ensure diversity of programming.

2) Basic Service shall be offered to Subscribers throughout the term of this Ordinance and the Franchise.

3) The Grantee shall provide at the County's request and maintain at Grantee's sole cost, as specified in the Franchise Agreement, the following access channels:

(1) "Government Access Channel"

(2) "Educational Access Channel"

(3) "Public Access Channel"

4) The Grantee shall make available Leased Access channels, as required by Federal law.

5) The Grantee shall fully provide, at a minimum, the services, facilities and equipment for public, educational and government access as indicated in the Franchise.

B. Emergency Override. The Grantee shall, without charge, provide, service and maintain public emergency override facilities to the County, as described in the and as prescribed by the Communications Act and the FCC

Sec. 7-41. INSTALLATIONS, CONNECTIONS, AND OTHER GRANTEE SERVICES.

A. Standard Installations. Standard installation shall consist of a service not exceeding two hundred (200) Feet from a single point or pedestal attachment to the customer's residence. Service drops in excess of 200 Feet and concealed wiring in the home shall be charged to the subscriber based upon time and material. The desire of the Subscriber as to the point of entry into the residence shall be observed whenever possible. Runs in building interiors shall be as unobtrusive as possible. The Grantee shall use due care in the process of installation and shall repair any damage to the Subscriber's property caused by said installation. Such restoration shall be undertaken within no more than ten (10) days after the damage is incurred and shall be completed as soon as possible thereafter.

B. Deposits. Any deposit required by Grantee of Subscribers shall bear interest at a rate consistent with other service providers that require deposits, which interest shall belong to the Subscriber.

C. Antennas and Antenna Switches. The Grantee shall not, as a condition to providing Cable Service, require any Subscriber or potential Subscriber, to remove any existing antenna structures for the receipt of over-the-air television signals. The Grantee shall install, upon the request of the Subscriber, an RF or antenna switch where required for the provision of services provided by the Grantee as required by Federal law.

D. Lockout Devices. The Grantee shall provide to the potential Subscriber, as part of its installation literature, information concerning the availability of a lockout device for use by a Subscriber. The Grantee may require a reasonable deposit or purchase price for the use of this device, as set forth in the rate schedule. The lockout device described herein shall be made available to all Subscribers requesting it beginning on the first day that any Cable Service is provided.

E. Reconnection. Grantee shall restore service to Subscribers wishing restoration of service provided Subscriber shall first satisfy any previous obligations owed.

F. Free Disconnection. Subscribers shall have the right to have Cable Service disconnected without charge. Such disconnection shall be made as soon as practicable and in no case later than fifteen (15) days following notice to Grantee of same. A refund of unused service charges shall be paid to the customer within thirty (30) days from the date of termination of service.

G. Delinquent Accounts. Grantee shall use all reasonable efforts to collect on delinquent Subscriber accounts. In all cases, the Grantee shall provide the Subscriber with at least ten (10) working days written notice prior to disconnection. The Fee for reconnection shall not exceed the Fee for a new connection.

Sec. 7-42. CUSTOMER SERVICE STANDARDS.

A. The Company shall establish, operate and maintain in the County a business office and maintenance and repair facility for the purpose of receiving inquiries, requests and complaints concerning all aspects of the construction, installation, operation, and maintenance of the system and for the payment of Subscribers' service charges.

B. The Grantee shall have a listed, local, toll-free, or collect telephone number for service calls and such telephone service shall be available twenty-four (24) hours a day, seven (7) days a week according to FCC guidelines. Said number shall be made available to Subscribers and the general public.

C. The Grantee shall respond to and resolve Subscribers' complaints or requests for service in connection with repairs and maintenance and malfunctions of system facilities. The Grantee shall respond as quickly as possible to such complaints and requests, but shall in any case respond within the guidelines published by the FCC. Complaints or requests which may pose a potential health and safety hazard will be responded to immediately, following notification of the Grantee. In connection with billing complaints, the Grantee shall respond within time frame established by the FCC.

D. The Grantee shall prepare and file with the County copies of all of its rules and regulations in connection with the handling of inquiries, requests and complaints. The Grantee shall, by appropriate means, such as a card or brochure, furnish information concerning the procedures for making inquiries or complaints and furnish information concerning the County office responsible for the administration of the Franchise, including, but not limited to, the address and telephone number of said office.

E. The Grantee shall keep full records, as prescribed by the FCC, in connection with Customer Service Standards.

F. The County may review and monitor unresolved customer complaints.

Sec. 7-43. CONTINUITY OF SERVICE MANDATORY.

A. It shall be the right of all Subscribers to receive continuous, uninterrupted service insofar as their financial and other obligations to the Grantee are honored.

B. In the event that the Grantee elects to rebuild, modify or sell the System, or the County gives notice of intent to terminate or fails to renew its Franchise, the Grantee shall cooperate with the County or new Grantee or operator in maintaining continuity of service to all Subscribers for a period of six (6) months or such other time as mutually agreed upon. During such period, Grantee shall be entitled to the revenues for any period during which it operates the System, and shall be entitled to reasonable costs for the services when it no longer operates the System.

C. Failure to Provide Continuity. In the event the Grantee fails to operate the System for seven (7) consecutive days without prior approval of the County or without just cause, the County may,

at its option, operate the System or designate an operator until such time as Grantee restores service under conditions acceptable to the County or a permanent operator is selected. If the County is required to fulfill this obligation for the Grantee, the Grantee shall reimburse the County for all reasonable costs or damages incurred by the County as a the result of the Grantee's failure to perform.

Sec. 7-44. PROTECTION OF SUBSCRIBER PRIVACY MANDATORY.

Grantee shall at all times protect the privacy of Subscribers, as provided in this Ordinance and other applicable Federal, State, and Local laws, and in particular, Section 631 of the Communications Act (47 U.S.C. 551).

Sec. 7-45. RIGHTS OF INDIVIDUALS.

A. Nondiscrimination Required. Grantee shall not deny service, deny access, or otherwise discriminate against Subscribers, channel users or general citizens on the basis of race, color, religion, national origin, age, sex, or handicap, provided the Subscriber shall pay all applicable Fees for the service desired. Grantee shall comply at all times with all other applicable Federal, State and Local laws and regulations, and all executive and administrative orders relating to nondiscrimination which are hereby incorporated and made part of this Ordinance by reference.

Sec. 7-46. BOOKS AND RECORDS AVAILABLE TO THE GRANTOR.

A. The Grantee shall maintain an office within the County. The County shall have the right to inspect at any time during normal business hours, all books, records, maps, plans, income tax returns, financial statements, service complaint logs, performance test results and other like materials of the Grantee when necessary to ascertain the Grantee's compliance with this Ordinance or the Franchise Agreement. Access to the aforementioned records shall not be denied by the Grantee on the basis that said records contain "proprietary" information.

B. Grantee shall permit any duly authorized representative of the County to examine and copy or transcribe any and all maps and other records kept or maintained by Grantee or under its control concerning the operations, finances, affairs, transactions or property of Grantee. If any of such maps or records are not kept in the County, or upon reasonable request made available in the County, and if the County shall determine that an examination of such maps or records is necessary or appropriate to the performance of any of their duties, then all travel and maintenance expenses necessarily incurred in making such examination shall be paid by Grantee.

Sec. 7-47. REPORTS REQUIRED.

The Grantee shall file with the County, upon reasonable request:

A. Regulatory Communications. All reports required by the Federal Communications Commission (FCC) including, but not limited to annual proof of performance tests and results, and Equal Employment Opportunity (EEO) reports, and all petitions, applications and communications of all types submitted by Grantee to the FCC, the Security and Exchange Commission (SEC), or any other Federal or State regulatory commission or agency, having jurisdiction over any matter affecting operation of Grantee's System.

B. Facilities Report. An annual report setting forth the physical miles of plant construction and plant in operation during the fiscal year will be made available at the local office of the cable operator for review by County officials as needed and upon reasonable request.

C. Construction Reports. Construction reports shall be sent to the County thirty (30) days after the initial Franchise Agreement is awarded and monthly thereafter until construction is completed as specified in this Ordinance.

D. Proof of Performance Tests. Proof of performance test results performed as required by the FCC shall be supplied to the County upon request.

E. Test Required by County. Tests required by County as specified in this Ordinance shall be submitted within thirty (30) days of notification.

F. Grantee Rules. The Grantee's schedule of charges, contract or application forms of regular Subscriber service policy regarding the processing of Subscriber complaints, delinquent Subscriber disconnect and reconnect procedures and any other terms and conditions adopted as the Grantee's policy in connection with its Subscribers shall be in accordance with applicable state and federal laws, rules or regulations.

G. Proof of Bonds and Insurance. Grantee shall submit to the County the required performance bond, or a certified copy thereof, and insurance certificates as required under the terms and conditions described in this Ordinance.

H. Financial and Ownership Reports. The following financial reports for the Franchise area shall be submitted to the County, upon reasonable notice and as required by the County:

1) A statement of Gross Annual Revenues verifying all revenues from the County Franchise as certified by the Vice President for Finance or an Officer of the Grantee.

2) An annual list of officers and members of the Board of Grantee and of any parent corporation.

I. Additional Reports. The Grantee shall prepare and furnish to the County at the times and in the form prescribed, such additional reports with respect to its operation, affairs, transactions or property, as may be reasonably necessary and appropriate to ascertain Grantee's compliance with this Ordinance or the Franchise Agreement.

Sec. 7-48. RECORDS REQUIRED.

The County may, from time to time, impose reasonable requests for information, records and documents as may be reasonably necessary and appropriate to ascertain Grantee's compliance with this Ordinance or the Franchise Agreement.

Sec. 7-49. PUBLIC NOTICE.

Public notice of any public meeting relating to this Ordinance or the Franchise shall be in compliance with the County's public notice requirements.

Sec. 7-50. CAPTIONS.

The captions to sections throughout this ordinance are intended solely to facilitate reading and reference to the sections and provisions of this ordinance. Such captions shall not affect the meaning or interpretation of this ordinance.

Sec. 7-51. FRANCHISE APPLICATIONS.

A. Applicants for an initial Franchise shall submit to the County, a written application utilizing the standard format provided by the County, at the time and place designated by the County for accepting applications. The application shall include, at a minimum, the following:

1) Applicant's proper business, corporate, or partnership name;

2) If a corporation, applicant shall also state the corporation's process agent address for service of notice, provide a certified copy from the North Carolina Secretary of State of authorization to do business in the State;

3) If a partnership, application shall also contain names and addresses of all partners, names and addresses of general partner(s) responsible for overseeing the management of the Franchise;

4) Financial statement certified by a Certified Public Accountant;

5) Insurance Bonds and Certificates

6) Any other material required by this ordinance or reasonably requested by the County.

B. In awarding a Franchise, the County: shall enter into agreement with Franchisee upon any reasonable conditions it may require and subject to the provisions of this ordinance and applicable law.

C. An application Fee in the amount of $6000 shall be paid for each initial Franchise at the time of application for Franchise, which Fee shall be in the form of cash, certified check, or money order to defer the cost of studying, investigating, and otherwise processing such application and which shall be in consideration thereof and not refundable or returnable in whole or in part. To offset the effects of inflation, the amount of the application Fee provided for herein, is subject to reasonable increase in accord with the annual rate of inflation as decided by the Board.

D. Any administrative Fee associated with the renewal of a Franchise Agreement shall be negotiated in the renewed Franchise Agreement.

E. Any conditions attached to the payment of an application Fee shall be enumerated in the Franchise Agreement.

Sec. 7-52. PUBLIC HEARINGS.

Whenever a public hearing is required by this Ordinance and related communications ordinances, the public hearing must be advertised in a newspaper with general circulation within the County at least ten (10) working days before the hearing, the hearing shall be open to the public and provide for public comment and any reliable, relevant evidence that is not unduly repetitive shall be admissible.

Piedmont Triad Council of Governments

Sample County Cable Television Franchise Agreement

IS APPROVED AND THE FRANCHISE IS GRANTED AS FOLLOWS PURSUANT TO N. C. GENERAL STATUTES SECTIONS 153 A - 46, 153A - 137 AND 153A - 154 AND OTHER APPLICABLE LAW:

FRANCHISE AGREEMENT

THIS AGREEMENT is made and entered into as of the day of adoption by the County of, North Carolina, hereinafter referred to as "County" and Time Warner Entertainment/Advance -Newhouse Partnership, d. b. a. Time Warner Cable, hereinafter referred to as "Time Warner," or "Grantee." This Agreement shall be executed, by Time Warner, within thirty days following adoption by County.

SECTION 1. GRANT OF FRANCHISE.

Time Warner is hereby granted for itself and its successors and assignees, subject to the terms and conditions of this Franchise Agreement and the Ordinance, the right, privilege, and authority to construct, operate, maintain, and reconstruct a cable television system within the streets, alleys, and Public Ways of the County for the purpose of providing cable television service, subject to current and future State, Federal, and Local Laws and other regulations and the payment of any applicable fees, services or other compensation directly or indirectly to the County. Time Warner shall provide a State-of-the-Art, Countywide cable television system to the residents and institutions of the County in accordance with this Franchise Agreement and the Ordinance. Services to residents will be uniformly available and in accordance with density requirements of Section 6 of this Agreement. Service hereunder shall be provided in a competent, continuous and professional manner.

(b) Nothing in this Franchise Agreement shall be deemed to waive the various codes and ordinances of the County (specifically the Ordinance) regarding permits, fees to be paid, or manner of operation and construction, which Ordinance shall take precedent in the event of conflict.

(c) For the purpose of operating and maintaining a cable television system in the County, Time Warner may erect, in, over, under, or upon, across, and along the Public streets, alleys, and ways within the County such wires, cables, fiber optics, conductors, ducts, conduits, vaults, manholes, amplifiers, appliances, pedestals, attachments, and other property and equipment as are necessary and appurtenant to the operation of the cable television system in the County and in accordance with this Franchise Agreement and the "Cable Television Ordinance for the County of ," adopted November 13, 1997, hereinafter referred to as the "Ordinance,"

as amended, which Ordinance is codified in Chapter 7 of the County Code.

(d) Franchise nonexclusive. This Franchise Agreement shall not be construed as any limitation upon the right of the County to grant to other persons, rights, privileges, or authorities equivalent to the rights, privileges, and authorities herein set forth, in the same or other streets, alleys, or other Public Ways or Public Places. The County specifically reserves the right to grant at any time during the term of this Franchise Agreement or renewal thereof, if any, such additional franchises for a cable television system as it deems appropriate, provided, however, that such additional franchise(s), so granted, shall be on a non-discriminatory and competitively neutral basis, to the extent allowed by law.

SECTION 2. RIGHT OF COUNTY TO ISSUE FRANCHISE.

Time Warner acknowledges and accepts the legal right of the County to issue this Franchise Agreement.

SECTION 3. EFFECTIVE DATE OF FRANCHISE, EFFECT UPON EXISTING FRANCHISE.

This Franchise Agreement shall be effective as of adoption by the County Board of Commissioners and execution by the County and Time Warner and immediately upon the taking effect of this Franchise and Agreement, the prior Franchise and Agreement granted to Time Warner Entertainment/Advance - Newhouse Partnership shall be superseded and of no further force and effect; provided that any proceedings commenced under or pursuant to said prior Franchise and Agreement shall in no manner be affected.

SECTION 4. FRANCHISE TERM AND RENEWAL.

(a) This Franchise Agreement shall take effect and be in full force from and after the final passage hereof, subject to acceptance by the Grantee as provided by the Ordinance and the same shall continue in full force and effect for a period of fifteen (15) years beginning with the date of acceptance.

(b) Subject to the provisions of this Section 4, the County may amend this Franchise Agreement so as to require the Grantee to upgrade the Cable System to incorporate the State of the Art (the "State of the Art Option"). For the purposes of this Franchise Agreement the term "State of the Art" means equipment that is readily available with reasonable delivery schedules from two or more sources of supply; has the capability to perform the intended functions demonstrated within communities with similar characteristics (including, but not necessarily limited to population, density, customer penetration, etc.) under actual operating conditions for purposes other than test or experimentation; and can be implemented by the Grantee in an economically feasible manner taking into account economic waste (i.e., early retirement of assets) with the likelihood of generating a reasonable return on the Grantee's investment when measured over the then remaining term of the franchise. The term "State of the Art" does not include equipment or facilities associated with public, educational or governmental access.

(1) The County may not initiate the State of the Art Option at any time when the

Grantee is subject to effective competition as defined from time to time by federal law

(2) In order to initiate the State Of the Art Option, the County shall first commence a review of the Cable System. There shall not be more than one (1) such review every two (2) calendar years. A review may not commence prior to the ninth (9th) or after the twelfth (12th) anniversary of the acceptance date.

a. The review described in this paragraph (2) shall, at a minimum, take into account the following:

1. Characteristics of the existing Cable System,

2. The State of the Art

3 The additional benefits provided to customers by the State of the Art

4. The marketplace demand for the State of the Art taking into account any associated rate increase; and

5. Any additional factors deemed relevant by the County or the Grantee.

b. If, after conducting such a review, the County determines that the exercise of the State of the Art option may be warranted, the County shall hold at least two (2) public hearings to enable the general public and the Grantee to comment and present additional evidence.

(3) If, following such hearings, the County determines that the exercise of the

state of the Art Option is warranted, it may order the State of the Art be implemented (the "Order"). The Order shall be in writing and shall set forth the basis for the County's decision. Upon agreement, the

parties may amend this Franchise Agreement accordingly. If, however, the Grantee is not willing to comply with such Order, the Grantee may, within sixty (60) days after the County's Order;

a. Appeal the County's Order to any court of competent jurisdiction; or

b. Notify the County pursuant to Section 626 of the Cable Act that it wishes to commence renewal proceedings to renew the franchise. Such notice shall be deemed to shorten the term of the Franchise such that the Franchise will expire thirty-six (36) months from the date of the Grantee's notice. The Grantee shall not be deemed in violation of the Order or the Franchise if such renewal proceedings are commenced.

(4) If the Court finds that the Grantee has demonstrated that the County's Order is not supported by a preponderance of evidence based on the record of the proceeding from (2) above, the Court shall grant appropriate relief, unless inconsistent with federal law.

(5) Should Federal Law change, causing significant and necessary modifications of this Franchise Agreement, the County and the Grantee agree to negotiate necessary additions as an amendment to this Franchise Agreement.

(6) Any renewal of this Franchise Agreement shall be done in accordance with applicable, state and federal law.

SECTION 5. FRANCHISE FEES AND PERFORMANCE BOND.

During the term of this Franchise Agreement, Time Warner shall pay to the County for use of its streets, Public places, and other facilities, as well as the maintenance, improvements, and supervision thereof, an annual franchise fee in the amount of three (3%) percent of the gross subscriber revenue, as defined in the Ordinance, during the period of its operation under this Franchise Agreement. This payment shall be in addition to any other tax or payment owed to the County by the Time Warner. Should national legislation regarding maximum franchise fees change, the County may, by adoption of an ordinance restate the franchise fee. If the Franchise Fee is changed, the County shall give Time Warner sufficient notice to make necessary announcements to the subscribers and allow time for changes to the billing system as provided for in Section 7-16 of the Ordinance.

In accordance with Section 7-29 A. of the Ordinance a performance bond is required. The performance bond amount is set at $50,000, which shall be filed with the County Manager or his designee upon execution of the Franchise Agreement by Time Warner. Said bond may be reduced or increased per Section 7-30 of the Ordinance.

(c) Upon acceptance of this Franchise Agreement, the Grantee shall make a one-time lump sum payment to the County in the amount of Two Hundred Thousand ($200,000) Dollars to be used in support of access activities. The parties agree that this grant will not be deducted from any franchise fee payment due and payable to the County, will not be passed through to subscribers and will not be treated as an external cost, provided however, in the event the County should increase the franchise fee pursuant to paragraph (a) above then the Grantee shall be entitled to a credit on franchise fee payments thereafter in the amount of Two Hundred Thousand ($200,000) Dollars. The Grantee shall be entitled to such a credit over the then remaining term of the franchise or three (3) years, whichever is shorter.

SECTION 6. SERVICE AREA.

(a) Service area. The service area of Time Warner shall be the entire unincorporated boundaries of the County of to include those incorporated areas which are not serviced by a cable television franchise agreement with Time Warner, to the extent allowed by law.

(b) New residential construction. Time Warner shall extend service to all new residences, all unwired developments and commercial developments within eighteen months of a request pursuant to the following requirements:

(1) Line extension policy. Time Warner shall extend its cable system and make cable service available to every existing residentially zoned area within the franchise area and within eighteen (18) months for newly developed areas, which is unserved by another cable system whenever density of at least twenty (20) residential dwelling units per cable plant mile, as measured from the existing facilities of Time Warner's cable system in the Franchise Area. For purposes of this section, density per cable mile shall be computed by dividing the number of residential dwelling units in the area by the length, in miles or fractions thereof, of the total length of aerial or underground cable necessary to make service available to residential dwelling units in such area in accordance with Time Warner's system design parameters. The cable length shall be measured from the nearest point that is located within the Public Ways. The total cable length shall exclude the drop cable necessary to serve subscriber premises.

(2) Cost-sharing. In areas with less than twenty (20) homes per proposed cable mile, Time Warner shall offer a cost-sharing arrangement to residents. Time Warner shall bear its pro rata share of the current construction costs based upon the actual number of homes per mile. The cost-sharing arrangement shall consist of the following: On the request of a subscriber desiring service, Time Warner shall prepare, at its cost, an engineering survey and cost analysis to determine the cost of the plant extension required to provide service to the subscriber from the closest usable point on the cable system. The cost of construction shall be allocated based on the following formula: If a request for extension into a residential area requires the construction of cable plant, which does not pass at least twenty (20) homes per mile, Time Warner and subscribers will each bear their proportionate share of construction costs. For example, if there are ten(10) dwelling units per mile, Time Warner's share will equal 10/20th of the construction cost. The remaining cost will be shared equally by each subscriber in the area to be constructed. The line extension formula shall also be applied to a portion of a mile meeting proportionate density requirements. For example, if there are five (5) dwelling units per one fifth mile, then Time Warner shall construct the plant. The cost sharing described above would be utilized if there were less than the proportionate share of dwelling units per the portion of a mile needed to reach the dwelling units. Should additional subscribers request cable television service, subscribers utilizing the cost-sharing plan for extension shall be reimbursed pro-rata for their contribution or a proportional share thereof. In such case, the pro-rata shares shall be recalculated and each new subscriber shall pay the new pro-rata share, and all prior subscribers shall receive refunds. In any event, at the end of twenty-four (24) months from completion of the project, the subscribers are no longer eligible for refunds, and the amounts paid in construction costs will be credited to the plant account of Time Warner. The average cost of the line extension shall be recalculated annually and based upon the current costs of labor and material. Each person contributing toward the direct cost of the line extension agrees to waive all ownership interest in the line extension. All equipment and components of the line extension, including, but not limited to, cable wire, electronics and pedestals shall at all times remain the exclusive property of Time Warner.

(c) *Performance Testing.* Time Warner shall perform all system tests and maintenance procedures as required by the FCC and the ordinance, to the full extent allowed by law.

(d) *Technical Standards.* The cable television system permitted to be operated hereunder shall be installed and operated in conformance with the Ordinance, this Franchise Agreement, and FCC rules and regulations. Any FCC technical standards or guidelines related to the cable television system and facilities shall be deemed to be regulations under this Franchise Agreement and are incorporated by reference. At such time as the FCC does not regulate technical standards, Time Warner will continue to comply with the FCC standards which were effective prior to such discontinuance of regulation by the FCC.

(e) *Employee Identification.* Time Warner shall provide a standard identification document to all employees, including employees of subcontractors, who will be in contact with the Public. Such documents shall include a telephone number that can be used to verify identification. In addition, Time

Warner shall use its best efforts to clearly identify all field personnel, vehicles and other major equipment that are operating under the authority of Time Warner.

(f) *Stereo.* Upon completion of the rebuild, the system will have the capability and shall pass Broadcast Television Systems Committee (BTSC) stereo signals or other stereo signals for those broadcast, satellite and locally-originated services which transmit the stereo signals, excepting alphanumeric and news channels.

(g) *Underground Drops.* The cost of replacing aerial drops with underground placement will be determined by the location of the utility drops. If the subscriber is served underground for power, there will be no charge for the replacement. There will be a time and material charge assessed only if underground replacement is requested though power is served by aerial means.

(h) *Digital Signals.* Time Warner agrees to comply with all FCC regulations and requirements for the transmission of broadcast digital television signals on its cable system.

SECTION 7. SYSTEM SERVICES AFTER UPGRADE

Under the terms of the Ordinance, Time Warner agrees to the following:

(a) *Initial Residential Subscriber Service.* During the upgrade period, Time Warner shall use its best efforts to provide a good mix of entertainment and information programming generally available to the cable television industry, taking into account the needs and interests of the diverse population of the County of .

(b) *Service Upon Completion of the Upgrade.* Service will be at least comparable to that provided to the City of Greensboro.

Access Channels. In accordance with Section 611 of the Cable Act (47 U.S.C. Section 531), the Time Warner agrees to provide at no cost to the County, unless directed otherwise by the County Board of Commissioners, one channel for Public Access; one channel for Educational Access; and one channel for Government Access.

(1) Education Access Channel:

Provide one Education Access Channel available on a 24-hour per day basis connected from the Weaver Center to the Time Warner headend and made available to all system-wide subscribers.

Connect the following schools to the system: Eastern High School; Northeast High School; Northeast Middle School; and Nathaniel Greene Elementary School.

Retain active connection between Southwest High School and Sapp Road headend as backup to the Weaver Center origination site. Continue as long as economically feasible or until Sapp Road headend is eliminated. Upon elimination of the Sapp Road headend move equipment from SW High School to the Weaver Center.

Government Access:

Provide one Government Access Channel available on a 24-hour per day basis connected from the County Commissioner's meeting room through the Greensboro City Hall to the Time Warner headend and made available to all system-wide subscribers.

Public Access:

Provide one Public Access Channel available on a 24-hour per day basis connected from the GCTV production facility to the Time Warner headend and made available to all system-wide subscribers. The County Board of Commissioners shall have the right to remove the Public Access Channel from the County service area if the Board determines, in its sole discretion, that the Public Access Channel no longer meets the needs or serves the interests of the community.

(4) Future Channels. The Grantee shall make available up to an additional three (3) full time channels for public, educational and governmental access use. An additional channel shall be made available within six (6) months of a request from the County. Any such request from the County shall include a demonstration to the reasonable satisfaction of the Grantee that all current public, educational and governmental access channels are being substantially utilized and there is demand for an additional channel. For the purposes of this paragraph (4) the term "substantially utilized" shall mean that the existing channels have been programmed at least eighteen (18) hours a day for seven (7) days a week over six (6) consecutive weeks with non-repetitive, locally-produced audio-video programming. The Grantee shall be entitled to use any of the dedicated public, educational or governmental access channels when those channels are not being used for their dedicated purposes. Should the City of Greensboro receive additional Access Channels, these Access Channels will be interconnected to the County system, upon request of the Board of Commissioners.

(d) *Closed Captioning*. Time Warner shall pass through all closed-circuit signals received by the system for the hearing impaired.

SECTION 8. CUSTOMER SERVICES

Time Warner will meet the customer service standards as established in the Ordinance and Appendix A, as may be amended from time-to-time.

SECTION 9. REPORTS REQUIRED.

Time Warner shall file with the County:

(a) Time Warner rules. Time Warner's schedule of charges, contract or application forms of regular subscriber policy regarding the processing of subscriber complaints, delinquent subscriber disconnect or reconnect procedures and any other terms and conditions adopted as the Time Warner's policy in connection with its system subscribers.

(b) Proof of bonds and insurance. Upon execution of the Franchise Agreement, Time Warner shall submit to the County the required performance bond in a form acceptable to the County Attorney, or a certified copy thereof, and written evidence of payment of required premium, and certification of policies of insurance required by this Franchise Agreement, and written notice of payment of required premium.

(c) Financial reports. The financial reports required to document franchise fees paid under the provisions of Section 5 of this Agreement.

(d) A summary of the previous year's activities, including, but not limited to, new services offered upon reasonable notice.

(e) Any other reports required by the Ordinance.

SECTION 10. RECORDS REQUIRED.

(a) In accordance with the Ordinance, the Time Warner shall at all times maintain and make available to the County upon written notice and reasonable request and as may be reasonably necessary to monitor

or ascertain the Time Warner's compliance with the provisions of the Ordinance and this Franchise Agreement: a full and complete set of plans, records and "as-built" maps showing the exact location of all cable communication system equipment installed or in use in the County, exclusive of subscriber service drops. These plans, records and "as built maps" will be treated as proprietary information to the full extent allowed by law and will be maintained and viewed at the cable operator's office.

(b) Other records. The County may impose reasonable requests for additional information, records and documents from time to time, as may be reasonably necessary to monitor or ascertain the Time Warner's compliance with the Ordinance and this Franchise Agreement.

SECTION 11. ENTIRE AGREEMENT.

This agreement and all attachments hereto, as incorporated herein, represent the entire understanding and agreement between the parties hereto with respect to the subject matter hereof, supersede all prior oral negotiations between the parties, and can be amended, supplemented, modified, or changed only by a written document executed by the parties. However, requirements of the Ordinance shall take precedence over any conflicting requirement of this Agreement.

SECTION 12. REMEDIES.

(a) The County may enforce this Franchise by use of any remedy, or any combination of remedies, provided for in the Ordinance or other applicable law.

(b) Violations. For the violation of any of the following, the County will notify Time Warner in writing of the violation. The County shall provide Time Warner with detailed written notice of any alleged franchise violation upon which it proposes to take action, and a forty-five (45) day period within which Time Warner may demonstrate that a violation does not exist or to cure an alleged violation or, if the violation cannot be corrected in 45 days, to submit a plan satisfactory to the County to correct the violation. If an alleged violation is proven to exist, and no cure or action on a plan acceptable to the County has been received by the County within thirty (30) days, such damages shall, from the end of the forty-five (45) day period, be chargeable to the performance bond as set forth in this Franchise Agreement if not tendered by Time Warner within forty-five (45) days. Time Warner may petition the County Board for relief for just cause.

SECTION 13. FORCE MAJEURE

Notwithstanding any provision of the contrary contained herein, neither the County nor the Time Warner shall be held liable for or suffer any penalty or detriment for, any failure to comply with any provision of this Franchise Agreement if such failure to comply accrues from any act of God or any other condition not within the reasonable control of such non-complying person; provided, however, that this provision shall not apply to Time Warner's financial obligations hereunder.

SECTION 14. NOTICES

All notices and other communications hereunder shall be in writing and shall be deemed to have been given on the date of actual delivery, by registered or certified mail, return receipt requested, postage prepaid. The address for service of notice to the Time Warner shall be addressed to Time Warner Entertainment/Advance - Newhouse Partnership, Post Office, North Carolina 27404. Notices to the County shall be addressed to the Clerk to the Board of Commissioners, County of , Post Office Box , North Carolina 27402. Either the County or the Time Warner may change address to which all notices shall be sent by addressing a notice of such change in the manner provided in this section.

EXPECTED CONSUMER BENEFITS FROM WIRED VIDEO COMPETITION IN CALIFORNIA

by

Yale M. Braunstein[1]

School of Information
University of California, Berkeley

Introduction

Cable television is the dominant means by which households, both nationwide and in California, receive video programming. Using the most recent data available, over 68% of U.S. households and approximately 60% of the households in the four largest California metropolitan areas have cable television. (See Exhibit 1.) Almost all of the remainder of the over 98% of U.S. households with televisions currently either receive television signals over-the-air or via satellite. The vast majority of the cable systems operate with exclusive local franchises, and their subscribers have no competitive alternative for wired video delivery. In recent years the emergence of broadband service providers that offer both video and broadband data services has led to the situation where what happens in one area affects the other.

Exhibit 1	Penetration
	%
United States (a)	
Percentage of HH with Television	98.2%
Percentage of TV HH with Cable	69.4%
Percentage of HH with Cable	68.2%
California (b)	
Percentage of TV HH with Cable	
Los Angeles DMA	55.1%
Sacramento/Stockton/Modesto DMA	53.9%
San Diego DMA	72.9%
San Francisco DMA	66.3%
Weighted Average of four DMAs	59.3%

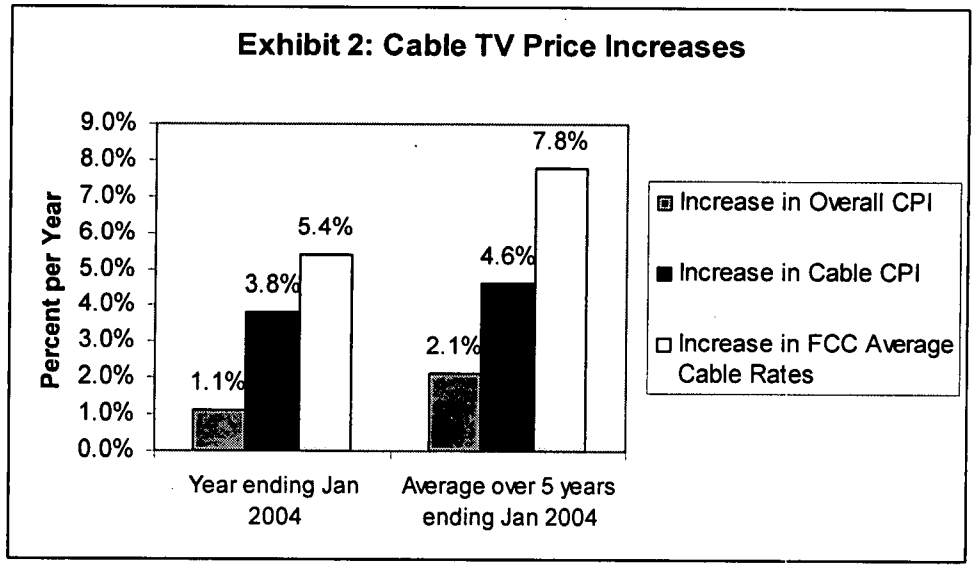
Notes:
(a) Data are for 2002. Source: Statistical Abstract of the United Sates, 2004-2005, Table 1120.
(b) Data are for 2005. Source: Calculated by the author.

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[1] Dr. Braunstein's past research on the economics of cable television has been funded by the National Science Foundation and the Network Inquiry Special Staff of the FCC. He has consulted for and published research on a wide variety of media and telecommunications industries. Christoph Rothballer and Nadine Schmidt provided research assistance for this study. This study was commissioned by AT&T, which sought an independent assessment of expected consumer savings in a competitive broadband subscription television services marketplace.

The widespread diffusion of new technologies has enabled carriers in what were previously viewed as separate industries to start to compete head-to-head, or at least bundle-for-bundle, in many geographic areas. In other words, the convergence that was a subject of much speculation and discussion over the past decade is now here, at least in part. But convergence is not complete, either geographically or across all service offerings. In its 2005 "Report on Cable Industry Prices," which uses 2004 data, the Federal Communications Commission (FCC) found that cable television service was provided in 32,510 "non-competitive" communities while there were only approximately 400 communities with competitive wireline overbuilds.[2] Based on a stratified random sample, the monthly subscription rates for basic and expanded basic services were on average 15.7% lower in the competitive group than in the non-competitive group and 27.2% lower on a per-channel basis.[3] There is very little direct competition in the cable industry, but where there is, consumers generally see both lower prices and additional service offerings.

Cable television system operators are subject to local franchise agreements and partial regulation by the FCC. In addition eleven states had public-utilities-like regulation of cable systems in the 1970s, but this state regulation was generally viewed as ineffective and was pre-empted by the federal government in 1984.[4] The remaining federal and local regulation is also viewed as being ineffective in controlling prices, and cable television subscription prices regularly increase at a rate faster than overall prices in the economy, as measured by the Consumer Price Index (CPI). (See Exhibit 2.)



[2] FCC, "Report on Cable Industry Prices" (February 4, 2005), at par 14.

[3] *Ibid.*, at par. 7.

[4] See Yale M. Braunstein, "Economic Effects of State Regulation of Cable Television," in H. S. Dordick, ed., *Proceedings of the Sixth Annual Telecommunications Policy Research Conference* (Lexington, 1979). The *1984 Cable Act*, 47 U.S.C. § 543(a), pre-empted state regulation of cable television rates.

This report provides an estimate of the savings cable television subscribers in California could expect if alternative wired distribution of video programming were to become widespread. Using current population and subscription rates and reasonable estimates of the effects of competition on subscription prices, we estimate the annual savings to consumers will range from approximately $690 million to just over $1 billion. The remainder of this report explains the data, assumptions, and analysis on which these estimates are based. A set of spreadsheets showing the details is available on the web at: www.sims.berkeley.edu/~bigyale/cable/ .

Analysis

We obtained data from a major cable television market research firm on the number of cable television subscribers and the monthly prices they pay for the major cable television systems in the four major Designated Market Areas (DMAs) in California: Los Angeles, Sacramento/Stockton/Modesto, San Diego, and San Francisco.[5] Together, these four DMAs contain approximately 90% of the households in California. (See Exhibit 3.)

Exhibit 3 DMA Size and Cable Television Prices

	Households	Average Cable TV Monthly Price
Los Angeles DMA	5,536,430	$ 58.29
Sacramento/Stockton/Modesto DMA	1,345,820	$ 53.41
San Diego DMA	1,026,160	$ 49.54
San Francisco DMA	2,355,740	$ 57.38
Four DMAs overall (a)	10,264,150	$ 56.40
California state total (b)	11,502,870	

Notes:
(a) Data are from 2005. Source: Nielsen Media Research Local Universe Estimates
(b) Data are from 2000. Source: California Quick Facts from the US Census Bureau

Since each cable system typically offers several packages of channels at different prices, the next step was to calculate weighted average monthly prices paid by the subscribers—first for each cable system, then for each DMA, and finally for the state. These average prices are also shown in Exhibit 3. In performing these calculations we needed to make a few assumptions:

- The average price paid to the cable system operator for non-digital cable television service without a premium package was the simple average of the prices for non-digital "basic cable" and "expanded basic." This assumes that basic and expanded basic each account for 50% of the subscriptions to non-digital packages without premium service.

[5] "Designated Market Area" is a term developed by Nielsen Media Research to indicate a group of counties that are covered by a specific group of television stations. It is a standard definition of metropolitan area used in media businesses.

- The average price paid for non-digital service with a premium package was on average $10 per month over the price charged for non-digital expanded basic.
- The market shares of the different cable television operators in each DMA are assumed to hold across all packages.

These assumptions represent approximations, but the overall results are not sensitive to small changes in the assumptions. Similarly, although the different sources provided data from different years, any errors introduced by this are likely to be small.

Combining the weighted average prices paid with the number of cable subscribers in each DMA gives us the total monthly spending on cable television in the DMA. We then multiplied this sum by twelve to get annual spending on cable television service in the four DMAs of over $4 billion. This number became the starting point from which we calculated the expected savings after the introduction of wired competition.

Our next step was to estimate the likely reduced cable subscription prices when there would be direct competition. One estimate was the 15.7% from the FCC's 2005 Cable Industry Prices report described above. Using a different methodology, the General Accounting Office (GAO) compared the monthly cable television rates in six markets with broadband service providers who offered a full range of services including subscription television with six comparable markets without such competition.[6] The monthly cable TV subscription prices for expanded basic service in five of the six matched markets ranged from 15% to 41% lower with competition than without.[7] In the sixth market the subscription price was 3% higher. Averaging the results from all six markets, the average price was 22.2% lower when competition was present. (Prices for voice telephone service and high-speed Internet service were either less or the same in the competitive markets when compared to their matched non-competitive pairs.)

Using these two estimates, we then calculated the likely prices for each cable package in each market and the resulting savings from competition. (We actually used 15% and 22% for the estimated savings percentages, figuring that it was more conservative to truncate the numbers rather than risk rounding up.) At this point we introduced another assumption; specifically, that savings occurred equally in percentage terms across all cable packages in a given DMA. The average monthly cable bill dropped to $47.94 with the 15% savings, which we called Scenario A, and to $43.99 with the 22% savings, our Scenario B. These figures represent average monthly savings of $8.46 and $12.41 for each cable subscriber with the two competition scenarios. The dollar estimates of the expected savings are likely to be low as they ignore cable subscriber spending on non-English language channels and programming that is not included in the packages.

Although the four DMAs account for the overwhelming majority of the households in California, there are still another 1.24 million households (just under 11% of the total)

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[6] U. S. General Accounting Office, "Wire-Based Competition Benefited Consumers in Selected Markets" (GAO 04-241, February 2004).

[7] *Ibid.*, p. 16.

outside the DMAs. Therefore, we scaled up the total savings to include these non-DMA households. This scaling may lead to an over-estimate of the savings if the non-DMA areas do not see wired video competition, or it may lead to an under-estimate if the cable penetration outside the DMAs is greater than in the metropolitan areas and competition does emerge. In any event, completely ignoring any savings outside the DMAs would only lower our savings estimate by 11%. The resulting annual savings statewide under the two scenarios amount to $692 million and $1.015 billion. These results are summarized in Exhibit 4.

Exhibit 4	Results		
	Current	Scenario A	Scenario B
Estimated percentage savings	--	15%	22%
Average monthly bill	$ 56.40	$ 47.94	$ 43.99
Average monthly savings	--	$ 8.46	$ 12.41
Annual savings ($ million)	--	$ 692	$ 1,015

Discussion

It is important to realize that there are additional benefits from wired video competition. The FCC Pricing Study found that the average price per-channel was, on a percentage basis, even lower than the average overall price for wired video service in competitive markets than in markets without competition. This finding can be explained by the fact that the operators in the competitive markets, on average, offer more channels as well as lower prices than those in the non-competitive markets.

Another advantage relates to competitive operators offering a wider variety of packages and options as they seek to serve additional market segments. One example of this can be seen in the packages and programming services available from SureWest, which serves parts of Roseville-Sacramento area. SureWest offers nine different digital video packages and a wide range of video programming services over a fiber-to-the-home network. These packages range from 27 to 244 channels, enabling SureWest to provide direct competition to the dominant cable operators.

Finally, we should point out that some of these gains from direct competition in the delivery of video services occur instantaneously while the full benefits will be achieved over time. The competitive pairs in the GAO study included broadband service providers who had offered video services for at least one year.[8] Our estimates assume competitive services are rolled-out sufficiently to provide competition throughout California. As a result it may take several years for the full value of these benefits to be achieved, and as the competition becomes more entrenched the magnitude of the benefits can increase substantially.

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[8] *Ibid.*, p. 2

The likely timing and nature of the roll-out of the infrastructure to provide competitive wired video services is difficult to predict. There are both franchise and regulatory hurdles that take time, and this delay can often be longer than the time necessary to install or upgrade the required network. In addition, some have charged that any roll-out by competitors will likely target high-income neighborhoods, leaving other demographic groups without the benefits of competition. It is difficult to understand how this would come about as the demand for video services does not appear to be positively correlated with family income or other related demographic and socio-economic factors.[9]

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[9] See, for example, General Accounting Office, "Issues in Providing Cable and Satellite Television Services" (GAO 03-130, October 2002; Table 3 on page 47) where the regression coefficient for the median household income variable in the reduced form cable subscribers equation is negative and significantly different from zero.

FEDERAL COMMUNICATIONS COMMISSION

FACT SHEET

June 2000

CABLE TELEVISION

INFORMATION BULLETIN

EVOLUTION OF CABLE TELEVISION

Cable television (also called CATV or community antenna television) was developed in the late 1940's for communities unable to receive TV signals because of terrain or distance from TV stations. Cable television system operators located antennas in areas with good reception, picked up broadcast station signals and then distributed them by coaxial cable to subscribers for a fee.

In 1950, cable systems operated in only 70 communities in the United States. These systems served 14,000 homes. By October 1998 there were more than 10,700 systems serving more than 65 million subscribers in more than 32,000 communities. Cable systems are operating in every state of the United States and in many other countries, including Austria, Canada, Belgium, Germany, Great Britain, Italy, Japan, Mexico, Spain, Sweden and Switzerland.

Most cable systems are technically capable of offering between 36 and 60 channels. Channel capacity in the industry has increased dramatically in recent years; some systems now offer in excess of 100 channels. Most cable subscribers receive service from a system offering more than 54 channels.

The channel capacity of a cable system makes it possible for a cable television system operator to provide many services. In addition to over-the-air television broadcast signals, most systems also offer diverse program services, including, for example, news, weather, business information, movies, sports, special entertainment features, and programming designed for specific audiences such as children, women, and ethnic and racial groups. Within the past few years, some cable systems have begun offering a full-range of telecommunications services, including high-speed Internet access and local telephone service. High-speed Internet access allows subscribers to connect to the Internet more than 100 times faster than the fastest standard analog modem.

Some cable operators also create their own local programming and provide access channels for public and institutional uses. They also provide leased access channels for "rent" to those wishing to show specific programs. Electronic banking, shopping, utility meter reading, and home security are some of the home services that are possible using the two-way transmission capabilities of cable television systems.

INITIAL JURISDICTION AND RULES

The Federal Communications Commission first established rules in 1965 for cable systems which received signals by microwave antennas. In March 1966, the Commission established rules for all cable systems (whether or not served by microwave). The Supreme Court affirmed the Commission's jurisdiction over cable in *United States v. Southwestern Cable Co.*, 392 U.S. 157 (1968). The Court ruled that "the Commission has reasonably concluded that regulatory authority over CATV is imperative

if it is to perform with appropriate effectiveness certain of its responsibilities." The Court found the Commission needed authority over cable systems to assure the preservation of local broadcast service and to effect an equitable distribution of broadcast services among the various regions of the country.

In March 1972, new rules regarding cable television became effective. These rules required cable television operators to obtain a certificate of compliance from the Commission prior to operating a cable television system or adding a television broadcast signal. The rules applicable to cable operators fell into several broad subject areas -- franchise standards, signal carriage, network program nonduplication and syndicated program exclusivity, nonbroadcast or cablecasting services, cross-ownership, equal employment opportunity, and technical standards. Cable television operators who originated programming were subject to equal time, Fairness Doctrine, sponsorship identification and other provisions similar to rules applicable to broadcasters. Cable operators were also required to maintain certain records and to file annual reports with the Commission concerning general statistics, employment and finances.

In succeeding years, the Commission modified or eliminated many of the rules. Among the more significant actions, the Commission deleted most of the franchise standards in 1977, substituted a registration process for the certificate of compliance application process in 1978, and eliminated the distant signal carriage restrictions and syndicated program exclusivity rules in 1980. In 1983, the Commission deleted its requirement that cable operators file financial information. In addition, court actions led to the deletion of the pay cable programming rules in 1977.

1984 CONGRESSIONAL POLICY AND RULES

In October 1984, the U.S. Congress amended the Communications Act of 1934 by adopting the Cable Communications Policy Act of 1984. The 1984 Cable Act established policies in the areas of ownership, channel usage, franchise provisions and renewals, subscriber rates and privacy, obscenity and lockboxes, unauthorized reception of services, equal employment opportunity, and pole attachments. The new law also defined jurisdictional boundaries among federal, state and local authorities for regulating cable television systems.

1992 CONGRESSIONAL POLICY AND RULES

Following the 1984 Cable Act, the number of households subscribing to cable television systems increased, as did the channel capacity of many cable systems. However, competition among distributors of cable services did not increase, and, in many communities, the rates for cable services far outpaced inflation. Responding to these problems, Congress enacted the Cable Television Consumer Protection and Competition Act of 1992. The 1992 Cable Act mandated a number of changes in the manner in which cable television is regulated.

In adopting the 1992 Cable Act, Congress stated that it wanted to promote the availability of diverse views and information, to rely on the marketplace to the maximum extent possible to achieve that availability, to ensure cable operators continue to expand their capacity and program offerings, to ensure cable operators do not have undue market power, and to ensure consumer interests are protected in the receipt of cable service. The Commission has adopted regulations to implement these goals.

1996 CONGRESSIONAL POLICY AND RULES

In adopting the Telecommunications Act of 1996, Congress noted that it wanted to provide a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector

deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition. The Commission has adopted regulations to implement the requirements of the 1996 Act and the intent of Congress.

WHAT IS CABLE TELEVISION?

Cable television is a video delivery service provided by a cable operator to subscribers via a coaxial cable or fiber optics. Programming delivered without a wire via satellite or other facilities is not "cable television" under the Commission's definitions.

A **cable television system operator** is any person or group of persons who provides cable service over a cable system and directly or through one or more affiliates owns a significant interest in such cable system, or who otherwise controls or is responsible for, through any arrangement, the management and operation of such a cable system.

Cable service is the transmission to subscribers of video programming, or other programming service. This definition includes any subscriber selection required in choosing video programming or other programming service.

A **cable system** is a facility, consisting of a set of closed transmission paths and associated signal generation, reception, and control equipment that is designed to provide cable service which includes video programming and which is provided to multiple subscribers within a community. This term does not include a facility that serves only to retransmit the television signals of one or more television broadcast stations; a facility that serves subscribers without using any public right-of-way; a facility of a common carrier which is subject in whole or in part, to the provisions of Title II of the Communications Act, except that such facility shall be considered a cable system to the extent such facility is used in the transmission of video programming directly to subscribers; unless the extent of such use is solely to provide interactive on demand services; an open video system; or any facilities of any electric utility used solely for operating its electric utility system.

Cable services are often provided in **tiers**. A tier is a category of cable service or services provided by a cable operator for which a separate rate is charged by the cable operator. There are three types of cable service: basic service, cable programming service, and per-channel or per-program (sometimes called pay-per-view) service. **Basic service** is the lowest level of cable service a subscriber can buy. It includes, at a minimum, all over-the-air television broadcast signals carried pursuant to the must-carry requirements of the Communications Act, and any public, educational, or government access channels required by the system's franchise agreement. It may include additional signals chosen by the operator. Basic service is generally regulated by the local franchising authority (the local or state entity empowered by Federal, State, or local law to grant a franchise to a cable company to operate in a given area). **Cable programming service** includes all program channels on the cable system that are not included in basic service, but are not separately offered as per-channel or per-program services. Pursuant to a 1996 federal law, the rates charged for cable programming services tiers provided after March 31, 1999 are not regulated. There may be one or more tiers of cable programming service.

Per-channel or per-program service includes those cable services that are provided as single-channel tiers by the cable operator, and individual programs for which the cable operator charges a separate rate Neither of these services is regulated by the local franchising authorities or the Commission.

A **local exchange carrier (LEC)** is a telephone company which provides local telephone service.

A **multichannel video programming distributor** is any person such as, but not limited to, a cable operator, a multichannel multipoint distribution service, a direct broadcast satellite service, or a television receive-only satellite program distributor, who makes available for purchase, by subscribers or customers, multiple channels of video programming.

REGISTRATION OF A CABLE SYSTEM

Before commencing operation, a cable system operator must send the following information to the Secretary of the Commission for each community to be served:

(1) The legal name of the operator, the entity identification or social security number, and whether the operator is an individual, private association, partnership or corporation. If the operator is a partnership, the legal name of the partner responsible for communications with the Commission;

(2) The assumed name (if any) used for doing business in the community;

(3) The mailing address, including zip code, and the telephone number to which all communications are to be directed;

(4) The date the system provided services to 50 or more subscribers;

(In order to comply with the requirements relating to aeronautical frequency usage, a system must register in advance of providing service to any subscribers, so that a subsequent aeronautical notification may be timely filed pursuant to § 76.615(b)).

(5) The name of the community or area served and the county in which it is located;

(6) The television broadcast signals to be carried;

(7) A certification that the applicant is not subject to a denial of federal benefits pursuant to Section 5301 of the Anti-Drug Abuse Act of 1988, 21 U.S.C., 853a, or, in the case of a non-individual applicant (for instance, a corporation, partnership, or other unincorporated association), that no party to the application is subject to a denial of federal benefits pursuant to that section; and

(8) For a cable system (or an employment unit) with six or more full-time employees, a statement of the proposed community unit's equal employment opportunity program, unless such program has previously been filed for the community unit or is not required to be filed based on an anticipated number if fewer than six full-time employees.

A registration statement must be signed by an authorized representative of the cable television company. The Commission issues a public notice setting forth the details of each registration statement as it is received. The cable television operator is not required to serve the registration statement on any party and may begin operation immediately upon filing the registration statement. However, commencement of operation is entirely at the risk of the system operator. If violations of the rules are subsequently discovered, appropriate regulatory sanctions, including imposition of a monetary forfeiture and/or the issuance of a cease and/or desist order, may be employed.

STATE AND LOCAL REGULATION OF CABLE SYSTEMS

A variety of laws and regulations for cable television exist at the state and local level. Some states, such

as Massachusetts, regulate cable television on a comprehensive basis through a state commission or advisory board established for the sole purpose of cable television regulation. In Alaska, Connecticut, Delaware, Nevada, New Jersey, Rhode Island, and Vermont, the agencies are state public utility commissions. In Hawaii, regulation of cable television is the responsibility of the Department of Regulatory Agencies. In other areas of the country, cable is regulated by local governments such as a city cable commission, city council, town council, or a board of supervisors. These regulatory entities are called "local franchising authorities." In addition, at least 30 other states have one or more laws specifically applicable to cable television, dealing most commonly with such subjects as franchising, theft of service, pole attachments, rate regulation and taxation.

The 1992 Cable Act codified, and the Commission has adopted, a regulatory plan allowing local and/or state authorities to select a cable franchisee and to regulate in any areas that the Commission did not preempt. Local franchising authorities have adopted laws and/or regulations in areas such as subscriber service requirements, public access requirements and franchise renewal standards. Under the 1992 Cable Act, local franchising authorities have specific responsibility for regulating the rates for basic cable service and equipment.

The Communications Act requires that no new cable operator may provide service without a franchise and establishes several policies relating to franchising requirements and franchise fees. The Communications Act authorizes local franchising authorities to grant one or more franchises within their jurisdiction. However, a local franchising authority may not grant an exclusive franchise, and may not unreasonably withhold its consent for new service. Included in the grant of a franchise to a cable system are rights relating to the construction of the system, including the local franchising authority's authorization to use public rights-of-way, easements, and to establish the areas to be served. In addition, the law requires just compensation to property owners who have suffered damages as a result of a cable operator's construction, operation, installation, or removal of its cable television facilities. Moreover, franchising authorities are required to ensure that access to cable service is not denied to any group of potential residential cable subscribers on the basis of income class. Although the Communications Act also generally precludes the regulation of cable systems as common carriers, it authorizes the Commission, to require, if it chooses, the filing of informational tariffs for intrastate communications services, other than cable service, which is provided by a cable system.

Franchising authorities may charge the cable operator a fee for the right to operate a cable system in that franchise area; however, the franchise fee paid by the cable system can be no more than five percent of its annual gross revenue. A franchising authority may use the money collected from this fee for any purpose. A cable operator must list any applicable franchise fee as a separate item on the subscriber's bill.

RATES FOR SERVICE

Prior to passage of the 1992 Cable Act, the Commission did not regulate rates for cable television service. Rates for basic cable service were regulated by local franchising authorities. The 1984 Cable Act permitted local franchising authorities to regulate only if the cable franchise area was served off the air by fewer than three unduplicated broadcast signals; in 1991, the Commission raised this number to six. In passing the 1992 Cable Act, Congress found rates for cable services rose significantly following the 1984 Cable Act. Congress directed the Commission to establish rules to govern rate regulation of cable service tiers offered by cable systems that are not subject to effective competition. These rules are intended to improve service to the cable subscriber and to ensure competitive rates.

Each service tier is regulated in a slightly different manner. Local franchising authorities are responsible for regulating the basic service tier and, until March 31, 1999 (as provided by the 1996 Act), the

Commission was responsible for regulating cable programming services tiers. Both follow rules set by the Commission, which established a "benchmark" rate based on a number of factors, including the number of subscribers, channels, and a number of other factors. Pay-per-channel and pay-per-program services are not regulated.

In addition, under the 1996 Act, small cable operators are partially or wholly exempt from rate regulation. A "small cable operator" is defined to include any operator that serves fewer than 1 percent of all subscribers in the United States and that is not affiliated with entities that have gross annual revenues exceeding $250 million. In any franchise area where a small cable operator serves fewer than 50,000 subscribers, rate regulation does not apply to the operator's cable programming services tiers, or to its basic tier if it was the only tier subject to regulation as of December 31, 1994.

Rates for a cable system's service tiers and associated equipment may be regulated only if the cable system is not subject to effective competition. There are four separate tests to establish that effective competition exists: (1) the households subscribing to a cable system constitute fewer than 30 percent of the households in its franchise area; or (2) (a) there are at least two unaffiliated multichannel video programming distributors (one of which may be the cable system in question), with each offering comparable video programming to at least 50 percent of the households in the franchise area, and (b) the households subscribing to all but the largest multichannel video programming distributor exceed 15 percent of the households in the franchise area; or (3) the franchising authority is itself a multichannel video programming distributor offering video programming to at least 50 percent of the households in the franchise area; or (4) a local exchange carrier or its affiliate (or any multichannel video programming distributor using the facilities of such carrier or its affiliate) offers video programming services directly to subscribers by any means (other than direct-to-home satellite services) in the franchise area, but only if the video programming services so offered in that area are comparable to the video programming services provided by the unaffiliated cable operator in that area. In the absence of a demonstration to the contrary, a franchising authority may presume that a cable system is not subject to effective competition.

In order to exercise its authority to regulate basic cable rates and equipment, a franchising authority must be certified by the Commission. Unless notified otherwise by the Commission, a franchising authority's certification becomes effective 30 days after it is filed with the Commission. A franchising authority whose request for certification has been denied or revoked may petition the Commission for re-certification. In addition, a franchising authority that lacks the resources or legal authority to regulate basic cable service rates may petition the Commission to assume regulation, but the franchising authority must affirmatively demonstrate its inability to regulate to the Commission. The Commission will not intervene to regulate basic cable service rates should a franchising authority choose not to seek certification or choose not to request that the Commission assume jurisdiction. Appeals of local decisions will be heard by the Commission or by state or local courts, depending upon the subject matter involved.

The 1996 Act modified the regulation of cable programming services and the rate complaint process established under the 1992 Cable Act. Pursuant to the 1996 Act, the Commission's authority to regulate the rates charged for cable programming services (those are the channels that are not on cable system's basic tier and are not sold on a per-channel or per-program basis) was terminated for services provided after March 31, 1999. Therefore, the rates charged for cable programming services are determined by the cable company and the Commission does not have the authority to review these rates or to investigate allegations that the rates are excessive.

The 1996 Act did not modify the local franchising authority's ability to regulate basic cable rates. Therefore, complaints about basic cable rates should be filed with the franchise authority.

Rates for channels sold on a per-channel or per-program basis are not regulated.

CUSTOMER SERVICE GUIDELINES

Pursuant to the 1992 Cable Act, the Commission adopted federal guidelines which provide a standard for improving the quality of customer service rendered by cable operators. These guidelines provide minimum levels of service which should be provided by a cable operator. The guidelines address issues such as the cable operator's communications with customers over the telephone, installations, service problems, changes in rates or service, billing practices and information that must be provided to all customers. **Although the standards were issued by the Commission, local franchising authorities are responsible for adopting and enforcing customer service standards. Franchising authorities may also adopt more stringent or additional standards with the consent of the cable operator or through enactment of a state or municipal law.**

Subscriber Calls to a Cable System

Under the federal guidelines, each cable system must maintain a local, toll-free or collect-call telephone line available 24 hours a day, 7 days a week. During normal business hours, company representatives must be available to respond to customer inquiries. After normal business hours, (the hours during which most similar businesses in the community are open to serve customers), the cable system may use an answering service or machine so long as messages are answered the next business day. In addition, the cable system's customer service center and bill payment locations must be conveniently located and must be open at least during normal business hours and should include at least one night per week and/or some weekend hours.

A call to a cable system must be answered -- including time the caller is put on hold -- within 30 seconds after the connection is made. If the call is transferred, the transfer time may not exceed 30 seconds. Also, cable system customers may receive a busy signal no more than three percent of the time. Although no special equipment is required to measure telephone answering and hold time, cable operators should use their best efforts in documenting compliance. These requirements must be met 90 percent of the time, measured quarterly, under normal operating conditions.

Installations, Service Interruptions and Service Calls

Federal guidelines state that standard installations -- which are those located up to 125 feet from the existing distribution system -- must be performed within seven days after an order has been placed. Except in situations beyond its control, the cable operator must begin working on a service interruption no later than 24 hours after being notified of the problem. A service interruption has occurred if picture or sound on one or more channels has been lost. The cable operator must begin to correct other service problems the next business day after learning of them. Cable operators may schedule appointments for installations and other service calls either at a specific time or, at a maximum, during a four-hour time block during normal business hours. Cable operators may also schedule service calls outside of normal business hours for the convenience of the customer. No appointment cancellations are permitted after the close of business on the business day prior to the scheduled appointment. If the cable installer or technician is running late and will not meet the specified appointment time, he or she must contact the customer and reschedule the appointment at the convenience of the subscriber. These requirements concerning installations, outages and service calls must ordinarily be met at least 95 percent of the time, measured quarterly, under normal operating conditions.

Changes in Rates or Service and Billing Practices

Thirty days advance written notice (using any reasonable written means) must be given to subscribers and local franchising authorities of any changes in rates, programming services or channel positions, if the change is within the control of the cable operator. Cable operators are not required to provide prior notice of any rate change that is the result of a regulatory fee, franchise fee, or any other fee, tax, assessment, or charge of any kind imposed by a Federal agency, State, or franchising authority on the transaction between the operator and the subscriber. Cable system bills must be clear, concise and understandable, with full itemization. Cable operators should respond to written complaints about billing matters within 30 days. Refunds must be issued no later than either the customer's next billing cycle or 30 days following resolution of the request, whichever is earlier, or upon the return of equipment when service is terminated. Credits must be issued no later than the billing cycle following the determination that a credit is warranted.

Information to Customers

The following information must be provided to customers at the time of installation and at least annually to all subscribers and at any time upon request: products and services offered; prices and options of programming services and conditions of subscription to programming and other services; installation and service maintenance policies; instructions on how to use the cable service; channel positions of programming carried on the system; and billing and complaint procedures, including the address and telephone number of the local franchising authority's office.

UNAUTHORIZED RECEPTION OF CABLE SERVICES

The 1984 Cable Act provides damages and penalties of up to two years in prison and/or $50,000 in fines to be assessed against anyone determined to be guilty either of the unauthorized interception or reception of cable television services or of the manufacture or distribution of equipment intended to be utilized for such a purpose. The Commission does not prosecute unauthorized reception of cable services. Rather, cable operators aggrieved by a violation may bring an action in a United States district court or in any other court of competent jurisdiction. Knowledge of violations should be reported directly to the cable system.

SIGNAL CARRIAGE REQUIREMENTS

The 1992 Cable Act established new standards for television broadcast station signal carriage on cable systems. Under these rules, each local commercial television broadcast station was given the option of selecting mandatory carriage ("must-carry") or retransmission consent ("may carry") for each cable system serving the same market as the commercial television station. The market of a television station is established by its Area of Dominant Influence ("ADI"), as defined by Arbitron and/or modified by the Commission. Every county in the country is assigned to an ADI, and those cable systems and television stations in the same ADI are considered to be in the same market. Upon the request of a television station or a cable system, the Commission has the authority to change the ADI to which a station is assigned. As a result of Arbitron abandoning the television research business, the Commission has determined that, effective January 1, 2000, the market of a television station shall be its Designated Market Area ("DMA") as determined by Nielsen Media Research.

Must-Carry/Retransmission Consent Election

Every three years, every local commercial television station has the right to elect either must-carry or retransmission consent. The initial election was made on June 17, 1993, and was effective on October 6, 1993. The next election occurred on October 1, 1996, and was effective January 1, 1997. All subsequent

elections will occur every three years (October 1 1999, to be effective January 1, 2000; October 1, 2002, to be effective January 1, 2003; etc.).

Election of Must-Carry Status

Generally, if a local commercial television station elects must-carry status, it is entitled to insist on cable carriage in its local market. Each cable system with more than 12 channels must set aside up to one-third of its channel capacity for must-carry stations. For example, if a cable system has 60 channels, it must set aside 20 of those channels for must-carry stations. If there are 25 stations in the market which elected must-carry, the cable operator may choose 20 to carry. On the other hand, if only 15 stations elected must-carry in the market, the cable system would have to carry all 15 of these stations. A must-carry station has a statutory right to a channel position, usually its over-the-air channel number, or another channel number on which it has historically been carried.

Retransmission Consent Election

A cable system is not permitted to carry a commercial station without the station's consent. Therefore, if the local commercial television station elects retransmission consent, the cable system must obtain that station's consent prior to carrying or transmitting its signal. Except for "superstations," a cable system may not carry the signal of any television broadcast station that is not located in the same market as the cable system without that broadcaster's consent. Superstations are transmitted via satellite, usually nationwide, and the cable system may carry such stations outside their local market without their consent. The negotiations between a television station and a cable system are private agreements which may, but need not, include some form of compensation to the television station such as money, advertising time or additional channel access.

Noncommercial Educational Television Stations

Every cable system across the country must carry at least one local noncommercial educational ("NCE") station. A noncommercial station which places a Grade B signal over a cable system's principal headend, or whose city of license is within fifty miles of the cable system's principal headend, is considered "local" for this purpose. Cable systems with more than 36 channels may be required to carry all local noncommercial educational television stations which request carriage. Any cable system operating in a market where no local NCE station is available is required to import one NCE station.

Low Power Television Stations

The 1992 Cable Act provides mandatory carriage for "qualified" low power television stations ("LPTV") in certain situations. A LPTV station has to meet certain qualifications specified in the Act and incorporated into the Commission's Rules, before it is qualified for the right to must-carry. If a LPTV is qualified, it may assert must-carry rights, and, provided the cable operator has not met its mandatory carriage obligations, the LPTV station must be carried. Otherwise, a LPTV station must negotiate for carriage under the retransmission consent provisions or under the leased commercial access provisions.

Radio Programming

While the 1992 Cable Act's must-carry provisions only apply to local commercial and noncommercial educational television stations, the Act's retransmission consent provisions apply to all commercial broadcast stations. Many cable systems carry radio stations as an "all-band" offering, meaning that as with any standard radio receiver, all stations which deliver a signal to the antenna are carried on the

system. The Commission only requires consent from those radio stations within 57 miles of the cable system's receiving antenna. Thus, even though a cable operator's antenna may pick up a station's signal, operators are not required to obtain the consent of stations outside of the 57 mile zone unless the station affirmatively seeks retransmission consent.

Manner of Carriage

Subject to the Commission's network nonduplication, syndicated exclusivity and sports broadcasting rules, cable systems must carry the entirety of the program schedule of every local television station carried pursuant to the mandatory carriage provisions or the retransmission consent provisions of the 1992 Cable Act. A broadcaster and a cable operator may negotiate for partial carriage of the signal where the station is not eligible for must carry rights, either because of the station's failure to meet the requisite definitions or because the cable system is outside the station's market. In those situations where the carriage in the entirety rule applies, the primary video and accompanying audio of all television broadcast stations must be carried in full, without alteration or deletion of their content. Ancillary services such as closed captioning and program-related material in the vertical blanking interval must be carried. However, other information contained in the vertical blanking interval need not be carried.

Syndicated Program Exclusivity Protection

With respect to non-network programming, cable systems that serve at least 1,000 subscribers may be required, upon proper notification, to provide syndicated protection to broadcasters who have contracted with program suppliers for exclusive exhibition rights to certain programs within specific geographic areas, whether or not the cable system affected is carrying the station requesting this protection. However, no cable system is required to delete a program broadcast by a station which is either significantly viewed or which places a Grade B or better contour over the community of the cable system.

Network Program Nonduplication

Commercial television station licensees are entitled to protect the network programming they have contracted for by exercising nonduplication rights against more distant television broadcast stations carried on a local cable television system that serves more than 1,000 subscribers. Commercial broadcast stations may assert these nonduplication rights regardless of whether or not their signals are being transmitted by the local cable system and regardless of when, or if, the network programming is scheduled to be broadcast. Generally, the zone of protection for such programming cannot exceed thirty-five miles for stations licensed to a community in the Commission's list of top 100 television markets or fifty-five miles for stations licensed to communities in smaller television markets. In addition, a cable operator does not have to delete the network programming of any station which the Commission has previously recognized as significantly viewed in the cable community.

Sports Programming Blackouts

A cable system located within 35 miles of the city of license of a broadcast station where a sporting event is taking place may not carry the live television broadcast of the sporting event on its system if the event is not available live on a local television broadcast station, if the holder of the broadcast rights to the event, or its agent, requests such a blackout. The holder of the rights is responsible for notifying the cable operator of its request for program deletion at least the Monday preceding the calendar week during which the deletion is desired. If no television broadcast station is licensed to the community in which the sports event is taking place, the 35-mile blackout zone extends from the broadcast station's

licensed community with which the sports event or team is identified. If the event or local team is not identified with any particular community (for instance, the New England Patriots), the 35-mile blackout zone extends from the community nearest the sports event which has a licensed broadcast station. The sports blackout rule does not apply to cable television systems serving less than 1,000 subscribers, nor does it require deletion of a sports event on a broadcast station's signal that was carried by a cable system prior to March 31, 1972. The rule does not apply to sports programming carried on nonbroadcast program distribution services such as ESPN. These services, however, may be subject to private contractual blackout restrictions.

For example, if the Boston Celtics are playing the Atlanta Hawks at Boston Gardens in a National Basketball Association ("NBA") game, and the game is not broadcast live on a Boston television station, and the NBA sends a blackout notice to cable systems within 35 miles of Boston, those systems will have to delete the game which is carried on their systems by "superstation" WTBS from Atlanta. If a sports event were carried, for example, on ESPN or a regional subscription sports network, any blackout would be the result of a private contractual agreement between the holder of the rights to the event and the sports network.

Copyright

The Copyright Act requires cable operators to obtain a compulsory license for the carriage of programming. The cable operator pays the fee to the copyright office, for distribution to the copyright holders of the program material. The fee for each cable system is based on the system's "gross receipts" from the carriage of broadcast signals and the number of "distant signal equivalents" a term identifying non-network programming from distant television stations carried by the system.

Under the Commission's must-carry rules, a cable operator is not required to carry a signal of a television broadcast station if that station would be considered a distant signal under the Copyright Act, unless the station agrees to indemnify the cable operator for any increased copyright liability resulting from carriage of the signal.

The Copyright Act requires a cable operator to file semi-annually a statement of account, including information about system revenue and signal carriage as well as the royalty fee payment. For further information regarding copyright regulation, contact the Licensing Division, Copyright Office, Library of Congress, Washington, DC 20557; telephone (202) 707-8380.

Program Content Regulations

Cable television system operators generally make their own selection of channels and programs to be distributed to subscribers in response to consumer demands. The Commission does, however, have rules in some areas that are applicable to programming -- called "origination cablecasting" that is subject to the editorial control of the system operator. The rules generally do not apply to the contents of broadcast signals or access channels over which the system operator has no editorial control.

Cable subscribers may request a "lockbox" from cable operators to prevent viewing of any channel on which objectional programming may appear. Cable operators are required to make lockboxes available for sale or lease to customers who request them. Lockboxes can also be purchased from other commercial distributors.

The 1996 Act included several provisions that were designed to increase the subscriber's ability to control the programming coming into the home. Section 551 of the 1996 Act required representatives of

the broadcast and cable television industries to develop, within one year after enactment of the 1996 Act, voluntary rules to rate programming that contains violence and sexual or other indecent material. The industry proposed the *TV Parental Guidelines* and the proposal was approved by the Commission on March 12, 1998. The *TV Parental Guidelines* (labels and content indicators and respective meanings) are:

TV-Y -- This program is designed to be appropriate for all children.

TV-Y7 -- This program is designed for children age 7 and above. Note: For those programs where fantasy violence may be more intense or more combative than other programs in this category, such programs will be designated **TV-Y7-FV**.

TV-G -- Most parents would find this program suitable for all ages.

TV-PG -- This program contains some material that parents may find unsuitable for younger children. The program contains one or more of the following: moderate violence (**V**), some sexual situations (**S**), infrequent coarse language (**L**), or some suggestive dialogue (**D**).

TV-14 -- This program contains some material that many parents would find unsuitable for children under 14 years of age. This program contains one or more of the following: intense violence (**V**), intense sexual situations (**S**), strong coarse language (**L**), or intensely suggestive dialogue (**D**).

TV-MA -- This program is specifically designed to be viewed by adults and therefore may be unsuitable for children under 17. This program contains one or more of the following: graphic violence (**V**), explicit sexual activity (**S**), or crude indecent language (**L**).

The ratings icons and associated symbols appear for 15 seconds at the beginning of all rated programming. Sports, news, commercials, promotions and unedited movies with a Motion Picture Association of America rating that are aired on premium cable channels are exempt from these ratings.

The 1996 Act also required that television receivers manufactured or imported for use in the United States be equipped with circuitry that is capable of identifying all programs with a common rating and blocking individual channels during selected time periods. This is the circuitry commonly referred to as the "V-chip." This requirement applies to all television sets with a least a 13 inch screen. Manufacturers of such equipment were required to include a v-chip on at least 50% of their products by July 1, 1999 and on the remaining 50% by January 1, 2000. The Commission also required that personal computers that include a television tuner and a 13 inch or larger monitor must also include the v-chip. However, the requirement to rate programming applies only to video transmissions that are delivered to the computer by using the television tuner. Video transmissions delivered over the Internet or via computer networks are not required to be rated.

Section 504 of the 1996 Act required a cable operator to fully scramble or block the audio and video portions of programming services not specifically subscribed to by a household. The cable operator must fully scramble or block the programming in question upon the request of the subscriber and at no charge to the subscriber. In addition, Section 505 states that cable operators or other multichannel video programming distributors who offer sexually explicit programming or other programming that is indecent on any channel(s) primarily dedicated to sexually-oriented programming must fully scramble or block both the audio and video portions of the channels so that someone who does not subscribe to the channel does not receive it. Until a multichannel video distributor complies with this provision, the distributor cannot provide the programming during hours when a significant number of children are

likely to view it.

On March 4, 1996, the Commission adopted an *Order and Notice of Proposed Rulemaking* (FCC 96-84) establishing interim rules to implement Section 505 of the 1996 Act. The interim rules established the hours of 6:00 a.m. to 10:00 p.m. as those hours when a significant number of children are likely to have access to and view the programming. However, before the rules could take effect, Section 505 was challenged in the courts and the Commission was subsequently prevented from enforcing the rules because of a temporary restraining order and a number of stays granted by the United States District Court for the District of Delaware. On March 24, 1997, the United States Supreme Court affirmed the District Court's decision to deny the request for a preliminary injunction of section 505. Thus, on April 17, 1997, the Commission adopted an Order establishing May 18, 1997 as the effective date of our rules implementing section 505. However, on December 28, 1998, a federal court in Delaware issued a decision (*Playboy Entertainment Group v. U.S.*) which determined that Section 505 is unconstitutional. Therefore, the Commission's rules based on Section 505 could not be enforced. An appeal of this decision was filed with the U.S. Supreme Court. On May 22, 2000, the U.S. Supreme Court also determined that Section 505 is unconstitutional. Thus, the Commission's rules implementing Section 505 cannot be enforced. However, persons who wish to prevent the viewing of such programming may do so by obtaining a "lockbox" or by exercising the options provided in Section 504 of the 1996 Act.

Finally, Section 506 of the 1996 Cable Act allows cable operators to refuse to transmit any public access or leased access program which contains obscenity, indecency, or nudity. On June 28, 1996, the U.S. Supreme Court issued a decision (*Denver Area Educational Telecommunications Consortium, Inc. v. FCC*) which held that cable operators may decline to carry indecent programming on leased access channels, but cannot exercise the same control over programming on public access channels.

Political Cablecasting

Once a cable system allows a legally qualified candidate to use its facilities, it must afford "equal opportunities" to all other candidates for that office to use its facilities. The cable system may not censor the content of the candidate's "equal opportunity" material in any way, and may not discriminate between candidates in practices, regulations, facilities or services rendered pursuant to the equal opportunities rules. Candidate appearances which are exempt from the "equal opportunities" rules include appearances on a bona fide newscast, bona fide news interview, bona fide news documentary, or on-the-spot coverage of a bona fide news event.

Cable television systems may charge political candidates only the "lowest unit charge" of the system for the same class and amount of time for the same period, during the 45 days preceding a primary or runoff election and the 60 days preceding a general or special election. Candidates should be charged no more per unit than the system charges its most favored commercial advertisers for the same classes and amounts of time for the same periods. Information concerning the rates, terms, conditions and all discounts and privileges offered to commercial advertisers should be disclosed and made available to candidates.

Fairness Doctrine

Prior to the Fairness Doctrine's repeal in 1987, cable television system operators engaging in origination cablecasting were required to afford reasonable opportunity for the discussion of conflicting views on controversial issues of public importance. Although this requirement still appears in the Commission's rules, the fairness doctrine in its broadcast application and from which the cable rules is derived, is no longer enforced as a consequence of a Commission proceeding and a court decision.

Personal Attacks

When an attack is made upon the honesty, character, integrity, or like personal qualities of an identified person or group during origination cablecasting concerning controversial issues of public importance, the cable system must give the following to the person or group attacked within one week: (1) notification and identification of the cablecast, (2) a script, tape or accurate summary of the attack, and (3) an offer of a reasonable opportunity to respond over the cable facilities. The rule exempts attacks by political candidates and their associates on other candidates, including attacks that occur during "uses" by candidates such as attacks made during bona fide newscasts, bona fide news interviews and on-the-spot coverage of bona fide news events; and attacks on foreign groups or foreign public figures.

Political Editorials

Once a cable system carries an editorial endorsing or opposing a legally qualified political candidate, it must give opposing candidates (or the candidate opposed in the editorial) an opportunity to respond. Within 24 hours after the political editorial, the cable system must give to the other candidates or the candidate opposed the following: (1) notification and identification of the editorial, (2) a script or tape of the editorial, and (3) an offer of a reasonable opportunity for the candidate or his or her spokesman to respond over the cable facilities. Where an editorial is cablecast within 72 hours prior to election day, the cable system is obliged to give notice and an opportunity to respond sufficiently far in advance to enable the candidate opposed or not endorsed a reasonable opportunity to prepare a response and to present it in a timely fashion.

Lottery Information

Like broadcasting stations, cable systems are generally prohibited from transmitting information or advertisements concerning lotteries or other schemes offering prizes dependent upon chance in exchange for consideration. The rule exempts information about a state lottery cablecast by a system located in that state or another state which conducts a state lottery, or by a system which is integrated with a cable system in such a state, if it is technically unable to terminate the transmission to other states. It also permits the cablecast of information about a lottery or similar scheme that is not prohibited by the state in which it is conducted and which is (1) conducted by a not-for-profit or governmental organization or (2) conducted by a commercial organization and which is clearly occasional and ancillary to the organization's primary business. Information about gaming conducted pursuant to the Indian Gaming Regulatory Act is also exempt.

On June 14, 1999, the U.S. Supreme Court issued a decision (*Greater New Orleans Broadcasting Association, Inc. v. U.S.*) which held that this prohibition could not be applied to the advertisements of lawful private casino gambling that are broadcast on radio or television stations located in Louisiana, where such gambling is legal.

Sponsorship Identification

The sponsorship identification rule requires the identification of the sponsor of any origination cablecasting which is presented in exchange for money, service or "other valuable consideration." All political spots must contain a visual sponsorship identification in letters equal to at least four percent of the screen height and which are on the air for at least four seconds. Where the cablecast advertises commercial products or services, a mention of the corporate or trade name is usually considered sufficient. Sponsorship identification announcements must also be made before and after certain material if inducements are given to the cable system in exchange for cablecasting the material.

Commercial Limits in Children's Programs

Regulations implemented pursuant to the Children's Television Act of 1990 restrict the amount of commercial matter that cable operators may cablecast on programs originally produced and broadcast primarily for children 12 years old and younger. Cable operators may transmit no more than 10.5 minutes of commercial matter per hour during children's programming on weekends and no more than 12 minutes of commercial matter per hour on weekdays. Cable systems must maintain records available for public inspection which document compliance with the rule.

Cigarette Advertising

Advertisements for cigarettes, little cigars and smokeless tobacco are prohibited on any medium of electronic communication subject to the jurisdiction of the Federal Communications Commission. Laws against these types of advertising have criminal penalties and are administered by the U.S. Department of Justice rather than by the Commission.

ACCESS AND ORIGINATION CHANNELS

Access channels typically provide community-oriented programming, such as local news, public announcements and government meetings. They are usually programmed by individuals or groups, on either public, educational or governmental access channels or on commercial leased access channels.

Origination channels are usually programmed by the cable system and may include many types of specialized program packages such as movies, sports, national news and public affairs, feature entertainment, children's programming or programming for specific ethnic or other minority groups.

The Commission's rules do not require cable operators to originate programming. Operators who originate programming, however, are required to comply with the Commission's program content rules.

Channels For Public, Educational, Or Governmental Use

Under the 1984 Cable Act, local franchising authorities may require that cable operators set aside channels for public, educational, or governmental ("PEG") use. In addition, franchising authorities may require cable operators to provide services, facilities, and equipment for the use of these channels. Many cable systems include several PEG channels.

In general, cable operators are not permitted to control the content of programming on PEG channels. Cable operators may impose non-content-based requirements, such as minimum production standards, and may mandate equipment user training.

PEG channel capacity which is not in use for its designated purpose may, with the franchising authority's permission, be used by the cable operator to provide other services. Under certain conditions, a franchising authority may authorize the use of unused PEG channels to carry low power commercial television stations and local noncommercial educational television stations that are required by law.

Information relating to PEG channels may be obtained directly from the cable system or the local franchising authority.

Leased Commercial Access

The statutory framework for commercial leased access was established by the 1984 Act and amended by the 1992 Cable Act. The 1984 Cable Act established leased access to assure access to the channel capacity of cable systems by parties unaffiliated with the cable operator who want to distribute video programming free of the editorial control of the cable operator. Channel set-aside requirements were established in proportion to a system's total activated channel capacity, in order to "assure that the widest possible diversity of information sources are made available to the public from cable systems in a manner consistent with the growth and development of cable systems." A cable system operator was permitted to use any unused leased access channel capacity for its own purposes, until such time as a written agreement for a leased channel use was obtained. Each system operator subject to this requirement was to establish the "price, terms, and conditions of such use which are at least sufficient to assure that such use will not adversely affect the operation, financial condition, or market development of the cable system."

The only exception to the leased commercial access channel set-aside provides that up to 33 percent of a system's designated leased commercial access channel capacity may be used for qualified minority or educational programming from sources that may or may not be affiliated with the cable operator. The qualified minority or educational source may be affiliated with the operator.

The 1992 Cable Act amendments broadened the statutory purpose to include "the promotion of competition in the delivery of diverse sources of video programming," and the Commission was provided with expanded authority: (1) to determine the maximum reasonable rates that a cable operator may establish for leased access use, including the rate charged for the billing of subscribers and for the collection of revenue from subscribers by the cable operator for such use; (2) to establish reasonable terms and conditions for leased access, including those for billing and collection; and (3) to establish procedures for the expedited resolution of leased access disputes. The legislative history of the 1992 amendments expresses concern that some cable operators may have established unreasonable terms or may have had financial incentives to refuse to lease channel capacity to potential leased access users based on anticompetitive motives, especially if the operator had a financial interest in the programming services it carried.

Any person aggrieved by the failure or the refusal of a cable operator to make commercial channel capacity available or to charge rates as required by Commission rules may file a petition for relief with the Commission within 60 days of the alleged violation. In order to merit relief, the petition must show by clear and convincing evidence that the operator violated the leased access statutory or regulatory provisions or otherwise acted unreasonably or in bad faith. Relief may be in the form of refunds, injunctive relief or forfeitures. The Commission encourages parties to use alternative dispute resolution procedures such as settlement negotiation, conciliation, facilitation, mediation, fact finding, mini-trials and arbitration. The 1992 Cable Act provides for both judicial and Commission review of leased commercial access disputes.

EQUAL EMPLOYMENT OPPORTUNITY ("EEO")

The Communications Act of 1934 and the Commission's rules prohibit cable operators, satellite master antenna television systems serving 50 or more subscribers and multichannel video programming distributors ("MVPDs") including, wireless cable operators and certain satellite distributors, from discriminating against any job applicant or employee because of the person's race, color, religion, national origin, age or gender. The law also requires that these entities establish, maintain and execute a continuing program to assure equal employment opportunity. Key areas which this program must address include: recruitment of minority and female applicants for job vacancies; promotions of minorities and women to positions of greater responsibility; and assessment of the system's EEO program.

The Commission monitors compliance with the EEO rules on a yearly basis. Entities are subject to an annual certification review which begins when employment units (i.e., local cable systems, MVPDs and their headquarters offices) with six or more full-time employees file an Annual Employment Report (FCC Form 395-A or 395-M) with the Commission by May 1st of each year. The purpose of this review is to determine whether the employment units are engaging in good faith EEO efforts. The Form 395-A or 395-M requests information about the entity's EEO program as well as employee profiles, hiring and promotion data, and job title information, by race and gender, for all employees classified among 15 job categories.

The Commission also requires operators to respond to selected questions from a Supplemental Investigation Sheet ("SIS") which requires more detailed information regarding the operator's EEO efforts and employee job classifications. SISs are sent out at least once every five years and responses to them allow the Commission to evaluate in greater detail each employment unit's employment practices, including the accuracy of its job classifications.

In addition, the Commission conducts random on-site audits. Audits are usually conducted by Commission staff and consist of interviews and a review of documents and employment practices at the main office or work-site of the employment unit.

The certification process consists of an examination of the information submitted on the Form 395-A or 395-M, and, if applicable, an SIS response or results of an audit. Any additional information that may have been supplied by the operator or requested by the Commission is also considered. Finally, the Commission notes any final decisions reached regarding complaints of discrimination by government agencies and courts established to enforce anti discrimination laws. If the data indicates compliance with the EEO requirements, a certification of compliance is issued for that year. If the data raises questions about the employment unit's efforts, additional information is requested.

If an operator violates the cable EEO rules, the Commission has various remedies and sanctions available. Based on the severity and frequency of the violation, the Commission may issue a letter of caution or decertify a unit. If a unit is decertified, the Commission may also impose reporting conditions, impose a fine, or suspend the unit's Cable Television Relay Service ("CARS") license until the violation is corrected. The Commission may also communicate its adverse findings to the local franchising authority.

EEO complaints may be filed by an employee, an applicant for employment or any other interested person. An interested person is an individual who lives within the cable system's franchise area. Complaints must be in writing, sworn and signed and must allege facts raising a *prima facie* case of non-compliance with the EEO provisions. To be timely, a complaint must be filed within 180 days of the alleged EEO violation.

In processing EEO complaints, the Commission first determines whether the complaint falls within the jurisdiction of the Equal Employment Opportunity Commission or a comparable state or local agency. If it does, the complaint is referred to the appropriate agency and the Commission defers action on the matter until a final decision is reached. If the matter is not referred, the Commission processes the complaint and determines what action or inquiry, if any, is appropriate.

Anyone wishing to file a complaint should write to: Federal Communications Commission, Mass Media Bureau, Enforcement Division, EEO Branch, 445 12th Street, S.W., Washington, D.C. 20554.

To receive more information about complaint procedures or the cable EEO provisions in general, please

contact the EEO Branch at (202) 418-1450.

In 1998, a federal court issued a decision (*Lutheran Church - Missouri Synod v. FCC*) which held that the Commission's EEO requirements for broadcast stations were unconstitutional. However, the court made clear that other requirements of this type could be constitutional and remanded the issue to the Commission. Pursuant to the court's remand, the Commission issued a *Notice of Proposed Rulemaking* which sought comment on proposals to modify the broadcast EEO rules in a manner that would be consistent with the court's decision. Although the court decision did not specifically address the cable EEO rules, the *Notice* proposed to modify the cable EEO rules to conform the cable rules to any new broadcast EEO rules. On January 20, 2000, the Commission adopted a *Report and Order* (FCC 00-20) in which it modified its EEO policies. The new policies became effective on April 17, 2000. However, the Commission's revies EEO policies have been challenged in federal court. The court's decision is pending.

For further information on the Commission's Equal Employment Opportunity rules, consult the following: 47 U.S.C. §554; 47 C.F.R. §§76.71 - 76.79; *Report and Order in MM Docket No. 92-261*, 8 FCC Rcd 5389 (1993); *Report and Order in MM Docket No. 85-61*, 102 FCC 2d 562 (1985).

CABLE SYSTEM OWNERSHIP

The Commission rules restrict the ability of television broadcast stations, national television networks, MMDS, and SMATV systems to own or control interests in cable systems. These rules also restrict the ownership interest of cable operators and their ability to own or control video programming services. While there are no prohibitions on foreign ownership of cable television systems, foreign governments or their representatives may not own CARS stations.

Cable/Telephone Cross-Ownership Restrictions

Pursuant to the 1984 Act, the Commission's rules placed restrictions on telephone companies providing cable television service. In general, telephone companies were prohibited from providing video programming directly to subscribers within their telephone service areas. However, telephone companies were allowed to provide cable television service in rural areas (defined as places of fewer than 2500 persons), or where the telephone company was able to show that cable service could not exist unless provided by the telephone company. Waivers could also be granted for good cause.

The 1996 Act established various options for local exchange carriers to provide video programming to subscribers. They are: common carrier transport, wireless ("MMDS"), cable, and open video systems. The Commission has structured a streamlined regulatory format for open video systems that allows open video system operators to offer their own programming and affords independent programmers the ability to reach subscribers directly. By encouraging entry into the video programming distribution market, the open video system framework will provide competitors to cable operators, direct broadcast satellite systems and wireless cable providers. Open video systems will advance competition in two areas of the video market, distribution and carriage. In the latter, open video systems will afford broad capability for video programming providers to reach subscribers directly, independent of the open video system operator.

Cable/MMDS Cross-Ownership

Commission rules and the Communications Act provisions generally preclude common ownership of a cable television system and a Multichannel Multipoint Distribution Service ("MMDS") system that

serves the same area. However, following passage of the 1996 Act, this restriction does not apply to cable systems subject to effective competition in the relevant franchise area.

With MMDS, often referred to as "wireless cable," an omnidirectional microwave signal is sent from a central transmission tower to receiving microwave antennas. The signals involve "line of sight" transmission and, as a result, the signals are subject to degradation when obstructed. On the other hand, absent obstacles, the signals can travel up to 70 miles, providing television pictures comparable to those received through cable television. The microwave signal is a high frequency signal which is converted for television use by a converter located on the subscriber's receiving antenna.

Vertical Ownership Restrictions

To prevent vertically integrated cable systems from unduly favoring their affiliated programmers over non-affiliated program providers, the Commission imposes a 40% limit on the number of channels that can be occupied by video programmers affiliated with the particular cable system. In this context, vertical integration refers to common ownership of both cable systems and program networks, channels, services or production companies. For purposes of determining common ownership, all interests of 5% or greater are recognized unless there is no possibility of such interests exerting control or influence over the cable system.

National Subscriber Limits

Section 613 of the Communications Act requires the Commission to prescribe rules establishing reasonable limits on the number of cable subscribers served by an individual cable operator through its ownership or control of local cable systems. In 1993, the Commission adopted rules prohibiting any person from reaching, through owned or controlled cable systems, more than 30% of all homes passed nationwide by cable. In 1999, the Commission amended this rule to prohibit any person from serving, through owned or controlled cable systems, more than 30% of all multiple video programming distribution ("MVPD") subscribers nationwide. The Commission concluded that actual subscriber numbers, rather than cable homes passed, more accurately reflected the market power of a multiple system operator ("MSO"). In addition, given that DBS and other non-cable providers have a growing impact on the market, the Commission decided to take into account the number of all MVPD subscribers, rather than cable subscribers alone. For cable operators, the 30% limit includes only those cable subscribers that any one MSO serves through incumbent cable franchises. An "incumbent cable franchise" is one that was in existence on October 20, 1999, and includes all subsequent owners of the franchise. In determining the 30% limit, the MSO must include all subscribers served by the incumbent cable franchise, regardless of when the subscriber actually purchased cable service. By limiting the horizontal concentration of the cable industry, the Commission seeks to prevent the concentration of local cable systems into the hands of only a few large operators and to limit the ability of multiple system operators to exercise undue influence in the program acquisition market.

The U.S. District Court for the District of Columbia ruled in *Daniels Cablevision, Inc. v. United States*, 835 F. Supp. 1 (1993), that governmentally-mandated subscriber limits are unconstitutional under the First Amendment. In light of this ruling and in order to avoid confusion, the Commission stayed the effective date of the subscriber-limit rules and determined that the rules would become effective upon the issuance of a court decision that upheld Section 613. On May 19, 2000, the U.S. Court of Appeals for the D.C. Circuit ruled in *Time Warner v. U.S.* that Section 613 is constitutional. This court decision means that the Commission's rules imposing a national limit on the number of cable subscribers that may be served by a single cable operator may be enforced. The Commission has determined that affected parties must comply with these rules no more than 180 days following the issuance of the court decision.

TECHNICAL REQUIREMENTS

Cable systems distribute TV signals either through optical fiber or through coaxial cable strung on existing poles owned by telephone or electric utility companies. Cable operators also may use their own poles, place their cable underground or use transmission facilities or rights-of-way owned or controlled by a utility or municipality. Some may use combinations of these arrangements. Sometimes conflicts arise between cable television systems and utility companies over pole attachment issues, particularly the rates for use of utility facilities. The Communications Act Amendments of 1978 authorized the Commission to resolve such disputes by regulating the rates, terms, and conditions for cable TV pole attachments to ensure they are just and reasonable unless a state regulates such factors.

In 1985, the Commission adopted rules requiring each state to certify that: it has issued, and made effective, rules implementing the state's regulatory authority over pole attachments; its rules and regulations include a specific methodology for regulating pole attachments, and; the methodology has been made publicly available in the state. Local pole attachment requirements may be obtained from local franchising authorities. The amended rules also require that jurisdiction revert to the Commission unless a state acts on a complaint in a timely fashion. The Commission periodically issues public notices listing those states which have filed pole attachment regulation certifications.

The 1996 Act made the existing maximum just and reasonable pole attachment rate formulas temporary applicable to telecommunications carriers and cable operators providing telecommunications services. The 1996 Act also created a distinction between pole attachments used by cable operators solely to provide cable service and pole attachments used by cable operators or by any telecommunications carrier to provide any telecommunications service. The Act prescribed a new methodology for determining pole attachment rates for the latter group. The new formulas will require that, in addition to paying their share of a pole's usable space, these telecommunications service providers also must pay their share of the fully allocated costs associated with the unusable space of the pole, duct, conduit, or right-of-way. In order to implement these new formulas, Congress directed the Commission to issue new pole attachment regulations relating to telecommunications carriers within two years after the date of enactment of the 1996 Act, to become effective 5 years after enactment.

Technical Standards

To ensure the delivery of satisfactory television signals to cable subscribers, the Commission has adopted various technical performance standards which local franchising authorities are generally authorized to enforce through their franchising process. Cable operators are required to establish a complaint resolution process and to advise their subscribers about it annually.

In addition to establishing new standards for the delivery of color signals and of closed captioned data, the Commission generally preempted conflicting local standards. Cable systems with fewer than 1,000 subscribers, as well as those serving rural areas, may negotiate with their respective franchising authorities for certain lower standards.

Prohibited Frequencies

No cable television system may utilize a frequency at power levels equal to or exceeding 10 microwatts within 100 kHz plus tolerance of the emergency aircraft locator frequency 121.5 MHz or within 50 kHz plus tolerance of the distress signal frequencies 156.8 MHz and 243.0 MHz.

Use of Aeronautical Frequencies

The Commission's technical rules include standards to control signal leakage from cable systems. Any cable system, regardless of its size, which intends to use a frequency in the band 108-137 MHz or 225-400 MHz above a power level of 100 microwatts, must first notify the Commission of its intention to do so before using the proposed frequencies. This requirement permits Commission review of the proposed frequency usage and insures that cable operations are on frequencies which are offset from the air navigation and communications functions of local aeronautical radio services. The standards used to determine the permissibility of proposed frequency usage are based on frequency separation between the proposed cable frequencies and aeronautical station assignments. Certain logging and leakage monitoring obligations are also imposed on operators using frequencies within the above-mentioned bands. The requirements on the use of aeronautical frequencies are contained in 47 C.F.R. §§ 76.611 - 76.617. All cable systems using aeronautical frequencies must file a yearly report demonstrating compliance with these rules.

Microwave Facilities

Cable systems obtain certain signals, sometimes from distances impractical to serve by cable, through microwave relay stations. Microwave systems may also be used by cable operators for distribution of signals within the cable system where it is impractical to run cable due to its cost or due to potential signal deterioration. Cable operators may purchase microwave relay service from companies providing such common carrier services, or they may operate their own relay stations licensed by the Commission as CARS stations.

The rules for CARS stations also authorize licensing of mobile remote pick-up stations for the transmission of programming from the scenes of events outside a studio back to the cable studio or headend. In addition, they provide for the licensing of studio-to-headend link stations. A license is necessary to operate a CARS Station. An applicant must file FCC Form 327 for a license. Cable system owners or cooperative enterprises and cable networks with at least 5 million subscribers are eligible to become CARS licensees. A CARS licensee also may serve nonaffiliated cable systems based on a cost-sharing, nonprofit arrangement. These arrangements permit the delivery of cable programming where economies might otherwise prevent a small system from using microwave transmission. Broadcast microwave facilities, are also permitted to provide signals to cable television systems on a similar nonprofit, cost-sharing basis.

The advent of satellite-earth station transmission capability adds another dimension to microwave communications. The interface between a receive-only earth station and a CARS network now offers greater flexibility in the distribution of programming to cable systems and a relatively inexpensive means of providing a long-haul transmission capability.

The rapid growth of the cable industry has led to increased demand for CARS band frequencies. In 1979, the Commission expanded the band from 12.7-12.95 GHz to 12.7-13.20 GHz. In 1983, the Commission allowed cable system operators to use frequencies in the 18 GHz area (specifically 17.7-18.58 GHz and 19.26-19.7 GHz). The Commission added the 31 GHz band for microwave services including CARS and provided access by cable operators and networks to the 2 and 6 GHz Bands (specifically 1.990-2.190, 6.425-6.525 and 6.875-7.125 GHz) for CARS mobile use only.

HOME WIRING

The home wiring rules are intended to encourage competition between multichannel video delivery services by allowing a consumer who voluntarily terminates cable service to use the wiring to receive a competing multichannel video delivery service, such as direct broadcast satellite, wireless cable

("MMDS"), or a different cable service, without the expense and inconvenience of installing new wire.

Under the Commission's rules, cable subscribers may provide and install their own cable home wiring within their premises and may connect additional home wiring within their premises to the wiring installed and owned by the cable operator prior to the termination of cable service. Under this rule, customers may select who will install their home wiring (e.g., themselves, the cable operator or a commercial contractor). In addition, customers may connect additional wiring, splitters or other equipment to the cable operator's wiring, or redirect or reroute the home wiring, so long as no electronic or physical harm is caused to the cable system and the physical integrity of the cable operator's wiring remains intact. Cable subscribers are not permitted to physically cut, improperly terminate, substantially alter or otherwise destroy cable operator-owned inside wiring. To protect the cable system from signal leakage, electronic and physical harm and other types of degradation, the cable operator may require that any home wiring (including passive splitters, connectors and other equipment used in the installation of home wiring) meets reasonable technical specifications, not to exceed the technical specifications of such equipment installed by the cable operator. However, if the subscriber's connection to, redirection of or rerouting of the home wiring causes electronic or physical harm to the cable system, the cable operator may impose additional technical specifications to eliminate such harm.

When a subscriber who does not own the cable wiring within the subscriber's home voluntarily terminates cable service, the cable operator may leave the wiring in place, or may notify the subscriber that it will remove the home wiring unless the subscriber purchases the wire from the operator (on a replacement cost basis). When the subscriber contacts the cable operator to terminate cable service voluntarily, the cable operator, if it owns and intends to remove the home wiring, must inform the subscriber: (1) that the cable operator owns the cable home wiring; (2) that the cable operator intends to remove it; (3) that the subscriber has the right to purchase it; and (4) what the per-foot replacement cost and the total charge for the wiring would be. If the consumer declines to purchase the wiring, the cable operator must remove the wiring at no charge to the subscriber within seven days of the subscriber's decision, under normal operating conditions. If the cable company fails to remove the wiring within the seven business day period, it forfeits its right to remove the wire or restrict its use at any later time. The cable company must pay for any damage done to the subscriber's home while removing the wire.

COMPATIBILITY BETWEEN CABLE SYSTEMS AND CONSUMER EQUIPMENT

Televisions and videocassette recorders ("VCRs") have many special features and functions that may not work when consumers are connected to cable services. The Commission has proposed regulations to allow consumers to use and enjoy the enhanced features of their TVs and VCRs such as "picture-in picture", viewing a program on one channel while simultaneously recording a program on another channel, and recording two or more consecutive programs that appear on different channels. The proposed rules do allow cable operators to protect their premium services from receipt by non-subscribers.

The Commission has established rules to assure compatibility between home electronic equipment and cable television systems so the advanced features of television receivers (TVs) and VCRs will function when connected to cable service. These rules were adopted in accordance with the provisions of Section 17 of the 1992 Cable Act.

The compatibility rules specify a number of measures to promote improved compatibility between existing cable system and consumer electronics equipment. They also include provisions for achieving additional improvements in compatibility through new cable and consumer equipment. These compatibility standards facilitate the recording of one program while viewing another, recording consecutive programs that appear on different channels, use of "picture-in-picture" and other advanced

features of newer television sets, and operation of subscriber-owned remote control units. In addition, the Commission intends to adopt standards for a Decoder Interface connector in new "cable ready" equipment and requirements for cable systems to support its use. This feature of consumer equipment will eliminate the need for set top converters, allowing them to be replaced with electronic components that plug into a special plug in the back of "cable ready" TV equipment.

With respect to existing equipment, the rules address problems associated with the existing universe of cable system and consumer electronic equipment. They require cable systems that use scrambling technology to offer their subscribers supplemental equipment that will enable subscribers to use the extended features of their TVs and VCRs such as "picture-in-picture" and timed recording. To meet such a requirement, the operator can offer to provide subscribers: (1) a single integrated device with dual descramblers/decoders and/or timers and bypass switches or (2) two independent set-top devices which support similar functionalities. The rules further provide that cable operators must offer subscribers the option of having all signals whose reception does not require use of a converter to pass those signals directly to the subscriber's TV or VCR, without passing through the set-top device. This capability can be provided through a by-pass switch or through internal by-pass circuitry in a set-top box. Cable operators are required to provide supplemental equipment on the request of individual subscribers and may charge for equipment provided under these requirements in accordance with the rate regulations for customer premises equipment.

The rules prohibit cable operators from scrambling signals on the basic tier of cable service. This prohibition ensures that consumers who have TVs and VCRs capable of tuning basic service channels are able to continue to receive service on those channels without a set-top device.

Cable operators who employ set-top devices that incorporate remote control capability must permit such operation with commercially available remote control units, or otherwise take no action that would prevent the use such remote control units. Upon a subscriber's request, a cable operator is, however, allowed to disable the remote control functions of a subscriber's set-top box.

The rules require cable operators to provide a consumer education program on compatibility matters to their subscribers. This information must be presented in writing and provided to consumers at least annually and when they first subscribe to the cable service. The consumer education program must alert subscribers that where a set-top device is used to receive service, subscribers may be prevented from using some of the special features and functions of their TVs. These functions include those that allow subscribers to: view one program on one channel and record a program on another channel; record two or more consecutive programs on different channels; and use advanced picture generation features such as "picture-in-picture," channel review and other functions that necessitate channel selection by the consumer device. Under the consumer education program requirements, cable operators must also inform subscribers that: certain TVs and VCRs simply may not be able to receive all of the channels offered by the cable system once they are connected directly to the cable system; there are various types of channelization (tuner reception) incompatibilities; and offer suggestions for resolving channelization problems, *e.g.*, use a set-top channel converter device that could be obtained from either the cable system or a retailer (in the latter case, only simple channel converter devices that do not include descrambling capability); and subscribers may purchase compatible remote control units from other sources. With respect to this last element, cable systems must provide a list of the models of set-top devices they provide to subscribers and a representative list of the remote control units currently available from retailers that are compatible with the set-top devices they employ.

The rules provide standards for new consumer TVs and VCRs marketed as "cable ready" (or "cable compatible") and are intended to provide the necessary flexibility for the transition from the existing analog cable to the new digital systems. The technical standards for "cable ready" consumer electronics

equipment only apply to TVs and VCRs specifically marketed as "cable ready" or "cable compatible." The rules specify that new TVs and VCRs marketed using the terms "cable ready" or "cable compatible" after June 30, 1997, must comply with the "cable ready" equipment standards. The rules further prohibit use of the terms "cable ready," "cable compatible" and other terms and descriptors that convey the impression a device is fully compatible with cable service, in the labeling and packaging of consumer TVs and VCRs manufactured or imported for sale to consumers in this country after October 31, 1994, unless the equipment complies with the "cable ready" technical standards.

RECORD RETENTION

The Commission requires cable operators to maintain various documents and records of their authorization and operation for inspection by the Commission, local franchising authorities and/or the public.

Cable operators must maintain a number of records for Commission inspection. These include a political file, sponsorship identification records, equal employment opportunities ("EEO") records, commercial records for children's programming, records demonstrating compliance with the Commission's leased access provisions, ownership records, the designation and location of the cable system's principal headend, and a list of broadcast television stations carried in fulfillment of the Commission's must-carry provisions.

Records required to be maintained primarily for inspection by the Commission or by local franchising authorities include evidence of compliance with the Commission's technical standards, a current list of channels offered to subscribers, proof-of-performance test data, signal leakage logs and repair records, a copy of the Commission's cable television regulations, records of subscribers (aggregate information used for assessing fees), and records of subscriber complaints on signal quality.

In addition to the above-listed files, cable systems with 1000 subscribers or more must maintain a public inspection file. This file must contain a copy of records to be maintained as part of the political file, sponsorship identification records, EEO documents, commercial records for children's programming, leased access records, ownership records, required proof-of-performance test data, and required signal leakage and repair logs.

The public inspection file must be kept at the office which the system operator maintains for business purposes, such as the place where the operator ordinarily collects subscriber charges, resolves subscriber complaints and conducts other business, or at any accessible place in the community served by the system (such as a public registry for documents or an attorney's office). The public inspection file must be available for public inspection at any time during regular business hours. However, if the cable system serves at least 1,000 but fewer than 5,000 subscribers, these records must only be provided upon request.

Cable operators have the option of maintaining all or part of the public inspection file in a computer database rather than in a paper file. If a cable operator chooses to exercise this option, the cable operator must provide a computer terminal for public use and make paper copies available upon request.

Cable operators must make copies of any materials in the public inspection file available for photocopying at the time of an in-person request. Cable operators may charge a reasonable fee for photocopying. Requests for photocopies must be fulfilled at a location specified by the cable operator, within a reasonable time not to exceed seven days. System operators are not required to honor requests for photocopying by mail but may do so at their discretion.

PROTECTION OF SUBSCRIBER PRIVACY

Cable operators generally are prohibited from using their cable systems to collect personally identifiable information concerning any subscriber without the prior written or electronic consent of the subscriber. However, cable operators may collect this information if necessary to render cable television or other service to the subscriber or to detect unauthorized reception of cable communications.

Cable operators generally are also prohibited from disclosing personally identifiable information without the prior written or electronic consent of the subscriber. However, there are certain circumstances where the cable operator may do so. A cable operator may disclose this information if such disclosure is necessary to render, or conduct a legitimate business activity related to, cable television or other service provided to the subscriber. The operator may also disclose such information pursuant to a court order authorizing the disclosure, however, the subscriber must be notified of such an order by the person to whom the order is directed (such as a government agency or the cable operator). Finally, the cable operator may disclose the names and addresses of subscribers, but the cable operator must provide the subscriber the opportunity to prohibit or limit such disclosure. Moreover, the cable operator must ensure the disclosure does not reveal, directly or indirectly, the extent of any viewing or other use by the subscriber or the nature of any transaction made by the subscriber over the cable system.

At the time of entering into an agreement to provide cable service or any other service to a subscriber, cable operators must notify the subscriber of the following: the nature of any personally identifiable information collected, or that will be collected, regarding the subscriber; the nature of the use of such information; the nature, frequency, and purpose of any possible disclosure of such information; including an identification of the types of persons to whom the disclosure may be made, the period during which such information will be maintained by the cable operator, the times and place at which the subscriber may gain access to such information, and the limitations with respect to collection and disclosure of information by a cable operator and the right of subscribers to enforce these limitations. Notice to the subscriber must be in the form of a separate, written statement and must be clear and conspicuous. Notice must also be given at least once every year that the agreed upon service is provided. "Personally identifiable information" does not include any record of aggregate data which does not identify particular persons.

Cable operators must provide a subscriber access to all personally identifiable information regarding that subscriber. Such information must be made available to the subscriber at reasonable times and at a convenient place designated by the cable operator. The subscriber must be provided a reasonable opportunity to correct any error in such information. Cable operators must destroy personally identifiable information if such information is no longer necessary for the purpose for which it was collected and there are no pending requests or orders for access to such information.

Any person aggrieved by a cable operator's violation of these provisions may bring a civil action in a United States district court. As a remedy, the court may award actual damages, punitive damages, and reasonable attorneys' fees and other litigation costs reasonably incurred. A government entity may obtain personally identifiable information concerning a cable subscriber pursuant to a court order only if the entity offers clear and convincing evidence that the subject of the information is reasonably suspected of engaging in criminal activity and that the information sought would be material evidence in the case. In addition, the subject of the information must be afforded the opportunity to appear and contest the entity's claim.

COMPLAINTS, INVESTIGATIONS AND INQUIRIES

Under the dual jurisdictional approach to cable television regulation, several important areas of regulation are administered by local franchising authorities rather than by the Commission. These include subscriber rates for basic cable service, installation fees, equipment and customer service, where the local franchising authority has chosen to regulate; bills and billing practices; extension of cable service to individual homes and businesses; repairs; improper wiring; theft of service; and false or misleading advertising concerning the cable system's capabilities. Complainants are urged to make their complaints by letter, directed to local officials responsible for regulation of their cable system. In most cases, the local franchising authority will review the charges for basic cable service and equipment to determine if the charges are justified.

Pursuant to the 1996 Act, the Commission's authority to regulate the rates charged for cable programming service was terminated on March 31, 1999. Therefore, the cable company determines the rate for this service and the Commission does not have the authority to review the rate or to accept complaints about the rate.

The Commission is particularly interested in interference problems to cable service generated by citizens band or amateur radio operations. These problems may be addressed to the Commission field office located closest to the affected cable system or to the Commission headquarters in Washington, D.C.

REQUESTS FOR SPECIAL RELIEF

A cable system operator, broadcaster, franchising authority and, under certain circumstances, individuals, by filing a petition for special relief with a filing fee, may seek special relief or a waiver of any rule relating to cable television. Requests for declaratory orders seeking Commission interpretation of a disputed question about the rules may be treated as petitions for special relief or rulemaking. Neither complaints related to the mandatory carriage provisions, nor petitions for declaratory ruling are subject to a filing fee.

A petitioner may submit the request by letter, accompanied by a certification that all interested parties who may be directly affected by any Commission action have been given a copy of the request. In addition to stating the relief requested, the petition should contain the facts demonstrating the need for relief and should show how granting the request would serve the public interest. An original and two copies of the petitions not requiring a filing fee must be filed with the Office of the Secretary, Federal Communications Commission, 445 12th Street, S.W., Washington, D.C. 20554. Any petition requiring a fee must be submitted, along with a check or money order, to: Federal Communications Commission, Cable Services Bureau, P.O. Box 358205, Pittsburgh, Pennsylvania 15251. Notification about the filing of petitions for special relief is given to the general public through Public Notices published by the Commission. These Notices are accessible through the Internet at: Web site: http://www.fcc.gov.

Any person may submit comments in opposition to or in support of the petition generally within 20 days after it is filed. These pleadings also must be served on the petitioner and on all persons listed in the petitioner's certificate of service, and an original and two copies should be submitted to the Secretary. The petitioner may then file reply comments within generally 10 days after the submission of comments or oppositions.

SHOW CAUSE ORDERS AND FORFEITURE ACTIONS

In response to a petition, or on its own motion, the Commission may issue an order to show cause or initiate a forfeiture proceeding. This action begins a proceeding similar to a civil suit for an injunction; if the complainant prevails at the hearing, the Commission issues a cease and desist order and/or a

forfeiture. Such a proceeding may be started by filing an original and two copies of a petition that the Commission subsequently places on public notice. Comments or oppositions may be submitted within 30 days and replies within 20 days. In the case of a forfeiture, a hearing may be held, but in almost all cases, a decision on a forfeiture is made without a hearing.

Such petitions usually seek to remedy an alleged violation of the Commission's rules. A copy of the petition should be sent to the cable system operator and to other interested parties. It is possible, however, for an individual or group to join a cable system in opposing a request for an order to show cause. Once all the pleadings have been submitted, the Commission reviews the arguments and determines whether an order to show cause should be issued or a forfeiture proceeding should be initiated.

Forfeiture Authority

The Commission has the authority to impose monetary forfeitures on cable television systems or CARS licensees found to be in violation of the Commission's Rules, terms or conditions of a certificate or license, any Commission order, or any provision of the Communications Act. The Commission may impose forfeitures on cable systems by issuing either a notice affording an opportunity for hearing or a notice of apparent liability. The maximum fine imposed on cable system operators for each separate offense is $25,000 for each day, the total fine not to exceed $250,000 for each notice of apparent liability or hearing. Each day of a continuing violation is considered a separate offense. In the case of cable systems, the Commission must issue any such notice within one year of the offense.

RULEMAKING PROCEEDINGS

The Commission is continually in the process of adopting new rules or amending existing ones to ensure its regulations serve the public interest. Since many of these rules have widespread impact, the public may want to participate in the rulemaking process. Anyone may petition the Commission to adopt a rule at any time. A petition should include the text or substance of the proposed rule and provide supporting arguments, rationale, and data for the proposed new rule.

If the Commission initiates a rule making proceeding, it will issue a "Notice of Proposed Rulemaking" inviting public comment for a limited time period -- usually 30 days or more. A summary of the notice is published in the Federal Register which is available in many large libraries. In addition, trade publications also report the issuance of rulemaking notices.

The rules require that an original and five copies of all petitions and comments be filed. Participants who want each Commissioner to have a copy may submit 12 copies (an original and 11 copies). Members of the public may participate informally in rulemaking proceedings by submitting a single copy of their comments. This information should be mailed or delivered to the Office of the Secretary, Federal Communications Commission, 445 12th Street, S.W., Washington, D.C. 20554.

CITIZEN PARTICIPATION IN COMMISSION REGULATION

The Commission encourages and invites input from the public in all phases of its regulatory proceedings. Persons interested in participating by filing comments but who are unfamiliar with Commission procedures may contact the FCC's Call Center at no charge by dialing 1-888-CALLFCC (1-888-225-5322). The Call Center offers Commission information and outreach to individual consumers, public interest and consumer organizations, and other interested persons.

Any member of the public may participate in the Commission's regulatory proceedings. The Consumer Assistance Branch maintains and disseminates general information bulletins on the functions and organization of the Commission, historical information on Commission actions and policies as they relate to its minority ownership policies, and fact sheets that provide concise information on policy changes and information concerning new telecommunications services.

As part of its ongoing outreach activities, the Commission holds a monthly "brown bag" luncheon series on issues and recent policy changes. It conducts other workshops and seminars designed to keep the public informed. It conducts briefings for visitors, colleges and universities with an interest in learning more about the Commission and its regulatory authority.

The Commission's Office of Public Affairs issues public notices of the filings of cable TV registration statements, petitions, comments and Commission actions. Copies of FCC decisions and comments filed may be obtained from the Commission's duplicating contractor, International Transcription Service, telephone (202) 857-3800. Selected documents may be obtained through the Internet at the following address: Web site: http://www.fcc.gov. Several commercial distributors will send copies of all, or selected, public notices and news releases on a regular basis for a fee. A list of these distributors is available from the Public Service Division. Other sources of information include trade publications, such as *Broadcasting & Cable, Cablevision, Communications Daily, Television Digest, Electronic Media and Multichannel News.*

REPORTS AND FORMS

The Commission uses a variety of forms for specific purposes. Below is a list of the most frequently requested forms relating to cable television, and those which are required to be filed under our rules. Unless otherwise indicated, copies of these forms may be obtained by calling the Commission at: (202) 418-FORM (3676).

Cable System Forms:

Form 320 - Signal Leakage - At least once annually, every cable system must file a Form 320 which reports the results of signal leakage tests conducted by the operator. This form can be downloaded from the following Internet address: Web site: http://www.fcc.gov/formpage.html.

Form 325A - Annual Report - This report is required to be filed by every cable system on an annual basis. The Commission sends these forms to the operator and requests verification of the accuracy of the information on the form.

Form 394 - Application for Franchise Authority Consent to Assignment or Transfer of Control of Cable Television Franchise - This form is required to be filed by a cable system with its local franchising authority, for its approval prior to the cable system transferring ownership and/or control. This form can be downloaded from the following Internet address: Web site: http://www.fcc.gov/formpage.html.

Form 395A- Employment Report - At least once annually each cable operator must file an annual employment report. These forms are sent to the operator by the Commission for the operator to verify the accuracy of information. To request a copy of this form, call the Commission at (202) 418-1450.

*****The following 1200 series forms can be downloaded from the following Internet address: Web site: http://www.fcc.gov/formpage.html.*****

Form 1200 Setting Maximum Initial Permitted Rates for Regulated Cable Services Pursuant to Rules Adopted February 22, 1994 -- "First Time Filers Form" This form is used by operators the first time they filed any form to calculate maximum permissible rate under the rules.

Form 1205 Determining Regulated Equipment and Installation Costs -- "Equipment Form". This form is used to calculate allowable equipment costs. Generally, this form is submitted with a Form 1200 and then on an annual basis.

Form 1210 Updating Maximum Permitted Rates for Regulated Cable Services and Equipment -- "Update Form". This form is used to update the maximum permissible rate calculated using Form 1200 or a previous filing of Form 1210.

Form 1215 A La Carte Channel Offerings. This form is filed with each Form 1200 and each Form 1210 that you file to provide information on your a la carte service offerings.

Form 1220 Cost of Service Filing for Regulated Cable Services. Generally, this form is used by operators who believe their costs exceed the rates they would be permitted to charge under Form 1200 or 1210.

Form 1225 Cost of Service Filing for Regulated Cable Services for Small Systems. This form is used to file a streamlined cost of service showing by a small system, as defined in the Form, whose costs exceed maximum permissible rates.

Form 1230 Establishing Maximum Permitted Rates for Regulated Cable Services on Small Cable Systems. Pursuant to Commission rules adopted May 5, 1995, qualifying small cable systems owned by a small cable company may use this simplified cost-of-service procedure to set maximum permitted rates.

Form 1235 Abbreviated Cost-of-Service Filing for Cable Network Upgrades. This form enables cable operators to justify rate increases for significant network upgrades used to improve services to regulated cable subscribers. Form 1235 permits operators seeking rate increases to cover the costs of upgrades to submit only the costs of the upgrade instead of all current costs normally submitted in a cost-of-service filing.

Form 1240 Annual Updating of Maximum Permitted Rates for Regulated Cable Services. This form enables cable operators to adjust rates once per year to reflect reasonably certain and reasonably quantifiable changes in external costs, inflation, and the number of regulated channels that are projected for the 12 months following the rate change.

Franchise Authority Form:

Form 328 - Certification of Franchise Authority to Regulate Basic Service Rates and Initial Finding of Lack of Effective Competition - This form must be filed by any local franchising authority which intends to regulate basic cable service rates within the franchise area. The form requests information relating to the cable system to be regulated, requests the franchise authority certify that there is no effective competition, and requests that the franchise authority certify that it will adopt rate regulations and procedural regulations consistent with those of the Commission. This form can be downloaded from the following Internet address: Web site: http://www.fcc.gov/formpage.html.

Cable System Additional Reporting Requirements (No Form Required)

Whenever a change occurs in a system's mailing address, operator legal name or operational status, the operator must notify the Commission of the change within 30 days. The operator must furnish its legal name and type (individual, private association, partnership, or corporation), including the Employment Identity number or the Social Security number (if the company is an individual or partnership); the assumed name, if any; the mailing address; the nature of the operational status change; and the names of the communities affected and their FCC community unit identifier numbers.

HOW TO OBTAIN INFORMATION

Every cable operator serving 1,000 or more subscribers is required by the Commission to have an up-to-date copy of the Cable Television Rules and Regulations (47 C.F.R. Part 76 and 78) and to keep track of Commission actions that might alter the rules.

Due to budgetary constraints, the Commission is unable to supply copies of its regulations and orders free of charge. We regret that we are unable to do so. However, photocopies of the Commission's rules and orders may be obtained from International Transcription Services (ITS) at (202) 857-3800, or through the Internet at the following addresses: Gopher site: gopher.fcc.gov; Web site: http://www.fcc.gov/; and FTP site: ftp://ftp.fcc.gov/.

Copies of the Telecommunications Act of 1996, the Cable Television Consumer Protection and Competition Act of 1992, the Cable Communications Policy Act of 1984, and the entire Communications Act in the form of a Compilation of Communications Laws, the Code of Federal Regulations (47 C.F.R. Parts 70-79, including Part 76-Cable Regulations), or the Federal Register Summaries of decisions by published date, may be purchased from the Government Printing Office (GPO) in Washington, D.C. at (202) 512-1800. GPO outlets are also located in many major cities.

Copies of Fact Sheets on Cable Television Regulation may be obtained via the Internet at http://www.fcc.gov/csb/facts/csogpofa.html, from the Call Center at 1-888-225-5322, or through the use of Fax-on-Demand, or the Internet at the following electronic addresses: Gopher site: gopher.fcc.gov; Web site: http://www.fcc.gov/; and FTP site: ftp://ftp.fcc.gov/.

OBTAINING FURTHER INFORMATION FROM THE COMMISSION

The Cable Services Bureau is located at 445 12th Street, S.W., Washington, D.C. General inquiries should be directed to the Federal Communications Commission, 1-888-225-5322 (1-888-CALLFCC). This is a toll-free call. Commission offices are normally open from 8:00 a.m. to 5:30 p.m., Monday through Friday, excluding federal holidays, unless otherwise stated.

- FCC -

FiberSouth (BTI)

BTI Wake County

ORDINANCE NO. (1996) 947

STATE OF NORTH CAROLINA

CABLE - TELEVISION FRANCHISE

COUNTY OF WAKE

This Franchise, issued this 6th day of August, 1996 by and between the City of Raleigh, a North Carolina municipal corporation and FiberSouth, Inc., a North Carolina corporation, herein after the Grantee.

WHEREAS, the City of Raleigh, hereinafter referred to as "City", desires to assure the widespread availability of Cable Services within the City to promote commerce and otherwise further the public interest;

WHEREAS, the City seeks to ensure that the cable system deployed within the city enables all people to effectively exercise their fundamental rights to pursue and exchange information;

WHEREAS, the City desires to assure that cable service providers shall interconnect their facilities to offer unrestricted access to other information networks;

WHEREAS, the City is the owner of certain street rights-of-way;

WHEREAS, the City has, following reasonable notice, conducted full public proceedings, which proceedings were concerned with the analysis and consideration of the technical ability, financial condition, legal qualification and general character of the franchisee;

WHEREAS, the City, after consideration, analysis and deliberation, has approved and found sufficient the technical ability, financial condition, legal qualification and character of said Grantee;

WHEREAS, the City has also considered and analyzed the plans of the Grantee for the construction and operation of the Cable System and found the same to be adequate and feasible in view of the needs and requirements of the area to be served by the Cable System;

WHEREAS, the City has determined that it is in the best interest of and consistent with the public convenience and necessity of the residents of Raleigh to grant a franchise to FiberSouth, Inc. to operate a Cable System within the confines of the City and on the terms and conditions hereinafter set forth; and,

WHEREAS, the Grantee wishes for its sole interest and convenience to construct and or lease a fiber optic, coaxial and multi-pair cables along portions of the City's right-of-way; said areas being more fully described in Section 3.

NOW, THEREFORE, the parties agree as follows:

Section 1. Nature and Terms of Grant

A. City does hereby convey to the Grantee a city wide franchise to operate a Cable System, using owned [constructed] and leased facilities, in the City rights-of-way.

B. Notwithstanding the preceding, Grantee is awarded a franchise to construct and or lease fiber optic, coaxial and multi-pair cable and other cable communication facilities from City licensed or franchised providers to support the deployment of its Cable System throughout the City.

C. Grantee is given the right to operate its Cable System, as defined in Section 2, for a ten [10] year term, and may be renewed for one [1] consecutive term, subject to the conditions of then current City ordinances, public right-of-way use, and encroachment policies. The initial term shall commence on the date this Franchise is executed by the City.

Section 2. Definitions

For the purposes of this Franchise, the following terms, phrases, words, abbreviations and their derivations shall have the meaning given herein, when not inconsistent with the context, words used in the present tense include the future tense, words in the plural number include the singular number, words in the singular number include each of the other genders. The words "shall" and "must" are always mandatory and not merely directory .

"Access" shall mean any programming or channel designated for use by any other person other than the company.

"Access Center" shall mean the agency or agencies responsible for the administration, production and acquisition of television programs for telecast on the public, education and government access channels.

"Affiliate", when used in relation to any person, shall mean another person who owns or controls, is owned or controlled by, or is under common ownership or control with, such person.

"Basic Cable Service " or "Basic Service" shall mean any service tier which includes the retransmission of local television broadcast signals and access channels. This definition is

subject to changes in applicable Federal law.

"City Council" shall mean the City Council of the City of Raleigh, North Carolina or its designee.

"Cable Operator" shall mean any person or group of persons:

(1) who provides cable service over a cable system and directly or through one or more affiliates owns a significant interest in such cable system, or

(2) who otherwise controls or is responsible for, through any arrangement, the management and operation of such a cable system.

"Cable Service" shall mean:

(1) the one-way transmission to subscribers of (a) video programming, or (b) other programming service, and,

(2) subscriber interaction, if any, which is required for the selection or use of such video programming or other programming service.

"Cable System" shall mean a facility, consisting of a set of closed transmission paths and associated signal generation, reception, and control equipment that is designed to provide cable service which includes video programming and which is provided to multiple subscribers within a community, but such term does not include:

(1) a facility that serves only to retransmit the television signals of one (1) or more television broadcast stations;

(2) a facility that serves subscribers without using any public right-of-way;

(3) a facility of common carrier which is subject, in whole or in part, to the provisions of The Telecommunications Act of 1996, except that such facility shall be considered a cable system (other than for purposes of 47 USC §541(c)) to the extent such facility is used in the transmission of video programming directly to subscribers; unless the extent of such use is solely to provide interactive on-demand services; and,

(4) an open video system that complies with 47 USC § 653.

"City" shall mean the City of Raleigh or the area within the present and future territorial city limits of the City and such territory outside of the City over which the City has jurisdiction or control by virtue of any law.

"Channel" shall mean a 6 MHZ band of analog frequencies, or future encoding standard, in the electromagnetic spectrum (or any other means of transmission, including but not limited to optical fibers, which is capable of carrying the equivalent signal or signals), and includes uses of all or any portion of such band of frequencies for digital video/television signals.

"Construction Completion Date" shall mean the date, after receiving a request from franchisee, on which the City or its designee issues a certificate of completion to a franchisee.

"Customer Service Standards" shall mean FCC, National Cable Television Association, or successor organization, and standards adopted by the City, which govern the manner in which the Grantee interacts with the public and its customers.

"FCC" shall mean the Federal Communications Commission.

"Franchise" shall mean an initial authorization, or renewal thereof,(including a renewal of an authorization which has been granted subject to 47 USC§ 546), issued by the City, whether such authorization is designated as a franchise, permit, license, resolution, contract, certificate, agreement, or otherwise, which authorizes the construction or operation of a cable system but neither supersede nor take the place of any license, license fee or permit authorization which might otherwise be required for the privilege of transacting and operating a subscription Cable Service under any other City ordinance licensing or regulating business within such areas.

"Grantee" or "Franchisee" or "Company" shall mean the person, firm, or corporation to whom a franchise, as hereinabove defined, is granted by the City Council under this article, and the lawful successor, transferee or assignee of said person, firm, or corporation.

"Gross Revenues" shall mean all receipts received by the grantee, arising from to attributable to the sale of cable services or derived from the operation of the Cable System, including, but not limited to, monthly Cable Service fees; installation, connection, disconnection, reconnection up/down grade fees for the provision of Cable Service, leased access fees, late fees, returned check fees, bad debt recovery, interactive Cable Service fees, equipment sales, service and rentals; net advertising revenues attributed to the operation of the Cable System, revenues received by Grantee for home shopping program service carriage. Excluded are converter or other equipment deposits, bad debts, franchise fees, FCC regulatory charges, any sales, excise, or any other taxes collected by Grantee on behalf of any state, City, or other governmental unit [e.g., receipts remitted to the Access Center]. In no event shall Gross Revenue include any revenues otherwise classified as NOT a Cable Service revenue pursuant to federal or state law.

"Initial Service Area" shall mean that geographical area within the incorporated limits of the City as of the date of acceptance of a franchise pursuant to this article.

"**Interactive on-Demand Services**" shall mean a service providing video programming to subscribers on an on-demand basis, but does not include services providing video programming pre-scheduled by the programming provider;

"**NCTA**" shall mean the National Cable Television Association or successor organization.

"**Other Programming Service**" shall mean information audio, video, data or text service that a cable operator makes available to all subscribers;

"**Person**" shall mean an individual, partnership, association, joint stock company, trust, corporation, or governmental entity;

"**Public, Educational, or Governmental Access Facilities**" shall mean:

(1) channel capacity designated for public, educational, or governmental use; and,

(2) facilities and equipment for the use of such channel capacity;

"**Public Buildings**" shall mean county, city or town supported K-12 schools, post secondary technical schools, county and city government buildings [facilities] and county, city or town supported rescue and volunteer fire facilities.

"**Public Way and Right-Of-Way**" shall also mean the surface of, and the space above and below all streets, avenues, boulevards, roads, alleys, lanes, squares, bridges, viaducts, easements, tunnels, causeways, greenways, and sidewalks, lying within the street right-of-of-way, and all other public highways within the City.

"**Reasonable Notification**" shall mean 10 days for all non financial related matters and 30 days for financial matters.

"**Residential Subscriber**" shall mean a subscriber who receives service in an individual dwelling unit or multiple dwelling, where the service is not to be utilized in connection with a business, trade or profession.

"**Street**" shall mean the surface of and the space above and below any publicly owned or maintained property or right-of-way, street, road, highway, freeway, land, path, alley, court, sidewalk, parkway or drive, now or hereafter existing as such within the City.

"**Subscriber**" shall mean any person or entity lawfully receiving any portion of the Cable Service of a Grantee pursuant to this Franchise.

"**Service Tier**" shall mean a category of cable service or other services provided by a cable operator and for which a separate rate is charged by the cable operator;

"**Year**" shall mean a calendar year; and,

"**Video Programming**" shall mean programming provided by, or generally considered comparable to programming provided by, a television broadcast station.

Section 3. Service Area

A. The Grantee's initial service area, as defined in its cable television application, attached as **Exhibit A** and incorporated by reference as if fully set forth herein, is generally bounded by South Street on the south, Falls of the Neuse Road to the west, Capitol Boulevard to the east and Durant Road to the north.

B. The Grantee shall extend its Cable System in accordance with plans submitted to the City.

Section 4. Customer Service Standards

City has determined that it is in the best interest of its residents and consistent with the public convenience and necessity to adopt Customer Service Standards for the provision of cable services by the Grantee within the confines of the City. The standards, as they may be amended from time to time, set forth the terms and conditions for consumer protection. The Grantee shall operate its enterprise in a manner consistent with the City's Customer Service Standards, attached as **Exhibit B** and incorporated by reference as if fully set forth herein.

Section 5. Compensation and Auditing

A. Grantee shall pay the City of Raleigh throughout the term of this Franchise, as compensation, an annual franchise fee of five percent [5%] of the Grantee's Gross Revenues as defined in Section 2 or the maximum amount permitted by the Cable Act if hereafter adopted by resolution of the Grantor.

B. All such payments of franchise fees shall be payable quarterly by April 30, July 31, October 31 and January 31 for the preceding three [3] month periods ending respectively on March 31, June 30, September 30 and December 31. Franchise fee and Access Center payments shall be accompanied by a report itemizing and setting forth the revenues/receipts and showing the calculation of the payment[s] due for the preceding period.

C. The payment of the franchise fee by the Grantee is for the right to construct and operate its Cable System, as defined herein, within the public way and is in lieu of an

encroachment fee payment.

D. The City on an annual basis, shall be furnished a statement within ninety (90) days of the close of the calendar year, certified by an official of the franchisee responsible for the cable system's financial statements, reflecting the total amounts of Gross Revenues as defined herein, and all payments, and computations for the previous calendar year. Upon ten (10) days prior written notice, the City shall have the right to conduct an independent audit of Grantee's records. If, after resolving any dispute arising from such audit, Grantee has made a license fee under-payment of three percent (3%) or more, the Grantee shall assume all reasonable costs of such audit. In other events, the City shall sustain all costs associated with such audit.

E. All Grantee's books, maps and records concerning its Gross Revenues and its calculation of payments to the City, shall be open for inspection by the appropriate officer of the City, or its designee, at all convenient times to determine the amount of compensation due to the City from Grantee under this License. Such records shall be kept so as to accurately show the same. Grantee shall prepare and make available to the City at times reasonably prescribed by the City and in the form prescribed by the City after consultation with the Grantee, such reports with respect to its Cable System in Raleigh and the Gross Revenues derived therefrom, as the City may deem reasonably necessary or appropriate. All other reports required by the City shall be made by Grantee from time to time as required.

F. In the event Grantee makes one or more underpayments or in the event Grantee fails to make any payment on or before the date it is due, Grantee shall pay interest at a rate of one and one half percent (1.5%) per month on said underpayment(s) and/or said late payments.

G. Consistent with federal requirements, the Grantee shall file no less frequently than annually any tariffs, amendments, or modifications affecting the sale of its services and subscriber terminal equipment and shall provide written notification to the City within thirty (30) days of any proposed changes. The Grantee shall also provide to the City copies of all filings, reports and petitions to local, state, or federal regulatory agencies.

Section 6. Franchise - Not Exclusive

A. This Franchise is not exclusive. The City expressly reserves the right to grant franchises to other persons or corporations, as well as the right in its own name, to operate a cable system for similar or different purposes allowed Grantee hereunder. The material terms and conditions of such additional franchise or franchises shall be reasonably comparable to the material terms and conditions herein, taking into consideration all of the circumstances in existence at the time such additional franchise or franchises are granted, including without limitation any applicable legal limitations on the City's regulatory authority and the necessity to provide for competitive entry of multiple providers.

B. The grant of a cable television franchise to another enterprise may result in the Grantee having fewer or greater obligations than those established by this Franchise. The Grantee or the City may modify these provisions, in accordance with Section 36 to preserve a competitive market place.

C. The City reserves the right to require the Grantee to secure a separate telecommunication franchise or license, to the extent consistent with federal and state law, for the provision of telecommunication services within the City.

Section 7. No-Waiver

A. The failure of the City, upon one or more occasions, to exercise a right or to require compliance or performance under this franchise agreement or any other applicable law shall not be deemed to constitute a waiver of such right or a waiver of compliance or performance, unless such right has been specifically waived in writing.

B. Waiver of a breach of this franchise agreement or the enabling ordinance is not a waiver of any similar or different breach. Neither the granting of this Franchise nor any provision herein shall constitute a waiver or bar to the exercise of any governmental right or power of the City.

Section 8. Regulation

A. The City Council shall be vested with the power and authority to reasonably regulate the exercise of the privileges permitted by this Franchise in the public interest. Any failure by the City to promptly enforce compliance with this Franchise in accordance to federal, state and local laws and ordinances shall not relieve Grantee of its obligation to comply with any provision of this Franchise.

B. The Grantee's rights, without limitation upon the City's regulatory authority, pursuant to the Telecommunications Act of 1996 or any other subsequent federal or state law, shall not be abrogated or otherwise limited.

C. Following reasonable notice, the City reserves the right to inspect the installation and maintenance of all Cable System related facilities.

D. All construction maps, shall be provided to the City no less than 10 days prior to the commencement date for review and approval. As built maps shall be provided no more than 30 days following the conclusion of construction for each grid.

E. Construction and as-built documents shall be provided in both hard copy [paper] and electronic [data files] formats. The electronic version must be based upon NC State Plane

Coordinates NAD 1983. The Grantee shall provide Graphic Data System Software [GDS] files. Intermediate DXF files will be accepted as an alternative to the GDS files.

F. The Grantee shall comply with the FCC, NCTA and Customer Service Standards promulgated by the City for cable-telecommunication service providers as they may be amended from time to time.

G. The Grantee shall comply with all federal, state and local regulations, such as the National Electrical Code, National Electrical Safety Code, Fiber Optic Cable Installation Specifications, 1987 [Telecommunication Industry Committee], traffic safety/lane closure rules and construction requirements promulgated by the City and as amended periodically.

Section 9. Public Way Use Conditions

A. The City reserves the right, upon reasonable notice, to require the Grantee at his expense to protect, support, temporarily disconnect, relocate or remove from the City's streets any property of the Grantee by reason of traffic conditions public safety, street construction or excavation, change or establishment of street grade, installation of sewers, drains, water pipes, power or communication lines, tracts, or other types of structure or improvements by governmental agencies or any structures of public improvement. Reasonable notice for this provision shall be construed to mean at least ninety (90) days except in the case of emergencies where no specific notice period shall be required. The City shall endeavor to notify and seek comment from the Grantee, with respect to minimizing disruption to the cable system, where public works projects may affect the Grantee's cable system.

B. Whenever a public way exists to accommodate the Grantee's system, the Grantee shall not locate its facilities off the public of way and shall make every effort to locate its facilities within the public way before seeking private easements within the City and the Extra Territorial Jurisdiction [ETJ]. The Grantee shall, at no cost to the city, relocate its facilities and appliances which are in conflict with City projects to upgrade or construct roadways.

C. The Grantee shall locate, place and construct its facilities so as not to interfere with the construction, location and maintenance of sewer or water mains, lines or connections. The Grantee shall take the necessary preventative measures to protect existing the facilities within the public way.

D. The Grantee shall adhere to all federal state and local regulations as it relates to the location, construction, and maintenance of its facilities within or along the public way.

E. The Grantee shall restore and replace landscaped areas, pavement, pedestrian lighting, sidewalks, curbs, gutters or other facilities damaged by the Grantee or its contractors with like material to their former condition at the Grantee's expense, and shall thereafter, from time to time,

but no longer than one (1) year from the completion of the job, readjust, fill and finish the same as may be necessary due to settling of the earth beneath associated with the Grantee's disruption of the public way.

F. The City, at its sole discretion, may require the Grantee to locate and identify its facilities within the pubic way.

Section 10. Subscriber Network

A. The Cable System shall generally conform to the hybrid fiber coaxial [HFC] system design and channel capacity specifications set forth by the Grantee in its Cable Television Application submitted to the City on February 21, 1996. At a minimum, the Grantee shall construct a hybrid fiber coax [HFC] 750 MHZ star bus cable system in accordance with its application, attached as **Exhibit A** and incorporated by reference as if fully set forth herein. The Grantee is permitted to modify its design and implementation plan, pursuant to the conditions provided herein, to accommodate technological innovations and refinements which enhance system reliability and capacity.

B. The cable system shall be capable of distributing MPEG-2 video/audio compression formats to provide additional digital television program channels and services as consumer demand dictates.

C. Analog and digital television [audio/video] services shall be transported on the Grantee's fiber backbone to fiber nodes for redistribution to commercial and residential subscribers via coaxial cable.

D. The cable system shall satisfy all FCC, NCTA and industry standards for such cable systems.

E. The initial service build required under this franchise shall be completed no later than forty-eight (48) months after the effective date of this Franchise. If the Grantee shows that, notwithstanding its due diligence, that it has been unable to extend service to a specified area because the acts or omissions of a third party (not including the Grantee's subcontractors or agents) have caused a delay in construction beyond delays reasonably expected during the course of an upgrade or rebuild, and the Grantee proposes a reasonable alternative deadline for extension of service to that area, the City shall grant reasonable extensions of time to complete the build.

Section 11. System Design Review Process.

A. At least thirty (30) days prior to the date construction of any initial build, upgrade or rebuild is scheduled to commence, the Grantee shall provide a detailed cable system design and construction plan which conforms to applicable federal, state, local and industry standards, for

review by the City at the local office of the Grantee, which shall include at least the following elements:

1. Design type; trunk and feeder design; number and location of hubs or nodes used;

2. Distribution system cable, fiber, equipment to be used;

3. Headend design and reception facilities including make and model number of antennae, signal processors, modulators, demodulators, etc.

4. Plans for standby power at headend, hub nodes, and satellite terminals. The plan should state the make and model number of equipment to be used as well as time capacity.

5. Longest amplifier cascade in the cable system (number of amplifiers, number of miles, type of cable fiber).

6. Design maps and tree trunk maps for the cable system. The cable system design will be shown on maps of industry standard scale using standard symbols, and shall depict all electronic and physical features of the cable plant.

B. The City shall have thirty (30) days to review and approve the Grantee's design and construction plans. Such approval shall not be unreasonably withheld. The Grantee shall submit written responses to review comments presented the Grantee by the City, and if necessary submit an amended plan, within ten (10) days.

C. The Grantee shall not set new utility poles for the installation of aerial facilities within the public way. This provision does not prevent the Grantee from leasing space on existing utility poles for its aerial cable distribution facilities from an existing power or telecommunication wireline provider [lessor]. Upon reasonable notice from the lessor, the Grantee shall relocate its aerial facilities underground upon the removal, elimination or vacation of an existing utility pole line.

Section 12. Initial and Continuing Tests

The Grantee shall perform all tests necessary to demonstrate compliance with the requirements 47 CFR 76 subpart K. All tests shall be conducted in accordance with federal rules and in accordance with the most recent edition of NCTA "Recommended Practices for Measurements on Cable Television Systems." The Grantee shall perform at least the following tests:

A. The Grantee shall perform preconstruction quality tests on system components

determined by the Grantee based on random samples. All new trunk and distribution cable shall be swept and Time Domain Reflectance [TDR] tested on the reel to verify compliance with manufacturer's specification of frequency response and structural return loss. No component shall be used in the cable system which fails to meet the manufacturer's specification.

B. The Grantee shall perform acceptance tests on the cable system at the conclusion of the build to demonstrate compliance with 47 CFR 76 subpart K. The City will be permitted to witness the tests. The test results shall be submitted to the City for review. The City shall issue a Certificate of Completion within 10 [10] days, upon receipt and review of the Grantee's proof-of-performance test, for any portion [e.g. node or power supply service area] of the cable system satisfying acceptance test parameters. The Grantee shall have the obligation, without further notice from the City, to take corrective action if any segment is not operating or performing within 47 CFR 76 subpart K.

C. Upon reasonable notice, the Grantee and the City will jointly select test points at various points of the cable system. The quantity of these test points will be mutually agreed upon based on what best represents the architecture of the cable system. The Grantee shall perform Proof of Performance Tests at these locations in conformance with testing required by 47 C.F.R. 76 subpart K through the life of the Franchise, and at other points mutually agreed upon where cable system user complaints indicate tests are warranted or as required to test all major trunk lines. The City will be permitted to witness the tests. A written report of the test results shall be filed with the City within thirty (30) days of the test. If a location fails to meet performance specifications outlined in 47 CFR 76 subpart K, the Grantee, without requirement of additional notice or request from the City, shall take corrective action, re-test the locations, and advise the City of the action taken and results achieved.

D. The City may conduct inspections of construction areas and subscriber installations, including to assure compliance with applicable laws, codes, and requirements of this Franchise. Any testing of the system necessary to accomplish such inspections shall only be performed in the presence of an authorized employee of the Grantee and only after reasonable advance notice to the Grantee. The Grantee shall be notified in writing of any violations found during the course of inspections. The Grantee must bring violations into compliance within whatever reasonable time is determined by the City, and submit a report to the City describing the steps taken to bring itself into compliance. Inspection does not relieve the Grantee of its obligation to build in compliance with all provisions of the Franchise.

E. Other Construction Procedures.

1. The Grantee shall:

a) file plans with the City's Streets Division and secure permits to perform work in the public way. The Grantee, its contractors and subcontractors shall keep the permit on the job site;

b) follow a cable system design and construction plan consistent with its obligations under this Franchise, and use the equipment specified (or substitute equipment of equivalent or better quality) in such distribution system design plan and construction plan (except insofar as those plans, if carried out, would result in construction of a system which would not meet requirements of federal, state, or local law; and except for such minor modifications as are typical in the industry); shall use equipment of good and durable quality;

c) provide a monthly construction report to the City in a form reasonably acceptable to the City;

d) maintain a public file showing its plan and timetable for rebuild of the cable system (the Grantee shall notify residents in any rebuild area at least one day in advance before first entering onto property to perform any work in conjunction with cable system rebuild, and shall additionally notify affected residents in advance of any work which will involve excavation, replacement of poles, or tree trimming);

e) submit as-built and design maps for the City's review at the local office of the Grantee after the completion of system construction in any geographic area; and,

f) make available to the City upon request maps showing the actual location of additions or extensions to its lines within thirty (30) days of completion of cable system construction in any geographic area.

2. System Maintenance

a) Interruptions to be Minimized. The Grantee shall schedule maintenance whenever possible so that activities likely to result in an interruption of service are performed during periods of minimum subscriber use of the cable system. The Grantee shall make best efforts to minimize interruptions of service consistent with reasonable and customary construction practices.

b) Maintenance Practices. In addition to its other obligations, the Grantee shall (a) use replacement components of good and durable quality, with characteristics better or equal to replaced equipment; and (b) follow the more stringent of industry maintenance standards or corporate maintenance standards.

3. The cable system shall meet or exceed the standards set forth in 47 CFR. 76 subpart K ("FCC Standards"), as those standards may be in effect at all times. If the FCC Standards are eliminated and not replaced, the City may continue to

enforce the standards which existed prior to the date of elimination. If the City has authority to establish standards, standards may be amended or added in conjunction with, and subject to, the Four Year Review.

4. The Grantee shall extend its cable system to provide service to other areas located within the City limits as competition and market conditions warrant.

Section 13. Allocation of Resources for Public Purposes: I-Net & PEG Access

A. The Grantee shall designate 5% of the installed capacity on its cable system, exclusive of PEG channels, for civic purposes. Such capability shall be available to the City and designated public agencies for I-Net purposes pursuant to terms and conditions described herein. The Institutional Network shall be reserved for use by the City .

B. The City may, at its sole discretion, either: a) purchase at the actual construction cost or b) lease at the actual operating cost, any portion of such I-Net capacity, excluding PEG channel signal carriage. I-Net capacity acquired pursuant to this provision shall not be "sold" by the City to any entity which may use that capacity to compete with services offered by the Grantee.

1. Upon reasonable notice, the Grantee shall extend, without cost to the City, the I-Net to any public building located within Grantee's cable system service area and located 250' or less from the Cable System.

2. Grantee shall cooperate with the City and its agents in designing and selecting components necessary to implement its application and, if requested, shall furnish terminal equipment at Grantee's cost and manage the tags and authorizations of said equipment through Grantee's computer at no cost to the City.

3. If in the future the City desires to have the I-Net extended beyond that which is anticipated herein, Grantee agrees to charge on a time and materials basis (including overhead costs) for the construction of such additional I-Net plant.

4. The Grantee may, upon presenting the City with a right of first refusal use such capacity reserved under this Section for its own purposes. The Grantee shall give the City ninety [90] days written notice of its intent to exercise its right under this Section.

5. The parties acknowledge that the agreement regarding usage of the I-Net is subject to all local, state, and federal law. The City or public agency agrees to indemnify and hold harmless the Grantee from and against any and all claims, damages, liabilities, costs and expenses, including reasonable attorney's fees and costs directly related to the material under the City or public agency user control carried on the I-Net, including but not limited to, copyright infringement, libel, slander, defamation, patent, trademark, or

invasion of privacy claims.

6. The parties agree that the I-Net contributions of the Grantee to the City do not represent an "in-kind" payment by Grantee, a Franchise Fee of any kind, but it may be treated as an "external cost" under FCC rules and regulations.

C. The Grantee shall reserve at least six (6) PEG access channels on its residential distribution system, on the effective date of this Franchise. One (1) upstream channel shall be reserved as a PEG access return feed when and where available; the PEG provider shall furnish the RF modulator for the return signal feed.

1. The City, or its designated access management entity shall provide the Grantee at least forty-five (45) days prior notice of the required activation.

2. PEG access signal transportation on the Grantee's cable system or interconnection facilities shall be provided without charge to the City or the Access Center.

3. In the event a previously activated PEG access channel is not utilized for more than 12 continuing months, the Grantee, upon 90 days written notice to the City, shall have the right to reclaim the unoccupied "dark" channel. The City or its or its access provider, shall have the ability to reclaim the channel in accordance with the provisions of the Four Year Review process.

4. One of the government access channels shall be designated for in service training for public safety personnel, police role call, teleconference and staff training and development. The City may direct the Grantee to encoded this channel so that it is only available to facilities or individuals authorized by the City.

D. Requirements Regarding Rules and Procedures for Use of PEG Access Channels.

1. The City may operate or designate one or more non-profit access management corporations (hereafter "Access Center") to operate one or more PEG access channels under the Franchise.

2. The Access Center shall establish and enforce rules for use of the PEG access channels (a) to assure non-discriminatory access to the channels to similarly situated users; and (b) to promote use and viewership of the channels, consistent with the obligation to provide non-discriminatory access to similarly situated users. The City shall be responsible for establishing and enforcing rules for use of the PEG access channels during any period such Access Center does not exist.

3. The Grantee may not exercise any editorial control over the content of programming on the designated PEG access channels (except for such programming the Grantee may produce and telecast via cable on the same basis as other PEG access channel users on its local origination channels).

4. The PEG access channels shall be available without charge to the Access Center.

5. When PEG access channels are not being used to carry programming provided by other PEG access users, the Access Center at its sole cost and expense shall have the right to back up access programming with other programming, consistent with its mission to promote public, educational, and governmental use of the channels. This paragraph shall not limit the Grantee's rights under 47 USC § 531(d).

E. For its capital equipment and facility, the Grantee shall remit to the City or the Access Center, an amount equivalent to $1.25 per subscriber [subscriber count * $1.25 = capital equipment contribution]. The capital equipment contribution shall be calculated when the Grantee has achieving 30% penetration of the home count within the initial service area. The initial service area home count shall be set the effective date of this Franchise Agreement. The capital contribution funds shall be remitted in 4 equal quarterly installments coinciding with the franchise fee remittance schedule set in Section 5.

F. Access Services

1. The Grantee shall pay to the access management entity designated by the City, a per subscriber amount prescribed by the City, or an amount prescribed by a subsequent resolution adopted by the Grantor, to support services provided to the residents of the City by the Access Center. The first such payment shall be made upon the effective date of this Franchise and thereafter as prescribed by the City. Nothing in this section requires or shall be deemed to require the Grantee to make any payment which constitutes a Franchise fee under 47 USC § 542 or an "external cost" under FCC rules and regulations.

2. The payments referred to herein are contingent at all times upon the Grantee having the legal right to obtain funds it has committed through charges to subscribers. It is intended that such recovery shall be made, upon direction from the City, through a flat charge on each subscriber's bill not to exceed $1.50 per month.

3. Unless modified in accordance with the provisions prescribed in Section 13 [F](1), the Grantee is directed to collect sixty-eight cents [$0.68] monthly from each subscriber to support capital and operating expenses of the Access Center and seven cents [$0.07] monthly from each subscriber to support the expenses of the CRC Education Channel. These funds shall be collected and remitted directly to the designated Access

Centers within 30 days from the prior month.

4. The Access Center shall not be constrained by the Grantee from engaging in entrepreneurial enterprises to off-set the operating expenses of the Access Center.

G. The parties agree that any cost to the Grantee associated with providing access services, facilities, and equipment under this Franchise, including without limitation, the amounts set forth in Sections F and G are not part of the Franchise fee, and fall within one or more of the exceptions to 47 USC § 542.

H. Through its contract with the designated Access Center, the City shall ensure that programs produced with equipment or facilities provided for under this Section shall not, to the extent legally possible, be made available for cable over any other video delivery system serving the City, unless the operator of such delivery system remits funds to the access center as is required herein.

Section 14. Universal Access

To ensure the seamless connectivity of the City's I-Net, public bandwidth, and the PEG channels, the Grantee shall:

A. Construct a fiber link directly to the City's I-Net [public bandwidth] point of presence [POP] within the central business district and the POPs of the various PEG access providers prior to the provision of cable services to subscribers.

B. The link shall support forward and reverse transmissions of I-Net and PEG access signals. The Grantee shall cooperate with the City to enable PEG access providers to telecast remote events, using the Grantee's Cable System, as well as link city, county and state public and non-profit organizations, desiring a connection to the City's government access channel, emergency medical or public safety training facilities and telecasts.

C. Upon direction from the City providing at least 180 days notice, the Grantee shall interconnect the PEG channels with other adjacent cable systems within Wake County to provide uniform regional distribution of the PEG access channels. The facilities and equipment necessary to interconnect the PEG channels shall be absorbed by the cable operators affected.

Section 15. Assignment

A. This Franchise shall be a privilege to be held in personal trust by the Grantee. It shall not be assigned, transferred, sold or disposed of, in whole or in part by voluntary sale, sale and lease back, merger, consolidation, or otherwise or by force or involuntary sale without prior consent of the City as authorized by resolution of the Council, and then only on such conditions as

may be therein prescribed and which shall not be unreasonably withheld.

B. Grantee shall notify the City of any pending transfer or hypothecation of assets thirty (30) days prior to such a transfer. The City's granting of consent in one instance shall not render unnecessary any subsequent consent in any other instance. Nothing contained herein shall be deemed to prohibit mortgage, pledge or assignment of tangible assets of Grantee's Cable system for the purpose of financing the acquisition of equipment for, or the construction and operation of, Grantee's Cable System, without the City's consent.

C. For the purpose of determining whether the City shall consent to any assignment, transfer, merger or mortgage, the City may inquire into the qualifications of the prospective party. The Grantee shall assist the City in any such inquiry. The City may condition any assignment, transfer, merger or mortgage upon such reasonable conditions as it deems appropriate and consistent with applicable law.

D. Any sale, transfer or assignment made in violation of the procedures set forth in this Section shall render this Franchise void.

Section 16. Arbitrary and Capricious Action by Grantee

If the Grantee arbitrarily and capriciously discontinues service to a substantial number of its subscribers, the Grantee's franchise may be revoked by the City following notice to the Grantee and an opportunity to be heard. Notwithstanding, notice to the grantee under this Section may be less than thirty (30) days. Simultaneously, the City may seek appropriate judicial and/or other relief as provided by the Franchise or applicable law.

Section 17. Remedies

A. In addition to any other rights set out elsewhere in this Franchise, and subject herein, the City reserves the right to declare a forfeiture of this Franchise, and all of Grantee's rights arising hereunder, in the event that:

1. The Grantee is found to have violated any material provision of the Contract; or

2. The Grantee is found by a court of competent jurisdiction to have practiced any fraud or deceit upon the City.

B. The City shall give Grantee thirty (30) days written notice of its intent to exercise its rights under this Section, stating the reasons for such action. If Grantee cures the problem within the thirty (30) days notice period, or if the Grantee initiates substantial effort, to remedy the stated problem, and the efforts continue in good faith, the City shall defer its remedy rights. If Grantee fails to cure the stated violation within the thirty (30) days notice period, or if the Grantee does

not undertake efforts satisfactory to the City, to remedy the stated violation, then the City, upon reasonable notice, may impose any or all of the remedies available herein.

Section 18. Expiration and Renewal

Prior to the expiration of the term of this Franchise, the parties agree to negotiate a successor Franchise in good faith. Notwithstanding any such negotiations, the City is not obligated to renew this Franchise and Grantee does not waive any right it may have under federal or state law.

Section 19. Confidential Information

Grantee may identify information, such as trade secrets, submitted to the City as confidential. Grantee shall prominently mark any information for which it claims confidentiality with the word "Confidential" in letters at least one-half (½) inch in height, prior to submitting such information to the City. The City shall make a good faith effort to protect such confidential information, subject to the City's obligations under local, state and federal disclosure laws.

Section 20. Forum for Litigation

Any litigation between the City/County and the Grantee arising under or regarding this Franchise shall occur, if in the state courts, in the Wake County Court having jurisdiction thereof, or if in the federal courts, in the United States District Court for the Eastern District of North Carolina.

Section 21. Notice

Any notice provided for under this Franchise shall be sufficient if in writing and delivered personally to the following addressee or deposited in the United States Mail, postage prepaid, certified mail, return receipt requested, addressed as follows, or to such other address as the receiving party hereafter shall specify in writing:

If to the City:
City Manager
City of Raleigh
PO Box 590
Raleigh, NC 27602

With a Copy to:
Information Services Department
City of Raleigh
PO Box 590
Raleigh, NC 27602

If to the Grantee: President
FiberSouth, Inc.
4300 Six forks Road, Suite 500
Raleigh, NC 27609

Grantee agrees to serve on the City all filings made at the North Carolina Public Utilities Commission, relating to Grantee's cable system, although failure to do so shall not constitute a breach of this Franchise.

Section 22. Severability

If any section, subsection, sentence, clause, phrase, or other portion of this Ordinance is, for any reason, declared invalid, in whole or in part, by any court, agency, commission, legislative body, or other authority of competent jurisdiction, such portion shall be deemed a separate, distinct, and independent portion. Such declaration shall not affect the validity of the remaining portions hereof, which other portions shall continue in full force and effect.

Section 23. Non-Discrimination

The Grantee shall not to discriminate in any manner on the basis of age, race, sex, handicap, color, creed, national origin, religion or sexual orientation. The Grantee shall comply with the terms and conditions of Ordinance Number 1969-889, as it may be amended periodically.

Section 24. Non-Divestiture

This Franchise shall not divest the City of any right or interest in the public rights-of-way.

Section 25. Letter of Credit

A. Within sixty (60) days following the award of the Franchise or 30 days prior to construction, the Grantee shall deposit with the City a letter of credit from a financial institution, approved by the City's Finance Director, in the amount of fifty-thousand dollars [$50,000]. The form and content of the letter shall be approved by the City Attorney. The letter of credit shall be used to insure the faithful performance of the Grantee of all provisions of the Franchise, and compliance with all orders, permits and directions of any agency, commission, board, department, division or office of the City exercising jurisdiction over the Grantee's acts or defaults, and payment by the Grantee of any penalties, claims, liens, liquidated damages, fees due the City or the Access Center.

B. If the Grantee fails to pay to the City any compensation, not in dispute, due the City within the time fixed herein; or fails, after ten (10) days notice to pay to the City any penalties, claims, liens, liquidated damages, fees due the City or the Access Center, such failure by the

Grantee can be remedied by demand on the letter of credit. The City may immediately request payment of the amount due, with interest and penalties, from the letter of credit. Upon such request for payment, the City shall notify the Grantee of the amount and date thereof.

C. The letter of credit shall be maintained at fifty-thousand dollars ($50,000) during the entire term of the Franchise unless modified in accordance with the procedures provided for in Section 37 of this Agreement. In the event that amounts are withdrawn pursuant to this Section, the Grantee, if necessary, shall take any required action to maintain the letter of credit said full amount within three (3) business days of notification by the City of its withdrawal against the letter of credit.

D. The rights reserved to the City with respect to the letter of credit are in addition to all other rights of the City, whether reserved by the Franchise, or authorized by law, and no action, proceeding or exercise of a right with respect to such a letter shall affect any other right the City may have.

E. The letter of credit shall contain the following endorsement:

> *"It is hereby understood and agreed that this letter of credit shall not be canceled by the surety nor the intention not to renew be stated by the surety until thirty (30) days after receipt by the City, by registered mail, of a written notice of such an intention to cancel or not to renew."*

F. The Grantee shall renew the letter of credit not less than 30 days prior to its expiration and provide a copy of the renewal to the City. Failure to comply with this provision shall entitle the City to draw down the letter of credit in its entirety.

Section 26. Remedies-Liquidated Damages

A. Because the Grantee's failure to comply with provisions of this Franchise will result in injury to the City, and because it will be difficult to estimate the extent of such injury, the City and the Grantee hereby agree to the following liquidated damages, which represent both parties' best estimate of the damages resulting from the specified injury. Damage amounts may be adjusted throughout term of Franchise by the City by resolution to take into account increases in the consumer price index.

B. For failure to complete construction within the initial service area or extend service in accordance with the Franchise: $1500/calendar day for each day the violation continues;

C. For failure to comply with material requirements of the I-Net provisions of the Franchise: $300/calendar day for each day the violation continues;

D. For repeated, willful, or continuing failure to submit reports, maintain records, provide documents or information: $500/calendar day for each day the violation continues;

E. For failure to comply with material requirements of the Customer Service Standards $500/violation/calendar day for each day the violation continues; and,

F. For failure to comply with transfer provisions: $500/calendar day from the date of any unlawful transfer.

G. Penalties will commence to accumulate only for days of non-compliance which occur after the final date set by the City for achieving compliance, in accordance with the procedure required herein. No penalties will be assessed for violation period which has existed prior to the expiration of the period set by the City herein for correcting the defect.

Section 27. Remedies-Cumulative

All remedies provided under this franchise agreement or the enabling ordinance shall be cumulative, unless otherwise expressly stated. The exercise of one remedy shall not foreclose use of another, nor shall it relieve the Grantee of its obligations to comply with the Franchise. Remedies may be used singly or in combination; in addition, the City may exercise any rights it has under law or at equity.

Section 28. Remedies-Continuity of Service

It is the right of all subscribers in the franchise area to receive all available services from the Grantee as long as their financial and other obligations to the Grantee are satisfied and Grantee is receiving all compensation due it from subscribers.

In the event the Grantee fails to operate the cable system for ninety-six (96) hours during any seven (7) day period without prior approval of the City, or if the System is abandoned as defined herein, the City may, at its option, operate the cable system or designate an operator until such time as the Grantee restores service under conditions acceptable to the City or until the Franchise is revoked and a permanent operator is selected. If the City is required to fulfill this obligation for the Grantee, the Grantee shall reimburse the City for all costs or damages resulting from the Grantee's failure to perform that are in excess of the revenues from the cable system received by the City. Additionally, the Grantee will cooperate with the City to allow City employees and/or City agents free access to the Grantee's facilities and premises for purposes of continuing cable system operation.

Section 29. Books and Records-Inspection

The City may inspect and copy the books, records, maps, plans, and other documents, including financial documents, in the control or possession of the Grantee, affiliates, or any person that constitutes an operator of the Grantee's cable system: (1) to enforce the City's rights or assess compliance with the Franchise and applicable law; (2) in the exercise of any lawful regulatory power; or (3) as may be convenient in connection with any proceeding the City may or must conduct under applicable law with respect to the Grantee's cable system. The material shall be duplicated at a City facility unless the City agrees to inspection and copying at some other place. Material that the City requires the Grantee to produce under this Section shall be produced upon reasonable notice, no later than 30 days after the request for production. Requests for extensions of time to respond shall not be unreasonably denied.

Access to Grantee's records shall not be denied to the City on the basis that said records contain "proprietary" information. Refusal to provide information required herein to the City shall be grounds for revocation. The Grantee may request that the City treat records containing trade secrets or proprietary information as confidential under the North Carolina Public Records law. To the extent authorized by the Public Records law and other applicable state and federal law, the City shall maintain the confidentiality of information designated "proprietary" by the Grantee. Should the City receive a request to review the Grantee's records or books under the North Carolina Public Records Law, it will promptly notify the Grantee and provide an opportunity for the Grantee to raise an objection, demonstrate why the requested information is proprietary and, if necessary, seek a court order to protect its proprietary information.

Section 30. Books and Records- Reports and Responses to Questions

The Grantee shall provide the following reports quarterly, in a form acceptable to the City, at the time it is scheduled to make its Franchise fee payment:

A. A report listing, by month, the number of service calls completed by type during the prior quarter;

B. A report showing the number of outages, by month, for the prior quarter, identifying separately: (1) each planned outage, the time it occurred, its duration, and the estimated number of subscribers affected; and (2) each unplanned outage, the time it occurred, its estimated duration, the area and the estimated number of subscribers affected;

C. A Franchise fee report listing revenues received, by category, in a form acceptable to the City;

D. A report stating the subscriber totals for (1) each cable service tier; (2) each premium service; (3) pay-per-view, and; (4) any other programming service, information service, or non-

programming service; and,

E. Within ninety (90) days after the close of the Grantee's fiscal year, the Grantee shall submit a written annual report, in a form approved by the City, including, but not limited to, the following information:

1. a summary of previous years activities in the development of its cable system in the City, including, but not limited to, additions, deletions, or improvements begun or discontinued during the reporting year, services initiated or discontinued, number of subscribers (including gains or losses), homes passed, and miles of cable distribution plant in service;

2. a financial statement, including a statement of income, balance sheet, and a statement of sources and applications of funds which shall be certified by Grantees' Chief Financial Officer under penalty of perjury; and cable system; and,

3. a detailed copy of updated maps or electronic media capable of being read by the City's GIS system, depicting the location of all cable plant, showing areas served and locations of all trunk lines and feeder lines in the City.

F. Unless otherwise specified, the Grantee shall mail the following documents to the City within thirty (30) days of the time they are filed (the documents shall be provided to the City so long as they relate to the Grantee's cable system, or the operation of that cable system, and without regard to whether the documents are filed or received by the Grantee, an affiliate, or some other entity):

1. within thirty (30) days of the date mailed to shareholders or partners, the annual report, if any, of the Grantee, or each affiliate which controls, owns, or manages the Grantee and issues an annual report;

2. copyright filings regarding the operations of the Grantee's system;

3. FCC Forms 325 and 395 (or their successor forms) for the Grantee's cable system; and,

4. FCC proof of performance and RF signal leakage tests (or their equivalent).

G. The Grantee shall file with the City any notice of deficiency, forfeiture, or other document issued by any state or federal agency which has instituted any investigation or civil or criminal proceeding naming the cable system, the Grantee, or any operator of the cable system, to the extent the same may affect or bear on the operations of the Grantee's cable system.

H. The Grantee shall file with the City any request for protection under Bankruptcy laws, or any judgment related to a declaration of bankruptcy by the Grantee, any affiliate which controls or manages the Grantee, or any operator of the cable system.

Section 31. Books and Records-Maintenance

In addition to reports required by this Franchise, the Grantee shall maintain records of the following in a form reasonably acceptable to City. The records shall be kept at the Grantee's local office and shall be available for City review and copying during normal business hours. Records of any event recorded shall be kept for the following time frames:

A. Records of outages, indicating date, duration, area and the estimated number of subscribers affected, type of outage, and cause (to be maintained for five (5) years);

B. Records of service calls for repair and maintenance, indicating date and time service was requested, date and time service was scheduled (if it was scheduled), date service was provided, and (if different) date the problem was solved (to be maintained three (3) years);

C. Records of installation and requests for service extension, indicating date of request, date of acknowledgment, and date and time service was extended (to be maintained three (3) years); and,

D. Maps showing the current location of the cable system.

Section 32. Inspection of Plant

The City may supervise and inspect the Grantee's cable system during construction, and upon completion, upon reasonable notice inspect the distribution facilities and equipment of the cable system. If, based on subscriber complaints or based on its own investigation, the City believes that the cable system may not be operating in compliance with the franchise agreement or applicable Federal rules, it may require the Grantee to perform tests, prepare a report and present to the City the results of those tests. The Grantee shall identify problem found and ameliorative action taken to remedy the problem.

Section 33. Insurance

A. Within thirty (30) days after the effective date of the Franchise, and prior to any operations pursuant to this Franchise, the Grantee shall provide proof of the required insurance. The Grantee and its subcontractors shall maintain this insurance throughout the franchise term. Insurance shall include, in amounts not less than those indicated herein:

1. Worker's Compensation coverage for all employees with Statutory Limits in

compliance with applicable state and federal laws. The policy shall include Employers' Liability with a limit of five-hundred thousand dollars ($500,000) for each accident;

2. Comprehensive General Liability with a minimum limit of two-million dollars ($2,000,000) per occurrence [four-million ($4,000,000) aggregate] combined single limit for bodily injury liability and property damage liability. This shall include premises and/or operations, independent contractors, and subcontractors and/or completed operations, broad form property damage, XCU Coverage, and a Contractual Liability Endorsement; and,

3. Business Auto Policy shall have minimum limits of one-million dollars ($1,000,000) per occurrence combined single limit for bodily injury liability and property damage liability. This shall include owned vehicles, hired and non-owned vehicles.

4. Follow form umbrella shall have minimum limits of ten million dollars ($10,000,000) per occurrence.

B. The insurance coverage obtained by this franchise in compliance within this Section shall be approved by the City's risk management office, and copies of such insurance policies [or certificate of insurance] and evidence of premium payment shall filed annually with the City.

C. The insurance coverage required herein may be modified, pursuant to the provisions of the Four Year Review, to reflect changing liability exposure limits.

D. The City of Raleigh shall be named as an additional inured as their interests may appear.

Section 34. Emergency Override

The Grantee shall install and maintain an emergency override system pursuant to FCC rules. The City's Emergency Communication Center shall be provided with access to the system so that it can communicate emergency messages and alerts to residents. The Grantee shall provide the interface equipment and signal transportation system necessary for this purpose without cost to the City.

Section 35. Service to Public Buildings

The Grantee shall, without installation or monthly service charge, provide service to public buildings located within 250 feet of the Grantee's existing distribution system. Additional outlets in these facilities may be provided for the cost of time and materials [FCC-1205 or equivalent rate schedule].

Section 36. Four-Year Review: Performance Monitoring

A. During the years which commence on the fourth and eighth anniversaries of the effective date of the Franchise, the City may commence a review of the Grantee's performance under the Franchise. As part of this review, the City may consider:

1. whether the Grantee has complied with its obligations under the Franchise and applicable law;

2. whether customer service standards, technical standards, or bond or security fund requirements are adequate or excessive; and,

3. other issues as may be raised by the Grantee, the City, or the public.

B. The City shall conduct public hearings to provide the Grantee and the public the opportunity to comment on the Grantee's performance and other issues considered as part of the four-year review.

C. Any revisions to the Franchise Agreement which either the City or the Grantee wishes to make as a result of these reviews shall be proposed under the procedures established herein.

D. Floating Reopener

1. The City or Grantee may, at any time after the effective date of this Franchise, commence a review to examine changes which either party wishes to make to the Franchise Agreement.

2. The City may conduct public hearings to provide the public the opportunity to comment on the issues which are to be considered.

3. The party initiating the process will provide the other with a full description of the changes it proposes, as well as the reasoning behind the proposal. If the City is the party proposing the changes, the Grantee shall develop a thorough analysis of the impact of such changes upon its operations and/or its subscribers, taking into consideration the acceptability of such changes and their cost, if any, to its subscriber rates and Grantee's return on investment. Grantee shall consider all the alterative means for recovering such costs.

4. Following receipt and analysis of a proposal, the City and the Grantee shall negotiate the proposed changes in good faith. If the parties are unable to reach agreement within ninety (90) days, or whatever longer period may be mutually acceptable, either party may call for mediation of the disagreement.

5. The City and Grantee will indemnify, agree upon and designate a mediator, whose fees will be shared equally by the parties.

6. At the completion of the process outlined above, the City Council shall amend the Franchise as necessary to allow for implementation of any changes agreed upon by the parties.

E. Grantee Cooperation. The Grantee shall cooperate in the four year reviews and the reopener process described in this Section.

Section 37. Acceptance of Franchise

Within thirty (30) calendar days following the grant of this Franchise, the Grantee shall file with the City its written acceptance of the Franchise, together with certificates of insurance and letter of credit instruments required herein. The Grantee shall state that it agrees to be bound by and to comply with all requirements pursuant to the provisions of this Franchise. All of the statements and declarations contained in the application shall be incorporated as conditions and material representations of any Franchise issued by the City, and the breach of any such conditions and representations shall constitute cause for the pursuit of remedies by the City as provided herein. Such acceptance and agreement shall be acknowledged by the Grantee before a notary public, and shall in form and content be approved by the City Attorney.

Section 38. Grant

This city wide Franchise is granted by the City to FiberSouth, Inc pursuant and subject to the conditions and requirements provided by City of Raleigh Ordinance 1995-631 and applicable federal, state and local laws, rules and conditions. This Franchise bestows upon the Grantee the authority to construct, maintain and operate a Cable System, utilizing the Public Way, to offer Cable Services within the city.

Approved this the 6th day of August, 1996.

Approved on second reading: September 3, 1996

IN WITNESS WHEREOF, the undersigned have caused this Agreement to be executed.

ATTEST

Gail G. Smith
City Clerk

CITY OF RALEIGH

D. E. Benton, Jr.
City Manager

city-seal

ATTEST:

Anthony M. Copeland
Vice President and General Council
FiberSouth Inc.

FIBERSOUTH, INC.

Peter T. Loftin
President, FiberSouth, Inc.

corp-seal

rev: August 6, 1996

Time Warner / Raleigh

November 17, 1999

MEMORANDUM

TO: D. E. Benton, City Manager
Tom McCormick, City Attorney
Gail Smith, City Clerk

FROM: Robert F. Sepe, Information Service Manager R.F. Sepe

RE: Time Warner Cable Television Franchise Agreement

Please execute the attached four original copies of the Franchise Agreement. Once the documents have been executed, I shall forward them to Randy Fraser at TWC for execution. Please advise Barbara Nelson (890-3522) after the document has been executed so that she can carry it to the next office for signature. Your assistance is appreciated

Attachment: Franchise Agreement - Final

xc: Lawrence Wray
Frank Seiber

file in Ordinance drawer

Cable Television Franchise Agreement

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ORDINANCE NUMBER 1999-679

STATE OF NORTH CAROLINA

CABLE TELEVISION FRANCHISE

CITY OF RALEIGH

An Ordinance Granting a Nonexclusive Franchise to Time Warner Entertainment: Advance-Newhouse Partnership, a New York General Partnership (Hereinafter Referred to as "Grantee") to Own, Operate and Maintain a Cable System, as Defined Herein, Setting Forth Conditions Accompanying the Grant of Franchise, Providing for the Regulation and Use of the Cable System, Providing Penalties, and Defining the Term of the Effective Date Thereof.

WHEREAS, the City of Raleigh (hereinafter referred to as "City" or "Grantor") desires to assure the widespread availability of Cable Services within the City to promote commerce and otherwise further the public interest;

WHEREAS, the City is the owner of certain street rights-of-way;

WHEREAS, the City has, following reasonable notice, and after consideration, analysis and deliberation conducted full public proceedings, during which proceedings the technical ability, financial condition, legal qualifications and general character of Grantee were determined acceptable to receive a renewal of its Franchise;

WHEREAS, the City has also considered and analyzed the plans of Grantee for the operation of its Cable System and found the same to be adequate and feasible in view of the needs and requirements of the residents to be served by the Cable System;

WHEREAS, the City has determined that it is in the best interest of and consistent with the public interest, convenience and necessity of its residents to grant a Franchise to Grantee to operate a Cable System within the City and on the terms and conditions hereinafter set forth; and

WHEREAS; Grantee desires to construct and operate a Cable System consisting of fiber optic, coaxial and multi-pair cables along portions of the City's right-of-way.

NOW, THEREFORE, BE IT ORDAINED BY THE CITY COUNCIL OF THE CITY OF RALEIGH, NORTH CAROLINA, THAT:

Section 1. Nature and Terms of Grant

A. City does hereby convey to Grantee a city-wide Franchise to construct and operate a Cable System, using owned and/or leased facilities which may be located in the City rights-of-way.

B. Notwithstanding Section 1A, Grantee may, in its sole discretion, elect to lease fiber optic, coaxial and multi-pair cable and other cable communication facilities from other City licensed or franchised providers of Cable Service to support the operation of its Cable System.

C. The Franchise granted herein shall run for a term of ten (10) years from the date of acceptance of this Franchise by Grantee.

Section 2. Definitions

For the purposes of this Franchise, the following terms, phrases, words, and abbreviations shall have the meaning given herein. When not inconsistent with the context, words used in the present tense include the future tense, words in the plural include the singular, and words in a particular gender shall include each of the other gender. The words "shall" and "must" are always mandatory and not merely directory .

"Access or Public, Education or Government Access" shall mean the availability of channels on the cable system for non commercial public, education or government use by agencies, institutions, organizations, groups and individuals in the community, including Grantor and its designees for the distribution of non commercial programming not under Grantee's editorial control and consistent with applicable law, including:

A. **"Public Access"** shall mean access where organizations, groups, or individual members of the general public are the designated programmers having editorial control over their programming pursuant to rules promulgated by Grantor;

B. **"Education Access"** shall mean access where local schools are the designated programmers having editorial control over their programming which shall concern their educational functions;

C. **"Government Access"** shall mean access where governmental institutions or their designees are the primary or designated programmers or users having editorial control over their programming which shall concern their governmental functions; and

D. **"PEG Access"** shall mean Public access, Education access, and Government access, collectively.

"Access Center" shall mean one or more agencies selected by the City to be responsible for the administration, production and acquisition of television programs for transmission on the Public, Education and Government access channels.

"Affiliate" when used in relation to any person, shall mean another person who owns or controls, is owned or controlled by, or is under common ownership or control with, such person.

"Basic Cable Service" or "Basic Service" shall mean any service tier which includes the retransmission of local television broadcast signals. This definition shall be deemed to change consistent with any changes in the definition of this term by the Federal Communications Commission.

"City Council" shall mean the City Council of the City of Raleigh, North Carolina.

"Cable Operator" shall mean any person or group of persons:

A. who provides Cable Service over a Cable System and directly or through one or more affiliates owns a significant interest in such Cable System, or

B. who otherwise controls or is responsible for, through any arrangement, the management and operation of such a Cable System under a Franchise with the City of Raleigh.

"Cable Service" shall mean:

A. the one-way transmission to Subscribers of (a) video programming, or (b) other programming services, and,

B. subscriber interaction, if any, which is required for the selection or use of such video programming or other programming services.

"Cable System" shall mean a facility, consisting of a set of closed transmission paths and associated signal generation, reception, and control equipment that is designed to provide Cable Service and which includes video programming and other lawful communications services and which is provided to multiple Subscribers within a community, but such term does not include:

A. a facility that serves only to retransmit the television signals of one (1) or more television broadcast stations;

B. a facility that serves subscribers without using any public right-of-way;

C. a facility of common carrier which is subject, in whole or in part, to the provisions of 47 U.S.C. §201-226, except that such facility shall be considered a cable system (other than for purposes of 47 U.S.C. §541(c)) to the extent such facility is used in the transmission of video programming directly to Subscribers; and

D. any facilities of an electric utility used solely for operating its electric utility system.

"City" shall mean the City of Raleigh or the area within the present and future territorial limits of the City and such territory outside of the City over which the City has jurisdiction or control by virtue of any law.

"Channel" shall mean a portion of the electromagnetic frequency spectrum which is capable of delivering both the audio and video portions of a television signal. At the time of enactment of this Franchise, such capability generally requires a 6 MHz capacity. This is subject to changes in technology.

"Customer Service Standards" shall mean those standards adopted by the FCC and by the City which govern the manner in which Grantee interacts with the public and its customers.

"FCC" shall mean the Federal Communications Commission or any successor agency.

"Franchise" shall mean an initial authorization, or renewal thereof, (including a renewal of an authorization which has been granted subject to 47 U.S.C.§ 546), issued by the City, whether such authorization is designated as a Franchise, permit, license, resolution, contract, certificate, agreement, or otherwise which authorizes the construction or operation of a Cable System but neither supersedes nor takes the place of any license, license fee or permit authorization which might otherwise be required of any similarly situated businesses for the privilege of transacting business within the City.

"Franchise Fee" shall mean an annual fee of five percent (5%) of Grantee's Gross Revenues paid for the use and occupation of the City's rights-of-way.

"Grantee" or "Franchisee" or "Company" shall mean the person, firm, or corporation to whom a Franchise, as herein above defined, is granted by the City and any lawful successor, transferee or assignee of said person, firm, or corporation.

"Gross Revenues" shall mean all revenue received by Grantee, which is derived from the operation of the Cable System to provide Cable Service which includes television video and/or audio program services, videotext services and video games within Grantor's Franchise area, including, but not limited to: fees charged to subscribers for Basic Cable Service; fees charged to subscribers for an optional video or audio service; fees charged to subscribers for any tier of video or audio program service other than Basic Cable Service; installation, disconnection and re-connection fees for the provision of video or audio program services; leased channel fees and equipment rentals and revenues from Internet services offered by the Grantee.

Gross Revenues shall also include an allocated portion of revenues received by Grantee for the carriage of home shopping channels on the Cable System; marketing, launch and carriage revenues which exceed reimbursements for expenses; and revenues from advertising on the Cable System sold by Grantee or its agents. The allocation shall be a percentage of such revenues determined by dividing the number of subscribers in Grantor's Franchise area by the total number of subscribers served by the Cable System. This sum shall be the basis for computing the fee imposed pursuant to Section 5 hereof.

The term "Gross Revenues" shall not include: converter or other equipment deposits; bad debts; any sales, excise or any other taxes collected by Grantee on behalf of any state, city or other governmental unit; Franchise Fees, refunds to subscribers by Grantee; reimbursement for expenses (including returned check fees, copy expenses and similar items); or items excluded by local, state or federal law. Revenues received for the provision of Other Communication Services including data transmission, point-to-point telecommunications, or telephone services shall not be included in Gross Revenues but may be subject to fees imposed by Grantor, upon the provision of such services, to the extent permitted by law.

"Initial Service Area" shall mean that geographical area served by Grantee within the incorporated limits of the City as of the date of acceptance of this Franchise.

"Institutional Network or I-Net" shall mean capacity on the System used for the provision of services to Grantor pursuant to the terms and conditions set forth in Section 13.

"Other Communications Services" shall mean any lawful service other than Cable Service that Cable Operator makes available for purchase.

"Person" shall mean an individual, partnership, association, limited liability company, joint stock company, trust, corporation, or governmental entity.

"Public, Education or Government Access (PEG) Facilities" shall mean:

A. channel capacity designated for public, education, or government use; and

B. facilities and equipment for the use of such channel capacity.

"Public Buildings" shall mean public schools (K-12), and City government buildings.

"Public Way and Right-Of-Way" shall include the surface of, and the space above and below all streets, avenues, boulevards, roads, alleys, lanes, squares, bridges, viaducts, easements, tunnels, causeways and sidewalks, lying within the street right-of-way, and all other public highways within the City.

"Reasonable Notification" shall mean fourteen (14) calendar days for all non-financial related matters and thirty (30) calendar days for financial matters.

"Residential Subscriber" shall mean a Subscriber who receives Cable Service in an individual dwelling or multiple dwelling unit where the service is not to be used in connection with a business, trade or profession.

"Subscriber" shall mean any person or entity lawfully receiving any portion of the Cable Service of Grantee pursuant to this Franchise.

"Service Tier" shall mean a category of Cable Service or Other Communications Services provided by a Cable Operator and for which a separate rate is charged by the Cable Operator;

"Year" shall mean a calendar year.

Section 3. Service Area

Grantee's Initial Service Area is generally bounded by the City limits as amended from time to time. Grantee shall serve such portion of the City as Grantee, in its sole discretion, shall elect to serve.

Section 4. Customer Service Standards

Grantor has determined that it is in the best interest of its residents and consistent with the public interest, convenience and necessity to adopt Customer Service Standards for the provision of Cable Services by Grantee. Grantee shall operate its Cable System in a manner consistent with the City's Customer Service Standards. A copy of the City's **Customer Service Standards** is attached as **Exhibit A**.

Section 5. Compensation, Auditing and Other Payments

A. Grantee shall pay Grantor, throughout the term of this Franchise, as compensation, an annual Franchise Fee of five percent (5%) of Grantee's Gross Revenues.

B. All such payments of Franchise Fees shall be payable quarterly by April 30, July 31, October 31 and January 31 for the preceding three (3) month period ending respectively on March 31, June 30, September 30 and December 31. Franchise Fee payments shall be accompanied by a report itemizing and setting forth the Gross Revenues and showing the calculation of the payment due for the preceding period.

C. The payment of the Franchise Fee by Grantee is for the right to construct and operate its Cable System, as defined herein, within Grantor's public right-of-way and is in lieu of an encroachment fee.

D. Grantor, on an annual basis, shall furnish a statement within ninety (90) calendar days of the close of the calendar year, certified by a corporate officer or a certified public accountant selected by the Grantee, reflecting the total amounts of Gross Revenues as defined herein, and all payments and computations for the previous calendar year. In order to determine whether proper Franchise Fees have been paid and upon ten (10) calendar days prior written notice, Grantor shall have the right to conduct an independent audit of Grantee's records for the period of the term of this Franchise, but in no event for a period longer than five (5) years from the date of the last audit. If, after resolving any dispute arising from such audit, Grantee has made a Franchise Fee underpayment of one and one-half (1 ½) percent or more, Grantee shall assume all reasonable costs of such audit. In other events, Grantor shall bear all costs and fees, associated with any such audit.

E. All Grantee's books and records concerning its Gross Revenues and its calculation of payments to Grantor, shall be available for inspection by an appropriate officer of Grantor, or its designee, at reasonable times to determine the amount of compensation due to Grantor from Grantee under this Franchise. Such records shall be kept to accurately show the same. Grantee shall prepare and make available to Grantor at times reasonably requested by Grantor and in the form prescribed by Grantor after consultation with Grantee, such reports with respect to its Cable System, and the Gross Revenues derived therefrom, as Grantor may deem reasonably necessary or appropriate.

F. In the event Grantee makes an underpayment or in the event Grantee fails to make any payment on or before the date it is due, Grantee shall pay interest at a rate of one (1) percent per month on any such underpayment and/or late payment.

G. Consistent with federal law, Grantee shall file no less frequently than annually any tariffs, amendments, or modifications affecting the sale of its services and subscriber terminal equipment and shall provide written notification to Grantor within thirty (30) calendar days of any proposed changes. Grantee shall also provide the Grantor copies of all filings, reports and petitions to local, state, or federal regulatory agencies which could materially effect the Franchise.

Section 6. Franchise - Not Exclusive

A. This Franchise is not exclusive. Grantor reserves the right to grant franchises to other persons or corporations, as well as the right in its own name, to operate a cable system for similar or different purposes allowed Grantee hereunder.

B. The material terms, provisions and conditions of any franchise granted to third parties by Grantor shall conform with federal and state law related to cable television and shall be non discriminatory. Material terms, provisions and conditions shall include at a minimum, Franchise Fees, PEG Access support in any form or manner provided, Institutional Network, liquidated damages, insurance, bonds, letters of credit and similar instruments, reports, customer service standards, computation of Gross Revenues, service to public buildings, right of way use conditions and inspection requirements.

Section 7. No Waiver

A. The failure of Grantor or Grantee, upon one or more occasions, to exercise a right or to require compliance or performance under this Franchise or any other applicable law shall not be deemed to constitute a waiver of such right or a waiver of compliance or performance, unless such right has been specifically waived in writing.

B. Waiver of a particular breach of this Franchise shall not be construed as a waiver of any other breach. Neither the grant of this Franchise nor any provision herein shall constitute a waiver or bar to the exercise of any governmental right or power of Grantor. No provision of this Franchise shall operate as a waiver by Grantor or Grantee of any right guaranteed by the federal or state constitutions or other applicable law.

Section 8. Regulation

A. The City Council shall be vested with the power and authority to reasonably regulate the exercise of the privileges permitted by this Franchise in the public interest. Any failure by Grantor to promptly enforce compliance with this Franchise in accordance

with applicable federal, state and local laws and ordinances shall not relieve Grantee of its obligation to comply with any provision of this Franchise.

B. Grantee's rights, without limitation upon Grantor's regulatory authority, pursuant to the Communications Act of 1934, as amended or any other subsequent federal or state law, shall not be abrogated or otherwise limited.

C. Following reasonable notice, Grantor reserves the right to inspect the installation and maintenance of the Cable System.

D. Grantee shall comply with all federal, state and local laws, rules and regulations, applicable to its Cable System, such as the National Electrical Code, National Electrical Safety Code, traffic safety/lane closure rules and construction requirements promulgated by Grantor.

Section 9. Public Right-of-Way Use Conditions

A. Grantor reserves the right, upon reasonable notice, to require Grantee at the Grantee's expense, to protect, support, temporarily disconnect, relocate or remove from the public way any property of Grantee, by reason of traffic conditions, public safety, street construction or excavation, change or establishment of street grade, installation of sewers, drains, water pipes, power or communication lines, or other type structure or improvements by governmental agencies for governmental purposes. Reasonable notice for this provision shall be construed to mean at least ninety (90) calendar days except in the case of emergencies where no specific notice period shall be required. Grantor shall endeavor to notify and seek comment from Grantee, with respect to minimizing disruption to the Cable System, where public works projects may affect Grantee's Cable System.

B. Grantee shall, at no cost to Grantor, relocate its facilities and appliances which are in conflict with projects of Grantor to upgrade or construct roadways or other public infrastructure.

C. Whenever a public way exists to accommodate Grantee's Cable System, Grantee shall make every effort to locate its facilities, other than subscriber drops, within Grantor's rights-of-way, unless there are legitimate legal, technical, operational, or economic reasons to do otherwise.

D. Grantee shall locate, place and construct its facilities so as not to interfere with the construction, location and maintenance of sewer or water mains, lines or other public infrastructure.

E. Grantee shall adhere to all federal, state and local regulations regarding the location, construction, and maintenance of its facilities within the public rights-of-way. Grantee shall take reasonable preventative measures to protect existing facilities within the public rights-of-way.

F. Grantee shall within thirty (30) calendar days restore and replace landscaped areas, pavement, pedestrian lighting, sidewalks, curbs, gutters or other facilities damaged by Grantee within the public way or by its contractors with like material to their former condition at Grantee's expense, and shall thereafter, from time to time, but no longer than one (1) year from the completion of the job, readjust, fill and finish the same as may be necessary due to settling of the earth associated with Grantee's disruption of the public rights-of-way.

G. Grantor, at its sole discretion, may require without cost to the Grantor, the Grantee to locate and identify its facilities within the public rights-of-way.

Section 10. Initial and Continuing Tests

A. Grantee shall, if requested by Grantor, perform all tests necessary to demonstrate compliance with the requirements of 47 CFR Section 76 subpart K. All tests shall be conducted in accordance with the FCC's rules at the Grantee's expense.

B. Engineering design, construction and as-built documents shall be provided in both hard copy (paper) and electronic (data files) formats. Such maps should designate the location of Grantee's facilities in a mutually acceptable form. The electronic version must be based upon NC State Plane Coordinates NAD 1983.

Section 11. Public Education and Government Access Provisions

A. Grantee shall initially make available to each of its Basic Cable Service Subscribers receipt of at least four (4) Access channels which shall be used solely for non commercial public, education and government purposes. The Access channels shall be made available by Grantee for use as provided for herein, by Grantor and its citizens in accordance with the rules and procedures established by Grantor or any lawfully designated person, group, organization or agency authorized by Grantor for that purpose.

B. Whenever all utilized Public, Education and/or Government Access channels are in continuous use from 4:00 P.M. to 11:00 P.M. for six (6) weeks running, Grantor may, with ninety (90) calendar days written advance notice, request an additional channel for additional access use. Grantee shall be required to provide additional

channel capacity for such access upon request by Grantor when such continuous use has existed, provided, however that:

1. In determining whether existing use is continuous and warrants additional channel capacity, the use of repeat programming and text or character-generated programming shall not be considered;

2. When technically and economically feasible alternatives are available, Grantee shall be given the opportunity to accommodate further channel usage for access purposes without dedicating a specific channel for Public, Education and/or Government access; and

3. Grantee shall not be required to provide a total number of PEG Access channels in excess of six (6) Channels. See Section 13 (F).

C. All programming transmitted over Public, Education and Government Access channels shall be noncommercial in nature. Program material to be distributed on Public, Education or Government Access channels shall contain no advertising or commercial content for which consideration of any kind is received directly or indirectly by Grantor or by the producer or distributor of such programming. Grantor may not enter into a lease, license, contract or arrangement of any kind whereby Grantor or its designee allows or requires a person, firm or corporation to program all or part of a Public, Education or Government Access channel in exchange for consideration of any kind. Program material to be distributed on Public, Education and Government Access channels shall: 1) be produced or provided in pre-produced form by any City or County resident or produced or provided by any agency, public or private, serving City or County residents regardless of the location at which the programming originated; and 2) allow for public expression relating to educational, political, social, or cultural interests of the residents of the City or County.

D. Grantor may designate locations from which Access programming may be originated and provided to Grantee for distribution on the designated Access channel(s), subject to the following conditions:

1. There may be one permanent PEG Access origination location for each designated Access channel;

2. Grantee shall not be obligated to extend its facilities from existing Cable System distribution plant more than 125 feet to each PEG Access origination location or furnish any internal wiring, modulator(s) or associated equipment.

3. PEG Access signal transportation from the permanent PEG Access origination location established under Section 11(D) shall be provided without charge to Grantor by Grantee.

E. Grantor shall establish rules and procedures under which Grantee is permitted to use access channel capacity for the provision of other services if such channel capacity is not being used for the purposes designated by this Section.

F. Grantor may direct Grantee to use Addressability (encryption) of one Government Access channel on a partial or full-time basis to limit reception of the channel to designated locations.

G. Grantor may operate or designate one or more nonprofit Access Center(s) to manage and program the PEG Access channels.

H. In consideration of ten dollars ($10.00), Grantee agrees to convey to Grantor the current inventory of PEG Access equipment provided by Grantee pursuant to City of Raleigh Ordinances #1983-121 and #1983-131 subsequent to Franchise acceptance.

I. Grantor, through any contract or PEG channel use agreement with Access Center(s) or other nonprofit agencies, or any other party shall ensure that all forms of audio or video programming produced with equipment or through facilities provided under Section 11 shall not, to the extent legally possible, be made available to any other Cable Operator or other video distribution system serving residents of the City unless such Cable Operator or video distribution system remits funds to support PEG access equivalent to those paid by Grantee and its subscribers.

Section 12. Support for "PEG" Facilities and Equipment Capital Costs

A. In the event the Grantor elects to approve a monthly "PEG" charge (PEG Capital Charge) upon Basic Service subscribers of Grantee's cable system and likewise any other franchised cable system to support PEG Facilities and Equipment Capital Costs, Grantee agrees to bill and collect such charge to the extent set forth herein. Upon the terms and conditions set forth below, Grantee shall itemize and bill in its monthly statements for the PEG Facilities and Equipment Capital Costs.

B. The amount of the "PEG" charge to be billed by Grantee shall be :

- 18¢ for years 1-5 of this franchise; and
- 21¢ for years 6-10 of this franchise

per directly billed Basic Service Subscriber.

C. The "PEG" charge shall be itemized as a monthly charge to directly billed Basic Service subscribers and shall be included by Grantee in its statements for the provision of Basic Service. No Franchise Fee payment shall be due on such funds collected by Grantee. Grantee's sole obligation shall be to remit the amounts of the "PEG" charge it collects to the Grantor on a quarterly basis along with Grantee's Franchise Fee payment. Other than as outlined in paragraph A above, Grantee shall have no obligation to attempt to collect unpaid "PEG" charges on behalf of the Grantor. Grantee shall not be obligated to terminate service to any Subscriber for failure to pay all or any portion of the "PEG" charge.

D. The Grantor must give Grantee sixty (60) days written notice of its decision to require Grantee to begin billing and collection of the "PEG" charge. Upon receipt of such notice, Grantee agrees to begin billing the "PEG" charge to directly billed Basic Service subscribers within ninety (90) days. The Grantor, at its election, may decrease (or eliminate) the amount of the "PEG" charge upon sixty (60) days written notice to Grantee.

E. Grantee's obligation to bill and remit the "PEG" charge shall terminate upon Grantee's giving thirty (30) days written notice to the Grantor should the funds collected through the "PEG" charge be used by the Grantor or Access Center, which may include the Grantor for purposes other than the production of Public, Education, and Government Access Programming distributed within the Grantor franchise area over facilities provided by Grantee.

F. The Grantee shall be permitted to recover all costs of funding franchise requirements in support of PEG equipment, facilities, and channels including a return on the funding as permitted by rules of the Federal Communications Commission.

G. The "PEG"charge described in this Section is not a Franchise Fee payment and falls within U.S.C. 542(g)(2)(C). In all other respects, all payments, contributions, services, equipment, facilities support or other resources supplied by Grantee pursuant to Franchise requirements by the Grantor shall be treated in accordance with applicable law for purposes of Franchise Fee computation. Grantee shall be permitted to pass through all Franchise commitments, obligations, or payments or recover them through adjustments to Basic Subscriber rates, as permitted by applicable law and FCC regulations and the Grantor shall promptly approve all such rates or adjustments submitted by Grantee in accordance with such laws or obligations.

Section 13. Institutional Network Provisions

Upon request of Grantor, Grantee shall provide capacity upon an Institutional Network in accordance with **Exhibit B** of this Agreement.

In lieu of the construction of Institutional Network (I-Net) capacity as set out in **Exhibit B,** Grantor may direct Grantee to provide data transmission capacity on the Cable System for non commercial governmental purposes subject to the following conditions:

A. In the event that I-Net capacity is being used in violation of the terms and conditions of the Franchise, Grantor shall provide written notification to Grantee;

B. Grantee shall own all equipment and facilities used to provide the capacity to Grantor;

C. Grantee shall have the right to use any capacity not in use by Grantor;

D. Grantor shall not re-sell, license or otherwise assign use of any of the capacity to a third party;

E. The capacity shall be used by the grantor for non commercial governmental purposes and no other purposes;

F. Grantee shall not be required to provide more than six (6) MHz downstream and three (3) MHz upstream for government data and/or digital video transmission purposes on the Cable System. The six (6) MHz downstream for data transmission capacity shall reduce the maximum commitment to provide PEG Access Channels by one (1) channel. Should the City discontinue the use of the I-Net, the six (6) MHz downstream that was used for data transmission shall be converted to a PEG channel; thereby, restoring the maximum commitment to six (6) PEG Access Channels.

G. Use of the data transmission capacity by Grantor shall not interfere with the operations of Grantee and shall not interfere with or impair the technical quality or reliability of the Cable System; and

H. Grantor shall be solely responsible for the purchase, installation, quality, maintenance and operation of end user equipment connected to the Cable System. Such equipment shall not interfere with the operation of Grantee's Cable System.

I. Grantor has designated locations, attached as **Exhibit C** and incorporated by reference as if fully set forth herein, to be served by the I-Net capacity on the Cable System. If in the future, Grantor desires to have the I-Net extended beyond that

which is set forth in **Exhibit C**, Grantee agrees to charge Grantor on a "time and materials" basis, including overhead costs, for the extension and construction of such additional I-Net facilities; and

J. The parties acknowledge that use of the I-Net is subject to applicable law. Grantor or public agency agrees to indemnify and hold harmless Grantee from and against any and all claims, damages, liabilities, costs and expenses, including reasonable attorney's fees and costs related to the material under Grantor's or public agency user's exclusive control carried on the I-Net, including but not limited to, copyright infringement, libel, slander, defamation, patent, trademark, or invasion of privacy claims.

Section 14. Transfer of Ownership or Control

A. Transfer of Franchise. Any Franchise granted hereunder cannot be sold, transferred, leased, assigned or disposed of, including but not limited to, by force or voluntary sale, merger, consolidation, receivership or other means without the prior consent of Grantor, which shall not be unreasonably withheld, provided that Grantee may transfer the Franchise to an entity under common control with Grantee without such consent, but notice thereof shall be provided to Grantor.

B. Transfer Threshold. Grantee shall promptly notify Grantor of any actual or proposed change in or transfer of, or acquisition by any other party of control of Grantee. The word "control" as used herein is not limited to major stockholders, but includes actual working control in whatever manner exercised. There shall be a rebuttable presumption of a transfer of control upon the disposal by Grantee, directly or indirectly, by gift, assignment, voluntary sale, merger, consolidation or otherwise, of ten percent (10%) or more, at one time, of the ownership or controlling interest in the system, or twenty percent (20%) cumulatively over the term of the Franchise of such interest to a corporation, partnership, trust or association, or person or group of persons acting in concert. Grantor shall exercise its power to approve a transfer of ownership or control in a manner consistent with Section 617 of the Communications Act (47 U.S.C. 537).

C. Process. Every change, transfer, or acquisition of control of Grantee, except a pro forma transfer of assignment contemplated by Section 14(A), shall make the Franchise subject to cancellation unless and until Grantor shall have consented thereto, which consent shall not be unreasonably withheld. For the purpose of determining whether it shall consent to such change, transfer or acquisition of control, Grantor may inquire into the legal, financial, and technical qualifications of the prospective controlling party, and whether or not Grantee has materially complied with the terms of the Franchise prior to transfer, and Grantee shall assist Grantor in

any such inquiry. Failure to provide all information reasonably requested by Grantor as part of said inquiry shall be grounds for denial of the proposed change, transfer or acquisition of control.

D. Assumption of Control. Grantor agrees that any financial institution having a pledge of the Franchise or its assets for the advancement of money for the construction and/or operation of the Franchise shall have the right to notify Grantor that it or a designee satisfactory to Grantor will take control and operate the cable television system. Further, said financial institution shall also submit a plan for such operation that will insure continued service and compliance with all Franchise obligations during the term the financial institution exercises control over the system. The financial institution shall not exercise control over the system for a period exceeding one (1) year, unless extended by Grantor at its discretion and during said period of time it shall have the right to petition for transfer of the Franchise to another Grantee as provided in this Section.

E. Regulation of Transfer. The consent or approval of Grantor to any transfer of Grantee shall not constitute a waiver or release of the rights of Grantor or the State in and to the street, or rights-of-way and any transfer shall, by its terms, be expressly subject to the terms and conditions of the Franchise Agreement.

F. Right to Review Purchase Price. Grantor reserves the right to review the purchase price of any transfer or assignment of the cable system for rate-making purposes to the extent permitted under applicable laws and regulations.

G. Signatory Requirement. Any approval by Grantor of transfer of ownership or control shall be contingent upon the prospective franchisee becoming a signatory to the Franchise.

Section 15. Remedies

A. In addition to any other rights set out elsewhere in this Franchise, and subject herein, Grantor reserves the right to declare a forfeiture of this Franchise, and all of Grantee's rights arising hereunder, in the event that:

1. Grantee is found to have violated any material provision of this Franchise; or

2. Grantee is found by a court of competent jurisdiction to have practiced any fraud or deceit upon Grantor.

B. Grantor shall give Grantee thirty (30) calendar days written notice of its intent to exercise its rights under this Section, stating the reasons for such action. If Grantee cures the problem within the thirty (30) day notice period, or if Grantee initiates substantial effort to remedy the stated problem, and the efforts continue in good faith, then Grantor shall not have the right to declare a forfeiture of the Franchise. If Grantee fails to cure the stated violation within the thirty (30) day notice period, or if Grantee does not undertake efforts reasonably satisfactory to Grantor to remedy the stated violation, then Grantor, upon thirty (30) calendar days notice to Grantee, shall schedule a public hearing to determine whether Grantor should declare a forfeiture of this Franchise. At such hearing, Grantee shall have the right to be heard and present evidence. Grantor shall issue a written decision, based on the evidence in the record, setting forth its findings of fact and conclusions of law. Grantee shall have the right to appeal any such decision to a court of competent jurisdiction. The determination by the City Council may be implemented during the pendency of any such appeal.

Section 16. Expiration and Renewal

Renewal of this Franchise shall be governed by applicable federal and state law.

Section 17. Forum for Litigation

Any litigation between Grantor and Grantee arising under or regarding this Franchise shall occur, if in the state courts, in the Wake County Superior or District Court having jurisdiction thereof, or if in the federal courts, in the United States District Court for the Eastern District of North Carolina.

Section 18. Notice

Any notice provided for under this Franchise shall be sufficient if in writing and delivered personally to the following addressee or deposited in the United States Mail, postage prepaid, certified mail, return receipt requested, addressed as follows, or to such other address as the receiving party hereafter shall specify in writing:

If to Grantor:
City Manager
City of Raleigh
Post Office Box 590
Raleigh, NC 27602

If to Grantee:
Division President
Time Warner Cable
Post Office Box 568
Morrisville, NC 27560-0568

Section 19. Severability

If any section, subsection, sentence, clause, phrase, or other portion of this Ordinance is, for any reason, declared invalid, in whole or in part, by any court, agency, commission, legislative body, or other authority of competent jurisdiction, such portion shall be deemed a separate, distinct, and independent portion. Such declaration shall not affect the validity of the remaining portions hereof, which other portions shall continue in full force and effect.

Section 20. Non - Discrimination

Grantee shall not discriminate in any manner on the basis of factors prohibited by law. Grantee shall comply with the terms and conditions of Ordinance Number 1969-889.

Section 21. Non - Divestiture

This Franchise shall not divest Grantor of any right or interest in the public rights-of-way.

Section 22. Letter of Credit

A. Within thirty (30) calendar days following the award of the Franchise, Grantee shall deposit with Grantor a letter of credit from a financial institution, approved by Grantor's Finance Director, in the amount of fifty-thousand dollars ($50,000). The form and content of the letter shall be approved by the City Attorney. The letter of credit shall be used to insure the faithful performance of Grantee of all provisions of the Franchise, and compliance with all orders, permits and directions of any agency, commission, board, department, division or office of Grantor exercising jurisdiction over Grantee's acts or defaults, and payment by Grantee of any penalties, claims, liens, liquidated damages, or fees due Grantor.

B. If Grantee fails to pay to Grantor any compensation not in dispute, due Grantor within the time fixed herein; or fails, after ten (10) calendar days notice to pay Grantor any penalties, claims, liens, liquidated damages, fees due Grantor, then such failure by Grantee can be remedied by demand on the letter of credit. Grantor may immediately request payment of the amount due from the letter of credit. Upon such request for payment, Grantor shall notify Grantee of the amount and date thereof.

C. The letter of credit shall be maintained at fifty-thousand dollars ($50,000) during the entire term of the Franchise unless modified in accordance with the procedures provided for in Section 32 herein. In the event that amounts are withdrawn pursuant to this Section, Grantee, shall take any required action to restore the letter of credit to fifty-thousand dollars ($50,000) within ten (10) calendar days of notification by Grantor of its withdrawal against the letter of credit.

D. The rights reserved to Grantor with respect to the letter of credit are in addition to all other rights of Grantor, whether reserved by the Franchise, or authorized by law, and no action, proceeding or exercise of a right with respect to such a letter shall affect any other right Grantor may have.

E. The letter of credit shall contain the following endorsement:

> *"It is hereby understood and agreed that this letter of credit shall not be canceled by the surety nor the intention not to renew be stated by the surety until thirty (30) calendar days after receipt by the City, by registered mail, of a written notice of such an intention to cancel or not to renew."*

F. Grantee shall renew the letter of credit not less than thirty (30) calendar days prior to its expiration and provide a copy of the renewal to Grantor.

Section 23. Remedies - Liquidated Damages

A. Because Grantee's failure to comply with provisions of this Franchise may result in injury to Grantor, Grantor may impose penalties commensurate to the harm caused to Grantor consistent with the standards set forth herein. Maximum damage amounts may be adjusted throughout the Franchise term by Grantor by resolution to take into account increases in the Consumer Price Index.

B. For failure to comply with material requirements of the I-Net provisions of the Franchise: up to five hundred dollars ($500.00) each calendar day for each offense. A separate and distinct offense shall be deemed committed each calendar day on which a violation occurs or continues;

C. For failure, pursuant to this agreement, to submit reports, maintain records, provide documents or information: up to five hundred dollars ($500.00) for each offense per calendar day. A separate and distinct offense shall be deemed committed each calendar day on which a violation occurs or continues;

D. For failure to comply with material requirements of the Customer Service Standards: up to five hundred dollars ($500.00) for each offense per calendar day. A separate and distinct offense shall be deemed committed each calendar day on which a violation occurs or continues;

E. For failure to comply with transfer provisions: up to five hundred dollars ($500.00) for each calendar day from the date of any unlawful transfer; and

F. For failure to comply with any material provision herein for which a penalty or sanction is not otherwise specifically provided: up to five hundred dollars ($500.00) for each offense per calendar day. A separate and distinct offense shall be deemed committed each calendar day on which a violation occurs or continues.

G. Penalties will commence to accumulate only for calendar days of noncompliance which occur after the final date set by Grantor for achieving compliance. Such date shall be set at a public hearing of which Grantee is given at least three (3) calendar days notice and at which it has an opportunity to be heard. No penalties will be assessed for a violation period which has existed prior to the expiration of the period set by Grantor herein for correcting the defect.

I. Consistent with Section 35, Grantor shall stay or waive the imposition of any penalties set forth herein upon a finding that any failure or delay is the result of an act of God or due to circumstances beyond the reasonable control of Grantee.

Section 24. Remedies - Cumulative

All remedies provided under this Franchise agreement or the enabling ordinance shall be cumulative, unless otherwise expressly stated. The exercise of one remedy shall not foreclose use of another, nor shall it relieve Grantee of its obligations to comply with the Franchise. Remedies may be used singly or in combination; in addition, Grantee or Grantor may exercise any rights they have under applicable law.

Section 25. Books and Records - Inspection

Grantor may inspect the books, records, maps, plans, and other documents, including financial documents, in the control or possession of Grantee, affiliates, or any person that constitutes an operator of Grantee's Cable System: (1) to enforce Grantor's rights or evaluate compliance with the Franchise and applicable law; (2) in the exercise of any lawful regulatory power; or (3) as may be convenient in connection with any proceeding Grantor may or must conduct under applicable law in accordance with the terms of this Franchise Agreement. The material may be duplicated at Grantor's facilities unless Grantee agrees to make inspection and copying available at some other place. Material that the Grantor requires the Grantee to produce under this Section shall be produced upon reasonable notice, no later than thirty (30) calendar days after the request for production. Requests for extensions of time to respond shall not be unreasonably denied.

The Grantee may request that the Grantor treat records containing trade secrets or proprietary information as confidential under the North Carolina Public Records law. To the extent authorized by the Public Records law and other applicable state and federal law, Grantor shall maintain the confidentiality of information designated "proprietary" by Grantee. Should Grantor receive a request to review Grantee's records or books under the North Carolina

Public Records law, it will promptly notify Grantee and provide an opportunity for the Grantee to raise an objection, demonstrate why the requested information is proprietary and, if necessary, seek a court order to protect its proprietary information. However, any action taken by the Grantee to protect its records or information shall be done at no cost or liability to the Grantor.

Section 26. Books and Records - Reports

Grantee shall provide the following reports to Grantor:

A. A quarterly Franchise Fee report listing revenues received;

B. Within ninety (90) calendar days after the close of Grantee's fiscal year the Grantee shall submit a written annual report setting forth revenues received by category for said fiscal year, certified by an official of Grantee. Upon request of Grantor, the Grantee shall furnish the Grantor a copy of the most recent annual report, if any, of its parent entity.

C. Grantee shall file with Grantor any notice of deficiency, forfeiture, or other document issued by any state or federal agency which has instituted any investigation or civil or criminal proceeding naming the cable system, Grantee, or any operator of the Cable System, to the extent the same may affect or bear on the operations of Grantee's cable system.

D. Grantee shall file with Grantor any request for protection under Bankruptcy laws, or any judgment related to a declaration of bankruptcy by Grantee, any affiliate which controls or manages Grantee, or any operator of the Cable System.

E. Upon request by Grantor, Grantee shall discuss its contingency plans for responding to natural disasters with representatives of Grantor.

F. Upon reasonable notification by the Grantor, the Grantee shall send a company official to any public meeting convened by the Grantor for the purpose of discussing Cable Service in Raleigh and/or the Grantee's performance pursuant to this Agreement.

Section 27. Books and Records - Maintenance

In addition to reports required by this Franchise, Grantee shall maintain records of the following:

A. FCC proof of performance; and

B. Records demonstrating compliance with applicable Customer Service Standards.

Section 28. Inspection of Cable System

Grantor may inspect Grantee's Cable System, and upon reasonable notice, inspect the distribution facilities and equipment of the Cable System. If, based upon Subscriber complaints or its own investigation, Grantor finds that the Cable System's operation is out of compliance with the Franchise agreement or applicable Federal rules, it may require Grantee to perform tests, prepare a report and present to Grantor the results of those tests. Grantee shall identify any problem found, advise the Grantor of the remedy it intends to pursue to correct the problem, take action to remedy the problem and provide copies of test data to show that the problem has been corrected.

Section 29. Insurance

A. Within thirty (30) calendar days after the effective date of the Franchise, Grantee shall provide proof of the required insurance. Grantee shall maintain this insurance throughout the Franchise term. Insurance shall include, in amounts not less than those indicated herein:

1. Worker's Compensation coverage for all employees with Statutory Limits in compliance with applicable state and federal laws. The policy shall include Employers' Liability with a limit of five-hundred thousand dollars ($500,000) for each accident;

2. Comprehensive General Liability with a minimum limit of two-million dollars ($2,000,000) per occurrence, four-million ($4,000,000) aggregate combined single limit for bodily injury liability and property damage liability. This shall include premises and/or operations, independent contractors, and subcontractors and/or completed operations, broad form property damage, XCU Coverage, and a Contractual Liability Endorsement;

3. Business Auto Policy shall have minimum limits of one-million dollars ($1,000,000) per occurrence combined single limit for bodily injury liability and property damage liability. This shall include owned vehicles, hired and non-owned vehicles; and

4. An umbrella policy which shall have minimum limits of five million dollars ($5,000,000) per occurrence.

B. The insurance coverage obtained by the Grantee necessary to comply with this Franchise Agreement shall be approved by Grantor's risk management office, such

approval not to be unreasonably denied or delayed, and a certificate of insurance shall be filed with the Grantor.

C. The City of Raleigh shall be named as an additional insured as its interests may appear.

Section 30. Emergency Alert System Participation

Grantee shall install and maintain an emergency alert system (EAS) pursuant to FCC's rules and the North Carolina Emergency Alert System Plan. Grantor's Public Safety Communication Center shall access the system in accordance with the State EAS Plan to communicate emergency messages and alerts to residents consistent with Section VI (B) of the North Carolina Emergency Alert System Plan.

Section 31. Service to Public Buildings

Grantee shall, upon request, provide Cable Service to public buildings located within one hundred twenty-five feet (125') of Grantee's existing distribution system; provided, however, if adequate underground conduit is provided by the requesting public agency, Grantee shall, upon request, provide Cable Service to public buildings within two hundred fifty feet (250') from Grantee's Cable System; provided, however, the Grantee shall not be required to provide internal wiring, distribution lines or facilities other than to a demarcation point for video or data distribution internal to the public building. All charges for installation and provision of Cable Services or Other Communication Services to such public buildings (except for those locations set out on **Exhibit D**), shall be at Grantee's then-current rates. To the extent services are provided to Public Buildings, neither Grantor nor any other person may resell such services. Nor shall any person, organization or other entity receiving free or reduced cost services or connections, extend such service or connection to other persons or locations without written approval by the Grantee.

Section 32. Five - Year Review: Performance Monitoring

A. During the years which commence on the fifth anniversary of the effective date of the Franchise, Grantor may commence a review of Grantee's performance under the Franchise. As part of this review, Grantor may consider:

1. whether Grantee has complied with its obligations under the Franchise and applicable law;

2. whether customer service standards, technical standards, bond or security fund requirements are adequate or excessive; and,

3. other issues as may be raised by Grantee, Grantor, or the public.

B. Grantor shall conduct public hearings to provide Grantee and the public the opportunity to comment on Grantee's performance and other issues considered as part of the five-year review.

C. Any revisions to the Franchise Agreement which either Grantor or Grantee wishes to make as a result of these reviews shall be proposed under the procedures established herein.

D. Periodic Evaluation, Review and Modification.

1. Grantor and Grantee acknowledge and agree that the field of cable television is a relatively new and rapidly changing one which may see many regulatory, technical, financial, marketing and legal changes during the term of this Franchise. Therefore, to provide for the maximum degree of flexibility in this Franchise, and to help achieve a continued, advanced and modern Cable System, the following evaluation and review provisions will apply:

(a) Grantor may, upon thirty (30) calendar days notice, request evaluation and review sessions at any time during the term of this Agreement and Grantee shall cooperate in such review and evaluation; provided, however, there shall not be more than one (1) evaluation and review session during any calendar year.

(b) Topics which may be discussed at any evaluation and review session include, but are not limited to, rates, channel capacity, the System performance, PEG Access, municipal uses of cable, Subscriber complaints, judicial rulings, FCC rulings and any other topics Grantor or Grantee may deem relevant.

(c) During an evaluation and review session, Grantee shall cooperate fully with Grantor and shall provide without cost such reasonable information and documents as Grantor may request to perform the evaluation and review.

(d) If at any time during the evaluation and review, Grantor reasonably believes evidence exists which substantiates the technical performance of the Cable System violates the terms of this Franchise, Grantor may require Grantee, at Grantee's expense, to perform appropriate tests and analyses directed toward such suspected technical inadequacies. In making such request, Grantor shall describe and identify, as specifically as possible, the nature of the problem and the type of test Grantor believes to be appropriate. Grantee shall cooperate fully with Grantor in performing such tests

and shall report to Grantor the results of the tests, which shall include at least:

(1) a description of the problem in the Cable System performance which precipitated the special tests;
(2) the Cable System component tested;
(3) the equipment used and procedures employed in testing;
(4) the method, if any, by which the Cable System performance problem was resolved; and
(5) any other information pertinent to said tests and analyses.

(e) As a result of an evaluation and review session, Grantor or Grantee may determine that a change to the Cable System or in the terms of the Franchise may be appropriate. In that event, either Grantor or Grantee may propose modifications to the Cable System or the Franchise. Grantee and Grantor shall, in good faith, review the terms of the proposed change or any proposed amendment to this Franchise and seek to reach agreement on such change or amendment.

2. Grantor and Grantee shall act in good faith during such negotiations and shall be obligated to agree to the reasonable requests of the other party for changes in the Cable System or amendment to the Franchise when the change or amendment is not inconsistent with the other terms of the Franchise, or with applicable law or regulations, and the change or amendment is technically feasible, economically reasonable, and will not result in a material alteration of the rights and duties of the parties under the Franchise.

Section 33. Conflict with Cable Regulatory Ordinance

In the event of any conflict between the terms and conditions of this Franchise Agreement and the provisions of the Cable-Telecommunications Standards Ordinance No. (1995) 631, the terms of this Franchise Agreement shall prevail.

Section 34. Reservation of Rights

Grantor and Grantee reserve all rights that they may possess under the law unless expressly waived herein.

Section 35. Force Majeure

In the event Grantee's performance of any of the terms, conditions, obligations or requirements of this Franchise is prevented or impaired due to any cause beyond its

reasonable control or not reasonably foreseeable, such inability to perform shall be deemed to be excused and no penalties or sanctions shall be imposed as a result thereof, provided Grantee provides notice to Grantor in writing within thirty (30) calendar days of Grantee's discovery of the occurrence of such an event or within thirty (30) calendar days of Grantor's notice to Grantee of a failure to perform occasioned by such cause, which notice explains the circumstances. Such causes beyond Grantee's reasonable control or not reasonably foreseeable shall include, but shall not be limited to, acts of God, civil emergencies and labor unrest or strikes, untimely delivery of equipment, inability of Grantee to obtain access to property easements, rights of way and inability of Grantee to secure all necessary permits to utilize poles and conduits so long as Grantee utilizes due diligence to obtain said permits in a timely fashion.

Section 36. Grant

This Franchise is granted by Grantor to Time Warner Cable Entertainment Advance-Newhouse Partnership pursuant and subject to the conditions and requirements and applicable federal, state and local laws. This Franchise bestows upon Grantee the authority to construct, maintain and operate a Cable System, utilizing the Public Rights-Of-Way, to offer Cable Services and Other Communications Services within the City.

Adopted : November 16, 1999

IN WITNESS WHEREOF, the undersigned have caused this Agreement to be executed.

ATTEST

By: _____
Gail G. Smith
City Clerk

CITY OF RALEIGH

By: _____
D. E. Benton
City Manager

APPROVED AS TO FORM:

By: _____
Tom McCormick
City Attorney

CITY OF RALEIGH city seal NORTH CAROLINA

Section 37. Acceptance by the Company

This Franchise and all of its terms and provisions shall be accepted by the Company in writing in the form hereinafter set forth within thirty (30) days of the grant of this Franchise by the City Council and when accepted shall be filed with the City Clerk who shall record the same in the Book of Ordinances. Such written acceptance may be upon or at the end of a copy of this Ordinance and it shall state and express the acceptance of the said Franchise and its terms, conditions, and provisions; and the said Company shall agree in said written acceptance to abide by, to observe and to perform the same according to all of its terms and provisions, subject to applicable state and federal law, and shall declare that statements and recitals contained on said Franchise are correct and that it has made and does make the agreements and statements set forth in this Franchise. Acceptance herein referred to shall be in the following form:

"The undersigned _____ does hereby accept and approve the foregoing and attached Franchise and all of its terms and conditions; and in consideration of the benefits and privileges granted to it does hereby agree to abide by, carry out, observe, and perform all of the obligations and things provided to be carried out and performed by it in said Franchise approved by the City Council of the City of Raleigh, subject to applicable state and federal law.

This the _____day of _____, _____.

By:_____,
President, Raleigh-Durham Division of Time Warner Entertainment-Advance Newhouse

ATTEST:

_____,

corp-seal

STATE OF NORTH CAROLINA)
) ss
COUNTY OF WAKE)

On the _____ day of _____, _____, before me, a Notary Public in and for the County and State aforesaid, personally appeared Randall O. Fraser the President, Time Warner Entertainment-Advance Newhouse-Raleigh-Durham Division and _____ the _____ of the Company, and for themselves and as such officers respectively, before and on the behalf of the said Company, acknowledge the signing and execution of the foregoing instrument and acknowledge that the seal affixed to said instrument is the corporate seal of the said Company; and they affixed such corporate seal to and otherwise executed said instrument on behalf of the said instrument is their free and voluntary act and deed as such officers respectively and is the free and voluntary act of the Company for all of the uses and purposes and said instrument mentioned, all pursuant to authority and direction duly given by the Board of Directors of the said Company.

In testimony whereof I have hereunto subscribed my name and affixed by notarial seal on the day and year first above written.

_____
Notary Public

My commission expires:

_____

Exhibit A

Customer Service Standards

1. Subscriber Privacy

In accordance with Section 631 of the Federal Cable Act of 1984, Grantee shall, no less than annually, provide a privacy notice in the form of a separate written statement to subscribers as required by the provisions of the Act.

2. Employee Identification

When calling in person on subscribers or other residents, all employees or authorized representatives of Grantee are required to display an employee identification card with their name, photograph and signature, and a telephone number that can be used for verification of the representative's capacity with Grantee. Grantee's vehicles shall display the name of the cable company in easily distinguishable alpha-numeric characters. Grantee shall make a reasonable effort to cause its subcontractors' vehicles to be identified in a like fashion.

3. Office and Telephone Availability

A. Knowledgeable, qualified company representatives will be available to respond to customer telephone inquiries inquiries Monday through Friday during normal business hours. Additionally, based on community needs, Grantee will staff its telephones for supplemental hours on weekdays and/or weekends.

B. Under normal operating conditions, telephone answer time by Grantee's customer service representatives, including wait time required to transfer the call, shall not exceed thirty (30) seconds. This standard shall be met no less than ninety percent (90%) of the time measured on an annual basis.

C. Under normal operating conditions, the customer shall receive a busy signal less than three percent of the total time that Grantee's office is open for business.

D. Customer service center and bill payment locations operated by Grantee shall be open for transactions Monday through Friday during normal business hours. Additionally, based on community needs, Grantee shall schedule supplemental hours on weekdays and/or weekends during which these centers shall be open.

E. Grantee shall be responsible for adopting and implementing subscriber complaint procedures, and for advising subscribers of the availability of these procedures. The

procedures shall be designed to resolve subscriber complaints in a timely and satisfactory manner; to develop sensitivity and responsiveness to subscriber needs by Grantee and its management; and to improve the quality and dependability of services to subscribers by Grantee.

Established complaint procedures shall include: specific provisions permitting subscriber repair service complaints received to be received by telephone twenty-four (24) hours each day and seven (7) calendar days each week; permitting subscriber repair service complaints to be received at Grantee's business office from 8:00 A.M. until 7:00 P.M. on Monday through Friday of each week and from 9:00 A.M. until 1:00 P.M. on Saturday; and the address of Grantee's business office.

4. Installations, Outage and Service Calls

Under normal operating conditions, each of the following standards shall be met no less than ninety-five percent (95%) of the time measured on an annual basis.

A. Standard installation shall be performed within seven (7) business days after an order has been placed. "Standard" installations are up to one hundred fifty (150) feet from the existing distribution system.

B. Excluding those situations beyond the control of Grantee, Grantee shall respond to service interruptions promptly and no later than twenty-four (24) hours after the interruption becomes known to Grantee. Grantee must begin actions to correct other service problems the next business day after notification to Grantee of the service problem.

C. The "appointment window" alternatives for installations, service calls, and other installation activities shall be: 1) morning, 2) afternoon, or 3) all day during normal business hours. Additionally, based on the community needs, Grantee shall schedule supplemental hours during which appointments can be set.

D. If, at any time an installer or technician is running late, an attempt to contact the customer shall be made and the appointment reschedule as necessary at a time which is convenient for the customer.

E. Grantee shall render efficient service, make repairs promptly and interrupt service only for good cause and for the shortest time possible. Such interruptions not within the midnight to 6:00 A.M. period, insofar as possible, shall be preceded by a notice to subscribers.

F. Grantee office and technical personnel, in lieu of answering devices, shall receive customer calls during business hours and respond to all customer complaint calls

until 10:00 P. M. on normal business days. After 10:00 P. M. on any day, trained technicians shall respond to calls if three (3) or more complaints are received by subscribers served by a common distribution system.

5. Communication, Statements, Refunds, and Credits

A. Grantee shall provide written information in each of the following areas at the time of installation and at any future time upon request:

* products and services offered
* prices and service options
* installation and service policies
* how to use the cable service

B. Subscriber billing statements shall be clear, concise and understandable. Such statements shall reflect all services and fees in an itemized fashion.

C. Refund checks shall be issued promptly, but no later than the earlier of thirty (30) calendar days or the customer's next billing cycle following the resolution of the request or, if service was terminated thirty (30) calendar days from the date of the return of the equipment supplied by the cable company.

D. Customers shall be notified in writing a minimum of thirty (30) calendar days in advance of any rate or channel change, provided the change is within the control of Grantee.

E. Grantee shall provide outage credit to subscribers in accordance with the following policy:

Upon notification, should Grantee fail to correct a service outage problem - within its control - within 24 hours after having receipt of such notice , Grantee shall credit 1/30th of the monthly charge for the affected service for each 24-hour period or fraction thereof following the first twenty-four (24) hour period during which the subscriber experiences service outage. Subscriber must advise Grantee of the duration of the service interruption for which credit is sought in order to receive such credit. Reasonable notice for this provision shall mean written, telephonic (voice), facsimile or e-mail communication to the Grantee.

F. Late fees shall not be assessed earlier than thirty (30) calendar days past the billing cycle due date.

6. Complaint - Appeals

A. Upon notification by a subscriber of an unresolved complaint, the Information Access Manager shall determine the facts of the complaint by obtaining information

from the subscriber and Grantee and shall act to resolve the complaint in a manner consistent with the City's authority.

B. The cable subscriber may register a complaint with the City, regarding rates or associated equipment rental, and the City may file a formal complaint with the Federal Communications Commission as provided by FCC regulations.

Exhibit B

Institutional Network

Upon Grantor's request, Grantee shall provide Grantor capacity upon an Institutional Network (I-Net) in accordance with the terms and conditions of this Exhibit and an agreement (I-Net Agreement) entered into between Grantor and Grantee.

A. Request for Plan

After acceptance of this Franchise, by Grantee, Grantor may request in writing thatGrantee prepare and present to Grantor a Preliminary Design for the use of capacity on its cable system as an Institutional Network ("I-Net"). The request by Grantor shall include a designation of locations to be serviced by the I-Net.

B. Preliminary Design

Upon Grantor's request, Grantee will provide one Preliminary Design of the I-Net and cost estimate at no cost to Grantor. The Preliminary Design will consist of a general I-Net design based on Grantor's stated present and future capacity needs. Grantee will suggest a basic design for the I-Net and provide a not-to-exceed estimate of construction costs for the capacity required on the I-Net. The Preliminary Design will not include a walkout of Grantor's building(s) to be provided I-Net capacity, a detailed network design or a specific cost proposal, all of which shall be part of the Final Design. It is recognized that it is the intent of the parties that the facilities providing I-Net capacity be constructed in conjunction with the upgrade of the cable system to the extent reasonably possible without causing interruption or delay in the cable system upgrade in order to minimize costs to Grantee and Grantor.

C. Final Design Agreement

(1) Upon written request of Grantor, after receipt of the Preliminary Design, Grantee shall quote a not-to-exceed fee for completion of a Final Design (the Final Design Fee). The Final Design Fee shall be the responsibility of Grantor. If Grantor requests I-Net capacity, the Final Design Fee may, at the option of Grantor, be added to the costs that determine the Service Fee, as defined below.

(2) Upon written request of Grantor, and within no more than 120 calendar days after receipt of the Preliminary Design, Grantee will provide a Final Design of the I-Net capacity requested by Grantor. The Final Design shall include the following: (i) a walkout of the public buildings to which I-Net capacity will be provided; (ii)

a detailed network design; (iii) a cost breakdown of all material (referred to as the Service Fee).

(3) Upon receipt of the Final Design, Grantor shall have one hundred-twenty (120) calendar days to enter into an I-Net Agreement on the terms set forth in the Final Design.

(4) Such Service Fee shall be reasonable and shall permit Grantee to recover all costs for construction, installation, maintenance and operation of the I-Net for it is the intention of the parties that the I-Net be self supporting from fees and charges paid by Grantor. When the parties have agreed on the terms and conditions with respect to the I-Net, its use and charges thereof, the parties shall execute a written agreement ("the I-Net Agreement") setting forth the terms and conditions which agreement shall be incorporated into and be a part of this Franchise Agreement. Grantee shall have no obligation to provide I-Net capacity absent such agreement.

D. Fees

(1) Service Fee. The Final Design will include a Service Fee, defined as Grantee's cost to provide all materials, labor, equipment and Facilities to provide capacity to Grantor as set forth in Section C (4) plus a return of 11.25 percent per annum. Such costs will be on an Incremental Cost basis if the construction of I-Net capacity is feasible in conjunction with the upgrade of the Cable System. Incremental Cost is defined as all avoidable costs that would not have been incurred by Grantee but for Grantor's request for I-Net capacity. If Grantor requests I-Net capacity that must be provided after the upgrade of the Cable System, the Service Fee will equal Grantee's costs to provide such capacity on an Allocated Cost basis. Allocated Cost is defined as all costs incurred by Grantee to provide the I-Net capacity to Grantor. Any costs incurred by Grantee to provide capacity in excess of that requested by Grantor shall be borne by Grantee.

(2) Usage Fee. In addition to the Service Fee, throughout the term of the Franchise, commencing upon activation of the I-Net capacity, Grantor shall pay Grantee a monthly Usage Fee. The Usage Fee shall be paid for the usage of the I-Net capacity, maintenance of outside plant and maintenance, replacement diagnosis of electronic equipment necessary to provide I-Net capacity. The Usage Fee will be equal to 80% of the average rate charged currently by at least three (3) land-line competitors in the same market for equivalent capacities of bandwidth being provided on the I-Net (the Average Rate). The Average Rate shall be based on the rates quoted by competitors in response to a survey conducted by Grantee and Grantor a least sixty (60) calendar days prior to activation of I-Net capacity. Each of the three (3) competitors must provide services similar to those provided by Grantee under the I-Net Agreement and be authorized by the North Carolina Utilities Commission. At least one of the competitors must be a local exchange

carrier. If there are only two (2) competitors in the same market, the Usage Fee will be an amount equal to 80% of the Average Rate offered for similar services by the two (2) competitors. If there is only one competitor in the market, the Usage Fee will be an amount equal to 80% of the rate for similar services offered on a nondiscriminatory basis by the one market competitor. The Usage Fee will be adjusted Annually to reflect changes in the local market. The Usage Fee shall never be less than Grantee's cost or be priced so as to violate federal, state or local law.

E. Operation of I-Net

Grantee shall own and maintain the I-Net.

The design of the I-Net shall enable the switching and routing of I-Net signals from Upstream to Downstream transmission to be accomplished remotely via video switcher, computer and modem by Grantor without assistance of Grantee.

Use of the I-Net by Grantor shall not interfere with the operations of Grantee and shall not interfere with or impair the technical quality or reliability of the I-Net or Cable System.

Grantor shall be solely responsible for the purchase, installation, quality, maintenance and operation of end user equipment connected to the I-Net. Such equipment shall not interfere with the operation of Grantee's Cable System.

Grantee shall be responsible for maintenance of the I-Net.

Grantee shall provide at least one-week advance notice to Grantor of any maintenance requiring temporary interruption of service, except in emergency situations.

When Grantee responds to requests for service by Grantor and there is no I-Net problem found, Grantee may charge Grantor for the service at a reasonable fee in addition to any Service and Usage Fees.

F. Additional I-Net Locations

Grantor may, after initial construction and activation of the I-Net, request in writing that the Grantee connect additional sites to the I-Net or construct extensions to the I-Net. The terms regarding any such additional connections, which may include increased Service and Usage Fees, may be set in the I-Net Agreement or by agreement of the parties after the request.

G. Use of I-Net

The parties acknowledge that use of the I-Net is subject to all state and federal law. Grantor agrees to indemnify and hold harmless Grantee from and against any and all claims, damages, liabilities, costs and expenses, including reasonable attorney's fees and costs directly related to the use of I-Net by Grantor, including but not limited to, copyright infringement, libel, slander, defamation, patent, trademark or invasion of privacy claims.

The I-Net shall be used only by Grantor for non commercial education and government purposes. Grantee may charge a fee for information transmitted by means of the I-Net provided that such fee is for the information only and not the transmission thereof and is the same as the fee charged by Grantee for the information when provided by other means. Nothing herein shall preclude Grantee from receiving a fee for the transmission of such information. No direct or indirect commercial use may be made of the I-Net by any party other than Grantee. The Institutional Network shall not be extended other than by Grantee to any location except as permitted by the I-Net Agreement and may not be used by Grantor to transmit or receive any communication (in whatever form, whether video, audio, data, voice or otherwise) destined to or originating from any other switched network, including without limitation, the facilities of any local or long-distance telephone company, except for video programming for use on the Public, Education and Government Access channels. Any use of the Institutional Network other than as permitted herein shall be on terms and conditions agreed to in writing by Grantee and Grantor.

Grantor agrees as a condition of its use of the Institutional Network that:

1. Grantor may not re-sell, license, or otherwise assign use of the Institutional Network Capacity or Services to a third party;

2. The Institutional Network may be used by Grantor for non commercial education and government purposes and for the transmission of PEG video programming, but for no other purposes.

3. Grantor shall notify Grantee in the event that the I-Net capacity is being used in violation of the terms and conditions of the Franchise.

Grantee shall own all equipment and Facilities used to provide the I-Net capacity to Grantor. Grantee shall have the right to use any bandwidth or I-Net capacity not specifically guaranteed or provided to Grantor under the I-Net Agreement.

H. Term

The I-Net Agreement between Grantor and Grantee shall be coterminous with the term of the Franchise Agreement unless otherwise agreed to in writing between Grantor and Grantee.

1. Equipment Space

Grantee shall make available, for Grantor's equipment, space for equipment racks within Grantee's facilities as provided in the I-Net Agreement. Grantor's equipment shall not interfere with the maintenance or operation of Grantee's equipment and operations. Access to Grantee's facilities shall be restricted upon terms and conditions adopted by Grantee. Any space rental fees shall not exceed the charges to other similar users.

Exhibit C

Government, Education and Public Agencies Scheduled
for Institutional Network (I-Net)
Connections and Services

The City has directed all cable television providers to provide sufficient I-Net capacity to support video and data communication links between and among various local government buildings passed by their Cable System. These include data transmission and networking between remote sites (e.g. parks, recreation, sanitation, water treatment fire stations & training center), video conferences between remote public safety and citizen information sites, traffic information - surveillance video from key intersections.

City of Raleigh Government Facilities	Location Street Address	Service Requirement	I-Net video
Avery C. Upchurch Municipal Complex	222 West Hargett Street	Maintain	Yes
ACUM Annex #1	310 West Martin Street	Maintain	Yes
ACUM Annex #2	301 Hillsborough Street	New	Yes
Municipal Complex Satellite	211 West Martin Street	Maintain	Yes
Civic Center	500 Fayetteville St.	Maintain	Yes
Memorial Auditorium	1 East South Street	Maintain	Yes
Remote City Hall @ Litchford Village	8320 Litchford Road	Maintain	No
Remote City Hall @ Laurell Hills	3808 Edwards Mill Road	Maintain	No
Remote City Hall #3	Future Connection	Phase II	No
Remote City Hall #4	Future Connection	Phase II	No
Housing Authority	600 Tucker Street	Phase II	Yes
Transit - Capital Area Transit	1420 Blount Street	Maintain	Yes
Wake CO & NC State Gov't Offices	**Location Street Address**	**Service Requirement**	**I-Net video**
Wake County Government Center	336 Fayetteville St.	Maintain	Yes
NC - Department of Motor Vehicles @ SIPS	3700 Wake Forest Road	New	No
Raleigh City Park and Recreation Facilities	**Location Street Address**	**Subscriber CATV**	**I-Net video**
Millbrook Exchange Tennis Center	1905 Spring Forest Road	Maintain	Yes
Tarboro Park	120 Tarboro Road	Maintain	Yes
Optimist Park	5900 Whittier Road	Maintain	Yes

Pullen Park - Arts Center	105 Pullen Road	Maintain	Yes
Pullen Park - Community Center	408 Ashe Avenue	Maintain	Yes
Lions Park	518 Dennis Avenue	Maintain	Yes
Jaycee Park - Administration Ctr.	2401 Wade Avenue	Maintain	Yes
Jaycee Park - Community Center	2405 Wade Avenue	Maintain	Yes
Sertoma Park	1400 Millbrook Road	Maintain	Yes
Brentwood Park	3315 Vinson Court	Maintain	Yes
Fletcher Park	820 Clay Court	Maintain	Yes
Worthdale Park	1001 Cooper Road	Maintain	Yes
Halifax Park	1015 Halifax Road	Maintain	Yes
Chavis Park	840 Holmes Street	Maintain	Yes
Carolina Pines Park	2305 Lake Wheeler Road	Maintain	Yes
Campbell Park	756 Lunar Drive	Maintain	Yes
Roberts Park	1300 Martin Street	Maintain	Yes
Method Park	514 Method Road	Maintain	Yes
Kiwanis Park	2525 Noble Road	Maintain	Yes
Powell Park	740 Powell Drive	Maintain	Yes
Southgate Park	1801 Proctor Road	Maintain	Yes
Eastgate Park	4200 Quail Hollow Drive	Maintain	Yes
Glen Eden Park	1500 Glen Eden Drive	Maintain	Yes
Biltmore Hills Center	2615 Fitzgerald Drive	Maintain	Yes
Green Road Center	4201 Green Road	Maintain	Yes
Walnut Terrace Recreation Center	111 Lee Street	Maintain	Yes
Park & Recreation Maintenance @ Marsh Creek	4225 Daly Road	Maintain	Yes
Lake Lynn Community Center	7921 Ray Road	Maintain	Yes
City of Raleigh City Fire Stations	Location Street Address	Service Requirement	I-Net video
Fire Administration	310 West Martin Street	Maintain	Yes
Keeter Training Center	105 West Hoke Street	Maintain	Yes
Training Center - Academy	105 West Hoke Road	Phase II	Yes
Career Development Center	2913 Wake Forest Road	Phase II	Yes

Fire Stations #1	220 South Dawson Street	Phase II	Yes
Fire Stations #2	263 Pecan Road	Phase II	Yes
Fire Stations #3	13 South East Street	Phase II	Yes
Fire Stations #4	121 Northway Court	Phase II	Yes
Fire Stations #5	300 Oberlin Road	Phase II	Yes
Fire Stations #6	2601 Fairview Road	Phase II	Yes
Fire Stations #7	2100 Glascock Street	Phase II	Yes
Fire Stations #8	5001 Western Blvd.	Phase II	Yes
Fire Stations #9	4465 Six Forks Road	Phase II	Yes
Fire Stations #10	2711 Sanderford Road	Phase II	Yes
Fire Stations #11	2925 Glenridge Road	Phase II	Yes
Fire Stations #12	3409 Poole Road	Phase II	Yes
Fire Stations #13			
Fire Stations #14	4220 Lake Boone Trail	Phase II	Yes
Fire Stations #15	1815 Spring Forest Road	Phase II	Yes
Fire Stations #16	5225 Lead Mine Road	Phase II	Yes
Fire Stations #17	4601 Pleasant Valley Road	Phase II	Yes
Fire Stations #18	8200 Morgan's Way	Phase II	Yes
Fire Stations #19	4209 Spring Forest Road	Phase II	Yes
Fire Stations #20	1721 Trailwood Drive	Phase II	Yes
Fire Station #21	2651 South Hall Drive	Install	Yes
Fire Station #22	9353 Durant Road	Install	Yes
City of Raleigh Police Department	Location Street Address	Service Requirement	I-Net video
Police Academy -Training Center	4205 Spring Forest Road	Maintain	Yes
Northside Substation	4818 Six Forks Road	Maintain	Yes
Remote East Substation	317 South Blount Street	Maintain	Yes
Southgate Substation	1601-30 Crosslink Road	New	Yes
Avent Ferry West Substation @, Suite 101	3281 Avent Ferry Road	New	Yes
Compass Station @ Halifax Court	922 Harp Terrace	Maintain	Yes
Compass Station @ Heritage Park	524 Dorothea Drive	Maintain	Yes
Compass Station @ Chavis Heights	596 East Lenoir Street	Maintain	Yes

Compass Station @ Walnut Terrace	1207 Holman Street	Maintain	Yes
Public Utilities Department	Location Street Address	Service Requirement	I-Net video
Meters & Service	3304 Lake Woodard Road	Maintain	Yes
Construction	3304 Lake Woodard Road	Maintain	Yes
Warehouse	3304 Lake Woodard Road	Maintain	Yes
Maintenance	3304 Lake Woodard Road	Maintain	Yes
Water Treatment Plant	10301 Falls of the Neuse Road	Maintain	Yes
Waste Water Treatment Plant	8500 Battle Bridge Road	Maintain	Yes
Public Works	Location Street Address	Service Requirement	I-Net video
Equipment Services Depot	1014 North West Street	Maintain	Yes
Street Maintenance	1027 North West Street	Maintain	Yes
Sanitation	400 West Peace Street	Maintain	Yes
Traffic Camera #1 @ Crabtree Road*	Glenwood Ave @ SR#50	Phase II	No
Traffic Camera #2 @ Trawick Road*	Capital Blvd @ Trawick Rd.	Phase II	No
Traffic Camera #3 @ New Bern Avenue*	I-440 @ New Bern Avenue	Phase II	No
Traffic Camera #4 @ Blue Ridge Road*	Hillsborough Avenue @ Blue Ridge Road	Phase II	No
Traffic Camera #5 @ Beltline*	I440 @ Glenwood Ave	Phase II	No
Security Camera #1 @ Moore Street Parking Garage #1	Moore Street Parking Garage	Maintain	Yes
Security Camera #1 @ Moore Street Parking Garage #2	Moore Street Parking Garage	Maintain	Yes
Security Camera @ Salisbury Street Parking Garage	Salisbury Street Parking Garage	Maintain	Yes
Security Camera @ Parking Garage	Downtown	Phase II	Yes
Security Camera @ Parking Garage	Downtown	Phase II	Yes
Yard Waste Center	900 New Hope Road	Phase II	Yes
Wilders Grove Landfill	4120 New Bern Avenue	Phase II	Yes
Transportation	Location Street Address	Service Requirement	I-Net video
Signs/Maintenance/Radio Shop	1615 South Wilmington Street	Maintain	Yes

Information Services	Location Street Address	Service Requirement	I-Net video
IS- COR Staff Development Center	310 West Martin Street	Maintain	Yes
Montgomery Green Building	1420 South Wilmington Street	Phase II	Yes

* denotes approximate locations

The City's Information Services Infrastructure staff shall work closely with TWC's engineers to prepare a transition and deployment plan to provide for an orderly deployment of I-Net services to the aforementioned sites. The site locations are not inclusive, new sites may be added while others are decommissioned. I-Net communication facilities may be up or downgraded to parallel changing data communication requirements. The aforementioned list, at best, represents a long term service deployment scheme. Some locations serve more than one city department. In some cases, a single I-Net connection may serve an entire government office complex.

Exhibit D

Government, Education and Public Agencies Scheduled for Subscriber Connections and Services

The City requests that cable television providers serve selected government and public facilities without cost. Access to news and weather programs is required at public facilities where public safety/shelter is part of the service requirement. Organizations charged with public safety, regulatory and recreation (children's programs) require 24 hour x 7 day access to news, weather, education and/or cable television entertainment program services. The following list defines the cable television service level at each location.

City Government Facilities	Location or Street Address	Basic	Standard
Avery C. Upchurch Municipal Complex	222 West Hargett Street		X
ACUM Annex #1	310 West Martin Street		X
ACUM Annex #2	301 Hillsborough Street		X
Municipal Complex Satellite	211 West Martin Street		X
Civic Center - Administration	500 Fayetteville St.		X
Memorial Auditorium	1 East South Street	X	
Remote City Hall @ Litchford Village	8320 Litchford Road		X
Remote City Hall @ Laurell Hills	3808 Edwards Mill Road		X
Remote City Hall #3	Future		X
Remote City Hall #4	Future		X
Housing Authority	600 Tucker Street	X	
Transit - Capital Area Transit	1420 Blount Street		X
City Art Centers	**Location or Street Address**	**Basic**	**Standard**
Pullen	105 Pullen Road		X
Sertoma	1400 Millbrook Road		X
City Camps	**Location or Street Address**	**Basic**	**Standard**
Durant	8305 Durant Road		X
Community Centers/Parks	**Location or Street Address**	**Basic**	**Standard**
Biltmore	2615 Fitzgerald Drive		X
Brentwood	3315 Vinson Court		X
Carolina Pines	2305 lake Wheeler Road		X
Cedar Hills	5600 Sweetbriar Street		X

Chavis	840 Holmes Street		X
Eastgate	4200 Quail Hollow Drive		X
Fletcher	820 Clay Street		X
Glen Eden	1500 Glen Eden Drive		X
Green Road	4101 Green Road		X
Halifax	1015 Halifax Street		X
Jaycee Park - Administration Ctr.	2401 Wade Avenue		X
Jaycee Park - Community Center	2405 Wade Avenue		X
Kiwanis Park	2525 Noble Road		X
Lions Park	518 Dennis Avenue		X
Method Park	514 Method Road		X
Millbrook Exchange Tennis Center	1905 Spring Forest Road		X
Optimist Park	5900 Whittier Road		X
Powell Drive	740 Powell Drive		X
Pullen Park - Arts Center	105 Pullen Road		X
Pullen Park - Community Center	408 Ashe Avenue		X
Ralph Campbell Park	756 Lunar Drive		X
Roberts Park	1300 Martin Street		X
Sanderford Road	2623 Sanderford Road		X
Southgate Park	1801 Proctor Road		X
Spring Forest	4203 Spring Forest Road		X
Tarboro Park	120 Tarboro Road		X
Walnut Terrace Recreation Center	111 Lee Street		X
Williams	6601 Lead Mine Road		X
Worthdale Park	1001 Cooper Road		X
Lakes	Location or Street Address	Basic	Standard
Benson	1807 Buffaloe Road		X
Johnson	14016 Athens Drive		X
Shelly	1400 West Millbrook Road		X
Wheeler	6404 lake Wheeler Road		X
Pools	Location or Street Address	Basic	Standard

Biltmore	2615 Fitzgerald Drive		X
Chavis	840 Holmes Court		X
Lake Johnson	1416 Athens Drive		X
Longview	321 Bertie Drive		X
Millbrook	1905 Spring Forest Road		X
Optimist	5902 Whittier Drive		X
Pullen Aquatic Center	410 Ashe Avenue		X
Ridge Road	1709 Ridge Road		X
Special Facilities	Location or Street Address	Basic	Standard
Park & Recreation Maintenance @ Marsh Creek	4225 Daly Road		X
Lake Lynn Community Center	7921 Ray Road		X
Fire Stations	Location or Street Address	Basic	Standard
Fire Administration	310 West Martin Street		X
Keeter Training Center	105 West Hoke Street		X
Training Center - Academy	105 West Hoke Road		X
Career Development Center	2913 Wake Forest Road	X	
Fire Station #1	220 South Dawson Street	X	
Fire Station #2	263 Pecan Road	X	
Fire Station #3	13 South East Street	X	
Fire Station #4	121 Northway Court	X	
Fire Station #5	300 Oberlin Road	X	
Fire Station #6	2601 Fairview Road	X	
Fire Station #7	2100 Glascock Street	X	
Fire Station #8	5001 Western Blvd.	X	
Fire Station #9	4465 Six Forks Road	X	
Fire Station #10	2711 Sanderford Road	X	
Fire Station #11	2925 Glenridge Road	X	
Fire Station #12	3409 Poole Road	X	
Fire Station #13			
Fire Station #14	4220 Lake Boone Trail	X	
Fire Station #15	1815 Spring Forest Road	X	

Fire Station #16	5225 Lead Mine Road	X	
Fire Station #17	4601 Pleasant Valley Road	X	
Fire Station #18	8200 Morgan's Way	X	
Fire Station #19	4209 Spring Forest Road	X	
Fire Station #20	1721 Trailwood Drive	X	
Fire Station #21	2651 South Hall	X	
Fire Station #22	9353 Durant Road	X	
Police Facilities	**Location or Street Address**	**Basic**	**Standard**
Special Ops - Crime Prevention	317 South Bloodworth Street		X
Police Training Center	4205 Spring Forest Road		X
Police Administration	110 South McDowell Street		X
Northside Substation	4818 Six Forks Road		X
Remote East Substation	317 South Blount Street		X
Southgate Substation	1601-30 Crosslink Road		X
Avent Ferry West Substation @, Suite 101	3281 Avent Ferry Road		X
Compass Station @ Halifax Court	922 Harp Terrace		X
Compass Station @ Heritage Park	524 Dorothea Drive		X
Compass Station @ Chavis Heights	596 East Lenoir Street		X
Compass Station @ Walnut Terrace	1207 Holman Street		X
Remote City Office Sites	**Street Address**	**Basic**	**Standard**
Public Utilities	3304 Lake Woodard Road		X
Water Treatment Plant	10301 Falls of the Neuse Rd.		X
Waste Water Treatment Plant	8500 Battle Bridge Road		X
Equipment Services Depot	1014 North West Street		X
Street Maintenance	1027 North West Street		X
Sanitation	400 West Peace Street	X	
Yard Waste Center	900 New Hope Road	X	
Wilders Grove Landfill	4120 New Bern Avenue	X	
Signs/Maintenance/Radio Shop	1615 South Wilmington St.	X	
Personnel - Staff Training & Development	211 West Martin Street	X	
West Martin Building	310 West Martin Street		X

Montgomery Green Building	1420 South Wilmington St.		X

* proposed locations

The site locations are not inclusive, new sites may be added while others are decommissioned. The aforementioned list, at best, represents a long term service deployment scheme. Some locations serve more than one City department.

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City of Raleigh
Cable Television Franchise

Carolina BroadBand, Inc.

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STATE OF NORTH CAROLINA

CABLE TELEVISION FRANCHISE

CITY OF RALEIGH

An Ordinance Granting a Nonexclusive Franchise to Carolina BroadBand, Inc, a Delaware Corporation duly qualified to do business in the State of North Carolina (Hereinafter Referred to as "Grantee") to Own, Operate and Maintain a Cable System, as Defined Herein, Setting Forth Conditions Accompanying the Grant of Franchise, Providing for the Regulation and Use of the Cable System, Providing Penalties, and Defining the Term of the Effective Date Thereof.

WHEREAS, Article 16 of Chapter 160A of the North Carolina General Statutes empowers the City of Raleigh to grant upon reasonable terms a Franchise to contract for the operation of a cable television system to furnish services to the City and its citizens; and

WHEREAS, North Carolina General Statutes §160A-76 requires the City of Raleigh to grant any such Franchise by an ordinance adopted at two (2) regularly scheduled meetings of the City Council; and

WHEREAS, the City of Raleigh desires to assure the widespread availability of Cable Services within the City to promote commerce and otherwise further the public interest;

WHEREAS, the City is the owner of certain street rights-of-way;

WHEREAS, the City has determined to award said nonexclusive Franchise subject to the provisions of the Cable Communications Regulatory Ordinance and to the execution by the City and Grantee of this Franchise Agreement; and

WHEREAS, the City: is requiring the Grantee to provide funds for facilities and equipment for the development of public, educational and government access; has considered the needs of the community for access and/or institutional network; is requiring an Institutional network for public safety applications and other governmental purposes; and that the City believes this will meet some of the future community needs in this area.

WHEREAS, the City has, following reasonable notice, and after consideration, analysis and deliberation conducted full public proceedings, during which proceedings the technical ability, financial condition, legal qualifications and general character of Grantee were determined acceptable to receive a Cable Franchise;

WHEREAS, the City has also considered and analyzed the plans of Grantee for the operation of

a Cable System and found the same to be adequate and feasible in view of the needs and requirements of the residents to be served by the Cable System; and the City has noted and relied upon the intent of the Grantee to build and extend its Cable System in a timely manner to serve citizens of the City on a fair and equitable basis without regard to variations in household economic characteristics among various areas of the City;

WHEREAS, the City has determined that it is in the best interest of and consistent with the public interest, convenience and necessity of its residents to grant a Franchise to Grantee to operate a Cable System within the City and on the terms and conditions hereinafter set forth; and

WHEREAS; Grantee desires to construct and operate a Cable System consisting of fiber optic, coaxial and multi-pair cables along portions of the City's right-of-way.

NOW, THEREFORE, BE IT ORDAINED BY THE CITY COUNCIL OF THE CITY OF RALEIGH, NORTH CAROLINA, THAT:

Section 1. Definitions

For the purposes of this Franchise, the following terms, phrases, words, and abbreviations shall have the meaning given herein. When consistent with the context, words used in the present tense include the future tense, words in the plural include the singular, and words in a particular gender shall include each of the other gender. The words "shall" and "must" are always mandatory and not merely directory.

"Access or Public, Education or Government Access" shall mean the availability of channels on the Cable System for non commercial public, education or government use by agencies, institutions, organizations, groups and individuals in the community, including Grantor and its designees, for the distribution of non commercial programming not under Grantee's editorial control and consistent with applicable law, including:

A. **"Public Access"** shall mean Access where organizations, groups, or individual members of the general public are the designated programmers having editorial control over their programming pursuant to rules promulgated by Grantor;

B. **"Education Access"** shall mean Access where local schools are the designated programmers having editorial control over their programming which shall concern their educational functions;

C. **"Government Access"** shall mean Access where governmental institutions or their designees are the primary or designated programmers or users having editorial control over their programming which shall concern their governmental functions; and

D. **"PEG Access"** shall mean Public Access, Education Access, and Government Access,

collectively.

"Access Center" shall mean one or more agencies selected by the City to be responsible for the administration, production and acquisition of television programs for transmission on the Public, Education and Government Access channels.

"Affiliate" when used in relation to any person, shall mean another person who owns or controls, is owned or controlled by, or is under common ownership or control with, such person.

"Basic Cable Service" or "Basic Service" shall mean any service tier, which includes the retransmission of local television broadcast signals. This definition shall be changed as needed to be consistent with any changes in the definition of this term by the Federal Communications Commission.

"City Council" shall mean the City Council of the City of Raleigh, North Carolina.

"Cable Operator" shall mean any person or group of persons:

A. who provides Cable Service over a Cable System and directly or through one or more affiliates owns a significant interest in such Cable System, or

B. who otherwise controls or is responsible for, through any arrangement, the management and operation of such a Cable System under a Franchise with the City of Raleigh.

"Cable Service" shall mean:

A. the one-way transmission to Subscribers of (a) video programming, or (b) other programming services, and

B. subscriber interaction, if any, which is required for the selection or use of such video programming or other programming services.

"Cable System" shall mean a facility, consisting of a set of closed transmission paths and associated signal generation, reception, and control equipment that is designed to provide Cable Service and which includes video programming and other lawful communications services and which is provided to multiple Subscribers within a community, but such term does not include:

A. a facility that serves only to retransmit the television signals of one (1) or more television broadcast stations;

B. a facility that serves subscribers without using any public right-of-way;

C. a facility of common carrier which is subject, in whole or in part, to the provisions of 47 U.S.C. §201-226, except that such facility shall be considered a cable system (other than

for purposes of 47 U.S.C. §541(c)) to the extent such facility is used in the transmission of video programming directly to Subscribers; and

D. any facilities of an electric utility used solely for operating its electric utility system.

"City" shall mean the City of Raleigh or the area within the present and future territorial limits of the City and such territory outside of the City over which the City has jurisdiction or control by virtue of any law.

"Channel" shall mean a portion of the electromagnetic frequency spectrum, which is capable of delivering both the audio and video portions of a television signal. At the time of enactment of this Franchise, such capability generally requires a 6-MHz capacity. This is subject to changes in technology.

"Customer Service Standards" shall mean those standards adopted by the FCC and by the City, which govern the manner in which Grantee interacts with the public and its customers.

"FCC" shall mean the Federal Communications Commission or any successor agency.

"Franchise or Cable Franchise" shall mean an initial authorization, or renewal thereof issued by the City, whether such authorization is designated as a franchise, permit, license, resolution, contract, certificate, agreement, or otherwise, which authorizes the construction or operation of an Cable System but neither supersedes nor takes the place of any franchise, license, license fee or permit authorization, which might otherwise be required of any similarly situated businesses for the privilege of transacting business within the City.

"Franchise Fee" shall mean an annual fee of five percent (5%) of Grantee's Gross Revenues paid for the use and occupation of the City's rights-of-way.

"Franchise Service Area" shall be defined as the entire City of Raleigh.

"Grantee" or "Franchisee" or "Company" shall mean the person, firm, to whom a Franchise, as herein above defined, is granted by the City and any lawful successor, transferee or assignee of said person, firm, or corporation.

"Gross Revenues"

A. Gross Revenues shall mean all revenue received by Grantee, which is derived from the operation of the Cable System to provide Cable Service which includes television video and/or audio program services, videotext services and video games within Grantor's Franchise area, including, but not limited to: fees charged to subscribers for Basic Cable Service; fees charged to subscribers for an optional video or audio service; fees charged to subscribers for any tier of video or audio program service other than Basic Cable Service; installation, disconnection and re-connection fees for the provision of video or

audio program services; leased channel fees and equipment rentals and revenues from Internet services offered by the Grantee. Gross Revenues shall include all revenue received by Grantee from a third party video programming provider for use of the common carrier channels of the Cable System. If Grantee acts as billing and collection agent for such third party video-programming provider, Gross Revenues shall include the portion of such receipts retained by Grantee.

B. Gross Revenues shall also include an allocated portion of revenues received by Grantee for the carriage of home shopping channels on the Cable System; marketing, launch and carriage revenues which exceed reimbursements for expenses; and revenues from advertising on the Cable System sold by Grantee or its agents. The allocation shall be a percentage of such revenues determined by dividing the number of subscribers in Grantor's Franchise area by the total number of subscribers served by the Cable System. This sum shall be the basis for computing the fee imposed pursuant to Section 5 hereof.

C. To the extent that Grantee receives revenue from a source identified in paragraph A above, and that revenue is received for services that are provided to the subscriber for a fixed price that also includes Other Communications Services (i.e., those services are "bundled"), Grantee shall appropriately allocate a portion of such revenues for inclusion in Gross Revenues. If the fixed price of the bundled services is lower than the aggregate of the prices of those services if purchased individually, then the amount of the revenue to be allocated to each service shall be proportional to the individual price of that service compared to the aggregate of the individual prices of those services when unbundled.

D. The term "Gross Revenues" shall not include: converter or other equipment deposits; bad debts; any sales, excise or any other taxes collected by Grantee on behalf of any State, city or other governmental unit; Cable Gross Revenues Fees, Franchise Fees, refunds to subscribers by Grantee; reimbursement for expenses (including returned check fees, copy expenses and similar items); amounts collected by Grantee on behalf of third party video programming providers (except the portion thereof retained by Grantee); or items excluded by local, State or Federal law. Revenues received for the provision of Other Communication Services including data transmission, point-to-point telecommunications, or telephone services shall not be included in Gross Revenues but may be subject to fees imposed by Grantor, upon the provision of such services, to the extent permitted by law.

"Institutional Network or I-Net" shall mean capacity on the Cable System used for the provision of telecommunication services pursuant to the terms and conditions set forth in Section 11.

"Other Communications Services" shall mean any lawful service other than Cable Service that the Cable Operator makes available for purchase.

"Person" shall mean an individual, partnership, association, Limited Liability Company, Joint

Stock Company, trust, corporation, or governmental entity.

"Public, Education or Government Access (PEG) Facilities" shall mean:

A. channel capacity designated for public, education, or government use; and

B. facilities and equipment for the use of such channel capacity.

"Public Buildings" shall mean public schools (K-12), and City government buildings.

"Public Way and Right-of-Way" shall include the surface of, and the space above and below all streets, avenues, boulevards, roads, alleys, lanes, squares, bridges, viaducts, easements, tunnels, causeways and sidewalks, lying within the street right-of-way, and all other public highways within the City.

"Reasonable Notification" shall mean fourteen (14) calendar days for all non-financial related

"Residential Subscriber" shall mean a Subscriber who receives Cable Service in an individual dwelling or multiple dwelling units where the service is not to be used in connection with a business, trade or profession.

"Subscriber" shall mean any person or entity lawfully receiving any portion of the Cable Service of Grantee pursuant to this Franchise.

"Service Tier" shall mean a category of Cable Service or Other Communications Services provided by an Cable Operator and for which a separate rate is charged by the Cable Operator;

"Year" shall mean a calendar year.

Section 2. Nature and Terms of Grant

A. City does hereby convey to Grantee a citywide Franchise to construct and operate a Cable System, using owned and/or leased facilities, which may be located in the City rights-of-way.

B. Notwithstanding Section 2A, Grantee may, in its sole discretion, elect to lease fiber optic, coaxial, other cables and cable communication facilities and services from other City licensed or franchised providers of Cable Service or telecommunication services from other lawfully operating providers to support the operation of its Cable System.

C. The Franchise granted herein shall run for a term of fifteen (15) years from the date of acceptance of this Franchise by Grantee.

D. City does hereby replace the Open Video System License issued March 21, 2000 by and between the City and Carolina BroadBand, Inc., for the construction and operation of Open Video System facilities within the public way with this Cable Franchise. The Open Video System License agreement is hereby terminated and declared null and void on the effective date of this Franchise.

Section 3. Service Area, Construction and Extension

Grantee's Service Area is generally bounded by the City limits as amended from time to time.

A. System Development

Grantee shall begin initial construction in the area generally bounded by South Street on the south, Falls of the Neuse Road to the west, Capitol Boulevard to the east and Durant Road to the north.

1. Grantee shall complete construction of the system within the Franchise Service Area in compliance with the terms of this section 3, which the City and Grantee have negotiated in the good faith belief that the number of dwelling units ("homes") to be passed thereby will be equivalent to those passed if Grantee were to construct its System to serve homes that lie within contiguous route miles having a density of at least eighty (80) homes per cable mile. Within forty-eight (48) months after the Effective Date, Grantee shall cause the System to be functional throughout sufficient portions of the Franchise Service Area that the System passes at least seventy percent (70%) (the "Construction Percentage") of the homes in the Franchise Service Area. The City and Grantee agree that, as may be adjusted pursuant to subsection 3, for purposes of applying this Section 3A throughout the Franchise term, the number of homes in the Franchise Service Area shall be 125,381. If Grantee seeks but can not obtain property owner permission under commercially reasonable terms to provide service to a multiple dwelling unit ("MDU"), that MDU shall be deemed to be passed by the System.

2. Grantee has committed to the City that Grantee will further extend the reach of the System if Grantee achieves specified levels of success in the areas served by the System. For purposes of this subsection, "Market Penetration" shall be defined as a fraction: the numerator of which is the number of Grantee's paying Cable Service Subscribers with non-delinquent accounts ("Current Subscribers"); and the denominator of which is the product of the Construction Percentage (as adjusted pursuant to this subsection 2 and subsection 4) multiplied by the number of homes in the Franchise Service Area (as specified in subsection 1, as may be adjusted pursuant to subsection 3).

   If, at any time after completion of initial construction of the System, Grantee achieves a Market Penetration for Cable Service of at least thirty-five percent (35%) throughout two consecutive calendar quarters, the then prevailing Construction Percentage shall be increased by three percentage points, and Grantee shall within a reasonable time pass the adjusted Construction Percentage of homes in the Franchise Service Area, including any extensions as may be needed. [An illustrative example is as follows: If the number of homes in the Franchise Service Area is 125,381, and if the Construction Percentage is 70%, Grantee's initial construction requirement would be to build the System to pass 87,767 homes (125,381 x .7). Grantee would achieve the specified Market Penetration of 35% by having at least 30,718 Current Subscribers throughout two consecutive calendar quarters:

   $.35 = X \div (.7 * 125{,}381)$

   $X = .35 * (.7 * 125{,}381)$

   $X = 30{,}718$

   Upon such achievement of said Market Penetration, the Construction Percentage would be increased to 73% and the Grantee would be required to pass at least 91,528 homes (125,381 x .73).]

   If at any time thereafter, Grantee achieves a Market Penetration for Cable Service of at least forty percent (40%) throughout two consecutive calendar quarters, the then prevailing Construction Percentage shall be increased by three percentage points, and Grantee shall within a reasonable time pass the adjusted Construction Percentage of homes in the Franchise Service Area, including any extensions as may be needed.

   If at any time thereafter, Grantee achieves a Market Penetration for Cable Service of at least forty-five percent (45%) throughout two consecutive calendar quarters, the then prevailing Construction Percentage shall be increased by four percentage points, and Grantee shall within a reasonable time pass the adjusted Construction Percentage of homes in the Franchise Service Area, including any extensions as may be needed.

If at any time thereafter, Grantee achieves a Market Penetration for Cable Service of at least fifty percent (50%) throughout two consecutive calendar quarters, the then prevailing Construction Percentage shall be increased by five percentage points, and Grantee shall within a reasonable time pass the adjusted Construction Percentage of homes in the Franchise Service Area, including any extensions as may be needed.

If at any time thereafter, Grantee achieves a Market Penetration for Cable Service of at least fifty-five percent (55%) throughout two consecutive calendar quarters, the then prevailing Construction Percentage shall be increased by five percentage points, and Grantee shall within a reasonable time pass the adjusted Construction Percentage of homes in the Franchise Service Area, including any extensions as may be needed.

If at any time thereafter, Grantee achieves a Market Penetration for Cable Service of at least seventy-five percent (75%) throughout two consecutive calendar quarters, within a reasonable time the System, including any extensions as may be needed, shall pass all homes located in contiguous areas of the Franchise Service Area having a density of at least thirty (30) homes per cable mile. "Homes per cable mile" is defined as a value determined by dividing (a) the number of incremental consecutive homes along a street that can be serviced by a standard one hundred fifty (150) foot RG-6 drop cable by (b) the total linear, unduplicated feet of new coaxial feeder cable that must be placed in the right of way to pass those homes, divided by 5,280. Homes in an MDU are only included in this calculation when Grantee can obtain access to them on commercially reasonable terms.

3. Promptly after the Effective Date, Grantee shall commence, and thereafter diligently pursue to completion, the strand mapping of the entire Franchise Service Area. If the number of homes charted on the strand maps is less than 125,381, Grantee may demonstrate to the City that the number of homes in subsection 1 should be adjusted which request shall not be unreasonably denied by the City. Upon approval by the City, the number of homes in the Franchise Service Area specified above in subsection 1 shall be so adjusted. If the number of homes charted on the strand maps is more than 125,381, Grantee will so adjust the number of homes in the Franchise Service Area specified above in subsection 1 to reflect the number of homes charted on the strand maps.

4. Grantee shall prepare plans and specifications for construction of its System throughout such areas within the Franchise Service Area that will cause the System to satisfy the Construction Percentage. If, in the course of the development of the System, Grantee encounters excessive make ready, pole or conduit costs, Force Majeure Events (as defined below), or delays in the performance of utility or Incumbent Cable Operator make ready work, or is unable to obtain materials, labor or required legal rights or permits, that render it impossible or economically impractical to construct the System within an area to which Grantee had planned to extend the System, the number of homes in that area shall be subtracted from the number of homes that must be passed by the System, and the Construction Percentage shall be reduced accordingly. Notwithstanding

the foregoing, the Construction Percentage shall never be less than sixty percent (60%). Provided however, notwithstanding anything herein to the contrary, in the event that an additional cable television provider (other than the incumbent) undertakes construction of cable plant in the City, the total number of homes in the Franchise Service Area shall be reduced by the number of homes passed by such additional provider, and the number of homes required to be passed by Grantee shall be reduced accordingly. Provided further, if such additional provider permanently discontinues service on its system and its plant is removed from the poles and right of way, the number of homes passed by such system shall be restored to the total number in the Franchise Service Area.

5. In the event that Grantee buys or otherwise acquires the system of the Incumbent Cable Operator, Grantee shall not decrease the geographic coverage then being provided by the Incumbent Cable Operator in the Franchise Service Area.

6. In the event that Grantee is delayed in the construction of the System or any extension thereto by a Force Majeure Event or by any other cause beyond the reasonable control of Grantee, including but not limited to delays in the performance of utility or Incumbent Cable Operator make ready work, or the inability to obtain materials, labor or required legal rights or permits, or litigation or other action or inaction by the Incumbent Cable Operator or other third party, then the deadline for completion of construction may, upon the approval of the City, be postponed by the period of the delay so caused. The Grantee must request City approval for the postponement in writing, describing fully the grounds on which it seeks such postponement. The City shall not unreasonably withhold its approval. Grantee shall use commercially reasonable efforts to mitigate any such delay and shall from time to time communicate with the City regarding the existence and extent of any such delay and any steps being taken to mitigate the delay.

Section 4. Customer Service Standards

Grantor has determined that it is in the best interest of its residents and consistent with the public interest, convenience and necessity to adopt Customer Service Standards for the provision of Cable Services by Grantee. Grantee shall operate its Cable System in a manner consistent with the City's Customer Service Standards. A copy of the City's **Customer Service Standards** is attached as **Exhibit A.**

Section 5. Compensation, Auditing and Other Payments

A. Grantee shall pay Grantor, throughout the term of this Franchise, as compensation, an annual Franchise Fee of five percent (5%) of Grantee's Gross Revenues.

B. All such payments of Franchise Fees shall be payable quarterly by April 30, July 31, October 31 and January 31 for the preceding three (3) month period ending respectively on March 31, June 30, September 30 and December 31. Franchise Fee payments shall be accompanied by a report itemizing and setting forth the Gross Revenues and showing the

calculation of the payment due for the preceding period. Grantee may include within any such report an analysis of any overpayment or underpayment discovered with respect to a previous quarterly report and payment, and the quarterly payment shall be adjusted appropriately to correct for such previous incorrect payment amount.

C. The payment of the Franchise Fee by Grantee is for the right to construct and operate its Cable System, as defined herein, within Grantor's public right-of-way and is in lieu of an encroachment fee.

1. Grantee, on an annual basis, shall furnish a statement within ninety (90) calendar days of the close of the calendar year, certified by a corporate officer or a certified public accountant selected by the Grantee, reflecting the total amounts of Gross Revenues as defined herein, and all payments and computations for the previous calendar year. In order to determine whether proper Franchise Fees have been paid and upon ten (10) calendar days prior written notice, Grantor shall have the right to conduct an independent audit of Grantee's records at any time within (5) years from the date of the last audit. If, after resolving any dispute arising from such audit, Grantee has made a Franchise Fee underpayment of one and one-half (1 ½) percent or more, Grantee shall assume all reasonable costs of such audit. Otherwise, Grantor shall bear all costs and fees, associated with any such audit.

2. All Grantee's books and records concerning its Gross Revenues and its calculation of payments to Grantor shall be available for inspection by an appropriate officer of Grantor, or its designee, at reasonable times to determine the amount of compensation due to Grantor from Grantee under this Franchise. Such records shall be kept to accurately show the same. Grantee shall prepare and make available to Grantor at times reasonably requested by Grantor and in the form reasonably prescribed by Grantor after consultation with Grantee, such reports with respect to its Cable System, and the Gross Revenues derived therefrom, as Grantor may deem reasonably necessary or appropriate.

3. In the event Grantee makes an underpayment or in the event Grantee fails to make any payment on or before the date it is due, Grantee shall pay interest at a rate of one (1) percent per month on any such underpayment and/or late payment.

4. To the extent required by Federal law, Grantee shall file with Grantor, copies of any tariffs, amendments, or modifications affecting the sale of its services and subscriber terminal equipment and shall provide written notification to Grantor within thirty (30) calendar days of any proposed changes. Grantee shall also provide the Grantor copies of all filings, reports and petitions to local, State, or Federal regulatory agencies, which could materially effect the Franchise.

5. The percentage of Gross Revenues to be paid by Grantee under subsection A shall not be greater than the percentage paid by any other operator of an OVS System or any

Cable Operator in the City, nor shall the definition of Gross Revenues against which such percentage is applied be broader than the definition of gross revenues contained in the License or Franchise of such other entity.

Section 6. Franchise - Not Exclusive

A. This Franchise is not exclusive. Grantor reserves the right to grant Franchises to other persons or corporations, as well as the right in its own name, to operate a Cable System or OVS System for similar or different purposes allowed Grantee hereunder.

B. The material terms, provisions and conditions of any Franchise granted to third parties by Grantor shall conform with applicable provisions of Federal and State law and shall be non discriminatory.

Section 7. No Waiver

A. The failure of Grantor or Grantee, upon one or more occasions, to exercise a right or to require compliance or performance under this Franchise or any other applicable law shall not be deemed to constitute a waiver of such right or a waiver of compliance or performance, unless such right has been specifically waived in writing.

B. Waiver of a particular breach of this Franchise shall not be construed as a waiver of any other breach. The grant of this Franchise nor any provision herein shall constitute neither a waiver or bar to the exercise of any governmental right or power of Grantor. No provision of this Franchise shall operate as a waiver by Grantor or Grantee of any right guaranteed by the Federal or State constitutions or other applicable law.

Section 8. Regulation

A. The City Council shall be vested with the power and authority to reasonably regulate the exercise of the privileges permitted by this Franchise in the public interest. Any failure by the City to promptly enforce compliance with this Franchise by Federal, State and local laws and ordinances shall not relieve Grantee of its obligation to comply with any provision of this Franchise.

B. The City reserves the right to inspect the installation and maintenance of the fiber optic cable and related equipment. Grantee shall provide to the City accurate as-built maps within one hundred twenty (120) days following the completion date of Cable System construction.

C. Grantee shall adhere to all Federal, State, and local regulations regarding the location, construction, and maintenance of its facilities within the public right-of-way.

D. Engineering design, construction and as-built documents shall be provided in both hard

copy (paper) and electronic (data files) formats. Such maps should designate the location of Grantee's facilities in a mutually acceptable form. The electronic version must be based upon NC State Plane Coordinates NAD 1983.

E. Grantee shall secure a Right-of-Way Permit from the Inspections Department prior to installation. Such permit shall not be unreasonably withheld or delayed.

F. Grantee agrees that it shall remove its abandoned facilities in the right-of-way.

G. The City reserves the right, upon reasonable notice, to require Grantee at its expense to protect, support, temporarily disconnect, relocate or remove from the City's streets any property of Grantee by reason of traffic conditions, public safety, street construction or excavation, change or establishment of street grade, installation of sewers, drains, water pipes, power or communication lines, tracts, or other types of structure or improvements by governmental agencies or any structures of public improvement. Reasonable notice for this provision shall be construed to mean at least ninety (90) days except in the case of emergencies where no specific notice period shall be required. The City shall endeavor to notify and seek comment from Grantee, with respect to minimizing disruption to the installed facilities where public works projects may affect Grantee's facilities.

H. Grantee shall place and construct its facilities so as not to interfere with the construction, location and maintenance of sewer or water mains, lines or connections, existing sidewalk, handicap ramps and trees along the ROW. Grantee shall take the necessary preventative measures to protect existing facilities within the public rights-of-way.

I. Grantee shall contact NC One Call Center forty-eight (48) hours prior to excavation and, where possible, shall remain at least ten (10) feet from existing water and sewer mains.

J. Grantee shall restore and replace landscaped areas, pavement, pedestrian lighting, sidewalks, curbs, gutters or other facilities damaged by Grantee or its contractors with like material to their condition immediately preceding the construction at Grantee's expense, and shall thereafter, from time to time, but no longer than one (1) year from the completion of the job, readjust, fill and finish the same as may be necessary due to settling of the earth associated with Grantee's disruption of the public way.

K. Where possible, grantee shall not disturb existing public sidewalks located within the right-of-way.

L. The Grantee shall comply with all Federal, State and local regulations, such as the National Electrical Code, National Electrical Safety Code, Fiber Optic Cable Installation Specifications, 1987 (Telecommunication Industry Committee), traffic safety/lane closure rules and construction requirements promulgated by the City and as amended periodically.

M. Grantee agrees to provide written notice to the City identifying any third party granted occupancy of its conduits or other facilities to enable the City to determine whether such third party has obtained independent lawful authorization to occupy the right-of-way pursuant to City of Raleigh Code 12-1022.

N. Grantee shall, if requested by Grantor, perform all tests necessary to demonstrate compliance with the requirements of any applicable provisions of 47 C.F.R. Section 76 subpart K. All tests shall be conducted in accordance with the FCC's rules at the Grantee's expense.

Section 9. Public Education and Government Access Provisions

A. Grantee shall initially make available to each of its Basic Cable Service Subscribers receipt of at least four (4) Access channels, which shall be used solely for non-commercial public, education and government purposes. The Access channels shall be made available by Grantee for use as provided for herein, by Grantor and its citizens in accordance with the rules and procedures established by Grantor or any lawfully designated person, group, organization or agency authorized by Grantor for that purpose.

B. Whenever all utilized Public, Education and/or Government Access channels are in continuous use from 4:00 P.M. to 11:00 P.M. for six (6) weeks running, Grantor may, with ninety (90) calendar days written advance notice, request an additional channel for additional access use. Grantee shall be required to provide additional channel capacity for such access upon request by Grantor when such continuous use has existed, provided, however that:

1. In determining whether existing use is continuous and warrants additional channel capacity, the use of repeat programming and text or character-generated programming shall not be considered;

2. When technically and economically feasible alternatives are available, Grantee shall be given the opportunity to accommodate further channel usage for access purposes without dedicating a specific channel for Public, Education and/or Government access; and

3. Grantee shall not be required to provide a total number of PEG Access channels in excess of six (6) Channels.

C. All programming transmitted over Public, Education and Government Access channels shall be non-commercial in nature. Program material to be distributed on Public, Education or Government Access channels shall contain no advertising or commercial content for which consideration of any kind is received directly or indirectly by Grantor or by the producer or distributor of such programming. Grantor may not enter into a

lease, license, contract or arrangement of any kind whereby Grantor or its designee allows or requires a person, firm or corporation to program all or part of a Public, Education or Government Access channel in exchange for consideration of any kind. Program material to be distributed on Public, Education and Government Access channels shall: 1) be produced or provided in recorded form by any City or County resident or produced or provided by any agency, public or private, serving City or County residents regardless of the location at which the programming originated; and 2) allow for public expression relating to educational, political, social, or cultural interests of the residents of the City or County.

D. The locations from which Access programming shall originate and available to Grantee for distribution on the designated Access channel(s), are 310 West Martin Street and Western Boulevard at Gorman Street. Such programming shall be supplied subject to the following conditions:

1. Grantee shall be obligated to extend its facilities to each PEG Access origination location and shall furnish any internal wiring, modulator(s) or associated transmission and reception equipment required for Grantee to receive the PEG content feed at the original location.

2. PEG Access signal transportation from the permanent PEG Access origination locations identified above shall be provided without charge to Grantor by Grantee.

3. Should Grantor wish to move one or more of the identified Access programming locations or establish not more than one additional such location, Grantor shall provide Grantee reasonable notice of such intention and shall confer with Grantee to discuss the details and options involved in such an action. The conditions specified above shall apply to any such relocated or new location. Furthermore, Grantee shall not be obligated to extend its facilities to such location or accept programming there if doing so would be economically infeasible or materially inconsistent with Grantee's network design or operations.

E. Grantor shall establish rules and procedures under which Grantee is permitted to use access channel capacity for the provision of other services if such channel capacity is not being used for the purposes designated by this Section.

F. Grantor may direct Grantee to use Addressability (encryption) of one Government Access channel on a partial or full-time basis to limit reception of the channel to designated locations. At its option, Grantee may accomplish such encryption with digital technology. Grantor shall be responsible for the cost of encryption and decryption.

G. Grantor may operate or designate one or more nonprofit Access Center(s) to manage and program the PEG Access channels.

H. Grantor, through any contract or PEG channel use agreement with Access Center(s) or other nonprofit agencies, or any other party shall ensure that all forms of audio or video programming produced with equipment or through facilities provided under Section 9 shall not, to the extent legally possible, be made available to any other Cable Operator or other video distribution system serving residents of the City unless such Cable Operator or video distribution system remits funds to support PEG access equivalent to those paid by Grantee and its subscribers.

Section 10. Support for "PEG" Facilities and Equipment Capital Costs

A. In the event the Grantor elects to impose a monthly "PEG" charge (PEG Capital Charge) upon Basic Service subscribers of Grantee's Cable System and likewise any other Franchised Cable System or Licensed OVS System to support PEG Facilities and Equipment Capital Costs, Grantee agrees to bill and collect such charge to the extent set forth herein. Upon the terms and conditions set forth below, Grantee shall itemize and bill in its monthly statements for the PEG Facilities and Equipment Capital Costs.

B. The amount of the "PEG" charge to be billed by Grantee shall be such amount that is established by Grantor from time to time to be collected by all operators of Franchised Cable Systems and Licensed OVS Systems from each of their directly billed Basic Service Subscribers. In no event shall the monthly amounts established be greater than 18 cents during the first five years of this Franchise and 21 cents during years six through ten and thereafter, the amount set by Resolution of the City Council.

C. The "PEG" charge shall be itemized as a monthly charge to directly billed Basic Service subscribers and shall be included by Grantee in its statements for the provision of Basic Service. No Franchise Fee payment shall be due on such funds collected by Grantee. Grantee's sole obligation shall be to remit the amounts of the "PEG" charge it collects to the Grantor on a quarterly basis along with Grantee's Franchise Fee payment. Other than as outlined in paragraph A above, Grantee shall have no obligation to attempt to collect unpaid "PEG" charges on behalf of the Grantor. Grantee shall not be obligated to terminate service to any Subscriber for failure to pay all or any portion of the "PEG" charge.

D. The Grantor must give Grantee sixty (60) days written notice of its decision to require Grantee to begin billing and collection of the "PEG" charge. Upon receipt of such notice, Grantee agrees to begin billing the "PEG" charges to directly billed Basic Service subscribers within ninety (90) days. The Grantor, at its election, may decrease (or eliminate) the amount of the "PEG" charge upon sixty (60) days written notice to Grantee.

E. Grantee's obligation to bill and remit the "PEG" charge shall terminate upon Grantee's giving thirty (30) days written notice to the Grantor should the funds collected through

the "PEG" charge be used by the Grantor and/or Access Center, which may include Grantor for purposes other than the production of Public, Education, and Government Access Programming distributed within the Grantor's Franchise area over facilities provided by Grantee.

F. The Grantee shall be permitted to recover all costs of funding Franchise requirements in support of PEG equipment, facilities, and channels including a return on the funding as permitted by rules of the Federal Communications Commission.

G. The "PEG"charge described in this Section is not a Franchise Fee payment and falls within U.S.C. 542(g)(2)(C). In all other respects, all payments, contributions, services, equipment, facilities support or other resources supplied by Grantee pursuant to Franchise requirements by the Grantor shall be treated in accordance with applicable law for purposes of Franchise Fee computation. Grantee shall be permitted to pass through all Franchise commitments, obligations, or payments or recover them through adjustments to Basic Subscriber rates, as permitted by applicable law and FCC regulations, and, to the extent that Grantor has any legal right of approval, the Grantor shall promptly approve all such rates or adjustments submitted by Grantee in accordance with such laws or obligations.

Section 11. Institutional Network Provisions

A. Upon timely request of Grantor in compliance with the terms and conditions set forth in Exhibit B of this Agreement, Grantee shall install certain fiber optic strands along designated routes, and shall otherwise assist Grantor as specified in Exhibit B in the development of an Institutional Network ("I-Net") to be operated for Grantor's internal communications purposes.

B. In lieu of the construction of the Institutional Network as set forth in Exhibit B, Grantor may direct Grantee to provide data transmission capacity ("City Cable Modem Service") on the Cable System for non-commercial governmental purposes subject to the following conditions:

1. Grantor may at any time during the term of this Franchise elect, by written notice to Grantee, to receive City Cable Modem Service in lieu of the Institutional Network. Notwithstanding the foregoing, if Grantor and Grantee have planned any portion of the Institutional Network and Grantee has with the concurrence of Grantor placed an order for materials to be used in construction of any portion of the Institutional Network, then Grantor shall be deemed to have elected to proceed with the Institutional Network and to have waived all rights to receive City Cable Modem Service.

2. When notifying Grantee that Grantor wishes to receive City Cable Modem Service,

Grantor shall in each such notice identify the locations at which Grantor wishes to receive service. Grantee shall promptly determine whether Grantee can supply service at the requested locations and shall so notify Grantor. Grantor shall be entitled to receive City Cable Modem Service at five (5) locations initially regardless of the number of Cable Service subscribers then being served by Grantee. After those first five locations, Grantor shall be entitled to receive City Cable Modem Service at one additional location for each two hundred fifty (250) Cable Service subscribers then being served by Grantee.

3. Grantee shall not be obligated to provide City Cable Modem Service to a location if Grantee's Cable System is not located on a street bordering the requested location or if the drop from Grantee's Cable System to the penetration point of the building at the requested location is longer than one hundred fifty (150) feet.

4. Grantor shall reimburse Grantee for Grantee's actual cost of installing the drop to the penetration point. Grantor shall be responsible for all internal building wiring and for purchase, installation and maintenance of the cable modems.

5. Grantee shall provide City Cable Modem Service to Grantor on a parity basis with other customers receiving basic tier cable modem service served by the same node. Grantor acknowledges that heavy usage by other customers may at certain times impact the service received by Grantor at a particular location. Grantor acknowledges that Grantee may elect to make available to the public different tiers of cable modem service, with higher tiers being guaranteed certain minimum speeds in return for higher monthly charges.

6. Grantee shall have the right to use any City Cable Modem Service capacity not in use by Grantor.

7. Grantor shall not re-sell, license or otherwise assign use of any of the City Cable Modem Service capacity to a third party; said capacity shall be used by the Grantor for non-commercial governmental purposes only.

8. Grantor's use of City Cable Modem Service shall reduce the maximum commitment to provide PEG Access Channels by one (1) channel. Should the City discontinue the use of the City Cable Modem Service, Grantor may elect to require Grantee to provide an additional PEG channel; thereby, restoring the maximum commitment to six (6) PEG Access Channels.

9. Use of the City Cable Modem Service by Grantor shall not interfere with the operations of Grantee and shall not interfere with or impair the technical quality or reliability of the Cable System; and

10. Grantor shall be solely responsible for the purchase, installation, quality, maintenance and operation of end user equipment connected to the Cable System to provide City Cable Modem Service at each of Grantor's served locations. Such equipment shall not interfere with the operation of Grantee's Cable System.

11. The parties acknowledge that use of the City Cable Modem Service is subject to applicable law. Grantor agrees to indemnify, defend and hold harmless Grantee from and against any and all claims, damages, liabilities, costs and expenses, including reasonable attorney's fees and costs related to the material under Grantor's or other public agency user's exclusive control carried by means of the City Cable Modem Service, including but not limited to, copyright infringement, libel, slander, defamation, patent, trademark, or invasion of privacy claims.

12. At any time after the third anniversary of the date of this Franchise, Grantor may elect to require Grantee to extend the Cable System so that Grantor may obtain City Cable Modem Service at a location that would otherwise not qualify under the limitations contained in paragraph 3 of this section. Such extension shall be performed at the sole cost of Grantor and shall be effected through the same planning, design and construction process that is described in the attached Exhibit B for use in construction of the I-Net.

Section 12. Transfer of Ownership or Control

A. **Transfer of Franchise.** The Franchise granted hereunder cannot be sold, transferred, leased, assigned or disposed of, including but not limited to, by force or voluntary sale, merger, consolidation, receivership or other means without the prior consent of Grantor, which shall not be unreasonably withheld, provided that Grantee may transfer the Franchise to an Affiliate under common control with Grantee without such consent, but notice thereof shall be provided to Grantor.

B. **Transfer Threshold.** Grantee shall promptly notify Grantor of any actual or proposed change in or transfer of, or acquisition by any other party of control of Grantee. The word "control" as used herein is not limited to majority stock ownership, but includes actual working control in whatever manner exercised. There shall be a rebuttable presumption of a transfer of control upon the disposal by Grantee, directly or indirectly, by gift, assignment, voluntary sale, merger, consolidation or otherwise, of ten percent (10%) or more, at one time, of the ownership or controlling interest in Grantee, or twenty percent (20%) cumulatively over the term of the Franchise of such interest to a corporation, partnership, trust or association, or person or group of persons acting in concert. Grantor shall exercise its power to approve a transfer of ownership or control in a manner consistent with Section 617 of the Communications Act (47 U.S.C. 537).

C. **Process.** Every change, transfer, or acquisition of control of Grantee, except a pro forma

transfer or assignment contemplated herein, shall make the Franchise subject to cancellation unless and until Grantor shall have consented thereto, which consent shall not be unreasonably withheld. For the purpose of determining whether it shall consent to such change, transfer or acquisition of control, Grantor may inquire into the legal, financial, and technical qualifications of the prospective controlling party, and whether or not Grantee is then in breach beyond the applicable cure period of any material terms of the Franchise, and Grantee shall assist Grantor in any such inquiry. Failure to provide all information reasonably requested by Grantor as part of said inquiry shall be grounds for denial of the proposed change, transfer or acquisition of control.

D. **Assumption of Control.** Grantor agrees that any financial institution having a pledge of the Franchise or Grantee's assets for the advancement of money for the construction and/or operation of the Cable System shall have the right to notify Grantor that it or a designee reasonably satisfactory to Grantor will take control and operate the Cable System. Further, upon request of Grantor, should Grantor notify said financial institution in writing that Grantor questions the ability or financial capability of said financial institution or its designee to operate the Cable System in compliance with this Franchise, said financial institution shall within thirty (30) days also submit a plan for such operation that will reasonably demonstrate the financial and technical capacity of said institution and/or its designee to insure continued service and compliance with all Franchise obligations during the term the financial institution exercises control over the Cable System. The financial institution shall not exercise control over the Cable System for a period exceeding one (1) year, unless extended by Grantor at its discretion, and during said period of time it shall have the right to petition for transfer of the Franchise to another Grantee as provided in this Section.

E. **Regulation of Transfer.** The consent or approval of Grantor to any transfer of the Franchise or to any change of control of Grantee shall not constitute a waiver or release of the rights of Grantor or the State in and to the street, or rights-of-way and any transfer shall, by its terms, be expressly subject to the terms and conditions of the Franchise Agreement.

F. **Right to Review Purchase Price.** Grantor reserves the right to review the purchase price of any transfer or assignment of the Cable System for ratemaking purposes to the extent permitted under applicable laws and regulations.

G. **Signatory Requirement.** Any approval by Grantor of assignment of the Franchise shall be contingent upon the assignee expressly assuming in writing all of the obligations of Grantee hereunder.

H. **Additional Equity Financing for Grantee.** Notwithstanding anything in this Franchise to the contrary, Grantee may, without the consent of Grantor, create, issue or reissue additional equity interests in Grantee or any parent company of Grantee and may sell

same to any person or entity, provided that, following such transaction, a majority of the equity interest in the entity in question is owned by persons or entities who owned an equity interest in such entity on the date of this Franchise.

Section 13. Remedies

A. In addition to any other rights set out elsewhere in this Franchise, and subject to the provisions set forth below, Grantor reserves the right to declare a forfeiture of this Franchise, and all of Grantee's rights arising hereunder, in the event that:

1. Grantee is found to have violated any material provision of this Franchise; or

2. Grantee is found by a court of competent jurisdiction to have practiced any fraud or deceit upon Grantor.

B. Grantor shall give Grantee thirty (30) calendar days written notice of its intent to exercise its rights under this Section, stating the reasons for such action. If Grantee cures the problem within the thirty (30) day notice period, or if Grantee initiates substantial effort to remedy the stated problem, and the efforts continue in good faith, then Grantor shall not have the right to declare a forfeiture of the Franchise. If Grantee fails to cure the stated violation within the thirty (30) day notice period, or if Grantee does not undertake efforts reasonably satisfactory to Grantor to remedy the stated violation, then Grantor, upon thirty (30) calendar days notice to Grantee, shall schedule a public hearing to determine whether Grantor should declare a forfeiture of this Franchise. At such hearing, Grantee shall have the right to be heard and present evidence. Grantor shall issue a written decision, based on the evidence in the record, setting forth its findings of fact and conclusions of law. Grantee shall have the right to appeal any such decision to a court of competent jurisdiction. The determination by the City Council may be implemented during the pendency of any such appeal.

Section 14. Expiration and Renewal

Applicable Federal and State law shall govern renewal of this Franchise.

Section 15. Forum for Litigation

Any litigation between Grantor and Grantee arising under or regarding this Franchise shall occur, if in the State courts, in the Wake County Superior or District Court having jurisdiction thereof, or if in the Federal courts, in the United States District Court for the Eastern District of North Carolina.

Section 16. Notice

Any notice provided for under this Franchise shall be sufficient if in writing and delivered personally to the following address or if deposited in the United States Mail, postage prepaid, certified mail, return receipt requested, or if committed to national overnight delivery service, addressed as follows, or to such other address as the receiving party hereafter shall specify in writing:

If to Grantor:
City Manager
City of Raleigh
Post Office Box 590
Raleigh, NC 27602

If to Grantee:
President
Carolina BroadBand, Inc.
9201H Southern Pines Blvd.
Charlotte, NC 28273

Section 17. Severability

If any court, agency, commission, legislative body, or other authority of competent jurisdiction for any reason, declares any section, subsection, sentence, clause, phrase, or other portion of this Ordinance invalid, in whole or in part, such portion shall be deemed a separate, distinct, and independent portion. Such declaration shall not affect the validity of the remaining portions hereof, which other portions shall continue in full force and effect.

Section 18. Non - Discrimination

Grantee shall not discriminate in any manner on the basis of factors prohibited by law. Grantee shall comply with the terms and conditions of Ordinance Number 1969-889.

Section 19. Non - Divestiture

This Franchise shall not divest Grantor of any right or interest in the public rights-of-way.

Section 20. Letter of Credit

A. Within thirty (30) calendar days following the award of the Franchise, Grantee shall deposit with Grantor a letter of credit from a financial institution, approved by Grantor's Finance Director, in the amount of fifty thousand dollars ($50,000). The City Attorney shall approve the form and content of the letter. The letter of credit shall be used to insure the faithful performance of Grantee of all provisions of the Franchise, and compliance with all orders, permits and directions of any agency, commission, board, department, division or office of Grantor exercising jurisdiction over Grantee's acts or defaults, and payment by Grantee of any penalties, claims, liens, liquidated damages, or fees due Grantor.

B. If Grantee fails to pay to Grantor any compensation not in dispute, due Grantor within the time fixed herein; or fails, after ten (10) calendar days notice to pay Grantor any penalties, claims, liens, liquidated damages, fees due Grantor, then such failure by Grantee can be remedied by demand on the letter of credit. Grantor may immediately request payment of the amount due from the letter of credit. Upon such request for payment, Grantor shall notify Grantee of the amount and date thereof.

C. The letter of credit shall be maintained at fifty thousand dollars ($50,000) during the entire term of the Franchise unless modified in accordance with the procedures provided for in Section 32 herein. In the event that amounts are withdrawn pursuant to this Section, Grantee, shall take any required action to restore the letter of credit to fifty-thousand dollars ($50,000) within ten (10) calendar days of notification by Grantor of its withdrawal against the letter of credit.

D. The rights reserved to Grantor with respect to the letter of credit are in addition to all other rights of Grantor, whether reserved by the Franchise, or authorized by law, and no action, proceeding or exercise of a right with respect to such a letter shall affect any other right Grantor may have.

E. The letter of credit shall contain the following endorsement:

"It is hereby understood and agreed that this letter of credit shall not be canceled by the surety nor the intention not to renew be stated by the surety until thirty (30) calendar days after receipt by the City, by registered mail, of a written notice of such an intention to cancel or not to renew."

F. Grantee shall renew the letter of credit not less than thirty (30) calendar days prior to its expiration and provide a copy of the renewal to Grantor.

Section 21. Remedies - Liquidated Damages

A. Because Grantee's failure to comply with provisions of this Franchise may result in injury to Grantor, Grantor may impose penalties commensurate to the harm caused to Grantor consistent with the standards set forth herein. Grantor may adjust maximum damage amounts throughout the Franchise term by resolution to take into account increases in the Consumer Price Index.

B. Grantor acknowledges that Grantee, as a competitive over builder, is undertaking considerably greater risk than the incumbent Cable Service provider and that, because Grantee is subject to competition from the incumbent provider, the risk of harm to the public due to Franchise violations by Grantee is significantly decreased.

C. For failure to comply with material requirements of the I-Net provisions of the Franchise: up to one hundred dollars ($100.00) each calendar day for each offense. A separate and distinct offense shall be deemed committed each calendar day on which a violation occurs or continues;

D. For failure, pursuant to this agreement, to submit reports, maintain records, provide documents or information: up to one hundred dollars ($100.00) for each offense per calendar day. A separate and distinct offense shall be deemed committed each calendar day on which a violation occurs or continues;

E. For failure to comply with material requirements of the Customer Service Standards: up to one hundred dollars ($100.00) for each offense per calendar day. A separate and distinct offense shall be deemed committed each calendar day on which a violation occurs or continues;

F. For failure to comply with transfer provisions: up to five hundred dollars ($500.00) for each calendar day from the date of any unlawful transfer; and

G. For failure to comply with any material provision herein for which a penalty or sanction is not otherwise specifically provided: up to one hundred dollars ($100.00) for each offense per calendar day. A separate and distinct offense shall be deemed committed each calendar day on which a violation occurs or continues.

H. The Grantor shall provide the Grantee with a Notice of Noncompliance and Grantee shall have thirty (30) days in which to cure the deficiency. Penalties shall commence and accumulate only for calendar days of noncompliance, which occur after the final date set by Grantor for achieving compliance. If Grantee fails to correct such situation within thirty (30) days after such notice, then Grantor may proceed to set a public hearing date. Such date shall be set at a public hearing of which Grantee is given at least fourteen (14) calendar days notice and at which it has an opportunity to be heard. No penalties will be

assessed for a violation period, which has existed prior to the expiration of the period set by Grantor herein for correcting the defect.

I. Grantor shall stay or waive the imposition of any penalties set forth herein upon a finding that any failure or delay is the result of an act of God or due to circumstances beyond the reasonable control of Grantee.

Section 22. Remedies - Cumulative

All remedies provided under this Franchise Agreement or the enabling ordinance shall be cumulative, unless otherwise expressly stated. The exercise of one remedy shall not foreclose use of another, nor shall it relieve Grantee of its obligations to comply with the Franchise. Remedies may be used singly or in combination; in addition, Grantee or Grantor may exercise any rights they have under applicable law.

Section 23. Books and Records - Inspection

Grantor may inspect the books, records, maps, plans, and other documents, including financial documents, in the control or possession of Grantee, its Affiliates, or any person that constitutes an operator of Grantee's Cable System: 1) to enforce Grantor's rights or evaluate compliance with the Franchise and applicable law; 2) in the exercise of any lawful regulatory power; or 3) as may be convenient in connection with any proceeding Grantor may or must conduct under applicable law in accordance with the terms of this Franchise Agreement. The material may be duplicated at Grantor's facilities unless Grantee agrees to make inspection and copying available at some other place. Material that the Grantor requires the Grantee to produce under this Section shall be produced upon reasonable notice, no later than thirty (30) calendar days after the request for production. Requests for extensions of time to respond shall not be unreasonably denied.

The Grantee may request that the Grantor treat records containing trade secrets or proprietary information as confidential under the North Carolina Public Records law. To the extent authorized by the Public Records law and other applicable State and Federal law, Grantor shall maintain the confidentiality of information designated "proprietary" by Grantee. Should Grantor receive a request to review Grantee's records or books under the North Carolina Public Records law, it will promptly notify Grantee and provide an opportunity for the Grantee to raise an objection, demonstrate why the requested information is proprietary and, if necessary, seek a court order to protect its proprietary information. However, any action taken by the Grantee to protect its records or information shall be done at no cost or liability to the Grantor.

Section 24. Books and Records - Reports

Grantee shall provide the following reports to Grantor:

A. A quarterly Franchise Fee report listing Gross Revenues received;

B. Within ninety (90) calendar days after the close of Grantee's fiscal year the Grantee shall submit a written annual report setting forth Gross Revenues received by category for said fiscal year, certified by an official of Grantee. Upon request of Grantor, the Grantee shall furnish the Grantor a copy of the most recent annual report, if any, of its parent entity.

C. Grantee shall file with Grantor any notice of deficiency, forfeiture, or other document issued by any State or Federal agency which has instituted any investigation or civil or criminal proceeding naming the Cable System, Grantee, or any operator of the Cable System, to the extent the same may affect or bear on the operations of Grantee's Cable System.

D. Grantee shall file with Grantor any request for protection under Bankruptcy laws, or any judgment related to a declaration of bankruptcy by Grantee, any affiliate which controls or manages Grantee, or any operator of the Cable System.

E. Upon request by Grantor, Grantee shall discuss its contingency plans for responding to natural disasters with representatives of Grantor.

F. Upon reasonable notification by the Grantor, the Grantee shall send a company official to any public meeting convened by the Grantor for the purpose of discussing Cable Service in Raleigh and/or the Grantee's performance pursuant to this Franchise.

Section 25. Books and Records - Maintenance

In addition to reports required by this Franchise, Grantee shall maintain records of the following:

A. FCC proof of performance that is required to be maintained by Grantee under Federal law.

B. Records demonstrating compliance with applicable Customer Service Standards provided herein as Exhibit A.

Section 26. Inspection of Cable System

Grantor may inspect Grantee's Cable System, and upon reasonable notice, inspect the distribution facilities and equipment of the Cable System. If, based upon Subscriber complaints or its own investigation, Grantor finds that the Cable System's operation is out of compliance with the Franchise Agreement or applicable Federal rules, it may require Grantee to perform tests, prepare a report and present to Grantor the results of those tests. Grantee shall identify any problem found, advise the Grantor of the remedy it intends to pursue to correct the problem, take action to remedy the problem and provide copies of test data to show that the problem has been corrected.

Section 27. Insurance

A. Within thirty (30) calendar days after the effective date of the Franchise, Grantee shall provide proof of the required insurance. Grantee shall maintain this insurance throughout the Franchise term. Insurance shall include, in amounts not less than those indicated herein:

1. Worker's Compensation coverage for all employees with Statutory Limits in compliance with applicable State and Federal laws. The policy shall include Employers' Liability with a limit of five hundred thousand dollars ($500,000) for each accident;

2. Comprehensive General Liability with a minimum limit of two million dollars ($2,000,000) per occurrence, four million ($4,000,000) aggregate combined single limit for bodily injury liability and property damage liability. This shall include premises and/or operations, independent contractors, and subcontractors and/or completed operations, broad form property damage, XCU Coverage, and a Contractual Liability Endorsement;

3. Business Auto Policy shall have minimum limits of one million dollars ($1,000,000) per occurrence combined single limit for bodily injury liability and property damage liability. This shall include owned vehicles, hired and non owned vehicles; and

4. An umbrella policy which shall have minimum limits of five million dollars ($5,000,000) per occurrence.

B. The insurance coverage obtained by the Grantee necessary to comply with this Franchise Agreement shall be approved by Grantor's risk management office, such approval not to be unreasonably denied or delayed, and a certificate of insurance shall be filed with the Grantor.

C. The City of Raleigh shall be named as an additional insured as its interests may appear.

Section 28. Emergency Alert System Participation

Grantee shall install and maintain an emergency alert system (EAS) pursuant to FCC's rules and the North Carolina Emergency Alert System Plan. Grantor's Public Safety Communication Center shall access the system in accordance with the State EAS Plan to communicate emergency messages and alerts to residents consistent with Section VI (B) of the North Carolina Emergency Alert System Plan.

Section 29. Service to Public Buildings

Grantee shall, upon request, provide Cable Service to public buildings located within one hundred twenty-five feet (125') of Grantee's existing distribution system; provided, however, if adequate underground conduit is provided by the requesting public agency, Grantee shall, upon request, provide Cable Service to public buildings within two hundred fifty feet (250') from Grantee's Cable System; provided, however, the Grantee shall not be required to provide internal wiring or equipment within the building. All charges for installation and provision of Cable Services or Other Communication Services to such public buildings shall be at Grantee's then-current rates. To the extent services are provided to Public Buildings, neither Grantor nor any other person may resell such services. Nor shall any person, organization or other entity receiving free or reduced cost services or connections, extend such service or connection to other persons or locations. Grantor shall be entitled to receive free Basic Service at five (5) such locations regardless of the number of Cable Service Subscribers served by Grantee. Additionally, Grantor shall be entitled to receive free Basic Service at one additional location for each two hundred and fifty (250) Cable Service Subscribers then being served by Grantee.

Section 30. Five - Year Review: Performance Monitoring

A. During the year, which commences on the fifth anniversary of the effective date of the Franchise, and each fifth year thereafter throughout the term, Grantor may commence a review of Grantee's performance under the Franchise. As part of this review, Grantor may consider:

1. whether Grantee has complied with its obligations under the Franchise and applicable law;

2. whether customer service standards, technical standards, bond or security fund requirements are adequate or excessive; and

3. other issues as may be raised by Grantee, Grantor, or the public.

B. Grantor shall conduct public hearings to provide Grantee and the public the opportunity to comment on Grantee's performance and other issues considered as part of the five-year review.

C. Any revisions to the Franchise Agreement which either Grantor or Grantee wishes to make as a result of these reviews shall be proposed under the procedures established herein.

D. Periodic Evaluation, Review and Modification.

1. Grantor and Grantee acknowledge and agree that the field of cable television is a

relatively new and rapidly changing one which may see many regulatory, technical, financial, marketing and legal changes during the term of this Franchise. Therefore, to provide for the maximum degree of flexibility in this Franchise, and to help achieve a continued, advanced and modern Cable System, the following evaluation and review provisions will apply:

a) Grantor may, upon thirty (30) calendar days notice, request evaluation and review sessions at any time during the term of this Agreement after the fifth anniversary, and Grantee shall cooperate in such review and evaluation; provided, however, there shall not be more than one (1) evaluation and review session during any calendar year.

b) Topics which may be discussed at any evaluation and review session include, but are not limited to, rates, channel capacity, the System performance, PEG Access, municipal uses of cable, Subscriber complaints, judicial rulings, FCC rulings and any other topics Grantor or Grantee may deem relevant.

c) During an evaluation and review session, Grantee shall cooperate fully with Grantor and shall provide without cost such reasonable information and documents as Grantor may request to perform the evaluation and review.

d) If at any time during the evaluation and review, Grantor reasonably believes evidence exists which substantiates that the technical performance of the Cable System violates the terms of this Franchise, Grantor may require Grantee, at Grantee's expense, to perform appropriate tests and analyses directed toward such suspected technical inadequacies. In making such request, Grantor shall describe and identify, as specifically as possible, the nature of the problem and the type of test Grantor believes to be appropriate. Grantee shall cooperate fully with Grantor in performing such tests and shall report to Grantor the results of the tests, which shall include at least:

   1) a description of the problem in the Cable System performance which precipitated the special tests;
   2) the Cable System component tested;
   3) the equipment used and procedures employed in testing;
   4) the method, if any, by which the Cable System performance problem was resolved; and
   5) any other information pertinent to said tests and analyses.

e) As a result of an evaluation and review session, Grantor or Grantee may determine that a change to the Cable System or in the terms of the Franchise may be appropriate. In that event, either Grantor or Grantee may propose modifications to the Cable System or the Franchise. Grantee and Grantor shall, in

good faith, review the terms of the proposed change or any proposed amendment to this Franchise and seek to reach agreement on such change or amendment.

2. Grantor and Grantee shall act in good faith during such negotiations and shall be obligated to agree to the reasonable requests of the other party for changes in the Cable System or amendment to the Franchise when the change or amendment is not inconsistent with the other terms of the Franchise, or with applicable law or regulations, and the change or amendment is technically feasible, economically reasonable, and will not result in a material alteration of the rights, obligations, liabilities and duties of the parties under the Franchise.

Section 31. Conflict with Cable Regulatory Ordinance

In the event of any conflict between the terms and conditions of this Franchise Agreement and the provisions of the Cable-Telecommunications Standards Ordinance No. (1995) 631, the terms of this Franchise Agreement shall prevail.

Section 32. Reservation of Rights

Grantor and Grantee reserve all rights that they may possess under the law unless expressly waived herein.

Section 33. Force Majeure

In the event Grantee's performance of any of the terms, conditions, obligations or requirements of this Franchise is prevented or impaired due to any cause beyond its reasonable control or not reasonably foreseeable, such inability to perform shall be deemed to be excused and no penalties or sanctions shall be imposed as a result thereof, provided Grantee provides notice to Grantor in writing within thirty (30) calendar days of Grantee's discovery of the occurrence of such an event or within thirty (30) calendar days of Grantor's notice to Grantee of a failure to perform occasioned by such cause, which notice explains the circumstances. Such causes beyond Grantee's reasonable control or not reasonably foreseeable shall include, but shall not be limited to, acts of God, civil emergencies and labor unrest or strikes, untimely delivery of equipment, inability of Grantee to obtain access to property easements, rights of way and inability of Grantee to secure all necessary permits to utilize poles and conduits so long as Grantee utilizes due diligence to obtain said permits in a timely fashion.

Section 34. Grant

Grantor grants this Franchise to Grantee pursuant and subject to the conditions and requirements and applicable Federal, State and local laws. This Franchise bestows upon Grantee the authority to construct, maintain and operate an Cable System, utilizing the Public Rights-Of-Way, to offer Cable Services and Other Communications Services within the City.

Adopted: _____, 2001

In Witness Whereof, the undersigned have caused this Agreement to be executed.

ATTEST

By: _____
Gail G. Smith, City Clerk

CITY OF RALEIGH

By: _____
J. Russell Allen, City Manager

Approved as to Form

By: _____
Tom McCormick
City Attorney

City-seal

Section 35. Acceptance by the Grantee

This Franchise and all of its terms and provisions shall be accepted by the Grantee in writing in the form hereinafter set forth within thirty (30) days of the grant of this Franchise by the City Council and when accepted shall be filed with the City Clerk who shall record the same in the Book of Ordinances. Such written acceptance may be upon or at the end of a copy of this Ordinance and it shall State and express the acceptance of the said Franchise and its terms, conditions, and provisions; and the said Grantee shall agree in said written acceptance to abide by, to observe and to perform the same according to all of its terms and provisions, subject to applicable State and Federal law, and shall declare that statements and recitals contained on said Franchise are correct and that it has made and does make the agreements and statements set forth in this Franchise. Acceptance herein referred to shall be in the following form:

"The undersigned, William A. Schuler, Chief Executive Officer, does hereby accept and approve the foregoing and attached Franchise and all of its terms and conditions. In consideration of the benefits and privileges granted to it does hereby agree to abide by, carry out, observe, and perform all of the obligations and things provided to be carried out and performed by it in said Franchise approved by the City Council of the City of Raleigh, subject to applicable State and Federal law.

This _____day of_____ 2001.

CAROLINA BROADBAND, INC.

By: _____
William A. Schuler, Chief Executive Officer

ATTEST:

_____ Corp-seal

STATE OF _____)
)
COUNTY OF _____)

On the _____ day of _____ 2001, before me, a Notary Public in and for the County and State aforesaid, William A. Schuler the Chief Executive Officer personally appeared and _____ the _____ of the Grantee, and for themselves and as such officers respectively, before and on the behalf of the said Grantee, acknowledge the signing and execution of the foregoing instrument and acknowledge that the seal affixed to said instrument is the corporate seal of the said Grantee; and they affixed such corporate seal to and otherwise executed said instrument on behalf of the said instrument is their free and voluntary act and deed as such officers respectively and is the free and voluntary act of the Grantee for all of the uses and purposes and said instrument mentioned, all pursuant to authority and direction duly given by the Board of Directors of the said Grantee.

In testimony whereof I have hereunto subscribed my name and affixed by notarial seal on the day and year first above written.

_____
Notary Public

My commission expires:

_____

Exhibit A
Customer Service Standards

A. Subscriber Privacy

In accordance with Section 631 of the Federal Cable Act of 1984, Grantee shall, no less than annually, provide a privacy notice in the form of a separate written statement to subscribers as required by the provisions of the Act.

B. Employee Identification

When calling in person on subscribers or other residents, all employees or authorized representatives of Grantee are required to display an employee identification card with their name, photograph and signature, and a telephone number that can be used for verification of the representative's capacity with Grantee. Grantee's vehicles shall display the name of the Cable Company in easily distinguishable alphanumeric characters. Grantee shall make a reasonable effort to cause its subcontractors' vehicles to be identified in a like fashion.

C. Office and Telephone Availability

1. Knowledgeable, qualified company customer service representatives will be available to respond to customer telephone calls Monday through Friday during normal business hours. Additionally, based on community needs, Grantee will staff its telephones for supplemental hours on weekdays and/or weekends.

2. Under normal operating conditions, telephone answer time by Grantee's customer service representatives, including wait time required to transfer the call, shall not exceed thirty (30) seconds. This standard shall be met no less than ninety percent (90%) of the time measured on an annual basis. Initial intake and routing of calls may be performed by an auto-attendant system.

3. Under normal operating conditions, the customer shall receive a busy signal less than three percent of the total time that Grantee's office is open for business.

4. Grantee shall be responsible for adopting and implementing subscriber complaint procedures, and for advising subscribers of the availability of these procedures. The procedures shall be designed to resolve subscriber complaints in a timely and satisfactory manner; to develop sensitivity and responsiveness to subscriber needs by Grantee and its management; and to improve the quality and dependability of services to subscribers by Grantee.

Established complaint procedures shall include: specific provisions permitting subscriber repair service complaints received to be received by telephone twenty-four (24) hours each day and seven (7) calendar days each week; permitting subscriber repair service complaints to be received at Grantee's business office from 8:00 A.M. until 7:00 P.M. on Monday through Friday of each week and from 9:00 A.M. until 1:00 P.M. on Saturday; and the address of Grantee's business office.

5. Grantor acknowledges that the foregoing performance standards were originally prepared for the incumbent provider, which had an established customer base and predictable levels of customer service requirements. Grantee is a newly established competitor that will experience rapid growth with fluctuating demands for customer service. Grantor agrees that it will reasonably consider such extenuating circumstances when evaluating Grantee's performance with respect to these Customer Service Standards.

D. Installations, Outage and Service Calls

Under normal operating conditions, each of the following standards shall be met no less than ninety-five percent (95%) of the time measured on an annual basis.

5. Standard installation shall be performed within seven (7) business days after an order has been placed. "Standard" installations are up to one hundred fifty (150) feet from the existing distribution system.

6. Excluding those situations beyond the control of Grantee, Grantee shall respond to service interruptions promptly and no later than twenty-four (24) hours after the interruption becomes known to Grantee. Grantee must begin actions to correct other service problems the next business day after notification to Grantee of the service problem.

7. The "appointment window" alternatives for installations, service calls, and other installation activities shall be: 1) morning, 2) afternoon, or 3) all day during normal business hours. Additionally, based on the community needs, Grantee shall schedule supplemental hours during which appointments can be set.

8. If, at any time an installer or technician is running late, an attempt to contact the customer shall be made and the appointment rescheduled as necessary at a time which is convenient for the customer.

9. Grantee shall render efficient service, make repairs promptly and interrupt service only for good cause and for the shortest time possible. A notice to subscribers shall precede such interruptions not within the midnight to 6:00 A.M. period, insofar as possible.

10. Grantee shall respond to all customer complaint calls reporting an outage until 10:00 P. M. on normal business days. After 10:00 P. M. on any day, trained technicians shall respond to calls if three (3) or more complaints are received from subscribers affected by an outage having a common cause.

E. Communication, Statements, Refunds, and Credits

1. Grantee shall provide written information in each of the following areas at the time of installation and at any future time upon request:

   - products and services offered
   - prices and service options
   - installation and service policies
   - how to use the cable service

2. Subscriber billing statements shall be clear, concise and understandable. Such statements shall reflect all services and fees in an itemized fashion.

3. Refund checks shall be issued promptly, but no later than the earlier of thirty (30) calendar days or the customer's next billing cycle following the resolution of the request or, if service was terminated, thirty (30) calendar days from the date of the return of the equipment supplied by the cable company.

4. Customers shall be notified in writing a minimum of thirty (30) calendar days in advance of any rate or channel change, provided the change is within the control of Grantee.

5. Grantee shall provide outage credit to subscribers in accordance with the following policy:

   Upon notification, should Grantee fail to correct a service outage problem - within its control - within 24 hours after having receipt of such notice, Grantee shall credit 1/30th of the monthly charge for the affected service for each 24-hour period or fraction thereof following the first twenty-four (24) hour period during which the subscriber experiences service outage. Subscriber must advise Grantee of the duration of the service interruption for which credit is sought in order to receive such credit, and such credit shall not apply to any period of time more than 48 hours prior to the Subscriber's giving of said notice to Grantee. Reasonable notice for this provision shall mean written, telephonic (voice), facsimile or e-mail communication to the Grantee.

6. Late fees shall not be assessed earlier than thirty (30) calendar days past the billing cycle due date.

F. Complaint - Appeals

1. Upon notification by a subscriber of an unresolved complaint, the Information Access Manager shall determine the facts of the complaint by obtaining information from the subscriber and Grantee and shall act to resolve the complaint in a manner consistent with the City's authority.

2. The cable subscriber may register a complaint with the City, regarding rates or associated equipment rental, and the City may file a formal complaint with the Federal Communications Commission as provided by FCC regulations.

Exhibit B
Institutional Network

Upon Grantor's timely request, Grantee shall cooperate with Grantor to acquire and install additional fiber optic strands that may be used by Grantee to create and operate an Institutional Network ("I-Net") in accordance with the terms and conditions of this Exhibit and an agreement (the "I-Net Agreement") entered into between Grantor and Grantee.

A. Request for Plan

After acceptance of this Franchise by Grantee, Grantor may request in writing that Grantee prepare and present to Grantor a Preliminary Design for the installation and use of certain additional fibers as an Institutional Network. The request by Grantor shall include a designation of locations to be serviced by the I-Net and the amount and type of capacity desired by Grantor to be available at each location. Grantor acknowledges that the design and implementation of the I-Net must take place in proper phasing with the design, materials ordering, and construction of the Cable System, and that, to the extent that Grantee's planning, design and construction on a particular section of the Cable System has progressed past the point at which elements of the I-Net could be included in that section of the Cable System without causing delay or expense to Grantee, that section of the Cable System will not be included in the I-Net. After Grantee has completed construction of the Cable System, and not less than three (3) years after Grantee's acceptance of this Franchise, Grantor may request that the I-Net be extended to a non-included section of the Cable System pursuant to paragraph F below.

B. Preliminary Design

Upon Grantor's request, Grantee will provide one Preliminary Design of the I-Net and cost estimate to Grantor. The Preliminary Design will consist of a general I-Net design based on Grantor's stated present and future capacity needs. Grantee will suggest a basic design for the I-Net and provide a not-to-exceed estimate of construction costs for the capacity required on the I-Net. The Preliminary Design will not include a walkout of Grantor's building(s) to be provided I-Net capacity, a detailed network design or a specific cost proposal, all of which shall be part of the Final Design. It is recognized that it is the intent of the parties that the facilities providing I-Net capacity be constructed in conjunction with the design and construction of the Cable System without causing interruption or delay in the Cable System project. Grantor shall, within thirty (30) days after receiving a reasonably itemized statement, reimburse Grantee for Grantee's actual cost incurred to produce the Preliminary Design and cost estimate.

C. Final Design Agreement

1. Upon written request of Grantor, after receipt of the Preliminary Design, Grantee shall quote a not-to-exceed fee for completion of a Final Design (the "Final Design Fee"). The Final Design Fee shall be the responsibility of Grantor and shall be paid within thirty (30) days after receipt of the Final Design.

2. Grantor may, by written request within thirty (30) days after receipt of the Preliminary Design and cost estimate, request that Grantee provide a Final Design of the I-Net. The Final Design shall be provided within no more than 120 calendar days after receipt of the Preliminary Design. The Final Design shall include the following: (i) a walkout of the public buildings to which I-Net capacity will be provided; (ii) a detailed network design; (iii) a cost breakdown of all material and all other charges and costs that will be incurred to complete the construction of the I-Net.

3. Upon receipt of the Final Design, Grantor shall have forty-five (45) calendar days to enter into an I-Net Agreement (as defined below) with Grantee on the terms set forth in the Final Design.

4. The I-Net Agreement shall include Grantor's obligation to pay Grantee a fee (the "Construction Fee") that shall be set at the level that will permit Grantee to recover all of its actual costs for construction, and, installation of the I-Net, plus an additional fee of eleven and one-quarter percent of the aforesaid aggregate costs. When the parties have agreed on the terms and conditions with respect to the I-Net, its use and charges thereof, the parties shall execute a written agreement ("the I-Net Agreement") setting forth the terms and conditions which agreement shall be incorporated into and be a part of this Franchise Agreement. Grantee shall have no obligation to provide I-Net capacity absent such agreement.

D. Fees

1. Construction Fee. The costs to be included in the Construction Fee will be calculated on an Incremental Cost basis if the construction of I-Net capacity is performed in conjunction with the construction of the Cable System. Incremental Cost is defined as all avoidable costs that would not have been incurred by Grantee but for Grantor's request for I-Net capacity. If pursuant to paragraph F below Grantor requests I-Net capacity that Grantee provides after the completion of construction of the Cable System, the Construction Fee will equal Grantee's costs to provide such capacity on an Allocated Cost basis. Allocated Cost is defined as all costs incurred by Grantee to provide the I-Net capacity to Grantor. Any costs incurred by Grantee to provide capacity in excess of that requested by Grantor shall be borne by Grantee.

2. Usage Fee. In addition to the Construction Fee, throughout the term of the Franchise, commencing upon activation of the I-Net capacity, Grantor shall pay Grantee a monthly Usage Fee. The Usage Fee shall be paid for the usage of the I-Net capacity, maintenance of outside plant and maintenance, replacement diagnosis of electronic equipment necessary to provide I-Net capacity. The Usage Fee will be equal to 80% of the average rate charged currently by at least three (3) land-line competitors in the same market for equivalent capacities of bandwidth being provided on the I-Net (the Average Rate). The Average Rate shall be based on the rates quoted by competitors in response to a survey conducted by Grantee and Grantor a least sixty (60) calendar days prior to activation of I-Net capacity. Each of the three (3) competitors must provide services similar to those provided by Grantee under the I-Net Agreement and be authorized by the North Carolina Utilities Commission. At least one of the competitors must be a local exchange carrier. If there are only two (2) competitors in the same market, the Usage Fee will be an amount equal to 80% of the Average Rate offered for similar services by the two (2) competitors. If there is only one competitor in the market, the Usage Fee will be an amount equal to 80% of the rate for similar services offered on a nondiscriminatory basis by the one market competitor. The Usage Fee will be adjusted annually to reflect changes in the local market. The Usage Fee shall never be less than Grantee's cost or be priced so as to violate Federal, State or local law.

E. Operation of I-Net

1. Grantee shall own and maintain the I-Net.

2. The design of the I-Net shall enable the switching and routing of I-Net signals from Upstream to Downstream transmission to be accomplished remotely via video switcher, computer and modem by Grantor without assistance of Grantee.

3. Use of the I-Net by Grantor shall not interfere with the operations of Grantee and shall not interfere with or impair the technical quality or reliability of the I-Net or Cable System.

4. Grantor shall be solely responsible for the purchase, installation, quality, maintenance and operation of end user equipment connected to the I-Net. Such equipment shall not interfere with the operation of Grantee's Cable System.

5. Grantee shall be responsible for maintenance of the I-Net.

6. Grantee shall provide at least one-week advance notice to Grantor of any maintenance requiring temporary interruption of service, except in emergency situations.

7. When Grantee responds to requests for service by Grantor and there is no I-Net problem found, Grantee may charge Grantor for the service at a reasonable fee in addition to any Service and Usage Fees.

F. Additional I-Net Locations

Grantor may, after initial construction and activation of the I-Net, request in writing that the Grantee connect additional sites to the I-Net or construct extensions to the I-Net. If Grantee elects to perform such work, the terms regarding any such additional connections, which may include increased Service and Usage Fees, may be set in the I-Net Agreement or by agreement of the parties after the request.

G. Use of I-Net

1. The parties acknowledge that use of the I-Net is subject to all State and Federal law. Grantor agrees to indemnify, defend and hold harmless Grantee from and against any and all claims, damages, liabilities, costs and expenses, including reasonable attorney's fees and costs directly related to the use of I-Net by Grantor, including but not limited to, copyright infringement, libel, slander, defamation, patent, trademark or invasion of privacy claims.

2. Only Grantor shall use the I-Net for non-commercial education and government purposes. Grantee may charge a fee for information transmitted by means of the I-Net provided that such fee is for the information only and not the transmission thereof and is the same as the fee charged by Grantee for the information when provided by other means. Nothing herein shall preclude Grantee from receiving a fee for the transmission of such information. Any party other than Grantee may make no direct or indirect commercial use of the I-Net. The Institutional Network shall not be extended other than by Grantee to any location except as permitted by the I-Net Agreement and may not be used by Grantor to transmit or receive any communication (in whatever form, whether video, audio, data, voice or otherwise) destined to or originating from any other switched network, including without limitation, the facilities of any local or long-distance telephone company, except for video programming for use on the Public, Education and Government Access channels. Any use of the Institutional Network other than as permitted herein shall be on terms and conditions agreed to in writing by Grantee and Grantor.

3. Grantor agrees as a condition of its use of the Institutional Network that:

a) Grantor may not re-sell, license, or otherwise assign use of the Institutional Network Capacity or Services to a third party;

b) The Institutional Network may be used by Grantor for non-commercial education and government purposes and for the transmission of PEG video programming, but for no other purposes.

c) Grantor shall notify Grantee in the event that the I-Net capacity is being used in violation of the terms and conditions of the Franchise.

d) Grantee shall own all equipment and Facilities used to provide the I-Net capacity to Grantor. Grantee shall have the right to use any bandwidth or I-Net capacity not specifically guaranteed or provided to Grantor under the I-Net Agreement.

H. Term

The I-Net Agreement between Grantor and Grantee shall be coterminous with the term of the Franchise Agreement unless otherwise agreed to in writing between Grantor and Grantee.

I. Equipment Space

If Grantee has adequate space available in Grantee's master switching facility, Grantee will allow Grantor to install, maintain and operate therein Grantor's I-Net equipment on terms and conditions that will be provided in greater detail in the I-Net Agreement. Grantor's equipment shall not interfere with the maintenance or operation of Grantee's equipment and operations. Access to Grantee's facility shall be restricted upon terms and conditions adopted by Grantee. Any space rental fees shall not exceed the charges to other similar users.

J. Offset for Non-Payment.

If Grantor fails to pay to Grantee when due any sum of money owed to Grantee under this Franchise, the I-Net Agreement, or any other agreement ancillary to this Franchise, and such failure continues for more than ten (10) days after notice from Grantee to Grantor, then Grantee may offset such overdue sum against the Franchise Fee payable by Grantee to Grantor.

Exhibit C
Equity Financial Interests

M/C Venture Partners
75 State Street
Suite 2500
Boston, MA 02109

Morgan Stanley Dean Witter
1221 Avenue of the Americas
33rd Floor
New York, NY 10020

Chase Capital Partners
1221 Avenue of the Americas
39th Floor
New York, NY 10020-1080

Bank of America Capital Investors
901 Main Street
66th Floor
Dallas, TX 75202

First Union Capital Partners
One First Union Center
301 South College Street, 5th Floor
Charlotte, NC 28288

Spectrum Equity
One International Place
29th Floor
Boston, MA 02110

Providence Equity Partners
50 Kennedy Plaza
Providence, RI 02903

Fleet Equity Partners
50 Kennedy Plaza
12th Floor
Providence, RI 02903

Whitney & Co.
46 Farnsworth Street
Boston, MA 02210

HarbourVest Partners, LLC
One Financial Center
44th Floor
Boston, MA 02111

Carousel Capital
201 North Tryon Street
Suite 2450
Charlotte, NC 28202

California State Teachers Retirement System
Mail Station #4, Investments Office
7667 Folsom Boulevard
Sacramento, CA 95816-3749

Wachovia Capital Associates
191 Peachtree Street, NE
26th Floor
Atlanta, GA 30303

The Competitive Effects of Telephone Entry into Video Markets

by

Robert W. Crandall†
J. Gregory Sidak††
Hal J. Singer†††

I. Introduction

II. A Brief History of the Cable Franchising Process
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Conclusion

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† Senior Fellow, the Brookings Institution.
†† Visiting Professor of Law, Georgetown University Law Center.
††† President, Criterion Economics. Financial support for this article was provided by the Internet Innovation Alliance. Information about the coalition is available at www.internetinnovation.org.htm. The views expressed here are those of the authors and not those of the Georgetown University Law Center or the Brookings Institution, neither of which takes institutional positions on specific legislative, regulatory, adjudicatory, or executive matters.

I. INTRODUCTION

Beginning around 2004, certain local telephone companies—most notably, SBC and Verizon—upgraded their networks to provide a bundle of services consisting of voice over Internet protocol (VoIP), digital video, and high-speed Internet access. Once the fiber upgrade is completed, a local telephone company will have the capability to offer, among other services, multiple high-quality television streams that include high-definition television video (HDTV) programming and video-on-demand for each household. These upgraded telephone networks will provide a third pipeline for the delivery of multi-channel video programming (MVPD) services to compete against cable television operators and direct broadcast satellites (DBS), and will provide a comprehensive service package in competition with cable's bundle of voice, video, and data services. In September 2005, the investment firm Sanford C. Bernstein & Co. predicted that by 2010 nearly 40 percent of U.S. households will be able to get video service from their local telephone company.[1]

Verizon has named its new fiber network "FIOS." Verizon plans to invest $20 billion to lay thousands of miles of fiber-optic cables across its service area from Maine to Florida and into parts of Texas and California.[2] As of the end of October 2005, Verizon had initiated negotiations with roughly 300 municipalities, but it had secured only fourteen franchise agreements (a 4.6 percent initial success rate) for video service.[3] Verizon's low success rate has been attributed to "regulatory holdup"—that is, unrealistic demands made by municipalities in return for franchise approval.[4] According to the Buckingham Research Group, the local franchise requirements will

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1. Peter Grant, *Getting Your MTV from the Phone Company—Verizon Takes On Cable, Offering Cheaper TV Service*, WALL ST. J., Sept. 21, 2005, at D1 (discussing Sanford C. Bernstein study).
2. Dionne Searcey, *Spotty Reception—As Verizon Enters Cable Business, It Faces Local Static*, WALL ST. J., Oct. 28, 2005, at A1.
3. *Id.*
4. *Id.*

delay telephone entry into video services by between eight and sixteen months.[5] Not only are municipalities seeking to impose unreasonable requirements on telephone companies, but some are competing directly with local telephone companies for broadband customers by launching citywide wireless fidelity (Wi-Fi) networks.[6] These municipalities (which include Philadelphia, Madison, Minneapolis, Tempe, and Sacramento)[7] have a pronounced incentive to raise the entry cost of rival providers of broadband service. Indeed, the municipality need not build a broadband network to extract additional payouts from local telephone companies—it need only threaten to do so.

Verizon's FIOS project started in the Dallas suburb of Keller, where it offered video service to residents in September 2005.[8] Verizon planned to introduce its video service by the end of 2005 in other parts of country, including Fairfax County, Virginia; the New York City suburb of Massapequa Park; a community outside of Tampa, Florida; and several communities in California.[9] Verizon was charging $36.90 per month for 140 channels of digital service, and $43.90 for 185 channels of digital service, including the $3.95 rental charge for a set-top box.[10] The telecommunications consultancy Kagan Research estimates that the comparable (digital)

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5. The Buckingham Research Group, Communications Services As RBOC Video Efforts Falter, Outlook Improves for DBS, Cable, June 13, 2005, at 3 ("Cable operators are subject to local franchise approval processes, an arduous and time consuming process that can take anywhere from 6-18 months depending on the city and state.").

6. Philadelphia announced in October 2005 that it had chosen EarthLink to provide citywide wireless high-speed Internet access. By October 2005, San Francisco received 24 proposals from a range of Internet and telecommunications companies interested in equipping that city for wireless broadband, including a proposal by Google to offer the service free of charge. *See* Li Yuan & Kevin J. Delaney, *EarthLink Picked By Philadelphia To Provide Wi-Fi*, WALL ST. J., Oct. 4, 2005, at A20. According to muniwireless.com, a portal that tracks municipal wireless projects, the U.S. market for municipal broadband is expected to grow to $400 million by 2007. *See* Jesse Drucker, Kevin J. Delaney & Peter Grant, *Google's Wireless Plan Underscores Threat to Telecom—Free Internet Access Proposal In San Francisco Lets Users Bypass Phone, Cable Links*, WALL ST. J., Oct. 3, 2005, at A1.

7. Drucker, Delaney & Grant, *supra* note 6.

8. Searcey, *supra* note 2.

9. Peter Grant, *Getting Your MTV From the Phone Company—Verizon Takes On Cable, Offering Cheaper TV Service*, WALL ST. J., Sept. 21, 2005, at D1.

10. *Id.*

package from a cable company would cost $55 per month.[11] UBS Securities estimates that Verizon will spend $7 billion to offer television service to about one-half of the 32 million homes reached by its network,

SBC has named its new fiber network "Lightspeed." SBC plans to launch its video service in early 2006.[12] SBC predicts that it will be able to provide video service to 18 million homes by the first half of 2008.[13] For new builds, SBC is extending fiber all the way to the customer's home. For existing homes, SBC is extending fiber-optic lines into nodes of those neighborhoods and is using enhanced copper wire to carry video signals the last few thousand feet to the home.[14] Through this choice of network architecture, SBC projects an initial cost of $4 to $5 billion to offer video service.[15]

The technologies used by local telephone operators to offer video service are distinct. Verizon will provide television signals using the same technology that cable companies use, which essentially broadcasts all channels to a set-top box at once.[16] In contrast, SBC's video customers will request one channel at a time from servers, using the same way Internet protocol (IP) technology that enables users to access Web pages on their computers.[17] SBC's position is that its IP-based, interactive approach avoids the legal requirement under the Cable Act that cable operators obtain cable franchises from local municipalities. As of June 2005, BellSouth

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11. *Id.*
12. *Id.*
13. *Id.*
14. Peter Grant, *Technology (A Special Report): Telecommunications—Air Battle: SBC vs. Verizon: The war of the TV wannabes*, WALL ST. J., July 18, 2005, at R8.
15. *Id.*
16. *Id.*
17. *Id.*

acknowledged that it was working with Microsoft to conduct trials of its IP-enabled video service,[18] which would more closely resemble SBC's network architecture.

Setting aside any issues concerning the applicability of any particular regulatory regime, this report seeks to evaluate the competitive effects of telephone-company entry into video markets in terms of prices and quality of service. In Part II, we review the franchise process for cable services. Cable systems were franchised locally, and the Federal Communications Commission (FCC) initially took a passive stance on several regulatory issues. Before passage of the Cable Communications Policy Act of 1984, the FCC left the franchising process largely to local authorities. The Act established franchising procedures and an orderly franchise renewal process. By the 1980s, exclusivity for incumbent cable operators had become virtually universal in practice.

The Cable Television Consumer Protection and Competition Act of 1992 focused on consumer protection, primarily through the re-regulation of cable television rates. The Act also promoted competition in the distribution of programming by mandating that vertically integrated cable operators offer program access to rival programming distributors, and by prohibiting municipalities from unreasonably denying second franchises for cable systems. Through the Telecommunications Act of 1996, Congress gave a cable operator the freedom to increase rates without prior notice to its customers if the operator's costs rose because of a change in a regulatory fee or franchise fee imposed by any federal agency or franchising authority. The video provisions of the Act served to promote competition in the cable industry by deregulating any cable operator that was subject to effective competition, and by promoting entry among rival MVPDs, including local telephone companies. Congress established a sunset date of March 1999

18. Peter Grunt, Robert A. Guth & David Pringle, *Phone Companies Using Microsoft Hit TV Service Snags,*

for rate regulation of all but the basic tier of cable television services, and it phased out the remaining rate controls that had been imposed on larger system operators.

In Part III, we describe the reaction of cable operators to entry by DBS providers and wireline overbuilders. Cable television providers responded to DBS entry by investing heavily in their networks to offer enhanced services, including digital video signals, high-speed Internet access, HDTV, and telephony. By contrast, cable operators responded to targeted entry of wireline overbuilders by decreasing their prices significantly. Both responses have generated large increases in consumer welfare.

Part IV explores how local cable franchising requirements would serve as an entry barrier that would undermine the ability of telephone company entrants to compete effectively with cable operators. We explain why franchise requirements would have adverse consumer welfare effects in the related markets of voice and broadband as well. Upon ubiquitous deployment by telephone companies of fiber networks to provide video service, we estimate that cable customers living in areas not yet overbuilt by a wireline provider would enjoy the benefits of lower prices of roughly $7.15 per month, or $85.80 per year. A five-year net present value of the annualized savings would be roughly $26.52 billion (assuming a five percent discount rate). To the extent that DBS providers respond to lower cable prices with price reductions of their own, the net present value of the welfare benefits from RBOC entry into MVPD markets would increase by roughly 50 percent, to nearly $40 billion.

Next, we explore the potential economic justification for the imposition of additional fees for a telephone company's use of the rights-of-way, which the telephone company already has the right to use. With minor exceptions, there is no incremental burden to the municipality from a

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WALL ST. J., June 24, 2005, at B1.

local telephone company's use of those rights-of-way to offer video service provided over a telephone network. To the extent that the local telephone company is required to pay any franchise fee, we explain why the appropriate percentage should be significantly less than five percent. Finally, we discuss why a uniform national approach to regulating video service provided over a telephone network makes more sense and is more efficient.

II. A BRIEF HISTORY OF THE CABLE FRANCHISING PROCESS

Cable television began as the retransmission of terrestrial broadcast signals. Although the FCC required that a cable system carry all local broadcast signals, the agency was reluctant to intervene on issues such as franchising and rate regulation, which it left to municipalities or the states. Cable operators were largely free from competition in this era, as DBS firms did not establish a viable presence until the early 1990s.

A. The Early Cable Franchising Process

The municipal franchising process developed around the building of the first cable television systems in the 1960s and 1970s. Cable service was regulated on an informal basis by municipalities, which controlled the easements under and over public rights-of-way that cable needed to wire local communities.[19] In addition to granting franchises, municipalities also regulated cable rates at the local level. The FCC remained on the sidelines for much of this era. In the 1960s, some states stepped into the power vacuum created by the FCC's hands-off approach and began to regulate cable directly.

Before the 1984 Supreme Court decision in *Capital Cities Cable, Inc.* v. *Crisp*,[20] there was significant uncertainty over the boundaries between federal and local regulatory jurisdiction

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19. *See* JOHN THORNE, PETER HUBER & MICHAEL KELLOGG, FEDERAL BROADBAND LAW 179 (Little Brown & Co Law & Business 2002).
20. 467 U.S. 691 (1984).

of cable television. In *Crisp*, the Supreme Court held that, by banning the importation of alcoholic beverage advertising into Oklahoma, the state had trespassed on the authority of the FCC.[21] In *Community Communications Co., Inc.* v. *City of Boulder*, the Supreme Court held that the city's three-month moratorium prohibiting the local cable company from expanding was not immune from antitrust scrutiny.[22] As we explain below, the 1984 Cable Communications Act was motivated, in part, to clarify this uncertainty over the proper division of federal and local government jurisdiction.

B. The Cable Communications Policy Act of 1984

The Cable Communications Policy Act of 1984 was protective legislation for incumbent cable operators. The Act curbed the cities' powers with respect to franchise renewal and rate regulation, yet it preserved some limited role for municipalities. The 1984 Cable Act was the first attempt by Congress to provide guidance to the FCC on several critical issues relating to cable television.[23] The Act is best understood as a compromise between the interests of cities and cable operators: cities relinquished certain powers in exchange for, among other items, (1) the authority to require cable operators to upgrade and expand their video networks; (2) the authority to establish certain facilities, equipment, and services requirements; (3) continuation of local franchise fees and the ability to obtain the maximum fee without an FCC waiver; and (4) the ability to require cable companies to make available public, educational, and government (PEG) channels. The carrots for the incumbent cable operators were, among other items, (1) freedom from unreasonable demands by municipalities; (2) protection from competition, especially

21. *Id.* at 704.
22. 455 U.S. 40 (1982).
23. 47 U.S.C. § 521(1).

during the franchise renewal process; (3) an end to rate regulation in most markets; and (4) statutory limitations on franchise fees and other cash payments.

Congress wanted to create national rules to govern local franchising procedures with the aim of encouraging the growth and development of cable systems.[24] Before passage of the 1984 Cable Act, the FCC left the franchising process largely to local authorities.[25] The Act established franchising procedures and an orderly franchise renewal process.[26] By the 1980s, exclusivity for incumbent cable operators had become virtually universal in practice.[27] Potential entrants unsuccessfully challenged the exclusivity provisions in franchise agreements under the Sherman Act.[28] The 1984 Act authorized municipalities to grant "one or more" franchises, which the cities often interpreted as allowing them to grant merely one, exclusive franchise.[29]

Congress provided other protections from competition for incumbent cable operators because it was evidently concerned that cable operators would be unwilling to risk large amounts of capital if a local government could unreasonably deny a cable system the opportunity to renew its cable franchise at the end of the franchise period.[30] As a result, Congress created a provision that restricted a franchising authority's ability to deny renewal of an incumbent operator's franchise unless the local government could demonstrate that the cable operator or its proposal did not meet one or more of four statutory standards.[31] The 1984 Act did not impose a limit on the duration of a cable franchise.

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24. *See* DANIEL L. BRENNER, MONROE E. PRICE & MICHAEL I. MEYERSON, CABLE TELEVISION AND OTHER NONBROADCAST VIDEO Ch. 2 § 2.02 (Clark Boardman Callaghan 1996).
25. THORNE, HUBER & KELLOGG, *supra* note 21, at 229.
26. 47 U.S.C. § 521(2), 521(5).
27. THORNE, HUBER & KELLOGG, *supra* note 21, at 230.
28. *Id.*
29. *Id.*
30. *See* BRENNER, PRICE, & MEYERSON, *supra* note 26, at § 2.02.
31. 47 U.S.C. § 626.

Finally, by codifying in section 613(b) certain cross-ownership restrictions on local telephone companies,[32] Congress also shielded incumbent cable operators from entry by the local telephone company within the latter's service area, thereby eliminating a significant potential competitor for the incumbent cable operator.[33] (This statutory barrier to entry was later struck down on the grounds that it violated the First Amendment rights of telephone companies.[34])

Congress also established a ceiling on the fee that cities could charge cable systems for the continued access to its public streets. Specifically, this annual franchising fee could not exceed five percent of the cable system's gross revenues, and any non-capital PEG payments and other cash payments were counted against the fee.[35] The cap on franchise fees can be understood as establishing a ceiling on the rate that would emerge under competition among rival cable operators for a given local franchise. For example, in an open competition for a given franchise, competition among rival companies for a de facto monopoly cable franchise could have resulted in a franchise fee that substantially exceeded five percent.[36]

C. The Cable Television Consumer Protection and Competition Act of 1992

The Cable Television Consumer Protection and Competition Act of 1992 focused on consumer protection, primarily through the re-regulation of cable television rates. The Act also promoted competition in the distribution of programming by mandating that vertically integrated cable operators offer program access to rival programming distributors, and by prohibiting municipalities from unreasonably denying second franchises for cable systems. Importantly, the Act did not change the definition of a cable service.

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32. *Id.* § 533(b).
33. PETER W. HUBER, MICHAEL K. KELLOGG & JOHN THORNE, FEDERAL TELECOMMUNICATIONS LAW 1196-97 (2d ed. Aspen Law & Business 1999).
34. Chesapeake & Potomac Tel. Co. of Va. v. United States, 830 F. Supp. 909 (E.D. Va. 1993), *aff'd*, 42 F.3d 181 (4th Cir. 1994), *cert. granted*, 515 U.S. 1157 (1995), *judgment vacated*, 516 U.S. 415 (1996).
35. 47 U.S.C. § 542(b).

Congress passed the Cable Television Consumer Protection and Competition Act of 1992[37] to address the perceived problems created by the structure of the MVPD industry. By 1992, it became clear that Congress had added to cable's substantial monopoly power by enacting the 1984 Cable Act, resulting in numerous consumer complaints about cable rate increases and poor customer service.[38] In an attempt to constrain this monopoly power, Congress re-regulated cable rates, prohibited exclusive franchising, and imposed vertical and horizontal ownership limits.

The 1992 Cable Act imposed new responsibilities on the FCC to regulate cable television service.[39] To stimulate competition, downstream competitors such as DBS operators were granted access to all satellite-delivered programming provided by vertically integrated cable networks.[40] Despite findings by the FCC[41] and the Department of Justice[42] that entry into video programming by local telephone companies would be procompetitive on balance, Congress ignored the opportunity to eliminate the restriction on telephone-company video services that it had included in the 1984 Cable Act.

Congress reinstated rate regulation in 1992 by allowing both state and local governments and the FCC to assert control over the rates for non-premium services that cable systems could charge their customers.[43] The 1992 Cable Act laid out a complex system for regulating cable rates. For example, local rate regulation generally affected only the basic service tier. Regulation

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36. See discussion at Section IV.B., *infra.*
37. 47 U.S.C. § 543.
38. PAUL SIEGEL, COMMUNICATION LAW IN AMERICA 469 (Allyn & Bacon 2002).
39. 47 U.S.C. § 533(f).
40. History of Cable Television, the Cable Center (available at http://www.cablecenter.org/history/timeline/decade.cfm?start=1980) [hereinafter *Programming History*].
41. Second Report and Order, Recommendations to Congress and Second Further Notice of Proposed Rulemaking, Telephone Company-Cable Television Cross-Ownership Rules, 7 F.C.C. Rcd. 5784, 5847-51 (1992).
42. Reply Comments of the United States Department of Justice at 44, Telephone Company-Cable Television Cross-Ownership Rules Sections 63.54-63.58, FCC Dkt. No. 87-266 (filed Mar. 13, 1992).

of the higher tiers was to be conducted by the FCC in response to complaints. Premium channels, however, were exempt from regulation.[44]

Congress also empowered the FCC to impose both horizontal and vertical ownership limits on cable companies. Specifically, horizontal limits capped the total share of U.S. households that could receive multichannel programming from a single operator,[45] whereas vertical limits restricted the share of its channels that a system operator could use to offer programming services in which it had an attributable ownership interest.[46] In 1993, the FCC set that channel-occupancy limit at 40 percent and defined an attributable interest to be five percent or more of the total equity in a programming service.[47] The objective of the vertical restrictions was to reduce the incentive of vertically integrated cable operators to favor their affiliated content to the disadvantage of unaffiliated services.[48] The issue of a cable operator's market power was addressed once more in the Telecommunications Act of 1996.

D. The Telecommunications Act of 1996

The Telecommunications Act of 1996 encouraged the ubiquitous deployment of advanced services. The Act sought to remove entry barriers and open markets to competition.

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43. 47 U.S.C. § 543(a)(2).

44. For a detailed analysis of price regulation resulting from the 1992 Act, see THOMAS HAZLETT & MATTHEW L. SPITZER, PUBLIC POLICY TOWARD CABLE TELEVISION: THE ECONOMICS OF RATE CONTROLS 54-57 (AEI Press 1997) and ROBERT W. CRANDALL AND HAROLD FURCHTGOTT-ROTH: CABLE TELEVISION: REGULATION OR COMPETITION? BROOKINGS 1996 (CHECK DATE!).

45. 47 U.S.C. § 613(f).

46. *Id.*

47. Implementation of Sections 11 and 13 of the Cable Television Consumer Protection and Competition Act of 1992, MM Dkt. No. 92-264, 10 F.C.C. 4654 (1995). In 2001, both the horizontal and vertical limits adopted by the FCC were subsequently overturned by the U.S. Court of Appeals for the D.C. Circuit. *See* Time Warner Entertainment Company v. FCC, 240 F.3d. 1126 (D.C. Cir. 2001). In May 2005, the FCC issued a notice of proposed rulemaking to consider whether new limits should be imposed. Second Further Notice of Proposed Rulemaking, MM Dkt. No. 92-264 (May 17, 2005).

48. *See* DAVID WATERMAN & ANDREW A. WEISS, VERTICAL INTEGRATION IN CABLE TELEVISION 13 (MIT Press & AEI Press 1997). By comparing empirically the practices of vertically integrated cable operators with non-vertically integrated operators, Waterman and Weiss found that vertically integrated cable operators favored affiliated programming (either by more frequent carriage or by lower pricing) and tended to offer fewer numbers of cable networks to subscribers.

The Act expanded the definition of cable service but did not change the fundamental nature of cable service as a one-way service. The FCC referred to the 1996 Act amendment in its *Cable Modem Declaratory Ruling*, reasoning that the amendment addresses only the use of content otherwise qualifying as cable service, and that a cable operator lacks that requisite control over the selection of the information by the cable modem user.

The video provisions of the Telecommunications Act of 1996 served to promote competition in the cable industry by deregulating any cable operator that was subject to effective competition,[49] and by promoting entry among rival MVPDs, including local telephone companies.[50] Congress established a sunset date of March 1999 for all rate regulation but the basic tier of cable television services, and it phased out the remaining rate controls that had been imposed on larger system operators.[51] The Telecommunications Act immediately deregulated small cable systems,[52] which served about 20 percent of the estimated 61 million cable households in the United States. The Act also allowed local telephone companies to provide video service within their service territories, a provision that we examine in greater detail below.

Through the Telecommunications Act of 1996, Congress gave a cable operator the freedom to increase rates without prior notice to its customers if the operator's costs rose because of a change in a regulatory fee or franchise fee imposed by any federal agency or franchising authority.[53] An operator of an "open video system" (OVS), which we describe below, was subjected to the payment of franchise fees on the "gross revenues of the operator for the

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49. HAZLETT & SPITZER, *supra* note 46, at 68.
50. For a review of the extant video prospects for local exchange carriers in 1994, see LELAND L. JOHNSON, TOWARD COMPETITION IN CABLE TELEVISION 53-84 (MIT Press & AEI Press 1994).
51. 47 U.S.C. § 543(c)(4).
52. *Id.* § 543(m).
53. *Id.* § 522(g).

provision of *cable service* imposed by a local franchising authority or other governmental entity, in lieu of the franchise fees permitted under section 622."[54]

The 1996 Act did change the limitation on franchise fees paid by cable operators by adding the phrase "to provide cable services" to the sentence, "For any twelve-month period, the franchise fees paid by a cable operator with respect to any cable system shall not exceed 5% of such cable operator's gross revenues derived in such period from the operation of the cable system *to provide cable services.*"[55] Finally, Congress prevented a local franchising authority from ordering a cable operator to discontinue the operation of a cable system "to the extent such cable system is used for the provision of a telecommunications service, by reason of the failure of such cable operator or affiliate thereof to obtain a franchise or franchise renewal under this title with respect to the provision of such telecommunications service."[56]

The Telecommunications Act of 1996 removed many of the barriers that had previously prevented local telephone companies from competing as video operators.[57] The 1996 Act explicitly exempted OVS service from franchise fees and from certain other Cable Act requirements, including the requirement to obtain a local franchise. The Act's definition of OVS service allowed for 33 percent affiliated programming, with the remaining capacity devoted to leased access on an open, nondiscriminatory basis.[58] In particular, if demand by unaffiliated video programmers exceeds capacity, then an OVS operator is limited to providing programming to one-third of the capacity of its own system, and it is obligated to allocate the other two-thirds to unaffiliated video program providers.[59]

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54. *Id.* § 542(c)(2)(B) (emphasis added).
55. *Id.* § 542(b) (emphasis added).
56. *Id.* § 541(b).
57. *See* SIEGEL, *supra* note 40, at 469-70.
58. 47 U.S.C. § 653.
59. *Id.* § 653(b)(1)(B).

In exchange for this heavier access burden, OVS providers were exempted from leased access, local franchising, rate regulation, and an array of other regulations imposed upon cable systems.[60] OVS remained subject to rules requiring PEG access and to must-carry obligations.[61] The limitations on vertical integration and new prohibitions on competitive buyouts between cable and telephone companies applied to OVS.[62] Finally, the 1996 Act eliminated the requirement that a local telephone company obtain from the FCC a section 214 certificate of public convenience and necessity before it could construct or operate a video system.[63]

The 1996 Act sought to enhance competition in video programming by removing barriers to entry, especially those that stymied entry by telephone companies. The 1996 Act tried to facilitate telephone company entry into video services. But that experiment failed. For public policy reasons that we delineate below, to the extent that enhancing competition in video markets remains an important objective for Congress, existing barriers to telephone company entry, including cable franchise requirements, should be removed.

III. The Effect of Entry on the Price and Quality of Cable Television Service

In response to entry by DBS operators, cable television providers invested heavily in their networks to offer enhanced services, including digital video signals, high-speed Internet access, HDTV, and telephony. In response to wireline overbuilders, cable television providers decreased their prices significantly. Both responses have generated large increases in consumer welfare.

A. Ubiquitous Entry by DBS Induced Cable Operators to Upgrade Their Networks

Notwithstanding rate regulation imposed by municipalities, there were no market forces to constrain the prices of incumbent cable operators through the 1980s. Competitive multi-

60. *Id.* § 653(c).
61. *Id.* § 653(c)(2)(B).
62. *Id.* § 653(c).
63. *Id.* § 651(c).

channel distribution technologies, including direct-to-home (DTH), the predecessor to DBS, did not emerge until 1982.[64] But the DTH business was not viable, and satellite television providers did not become effective competitors until the mid-1990s.[65] Because DBS providers did not require local rights-of-way to transmit video programming, they were able to avoid the local franchising requirements imposed on cable operators. But these entrants faced several impediments to competing effectively, including the inability to secure video programming that was owned by incumbent cable operators. By June 1995, all DBS operators combined (DIRECTV, U.S. Satellite Broadcasting, and PrimeStar) had only 1.1 million subscribers.[66] EchoStar entered the market in 1996, and the number of DBS subscribers increased to over 5 million by 1998.[67] Another major impediment to DBS penetration was that, until November 1999, DBS operators were not permitted to offer their subscribers local television broadcast signals.[68] Cable operators had pursued a strategy of vertical integration in part to achieve certain efficiencies. According to the FCC, 53 percent (56 of 106) of national satellite-delivered cable programming services were vertically integrated in 1993.[69] One byproduct of vertical integration was the ability to deny downstream rivals the ability to offer affiliated programming.[70] The

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64. Programming History, *supra* note 40.

65. *See, e.g,* PATRICK R. PARSONS & ROBERT M. FRIEDEN, THE CABLE AND SATELLITE TELEVISION INDUSTRIES 9 (Allyn & Bacon 1998) (explaining that DTH operators caused their original investors to lose hundreds of millions of dollars in the 1980s).

66. Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming, Fourth Annual Report, CS Dkt. No. 97-141, 13 F.C.C.R. 1034, 1070, Jan. 13, 1998 [hereinafter *Fourth MVPD Report*].

67. PARSONS & FRIEDEN, *supra* note 65, at 9.

68. *See, e.g.*, General Accounting Office, LOCAL TV Act: Administrative Funds May No Longer Be Necessary, Apr. 22, 2005 (estimating that the number of U.S. television households without access to local television signals from DBS decreased from approximately 23.4 million in August 2003 to about 4.8 million as of September 2004). On November 19, 1999, Congress passed the Satellite Home Viewer Improvement Act of 1999 (SHVIA), which sought to place DBS providers on an equal footing with cable television operators with respect to the availability of broadcast programming. 47 U.S.C. § 325.

69. *Fourth MVPD Report*, *supra* note 66, at 158.

70. *See* DAVID WATERMAN & ANDREW A. WEISS, VERTICAL INTEGRATION IN CABLE TELEVISION (MIT Press & AEI Press 1997).

Cable Television and Consumer Protection Act of 1992, which we discussed above, addressed these foreclosure issues by compelling vertically integrated cable operators to make satellite-delivered affiliated programming available to rival MVPDs. Access to terrestrially delivered affiliated programming, such as regional sports networks, is not subject to the program access provisions of the 1992 Cable Act and remains a problem today.

Although there is little empirical evidence that supports the hypothesis that DBS entry constrained the prices of cable operators, DBS entry likely prodded cable operators to upgrade their networks to offer more channels with higher resolution.[71] DBS operators began offering digital television services upon entry, which were far superior to the extant analog services offered by cable operators. With the threat of losing market share, cable operators responded by investing heavily in digital technologies. According to the National Cable Television Association (NCTA), between 1996—the year that Echostar entered the market—and 2004 the cable industry's capital expenditures were almost $95 billion, which equates to roughly $1,300 per customer spent to upgrade cable systems for digital service and HDTV, introduce new equipment, and launch new broadband services.[72]

Although DBS entry cannot be credited entirely for spurring the cable industry to introduce cable modem service and cable telephony, once cable firms invested in digital systems to compete with DBS offerings, the incremental upgrades for these ancillary broadband services

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71. *See, e.g.*, General Accounting Office, Issues Related to Competition and Subscriber Rates in the Cable Television Industry, Oct. 2003, at 11 ("Also, in areas where both primary DBS operators provide local broadcast stations, we found that the cable operators offer subscribers approximately 5 percent more cable networks than cable operators in areas where this is not the case.") [hereinafter *GAO Study*]; Bara Vaida, *The Clash of the High-Tech Titans*, NAT'L J., Sept. 28, 2005 ("The satellite industry now boasts about 27 million subscribers, and cable companies, in response to this competition, have invested about $100 billion, upgrading their systems and improving service."); Andrew S. Wise & Kiran Duwadi, *Competition between Cable Television and Direct Broadcast Satellite – It's More Complicated than You Think*, 1 J. COMP. L. & ECON. (forthcoming 2005) ("Since DBS operators now are allowed to distribute local broadcast channels, and since many cable operators have upgraded their systems to offer more channels and digital services, DBS and cable provide similar services.").

were small. But the benefits to consumers from these incremental upgrades have been large. As of the end of the third quarter of 2004, the cable industry served 19.4 million high-speed Internet customers and was the most popular broadband access offering.[73] Cable operators deployed circuit-switched technologies to provide business and residential telephone services beginning in 1997.[74] Cable operators became certified local exchange carriers offering competitive residential voice services across the country on an essentially unregulated basis. Beginning in 2003, many cable operators launched VoIP service,[75] which provides many of the functionalities of the public switched telephone network but uses broadband capacity. As of the third quarter of 2004, cable operators served roughly 2.8 million residential cable telephony customers across the country through a combination of circuit-switched and VoIP technologies.[76]

B. Targeted Entry by Wireline Overbuilders Induced Cable Operators to Decrease Their Prices

Unlike the ubiquitous entry by DBS operators, entry by wireline overbuilders has been targeted to specific localities. In 2005, the FCC reported in its *Report on Cable Industry Prices* that monthly cable rates in January 2004 were 15.7 percent lower in geographic markets where incumbent cable operators faced competition from a wireline overbuilder relative to geographic

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72. National Cable and Television Association, Broadband Services (available at http://www.ncta.com/Docs/PageContent.cfm?pageID=37).
73. National Cable and Television Association, High-Speed Internet Access (available at http://www.ncta.com/Docs/PageContent.cfm?pageID=93).
74. National Cable and Television Association, Telephone Service (available at http://www.ncta.com/Docs/PageContent.cfm?pageID=32).
75. *Id.*
76. *Id.*

markets defined by the FCC to be "non-competitive."[77] In October 2003, the General Accounting Office independently estimated a similar effect of wireline entry on cable prices.[78]

In addition to these empirical analyses, there are many case studies of an incumbent cable operator responding to entry by wireline overbuilders with lower prices. For example, Comcast thwarted RCN's entry in Philadelphia with aggressive price reductions.[79] A month before RCN entered, Comcast offered to freeze rates and to give subscribers a free premium channel if they would sign a contract to stay with Comcast until 2001.[80]

Similar anecdotes can be found in Michigan, which has experienced significant overbuilding activity. According to Warren Communications' *MediaPrints* database of cable television systems,[81] 15.6 percent of Michigan residents have a choice of cable operators. The most widely reported cases of overbuilding in Michigan were by Ameritech (whose cable business is now owned and operated by Wide Open West). In February 1994, Ameritech asked federal regulators for approval to build a cable television service in Detroit and 13 other local communities for $55 million.[82] In February 1995, Ameritech commenced installation of equipment for an interactive cable television service in Detroit.[83] By June 1995, Ameritech had signed agreements with four Wayne County districts (Canton Township, Northville, Plymouth,

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77. Report on Cable Industry Prices, In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment, MM Dkt. No. 92-266, 20 F.C.C.R. 2718, 2721 (released Feb. 4, 2005) (available at http://www.fcc.gov/mb/csrptpg.html).

78. *GAO Study*, *supra* note 70, at 10 ("According to our cable-satellite model (see app. IV), in 2001, cable rates were approximately 15 percent lower in areas where a wire-based competitor was present.").

79. Philadelphia Cable TV rates rank with the highest, PHIL. INQUIRER, Oct. 15, 2000.

80. *Id.*

81. Warren Communications News & the Janus Group, MediaPrints: Cable-to-Census Block Group Translation Table (4th Quarter 2001).

82. *Ameritech Asks for OK to Build Digital TV Network; Seeks Fed OK to Build $55 Mil Digital Cable TV Svc in Detroit, MI, and 13 Other Local Communities*, DETROIT FREE PRESS, Feb. 2, 1994, at E1.

83. *Ameritech CEO Sees Interactive TV Soon; Begins Installing Equipment for New Interactive Cable Television Service in Detroit*, DETROIT FREE PRESS, Feb. 22, 1995, at E2.

and Plymouth Township) to provide cable television services; in so doing, it became the first telephone company in the United States to provide its own cable television service.[84]

Ameritech's entry into Michigan prompted incumbent cable operators there to improve their offerings in both price and non-price dimensions. Tom Bjorkland, a spokesman for Time Warner, conceded that Ameritech's entry "certainly had an impact on us because we now need to look at what our competition is doing."[85] Similarly, Detroit city officials stated that Comcast's customer service improved markedly in areas where Ameritech had overbuilt.[86] According to one press account, "[c]ompetition in the metropolitan Detroit has resulted in a windfall for customers. New channels, frozen rates and offers of free premium channels such as HBO are among the strategies established companies such as TCI, Comcast and MediaOne have adopted in the past two years, when Ameritech's Americast system entered the area cable TV market."[87]

The presence of Ameritech appears to have protected consumers against rising rates throughout the Detroit metropolitan area in 1996 and 1997. According to a survey by the *Detroit Free Press*, while basic cable rates in metropolitan Detroit increased an average of 11 percent from February 1996 to September 1997, "TCI customers who live in a community where Ameritech is offering cable service [experienced] a decrease in their cable rates."[88] In April 2002, Comcast customers who expressed interest in switching to overbuilder Wide Open West were offered a discounted $21.95 rate for basic cable compared to the regular rate of $33.95.[89]

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84. *A New Line for Ameritech; Signs Agreement With Four Wayne County, MI Districts to Provide Cable Television Services*, DETROIT FREE PRESS, June 29, 1995, at G1.

85. Deborah Solomon, *Higher Rates Coming for Detroit Area Cable Television*, DETROIT FREE PRESS, Sept. 25, 1997, at *1.

86. *Id.*

87. Ameritech Entry Into Metro Detroit Cable Market Triggers Competition, ASSOCIATED PRESS NEWSWIRES (July 1, 1997).

88. Deborah Solomon, *Higher Rates Coming for Detroit Area Cable Television*, DETROIT FREE PRESS (Sept. 25, 1997).

89. *Overbuilders Ask LFAs to Deal With Predatory Pricing by MSOs*, COMM. DAILY (Apr. 5, 2002).

IV. TELEPHONE ENTRY INTO VIDEO MARKETS WOULD SIGNIFICANTLY INCREASE CONSUMER WELFARE

Public policy considerations counsel that video service provided over a telephone network should not be subject to cable regulation. Telephone company entry would produce immediate consumer benefits in video markets. With some minor exceptions, there is no incremental burden to the municipality from the local telephone company's use of existing rights-of-way to offer video service. To the extent that the local telephone company is required to pay any franchise fee, the appropriate percentage should be substantially less than the prevailing five percent. The cable franchise requirement probably would significantly delay the local telephone company's deployment of advanced services and, in the worst case, could discourage the local telephone company's investment in fiber.

A. Cable Operators Would Reduce Their Prices in Response to Telephone Company Entry

Existing cable and DBS customers would benefit greatly from telephone company entry into video markets. Upon ubiquitous deployment by telephone companies into the local MVPD markets, all cable customers would enjoy the benefits of lower prices that currently are available only to consumers in geographic areas with wireline overbuilders. To calculate the savings to current MVPD subscribers from such entry, one needs estimates of (1) the number of MVPD households that are in a position to benefit from additional entry and (2) the monthly savings in cable television service from RBOC entry. We estimate the number of cable subscribers in currently non-competitive areas by multiplying the number of basic cable subscribers in June 2004 from the FCC's *Eleventh Annual Report* (66.1 million) by the percentage of cable subscribers in "non-competitive" communities (92.07 percent) in the FCC's 2005 *Report on*

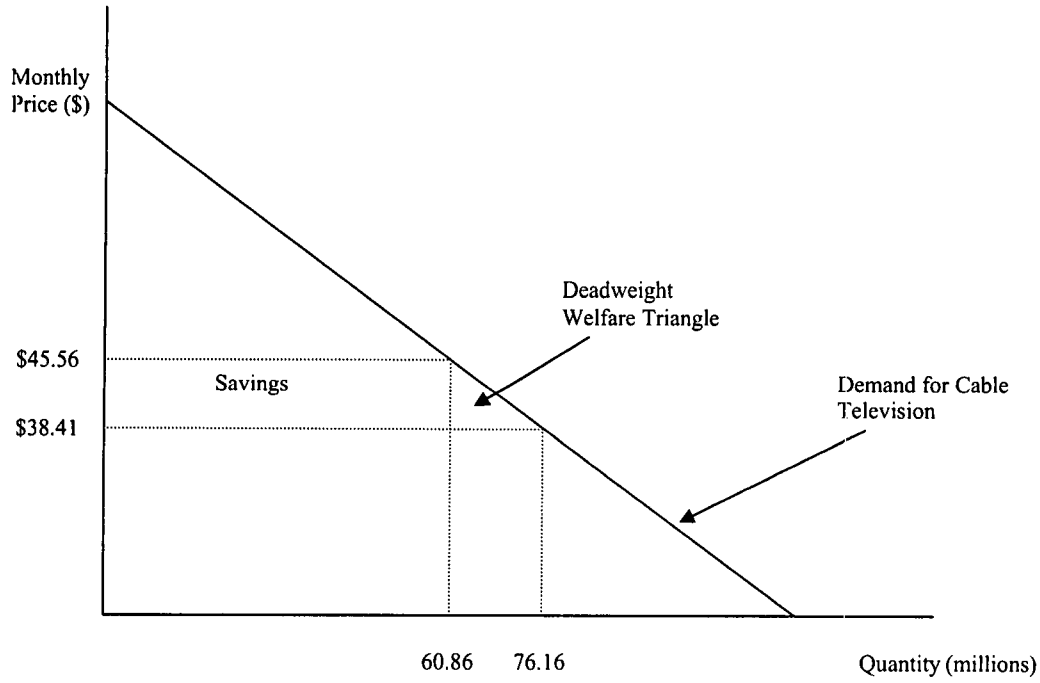
Cable Industry Prices survey sample.[90] Using these figures, 60.86 million cable subscribers in "non-competitive" areas paid an average monthly price of $45.56 for cable service in 2004. If these cable subscribers were to realize a $7.15 decrease in the monthly price of cable television service (equal to 15.7 percent of $45.56) as a result of the telephone companies' entry into the delivery of video services, then the annual savings across all such subscribers would be $5.22 billion per year. Because the decrease in prices would spur additional cable customers, an additional surplus of $0.613 billion per year would be created by the telephone companies' entry.[91] Figure 1 shows the gain in consumer welfare (equal to the savings by existing cable customers plus welfare gains by new cable customers) graphically.

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90. *Report on Cable Industry Prices,* Attachments 1 and 6; *Eleventh Annual Report*, In the Matter of Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming, MB Dkt. No. 04-227, 20 F.C.C.R. 2755, 2759 (released Feb. 4, 2005) (available at http://www.fcc.gov/mb/csrptpg.html) [hereinafter *Eleventh Annual Report*].

91. Assuming an elasticity of demand for cable television of -1.5, 14.3 million new cable television customers would emerge in response to a $7.15 price decrease. For estimates of the elasticity of demand for cable television, see In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992 Statistical Report on Average Rates for Basic Service, Cable Programming Services, and Equipment, MM Dkt. No. 92-266, 15 F.C.C.R. 10,927, 10,946, Report on Cable Industry Prices, June 15, 2000 ("The estimated price elasticity of cable according to this equation is 1.31, which indicates that the demand for cable services is somewhat price elastic."). The monthly increase in surplus for these new customers is equal to one-half of the product of the change in price and the change in customers. These calculations ignore the substantial likely benefits from innovative new interactive services that the telephone companies' new video service will deliver to consumers.

FIGURE 1: CONSUMER WELFARE GAIN FROM UBIQUITOUS TELEPHONE COMPANY DEPLOYMENT OF FIBER NETWORKS TO PROVIDE VIDEO SERVICES



The savings correspond to the rectangular area bounded by the old and the new monthly price for cable television. The deadweight triangle gains correspond to the triangular area below the demand curve bounded by the old and the new monthly price for cable television.

The annual welfare increase among existing cable subscribers living in non-competitive areas from ubiquitous RBOC deployment of fiber networks to provide video services would total $5.83 billion (equal to $5.22 billion plus $0.613 billion). A five-year net present value of the annualized savings would be roughly $26.52 billion (assuming a 5 percent discount rate). Of course, this estimate presumes that all MVPD households in "non-competitive" areas are passed by RBOCs on the first day of the first year in the five-year window. Finally, to the extent that DBS providers responded to lower cable prices with price reductions of their own, the welfare

benefits from RBOC entry in video markets would increase by roughly 50 percent to nearly $40 billion.[92]

To the extent that local franchise requirements delay telephone company entry into the MVPD market, consumers will not receive the benefits resulting from greater video competition. Franchise requirements would harm consumer welfare in related markets as well. Telephone companies are the most effective competitor to the cable companies' triple-play offering of voice, video, and data. Hence, the inability of telephone companies to enter video markets quickly will undermine their ability to compete effectively for the bundle of services currently offered by cable firms. Thus, consumers will be denied the benefits of the lower prices that competition can bring.

The cable franchise requirement could also discourage the local telephone company from investing in fiber. A local telephone company's incentive to invest in fiber depends critically on its ability to provide video service: without the margins from video service, the investment might not be warranted.[93] If local telephone companies decide not to upgrade their network or to delay such upgrades, then the deployment of broadband services will be slowed.

Finally, cable operators are not currently subject to franchise requirements in broadband or VoIP services. The FCC and the courts recognized that the social costs of regulating new services (in terms of forgone innovation) outweighed any benefits (such as greater proceeds generated by the franchise fee). Subjecting a telephone company's video offering to cable service regulation would be inconsistent with federal policy to promote deployment of new and

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92. The total number of DBS customers (27 million) in the United States is equal to roughly half the number of cable customers in areas not yet overbuilt (61 million). Because the welfare calculations are linear transformations of the number of affected customers, the welfare gain of DBS subscribers is equal to 44 percent (27 million divided 61 million) of the welfare gain for cable subscribers in areas not yet overbuilt.

advanced services. It makes no economic sense to saddle telephone companies with legacy regulations from a monopoly era as they enter video markets as one of several competing providers. Neither cable operators nor telephone companies should be discouraged from upgrading their networks to deliver new services by the threat of legacy regulation developed under entirely different circumstances than the market conditions that exist today. Nor does it serve any public policy objective to regulate the third entrant in MVPD services behind cable operators and DBS providers.

B. There Is No Economic Justification for the Imposition of Additional Fees for a Telephone Company's Use of the Rights-of-Way

Local telephone companies have already been granted the use of rights-of-way for the placement of telephone facilities and equipment. With the minor exception of the placement of limited equipment, there is no incremental burden to the municipality from the local telephone company's use of those rights-of-way to offer its video service. The local telephone company already compensates public owners for the use and occupation of public rights-of-way for the delivery of telephone service, albeit at the state level (and in certain cases, at the local level); consequently, the imposition of local franchise fees for video services delivered over the same network would amount to double recovery by local and state governments. The fact that the local telephone company is offering a new service—that is, a service other than local telephone service—over the same platform does not require a second franchise.[94] If telephone companies are discouraged from entering video markets by having to pay twice (once for a telephone franchise and a second time for a cable television franchise) for the use of such rights-of-way,

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93. *National Video Franchise, Local Broadband Attract Conflicting Viewpoints from Industry*, REGULATION & LAW, July 21, 2005, at A-14. According to Brent Olson, assistance vice president of regulatory policy at SBC, "this [SBC] network doesn't get built without video." *Id.*

consumers will continue to pay supra-competitive rates for video service. And in those local markets where telephone companies enter but pass along the duplicative tax in the form of higher rates, consumers will be denied the full price-constraining effect that local telephone companies have offered in other industries that they have entered, such as long-distance telephony.[95]

To the extent that a local telephone company is required to pay *any* franchise fee, the appropriate percentage should be significantly less than five percent. Local franchise fees can be analogized to an auction by municipalities for the rights to offer video service. When the municipality effectively guaranteed monopoly provision of cable television, it could demand the franchise fee associated with the monopoly price for cable television. Indeed, free of federal intervention and other payments to government employees, the franchise fee in equilibrium could be bid up to one penny less than 100 percent of the present discounted value of net cash flows associated with monopoly provision of cable television. The equilibrium fee associated with the monopoly provision of cable television reached by cities and cable operators was five percent. Permitting local telephone companies to supply video programming represents a repudiation by the municipality of its prior commitment to protect the incumbent cable operator from competitive entry. Stated differently, had the incumbent cable operator known *ex ante* that the municipality would not protect its monopoly status, the cable operator would have paid less than five percent of its gross operating revenues. Hence, it makes no economic sense to require a local telephone company to compensate the city at the monopoly-era rate of five percent of gross operating revenues when the market has at least three competitors. The city should be guaranteed

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94. Telephone companies are already required by the Pole Attachment Act to make its *private* "poles, ducts, conduits, and rights-of-way" available to cable television systems on a nondiscriminatory basis. 47 U.S.C. § 224(f)(1).

95. *See, e.g.*, Jerry A. Hausman, Gregory K. Leonard & J. Gregory Sidak, *Does Bell Company Entry into Long-Distance Telecommunications Benefit Consumers?*, 70 ANTITRUST L.J. 463 (2002).

no more than its forgone revenues (opportunity costs) under the assumption of competitive entry—not its forgone revenues under the assumption of monopoly maintenance. And the city's opportunity cost associated with competitive entry would be significantly less than five percent of gross operating revenues after telephony company entry.[96] After one determines that lower rate, it is then necessary to subtract the rate at which the telephone company already compensates the municipality for the rights-of-way (indirectly through state fees).[97]

C. The Consumer-Welfare Justification for a Uniform National Approach to Video Franchising

From the perspective of an individual customer, the value of subscribing to a network that delivers interactive services such as telephony, broadband, and interactive television increases as the number of subscribers on the network increases. Economists refer to this phenomenon as a network effect.[98] The presence of network effects in the provision of interactive video services requires a wider geographical domain of regulation of local telephone operators, to the extent that any regulation is justified. Simply put, a local regulator would not take these benefits, which spill across municipal boundaries, into consideration when setting fees and other rules. Purely municipal regulation of franchising would result in franchise fees that were ineffectively high from the perspective of maximizing societal benefits.[99]

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96. In reality, the cable operator may be locked into a long-term contract with the city at the monopoly rate of five percent. But upon renegotiation or renewal of its contract, the cable operator would insist on a payment significantly less than five percent.

97. For illustrative purposes only, suppose that a cable operator would pay only a three percent franchise fee under the assumption of telephone company entry. Suppose further that the telephone company currently compensates the city for the rights-of-way (directly or indirectly through state fees) at a rate of two percent of telephone revenues. The appropriate franchise fee for the telephone company would therefore be one percent (equal to the three percent opportunity cost less the two percent existing payment for the rights-of-way), adjusted for any relevant differences in the revenue base on which the percentages are calculated.

98. *See, e.g.*, JEFFREY H. ROHLFS, BANDWAGON EFFECTS IN HIGH TECHNOLOGY INDUSTRIES (MIT Press 2001).

99. Purely municipal regulation of franchising could also result in double marginalization: A municipality issuing a video franchise in Los Angeles will reduce output without taking into account the output reduction effected by anticompetitive municipal franchising in New York. To the extent that a Los Angeles consumer interacts with a

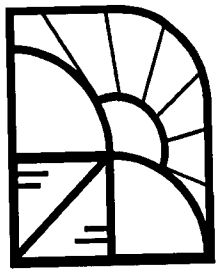
Finally, state and local governments would benefit from increased infrastructure investment by telephone companies. Because every dollar invested in telecommunications infrastructure generates jobs and income through the multiplier effect when a local economy is not at full employment, the planned fiber investment by local telephone companies will generate tens of thousands of new jobs per year and will contribute tens of billions of dollars to the U.S. economy between 2005 and 2010.[100] Removal of franchise restrictions could further contribute to expanded growth. Clearly, anything that delays these benefits from materializing, including the imposition of local franchise fees on telephone companies, should be rejected.

CONCLUSION

For the same reasons that a cable operator is not subject to second and third franchise requirements to distribute cable modem and VoIP telephony services over its existing network, a telephone company should not be subject to a second franchise requirement to distribute video service over its existing network. Telephone companies are already authorized to place facilities in the public rights of way, and additional franchising cannot be justified on economic or policy grounds. A cable franchise requirement would serve as an entry barrier that would undermine the ability of telephone company entrants to compete effectively with cable operators across video, voice, and broadband markets. Payment of franchise fees by telephone companies supplying video services would be duplicative of the payments that those companies have already made to state and local governments. To the extent that a local telephone company is required to pay any franchise fee, the appropriate percentage should be significantly less than the five percent level that was predicated on the continued existence of a local monopoly over video services.

New York consumer over a broadband video platform, the (perceived) monopoly margin will have been extracted twice. Aggregate output will be lower than under a single franchising authority.

100.*See, e.g.*, Robert W. Crandall & Hal J. Singer, The Effect of Ubiquitous Broadband Adoption on Investment, Jobs, and the U.S. Economy, Sept. 17, 2003.



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Competition After Unbundling: Entry, Industry Structure and Convergence

George S. Ford, PhD†
Thomas M. Koutsky, Esq.•
Lawrence J. Spiwak, Esq.‡

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Abstract: In the last few years, U.S. telecoms policy has shifted from encouraging the sharing of existing networks to facilitating the deployment of advanced communications networks. Given the large capital expenditures required for these networks, there can be only a few of such networks. In light of the natural forces that limit the number of facilities-based suppliers, it is vital for policymakers to investigate and implement rules that make markets more conducive to facilities-based entry, and eliminate any existing rules that discourage deployment. The purpose of this POLICY PAPER is to provide a simple conceptual framework that can be used to evaluate the effect of particular rules and regulation on the construction of advanced communications networks and the expansion of existing networks into new markets. We provide numerical examples and a number of applications to illustrate how the conceptual framework can be used to evaluate particular rules and regulations as to their effect on facilities-based entry. Applications include an analysis of convergence, regulated limitations on service offerings, the pernicious effects of cable franchising, and the potential for collusion.

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† Chief Economist, Phoenix Center for Advanced Legal & Economic Public Policy Studies.

• Resident Scholar, Phoenix Center for Advanced Legal & Economic Public Policy Studies.

‡ President, Phoenix Center for Advanced Legal & Economic Public Policy Studies. The views expressed in this paper are the authors' alone and do not represent the views of the Phoenix Center, its Adjunct Fellows, or any of its individual Editorial Advisory Board members.

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I. Introduction and Summary

In the last few years, the goal of U.S. telecoms policy has been to promote and rely upon facilities-based "inter-modal competition" - that is, competition among network platforms. This approach marks an important change from the initial implementation of the Telecommunications Act of 1996, in which policymakers vigorously enforced various network sharing and unbundling obligations that were designed to jump-start competition through "intra-modal" means.

This brave new world of telecoms competition raises very basic and essential questions for policymakers: (1) what will be the market structure of this new "inter-modal" market, in which competition is effectively limited to firms that own their own network facilities; and (2) will we be satisfied with the results? In this POLICY PAPER, we provide policymakers with a framework for analyzing this emerging industry structure. The linchpin of our framework is its focus on *the entry by new firms and the expansion by existing firms into related markets – i.e., for facilities-based "inter-modal" competition to work, entry by new firms should be encouraged and existing network platforms need to be able to expand freely into other markets in which their respective network platforms are capable of serving.*

At the outset, it is important for all to understand that facilities-based competition in local communications markets will be characterized by only a few firms. As consistently demonstrated by academic and Phoenix Center research, and again in this POLICY PAPER, given the huge fixed and sunk costs inherent to the construction and commercial operation of communications networks, the equilibrium level of concentration of terrestrial firms in local communications markets (voice, video, and data) will be relatively high.[1] As we discuss below, fewness arises because scale economies and sunk costs limit the number of firms that can profitably serve a market – and local communications networks are notoriously riddled with scale economies and sunk costs. Any policymaker interested in local communications markets should, therefore, start from the assumption that there will, at best, be only a "few" facilities-based firms. The notion that the local market can sustain five to seven local terrestrial networks all offering highly substitutable services is both naïve and unrealistic.[2] Indeed, a federal policy that relies on facilities-based, intermodal competition in

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1 Jerry B. Duvall and George S. Ford, *Changing Industry Structure: The Economics of Entry and Price Competition*, PHOENIX CENTER POLICY PAPER NO. 10 (April 2001) (http://www.phoenix-center.org/pcpp/PCPP10Final.pdf); T. Randolph Beard, George S. Ford and Lawrence J. Spiwak, *Why ADCo? Why Now? An Economic Exploration into the Future Industry Structure for the "Last Mile" in Local Telecommunications Markets*, PHOENIX CENTER POLICY PAPER NO. 12 (November 2001)(http://www.phoenix-center.org/pcpp/PCPP12.pdf); reprinted in 54 FED. COM. L. J. 421 (May 2002) (http://www.law.indiana.edu/fclj/pubs/v54/no3/spiwak.pdf); *see also* G. R. Faulhaber and C. Hogendorn, *The Market Structure of Broadband Communications*, Unpublished Manuscript, Research Center: Public Policy and Management Department (1999) (available at http://knowledge.wharton.upenn.edu/papers/701.pdf).

2 Unless, of course, these five to seven firms somehow collude to artificially raise prices to allow this structure. *See infra* Section II.A.2.

communications markets is a decision to embrace, or at least tolerate, more concentrated industry structures.

But, policymakers should not let the "perfect" become the enemy of the good: competition, even among a few firms, is vastly superior to (even regulated) monopoly.[3] While it is highly unlikely that dozens of local networks or facilities-based competitors could thrive in the communications markets (*i.e.*, various forms of video, voice, and data services), this lack of headcount does not mean that competition is absent or that consumers do not reap substantial benefits from a more limited number of competitors. Indeed, many telecommunications markets deemed substantially competitive are concentrated. In the wireless industry, the Herfindahl-Hirschman ("HHI") is nearly 3,000 (the numbers equivalent of 3 firms),[4] and in the long-distance market, the three largest firms (AT&T, MCI and Sprint) controlled nearly 70% of that market fifteen years after divestiture.[5] Yet, both markets have been characterized historically by substantial price and quality competition.

Nor do few facilities-based local distribution networks imply few competitors. For example, over one-thousand firms offer long distance services over about six nationwide long-haul networks.[6] A more contemporary example is the existence of many firms, large and small, offering consumers telephone service using VoIP technology (Voice-Over-Internet-Protocol). These "service" providers can provide meaningful benefits to consumers in both price and non-price dimensions, even though these providers did not spend billions to construct networks.

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3 For an interesting and detailed analysis of the prospects and welfare effects of competition in communications markets, *see* F. Gasmi, D. Kennet, J. Laffont, and W. Sharkey, COST PROXY MODELS AND TELECOMMUNICATIONS POLICY (2002), at, primarily, Ch. 5.

4 The HHI is an accepted measure of market concentration. The index is calculated by summing the squared market shares of each firm. For example, a market consisting of three equal sized firms has an HHI of 3,333 (= $33^2 + 33^2 + 33^2$). The numbers equivalent is simply [1/(HHI/1000)], where this ratio measures the number of hypothetical, equally-sized firms in a market (irrespective of the actual distribution of market shares).

5 TRENDS IN TELEPHONE SERVICE, Federal Communications Commission (August 2003) at Tbl. 9.6.

6 *See* PHOENIX CENTER POLICY PAPER NO. 12, *supra* n. 1; TRENDS IN TELEPHONE SERVICE, Federal Communications Commission (June 2005), at Tbl. 9.9.

Similarly, focusing narrowly on terrestrial, local distribution networks can present a misleading picture of rivalry. Alternative technologies, including wireless and satellite platforms, clearly expand service offerings to consumers, and in some cases provide meaningful price competition to more traditional communications services, even if only for subsets of consumers.[7] Wireless carriers are investing billions in 3G technologies (*e.g.*, EVDO) capable of providing advanced services, including some video applications. Even if these inter-modal substitutes (versus inter-modal competitors) do not provide a significant constraint on market power in traditional voice and video markets (though they may), they can have the effect of shrinking the negative effects of market power by reducing the size of traditional markets.[8] Minutes of long-distance telecommunications traffic have fallen by 25% over the past five years, probably due to increased use of wireless telephone services and email.[9] While such substitution may not reduce prices, it clearly reduces the relevance of any residual market power in the long-distance market.[10]

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7 Analysts suggest that roughly 9% of households have "cut the cord," using wireless exclusively for telephone service. *See* David W. Barden, Bank of America Securities Report, 2Q05 TELECOM RESULTS HEAT UP (13 July 2005). This does not imply, however, that wireless and wireline are effective economic substitutes. To be economic substitutes, there has to be some price at which both the buyer will switch back to wireline and the seller would be willing to offer the service. *See, e.g.*, Greg Lalas, *The Year of Living Wirelessly*, CHICAGO TRIBUNE (25 April 2005); *see also Time to Deregulate Wireline Communications in Texas*, Remarks of Barry M. Aarons, Research Fellow, Institute for Policy Innovation, Before the Texas House Committee on Regulated Industries (March 22, 2004) ("[my youngest son] who upon moving to [Butte, Montana] and renting a house decided that having cellular service was enough and having a hard wire residential local service was a waste of money. *** [T]he local phone company, Qwest, was never under consideration....") (http://www.ipi.org/ipi/IPIPublications.nsf/0/219fe5f44f5997f186256e6e00739891?OpenDocument).

8 As markets shrink, the absolute size of welfare loss from market power shrinks with it, and justifying the expense of remedial action becomes more difficult as the market gets smaller.

9 FCC TRENDS IN TELEPHONE SERVICE (June 2005) at Tbl. 10.1.

10 This type of substitution is perhaps best viewed as a rotation about the price axis intercept of, rather than a shift of, the demand curve. If the demand curve rotates as the number of potential customers falls, then the profit-maximizing price may not change. Nevertheless, the profits and welfare losses resulting from market power are reduced. The payphone market is a good example. While many described mobile phones and payphones are competitors, they are better characterized as inter-modal substitutes, since as mobile telephony has grown, payphone prices have rose. In essence, the owner of a mobile phone has left the payphone market.

Alternatively, inter-modal competitors (in contrast to inter-modal substitutes), like intra-modal rivals, strike directly at margins, providing substantial and direct consumer benefits in both price and non-price dimensions.[11] A government study shows, for example, that wireline (intra-modal) competition in the cable television industry provides three-times the price reduction as satellite competitors do (intra-modal competition). Our focus in this paper is on inter-modal competitors of arguably the most significant kind, that is those competitors offering very close substitutes to the traditional services (voice, video, and data) consumed by the vast majority of consumers (or, the typical household).

Given the inevitability of fewness in the number of competitors of this kind, it is vital for policymakers to understand the entry decisions of firms so that the number of competitors can be maximized under the relevant demand- and supply-side constraints of the market.

First and foremost, policymakers must identify and change those policies that make it more difficult for firms to enter or to expand into related markets. Recent advances in technology have substantially expanded the potential for facilities-based entry and inter-modal competition, provided that regulation does not foreclose opportunities for competitive entry, and that regulators do not act in concert with incumbents to raise effective entry barriers. The value of one more entrant in a concentrated market is sizeable, so policymakers should favor entry to the greatest extent possible. To do so, policymakers must understand the entry calculus of firms, and be able to apply the logic of this entry calculus to decipher how particular policies may affect entry. We provide in this POLICY PAPER a simple conceptual framework of entry ideally suited for the evaluation of policies that may influence the entry decisions of firms.

To flush these important points out in further detail, this POLICY PAPER is outlined as follows: Section II first establishes the fact that local telecoms markets will be characterized by only a "few" facilities-based firms. This section

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[11] The difference between inter-modal substitutes and competitors is perhaps best made in the context of antitrust market definition. An inter-modal competitor would be in the "antitrust" market of the traditional service (a close substitute that meaningfully affects market power), where an inter-modal substitute would not. *See* PHOENIX CENTER POLICY BULLETIN NO. 10: *Fixed-Mobile "Intermodal" Competition in Telecommunications: Fact or Fiction?* (30 March 2004)(available at http://www.phoenix-center.org/PolicyBulletin/PCPB10Final.pdf) for an application of this logic to wireless/wireline substitution.

draws on the economic literature on entry to show that given the huge sunk costs required for entry, the equilibrium number of terrestrial firms for the local market will be highly concentrated. Section III goes on to present a simple and intuitive economic model of entry accessible to the layperson, which illustrates the concept of an equilibrium industry structure. In this section, we describe the primary determinants of competitive entry, and present simple numerical examples to facilitate comprehension.

Section IV includes four applications of the logic of our entry model to real-world policy issues.

For example, there has always been great talk about "convergence", but true convergence (*i.e.*, one that actually affects the underlying market structure) is not the ability to "bundle" a variety of products in a single marketing but is, in fact, a technological spillover that reduces entry costs so that existing firms find it profitable to extend their networks into related markets, a decision that would not be profitable without the spillover. As such, "convergence" does not generally mean that busloads of new firms can now enter the market - it means *only those firms with assets in a related market that have been affected by the spillover can afford to enter.*

Similarly, if policymakers artificially restrict or impede access to various ancillary product markets, then firms may not expand into related markets or upgrade their existing networks (*e.g.*, copper to fiber) to facilitate the technological "convergence" discussed *supra*. If network modernization is to occur, then regulatory entry barriers that exist in any market that the network is capable of serving must be eliminated to the greatest extent possible.

The same can also be said about arguments for so-called "regulatory symmetry", such as franchise and build-out requirements on new terrestrial multichannel video programming distributors ("MVPD"), because such requirements, in fact, treat sunk costs incurred by the new entrant and the incumbent in a very *asymmetrical* way. As we show, incumbents can incur more sunk costs than entrants because their profits are higher. In fact, many cable systems were constructed during the era of exclusive franchising, so incumbent firms incurred these costs at a time when it was guaranteed a monopoly over cable services in the area. A firm offered a monopoly would readily propose or agree to a higher entry cost than it otherwise would have agreed to in a competitive environment, particularly if policy requires future entrants to match the sunk entry costs of the incumbent.

Finally, but perhaps most importantly, after all of these hurdles are overcome, the level and degree of entry can tell us much about the potential for collusion. As we show, it is easy to confuse collusion with intense price competition, and this confusion arises primarily from a strict adherence to the traditional view that the intensity of price competition rises with the number of firms.[12] Once the effects of sunk costs are incorporated into the model of competition, however, such a simple notion of competition no longer tells the complete story because the easiest time for firms to collude is *before* they enter one another's markets. As such, *if we observe reciprocal entry, then this is solid evidence that collusion is not occurring.* Indeed, as we continue to witness cable operators moving into the telephone business and the telephone companies moving aggressively into the video business, this simple observation alone is strong evidence that collusion is not present

II. Industry Concentration in Communications Markets

The construction of a local communications network - whether used for voice, video, data or some combination thereof - requires enormous capital expenditures. These expenditures are fixed costs and, consequently, firms in these markets have considerable economies of scale (*i.e.*, average costs fall as output increases).[13] The presence of these significant scale economies results in highly-concentrated market structures, since larger firms operate at a sizeable cost advantage over smaller firms.

This situation is exacerbated by the fact that in local communications markets, a good deal of these fixed costs are also "sunk." A sunk cost is a cost that, once incurred, cannot readily be recovered (it cannot be sold in an aftermarket). Communications plant, once installed, has no other use and, thus, cannot readily be sold in an aftermarket for alternative uses. In addition to scale

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12 This statement may be somewhat confusing. What we are saying is that the effect on price by the entry of additional firm can vary across markets, and the larger the effect the more intense is price competition.

13 Scale economies are a characteristic of the firm, not of a particular technology used by the firm. "Density economies" is a term often used to describe the cost/output relationship for a particular technology or asset used by a firm. The presence of either or both can lead to higher industry concentration.

economies, fixed costs that are sunk raise the risk of entry, since investments that are sunk have virtually no value if the business fails.[14]

The effects of fixed (scale economies) and sunk costs on equilibrium industry structure are well known. In fact, there are few theoretical concepts in economics with more empirical support than the relationship of sunk costs and scale economies to industry structure.[15]

From a theoretical (and empirical) perspective, Sutton (1995) provides an excellent treatment of the relationship of sunk costs to market structure, and this framework is extended slightly in PHOENIX CENTER POLICY PAPER NO. 10.[16] What these theoretical analyses show is that, under certain conditions, the equilibrium number of firms in a market is equal to (the integer part of)[17]

$$N^* = \sqrt{S/E} \qquad (1)$$

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14 In fact, a large portion of the capital expense of constructing communications plant is installation costs, and expended installation labor clearly has no value in an aftermarket.

15 *See, e.g.*, T. F. Bresnahan, P. C. Reiss, R. Willig, and G. J. Stigler, *Do Entry Conditions Vary Across Markets?* 1987 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 833-881 (1987); I. N. Kessides, *Market Concentration, Contestability, and Sunk Costs*, 72 REVIEW OF ECONOMICS AND STATISTICS 614-622 (1990); I. N. Kessides, *Advertising, Sunk Costs, and Barriers to Entry*, 68 REVIEW OF ECONOMICS AND STATISTICS 84-95 (1986); C. J. Morrison Paul, *Cost Economies: A Driving Force for Consolidation and Concentration?*, 70 SOUTHERN ECONOMIC JOURNAL 110-127 (2003); W. J. Mayer and W. F. Chappel, *Determinants of Entry and Exit: An Application of the Compounded Bivariate Poisson Distribution to U.S. Industries, 1972-1977*, 58 SOUTHERN ECONOMIC JOURNAL 770-778 (1992); D. Levy, *Specifying the Dynamics of Industry Concentration*, 34 JOURNAL OF INDUSTRIAL ECONOMICS 55-68 (1985); F. Jenny and A. Weber, *The Determinants of Concentration Trends in the French Manufacturing Sector*, 26 JOURNAL OF INDUSTRIAL ECONOMICS 193-207 (1978); D. F. Greer, *The Causes of Concentration in the US Brewing Industry*, 21 QUARTERLY REVIEW OF ECONOMICS AND BUSINESS 87-107 (1981); P. A. Geroski, R. T. Masson, and J. Shaanan, *The Dynamics of Market Structure*, 5 INTERNATIONAL JOURNAL OF INDUSTRIAL ORGANIZATION 93-101 (1987); E. W. Eckard Jr, *Plant-level Scale Economies and Industrial Concentration*, 34 QUARTERLY REVIEW OF ECONOMICS AND FINANCE 173-182 (1994); and M. Bhattacharya, "Industrial Concentration and Competition in Malaysian Manufacturing," 34 APPLIED ECONOMICS 2127 (2002).

16 *Supra* n. 1.

17 The assumptions of the model include Cournot competition in quantities, an isoelastic demand curve (that is, the demand elasticity is constant and equal to -1), constant costs, and symmetric firms. The game is a two-stage game and the equilibrium is a Nash Equilibrium. *See* John Sutton, SUNK COSTS AND MARKET STRUCTURE (1991) at Ch. 2.

where N^* is the equilibrium number of firms, S is the market size measured as the lifetime expenditures of consumers, and E are the sunk entry costs.[18] The equilibrium number of firms in a market is obtained when no firm has either the incentive to enter or to exit the market. Equation (1) indicates that if market size is $10 billion (measured as the present value of the flow of gross profits over the life of the investment), and entry costs are $2 billion, then the equilibrium number of firms is $N^* = 2$.[19] If entry costs rise to $3 billion, however, then the equilibrium is monopoly, or $N^* = 1$.[20] Equation (1) reveals that the equilibrium number of firms rises as the market gets larger (S gets bigger, other things constant), but falls as sunk costs rise (E gets bigger, other things constant).[21]

Perhaps the most important point for modern communications policy obtained from Equation (1) is that the *sustainable* number of firms in a market *depends on the economic characteristics of the market*, and not the desired, arbitrarily selected number of firms by some group of policymakers, trade group presidents, legislators, or other types of social reformers (no matter how well intentioned). While public policy cannot *choose* the long-run sustainable number of firms in a market, policymakers can take steps to affect the economic character of markets, and, consequently, influence the equilibrium number of firms. One clear example is investment tax credits, which directly lower sunk costs of entry by lowering taxes on such investment.[22] In addition, since the sustainable

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18 The ratios of "Revenues" to "Property Plant and Equipment" across the communications industries is interesting, with a lower ratio roughly indicating a higher expected level of concentration: (1) local exchange 0.92 (Bellsouth); (2) cable television 1.08 (Comcast); (3) mobile telephony 1.35 (Nextel); (4) long distance networks 2.65 (AT&T); (5) UNE-P providers 7.16 (Talk-America); and (6) VOIP retailers 64.8 (GlobeTel). The number of firms in each "market" is inversely correlated with these ratios. Of course, a more sophisticated analysis of capital stock to entry is required for a more compelling relationship of fixed/sunk costs to industry structure. *See supra* n. 15 for a list of studies on this topic.

19 The calculation is $\text{INT}(10/2)^{-2} = \text{INT}(2.24) = 2$.

20 The calculation is $\text{INT}(10/3)^{-2} = \text{INT}(1.83) = 1$.

21 While Equation (1) does not explicitly point to scale economies, the presence of scale economies is implicit. The limit on the number of firms is based on the inability of additional firms to achieve sufficient scale to serve the market profitably. For an extension of Equation (1) to a case of generalized conjectural variations, *see* PHOENIX CENTER POLICY PAPER NO. 10, *supra* n. 1.

22 *See, e.g.*, A. Gentzoglanis, *Sunk Costs, Innovation, and Spillover Effects in R&D-Intensive Industries*, 10 JOURNAL OF APPLIED BUSINESS RESEARCH 1-12 (1994).

number of firms in a market is a function of the size of that market, public policy can help expand that market, say by removing international trade barriers.[23]

It is important to recognize that a number of U.S. industries - including several that nearly all would regard as competitive - are relatively concentrated. The household appliance market, like refrigerators and freezers, has an HHI index of over 2700. The construction of large jetliners presently has only two competitors - Boeing and Airbus. Semiconductor equipment, breakfast cereal, chewing gum, soup, and disposable batteries also have only a few market participants. Indeed, while it is common to associate high concentration with poor market performance, the empirical evidence does not consistently support this common view.[24] High industry concentration does not *a fortiori* mean that the interests of consumers are poorly served. Competition in concentrated markets has been shown to provide good performance in many industries.[25]

While law and public policy can make markets more conducive to entry, they can also result in *even fewer* firms. For example, cable franchise contracts result in more concentrated markets for video programming distribution by raising entry

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23 The ability of international trade to expand markets and thereby reduce industry concentration is shown empirically in W. F. Chappell and B. Yandle, *An Entry Model of Import Penetration*, 19 ATLANTIC ECONOMIC JOURNAL 22-28 (1991).

24 *See, e.g.*, M. Salinger, R. E. Caves, and S. Peltzman, *The Concentration-Margins Relationship Reconsidered; Comments and Discussion*, 1990 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 287-335 (1990); G. Whalen, *The Determinants and Performance Effects of Rivalry in Local Banking Markets*, 31 QUARTERLY JOURNAL OF BUSINESS AND ECONOMICS 38-52 (1992) ("concentration affected neither rivalry nor profitability in the expected manner (at 38)"); M. B. Slovin, M. E. Sushka, and C. D. Hudson, *Deregulation, Contestability, and Airline Acquisitions*, 30 JOURNAL OF FINANCIAL ECONOMICS 231-252 (1991) ("changes in concentration after deregulation have no positive effect on carrier returns (at 231)"); J. R. Schroeter, *Estimating the Degree of Market Power in the Beef Packing Industry*, 70 REVIEW OF ECONOMICS AND STATISTICS 158-162 (1988) ("there has been no real worsening of the market's performance during the period of increasing concentration (at 158)"); S. A. Rhoades, *Market Share as a Source of Market Power: Implications and Some Evidence*, 37 JOURNAL OF ECONOMICS AND BUSINESS 343-364 (1985) ("market share *per se* is a source of high profits, regardless of the level of concentration and after controlling for firm size (at 343)"); R. L. Beck and S. Mozejko, *Concentration and Price/Cost Margins Across Time in Canada*, 9 REVUE CANADIENNE DES SCIENCES DE L'ADMINISTRATION 40-47 (1992) ("when a shift occurs from a single-point-in-time to a sequential-points-in-time approach, there is no longer a consistent relationship between changes in concentration and changes in profit margins (at 40)").

25 *Id.*

costs.[26] According to the Federal Communications Commission: *"The local franchise process is, perhaps, the most important policy-relevant barrier to competitive entry in local cable markets."*[27] It should come as no surprise that the only relatively-successful MVPD entrant to date is Direct Broadcast Satellite ("DBS"), which does not need a local franchise to operate. Until 1996, public policy in many states made entry into the local telephone business illegal, which certainly constituted a significant barrier to entry.[28]

Sometimes policymakers take more explicit steps directed at affecting market structure. Take for example the wireless PCS auctions: in the early 1990s, the FCC auctioned off hundreds of geographically-divided licenses for PCS spectrum, based upon an assumption that making five licenses available over multiple geographies would result in a more-competitive outcome than alternatives proposed. The FCC could not have known then whether or not five licensees in various overlapping geographies would be "too many" or "too few." It now appears that the FCC acted conservatively and issued far too many licenses for the ultimate wireless industry structure, which seems to be trending toward four or so more or less national networks (Sprint-Nextel, Verizon Wireless, Cingular, and T-Mobile) with additional regional, fringe competitors (like U.S. Cellular and ALLTEL) in certain areas. Today, we should not be surprised to see wireless industry mergers occur when the government has

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26 Another example of a policy that increased concentration is legal restrictions on advertising by cigarette companies. These restrictions limited the ability of entrants to inform consumers about their products. *See, e.g.*, E. W. Eckard Jr, *Competition and the Cigarette TV Advertising Ban*, 29 ECONOMIC INQUIRY 119-133 (1991). Advertising has two countervailing effects on industry structure. First, it raises the sunk costs of entry, thereby raising concentration. But, advertising is required for entry, since consumers must be informed about new products. *See* Kessides (1986), *supra* n. 15, for an empirical test of these two countervailing effects of sunk advertising expenditures.

27 *In re Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992, Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming*, 9 FCC Rcd 7442, Appendix H at ¶ 375 (1994) (hereinafter "Appendix H") (emphasis supplied); *see also* Richard Posner, *The Appropriate Scope of Regulation in the Cable Television Industry*, 3 BELL JOURNAL OF ECONOMICS 98-129 (1972).

28 Such laws were pre-empted by Section 253 of the Telecommunications Act of 1996, 47 U.S.C. § 253; *In the Matter of The Public Utility Commission of Texas*, CC Policy Docket Nos, 96-13, 96-14, 96-16 and 96-19, *Memorandum Opinion and Order*, FCC No. 97-346 (rel. Oct. 1, 1997).

initially (and artificially) divided up crucial raw materials among more firms than the industry appears to be able to profitably sustain.[29]

As we discuss more fully below, in light of the fact that communications markets will be - by their very nature - concentrated, policymakers should do what they can to make *all* communications markets more conducive to facilities-based entry. Indeed, as technology is transforming traditional "single use" networks (*i.e.*, telephone or cable networks) into "multi-use" networks (*i.e.*, advanced broadband networks that can provide telephone, video and data), competition between a "few firms" and the elimination of monopoly in the communications and video industries is now possible - but only if new and existing firms are not artificially hamstrung by regulations that limit their ability to utilize their networks to compete over *all* particular parts of a "bundle" of voice, video and data services. As a result, instead of focusing on "how many firms" are present in a market, policymakers should appropriately focus on "what policies will facilitate entry" by firms.

III. An Entry-Oriented Model of Industry Structure for Policy Analysis

Since domestic policymakers have chosen to rely on facilities-based entry in communications markets, policymakers focused on consumer welfare need to think in an analytical way about how this competition will develop. The most important aspect of network platform facilities-based competition for consumers is and will be the nature, quality, quantity, and diversity of communications services available over those competing network platforms. And, since we are in an environment in which traditional "single-use" networks are being transformed into advanced, "multiple-use" platforms competition, this transformation - to a large extent - will hinge on how those network platforms will *enter* one another's markets and how public policy will affect the mobility of existing networks into new lines of business.

In this section, we present a simple and intuitive framework for analyzing the factors that influence entry. We then utilize specific examples in order to show

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[29] A similar wave of consolidation occurred in the radio industry after Congress significantly altered FCC rules that artificially limited the number of radio stations one firm could own. *See, e.g.*, Robert B. Ekelund, George S. Ford and Thomas Koutsky, *Market Power in Radio Markets: An Empirical Analysis of Local and National Concentration*, 43 JOURNAL OF LAW AND ECONOMICS 157-184 (2000) (empirically demonstrating that the FCC's own rules created maximum fragmentation in the industry by nearly forbidding multi-station owners).

in more detail how policies affect the equilibrium number of firms and the behavior of those firms. The numerical examples provided are not intended to reflect precisely any particular industry and are not drawn from empirical analysis, but are presented merely to illustrate the concepts embodied in the conceptual framework.

At the core of the economic framework is the obvious notion that firms will enter a market only if it is profitable to do so, and firms will exit a market if they find it unprofitable. As a result, any model of entry must focus upon the profit function of the firm. Our framework is based on this very simple logic, and is consistent with earlier work on entry such as Salop (1979), Van Wittelustuhn (1993), Sutton (1995), Hazlett and Ford (2001), PHOENIX CENTER POLICY PAPER NO. 10 (2001), and a plethora of other academic and policy papers.[30]

Our discussion can be made more concise by the introduction of some simple notation. Let d be the flow of gross profits over the life of some venture, and e be the sunk setup costs (*e.g.*, "entry costs") to enter the market. We use the variable "d" to indicate profits since many entry models evaluate entry in the context of duopolistic competition (hence "d"). The flow of profits should be thought of as the sum of the difference between revenues and variable costs (in present value form). Entry costs, in this simple framework, are all upfront costs incurred immediately upon entry. These entry costs are fixed and sunk. The profitability of entry is determined by the difference between gross profits (d) and entry costs (e). Since firms only enter if profits are positive (or non-negative), we have entry when $d - e \geq 0$. If $d - e < 0$, then the firm stays out of the market (*i.e.*, does not enter). Thus, firms will enter as long as it is profitable to do so, and when entry stops, the existing number of firms will be the equilibrium number of firms (N^*). All firms, from lemonade stands to fiber network operators, go through this calculus in deciding whether to enter any new market.

The simple entry model, applied in a generic setting, is illustrated in Table 1. In the first column, there is a count of the number of firms in the market (N). In

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30 *See* S. Salop, *Strategic Entry Deterrence*, 69 AMERICAN ECONOMIC REVIEW 335-338 (1979); A. Van Witteloostuijn, *Multimarket Competition and Business Strategy*, 8 REVIEW OF INDUSTRIAL ORGANIZATION 83-100 (1993); Sutton, *supra* n. 17; Thomas W. Hazlett & George S. Ford, *The Fallacy of Regulatory Symmetry: An Economic Analysis of the 'Level Playing Field' in Cable TV Franchising Statutes*, 3 BUSINESS AND POLITICS 21 (2001) (available at: http://www.manhattan-institute.org/hazlett/the_fallacy_of_regulatory_symm.pdf); PHOENIX CENTER POLICY PAPER NO. 10, *supra* n. 1.

the second and third columns, profit (d) and entry costs (e) are listed. Profits are assumed to fall with the number of firms, a point we discuss in detail in the next section.[31] Entry costs are constant at $15.[32] Working through the table, it should be clear that the equilibrium number of firms in this example is 3. Firm 1 makes a large profit of $85. Upon the entry of firm 2, profits fall to $40 per firm, but this profit is more than sufficient to cover the entry costs $15. Likewise, the per-firm profits of $20 at 3 firms is larger than entry costs, so three firms enter. But, when the fourth firm enters, profits fall below entry costs ($12 < $15), so the fourth firm stays out. Thus, we have an equilibrium of 3 firms - no existing firm has an incentive to exit, and no new firm has the incentive to enter. Note that all firms earn positive economic profits in equilibrium ($5), but there is no threat of entry.[33]

Table 1. The Equilibrium Number of Firms

N	d	E	$d - e$
1	100	15	85
2	40	15	25
3	**20**	**15**	**5**
4	12	15	-3
5	8	15	-7
6	5	15	-10
7	4	15	-11

This simple condition on entry (*i.e.*, $d - e$ positive or negative), illustrated numerically in Table 1, is the core of our economic framework, and all economic models of entry. While we can and do delve into the finer properties of d and e,

31 Profits are for illustrative purposes only and do not represent expected or actual price declines in any particular market.

32 Note that industry profits at two firms are $80, versus $100 at monopoly. In the absence of perfect collusion, industry profits will decline as the number of firms rises. Even if collusion occurs and industry profits remain at $100, then per-firm profits will decline (*i.e.*, $100/$N$).

33 As entry costs fall to zero, then the economic profits of existing firms falls to zero. Thus, entry costs represent a barrier to entry in the traditional sense of allowing positive price-cost margins. *See, e.g.*, J. Bain, BARRIERS TO NEW COMPETITION (1956). What we have learned from this analysis (summarized clearly in Table 1) is how incumbent firms can sometimes be perceived as having an exaggerated perception of the degree of competition in a market. In markets with large capital expenditures, the addition of one additional firm may change the incumbent's situation from one of persistent profits to persistent losses. Thus, one's perception of the effects of a one more firm depends on the effects of one more firm. With few firms and sunk costs, the effect of one more firm is nearly always sizeable.

these two variables encapsulate the most important components of the entry decision and the nature of the equilibrium structure. Put simply, a prospective entrant asks "what's it worth for me to enter?" and "what does it cost me to enter?" If the benefits exceed the costs, then entry occurs. This thought process lies at the core of nearly all of economic science. For policymakers, the answer is simple and intuitive - *if you want there to be more entry, figure out how to make entry more profitable.* In particular, investigate and implement rules that increase gross profits (d), reduce entry costs (e), or, better yet, both (without harming consumers, of course).

A. *Factors Determining Profits*

As just described, it is the relationship between expected profits (d) and entry costs (e) that drives the entry decisions. Per-firm profits will fall as the number of firms increases, even with perfect collusion (as the monopoly profit is divided among a larger numbers of firms). Aside from the number of firms, we view profits as being driven by four factors: (1) the size of the market; (2) the intensity of price competition; (3) the extent of product differentiation; and (4) the degree to which two rival networks overlap in their markets served.

Table 2. Factors Determining Profits

Factor	Relationship to d	Effect on N^*
Larger Market Size	+	More firms
More Intense Price Competition	-	Fewer firms
More Product Differentiation	+	More firms
More Overlap of Rival Networks	-	Fewer firms

The effects of each factor are summarized in Table 2, and the factors are described in more detail in the following sections.

1. *Market Size and Entry*

All other things constant, an increase in market size will increase profits and, therefore, the number of firms that can profitably serve that market.[34] The easiest

[34] This point is obvious. For any given price-cost margin (m), profits are $m \cdot q$, where q is firm output. As q rises, m constant, profits rise. Empirical evidence on relationship of industry

(Footnote Continued. . . .)

way to think about how markets can increase in size is in international trade -- the removal of a tariff on a product increases the number of profitable sales for that product and invariably increases the size of the market and profits.[35] As we discuss later, market size is not necessarily the size of consumers' expenditures on a single product or service - it can also involve the potential for sales of additional or new services over the same infrastructure. A law that prohibits stores of a certain size from selling groceries (as anti-WalMart advocates often suggest) limits the size of the market that WalMart can address and therefore limits profits and makes WalMart entry less likely (the intended effect, of course). Like large stores, communications networks can often provide and sell multiple services, so market size can be approximated as total expenditures on the full array of services available over the network. Precluding the sale of particular services that a network is capable of providing obviously reduces market size and, therefore, reduces entry.

Table 3. Market Size and N^*

		Example 1: $N^* = 3$		Example 2: $N^* = 4$	
n	e	d	$d - e$	e	$d - e$
1	15	100	85	150	135
2	15	40	25	60	45
3	15	**20**	**5**	30	15
4	15	12	-3	**18**	**3**
5	15	8	-7	12	-3
6	15	5	-10	8	-7
7	15	4	-11	6	-9

We can extend our simple numerical example in Table 1 to illustrate the effect of market size. Our discussion indicates that larger markets increase profits and, consequently, may increase the number of firms in equilibrium. Example 1 in Table 2 is simply a replication of our initial example with an equilibrium number of firms $N^* = 3$. In Example 2, however, we increase the size of the market by 50% - for instance, an import tariff abroad has been

concentration to market size is provided by S. Kellner and G. F. Mathewson, *Entry, Size Distribution, Scale, and Scope Economies in the Life Insurance Industry*, 56 JOURNAL OF BUSINESS 25-45 (1983); M. B. Coate, *The Dynamics of Price-Cost Margins in Concentrated Industries*, 21 APPLIED ECONOMICS 261-273 (1989); Bhattacharya (2002), *supra* n. 15; and W. F. Chappell and B. Yandle, *supra* n. 23.

35 Chappell and Yandle, *id.*

eliminated.[36] Now, monopoly profits are $150, up $50 from Example 1. With entry costs constant (at $15), this larger market is capable of sustaining four firms ($N^* = 4$), since each firm is profitable at four firms ($d - e = \$3$), but none is profitable at five firms ($d - e = -\$3$). Clearly, larger markets, per dollar of sunk costs, result in a larger number of equilibrium firms.[37]

2. *The Intensity of Price Competition*

Profits are also affected by the intensity of price competition. If firms compete aggressively, then profits will fall sharply when new firms enter. Weak price competition, alternatively, allows profits to fall more slowly as additional firms enter. The relationship of price/profit reductions and additional firms has important implications for industry structure.

The model of small numbers competition that is the basis of most views on the issue is Cournot competition in quantities.[38] With this form of competition, market price falls and quantity rises to the perfectly competitive levels as the number of firms increases. In its most basic form, for example, the market quantity is $[N/(N + 1)\cdot Q_C]$, where N is the number of firms and Q_C is the quantity sold with perfect competition. Obviously, as N increases, the Cournot quantity gets closer to the perfectly competitive quantity.[39] Only with perfect collusion (which is practically unobtainable) would gross profits remain at the monopoly

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36 Profits are for illustrative purposes only and do not represent expected or actual price declines in any particular market. The larger market is assumed to be 50% larger than the initial case.

37 Of course, the increase in market size must be large enough to alter the entry decision of the marginal firm.

38 This relationship is certainly true of Cournot competition in quantities, which typically results in a smooth movement from monopoly to perfectly competitive prices as the number of rivals increases. In the Cournot model, rival firms choose the quantity they wish to offer for sale. Each firm maximizes profit on the assumption that the quantity produced by its rivals is not affected by its own output decisions. With Bertrand competition in prices and homogenous products, the duopoly price is equal to the perfectly competitive price. With heterogenous products, the Bertrand equilibrium price falls toward the perfectly competitive as the number of firms enters. Kreps and Scheinkman (1983) show that when firms must first choose capacity plant size, the equilibrium of Bertrand competition in prices is identical to that of the simple Cournot model. D. Kreps & J. Scheinkman, *Quantity Precommitment and Bertrand Competition Yield Cournot Outcomes*, 14 BELL JOURNAL OF ECONOMICS. 326-337 (1983).

39 A monopolist sells one-half the competitive output [1/(1+1) = 0.5]. At five firms, the industry output is 83% (= 5/6) of the perfectly competitive output.

level as the number of firms increase. At the other extreme, we may have very intense price competition (*i.e.*, Bertrand competition in prices) so the perfectly competitive price is obtained with only two firms. In this case, the addition of firms after the second will have no effect on prices or profits.

These widely disparate competitive interactions are not simply theoretical. Empirical and experimental research has shown that there is substantial variation in the relationship between the number of firms (or industry concentration) and prices/profits across industries or over time.

Experimental research is particularly interesting on this point. Fouraker and Siegal (1963) evaluated the competitive behavior of 16 pairs of "student duopolists."[40] In 7 of 16 games, the Cournot equilibrium was observed. Other outcomes included 5 Bertrand (perfect competition) outcomes, 3 collusive outcomes, and 1 outcome between collusion and Cournot. The average outcome was Cournot, but there were significant departures from Cournot behavior. These experiments illustrate the variety of outcomes possible with small number competition. Interestingly, *when the experiment was extended to three players, the Bertrand outcome was the most common.* Holt (1985) and Plott (1982) also find support for the Cournot outcome in experiments.[41]

There are many empirical studies showing a positive relationship between concentration and prices/profits; but, there also exists a large literature showing no link between the two. Econometric research finds support for the Cournot outcome, as well as more and less competitive outcomes. Iwata (1974) could not reject Cournot outcome in the Japanese glass industry, and Brander and Zhang (1990, 1993) find evidence of Cournot outcomes in the U.S. airline industry.[42] Haskel and Martin (1994) find support for Cournot over Bertrand behavior when

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40 L. Fouraker and S. Siegel, BARGAINING BEHAVIOR (1963).

41 C. A. Holt Jr., *An Experimental Test of the Consistent-Conjectures Hypothesis*, 75 AMERICAN ECONOMIC REVIEW 314-25 (1985); C. R. Plott, *Industrial Organization Theory and Experimental Economics*, 20 JOURNAL OF ECONOMIC LITERATURE 1485-1527 (1982).

42 G. Iwata, *Measurement of Conjectural Variations in Oligopoly*, 42 ECONOMETRICA 947-966 (1974); J. A. Brander and A. Zhang, *Market Conduct in the Airline Industry: An Empirical Investigation*, 21 RAND JOURNAL OF ECONOMICS 567-583 (1990); J. A. Brander and A. Zhang, *Dynamic Oligopoly Behavior in the Airline Industry*, 11 INTERNATIONAL JOURNAL OF INDUSTRIAL ORGANIZATION 407-435 (1993).

firms face capacity constraints.[43] But, Berg and Kim (1994) reject Cournot behavior in the Norwegian banking industry, and Ford (2000) presents evidence that the international message telephone industry is more competitive than Cournot.[44] Karp and Perloff (1989) show that the oligopolistic rice market is closer to the competitive than the collusive outcome. Without question, the empirical economics literature supports neither a simple nor consistent relationship between industry concentration and prices or profits.[45] Competition among small numbers of firms can produce a variety of outcomes and assuming blindly high concentration is bad for consumers is inappropriate.

We know that the intensity of price competition can vary across industries, and the intensity of price competition can produce a somewhat paradoxical result. That is, industries with intense price competition are often highly concentrated (such as soft drinks, batteries, and soup).[46]

This is a less-than obvious point, so an illustration (Table 3) will be helpful. In all our examples thus far, adding firms reduces gross profits. However, let us assume that the market we are considering is one in which the firms necessarily must compete on price.[47] The presence of price competition allows for variations in the reduction in profits per added firm. We present three examples. In all three, entry costs are $15 and market size is constant, and the maximum gross (*e.g.*, monopoly) profit is $100.

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43 J. Haskel and C. Martin, *Capacity and Competition: Empirical Evidence on UK Panel Data*, 42 JOURNAL OF INDUSTRIAL ECONOMICS 23-44 (1994).

44 S. A. Berg and M. Kim, *Oligopolistic Interdependence and the Structure of Production in Banking: An Empirical Evaluation*, 26 JOURNAL OF MONEY, CREDIT AND BANKING 309-322 (1994); G. S. Ford, *Flow-Through and Competition in the International Message Telephone Service Market*, PHOENIX CENTER POLICY PAPER NO. 7 (September 2000).

45 *Supra* n. 24.

46 For empirical evidence on the relationship of industry structure to the intensity of price competition, *see* S. T. Berry, *Estimation of a Model of Entry in the Airline Industry*, 60 ECONOMETRICA 889-918 (1992).

47 There is anecdotal evidence that the "residential broadband" market may be such a market. Market observers have recently noted that where robust broadband competition is present, like Japan and some locations in Europe, price for local bandwidth drops sharply. There is anecdotal evidence that the "residential broadband" market may be such a market in which price competition plays an important role. One market observer has noted that there is a "huge increase in demand when [monthly] prices go to $15-$20 (Italy, France, Japan, adjust for included phone calls)." Dave Burstein, *Huffing and Puffing*, DSL PRIME (June 8, 2005).

Table 3. Price Competition and N^*

		Example 1: Less Intense Competition ($N^* = 3$)		Example 2: Intense Competition ($N^* = 2$)		Example 3: Perfect Collusion ($N^* = 6$)	
n	e	d	$d - e$	d	$d - e$	d	$d - e$
1	15	100	85	100	85	100	85
2	15	40	25	**28**	**13**	50	35
3	15	**20**	**5**	12	-3	33	18
4	15	12	-3	6	-9	25	10
5	15	8	-7	4	-11	20	5
6	15	5	-10	3	-12	**17**	**2**
7	15	4	-11	2	-13	14	-1

Example 1 is described as "Less Intense Competition," since gross industry profits do not fall with the increasing number of firms as rapidly as they do in Example 2, "Intense Competition."[48] Example 1 is the same as the initial example (Table 1), and the equilibrium number of firms is $N^* = 3$. In Example 2 where competition is more intense (and profits are therefore lower), the equilibrium number of firms falls to $N^* = 2$, since a third entrant has an expected net profit of -$3. *If firms compete aggressively on price, therefore, then the number of firms in equilibrium will be smaller than if firms are more accommodating to their rivals.* Note that we have not assumed any collusion between the firms in any of these models - the fact that N^* is lower where intense price competition is present is a *symptom* of intense competition and not necessarily a harbinger or evidence of collusion.[49]

In Example 3 in Table 3, we demonstrate how "Perfect Collusion" impacts N^*. In this example, industry profits remain at the monopoly level ($100) regardless of the number of firms, with each firm taking an equal share of the

48 Note that industry profits at two firms are $80, versus $100 at monopoly. In the absence of perfect collusion, industry profits will decline as the number of firms rises. Even if collusion occurs and industry profits remain at $100, then per-firm profits will decline (*i.e.*, $100/$N$).

49 It is often difficult to distinguish between cooperative and non-cooperative behavior. For example, price leadership is often viewed as cooperative behavior, but if there is some legitimate reason for prices to rise (a cost shock, for example), it is likely that one firm will be the first to do so and then the others will follow. The behavior in this latter case is consistent with non-cooperative behavior, thought it may be difficult in practice to distinguish it from cooperative price leadership. Phlips (1995) provides an excellent and policy-oriented overview of this issue. *See* L. Phlips, COMPETITION POLICY: A GAME-THEORETIC PERSPECTIVE (1995).

profits. Given this perfect collusion, the equilibrium number of firms interestingly rises to $N^* = 6$.

The examples in Table 3 present an interesting paradox and a challenge for policymakers. Normally, we think of price competition as becoming more intense as the number of firms rises. Yet Table 3 shows that this is not necessarily the case. As a result, policymakers must separate their assumptions about the effects on prices (or profits) from the number of firms in a market and the way in which firms interact.

An even more important lesson from the examples in Table 3 is that *a highly concentrated equilibrium may be the result of intense price competition rather than an indication of a lack thereof.* Consider, for example, how we would view the competitiveness of the three markets in Table 3 if we adhered to the traditional view that price competition increases as the number of firms rises (the Cournot assumption). In the traditional view, we would conclude that the collusive outcome (Example 3, $N^* = 6$) is the most competitive, and that the most competitive outcome (Example 2, $N^* = 2$) is the least competitive. The confusion arises due to the presence of fixed and sunk costs.[50] Thus, the risk of such confusion is considerable in communications markets where sunk costs are significant.

The examples in Table 3 also show a potential danger for policymakers. If a policymaker has as a *sole* goal to increase the number of firms in a market, then that policymaker would be advised to adopt policies that *facilitate* collusion. For some real-world examples, consider the Common Agricultural Policy of the European Union and the Northeast Dairy Compact in New England, both of which impose price and production controls with the purpose of maximizing the number of farmers and dairies in the market. The OPEC oil cartel, by raising the price of oil, a commodity for which price competition is strong, has the effect of increasing the number of countries that can profitably produce and export oil. Consumers are not better off simply because there are "more farmers", "more dairies" or "more oil-producing nations" - indeed, they pay higher prices as a result.

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50 If fixed and sunk costs are small, the number of firms is likely to be very large (absent Bertrand competition in prices), so that "collusion confusion" is likely to be minimal.

Put simply, a "few" number of firms in a market does not necessarily mean that those "few" firms will not compete aggressively - indeed, there may be "few" firms simply *because* of the presence of aggressive competition. Thus, a review of competition in concentrated industry structures will likely require a more sophisticated and subtle analysis.

3. *Degree of Product Differentiation*

Profits are also affected by the ability of firms to differentiate their product from their competitors', called product differentiation. The more alike are products, the more a consumer's purchase decision will be based purely on price. As a result, competition among firms selling homogeneous (*i.e.*, identical) products likely will focus on price competition. Commodities like milk or oil, for example, are relatively homogeneous, and thus price is the sole determinant of consumer choice. However, if a firm can alter or tweak its product in a useful way (*e.g.*, organic milk, fuel additives), then it might be able to charge more, and the degree of this differentiation can affects profits. Any stroll down the breakfast cereal aisle of a grocery store is a vivid reminder of the power of product differentiation - two firms, General Mills and Kellogg, dominate this market yet dozens of different product offerings are sold at various prices.

As products become differentiated, price competition weakens. In many cases, sellers may very well be selling identical products (Whirlpool and Kenmore refrigerators are the same, as are Prell and Pantene shampoos), but will differentiate themselves by offering varying levels of customer service, return policies, product information or demonstration, colors, and so forth.[51] Location and convenience can be powerful differentiators, even if selling something as homogenous as a gallon of milk.

The effect of differentiation on prices can be significant. At the extreme, two products can become so different that they no longer are substitutes for one another - while both made by General Motors, a Hummer is not really a viable substitute product for a Chevette. Accordingly, we should expect firms to

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51 Such services will only be offered if higher prices or high volumes sufficiently raise profits to cover the additional costs.

attempt to differentiate their products as much as possible in order to soften price competition.[52]

As to whether consumers are better off as a result of product differentiation, the answer is "it depends."[53] Consumers usually value variety, so while differentiation results in higher prices, the value of increased variety may offset the reduction in consumer welfare from higher prices.[54] So, there is a trade-off for consumers between variety and price. Differentiation is not always beneficial to consumers, and some firms may excessively differentiate in an effort to more aggressively soften price competition. One type of differentiation that would harm consumers is differentiation through sabotage, where one firm reduces the quality of a rival's product instead of improving its own quality.[55] Product differentiation may also create entry barriers by forcing entry to incur increased sunk advertising costs to win customers.

A recent study by the General Accounting Office ("GAO") on competition between cable television and DBS firms illustrates the importance of product differentiation.[56] While both terrestrial and satellite multichannel video providers offer similar products, there are some meaningful forms of differentiation between the two. The differences in the delivery technology itself (*i.e.*, inter-modality) are not lost on consumers. Intuitively, we would expect that product differentiation between terrestrial rivals would be less than between terrestrial and DBS providers. The GAO study indicates that this is true. Econometric evidence presented in the study shows that satellite video providers reduce cable prices by about 5%, whereas the presence of a wireline, terrestrial

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52 In economic theory, this is known as the principle of *maximum differentiation*. S. Martin ADVANCED INDUSTRIAL ECONOMICS (2001), ch. 4.

53 In some cases, differentiation improves consumer welfare while in others it may not. There is an optimal amount of differentiation. Most Industrial Economics textbook cover this point. *See, e.g.*, D. E. Waldman and E. J. Jensen, INDUSTRIAL ORGANIZATION: THEORY AND PRACTICE (1998), at 308.

54 Appendix H, *supra* n. 27 at ¶ 373.

55 Product differentiation can alter the absolute quality as well as the relative quality among firms and. Beneficial differentiation raises absolute quality (and may affect relative quality), whereas differentiation for sabotage only alters relative quality.

56 *Direct Broadcast Satellite Subscribership Has Grown Rapidly, but Varies across Different Types of Markets, Report to the Subcommittee on Antitrust, Competition Policy and Consumer Rights*, Committee on the Judiciary, U.S. Senate, US Government Accountability Office, GAO-05-257 (2005).

video rival reduces price by about 16%.[57] The competitive effect of the "closer" rival is three times that of the satellite delivered video.

Other statistics in the study provider further support for the powerful impact of differentiation among multichannel video providers. For example, subscription to satellite services falls considerably (37%) when a terrestrial competitor exists.[58] Even inter-market variations in the quality of the DBS service are shown to affect cable prices. The GAO study also concludes that consumers are more likely to subscribe to DBS service when the DBS provider is able to offer local broadcast stations.[59] Limits on the ability of DBS providers to offer local broadcast channels is a classic example of public policy failing to make markets more conducive to competitive entry.

4. *Geographic Overlap*

Finally, profits are certainly related to the extent the "geographic" markets of rivals overlap. The question of geographic availability is particularly important for local communications networks, because the whole purpose of these networks is to provide communications services to where customers live or work. It does no good for a residential customer to be told that a new network's service is available across the street or down the block. As a result, the degree of overlap between competing networks has a significant impact on the degree of competition that may or may not exist between those networks.

The market boundary of communications networks is frequently referred to as "homes passed." We have observed that price competition and profits are related to geographic overlap of rivals. Beard *et al.* (2005) show that if the same price is charged across the entire market (*i.e.*, price discrimination is prohibited), then the equilibrium price in cable television markets declines as the service

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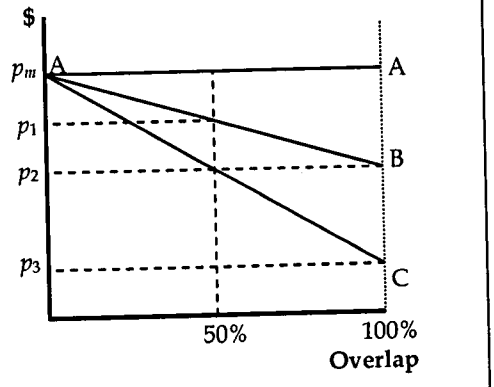
57 These price differences can be computed from the reported econometric results. For the DBS price change, a 100% reduction from the mean (22%) DBS penetration is equivalent to eliminating the DBS providers from the market. The coefficient is -0.0476, which is roughly equal to 5% (the effect of DBS is measured as -0.0476·100% = -0.0476). The coefficient on a terrestrial overbuild is -0.1694, and the percentage change in price is measured as exp(-0.1694) - 1 = 15.6%.

58 GAO (2005) at 33.

59 GAO (2005) at 33.

areas of rival cable systems increasingly overlap.[60] Thus, the larger number of homes passed by both networks in a given market, the lower equilibrium price will be.[61]

Figure 1. Differentiation and Overlap



In Figure 1, we illustrate the affect on price of changes in overlap and product differentiation. We assume that with zero overlap, the incumbent firm is a monopolist and charges price p_m. Dollars are measured on the vertical axis, and the percentage of rival system overlap is measured on the horizontal axis. First, consider the case where the services is so highly differentiated that consumers do not view them as substitutable in any way. In this case, we have the line labeled AA in the figure. Regardless of the overlap of the two networks, price remains at the monopoly level (p_m). If the two services are highly substitutable, then we might have a price-overlap relationship labeled AC. Now, price falls quickly as the overlap of the networks increases, with price p_2 at a 50% overlap and p_3 at 100% overlap. Finally, an intermediate case of product differentiation is indicated by the line labeled AB. At 100% overlap, price is p_2, whereas at 50% overlap, price is p_1. Note that price at 100% overlap with moderate

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60 T. R. Beard, G. S. Ford, R. C. Hill, and R. P. Saba, *Fragmented Duopoly: A Conceptual and Empirical Investigation* (Forthcoming in the JOURNAL OF BUSINESS 2005)(available at: http://www.aestudies.com/library/fragjune.pdf).

61 If different prices can be charged in the monopoly and contested segment, then a unique price for each segment will be charged (the monopoly price in one and the duopoly price in the other).

differentiation (line AB) is equal the price for 50% of overlap with very little differentiation (line AC).

On the issue of system overlap, Beard *et al.* (2005) provide strong evidence that overlap matters for cable prices.[62] But the logic of Figure 1 is probably best demonstrated by evidence regarding the nature and consequences of competition between cable operators and DBS providers. As we mentioned above, the price effect in cable markets from a terrestrial cable rival is substantially larger than a DBS providers, because of the satellite service is more differentiated from traditional cable service. On the issue of overlap, the GAO study shows that geographic conditions that adversely affect the ability of consumers to get DBS service raises cable prices. These geographic limitations on DBS effectively reduce system overlap in the same way that terrestrial systems may not serve identical geographic areas.

Overlap is likely to be an important feature of the emerging competition between cable and telephone carriers. The geographic areas of cable operators and telephone carriers do not always coincide, leaving the possibility for less than complete overlap of networks. Further, cable networks pass most, but not all homes. According to industry statistics, cable multichannel video service is available to 97% of U.S. homes, and cable modem service is available to 96% of homes.[63] As a result, VoIP telephone services that use broadband connections, sold by either cable operators or other firms, is generally available. However, since only about 40% (and growing) of homes *actually subscribe* to broadband services, that limited penetration serves to reduce the effective overlap of VoIP and traditional telephone service (the latter of which is ubiquitously available).[64] It is not yet clear whether or not cable operators will require consumers to purchase a broadband connection in order to buy the cable operator's digital telephone service, nor is it clear how many cable operators will offer digital telephone service, but both of these decisions implicate the amount of overlap of the rival networks.

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62 *Supra* n. 60.

63 http://www.ncta.com/Docs/PageContent.cfm?pageID=86.

64 http://www.urlwire.com/news/010204.html.

B. *Types of Entry Costs*

The other significant component of our entry equation constitutes entry costs. The higher are entry costs, other things constant, the fewer is the number of firms in equilibrium. Entry costs (e) can take a variety of forms, but entry costs are all fixed and sunk in our model. For a meaningful analysis of communications markets, we believe it is appropriate to divide entry costs into four major categories: (1) technological entry costs; (2) strategic entry costs; (3) regulatory entry costs; all of which may be offset by (4) spillovers. Table 4 summarizes the types of entry costs and their effect on the equilibrium number of firms (N^*).

Table 4. Types of Entry Costs

Factor	Relationship to e	Effect on N^*
Increase in Technological Entry Costs	+	Fewer firms
Increase in Strategic Entry Costs	+	Fewer firms
Higher Regulatory Entry Costs	+	Fewer firms
Presence of Spillovers	-	More firms

As summarized in Table 4, three of the four forms of entry costs raise the cost of entry and, consequently, reduce N^*. Spillovers, which can be construed as a contra-cost, are actual reductions (or offsets) in entry costs caused by the use of a firm's existing assets to enter a related market. The larger are spillovers, the larger N^* will be. As we describe later, however, spillovers need not be available to any and all firms, but instead are often limited to particular firms with existing assets.

Table 1. Entry Costs and N^*

		Example 1: $N^* = 3$		Example 2: $N^* = 2$	
n	d	e	$d - e$	e	$d - e$
1	100	15	85	25	75
2	40	15	25	**25**	**15**
3	20	**15**	**5**	25	-5
4	12	15	-3	25	-13
5	8	15	-7	25	-17
6	5	15	-10	25	-20
7	4	15	-11	25	-21

A numerical example illustrating the effect of entry costs on N^* is provided in Table 5. Table 5 contains two examples. The first example is a repeat of the

example from Table 1, with entry costs of $15. With entry costs of $15, we have already shown that $N^* = 3$. In Example 2, with entry costs of $25, the second firm still finds it profitable to enter, with net profits of $15 (= $40 - $25). But, with higher entry costs, the third firm now realizes a negative net profit upon entry (-$5), so the third firm stays out. Now, the equilibrium is two firms ($N^* = 2$). As expected, the increase in entry cost has reduced the equilibrium number of firms.

This example assumes only that entry costs rise. In the following sections, we provide examples as to what form these higher entry costs might take.

1. *Technological Entry Costs*

Technological entry costs are those entry costs inherent to providing the service. These costs include, for example, the cost of building a network, operating capital, advertising, and so forth. The technological entry costs required to construct a facilities-based telecommunications network to serve households are sizeable, and these costs alone are sufficient to render a highly concentrated industry equilibrium. It is also important to understand that technological entry costs are not simply network plant, but consist of any expenditure that is sunk.[65]

2. *Strategic Entry Costs*

Strategic entry costs are costs borne by a new entrant that exist solely because of an incumbent's strategic behavior.[66] For example, the incumbent may advertise excessively (creating differentiation) so that any entrant will have to do the same to attract customers.[67] Or the incumbent may lobby local authorities to

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65 PHOENIX CENTER POLICY PAPER NO. 12, *supra* n. 1 (calculating that for every $1 in network, telecommunications entrants spend $2 of capital on other things, and most of these expenditures are probably sunk)

66 Appendix H, *supra* n. 27 at ¶ 369. ("Incumbent systems may be able to use their incumbency to forestall or deter competitive entry via a number of entry deterring strategies."). Salop (1979) notes that incumbent behavior that raises entry barriers may be innocent or strategic. For this analysis, we would place "innocent" barriers in the "technological entry costs" category.

67 *See, e.g.*, J. A. Dalton and S. A. Rhoades, *Growth and Product Differentiability as Factors Influencing Changes in Concentration*, 22 JOURNAL OF INDUSTRIAL ECONOMICS 235-240 (1974) and R. E. Caves and P. J. Williamson, *What is Product Differentiation, Really?* 34 JOURNAL OF INDUSTRIAL ECONOMICS 113-132 (1985) ("a product-differentiation barrier to entry has at its heart information-based differentiation coupled with scale economies is sales promotion (at 128-9)"). The Commission discussed this possibility in detail in the 1994 Cable Competition Report, Appendix H,

(Footnote Continued. . . .)

deny or delay the granting of rights-of-way construction permits. Finally, incumbent cable operators can "lock-up" popular programming via exclusive distribution contracts if the programming is transmitted via terrestrial means.[68]

Sometimes such costs can be imposed in a less-than-subtle fashion - for example, a marketing plan by a cable operator that offers customers discounts for taking down and returning DBS dishes (an action that would make subsequent DBS entry into that household more expensive.) By raising entry costs in this way, the incumbent can deter entry. Strategic entry costs typically arise only in cases of *sequential* entry, where there is already an incumbent(s) in the market. In that situation, the incumbent is usually willing to increase its own costs or reduce its own profits (*e.g.*, give a discount for a return of a DBS dish) in order to raise the entry costs of potential rivals. As observed by Thomas Schelling, "the essence of [strategic entry costs] is some voluntary but irreversible sacrifice of freedom of choice. They rest on the paradox that the power to constrain an adversary may depend on the power to bind oneself."[69] In fact, we show later that an incumbent always has more incentive to deter entry than an entrant has to enter.

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supra n. 27 at ¶ 372 ("Product differentiation may constitute a barrier to entry if the extent of differentiation is sufficiently "intense," *i.e.*, consumers perceive alternative products as poor substitutes for the differentiated product or service."). Strategically holding excess capacity can be means by which to deter entry. For empirical evidence and a review of the theory, *see* J. C. Hilke, *Excess Capacity and Entry: Some Empirical Evidence*, 33 JOURNAL OF INDUSTRIAL ECONOMICS 233-240 (1984).

68 *See, e.g.*, James W. Olson and Lawrence J. Spiwak, *Can Short-Term Limits on Strategic Vertical Restraints Improve Long-Term Cable IndustryMarket Performance?* 13 CARDOZO ARTS & ENT. L.J. 283 (1995) (http://www.phoenix-enter.org/library/prog_access.doc). In some cases, blocking an entrant's access to programming is product differentiation through sabotage. Impeding access to existing programming does not increase the amount of programming available to consumers and thus has no effect on absolute quality. Rather, the restriction merely alters the relative qualities of the incumbent and entrant in favor of the incumbent. *C.f., See* Press Release: *DirecTV Files Complaint With FCC Against iN DEMAND For Unlawful Pricing Scheme, Discriminatory Pricing Strategy Would Force DirecTV to Pay Three to Four Times What iN DEMAND's Cable Owners Pay for Same Service* (29 June 2005) (http://www.directv.com/DTVAPP/aboutus/headline.dsp?id=06_29_2005B).

69 T. Schelling, THE STRATEGY OF CONFLICT (1960), at 22.

3. *Regulatory Entry Costs*

Regulatory entry costs are the result of rules and regulations enforced by government agencies. An excellent example of regulatory entry costs is cable franchise obligations, which often raise entry costs by burdening entrants with build out obligations and other rules that raise entry costs above what is necessary to provide service. In many cases, incumbents make their strategic entry costs more effective by using regulators to enforce duplication of such costs by entrants. Hazlett and Ford (2001), for example, illustrate how level-playing-field laws enacted by some states deter entry in cable television markets by forcing entrants to match the entry costs of incumbent firms.[70] As we will show later in the text, under such a law the incumbent cable operators have a powerful incentive to raise their own entry costs in order to deter future entry. We have already mentioned how public policy reduced the success of DBS providers by failing to address the issue of access to vital programming, thereby shrinking the market of the entrant.

4. *Spillover Effects*

Spillovers are *reductions* in entry costs arising from the ability of a firm to use its existing assets to provide service in a related market. For example, the local exchange companies were able to enter the data business by upgrading their networks to deliver data over copper wires (Digital Subscriber Line or DSL). Thus, these carriers did not have to build a complete data network from scratch, but simply "spilled over" their existing network into the data market with a marginal investment. Likewise, cable operators upgraded their one-way video networks to become two-way data networks. Similarly, the potential for broadband powerline ("BPL") "spills over" from the sunk network investment of electric utilities.

Plainly, another firm without a physical distribution network in local markets would have faced much higher entry costs to provide data service to businesses and households in a market. Today, because the FCC and the courts[71] have taken a strong stands toward reducing barriers to entry for cable modem service and VoIP - the cable companies' primary vehicle into telephony - cable operators are upgrading their networks to provide voice and other enhanced services over

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70 *Supra* n. 30.

71 *NCTA v. Brand X*, 125 S. Ct. 2688 (2005).

their data service.[72] As such, spillovers are very important in communications markets, particularly as new technologies expand the capabilities of existing terrestrial networks. Importantly, spillovers are frequently limited to a few, existing firms, and this limitation gives rise to the concept of the "most likely entrant."[73]

IV. Modern Communications Policy and the Entry Model: Four Applications

Having explained the various components of our entry model, looking at both profits and entry costs, in this Section IV we apply the model in particular cases to show that policymakers can use the model to draw conclusions. As we do so, remember our basic tenet: firms will enter as long as it is profitable to do so, and the profitability of entry is determined by the difference between gross profits (d) and entry costs (e), where if $d \geq e$ there is entry.

We provide four applications.

First, we illustrate how the entry model can be used to translate the concept of "convergence" into changes in industry structure. Convergence is an idea that has been bandied about in communications markets since the 1960s, when AT&T argued in FCC proceedings that IBM mainframe computers were operating illegally as common carriers without a license. We show, using the logic of the entry model, what is required for "convergence" to have a meaningful impact on consumers and why only now convergence is only now becoming a reality in communications markets. We also show why convergence does not necessarily lead to a large number of competitors. Convergence typically affects only firms with existing assets, and thus the effect of convergence on industry structure will be limited.

Second, we illustrate why current limitations on the ability of telephone companies to offer video services over their networks will reduce the deployment of advanced communications networks.

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72 Several cable companies who pioneered entry into voice service, such as Cox Communications, provided traditional switched telephony, but are in the process of transitioning transition to VoIP. Joan Engebretson, *Analysis: Cox Adopts VoIP at the Core*, AMERICA'S NETWORK (19 June 2004).

73 *See In re Applications of NYNEX and Bell Atlantic Corp. For Consent to Transfer Control*, Memorandum Opinion & Order, 12 FCC Rcd 19,985, FCC 97-286 (rel. Aug. 14, 1997) (hereinafter "*Bell Atlantic/NYNEX Order*").

Third, we illustrate the point that the incumbent always has a greater incentive to deter entry than the entrant has to enter. This analysis is highly relevant to the debate on cable franchising presently underway.

Finally, we use the entry model, slightly adjusted, to evaluate the prospect for collusion among telecommunications carriers and cable operators in a converged world. The entry model is exceptionally useful for this purpose, and provides a compelling argument for why collusion should not be of great concern (at this time).

A. *Effect of Convergence on Industry Structure*

Convergence loosely implies the marriage of communications and computer technology, or "the coming together of the basic technology that supports voice communications, computer communications, and, more recently, video and home entertainment."[74] With all forms of communications reduced to a digital transmission, a single digital network would be capable of delivering a wide array of communications services including voice, video, and data. Typically, commentators have expected convergence to increase competition by allowing all the various digital networks to provide a full suite of communications services.[75]

But consumers have not seen this form of "true convergence" just yet. In the last few years, rather than converging, communications products have oftentimes *diverged*, to the point that many well-heeled professionals now subscribe to landline phone, cable service, high-speed Internet, mobile phone, a separate BlackBerry wireless email account, "On-Star" communications services in their car, in addition to owning an iPod and TiVo unit. True convergence of services would create a spillover in which it would be profitable for a firm to sell multiple services over a common network. It is this spillover effect that would allows the industry to move to a more competitive structure. Convergence can

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74 Steven Titch, *Telephony, Defined and Redefined*, TELEPHONY (May 1, 1995) at 1, 5.

75 *Id.* ("Telephony was once only about a small group of carriers. Now it's about a universe of carriers."); *but c.f.*, Jeanette Symons, *Let's Not Go Broke Repaving the Last Mile*, IEEE SPECTRUM (Jan 2001) at p. 46 ("It does not take much imagination to see that a single, converged network is the future of voice and data networking.")

come from unlikely sources - for example, it is expected that mobile telephone makers will sell more cameras in 2005 than the entire photo industry.[76]

The entry model, slightly adjusted, can be used to illustrate this fact. Say we have two monopolists serving markets A and B with each earning $100. These firms might like to enter one another's markets, but doing so would require the construction of entirely new networks. Assume, for example, that entry costs are $50 and the (gross) duopoly profit is $40, so neither firm has an incentive to enter the other's market (because $40 < $50). Thus, each firm enjoys the good life of an unchallenged monopolist. But this good life does not last long - a technological breakthrough allows each of the monopolists to leverage their existing assets to provide service in the other firm's market. This technological breakthrough creates a *spillover* that reduces entry costs into their respective markets to $30, *but only for these two firms*. Now, entry is feasible, since the $40 duopoly profit exceeds the entry cost of $30.

This example reveals a number of very important insights. First, *absent the spillover, entry would not have occurred.* Entry is an option solely because of a technological change (*e.g.*, VoIP, DSL, Fiber, BPL) that allowed each firm to leverage their existing assets to enter the other market. In the modern lingo of telecommunications, we have *convergence* - but the technological change only has an effect on industry structure when convergence creates a spillover large enough to alter equilibrium industry structure. Second, *only those firms with assets affected by the spillover can afford to enter.* "Convergence" does not mean that busloads of new firms can now enter the market - it means that firms already in another, related market can now enter and be profitable. As a result, there is some limit to the benefit of convergence if the generated spillover is restricted to a few firms.

Perhaps the most profound expression of convergence and spillovers today is the deployment of digital telephone service by cable operators. With the substantial improvements and innovations in VoIP over the past few years, the cable industry has now abandoned efforts to offer analog, circuit-switched voice to consumers in favor of leveraging their existing data networks to offer a digital

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76 *Mobile Snaps: Are Camera-Phones Good News or Bad for the Photography Industry?* THE ECONOMIST (July 3, 2003).

voice product.[77] The analog voice market never really developed for the cable operators, but the relatively cheap deployment of digital voice likely will make cable a serious contender in the voice market. Moreover, not only has the FCC taken exclusive Federal jurisdiction over VoIP[78] (thus preventing a "patchwork" of regulations among the fifty States), but the FCC has explicitly preempted state laws that require new telephone entrants from any "build-out" requirements.[79] As a result, a cable company can deploy VoIP to whatever customer base it pleases without regulatory consequence. The absence of a build-out requirement for VoIP greatly increases the potential profit for that service.

B. *Market Size and the Deployment of Advanced Communications Networks*

Nearly all existing networks must be upgraded to take full advantage of "convergence." Such upgrades can improve the quality of existing services offered by a firm, as well as allow the firm to expand into new services. One example of a radical network upgrade is fiber to the premises, where incumbent telephone companies are replacing their copper distribution plant with fiber optic transmission paths that terminate at the customer's premises. These advanced networks offer exceptionally high bandwidth and can deliver a wide array of services. The value of network modernization is sizeable, and policymakers should facilitate the deployment of advanced networks.

We can use the entry model to illustrate how policymakers can encourage, and discourage, the deployment of advanced communications networks. Say

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77 *See, e.g., Comcast to Boost Residential Internet Service Speed,* WALL STREET JOURNAL (July 12, 2005) at D4 (reporting that Comcast, the nation's largest cable operator, will automatically begin to upgrade existing subscribers located in Philadelphia, Baltimore, Detroit, New Jersey and Washington, D.C. to six megabits per second for free (or eight megabits per second for an additional $10) during Summer 2005.) Coincidentally, these are the same states where Verizon plans to roll-out its FiOs fiber-to-the home product.

78 *In the Matter of Vonage Holdings Corporation, Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission,* MEMORANDUM OPINION AND ORDER, FCC 04-267, __ FCC Rcd __ (rel. 12 November 2004).

79 Significantly, the FCC struck down a competitive local exchange build-out requirement in Texas, noting "build-out requirements are of central importance to competitive entry because these requirements impact the threshold question of whether a potential competitor will enter the local exchange market at all." *In the Matter of The Public Utility Commission of Texas,* CCB Pol. Docket Nos. 96-13, 96-14, 96-16 and 96-19, MEMORANDUM OPINION AND ORDER, FCC 97-346 (rel. Oct. 1, 1997) at ¶ 13.

there is a firm with a legacy network that is capable of delivering a service (*e.g.*, voice) that renders $25 in profits over the network's remaining economic life. A radical upgrade to the network would improve the quality of the existing service, increasing profits to $40. The new network would also be capable of providing another service, also worth $40 in profits. Say the upgrade costs $50 in entry (or upgrade) costs. With gross profits of $80 and an entry costs of $50, the firm chooses to upgrade the network and earns a profit of $30 (a $5 increase over the status quo of $25).

But what if policymakers restrict the firm's access to the new market? If policy blocks entry into the new market altogether, then the gain to the upgrade of $15 (= $40 - $25) is far below the entry cost of $50. There is no profit in the upgrade, so the upgrade is shelved. Even if policy allows entry, but tacks on an additional $10 in entry costs, then the firm chooses not to upgrade the network (the gain is only $20 = 80 - 50 - 10 < 25$).

These examples illustrate how with convergence policymakers must be aware of how entry barriers in related markets can affect primary markets. If network modernization is to occur, then regulatory entry barriers that exist in any market that the network may serve must be eliminated to the greatest extent possible. Similarly, policymakers should not facilitate the creation of strategic entry barriers by incumbent firms.

C. *Deterring Entry by Treating Entrants and Incumbents Equally*

As noted above, the Federal Communications Commission has explicitly found that the "*local franchise process is, perhaps, the most important policy-relevant barrier to competitive entry in local cable markets.*"[80] Notwithstanding, it is often argued, in the interests of "fairness", that new entrants should have to overcome and face the same hurdles that an incumbent has faced. We are currently seeing this argument develop in the context of cable franchise and build-out requirements, where incumbent cable companies are insisting that telephone companies that seek to sell video services commit to the same franchise process and build-out requirements that the incumbent cable company had to face.

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[80] Appendix H, *supra* n. 27 at ¶ 375 (emphasis supplied); *see also* Richard Posner, *The Appropriate Scope of Regulation in the Cable Television Industry*, 3 BELL J. ECON. 98-129 (1972).

But the sequence of entry is critical and an asymmetry arises from the differential treatment of sunk costs by the incumbent and the entrant. To the incumbent, entry costs are sunk and bygone and thus will not affect marginal decisions. However, to the entrant, sunk entry costs are marginal costs (*i.e.*, fixed costs are neither fixed nor sunk until incurred), and thus play a key role in decisions. The incumbent, therefore, considers these entry costs much differently than the entrant, simply because the incumbent need not incur them in the future and what he has spent is sunk. Sunk costs, then, give the incumbent a "first mover" advantage over entrants. The presence of a "first mover" advantage means that requiring a new entrant to bear an entry cost simply because the incumbent has already borne it will have the effect of deterring entry substantially, even if such costs did not deter the incumbent from offering service.

To illustrate the first mover advantage, we simplify the entry model to a case of two firms – an incumbent and one entrant. The incumbent monopolist makes a profit of m. If entry occurs, then both the incumbent and entrant make the duopoly profit d. Entry requires entry costs equal to e, so post-entry the incumbent has profits of d and the entrant has profits of $d - e$. (A numerical example will be provided later in the text). Since the monopoly profit is the largest possible profit, it must be true that $2d - e < m$; in other words, the summed profits of the incumbent and the entrant are less than the monopoly profit (even with perfect collusion due to the presence of e).

Assume that the entrant's post-entry profit is positive ($d - e > 0$) so that it plans to enter. Knowing this, the incumbent decides to voluntarily incur some sunk expenditure b that the entrant must match. The entrant's entry costs are now $e + b$; post-entry profit for the incumbent is $d - b$ and for the entrant is $d - e - b$.

We have assumed that without the extra entry costs b, the entrant would enter. Now, the question is whether or not the incumbent has an incentive to make b large enough to deter entry. The answer is yes.

If entry occurs, then the monopolist's lost profits are $m - d$. The gain to the entrant from entering the market is $d - e$. But, since $2d - e < m$, the monopolist

loses more than the entrant gains.[81] Thus, the monopolist will be willing to expend more of its profits to deter entry than the entrant can gain in profit by entering. By setting $b = d - e + g$ (where g is just a very small number), the monopolist can deter entry and come out ahead.

A numerical example may help. Let the monopoly profit (m) be \$100, the duopoly profit (d) be \$40, and entry costs (e) be \$30. Since the duopoly profit exceeds entry costs ($40 - 30 = 10 > 0$), the entrant plans to enter. Prior to entry, the incumbent incurs a sunk expenditure of \$11 than the entrant must match. Now, the entrants net gain from entry is -\$1 ($40 - 30 - 11 = -1 < 0$), so the entrant stays out. Is the incumbent better off? Yes. By deterring entry, the monopolist now earns \$89 (100 - 11). Had entry occurred, the monopolists profit would be \$40, so the monopolist chooses to deter entry. If the entrant must match the sunk expenditures of the incumbent, then it will always be rewarding to the incumbent to deter entry, even if that action increases the costs of the incumbent.

Given the condition on joint profits, if entry costs of the entrant must match exactly (or be larger) than the incumbent, then the incumbent always has more incentive to deter entry than an entrant has to enter the same market. An extreme example can illustrate this point. Say the incumbent and entrant plan to collude post-entry so that expected profits are 50 (*i.e.*, 100/2). The entrant needs to incur a technological entry cost of only 1. So, we have a situation with the highest possible post-entry profits and nearly no entry costs. The post-entry profit of the incumbent is \$50, and the entrant makes \$49 (= \$50 - \$1). Note that if the incumbent spends \$49.01 in sunk costs that the entrant must match, the incumbent's profit rises to \$50.99 and the entrant's profit falls to -\$0.01. Clearly, it pays for the incumbent to deter entry by raising strategic entry costs, since the incumbent is more profitable without than with entry.

There are three important lessons to be learned from this example, all of which arise from the fact that incumbents and entrants are not equals. First, policymakers should recognize that incumbents can incur more sunk costs than entrants because their profits are higher. In fact, many cable systems were constructed during the era of exclusive franchising, in which a cable company incurred these costs at a time when it was guaranteed a monopoly over cable services in the area. A firm offered a monopoly would readily propose or agree

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[81] We can rearrange the condition on joint profits to be: $d + d - e < m$, or more directly $d - e < m - d$.

to a higher entry cost than it otherwise would have agreed to in a competitive environment. Second, policymakers should avoid any rule or regulation that requires, out of some concept of "fairness", entrants to match the sunk expenditures of incumbents. Incumbents and entrants view sunk entry costs differently. This is due to the very nature of sunk costs and sequential entry - once the first firm (the incumbent) has incurred those costs, those costs are sunk and essentially irrelevant to that firm's subsequent business decisions. For the second firm (the prospective entrant), sunk costs are a *marginal* cost and before spending them, the prospective entrant will consider other uses of those funds. The incumbent and the entrant will treat sunk costs in different ways: Equal treatment of unequals is not equal treatment. Third, markets with sunk costs have a technological bias against entry, thus providing justification for policymakers to err on the side of making entry *easier* and less expensive, rather than harder and more costly.

D. *What Entry Says About Collusion*

When faced with a concentrated market, probably the first concern that comes to the mind of a policymaker is the threat of collusion. We noted *supra* in Section III.2 at Table 3 that it is easy to confuse collusion with intense price competition, and this confusion arises primarily from a strict adherence to the traditional view that the intensity of price competition rises with the number of firms. Once the effects of sunk costs are incorporated into the model of competition, such a simple notion of competition no longer tells the complete story. But the entry model has more to say about collusion.

Consider the game of reciprocal entry from the previous section on convergence. We have two monopolists serving markets A and B with each earning $100. Entry costs are $50 and the (gross) duopoly profit is $40, so neither firm has an incentive to enter either market. A technological breakthrough allows each of the monopolists to leverage their existing assets to provide service in the other firm's market, so that entry costs for these firms falls to $30. Entry is now feasible for both firms.

Assume both firms enter each other's markets. The incumbents earn post-entry profits of $40 in their own market and $10 in profits from the entered market [= 40 - 30], for a total of $50 in profit for each firm. After entry, their profits have fallen from $100 to $50. In retrospect, reciprocal entry, obviously, was not a very good idea. Despite the technological breakthrough and spillover effect of convergence, firms A and B would have been much better off had they ignored the development and stayed in their own respective markets. If A and B

were the only two firms for which the spillover effect of convergence were available (that is, a new firm, C, could not reap those benefits), then there is every reason to believe that this collusion could be sustainable in the long-term.

In our example, the collusive outcome is to ignore convergence and not enter. The converse is also true – *if we observe reciprocal entry, then this is solid evidence that collusion is not occurring*. The easiest time for firms to collude is *before* they enter one another's markets. Today, we observe cable operators moving into the telephone business and the telephone companies moving aggressively into the video business (though the latter is hindered by franchising), and this simple observation alone is strong evidence that collusion is not present.[82] Thus, at present, we believe that policymakers should not focus at present on the possibility of collusion, at least in those markets where reciprocal entry is observed.[83]

An interesting twist to this example of reciprocal entry is one-sided entry. One-sided entry occurs, say, if only one firm experienced the spillover. In this scenario, the advantaged firm would enter the rival market and increase profits to $110 ($100 from the monopoly, plus $10 from the rival market). The profits of the incumbent in the rival market fall to the duopoly level of $40. Since only one firm experienced the spillover, there is no threat of retaliatory entry by the firm unaffected by the spillover.[84] Perhaps the cable industry's venture into voice services was motivated, in part, by the assurances that cable franchising would effectively deter retaliatory entry by telephone carriers.

V. Conclusion

U.S. telecoms policy now aims to rely upon facilities-based and "inter-modal competition" to benefit consumers in voice, video and data markets. History suggests that a reliance on facilities-based competition implicitly embraces highly concentrated markets, where few firms vie for the patronage of customers. This POLICY PAPER demonstrates that in order to have vibrant inter-

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82 Reciprocal entry might be profitable if the markets are already reasonably competitive (i.e., there is little to give up if reciprocal entry occurs).

83 Once market shares stabilize, probably five to seven years out, then policymakers may wish to revisit the question of collusion.

84 The collusive outcome would involve the incumbent without a spillover paying the other firm to stay out (an amount equal to something between $10 and $60).

modal, facilities-based competition in all communications markets, policymakers must focus their attention on the consequences of their actions on the entry and expansion decisions of firms into related markets. This task is simple and intuitive - *if you want there to be more entry, then figure out how to make entry more profitable, without, of course, harming consumers.* In particular, policymakers should implement policies that increase gross profits (*e.g.*, allow firms to sell as many services as possible), reduce entry costs (*e.g.*, remove franchising requirements and "regulatory symmetry" requirements), or, better yet, both. Assuming policymakers can increase post-entry profits in this way, it is not unreasonable to expect that facilities-based firms will invest and/or upgrade their networks to take advantage of true technological convergence and compete vigorously on both price and product differentiation - a result that is clearly beneficial to U.S. consumers.

An Analysis of Cable TV Services: Are Older Consumers Losing Out?

The American Consumer Institute
Advocating Smart Consumer Policies
P.O. Box 2161
Reston, VA, 20195
www.theamericanconsumer.org

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An Analysis of Cable TV Services: Are Older Consumers Losing Out?[1]

Executive Summary

Cable TV services are an important aspect of consumer's daily lives, providing vital information, news and entertainment. Americans aged 50 and above are most reliant on television services, viewing on average 5.5 hours per day.[2] However, this study finds that consumer are needlessly overpaying for cable TV services. The major findings of this study are:

- Televisions and cable TV services represent a substantial portion of consumer spending, exceeding the annual costs of many critically important products and services, such as drugs (prescription, nonprescription and vitamins), tuition, and personal care products.[3]
- Each year, compared to other consumers, older consumers pay on average a greater proportion of their income on cable TV services.
- The increasing prices for cable TV services pose an accelerating risk for consumers. Cable television prices have risen much faster than the prices for other network services, such as telephone and Internet services. Over the last five years, according to FCC survey data, cable prices have increased 7.5% per year. Compared to the Bureau of Labor Statistic's Consumer Price Index, telephone and Internet prices have actually declined by 4% and 2% per year, respectively. To put this increase in perspective, cable service prices have increased faster than prescription drugs, nonprescription drugs, and medical care commodities, which represent another critical area of spending for older consumers.
- The lack of competition appears to be a key reason for the high (and increasing higher) cable TV service prices. FCC data show that consumers would realize a 27% price decrease when alternative wireline cable TV and video service providers compete against incumbent cable TV providers.
- The benefits of competition appear to be significant. This study estimates that competition would lead to more competitive pricing and result in savings of $107 billion over the next five years. In addition, competition would hold future price increases in check and stimulate more demand for cable TV and video services, further increasing consumer benefits.
- Due to their reliance on television services for their information and news, older consumers are most harmed by noncompetitive pricing. This study estimates that American seniors would save $1,156 over the next 5 years, if competition were increased.

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[1] This research was not funded (directly or indirectly) by any group, organization or corporation, but represents the volunteer efforts of our public policy experts. For information about the American Consumer Institute, see www.theamericanconsumer.org. Comments on this study should be directed to editor@theamericanconsumer.org.

[2] Lavada DeSalles, "Preparing Consumers for the End of the Digital Television Transition," AARP's Testimony Before the House Subcommittee on Telecommunications and the Internet of the House Committee on Energy and Commerce, AARP, Washington, DC, March 10, 2005.

[3] *Consumer Expenditure Survey*, U.S. Department of Labor, Bureau of Labor Statistics, 2003, Table 1300.

The lack of wireline competition is an area that public policymakers must address, if consumers are to see these consumer benefits. While wireline competitors are attempting to enter the cable TV and video services market, regulators need to understand the high stakes involved and develop policies that speed market entry. For older American consumers, failure to encourage competition into the cable TV and video services market will put billions of dollars of savings on hold.

An Analysis of Cable TV Services: Are Older Consumers Losing Out?

I. Spending by Older Consumers

On March 10, 2005, Lavada DeSalles, a member of AARP's Board of Directors, provided compelling Congressional testimony that the government mandated conversion from analogy television to digital television would impose significant costs on Americans.[4] She also pointed out that older Americans, those 50 years and older, watch the greatest amount of television, averaging nearly 5.5 hours each day.[5] Referring to television as an "essential service" for older Americans, in her testimony, DeSalles pointed out that the costs incurred by consumers during the transition from analog to digital television "will be disproportionately imposed on those least able to afford it," requiring consumers to buy more expensive digital TVs or upgrade existing TV's with a converter box.[6] While her points are well taken, not mentioned one important observation – that for most American consumers, the annual cost of a television set or a converter box pales in comparison to what consumers pay for cable TV services. While public policy needs to be very mindful of DeSalles concerns, and while we support her recommendations, greater public focus is needed to address the high costs for cable TV services.

Annual television expenditures, essentially the spending on televisions and cable TV services, exceed consumer spending for drugs (prescription, nonprescription, and vitamins), personal care products, or college tuition. Of television expenditures, cable TV service makes up the bulk share of television expenditures by consumer. To put these costs in perspective, as **Figure 1** (on the next page) shows, in 2003 households spent on average $91.49 for television equipment, while spending $423.79 on cable TV services. We estimate that the average consumer will spend $490 in 2005 for cable TV services.[7]

Older householders spend ten times more on cable television services than they did for television equipment. While those householders aged 35 to 64 spent the most on cable TV services, they also earned more income and tended to have more individuals living in those households. When taking this into account, as **Figure 1** shows, older householders spend a higher proportion of their income on cable TV service than other householders. This fact agrees with Ms. DeSalles point that older consumers are more reliant on the television. In terms of individuals per household, again, older consumers tend to buy more cable TV services than younger consumers. Thus, cable TV services are an important part of consumer expenditures, and more so for older Americans who face the highest cost burden for these services. This study will investigate the high costs of cable TV services, and the affects on older consumers.

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[4] DeSalles, 2005.
[5] Ibid.
[6] Ibid. She provides an estimate of the cost of a converter box as $50 to $125 per TV set. That equipment would permit existing analog TVs to receive digital over-the-air broadcast signals.
[7] Based on the 5-year inflation rate to be discussed in detail later in this study.

Figure 1: Television Spending By Age Group - 2003

Average Household Expenditures

	TV Equipment	Cable TV Service
All Consumer	$91.49	$423.79
Under 25	$55.49	$202.60
25 to 34	$105.16	$397.00
35 to 44	$114.09	$449.26
45 to 54	$116.51	$498.11
55 to 64	$95.66	$481.61
65 and Over	$40.87	$384.31
65 to 74	$51.07	$424.22
74 and Over	$30.61	$344.12

Television Spending as a Percent of Household Income

	TV Equipment	Cable TV Service
All Consumer	0.18%	0.83%
Under 25	0.27%	0.98%
25 to 34	0.21%	0.79%
35 to 44	0.19%	0.74%
45 to 54	0.17%	0.73%
55 to 64	0.16%	0.82%
65 and Over	0.13%	1.26%
65 to 74	0.14%	1.20%
74 and Over	0.12%	1.35%

Television Spending Per Consumer

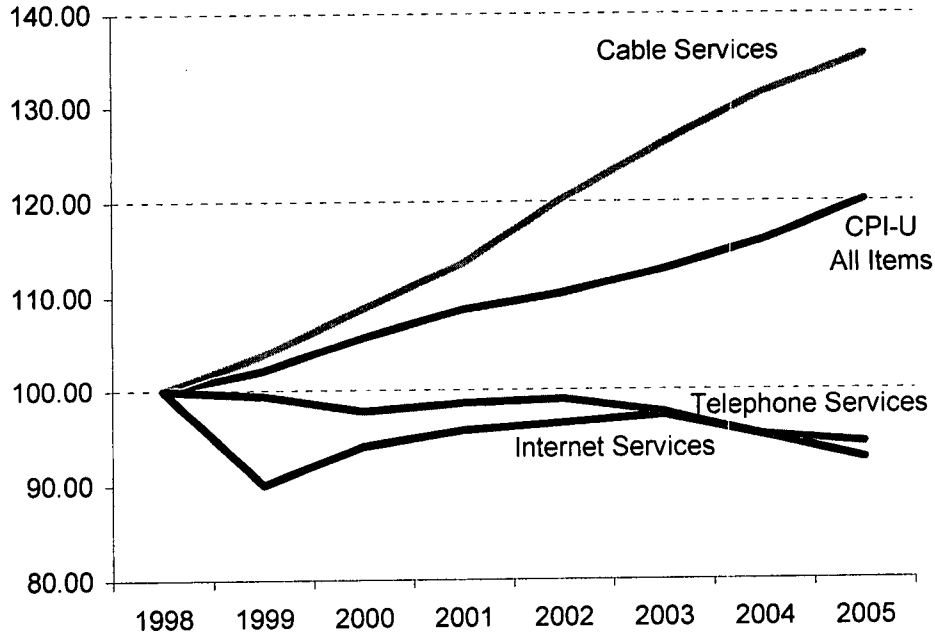
	TV Equipment	Cable TV Service
All Consumer	$36.60	$169.52
Under 25	$30.83	$112.56
25 to 34	$36.26	$136.90
35 to 44	$35.65	$140.39
45 to 54	$44.81	$191.58
55 to 64	$45.55	$229.34
65 and Over	$24.04	$226.06
65 to 74	$26.88	$223.27
74 and Over	$20.41	$229.41

Source: *Consumer Expenditure Survey*, U.S. Department of Labor, Bureau of Labor Statistics, 2003 figures, Table 1300.

II. Prices and Inflation

As the previous section showed, cable television amounts to a sizable portion of consumer's annual expenditures, with the highest cost burden falling on older American consumers. One reason for the sizable cable expenditures is that cable prices are high and are increasing faster than other goods and services. For example, over the last five years, cable TV service prices have increased faster than prescription drugs, nonprescription drugs, and medical care commodities – all critical products for the elderly.[8] As **Figure 2** shows, cable TV service prices have increased twice as fast as the price for other goods (measured by the CPI for all items), and much faster than other network communications services, namely telephone and Internet services.[9] According to government statistics, in the last five years, cable prices have increase 25%, while telephone and Internet service prices have fallen by 4% and 2%, respectively.[10]

Figure 2: Price Changes
Index 1998=100



Source: Bureau of Labor Statistics, downloaded Oct. 7, 2005.

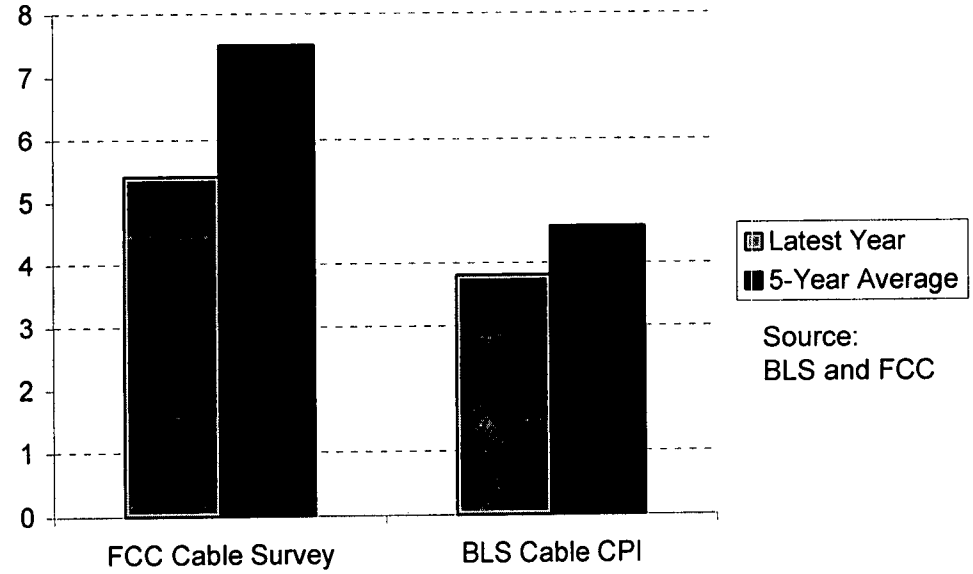
[8] This estimate comes from the Bureau of Labor Statistics (BLS) Consumer Price Index for urban consumers (CPI-U), comparing August 2005 to August 2000. The data were downloaded as of Oct. 7, 2005. This study will refer to these figures as CPI indexes.

[9] These prices represent yearly changes in the CPI indexes with a 2005 year-to-date estimate.

[10] These data, as well as other historical data, are available in the **APPENDIX** of this study.

What the data in **Figure 2** do not show is that the CPI index for Cable TV services underestimates the actual price increase for cable TV services, since these indexes include other services, such as satellite and radio services, which have not experienced similar price increases. Another estimate of cable television price increases comes from a survey of cable TV operators published by the Federal Communications Commission (FCC).[11] In their survey report, the FCC compared the CPI for cable TV services to its survey of cable operator prices and found that cable TV prices are actually increasing 3% faster than indicated in the CPI index for cable TV services. **Figure 3** compares the CPI price changes to the FCC price changes and confirms that cable TV prices have increased on average 7.5% per year over the last five years.

Figure 3: A Comparison of FCC Cable Survey Price Changes to the BLS Cable CPI Price Changes (All Figures are Percent Annual Averages)

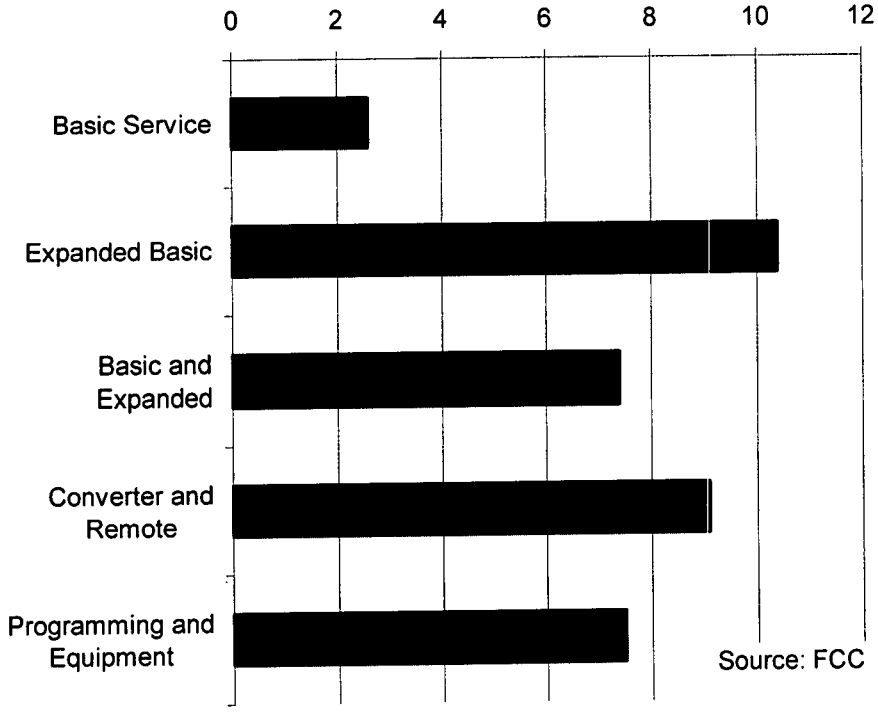


The FCC survey provides compelling evidence that consumers are subject to steep price increases at the same time that network service prices, such as telephone and Internet services, are declining. These price increases pose an accelerating cost for low-income consumers. When analyzing the various component costs of cable television services, **Figure 4** shows that cable TV service prices are increasing for basic services, expanded services, converter and remote, and programming and equipment. The data shows that some cable prices have increased (on average) more than ten percent per year – or three times faster than worker wages, pensions and social security. The fact that

[11] "Report on Cable Industry Prices," FCC, MM Docket No. 92-266, released Feb. 4, 2005.

cable television services account for a significant part of consumer expenditures and prices continue to increase faster than the price of other commonly purchased goods suggests that consumers are being harmed. The cause of the high and increasing higher cable TV service prices is that cable television operators face limited competition. Currently, the biggest competitor for cable TV services is satellite TV services, though there is some question to satellite's competitiveness. According to a GAO report, satellite services are significantly less competitive when facing cable TV operators that offer advanced services, presenting a problem in most markets.[12] As for over-the-air broadcast, these services cannot compete on quality or programming variety. There are some other wireless cable providers, but their geographic presence is limited.[13] Therefore, with few competitive options, consumers are paying too much for cable TV services.

Figure 4: Cable Price Increases
(All Figures Are Percent Annual Averages)



[12] See "Direct Broadcast Satellite Subscribership Has Grown Rapidly, but Varies Across Different Types of Markets," GAO-05-257, April 2005.

[13] Non-cable multichannel video program distributors account for nearly 28 million subscribers as of June 2005, compared to 110, million basic cable TV subscribers, according to the National Cable & Telecommunications Association. See Statistics & Resources page at www.ncta.com, downloaded on Oct. 10, 2005.

III. The Lack of Competition

The FCC survey results document the importance that cable TV service competition can have in reducing consumer prices. The FCC collected price data on non-competitive and competitive cable TV service operators, and analyzed differences between these operators. The FCC found that, when subtracting non-competitive cable TV prices from competitive TV prices, the difference in prices was positive, indicating that non-competitive prices were more expensive than competitive prices. The FCC also found that the difference in cable channels was negative, indicating that non-competitive operators offered fewer channels than competitive providers. **Figure 5** shows these positive price differences and negative channel differences, and finds the most significant differences were those between non-competitive cable TV operators and competitors using a wireline network, called a *wireline overbuild.* As **Figure 5** shows, non-competitive cable TV prices were 16% higher than wireline overbuilders, and non-competitive cable TV operators offered 6% fewer programs than wireline overbuilders. On a price per channel basis, a common industry measure of price performance, non-competitive cable TV operator prices were 27% higher than competitive wireline overbuilders. These FCC results are consistent with earlier studies that found cable competition would result in a 30% price reduction.[14] Therefore, competition can provide consumers with significant savings and benefits.

Figure 5: Competitive Differentials

Non-competitive Prices/Channels Minus Competitive Prices/Channels

	DBS Service (Satellite)	Wireline Overbuild	Wireless Overbuild
Monthly Price	3.7%	15.7%	-1.0%
Number of Channels	-0.6%	-5.6%	-1.4%
Price Per Channel	2.6%	27.2%	4.6%

Source: FCC

Example: Non-competitive operators offer prices per channel that are 27.2% higher than prices that competitive operators offer. See the outlined box (as shown above).

[14] For citations of earlier estimates that cable TV competition would result in a 30% decline in prices see: "Comments on the Commission's Rate Survey by the National Association of Telecommunications Officers and Advisors," the National League of Cities, the United States Conference of Mayors, and the National Association of Counties, FCC MM Docket No. 92-266, filed March 8, 1993, p.4; "FCC Cable-rate Survey: Competition Lowers Rates," *Broadcasting and Cable*, March 8, 1993; and "Report and Order and Further Notice of Proposed Rulemaking," FCC, FCC MM Docket No. 92-266, Appendix E, Survey Results: Technical Issues, 1993, p. 13.

IV. Immense Consumer Losses

This study has shown that cable TV services represent a sizable portion of consumer expenditures, cable TV prices are increasing much faster than other goods, and competition would provide significant savings to consumers in the form of lower prices. Lower prices would also stimulate consumer demand and lead to additional consumer benefits. In addition, competition would also tend to hold future price increases in check and create pricing pressures on all other cable TV and video service providers, including satellite and multichannel video program distributors.

What savings could consumer expect from additional cable TV competition? In 2003, cable TV revenue was $53 billion, and predictions are that the cable TV revenues will increase to $117.7 billion over the next ten years.[15] The National Cable & Telecommunications Association (NCTA) estimates 2005 revenues to be 63.1 billion.[16] Using the NCTA estimate and the FCC survey's 5-year average growth for cable TV prices, if competition were to hold cable TV prices in check, consumers would realize about $5 billion dollar savings off the 2005 base of cable TV revenues. Using the FCC survey's estimate of savings from competition, competition would result in another 27% decrease in cable TV prices, an annual savings to consumers of $17 billion off the 2005 base. Using the 5-year inflation rate for cable TV price inflation, the consumer benefits from cable TV and video service competition is projected to reach $107 billion over the next five years.

With American's aged 50 years and above accounting for 40% of consumers over 20 years of age, the potential benefits for older American would be significant, amounting to billions of dollars each year. To illustrate this savings, consider those consumers aged 65 and older. Using the consumer expenditure data presented in **Figure 1** of this study, and assuming the average inflation rate estimated by the FCC survey, consumers aged 65 years and older will save (on average) $1,156 per household over the next five years, if cable TV competition increased and if price levels remained stable.

In addition to these benefits, consumers stand to see other economic gains from increased cable TV and video competition. Lower prices will stimulate additional demand for cable TV services. For instance, given 73.2 million basic cable subscribers as of February 2005,[17] a 27% drop in price (say from $45.32 to $33.08)[18] would yield a 22% increase in the demand for basic cable services (16 million more subscribers) and

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[15] The historical figure comes from the *Statistical Abstract of the United States: 2004-2005*, U.S. Census Bureau, citing Kagen Research, LLC as the source. The forecast comes from Carol Wilson, "Cable Rides Surge of Revenues from Bundling, New Services," *Telephony Online*, Aug. 15, 2005, citing Renee Shaening of Kagen Research, LLC.

[16] This figure is for 2005 cable revenue and was downloaded from the National Cable & Telecommunications Association web site at www.ncta.com, Statistics & Resources page, Oct. 10, 2005, citing Kagen Research, LLC.

[17] This figure comes from the National Cable & Telecommunications Association web site at www.ncta.com, Statistics & Resources page, Oct. 10, 2005.

[18] The current average monthly price for programming and equipment comes from "Report on Cable Industry Prices," FCC, MM Docket No. 92-266, released Feb. 4, 2005, at par. 24.

yield addition consumer benefits and savings.[19] There will also be stimulated demand for premium and pay-per-view services, which also will yield consumer benefits and savings. Additionally, falling cable TV prices would affect other market competitors, such as satellite and non-cable multichannel video program distributors, leading to across-the-board declines in prices, all of which would benefit consumers.

In summary, if cable TV services were more competitive, consumers would realize at least $107 billion in savings over the next five years. For this reason, public policymakers need to encourage market entry, which would speed these benefits to all consumers – both young and old.

V. Conclusion

In summary, this study finds that cable TV operators charge consumers more for cable TV services in the absence of competition, resulting in billions of dollars of losses for consumers. Older consumers, who are very reliant on television services, face the highest cost burden for cable TV services and stand to lose from the lack of competition in the market.

Public policymakers need to take steps to speed competition and save consumers from needlessly high and increasingly higher cable TV prices. This study shows that speeding competition would lead to price competition and drive cable TV service prices 27% lower than they are today. The result of competition would save consumers at least $107 billion dollars over the next five years, and stimulate more demand. The benefits to consumers aged 65 years and above are estimated to be $1,156 per household over the next five years. Clearly, consumers are losing out to the high costs of cable TV services.

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[19] Based on an elasticity of demand estimate of –0.8, as cited in Robert W. Crandall and Harold Furchtgott-Roth, *Cable TV: Regulation or Competition*, Brookings Institution, Washington, DC, 1996, p. 60.

APPENDIX:

Cable TV Service Prices Have Historically Increased Faster Than Other Goods, Including Other Network Services

(Percent Price Changes)

	CPI-U	Cable Services	TVs Equipment	Telephone Services	Internet Services
5-Year	13.7%	24.6%	-46.7%	-3.7%	-1.6%
10-Year	28.5%	65.7%	-60.9%	-2.4%	N.A.
15-Year	49.8%	109.9%	-64.3%	2.8%	N.A.
20-Year	81.9%	200.7%	-70.0%	8.3%	N.A.

Source: Consumer Price Indexes, Bureau of Labor Statistics, downloaded October 7, 2005. These figures are for urban consumers. The CPI-U figure is for all items purchased by consumers. The figures shown in the table above represent cumulative percent changes covering the period shown, and are not annual averages. The latest year of data was estimated based on the August 2005 to August 2004 percent change.

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The American Consumer Institute is an independent consumer organization devoted to improving the lives of American consumers. Our goal is to educate mainstream consumers on important issues that affect their lives by providing consumer information, news and public policy research.

To comment on this study, please send an email to:
editor@theamericanconsumer.org

For other inquiries, send an email to:
info@theamericanconsumer.org

To reach us by telephone, call us at (703) 282-9400

To reach us by U.S. Mail, write us at:
The American Consumer Institute
P.O. Box 2161
Reston, VA 20195

Further Report

On the Packaging and Sale of

Video Programming Services

To the Public

February 9, 2006

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I. INTRODUCTION AND BACKGROUND

1. In response to requests from several members of the U.S. House of Representative's Committee on Energy and Commerce and, separately, from the Chairman of the U.S. Senate's Committee on Commerce, Science and Transportation, the Media Bureau of the Federal Communications Commission prepared and, on November 18, 2004, released a *Report on the Packaging and Sale of Video Programming Services to the Public* ("First Report") addressing issues relating to "the efficacy of providing a la carte and themed-tier services to cable and satellite subscribers."[1] The First Report addressed both constraints on the ability of multichannel video programming distributors ("MVPDs") to offer such a la carte and themed-tier services, resulting from the contractual agreements entered into with sellers of programming (wholesale issues), and economic and consumer welfare issues associated with the manner in which content distributors package and market such programming (retail issues). The First Report concluded that a la carte regulation would increase operational expenses for MVPDs, increase the marketing costs and reduce the revenues of programming networks, and provide little economic benefit to consumers.[2] The First Report thus implied that a la carte regulation is undesirable and focused its policy recommendations on methods to increase competition and investment in new technologies in the retail MVPD market.

2. The staff has undertaken a Further Report ("Further Report") to respond to questions that have arisen regarding the appropriateness of the assumptions relied upon and the conclusions reached in the First Report. The Further Report concludes that the First Report relied on problematic assumptions and presented incorrect and biased analysis. Based on a more complete analysis of the costs and benefits of bundling and the potential costs and benefits of a la carte, the Further Report concludes that a la carte could be in consumers' best interests. Moreover, it explores several alternatives for increasing consumer choice in purchasing multichannel video programming that could provide substantial consumer benefits.

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[1] Federal Communications Commission, Media Bureau, *Report On the Packaging and Sale of Video Programming Services To the Public*, rel. Nov. 18, 2004 ("First Report").

[2] First Report at 6.

3. Specifically, Section II of this report provides the following conclusions regarding the First Report, which are more fully discussed below:

- To predict the effects of a switch to a la carte, the First Report relies on a study by Booz Allen Hamilton ("Booz-Allen-Hamilton Study") conducted on behalf of an industry association and based largely on unsupported and unrealistic assumptions.[3] Based on a mistake in its calculations, the study concludes that under a la carte, "consumers that purchase at least 9 networks would likely face an increase in their monthly bills."[4] To the contrary, even under the assumptions of the Booz-Allen-Hamilton Study, if there are 6 broadcast stations, consumers could receive as many as 20 channels without seeing an increase in their monthly bills.[5] That is actually 3 more channels than the average cable household watches today.

- Although the Booz-Allen-Hamilton Study concludes that an average consumer would face a bill increase ranging from 14% to 30% under a la carte, correcting for the Study's mistake as described above, the Study's own assumptions show that a consumer purchasing 11 cable channels would face a change in his bill ranging from a 13% *decrease* to a 4% increase, with a decrease in 3 out of 4 cases.

- The results of the Booz-Allen-Hamilton Study are highly sensitive to the assumed parameters of the study, many of which are questionable. For example, the Study assumes, without any basis, that a shift to a la carte would cause consumers to watch more than 2 hours less television per day. That is, the Study assumes consumers would watch nearly 25% less television and states that consumers watch on average 9 hours a day.[6] There is no reason to believe that total viewership would decline so significantly simply because consumers were able to purchase only the channels they most preferred. Thus, the predictions of the Booz-Allen-Hamilton Study are suspect.

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[3] Booz Allen Hamilton, *The a la Carte Paradox: Higher Consumer Costs and Reduced Programming Diversity: An Economic Analysis of the Implications of a la Carte Pricing on Cable Customers* (July 2004) ("Booz-Allen-Hamilton Study").

[4] First Report at 6. As Booz Allen Hamilton has since conceded, "as Chairman Martin's statement suggested, revenues from the broadcast basic tier should have been excluded from the operators' video average revenue per user (ARPU) before calculating the average cost per channel under a la carte." Letter from John Frelinghuysen, Vice President, Booz Allen Hamilton Inc., to Dr. Leslie Marx, Chief Economist, Federal Communications Commission (Dec. 16, 2005).

[5] According to a General Accounting Office report, the average cable household watches approximately 17 channels, including broadcast stations. *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8, at 31 (Oct. 2003).

[6] *See* Booz-Allen-Hamilton Report at 14.

- The First Report focuses primarily on the potential benefits of bundling video programming in tiers and so neglects to consider fully the potential harms thereof. A more balanced analysis finds that bundling may drive up retail prices, making video programming less affordable and causing some consumers not to purchase MVPD services. A la carte and increased themed tiers could give consumers the opportunity to lower their cable bills by purchasing fewer channels or smaller packages.

- The First Report provides insufficient analysis of the likely impact of a switch to a la carte on networks' revenues. Contrary to the First Report's assumptions, there is little reason to suspect that consumers would watch less video programming than they do today, under a la carte, and there is no basis whatsoever for the assumed decrease of almost 15 hours of television watching per week. Absent a change in audience levels, significant decreases in advertising revenue or increases in licensing fees are unlikely. Indeed, for many popular networks, advertising and subscription fees might rise from the shifts in viewers. Consumers who watch only those channels may then find a significant savings in their total bills from switching to a la carte, as well as a drop in the per-channel costs of the networks they watch.

- Contrary to the First Report's analysis, a la carte could make it easier for some networks to enter the market. Advertisers and MVPDs might find it easier to judge the value of smaller networks if consumers were able to express their interests through subscriptions.

- The First Report fails to analyze fully the difficulties and costs that industry commenters alleged MVPDs would incur in implementing a la carte. Most significantly, the First Report fails to examine any means by which implementation costs could be reduced, in particular, the potential reduction in implementation costs if a la carte were offered only for digital channels.

- The First Report fails to address the consumer benefits that offering programming a la carte could provide. Offering programming only in very large bundles as has been the past practice in the cable industry may fail to provide consumers the programming they desire. Consumers may find that they are purchasing programming that they do not watch and that programming that they find valuable is not offered under bundling. A la carte could be preferable to bundling in providing diverse programming responsive to consumer demand.

- In sum, many consumers could be better off under an a la carte model.

4. Section III of the Further Report explores three alternatives to bundling that have the potential to provide consumers economic benefits and additional choice. Given the on-going digital transition and the large number of consumers currently receiving their multi-channel programming digitally, as well as the expectation that implementation

costs could be reduced in a digital environment, the proposals focus on providing greater consumer choices for channels that already are transmitted digitally. In the first alternative, called "mixed bundling," MVPDs would provide all of the digital networks that they currently carry on an a la carte basis, in addition to providing any bundles they choose to offer.[7] Under the second alternative, MVPDs would introduce one or more additional tiers composed of channels that are currently being transmitted in digital format and that are related to a particular theme (such as family friendly programming), so-called "themed tiers." Pursuant to the third alternative, "subscriber-selected tiers," MVPDs would give consumers the option of buying a small or larger number of digital networks, where the consumers select the networks from among those available on the system. In the context of an increasingly competitive MVPD marketplace, presenting such options should help MVPDs compete for consumers, while enhancing overall consumer welfare.

II. ASSESSMENT OF FIRST REPORT'S ANALYSIS AND CONCLUSIONS

A. INTRODUCTION

5. The First Report relies on incomplete and incorrect analyses regarding the alleged costs and benefits of bundling as opposed to the potential costs and benefits of a la carte. A reexamination of the First Report indicates that many consumers could benefit from the ability to purchase network programming on an a la carte basis.

6. The First Report fails to examine critically industry allegations of potential economic harms from a la carte. Moreover, it does not investigate the appropriateness of various assumptions underlying the analysis provided by industry commenters. Much of this analysis, including a study conducted by Booz Allen Hamilton on behalf of an industry association, is based on assumptions that are not properly supported and that, in some cases, appear unreasonable. In addition, the Booz-Allen-Hamilton study contains

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[7] Under "mixed bundling," consumers can purchase programming networks either individually or as part of a bundle. In contrast, under "pure bundling," consumers can only purchase programming networks as part of a bundle, and under "pure a la carte," consumers can only purchase programming networks individually.

errors.[8] Further analysis raises questions about the predictions in the First Report that a la carte would produce increases in consumer bills and negatively affect networks and MVPDs. Moreover, the First Report appears to overstate the costs of implementing an a la carte regime, as it fails to consider adequately ways of minimizing such costs.

7. A more balanced analysis suggests that a la carte could produce many consumer benefits that the First Report fails to consider. A la carte may reduce consumers' prices, thereby potentially increasing demand for MVPD services. Moreover, under a la carte, production of programming may be both more economically efficient and more responsive to consumer demand.

B. IMPACT OF A LA CARTE ON THE PRICE OF PROGRAMMING

1. First Report Relies on Booz-Allen-Hamilton Study That Contains Errors and Relies on Unsupported Assumptions

8. Section II of the Economic Appendix to the First Report summarizes a study prepared by the management consulting firm Booz Allen Hamilton that models the likely outcomes if a la carte were introduced in some form. The First Report relies upon the study significantly to support the contention that a shift to a la carte would raise prices and reduce programming diversity.[9] As discussed below, the study contains mistakes and relies too heavily on untested assumptions, some of which appear unlikely to occur. Correcting solely for the mathematical mistakes in the Booz-Allen-Hamilton Study, even with their questionable assumptions, we find that consumers could be better off. Moreover, using a different set of assumptions, the results could be significantly different.

9. A critical limitation of the study is its reliance on projections without underlying data. Only the study's first step, which divides programming networks into segments like

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[8] As Booz Allen Hamilton subsequently stated: "We reviewed the July 2004 analysis in light of the Chairman's statement and found the following: To be consistent with the assumptions in our analysis, the anticipated charges for the basic tier of broadcast stations (which, under current law, must be purchased by all customers) should have been consistently removed from the calculation of the 'breakeven' number of cable channels that a customer could buy without seeing an increase in his or her bill." Letter from John Frelinghuysen, Vice President, Booz Allen Hamilton Inc., to Dr. Leslie Marx, Chief Economist, Federal Communications Commission (Dec. 16, 2005).

[9] *See* First Report at 26-27.

"general entertainment," "sports," and "news" is based on real-world data and econometric techniques, but the validity of this process is impossible to assess, because it is not described in any detail.[10] All further study results are simply illustrations of what might happen in a theoretical world, given the assumptions made. And many of those assumptions are based on interviews with parties opposed to a la carte whose responses may therefore be biased.

10. The calculations in the Booz-Allen-Hamilton Study do not consistently recognize differences among networks and network segments. They assume that under a la carte, consumers would be three times as likely to purchase programming in segments such as "general entertainment and sports" than in segments such as "emerging niche" and "emerging mass."[11] Thus, one might expect a la carte prices for different channels, especially channels in different segments, to be markedly different. However, the Study bases its analysis of how many channels a consumer could purchase on the average price per channel.[12] The Study neglects the fact that under a la carte, consumers could choose to purchase a large number of less expensive channels, or a small number of more expensive channels, to maximize the benefit they receive from cable television viewing. Furthermore, to the extent that there is a large degree of overlap in the choices consumers make, viewership of the most popular channels may increase. To see this, note that if a large percentage of consumers choose to purchase a channel, then the channel's subscriber base would be relatively unchanged, and with fewer alternative channels to surf through, we would expect consumers purchasing the channel to watch it with greater intensity.

11. The overall approach of the Booz-Allen-Hamilton Study is itself problematic. Briefly, the study assumes take rates under a la carte, predicting that the average

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[10] The Booz-Allen-Hamilton Study divided networks into different segments in order to examine different effects on different kinds of networks.

[11] Booz-Allen-Hamilton Study at 24.

[12] There is some inconsistency within the Booz-Allen-Hamilton Study on this point. For example, the Study states that "[o]perators would price channels at $4 to $5 each." Booz-Allen-Hamilton Study at 33. This conclusion is unsupported and contradicts other parts of the Study, which say that the "average price per channel for a la carte would be approximately $4 to $5. This represents the likely range for the average cable network." *Id.* at 6, 34.

consumer would purchase 11 cable channels, and estimates costs and prices based on that assumption.[13] From an economic perspective, it does not make sense to develop an assumption about the quantity demanded without regard to price and then to estimate prices based on that assumption. Instead, a standard approach to consumer behavior would take prices as fixed and estimate how much consumers would demand given those prices. Then, one could examine what prices would be chosen by profit-maximizing MVPDs, taking into account the consumer reaction to different possible prices.

12. The First Report relies on the Booz-Allen-Hamilton Study for its conclusion that the average household would likely face an increase in its monthly cable bills of 14% to 30% under a la carte.[14] The Booz-Allen-Hamilton Study, in fact, shows that the "applicable bill increase" is between -2% and +15%. That is, if it were not for the cost of set-top boxes, the Booz-Allen-Hamilton Study would show that monthly bills could decrease by as much as 2% as a result of a la carte.[15] Furthermore, although the Booz-Allen-Hamilton Study concludes that an average consumer would face a bill increase ranging from 14% to 30% under a la carte, correcting for the Study's mistake as described above, the Study's own assumptions show that a consumer purchasing 11 cable channels would face a change in his bill ranging from a 13% *decrease* to a 4% increase, with a decrease in 3 out of 4 cases.[16]

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[13] According to the Booz-Allen-Hamilton Study at 24, their assumptions on the maximum take rates for networks imply that an a la carte household would subscribe to 11 cable networks.

[14] The Booz-Allen-Hamilton Study assumes that cable operators would price a la carte offerings so as to maintain their earnings (EBITDA), which they claim are currently at 36%. Booz-Allen-Hamilton Study at 32. For example, the Study shows that cable providers' current earnings per subscriber are $22.70. *Id.* at 52.

[15] Booz-Allen-Hamilton Study at 54. If the switch to a la carte is only made for customers that already receive digital programming, and thus already pay for a set-top box, then it is inappropriate to associate the entire cost of a new set-top box with a la carte. *See infra* II.B.8.

[16] A General Accounting Office Report finds that it is "difficult to ascertain how many consumers would be better off and how many would be made worse off under an a la carte approach." *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8, at 6 (Oct. 2003). Despite this, the General Accounting Office notes that, "for subscribers who purchase only a few cable networks, rates would likely decline [] because they would only have to pay for the limited number of networks that they choose to purchase." GAO also notes that an a la carte approach would provide consumers with greater control over their cable choices, even if, on average, consumer bills did not decline." *Id.* at 36.

13. The First Report also relies on the Booz-Allen-Hamilton Study for its conclusion that consumers that purchase at least 9 networks would likely face an increase in their monthly bills.[17] First, note that the correct conclusion from the Booz-Allen-Hamilton Study is that a consumer that purchases 9 networks in addition to the broadcast stations would likely face an increase in his or her monthly bill. Assuming 6 broadcast stations, this implies that a consumer could receive 15 channels without seeing an increase in his monthly bill.[18]

14. Furthermore, there is a mistake in the Booz-Allen-Hamilton Study's calculations regarding the number of networks consumers can purchase without increasing their monthly bills.[19] When calculating the average price per a la carte channel, the Booz-Allen-Hamilton Study fails to net out the cost of broadcast basic stations.[20] When this mistake is corrected, the break-even number of a la carte channels is between 10 and 14, depending on which of the Booz-Allen-Hamilton assumptions one

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[17] First Report at 6.

[18] 92.2% of the population receives at least 6 full-power broadcast stations. BIA Financial Network, Inc., Media Access Pro Database, Nov. 18, 2005.

[19] Indeed, Booz Allen Hamilton even concedes that the cost of broadcast channels should have been "netted" out. Letter from John Frelinghuysen, Vice President, Booz Allen Hamilton Inc., to Dr. Leslie Marx, Chief Economist, Federal Communications Commission (Dec. 16, 2005).

[20] In particular, the Booz-Allen-Hamilton Study calculates as a subtotal the amount of the consumer bill related to the purchase of programming and then divides by the number of cable channels to obtain a price per channel. The correct calculation would subtract the cost of broadcast basic (assumed $15.00) from the subtotal before dividing by the assumed 11 a la carte cable channels. Booz-Allen-Hamilton Study at 54. To explain this mistaken calculation further, consider the following word problem: If basic cable (broadcast only) costs $15.00 and a consumer's total bill is $45.00 and the consumer receives 10 cable channels, what is the average cost per cable channel? The correct calculation would involve first calculating the total amount spent on cable programming, which is $45-$15 = $30, and then dividing by 10 channels to get $3.00 per channel. The mistake made by Booz-Allen-Hamilton is the equivalent of dividing the total bill of $45 by 10 channels to get an average cost of $4.50 per cable channel. Thus, the Booz-Allen-Hamilton Study estimates an average cost per cable channel under a la carte that is too high. Due to the mistake in the calculation of the average cost per channel, the Booz-Allen-Hamilton Study's estimates of the breakeven number of cable channels are incorrect. To continue with the above example, suppose we want to know how many cable channels a consumer could buy and still have his total cable bill be less than $45, assuming each channel is priced at the average price. Then, using our calculation above of $3.00 per channel, we see that a consumer could purchase 10 channels ($15+$3*10 = $45). However, if we use the Booz-Allen-Hamilton cost of $4.50 per channel, we find that a consumer could purchase only 6 channels without seeing an increase in the total bill (purchasing 7 would result in a bill of $15+$4.5*7 = $46.5, which is larger than the target of $45). So the calculation mistake causes Booz-Allen-Hamilton to underestimate the number of cable channels a consumer could purchase without seeing an increase in his bill.

adopts. Thus, even under the Booz-Allen-Hamilton assumptions, if there are 6 broadcast basic stations, then consumers could receive as many as 20 channels without seeing an increase in their monthly bills.

15. The Booz-Allen-Hamilton Study concludes that all networks would suffer from the imposition of a la carte for two reasons.[21] First, the study assumes that all networks would face increased marketing costs under a la carte, to gain subscribers to the network.[22] We note, however, that some larger, established networks might be able to rely on existing brand name and thus avoid increased marketing costs. Second, the study makes the questionable assumption of substantially reduced viewership, and therefore reduced advertising revenue, for all networks under a la carte.

16. The Booz-Allen-Hamilton Study assumes that program networks would lose at least 70% of their subscribers but would realize only a 10% increase in viewing from their remaining subscribers, with the implication that under pure a la carte there would be a 23% decrease in overall viewing.[23] In real terms both the Booz-Allen-Hamilton Study and the First Report assume that the average household would watch 2.07 fewer hours of television per day and 14.49 fewer hours of television per week if he were able to choose the channels he wanted to watch. Not only is there no support for such an assumption, but it seems unlikely that the average consumer would spend 2 hours more reading, listening to music, or working per day instead of watching television merely because he is no longer required to buy a particular channel of programming. For example, if a consumer regularly watches only 10 channels and under a la carte continues to subscribe to those 10 channels, one would not expect the time the consumer spends viewing video programming to change dramatically.

17. Based on its regression analysis, the study concludes that two of the most important factors that explain the variance in advertising rates across different segments of networks are the demographic composition of the audience and the degree of targeting,

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[21] *See* Booz-Allen-Hamilton Study at 22-29.

[22] Booz-Allen-Hamilton Study at 26-27.

[23] Booz-Allen-Hamilton Study, Figure 15, at 26.

meaning the degree to which programming on the network is targeted toward specific consumer interests. After so concluding, however, the study fails to consider those very factors in its subsequent analysis of the effects of a la carte on advertising revenues. If properly applied, the study's conclusions regarding advertising rates suggest that a la carte could lead to increased advertising on niche programming networks, particularly for products with narrow and well-defined demographics. Accordingly, it is not clear whether the niche networks will experience a net reduction of 10% to 20% in their ad revenues due to an a la carte provision, as claimed by the study.[24]

18. The Booz-Allen-Hamilton Study assumes that a la carte would reduce audience size for cable networks, thereby lowering per subscriber revenue from carriage fees and advertising for those networks and increasing costs for digital boxes and marketing. It suggests that MVPDs and programmers would seek to regain some (or all) of these revenues through increased fees and/or decreased costs if program demand for viewers and advertisers tended to be relatively price inelastic. However, the final effect on revenues for providers and subscription fees for consumers is unclear because it would depend on pricing and demand data that are unavailable.

19. Under the assumption of reduced revenue and increased costs for networks, the study compares two possible programming network responses to the implementation of a la carte: raising license fees and lowering programming expenses.[25] Even if per-subscriber license fees increased under a la carte, this might not have a large effect on consumers, because under a la carte consumers would only be paying for the networks they watch or plan to watch and would not have to pay for the networks they do not plan to watch.[26] Thus, under a la carte, the license fees could be charged for people who

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[24] Booz-Allen-Hamilton Study at 26-27.

[25] Booz-Allen-Hamilton Study at 29.

[26] For example, if a consumer receives 5 channels in a bundle and watches only one of them, all five networks are getting license fees for that consumer. Under a la carte only the channel the consumer watches will get a license fee. Even if that channel doubles or triples its license fee under a la carte, the consumer would still be paying less to watch that channel than was paid under bundling. Thus under a la carte the price paid per channel *watched* could significantly decline, even as the price paid per channel *received* rises. Moreover, any increases in license fees for channels that are actually watched would allow those channels to cover more programming costs and so could lead to increases in quality.

subscribe to the particular network, and therefore are presumably more likely to watch the network, while under bundling they are charged for people to have the network available.[27] Similarly, as discussed elsewhere, smaller networks that are not currently reported on by Nielsen Media Research ("Nielsen") might be able to increase advertising revenue, because a la carte sales would be a strong, if indirect, indication of actual viewers.[28] Currently, many networks, especially smaller ones, simply report subscribership to the tiers on which they are carried, and purchasers of advertising may wonder if anyone at all is watching.

20. In addition, even if the study were correct in its contention that under the increased license fee scenario, the average price per a la carte channel would be approximately $4 to $5,[29] it is not clear that this is significantly different or worse than the current environment, as it is difficult to ascertain the "price" of a particular channel in a bundled environment. For example, assume that a consumer pays $55, $15 of which is for broadcast channels, and receives 75 non-broadcast channels (i.e., $0.53 per channel), but that the consumer watches only 10 of those non-broadcast channels. This amounts to a per channel rate of $4, a rate not unlike the per-channel rate that the Booz-Allen-Hamilton Study contends would be charged under a la carte.

21. The Booz-Allen-Hamilton scenario of lower programming expenses suggests the possibility that programmers would reduce quality under a la carte. However, the nature of the programming industry undermines the idea that programmers would react in this way. Given that substantial sunk costs are present in the industry, under certain conditions, sellers have incentive to compete on quality and may even engage in a race for dominance, in which all invest in quality with one or two survivors. In the programming industry, evidence of this kind of competition is already present within programming niches. For example, in the sports category, ESPN has long been recognized as the dominant player. Still, both Time Warner and Fox attempted to enter

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[27] *See infra* II.B.4.

[28] *See infra* II.B.4.

[29] Booz-Allen-Hamilton Study at 7. Note that if one corrects for the math error described above, the average cost per channel would range from $2.54 to $3.37.

the national sports network market, more specifically, Time Warner by launching CNN/Sports Illustrated in December 1996 and News Corporation by acquiring a group of regional sports networks and redirecting a portion of their programming toward national sports. ESPN did not respond by slashing prices, but instead by spending heavily on exclusive sports rights (such as the National Football League and Major League Baseball) and original programming. Despite the backing of large corporations, strong brand names, and a guaranteed distribution system, neither new sports network was able to survive. Similar examples can be found in financial news (where CNBC is dominant) and programming aimed at women (where Lifetime is dominant).

22. While it is possible that some networks would react to a la carte by reducing quality, it is also possible that other networks would react to a la carte by increasing quality. For example, if a la carte does not cause a significant decline in viewership, but does cause shifts in viewing so that viewership for some networks increases, then these networks would expect increases in revenue that could be used to improve quality. In addition, if a la carte results in more competition among networks for subscribers, then one outcome of this increased competition could be higher quality offerings from the networks. Finally, under a la carte, consumers could cancel their subscriptions to networks whose offerings do not provide them with sufficient value, which could create an environment in which networks are more responsive to consumer preferences in terms of the content, quality, and consistency of their programming.

23. In general, contrary to the overly broad conclusions stated in the Booz-Allen-Hamilton Study, while some networks may suffer from a la carte, others may benefit. Indeed if overall television watching does not decrease under a la carte, if one programmer is "harmed" by not being selected, the programmer that is selected is "helped" to the same degree. It may be the case for many networks that their true value to consumers is hidden because they are bundled with other networks and they lack a means to extract that value by selling directly to consumers. A la carte would allow these networks to increase revenue, both from license fees and from advertising, by more directly interacting with their ultimate audience, viewers.

2. First Report Understates Benefits of A La Carte and Harms of Bundling

24. Generally, the text of the First Report lacks in-depth independent economic analysis, tending to rely instead on assertions of industry commenters. Almost all of the economic analysis relied upon in the First Report is placed in the Economic Appendix, which is the focus of much of the discussion below.

25. Specifically, the First Report's analysis does not provide a balanced view of the consequences of implementing a la carte. It fails to consider fully or to appreciate the benefits that consumers could gain from a la carte, including reduced programming bills.

26. The First Report neglects the discussion in the economics literature concerning when bundling causes harm to consumers and to social welfare. For example, results in the economics literature show that a change from bundled pricing to a la carte may either increase or decrease economic efficiency,[30] depending on the environment, but the Economic Appendix of the First Report provides only an example in which a la carte decreases economic efficiency. The Economic Appendix of this Report presents a number of examples in which a la carte increases economic efficiency relative to bundling.

27. In its analysis of bundling, the economics literature typically compares three different regimes for selling goods, in which goods are sold either strictly in a bundle, strictly individually, or both individually and in a bundle.[31] In the retail MVPD market, these alternatives correspond to consumers purchasing programming networks either strictly as part of a bundle ("pure bundling"), individually ("pure a la carte"), or with the choice of buying either bundles or individual channels ("mixed bundling"). As pointed out in the First Report, economists have posited that firms choose to sell their goods in bundles, as opposed to selling them individually, for the following reasons: (1) as a

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[30] *See, e.g.*, Barry Nalebuff, *Bundling, Tying, and Portfolio Effects: Part 1 – Conceptual Issues*, DTI Economics Paper No. 1, February 2003 (available at http://www.dti.gov.uk/economics/paper1-nalebuff-p1.pdf); Dennis W. Carlton & Jeffrey Perloff, *Modern Industrial Organization*, 289-90 (3rd ed. 2000) ("Carlton & Perloff"); W.J. Adams and Janet L. Yellen, *Commodity Bundling and the Burden of Monopoly*, 90 Quarterly Journal of Economics 475-498 (Aug. 1976) ("Adams & Yellen").

[31] These are usually referred to as "pure bundling," "pure components," and "mixed bundling" strategies, respectively. *See* Adams & Yellen at 475-498

means of price discrimination (rather than charging a single price for each good, the bundle price incorporates the fact that some consumers value some goods more than others do); (2) as a means of reducing production costs (due to economies of scale and economies of scope), reducing transaction and information costs, and improving quality; and (3) as a strategic device for deterring entry of new competitors.[32] Most of the literature focuses on the price discrimination explanation for bundling and why bundling can increase profits for firms in a variety of circumstances.

28. The First Report focuses its economic analysis on the comparison of pure bundling with pure a la carte. The First Report relies on two key economic theories to support its contention that bundling is welfare-enhancing: (1) the non-rivalrous nature of the consumption of programming; and (2) the use of bundling as a means of price discrimination. Careful consideration shows that neither of these theories leads to the First Report's conclusions.

29. First, the First Report claims that bundling is more efficient than a la carte, because the consumption of programming is non-rivalrous. That is, once programming has been produced, everyone can watch it without diminishing others' ability to watch it.[33] While the First Report is correct that efficiency is increased if programming with a positive value is distributed more widely, since this can be done at close to zero marginal cost, it is not correct that pure bundling will better achieve this result than pure a la carte or mixed bundling. As demonstrated below, sales of some desirable networks could be greater under a la carte than under bundling. Moreover, the First Report ignores the impact of such a mechanism on the amount of programming that is produced; i.e., it assumes that because programming is produced it should be widely distributed, without considering whether the appropriate amount of programming is produced.

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[32] First Report at 83-87; *see also* Adams & Yellen; Barry Nalebuff, *Bundling, Tying, and Portfolio Effects: Part 1 – Conceptual Issues*, DTI Economics Paper No. 1, February 2003 (available at http://www.dti.gov.uk/economics/paper1-nalebuff-p1.pdf).

[33] Information goods almost always tend to exhibit this quality, in contrast to physical goods, which tend to have rivalrous consumption. One person's purchase of a car, for example, prevents others from consuming that good.

30. Second, the First Report touts the benefits derived from bundling as an improved means of price discrimination.[34] The First Report explains that bundling permits MVPDs to recover a larger portion of the cost of a given network from customers who value that network more highly and a lower portion from customers who value it less highly. The First Report contends that such price discrimination facilitates the MVPDs' ability to generate sufficient revenue to cover the cost of offering the networks that consumers want, thereby enhancing welfare.[35] As the economics literature indicates, however, it is unclear whether *consumers and society* are better off with the use of price discrimination schemes (like bundling of programming) than with the use of single market prices (like offering programming a la carte).[36] Indeed, that literature discusses the potential problems caused by bundling,[37] in some cases finding that bundling can be bad for consumers[38] and can create greater inefficiency than a la carte.[39]

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[34] The economics literature says that firms gain increased revenue from bundling compared to a pure components approach because customer valuations of a bundle of goods are more homogenous, either because they are negatively correlated (so customers with low values of one good have a high value for another) or because the effective dispersion of values is smaller for a bundle of goods than for the individual goods (assuming the valuations are not perfectly correlated), due to statistical averaging. Richard Schmalensee, *Gaussian Demand and Commodity Bundling*, Journal of Business, S211-46, (January 1984) ("Schmalensee 1984"); Yannis Bakos & Eric Brynjolfsson, *Bundling Information Goods: Pricing, Profits, and Efficiency,* Management Science, 1613-30 (Dec. 1999) ("Bakos & Brynjolfsson 1999"); Yannis Bakos & Erik Brynjolfsson, *Bundling and Competition on the Internet*, Marketing Science, Vol. 19(1), 63-82 (2000) ("Bakos & Brynjolfsson 2000").

[35] As discussed below, such price discrimination also allows the MVPDs to extract greater profits from their customers.

[36] *See, e.g.*, Carlton & Perloff at 289-90; Adams & Yellen at 490-95. There is one notable exception to this finding of ambiguous results – economic theory says that perfect price discrimination (charging exactly each consumer's valuation of a good) maximizes social welfare, but yields zero consumer surplus. Perfect price discrimination, however, is generally considered to be unobtainable since it requires that different prices be charged to each consumer, with those prices tailored to each consumer's individual preferences.

[37] Doubts about bundling's impact on efficiency are well known in the literature. *See, e.g.*, Steven S. Wildman and Bruce M. Owen, *Program Competition, Diversity, and Multichannel Bundling in New Video Industry*, in Video Media Competition, 258 (Eli Noam ed., 1985).

[38] Using certain assumptions, Schmalensee found in his model that bundling is usually bad for buyers. Schmalensee 1984.

[39] In their seminal paper, Adams and Yellen argued that bundling can create both allocative inefficiency (whether the right quantity of the good is produced) and distributive inefficiency (whether the good is distributed to those consumers that value it most highly). They also determined that the deadweight loss from bundling (which is a measure of inefficiency used by economists) could be higher than the loss associated with simple a la carte by a monopolist. Adams & Yellen at 490-95.

31. Therefore, the First Report's economic arguments are incomplete and thus misleading or at least do not paint a complete picture of whether bundling programming networks is in consumers' and society's best interest. To assess the desirability of switching to a la carte properly, one must also consider the potential harms that bundling may cause. Specifically, as discussed below, bundling may raise consumers' programming costs and provide consumers with programming packages less valuable to them than those they could purchase under a la carte. For many consumers, these harms could outweigh any benefits gained from bundling.

32. As discussed below, bundling can cause harm in two basic ways. First, bundling is a means of price discrimination, so it can reduce consumer surplus and cause consumers to purchase fewer services.[40] Second, an MVPD determines which networks to carry based on how much each network adds to the profit from its bundles, either by raising the bundle's price or increasing the MVPD's subscription base. The incremental revenue gain from adding a network is only imperfectly related to its value to consumers. Thus, the use of pure bundling may give MVPDs an incentive not to carry some valuable and desirable programming, while making other less valuable programming profitable to carry.

3. First Report Overstates Costs of A La Carte

33. The First Report's conclusion that total consumer payments for multichannel video programming service will rise under a la carte is suspect. A more careful and balanced analysis shows that many consumers' video programming bills could decrease under a la carte. Indeed, providing a la carte would give all consumers an opportunity to lower their video programming bills. There are three reasons why the First Report erred in concluding that bundling likely would lower prices to consumers.[41] First, the First Report overstates the cost savings that bundling may provide. Second, the First Report

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[40] Consumer surplus is the difference between a buyer's personal use value of the good purchased and the price at which the good is purchased or, in other words, the benefit an individual (or, summed across all individuals, the total consumer benefit) gains from purchasing a good.

[41] *See* First Report at 6.

discounts bundling's potential to inflate programming prices. Third, the First Report overstates the complexity associated with a la carte.

34. First, the First Report overstates the cost savings benefits that bundling may provide.[42] It concludes that bundling keeps the per-channel cost of MVPD service down, because it allows sellers to take advantage of scale and scope economies and keep average costs down.[43] It asserts that since there are fixed costs in providing MVPD service, and consumers will likely receive more channels under bundling than under a la carte, bundles will likely have lower per-channel costs than a la carte purchases of channels.

35. In reaching these conclusions, the First Report focuses inappropriately on the per-channel cost of networks received, rather than the costs that are likely more important to consumers -- the per-channel cost of networks *watched* and the total video programming bill.[44] Although bundling could allow MVPDs to spread the fixed distribution costs over more channels, such cost spreading does not necessarily benefit those consumers who do not want the extra channels to begin with. Some consumers would prefer to buy fewer channels even with slightly higher average distribution costs

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[42] First Report at 22-23. The First Report uses an inappropriate analogy to the newspaper business to analyze the alleged cost-savings generated by bundling. The First Report indicates three reasons why a newspaper is sold as a bundled product: "(1) ... the economies of having all sections delivered at once rather than having separate distribution mechanisms for each section; (2) ... the value to subscribers of having the option to look at all of the sections, even if they do not read all sections every day; and (3) ... the efficiencies for advertisers who prefer paying a single price to reach all of the newspaper's readers with a single advertisement." First Report at 22. Of the three reasons for newspapers to be sold as bundled products, the first and third points do not translate to the video programming world. On point (1): the economies of having all sections delivered at once would be available to a la carte customers, since they would be getting all of their service from the MVPD. On point (3): the bundle does not make it easier for an advertiser to reach many subscribers, compared to a la carte. Only the second point could apply, that some customers may like having the option of looking at all the sections of the newspaper, or for video programming, having the ability to watch a different channel when they feel like it. Moreover, while it is true that some subscribers may value having the option to look at all the sections, even if they do not read them every day, the analogy is incomplete for another reason. Newspaper readers have the option of receiving the newspaper only on days when they want to read more sections. For example, they could subscribe only to the New York Times Sunday edition. No such option is available to the cable subscribers.

[43] First Report at 22-23.

[44] As noted previously, based on a 2000 Nielsen Report, a 2003 Government Accountability Office report concluded that "households receiving more than 70 networks only watch, on average, about 17 of these networks." *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8, at 31 (Oct. 2003).

factored in. If consumers do not watch the extra channels, then the addition of those channels would actually raise the per-channel cost of networks watched, thus making consumers worse off.

36. In this regard, another way to provide increased consumer choice would be for cable providers to continue to bundle, but then to reimburse consumers for any channels the consumers choose to have blocked. Under that approach, cable operators would presumably set prices in such a way that they continue to cover their fixed costs. If such an option were available, additional consumers might choose to subscribe to cable, potentially increasing cable operators' revenues.

37. Second, the First Report provides little analysis of how bundling may inflate prices charged to consumers. Since bundling is a means of price discrimination, it enables MVPDs to extract consumer surplus better than does a la carte. The economic analysis of pricing provided in the First Report's Appendix focuses on the need to cover the cost of the networks provided and says little about how bundling might increase prices to consumers.[45]

38. The First Report characterizes bundling as valuable because it allows MVPDs to extract additional surplus that can be used to cover programming costs.[46] But this ignores the primary role of bundling, which is to extract surplus to enhance profits, and it also ignores the fact that bundling may allow MVPDs to extract so much surplus that they have an incentive to carry programming that is so costly to produce that its cost is greater than the total value to consumers of that programming.[47] Thus, the cross-subsidization that the First Report portrays as a valuable feature of bundling[48] can actually be harmful to consumers and society.[49]

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[45] First Report at 84-86.

[46] *See* First Report at 84-85.

[47] *See infra* II.C.2.

[48] *See* First Report at 5.

[49] In addition, bundling creates the additional harm of putting some consumers in the position of having to pay for programming that they do not value in order to receive programming they do value.

39. Careful analysis shows that prices for video programming service could be lower under a la carte than under bundling. As an example, one need only reconsider an example in the Economic Appendix to the First Report.[50] That example illustrates that *under certain conditions* bundling is better at covering the cost of networks and providing consumer benefits. These benefits, however, do not hold under all conditions, as demonstrated by making just a small change to the original example (changing the value of the networks to the consumers), as is done in Example 1 in the appendix to this Report.[51]

40. As Example 1 demonstrates, pure a la carte can yield lower prices for consumers than bundling, while still generating sufficient revenue to cover network costs. In this example, the bundled price is higher than the total price of the individual items in the bundle priced under a la carte, because bundling enables the MVPD to extract more revenues from consumers than it could using a la carte.[52] The example demonstrates that bundled prices may be inflated above cost, since bundling often enables MVPDs to extract consumer surplus better than a la carte does. Therefore, under bundling, some consumers pay more than they would under pure a la carte without getting more service.

41. As the second part of Example 1 demonstrates, the high price of bundled networks can also preclude some consumers who might otherwise do so from purchasing programming. Some consumers who do not want to pay the bundle price might be willing to purchase a few channels at a lesser total price. That is, bundling can raise prices sufficiently to drive some consumers out of the market. Making networks available a la carte can lower the price of MVPD service and thereby increase consumer purchases of programming networks.[53]

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[50] First Report at 82-83.

[51] *See infra* Economic Appendix B.1.

[52] Note that there is no assurance that the higher rates paid under bundling will be passed through to the networks, particularly if the market for programming is competitive and networks lack market power.

[53] With mixed bundling, which provides both a la carte and bundled options, consumers could still take advantage of the lower average per-channel costs by buying the bundle, if that is their preference. On the other hand, they would also have the option of buying only a few channels, potentially limiting their total bill.

42. The First Report also argues that bundling promotes fiercer competition between MVPDs, thereby yielding lower prices for consumers. To support this contention, the First Report inappropriately relies on research by two economists, Yannis Bakos and Erik Brynjolfsson, who found that two competing firms with large bundles of information goods (i.e., goods with non-rivalrous consumption) will have lower prices than firms competing with a la carte sales of the same goods.[54] Their research assumes, however, that all consumers are alike in the sense that their values for the component products can be viewed as random draws from the same range of possible values,[55] an assumption that does not ring true with regard to video programming bundles. Their assumptions about the workings of the marketplace also differ from the retail video programming market. In their paper, competition between the two suppliers in their model results in prices such that all consumers buy bundles from both suppliers.[56] Clearly, this type of competition does not exist in the retail video programming market, in which prices have generally been rising at a rate faster than inflation, and few consumers buy video programming from more than one MVPD.

43. Finally, the First Report notes that a la carte choice might be too confusing for consumers because of the large number of options available and the complexity of the bills received, thereby imposing another potential cost on consumers.[57] Further consideration suggests that the First Report overstates the issue. Many consumers in other contexts are able to choose from a large variety of choices without undue confusion or frustration. And the MVPD consumer need make a simple yes or no decision on each channel only once. Moreover, nothing would prevent MVPDs from suggesting coherent combinations of channels to their customers.[58]

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[54] First Report at 23; Bakos & Brynjolfsson 2000.

[55] As noted in Bakos & Brynjolfsson 1999 at 1623, their results depend on sellers being better able to predict consumer demand by bundling more goods together. They assume that demand for each good is random, and thus bundling reduces the dispersion of values.

[56] Bakos & Brynjolfsson 2000 at 70-74.

[57] First Report at 22, 40-42.

[58] With mixed bundling, consumers would also have the simple option of buying a large bundle.

4. First Report Incorrectly Assesses Impact on Advertising Revenues

44. As described in the First Report, the costs of production of most cable programming networks are recovered from two sources of revenues: (1) network advertising; and (2) license fees paid by MVPDs for the right to distribute the network programming to subscribers.[59] Ultimately, both revenue streams are dependent on the number of subscribers who view the network. The First Report's analysis of the impact of introducing additional choice through a la carte took a pessimistic view of the associated costs and likely consumer responses.[60] Industry commenters projected significant drops in audience share, as well as in advertising revenues and license fees, for programming networks. Many of these projections, however, were based on unproven assumptions about the reactions of consumers to new options.[61] The First Report's analysis of the impact of a la carte on network entry and funding contains conceptual errors and faulty assumptions that are re-examined below.[62]

45. As stated above, the Booz-Allen-Hamilton Study, on which the First Report relied, predicts a la carte would cause consumers to view almost 25% less television and states that the average household watches on average 9 hours a day.[63] Thus, the Study assumes, without any basis, that a shift to a la carte would cause the average household to watch more than 2 hours less television per day or almost 15 hours less per week. While the First Report predicts substantial drops in audience shares following the introduction of a la carte, this is not the only possible response. There is little reason to believe that, given enhanced choice, consumers would watch video programming less than they do today, although they may make some changes in what they watch. If this is the consumer reaction, there would be little if any change in overall audience levels. In the absence of a change in audience levels, significant decreases in the advertising revenues of program networks are less likely.

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[59] First Report at 89.

[60] First Report at 45-51.

[61] *See supra* at II.B.1 (discussing assumptions regarding viewership in the Booz-Allen-Hamilton Study).

[62] *See* First Report at 42-56.

[63] *See* Booz-Allen-Hamilton Report at 14.

46. As described in the First Report, a program network's revenue from advertising is based on the rate of service it can charge advertisers, which depends on the number of actual and potential viewers it has.[64] The ability of Nielsen to measure actual viewers ("reach") would not be affected by a change from bundling to a la carte. The number of potential viewers would change from the number of consumers choosing to purchase the bundle in which the network was included to the number of consumers choosing to purchase the network on an a la carte basis, which is arguably a better measure of the number of consumers who are likely to watch the network's programming, as it reflects a more affirmative decision by the consumer that he or she will view the channel. Thus, one would expect a move to a la carte to reduce advertisers' uncertainty regarding how many consumers their advertisements are actually reaching.

47. As the First Report notes, Nielsen does not rate smaller networks.[65] The First Report asserts that small, new, or independent networks may find it harder to attract advertisers if they are not in bundles, because a la carte distribution will reduce their potential viewership.[66] Although industry participants affirm that advertisers pay a premium to have access to a potentially larger audience through expanded circulation among consumers who rarely tune to that channel, ultimately advertisers pay to reach actual audiences, not potential audiences. If bundling adds many people to the distribution of a network who do not watch the network, then it is unlikely that this will significantly augment the network's advertising income.

48. Advertisers likely rely on a network's potential viewership today for determining their ad buys because they lack other measures to indicate the number of viewers the channel might actually have. Thus, advertisers might be more willing to buy ads on new networks with proof of popularity, such as strong a la carte sales, than they would on new networks that have achieved wide distribution but possibly few viewers. Distribution indicates only the cable operator's guess about a network's likely popularity

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[64] First Report at 43.

[65] First Report at 43 (noting that "Nielsen only provides ratings for 59 of the over 300 national program networks").

[66] First Report at 43-47.

and the value it adds to the bundle, not its actual success with viewers.[67] A la carte reflects the viewer's guess about the likelihood of watching a channel, at least as accurate a prediction of likely viewership.

49. In addition, while the First Report focuses on a possible negative impact of a la carte on smaller networks, highly valued networks may find an increase in revenues under a la carte. As discussed below, a la carte could weed out those networks that consumers value at less than the networks' costs, thereby shifting some viewers to more valuable networks.[68] As a result of this shift, more valuable networks' ratings might rise, which could lead to additional revenues for those networks.

5. First Report Presents Incomplete Analysis of License Fees

50. The First Report contains a number of assumptions in its analysis of the license fees that networks are likely to collect under a la carte.[69] While many networks would likely experience a reduction in revenues without the superior revenue-generating capability of bundling, that loss may not be as deep as is implied. In addition, some networks could actually increase their revenue in an a la carte world.

51. The First Report's analysis of the impact of a la carte on license fees rests on the assumption that advertising revenues will decrease and license fees will have to increase to compensate.[70] As discussed above, advertising revenues would not necessarily

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[67] The First Report's assertion that networks need distribution on popular tiers to get reliable counts of subscribers is puzzling, because this distribution does not indicate viewership. Subscribership to a channel under a la carte (or any plan with smaller tiers) would provide a much more reliable indicator of viewership than inclusion in a broad bundle. People who have chosen to pay for a particular channel are much more likely to watch it. *See* First Report at 44.

[68] *See infra* II.C.2.

[69] *See* First Report at 47-48.

[70] The First Report states that "[t]o make up the loss in advertising revenue, a program network will have to increase its license fee, which will, in turn, increase the cost of programming to cable and DBS subscribers." First Report at 47. This is directly counter to "Response B" of the Booz-Allen-Hamilton Study, which assumes that "operators hold affiliate fees constant despite the pressures on networks." Booz-Allen-Hamilton Study at 22. The Booz-Allen-Hamilton Study also states that "[w]e recognize that most networks or operators would likely respond somewhere in between these two extremes." Booz-Allen-Hamilton Study at 22. Thus, even the Booz-Allen-Hamilton Study, upon which the First Report relies so heavily, would characterize the statement in the First Report that networks would have to make up any lost advertising revenue with increased license fees as extreme.

decrease, unless the actual, as opposed to potential, number of viewers decreases. New, small networks that may demonstrate their popularity through a la carte sales could also be better able to attract advertising revenues.

52. While license fees are established on a fixed-rate "per subscriber" basis, this rate varies according to the importance of the network to the MVPD's subscriber base and to the revenues gained from its bundle. In general, the total payment to the network should depend on its value to those consumers who are willing to pay the MVPD to be able to watch the network. Thus, if a network with a small dedicated (and well-paying) audience were removed from a bundle and made available on an a la carte basis instead, it might be able to generate almost the same revenue, through a higher per-subscriber license fee. [71]

6. First Report Presents Inadequate Analysis of Marketing Costs

53. The First Report provides inadequate analysis of industry allegations that marketing costs would increase dramatically in an a la carte regime, thereby deterring entry. It fails to consider adequately industry assertions regarding the size of these added costs and whether networks could find alternative means to market themselves in a pure a la carte or mixed bundling world.

54. Specifically, the First Report notes the importance of channel surfing as an inexpensive means of advertising a new network.[72] As the First Report acknowledges, however, a study by the Cable and Telecommunications Association for Marketing found that less than half of viewers find new channels through channel surfing.[73] If less than half of viewers "surf" for new channels, by implication, networks today have to find ways to advertise their programming to the remaining MVPD viewers. So, networks are already confronting the problem of marketing themselves to non-surfers, even with bundling.

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[71] To maximize distribution, such networks could even offer themselves for free and rely exclusively on advertising revenues, just as broadcasting networks did prior to the introduction of cable.

[72] First Report at 14-15, 48-50.

[73] *See* First Report at 15.

55. If indeed surfers place a higher value on getting a bundle than non-surfers, they could benefit from the sort of mixed bundling regimes explored in Section III of this Report. Under this scenario, switching to mixed bundling from pure bundling might not affect networks' ability to market to surfers and non-surfers nearly as much as the First Report suggests.

56. Finally, networks would likely find new ways to market were some form of increased consumer choice allowed. While having to solicit subscribers directly could raise networks' marketing and advertising expenses, countless products in numerous markets manage to establish one-on-one relationships with consumers. New networks could successfully enter by finding an underserved niche that is eager for their programming[74] or providing original high-quality programming.

7. First Report Ignores Benefits of A La Carte for Niche Networks

57. The First Report mentions but fails to discuss at any length the Urban Broadcasting Company's ("UBC") assertion that a la carte would benefit networks with smaller audiences trying to enter the market, such as a minority network like itself. As shown below,[75] networks with small, dedicated audiences may not be appealing to MVPDs providing bundles, because they may not generate enough revenue to MVPDs to be profitable to carry. But the dedicated audience of such a network may be willing to pay sufficient fees to more than cover the network's costs, in a manner similar to how premium networks and pay-per-view programs support themselves. As the UBC states, an a la carte regime could make it easier for niche networks to gain carriage, because they could demonstrate their popularity with the public through a la carte sales.[76] Under a la

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[74] Marketing to special niches can be cheaper and easier. Echostar argues that micromarketing to niches is replacing mass marketing. First Report at 47.

[75] *See infra* II.C.2.

[76] UBC argues that minority viewers are currently underserved and that a la carte would change this. UBC's Comments state: "Fortunately, a la carte could open up the cable industry to minority cable television networks, such as UBC. If consumers were able to purchase minority cable television networks on an a la carte basis, cable carriers would have no excuse not to enter into carriage deals with minority cable television networks. Currently, cable carriers claim that they do not enter into such deals, because ... too many consumers are not willing to pay for minority cable networks to be added to their cable packages. This would not be an issue if minority cable television networks were offered on an a la carte basis,

carte, the network's success would depend on what the audience will pay just for that network, rather than what additional revenue the bundle generates from adding the network.

8. First Report Fails to Consider Ways to Mitigate Implementation Costs

58. The First Report correctly points out that a la carte would not benefit consumers if the costs of implementation were so high that MVPDs were forced to raise rates significantly.[77] The First Report alleges that implementing some kind of a la carte (either pure or mixed) would significantly increase operational expenses. It further contends that these increased costs would substantially raise subscription fees for all MVPD customers.[78] The First Report fails, however, to take into account any means by which the implementation costs could be reduced, in particular the potential reduction in implementation costs if a la carte were offered only for digital channels.

59. The costs of implementing additional consumer choice are generally analyzed in the First Report and the Booz-Allen-Hamilton study based on the historical model of how cable services have been distributed. It is assumed that cable operators would either have to: (1) deploy equipment (such as traps that block signals or set-top boxes to descramble channels) that can block analog channels that consumers do not purchase; (2) convert their systems to full digital transmission; or (3) simulcast their current analog offerings in a digital format and require customers who want to purchase a la carte service to receive digital service. Since industry considered the first option to be prohibitively expensive, the analysis focused on the latter two options, which would require consumers currently receiving analog service but desiring a la carte to purchase a digital set-top box.[79] The Booz-Allen-Hamilton Study assumed the second option would be used for pure a la carte and the third option for mixed bundling and themed tiers.[80]

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because then only consumers who want minority cable networks would have to pay for them." UBC Comments in MB Docket No. 04-207 at 2 ("UBC Comments").

[77] First Report at 27-33, 38-42.

[78] First Report at 27-33, 38-42, 95.

[79] First Report at 27-31, 39-41, 93-94.

[80] First Report at 94.

60. The cost of switching to full digital transmission accounted for a substantial share of the financial burden on MVPDs that was forecast to be passed on to consumers. Digital set-top boxes constituted 71% to 80% of the projected increased costs of cable operators to implement pure a la carte, excluding the possible rise in license fees that networks demand, the size of which this Report has already questioned.[81] The Booz-Allen-Hamilton study claimed that the cost of adding set-top boxes would raise consumers' bills by about 15.7%.[82]

61. Offering some form of additional consumer choice only for those channels that are carried in a digital format could reduce the extensive equipment costs hypothesized in the First Report. Presumably, in such a scenario, the MVPD would not have to simulcast its analog channels in a digital format and would not have to provide set-top boxes to all consumers immediately. In any event, cable's transition to digital is occurring independently of any a la carte options, in conjunction with broadcasters' digital transition, which is mandated by statute.[83] Thus, the cable industry's transition costs should not be regarded as attributable to the offering of greater consumer choice.[84]

62. While limiting the roll-out of additional consumer choice to the digital realm would reduce the immediate benefits of the change for those customers receiving analog service, there are many consumers who already take digital service and could benefit from the availability of a la carte. Other consumers would reap the benefits of expanded choice as the transition to digital progresses.

63. Moreover, limiting a la carte to the digital realm could have some useful consequences beyond reducing infrastructure costs. Because much of the cable industry's equipment and institutional structure will likely be redesigned in the next few years, the digital transition provides a window of opportunity for implementing increased

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[81] First Report at 95.

[82] Booz-Allen-Hamilton Study at 6, Figure 1, under Response B (Networks Reduce Programming Expense), A La Carte option, Scenario 1 (pure a la carte scenario).

[83] *See* 47 U.S.C. 309(j)(14).

[84] A la carte implementation costs would no doubt vary across cable systems and need further study. In addition, the cost of implementing a la carte for DBS, an industry using different technology than cable, merits further exploration. Echostar states it could implement a la carte now.

consumer choice. Phasing in new options as these changes occur should allow industry participants, as well as consumers, to adjust to these new realities and limit possible disruptions.

64. Additionally, enhancing choice for digital subscribers is likely to prompt some analog subscribers to switch to digital service, thus potentially quickening the pace of the transition.

C. IMPACT OF A LA CARTE ON PROGRAMMING DIVERSITY

1. Introduction

65. A la carte could be preferable to bundling in providing diverse programming responsive to consumer demand. The First Report implies that bundling gives consumers the programming they desire when it argues that "bundling does not force consumers to pay for programming they do not want."[85] Since no one alleges that consumers are being forced to buy bundles for more than they value them, this argument is a straw man. As the First Report notes, in a free market economy consumers will not purchase goods if the price exceeds the value they place on it.[86] The relevant question concerns not whether consumers are paying for bundles in excess of the bundles' value, but rather whether consumers would prefer the service they could get under a la carte. If bundling, as compared to a la carte, causes consumers to pay more or prevents customers from getting the programming they want, then bundling has made them worse off.

66. To maximize revenue under pure bundling, MVPDs carry networks that either: (1) allow them to raise the price of the bundle; or (2) add to subscribership. This means that the networks that have value to consumers will not always get carriage under pure bundling for two reasons. First, because their goal is to maximize the price and sales of the bundle, there are many circumstances when MVPDs will have an incentive not to provide the networks preferred by some consumers. For example, some mainstream networks may not be added because, unlike niche networks, they do not increase

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[85] First Report at 23, 85-86.

[86] First Report at 85.

subscribership.[87] Second, bundling can obscure signals regarding consumer valuation of individual networks. Under bundling, consumers provide no information about which networks they like best; while under a la carte, consumers' interest in a network can be measured by its a la carte sales. Thus, it is more difficult to ascertain the relative value of networks under bundling, especially for smaller networks that have no published ratings. The analysis below considers how these factors can affect the availability of diverse programming responsive to consumer demand.

2. Bundling Distorts Incentives to Carry Networks

67. Bundling may create incentives for MVPDs to include or exclude programming in a manner inconsistent with consumer preference. The First Report assumes that MVPDs will want to carry networks that are preferred by consumers. Because their goal is not to maximize sales of an individual network, but instead to maximize the revenue gained from the bundle, there are circumstances in which MVPDs will not carry the most desired networks. Indeed, consumers may be disappointed with the programming they receive in bundled packages either because it includes programming they find without sufficient value to justify its cost or because it excludes valued networks.

68. First, MVPDs that bundle may find it profitable to include content that some consumers do not watch, potentially forcing those consumers to pay more than they would under a la carte. The First Report takes the view that since programming is non-rivalrous in consumption, it is desirable to distribute all available programming to the largest possible viewing audience.[88] This ignores the possibility that some consumers might find some programming to be without value, so that they would prefer not to pay for the programming as part of the bundle price. Yet, bundling of such programming networks may be profitable to MVPDs, even though some consumers do not watch it.

69. It can be profitable to include networks that particular consumers do not watch if it raises the price other buyers are willing to pay for the bundle to a level that the former consumers remain willing to pay. This is demonstrated in Example 2, which

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[87] Conversely, networks that appeal to a minority of viewers may not be added to the bundle if the addition of those networks does not raise the total value of the bundle to minority viewers up to the bundle price.

shows that the MVPD will find it profitable to include a network that one buyer does not value.[89] If the network in question were offered a la carte, the example shows that the consumer would be better off, because she would have the option to purchase fewer channels at a lower cost.

70. Second, some programming networks that appeal to mainstream consumers might find it more difficult to enter under bundling than under a la carte.[90] As stated above, an MVPD carries a network only if it either expands the base of subscribers willing to pay the bundle price or if it enables the MVPD to increase the price it can charge for the bundle. As Example 4 shows, an MVPD may prefer to add niche programming that appeals to a small set of subscribers rather than add additional mainstream programming that provides greater total value to consumers if existing mainstream programming is sufficient to attract the mainstream consumers. The example shows that programming additions that enhance the value to existing mainstream consumers may not increase subscribership and may not allow the cable provider to increase the bundle price without losing significant numbers of non-mainstream consumers.[91] Thus, some mainstream programming may not be provided under bundling, even though it provides more total value to consumers than some niche programming that is provided. In contrast, under a la carte, the example shows that the most valued programming is provided.

71. Third, bundling may induce MVPDs to exclude from their bundles the networks some of their viewers most strongly value. This applies particularly to networks that

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[88] First Report at 85.

[89] *See infra* Economic Appendix B.2.

[90] The First Report contends that smaller, niche networks, including those aimed at "minority interests," (or, alternatively "minority cable television networks") would feel the brunt of the damages that are alleged will befall networks under a la carte and thus presumably would be most likely to fail. First Report at 8, 56. However, in some cases, a switch to a la carte could actually increase program diversity, particularly with respect to minority-interest and niche programming. To see this, note that under bundling, MVPDs may not want to carry networks that appeal only to a minority segment of viewers who are otherwise unwilling to pay the bundle price. As Example 3 demonstrates, some minority programming that would be carried under a la carte might not be carried under bundling, even if its value to consumers exceeds its cost. *See infra* Economic Appendix B.3. This programming would be carried under a la carte, since the consumers would be willing to pay enough to cover the cost of providing it.

[91] *See infra* Economic Appendix B.4.

attempt to serve a programming niche that is already served by one or more other networks. Networks that are less strongly preferred by viewers might better increase MVPD revenues from the bundle and thus gain carriage. The preferred networks could be available under pure a la carte, provided the value to the consumer of the preferred programming network exceeds the network's costs.

72. Example 5 demonstrates such a scenario.[92] In that example, carriage of a network that appeals strongly to a group of viewers adds less revenue than networks that have broader, if more modest, appeal, so that the MVPD may exclude it from the bundle.[93] Even if a network is strongly preferred by a group of existing subscribers, if other subscribers do not value the network enough to raise their valuation of the bundle, then the MVPD may not be able to raise the bundle price charged to all subscribers. If the network also fails to attract many new subscribers, then the cost of paying for the network may exceed any revenue the MVPD could gain by carrying it, making carriage unprofitable. Under a la carte, however, programming of strong interest to a few subscribers might be profitable to carry, provided its value to those consumers exceeds its cost.

73. Finally, in its discussion of efficiency in the marketplace, the First Report fails to note that bundling may result in the production of programming for which the consumer value is less than the cost of production, leading to an inflated supply of programming. If a switch to a la carte eliminated such programming, the result would

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[92] *See infra* Economic Appendix B.5.

[93] Thus, the MVPD may not find it desirable to carry a new network serving an existing niche, such as a new weather channel, food channel, or science fiction channel, if the new network appeals only to existing customers and does not have demonstrated value to other subscribers or non-subscribers. Indeed, the First Report notes that the Urban Broadcasting Company (UBC), a minority cable network, has made this very complaint. The UBC says that it "has difficulty obtaining carriage deals, because many cable television carriers find little to no value in meaningful and tasteful programming that targets people of color." It also argues that it is denied carriage because: "Cable carriers often tell minority cable television networks that there is already enough programming that targets people of color. Cable carriers also tell minority cable television networks that too many consumers are not willing to pay for minority cable networks to be added to their already expensive cable television packages." UBC Comments at 2.

not be a blow to program diversity, as the First Report suggests,[94] but rather a restoration of programming to an efficient level, more consistent with consumer value.

74. Economists consider producing a good to be inefficient (and thus undesirable) if the benefits the good provides to buyers is less than the cost of producing it. The use of bundling can provide an incentive to carry a network for which the total value to consumers is less than the fixed costs, such that production of the network reduces economic efficiency. This can occur because the addition of a network to the bundle may allow MVPDs to extract additional revenue from consumers even if consumers' value for the additional network is less than its fixed cost. In this case, the addition of a network to the bundle can result in an increase in the cost of the bundle to a consumer that is greater than the increase in value to the consumer. Example 6 illustrates this point.[95]

75. In Example 6, an increase in revenue made possible by the addition of a second programming network to a bundle induces the MVPD to carry that network even though the consumer value from the network is less than its fixed cost. Under pure a la carte, only one network would be carried. MVPD profit, however, is lower under the a la carte option, even though consumer welfare and economic efficiency are higher.

76. The First Report also suggests that bundling allows an increase in the quality of programming.[96] In a similar manner to that just described, however, bundling provides an incentive to networks to make economically inefficient investments in programming. Such increased programming costs inflate expenses, which can unnecessarily raise the price of the bundle to the detriment of consumers. Example 7 illustrates this scenario.[97]

77. In Example 7, the programmer invests in content even though the cost of that additional content is greater than the incremental value created for consumers. The example demonstrates that what the First Report portrays as an increase in program quality may instead, as in this case, be merely a transfer of surplus from consumers to

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[94] First Report at 56.

[95] *See infra* Economic Appendix B.6.

[96] First Report at 86.

[97] *See infra* Economic Appendix B.7.

networks and content providers. Networks do not have the same incentive with pure a la carte, because they cannot get consumers to pay more than then the value of any improvement in programming. The example suggests that the First Report may overstate the benefits of bundling on program quality.

3. Bundling Limits Ability to Ascertain Demand

78. Even when the MVPD wants to carry the most-desired networks, it may have difficulty determining which ones are most popular with viewers under bundling. Whether or not a network gets carried depends on an MVPD's guess as to the popularity and profitability of carrying a network. Since consumers are buying a bundle of networks, and since Nielsen does not rate smaller networks, the MVPD may have little information about how much consumers value the ability to watch a particular network, even after carrying it for a while.

79. Under a la carte, consumers indicate their interest by agreeing to pay a fee for receiving the network. This provides the MVPD direct information about how many consumers place a high valuation on the network. Because the consumers who pay for a network are likely to be watching it a portion of the time, it also provides information to advertisers about the likely number of viewers. Since MVPDs want to carry networks that increase subscribers and revenues per subscriber, and since advertisers want to know which networks have large numbers of viewers, networks with large numbers of viewers might find it easier to get higher license fees and advertising revenues under a la carte than under bundling. Meanwhile networks with few interested viewers will likely get less revenue when it becomes obvious they have few subscribers under a la carte, and they may consequently lose carriage.

80. In addition, under bundling a network may have a reduced incentive to improve its quality, because a moderately higher number of viewers for a network may go unnoticed and unrewarded. Under a la carte, on the other hand, improvements in quality can lead quickly to an increase in the number of paying subscribers and the size of the fees they are willing to pay for the network, thus quickly providing a reward for the investment. The marketplace will thus be able more quickly to shed unpopular networks in favor of popular networks under a la carte than under bundling and in the process

become more responsive to consumer demand for better programming. Programmers may also have an increased incentive to improve their programming under a la carte.

III. ADDITIONAL OPTIONS FOR INTRODUCING CONSUMER CHOICE

A. INTRODUCTION

81. As Section II of this Report explained, the First Report did not present an accurate or balanced picture of the consequences of increasing consumer choice. In fact, there are significant benefits that may be gained by allowing consumers to choose. For example, a la carte could decrease many consumers' video programming bills. This section examines some alternative options for providing increased consumer choice that the First Report failed to analyze fully. These options are limited to channels currently offered in a digital format, in hopes of minimizing any cost and disruption associated with the transition to increased consumer choice.[98]

82. Below we consider three options for increasing consumer choice. They are: (1) mixed bundling, in which consumers are allowed to choose from all the digital channels on an a la carte basis, in addition to bundles the MVPD may choose to provide; (2) themed tiers, in which MVPDs offer tiers of related digital programming, such as a children's programming tier or sports programming tier; and (3) subscriber-selected tiers, in which customers have the option of purchasing smaller bundles than are currently offered and choosing the channels that go into that bundle from among the MVPDs' digital offerings. All of these options provide consumers increased choice in selecting the programming they wish to pay for and receive. Likewise, all the options permit MVPDs to continue to offer their current bundled and a la carte selections,[99] so that consumers can continue to purchase pre-established bundles if those bundles best meet their needs. The following section discusses the advantages and disadvantages of each option and the implementation issues they present.[100]

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[98] *See supra* II.B.8.

[99] Premium channels are offered for the most part on an a la carte basis or as "mini-tiers."

[100] How prices are set would help determine whether consumers realize significant benefits from the additional choices they gain. High prices for the new options could negate the benefit from adding these

B. DISCUSSION OF OPTIONS

1. Mixed Bundling

83. Instead of receiving most of their digital channels exclusively in bundles as they do today, consumers could be allowed the choice of purchasing such channels either on an a la carte basis or as part of the bundles an MVPD chooses to provide ("mixed bundling"). That is, under this option, consumers could elect to purchase networks individually, at a set price for each network, or to pay the bundled price.

84. It is worth noting that MVPDs have some experience selling channels and features on an a la carte or smaller bundle basis. For example, consumers are able to purchase premium channels, pay-per-view features,[101] and Video-On-Demand[102] (VOD) programming either individually or as part of small packages, with a variety of approaches being taken for offering these services.[103] In counterpoint to industry claims that the increased complexity of a la carte will harm the market and impose undue costs on their operations, cable operators have been able to absorb the increased marketing and customer care requirements associated with their premium, pay-per-view, and VOD program offerings, which offer their subscribers essentially a la carte programming options. Moreover, many of the network and system costs are already in place to allow for premium, pay-per-view, and VOD offerings.

85. Mixed bundling would provide many benefits over pure bundling. First, consumers who are only interested in a few channels could buy the channels they want,

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options, while excessively low prices could reduce MVPDs' and networks' incentives to maintain the quality of their services.

[101] Pay-per-view programming is another type of video service that is offered by MVPDs on an a la carte basis. Rather than paying for a channel of programming, like HBO, a subscriber pays for a specific program. With pay-per-view, cable and satellite subscribers can order hundreds of recently released movies or current sports events on a per-program basis, which they can view at the time it is aired.

[102] Video-On-Demand provides subscribers immediate access to video programming content on a program-by-program basis.

[103] Cable operators offer a mix of free and pay VOD. While some pay VOD is offered on a pure a la carte basis, certain operators are offering subscription video-on-demand ("SVOD"), which functions like VOD but has a different marketing structure. Rather than paying for each event viewed, the subscriber pays a monthly fee to access certain programming on an at-will basis. For example, a subscriber would pay an additional $3.00 more per month for HBO SVOD, which would allow him to access a catalog of programming for immediate viewing.

possibly at a considerable cost savings to the bundle price. This could significantly lower these consumers' total bills for video programming. Moreover, a la carte could induce consumers to take MVPD service who would not otherwise be willing to pay the bundle price. Finally, mixed bundling would permit consumers to avoid paying for networks that they do not watch.

86. The fact that consumers could still buy the MVPD-established bundles would provide an additional layer of benefits. If there were significant savings from bundling channels that appeal to different sets of customers, as industry suggests in its comments, then the pre-established bundles should remain an attractive option to consumers. Similarly, any consumers who found the decisions presented by an a la carte programming option overwhelming could purchase bundled programming instead.

87. Increased choice for consumers of this sort could also increase competitive pressures among competing MVPDs, who might feel pressure to match each others' prices and offerings. The current programming packages that MVPDs offer tend to be remarkably similar and few in number, which may limit the strength of competition among MVPDs. Offering consumers additional options in programming packages could spur increased competition among MVPDs by opening up additional fronts on which MVPDs could compete to satisfy consumer demand.[104]

88. Mixed bundling would also help to provide market signals that reflect the popularity of a network with consumers. Although not fully representative of the number of viewers (because many subscribers may have access through purchase of a bundle), the volume of a la carte sales could represent useful information to advertisers and MVPDs concerning the popularity of a network. This could increase advertising revenues for popular networks, allowing those networks to lower their license fees.

89. The availability of bundles under mixed bundling should also alleviate many of the concerns expressed by networks about the cost of marketing themselves under a pure

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[104] Mixed bundling could also help ensure that consumers receive the minority and niche programming they want and prefer. As discussed above, some new networks might find it easier to enter under a la carte. If a new network had a dedicated audience, that audience might be willing to pay sufficiently to support the network outside the bundle, even if the network failed to attract new subscribers to the bundle or generate higher revenues from the bundle.

a la carte regime. Those consumers that like to channel surf could continue to buy the pre-established bundles.

90. As discussed further below, we lack information about what a la carte prices would be for individual networks.[105] Some a la carte network prices could be relatively low, but other network prices could appear relatively high to consumers. In any event, consumers would likely have the opportunity to lower their total programming bill by purchasing fewer channels.

91. Overall, a mixed bundling regime has the potential to provide great flexibility to consumers. Mixed bundling could produce reduced prices for some consumers, as well as make programming available to consumers with a limited interest in MVPD programming and a small budget. While consumers would have the option to purchase channels a la carte, they would retain the option of buying a pre-established bundle if that best suited their needs.

2. Themed Tiers

92. Another possible sales method is the themed-tier model, pursuant to which MVPDs would offer one or more tiers of digital programming with a particular theme.[106] The program networks in this type of tier would still be available in a larger, more

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[105] Pricing would have an impact on the gains consumers get from a la carte purchases. Under mixed bundling MVPDs might have an incentive to set the a la carte prices high, in order to induce customers to buy the bundle. In some of the examples in the Appendix to this Report, it was assumed that the price was fixed at the pure a la carte profit-maximizing level. These prices are often lower than the per-channel bundle price. In example 1, the bundle price is $8 for two channels, yielding an average per-channel price of $4, compared to the a la carte price of $3 for each network. However, the pure a la carte price could also be higher. Consider the example provided in the Economic Appendix to the First Report. If Aaron values X at $5 and Y at $2, and Betty values X at $2 and Y at $5, then the revenue-maximizing price is $5. The bundle price is $7, for an average per-channel price of $3.50.

[106] Today, all major cable operators offer digitally-compressed video channels to cable subscribers on digital tiers. The digital cable services may be viewed on analog television receivers through use of a digital cable set-top box. Digital compression technologies allow anywhere from four to twelve video channels to be compressed into the capacity previously used to provide just one standard six MHz analog channel. The programming available on digital tiers includes a variety of genres, such as sports, movies, children's, and foreign-language programming. There are approximately 25 million digital cable subscribers in the United States. *See NCTA 2004 Year-End Industry Overview* at 6. There are approximately 25 million DBS customers, equipped with digital set-top boxes, as well. *See* Echostar Press Release, *Echostar Reports First Quarter 2005 Financial Results* (May, 5, 2005) (reporting that it has approximately 11.23 million subscribers); DirecTV Press Release, *The DirecTV Group Announces First Quarter 2005 Results* (May 2, 2005) (reporting that it has approximately 14.5 million subscribers).

general (and more expensive) package if the distributor so chose. A themed tier would allow a consumer to pay a subscription fee only for that genre of programming that he or she finds appealing.

93. Domestic cable operators are technically capable of offering such tiers, as evidenced by the sports, foreign language, and other themed tiers currently offered for sale. Charter, for example, offers a limited basic service tier consisting of broadcast stations and local access channels, an expanded basic tier, and many additional channels on four separate digital tiers (the "Family and Information Tier," the "Movie Tier," the "Sports Tier," and the "Latino Tier").[107] Bright House Networks has focused on expanding its digital offerings, which include, *inter alia*, a digital basic tier and a digital sports tier.[108] Cablevision offers seven separate tiers of foreign language programming catering to, among others, Russian, Korean, and Hispanic subscribers, as well as digital tiers for sports enthusiasts.[109] These examples and others like them demonstrate that such tiers are economically and technically feasible.[110]

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[107] Charter Comments in MB Docket No. 04-207, at 3.

[108] Bright House Network Comments in MB Docket No. 04-207 at 8-9.

[109] *See* http://www.io.tv/index.jhtml?pageType=international (visited Dec. 8, 2005) and http://www.io.tv/index.jhtml?pageType=sports (visited Dec. 8, 2005). *See also CVC Tiers Up Again*, CableFax Daily, 1 (Apr. 13, 2005) (stating that Cablevision is launching another sports tier, which will include 10 national sports channels for $4.95 per month). Comcast and Cox offer themed tiers as well. *See* Don Steinberg, *Comcast to Roll Out New Package for Digital Cable*, Philadelphia Inquirer, D2 (Aug. 1, 2004) (discussing Comcast's digital sports tier which includes six channels for $4.95); Mike Reynolds, *Cox Beefs up Hispanic Package*, Multichannel News, 24 (Sept. 27, 2004) (Cox offers a new Hispanic Package, named Paquete Latino, which includes 35 Spanish-language channels for $34.95 per month).

[110] Many examples of digital family tiers can already be found around the world. For example, Rogers Cable in Canada offers a "family fun" themed tier for $5.99 (Canadian), that consists of BBC Canada, BBC Kids, Biography Channel, Country Canada, Detroit Public Television, Discovery Kids, National Geographic, and Treehouse. EastLink, serving Halifax, Canada, offers an "Education Pak" for $6.95 (Canadian) consisting of the Documentary Channel, Biography, BBC Kids, National Geographic, Discovery Kids, Discovery Civilization, and Animal Planet. *See* http://www.eastlink.ca/cable/channelguides/channelguide3.asp (visited Dec. 8, 2005). CableBahamas, serving the Bahamas Islands, offers a "FamilyPak" in Grand Bahamas for $5.95 that consists of Noggin, History Channel, TV Land, Animal Planet, ABC Family, and Comedy Central. *See* http://www.cablebahamas.com/tv.lasso?id=177&market=Grand Bahama&package=FamilyPAK (visited Dec. 8, 2005). NTL, a British cable operator, offers a Family Pack of over 100 digital television program networks and 40 radio channels for £29.00. *See* http://www.home.ntl.com/icat/television&source+ntlcomtv_link (visited Dec. 8, 2005). Starhub, a cable operator serving Singapore, allows its subscribers to purchase three themed tier packages for $20.00. One of these packages is the "Kids" group, which consists of Cartoon Network, Nickelodeon, and Disney

94. Under a themed-tiers option, consumers could reap some of the economic benefits that bundling may provide, while still receiving and paying for only the kinds of networks that appeal to their interests. Indeed, consumers could potentially save money by purchasing themed tiers, either because themed tiers could be cheaper than existing bundles or because consumers could avoid purchasing networks they do not watch. Example 8, in which every consumer spends less by buying themed tiers rather than a big bundle, illustrates how themed tiers could reduce the overall cost of MVPD service for some consumers.[111]

95. The cost of implementing themed tiers should be relatively low. In particular, the marketing and administrative costs of offering themed tiers would likely be low for MVPDs, since this option appears to be fairly simple to implement and to market to consumers. Domestic cable operators are technically capable of offering such tiers, as evidenced by the sports, foreign language, and other themed tiers currently offered for sale.

96. In summary, the provision of themed tiers appears to be an inexpensive option that would benefit some consumers by reducing their expenditures on multichannel video programming. Just how much consumers benefit from this increased choice will depend, of course, on the composition and pricing of the tiers.[112]

Channel. *See* http://www.maxonline.starhub.com/cabletvnewplanportal/newplan_ns2.asp?section_= (visited Dec. 12, 2005).

[111] *See infra* Economic Appendix B.8.

[112] Recently a number of cable and DBS operators have announced plans to offer family-friendly programming tiers. In early 2006, Time Warner, Comcast, Cox, and Insight all will begin to offer approximately 15 channels of family-friendly programming that can be purchased in conjunction with the basic service tier of programming. Other cable operators, such as Midcontinent and Charter, have stated they are committed to developing family-friendly offerings but have not yet announced specific plans. DIRECTV and EchoStar both plan to offer a family tier with more than 40 channels. *See* Time Warner, *Time Warner Cable Launches Family Choice Tier* (press release), Dec. 15, 2005; Comcast Corp., *Comcast Announces Family Tier* (press release), Dec. 22, 2005; Cox Communications, Inc., *Cox Communications Announces Family Friendly Package* (press release), Jan. 10, 2006; Insight Communications Company, *Insight Communication Announces Plans for Family-Friendly Tier of Programming* (press release), Jan. 17, 2006; Midcontinent, *Midcontinent Communications to Develop Family Friendly Choice* (press release), Dec. 12, 2005; EchoStar Communications Corp., *DISH Network Offers 'DishFAMILY' Programming Tier, Providing Parents with Worry-Free TV* (press release), Feb. 1, 2006; Jean Spenner, *Cable TV Planning "Family Friendly" Tier*, THE SAGINAW NEWS, Dec. 16, 2005, at http://www.mlive.com/business/sinews/index.ssf?/base/business-1/1134746428242260.xr. (visited Dec. 29, 2005); Glen Dickson, *Family Tiering Gets Technical*, BROADCASTING & CABLE, Dec. 19, 2005, at 24.

3. Subscriber-Selected Tiers

97. An alternative to MVPD-established themed tiers would be a subscriber-selected tier. That is, the MVPD subscriber, rather than the MVPD, could choose the content of the tier to be purchased. For example, if a subscriber desired a mix of program network types, such as sports, movies, and children's programming, she would be able to select a prescribed number of channels for a set price from among the MVPD's digital offerings. This tier would be smaller than the MVPD's pre-established bundles. Thus instead of being required to purchase perhaps 80 networks as part of a larger bundle, a subscriber could purchase a smaller package of perhaps 20 or 40 or 60 networks for a reduced price, with the subscriber choosing the networks. Subscribers could continue to buy the pre-established programming packages if they so chose.

98. Subscriber-selected tiers would combine the potential benefits of bundling with the potential benefits and greater choice that a la carte could provide consumers and have therefore received some attention in the economics literature. Two FCC economists recommended examining this option in a recently published paper.[113]

99. Moreover, international examples suggest the feasibility of this approach. For example, Videotron, a Canadian cable operator, allows its subscribers to select certain types of digital program networks on an a la carte basis. Videotron customers must buy a basic digital tier that includes 22 government-mandated channels for a monthly fee of $19.48. Customers then have a variety of additional choices. Customers can purchase channels one at a time, in small bundles of five or six, or in larger bundles of 20, 30, 65, or 106 channels.[114]

100. Rogers Cable, another Canadian cable operator, likewise offers subscriber-selected tiers. Subscribers who purchase a 30 channel basic tier for $24.00 and lease a digital converter box for $8.95 can then purchase certain digital networks on an a la carte basis for $2.49 each. Alternatively, subscribers can create their own new digital "5-pack"

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[113] Keith Brown and Peter J. Alexander, *Bundling in Cable Television: A Pedagogical Note With a Policy Option*, The International Journal on Media Management, 6 (3&4), 162-67 (2004). They call this option "quasi-bundling."

[114] *See* Bill McConnell, *Cheaper by the Dozen*, Broadcasting & Cable, July 19, 2004, at 22.

for $9.95, "10-pack" for $14.95, "15-pack" for $18.75 and so forth.[115] Other Canadian cable operators offer similar packages.[116]

101. Subscriber-selected tiers would allow consumers to purchase the networks they want, while avoiding receiving or paying for other networks that they do not watch. In contrast to themed tiers, with subscriber-selected tiers, consumers would not be restricted to the networks the MVPD bundled together in making their choices. The ability of consumers to choose which channels go into their bundles would also provide feedback to MVPDs and advertisers as to which networks are most popular. We would expect MVPDs to monitor closely which networks consumers select, as a yardstick of a network's value to viewers. As discussed above, having this information available about consumer preferences would help make programming more responsive to consumer demand, since networks that are more popular and that have invested in raising their quality would find it easier to demonstrate their success to MVPDs and advertisers under subscriber-selected tiers, as compared to pure bundling.

102. The First Report raises the concern that networks have different costs and thus cannot be lumped together in a single package at a fixed price.[117] The concern is that, because some networks cost more to provide than others, providing a single package with high and low cost networks could be difficult to price. The theory is presumably that consumers should pay more for the high cost networks. Yet this is not how the video programming industry works, either through broadcast television or MVPD bundling. Networks that cost more and provide greater quality would get more viewers and

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[115] *See* http://www.shoprogers.com/store/cable/DigitalTVPurchase/digitaltv_bestValueOptions.asp (visited Dec. 8, 2005).

[116] *See* Access Communications at http://www.accesscomm.ca/access?pageid=181 (permitting subscribers to create their own digital packages—5 channels for $6.95 or 10 channels for $11.95) (visited Dec. 8, 2005); Shaw Cable at http://www.shaw.ca/en-ca/ProductsServices/BundlesAndPricing/ALaCarteServices.htm (permitting subscribers to pick 5 channels for $6.95 and 10 channels for $10.95) (visited Dec. 8, 2005); Cogeco at http://www.cogeco.ca/en/alacarte_services_o.html (permitting subscribers to pick 5 channels for $6.99, 10 channels for $9.99, up to 30 channels for $19.99) (visited Dec. 8, 2005).

[117] The First Report casually characterized the option of allowing "subscribers to select a set number of channels from a menu of options at a flat rate" as "a highly unlikely scenario considering the programming cost differences among various channels." First Report at 41. No analysis was provided to support this statement.

subscribers and thus are compensated with more subscription fees and advertising revenues. In addition, the price of the bundle, and the proportion of the price that goes to each network, could be adjusted to account for the average take rate of the different kinds of networks.

103. Subscriber-selected tiers would present issues, however, regarding how to set the size and price of the bundles. Indeed, the ability of subscriber-selected tiers to generate consumer savings is difficult to determine absent more pricing information. As discussed above, though, the concerns expressed in the First Report are overstated in terms of the difficulties smaller networks might face.[118] Further, the inclusion of networks in bundles would mean that the networks and MVPDs would still get the benefits of bundling in terms of getting contributions from both high-interest and low-interest consumers to cover their costs.

104. In practice, the potential for significant consumer benefits from offering a subscriber-selected tiers option could outweigh any potential difficulties in determining how the size and price of these smaller bundles would be set. This form of increased consumer choice would provide some consumers lower prices and all consumers the ability to avoid paying for networks they do not watch. Meanwhile this option retains any potential benefits of bundling.

C. MVPD COMPETITION

105. The First Report correctly noted that "[m]arketplace forces and technological advances are poised to bring more competition and choices to the public."[119] MVPD competition continues to provide consumers with increased choice, better picture quality, and greater technological innovation. The Commission recently found that almost all consumers now have the choice between over-the-air broadcast television, a cable service, and at least two DBS providers. And in some areas, consumers also may have access to video programming delivered by emerging technologies, such as digital

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[118] *See supra* Section II.B.7.

[119] First Report at 7, 62-65.

broadcast spectrum, fiber to the home, or video over the Internet.[120] Increased choice in providers should foster increased consumer choice.

106. DBS market share continues to grow, providing an alternative to cable service that offers many tiers of service, some with lower prices than those offered by cable operators. In response to DBS competition, cable operators have, among other things, expanded their channel line ups and bundled video service with other service offerings, such as cable modem service or telephone service. DBS operators in turn are offering local broadcast channels, additional sports and international programming, and advanced set-top boxes with digital video recorder (DVR) capabilities. Similarly, broadband service providers continue to offer a triple play of video, voice, and Internet access service that has proved to be price competitive with cable. In rural and small markets, LECs are upgrading their traditional copper facilities to digital subscriber line (DSL) and fiber-based platforms to allow them to offer a suite of video, telephone, and data services.[121]

107. Notably LECs, such as AT&T and Verizon, who continue to partner with DBS providers in order to offer video service, have spent the past year preparing to offer video in their operating areas and are building out their facilities to add video offerings.[122] The larger LECs have accelerated their plans to roll out video services using DSL and fiber-based distribution platforms. Verizon is deploying an FTTH network under the brand name "FiOS TV" that will allow delivery of multichannel video services in addition to telephony and high-speed Internet access service at speeds above those of ADSL technology. Verizon has received franchises from local communities in California, Florida, Virginia, Texas, Massachusetts, and Maryland. It began offering multichannel video service in Keller, Texas, in September 2005, in Herndon, Virginia, in November 2005, and in Temple Terrace, Florida, in December 2005, and it planned to offer video

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[120] *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Twelfth Annual Report, MB Docket No. 05-255, paragraph 5.

[121] *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Twelfth Annual Report, MB Docket No. 05-255, paragraph 7.

[122] *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Twelfth Annual Report, MB Docet No. 05-255, paragraph 6.

service in several additional communities by the end of 2005. AT&T is planning to deploy an IP-enabled broadband network called "Project Lightspeed" using both FTTN and FTTH to deliver video and other services to residential customers. The company reports that the network will be available to 18 million homes nationwide within three years.[123]

108. As the First Report noted, "more consumer choices will appear as technology progresses and video competition flourishes."[124] It is critical that the government "implement policies that unlease competition and motivate MVPDs to innovate."[125]

D. SUMMARY

109. In conclusion, the First Report fails to consider adequately viable options for introducing consumer choice in the MVPD market. As discussed above, mixed bundles, themed tiers, and subscriber-selected tiers all potentially offer benefits, as compared with pure bundling. These options potentially would allow some consumers to reduce their MVPD bills and others to purchase video programming that they do not currently receive because of bundled pricing. Moreover, these options would increase consumer control, allowing them to avoid paying for programming that they do not watch.

IV. CONCLUSION

110. The First Report presented an incomplete and flawed analysis of the costs and benefits of bundling in the MVPD marketplace, as compared to offering programming a la carte. Characterizing bundling as an economically efficient way of distributing programming, the First Report paid short shrift to the potential impact of bundling on consumers. Bundling may drive up the price of video programming, making programming less affordable and precluding some consumers from purchasing programming services all together. Moreover, bundling mutes signals from consumers about the programming they find most desirable. Consumers may find that the

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[123] *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Twelfth Annual Report, MB Docket No. 05-255, paragraphs 127-130.

[124] First Report at 65.

[125] *Id.*

programming they pay for as part of a bundle contains networks they do not watch and fails to include other quality programming that they would enjoy.

111. In contrast, further examination reveals the promise of a la carte as a means of combating rising MVPD rates and lowering consumer bills. For example, under a la carte, a consumer could cut his programming bills merely by electing to purchase fewer networks. And a la carte could make service affordable to those who cannot afford bundled rates. A la carte also could offer consumers the ability to pay only for the programming that they value.

112. As outlined above, several alternatives for increasing consumer choice merit further consideration. Preliminary analysis suggests that mixed bundles, themed tiers, and subscriber-selected tiers all potentially offer consumer benefits, as compared with bundling channels into tiers of service. Each of these options would allow some consumers to reduce their MVPD bills and permit others to purchase video programming that they do not currently receive because of bundled pricing.

ECONOMIC APPENDIX

A. INTRODUCTION TO EXAMPLES

1. This appendix examines the examples discussed in the text regarding the impact of video programming sales strategies on consumers and MVPD profits. These examples help illustrate certain effects discussed in the text. They compare the consequences of an MVPD's provision of programming only through bundling (pure bundling) with those resulting from a pure a la carte scheme and those resulting from mixed bundling and themed tiers, each of which was examined in the Report. The examples are kept simple, often with just two networks and two customers, to illustrate the particular effects of each strategy, but the effects can be generalized to situations with many goods and consumers. A broader way to view these examples is to consider the networks and consumers to be types, such that there are two types of networks and two types of consumers in the market.

2. Each example is illustrated by a figure that contains the basic assumptions for that example. The figures indicate each consumer's valuation for each network. The examples assume that these are the maximum values consumers are willing to pay for a network and adopt the standard economic assumption that consumers benefit from buying the network (or bundle of networks) to the extent that the price they pay for the network (or bundle) is below the value they place on that network (or bundle of networks).[1] To keep the examples simple, demand for each network is assumed to be independent of whether or not other networks are consumed. Thus, purchasing network X does not change a consumer's valuation of network Y.

3. The cost of producing a network is assumed to be fixed. That is, the cost does not vary with the number of consumers that receive and view a network. We assume the MVPD chooses its a la carte or bundled prices to maximize the joint profit of the MVPD and the networks, i.e., to maximize revenue from consumers minus the fixed costs of

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[1] Thus in Figure 1, Aaron places a value of $5 on network X and $3 on network Y. If he paid $3 for each, he would gain (5-3) or $2 of net benefit (called consumer surplus) from purchasing X and (3-3) or $0 of surplus from purchasing Y. If the bundle price of X and Y (call it bundle XY) is $7, since he values the bundle at (5+3) or $8, he gains a surplus of (8-7) or $1.

producing the networks. In Section B, when we refer to "profit" it is this joint profit to which we refer. We also consider the allocation of profit between the MVPD and networks in more detail.[2] For simplicity, we ignore advertising revenue. In choosing prices, the MVPD may set the price just low enough to get everyone to purchase the network/bundle[3] or at the highest level, such that only one consumer purchases the network/bundle.[4]

4. As the examples illustrate, there are two reasons why MVPDs may not voluntarily provide increased consumer choice – through, for example, mixed bundling, themed tiers, or subscriber-selected tiers. First, providing increased choice, though in the consumers' best interests, may not be profit maximizing for MVPDs in some circumstances. Second, even in those instances where providing a la carte would be profit maximizing, MVPDs may currently be contractually prevented from providing such an option.[5]

5. Note that in examples 1, 2, 6, and 7 below, a profit maximizing MVPD would offer pure bundling. In examples 1 and 2, that strategy would harm consumers by reducing consumer surplus, as compared to pure a la carte. In examples 6 and 7, such a strategy would be inefficient as compared to a la carte, because it would result in the production of inefficient programming or programming with inefficient quality increases.

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[2] In Section C *infra* we discuss the effects on the decision to bundle and on pricing of market power by the MVPD and/or the networks.

[3] This requires setting the price at a level equal to the smallest total valuation by all consumers, so that all consumers will want to purchase the network/bundle.

[4] In figure 1.a, the MVPD can price network X at $3 and get both consumers to buy it, or at $5 and get just Aaron to buy it. In this case, the low price of $3 yields the greatest revenue, $6. By contrast, network Y in figure 2 would be priced at $18, which is the maximum price that can be charged and still get Betty to buy it (Aaron will not buy at this price). This yields more revenue than pricing it at $4 and getting two sales, for total revenue of only $8.

[5] MVPD executives have testified before Congress that their contracts with programmers prevent them from offering channels on an a la carte basis. *See* Letter from the Hons. Joe Barton, John D. Dingell, Fred Upton, Edward Markey, and Nathan Deal, U.S. House of Representatives, to the Hon. Michael K. Powell, Chairman, Federal Communications Commission (May 18, 2004); Letter from the Hon. John McCain, Chairman, United States Senate, Committee on Commerce, Science, and Transportation, to the Hon. Michael K. Powell, Chairman, Federal Communications Commission (May 19, 2004).

6. In examples 3, 4, 5, and 8 below, a profit maximizing MVPD would prefer to offer mixed bundling, combining bundles with a la carte, or themed tiers, but might not do so based on contractual obligations. Examples 3 and 5 demonstrate that bundling may result in less minority and niche programming, Example 4 shows that bundling may cause lower valued niche networks to be carried instead of higher valued mainstream networks, and Example 8 illustrates themed tiers.

B. EXAMPLES

1. Example of a la Carte Lowering Prices and Increasing Distribution

7. In this example, we demonstrate that a la carte can yield lower prices than pure bundling, while generating sufficient revenue to cover costs. In addition, we show that some consumers may increase their purchases of video programming if they are given increased purchasing options, such as a la carte.

8. Suppose that there are two buyers (Aaron and Betty in the table below) and two networks, X and Y, which are assumed to have $6 in programming costs each. Suppose that Aaron values Networks X and Y at $5 and $3, respectively (instead of at $5 and $2, as described in the example in the Economic Appendix to the First Report), and Betty values Networks X and Y at $3 and $5 respectively (instead of at $2 and $5 as described in the example shown in the Economic Appendix to the First Report). Then the profit-maximizing a la carte price for each network is $3, generating two sales of each network and total revenue to the cable operator of $12. This revenue is sufficient to cover the assumed programming costs of $6 for each network. The bundled price, however, is $8, so that consumers are forced to pay $2 more than under a la carte for the two networks. The total revenue under bundling is $16, which covers the programming costs of $12 and provides a profit of $4.[6] Thus, with bundling, consumers pay more than they would under pure a la carte without getting more service.

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[6] The bargaining power between the MVPD and the networks would determine how this profit is allocated among them.

Figure 1.a

		Consumer	
		Aaron	Betty
Network	X	5	3
	Y	3	5
Value of bundle		*8*	*8*

* The cost of each network is assumed to be $6.

9. Furthermore, bundling can reduce consumers' programming purchases. If it is assumed that there is a third person (Charlie), who values network X at just $3 and network Y at $0, as shown in the table below, then this consumer would never pay the bundle price and would buy no services from the cable operator. Under a la carte, this consumer would buy one network at $3. Thus, bundling can raise prices sufficiently to drive some consumers out of the market. Making networks available a la carte could lower prices and increase consumer purchases of cable networks.

Figure 1.b

		Consumer		
		Aaron	Betty	Charlie
Network	X	5	3	3
	Y	3	5	0
Value of bundle		*8*	*8*	*3*

* The cost of each network is assumed to be $6.

10. Note that if there were mixed bundling and the price of network X were fixed at the pure a la carte level of $3,[7] Aaron and Charlie would prefer to buy service a la carte rather than the bundle at a price of $8. This result would force the price of the bundle down to $6. Thus, under mixed bundling, bundle prices could be forced down because of the a la carte availability of the individual channels, assuming that the prices of the a la carte items are not set at high levels.

[7] With mixed bundling, the MVPD might have an incentive to set a high price for the individual channels offered a la carte to induce customers to buy the bundle.

2. Example of Bundling Networks with Zero Value to Some Consumers

11. The following example demonstrates how a network that carries content that some viewers do not value may be bundled profitably with other channels, while under a la carte, consumers would not have to purchase the network they do not value and would pay less for the programming they do value. Suppose that there are two consumers, Aaron and Betty, who are each offered three networks. Aaron values networks X, Y, and Z at $12, $5, and $3, respectively. Betty values networks X and Y at $5 and $15, respectively. She does not value network Z, so she places a zero value on it. If the MVPD offers only networks X and Y in the bundle (bundle XY), it would charge $17 for the bundle, earning $34 in revenue. The provider would prefer to bundle all three networks together (bundle XYZ) for a price of $20, yielding revenue of $40. Betty would prefer that Z not be included in the package, such as under a mixed bundling scheme, where X and Y are offered in a bundle for $17 and Z is sold separately for $3. Under such pricing, Betty could pay less and still receive the channels she likes. The MVPD would get less revenue ($37) under this scheme, however, so it prefers to include network Z in the bundle it offers, namely XYZ.[8]

Figure 2

		Consumer	
		Aaron	Betty
Network	X	12	5
	Y	5	15
	Z	3	0
Value to consumers of bundle XYZ		*20*	*20*

3. Example of Minority and Niche Programming Not Being Produced Under Bundling

12. This example demonstrates that networks that appeal to a minority of viewers may not be carried if those networks do not raise the total value of the bundle to those viewers up to the bundle price. In this example, Aaron values networks X, Y, and Z at

[8] As in the previous example, the MVPD would have an incentive to raise the a la carte price to induce consumers to buy the larger bundle.

$5, $9, and $0 respectively. Betty values networks X, Y, and Z at $9, $5, and $0 respectively. Network Z appeals only to Charlie, who values it at $6 but places $0 value on networks X and Y. We assume that the cost of network Z is $5 (any amount less than $6 will give equivalent results).

13. Under pure bundling, the MVPD will choose to provide networks X and Y as a bundle (bundle XY) for a price of $14. There is no benefit to including network Z in the bundle (creating bundle XYZ), because the MVPD would have to lower its price to $6 for the bundle to get Charlie to purchase the bundle XYZ. Thus, as a consequence, the MVPD doesn't offer network Z, and Charlie cannot purchase it from the MVPD. Since we assume that Z costs less than $6, it would be both good for consumers and economically efficient to carry and sell network Z to Charlie. Under a la carte, the MVPD would offer networks X and Y for $5 each and network Z for $6 and receive $2 less revenue. Given that option, all three consumers would purchase the networks they valued. Increasing consumer choices may then increase program offerings, especially those that appeal to a minority of the population, including those who want to receive programming but may not value the full bundle enough to purchase it.

Figure 3

		Consumer		
		Aaron	Betty	Charlie
Network	X	5	9	0
	Y	9	5	0
	Z	0	0	6
Value of bundle XYZ		*14*	*14*	*6*

* The cost of network Z is assumed to be $5.

14. Note that if X and Y are high-cost networks with a cost of $12 each (as an example), then pure a la carte would generate insufficient revenues to cover their costs.[9] A regime of mixed bundling, however, would allow a bundle of X and Y to be sold at a price of $14, yielding revenue of $28 and thus covering the networks' combined costs of

[9] Note that if the cost of these networks is not particularly high ($10 or less), then a la carte would generate sufficient revenues to cover the cost of these networks and would also lower the price of service to customers, as we found in Example 1.

$24, while network Z could be sold separately for $6. Mixed bundling would allow the MVPD to increase its revenue.[10] As this example illustrates, mixed bundling can provide the benefits of both bundling and a la carte.

4. Example of Bundling Causing Less Valued Networks to be Carried

15. Bundling can give cable providers the incentive to carry networks that are attractive to small groups of consumers when other more mainstream programming would provide greater social value. For example, consider the example in the table below. There are four networks, including two mainstream networks, M1 and M2, and two niche networks, A and B. The mainstream networks appeal to mainstream consumers, Network A appeals to niche A consumers, and network B appeals to niche B consumers. The two mainstream networks provide the greatest social value.

Figure 4

		Consumer				
		Mainstream (10 people)	Niche A (5 people)	Niche B (5 people)	Fixed Cost	Total Value
Network	M1	10	0	0	5	95
	M2	8	0	0	5	75
	A	0	10	0	5	45
	B	0	0	10	5	45

16. By bundling networks M1, A, and B and charging a price of $10 for the bundle, a cable provider obtains profit of $200-$15 = $185 (the 10 mainstream consumers, 5 niche A consumers, and 5 niche B consumers all purchase the bundle, and the total cost is $15). The cable provider might consider adding network M2 to the bundle and raising its price to $18, but then only the mainstream consumers would purchase the bundle. In this case, assuming only M1 and M2 are produced, profit would be only $180-$10 = $170. Thus, under bundling, the cable provider does not provide network M2, and instead provides the two niche networks, which offer lower social value.

17. Under a la carte, the cable provider maximizes revenue by charging $10 for M1, $8 for M2, $10 for A, and $10 for B. The mainstream consumers purchase M1 and M2,

[10] This example suggests that a profit maximizing firm would use mixed bundling. *But see supra* n. 5.

and the niche consumers purchase their favored niche networks. All networks are provided and the cable provider's profit is \$280-\$20 = \$260. Thus, under a la carte, all the networks are provided.

18. Furthermore, if the cable provider were constrained only to carry three networks, under bundling it would be M1, A, and B, i.e., the network M2, which provides more social value than A and B would not be carried. In contrast, under a la carte, the cable provider would carry M1, M2, and either A or B, and so social value would be maximized, conditional on only three networks being carried.

5. Example of MVPD Not Carrying Preferred Niche Programming Under Bundling

19. We show here how bundling may give the MVPD an incentive not to carry a network most valuable to a small group of consumers because it adds less to the revenue from the bundle than other networks less strongly valued by a larger group of consumers. In the table below, the MVPD has a choice of three networks to offer as part of a bundle, each of which has a cost of \$10. Aaron values networks X, Y, and Z at \$9, \$5, and \$0 respectively, and Betty values them at \$5, \$9, and \$16 respectively. Thus, networks X and Y yield total value of \$14 to customers, while network Z is more valuable in terms of total value provided, yielding \$16. Yet, Z is not an attractive addition to a bundle, because Aaron does not value Z and will not pay a higher bundle price for it. A bundle of X and Y yields the greatest profits of \$8, compared to the other pure bundles. Thus, under pure bundling, the network most preferred by Betty, which in fact is the most valuable network overall, is not carried, because its more narrow appeal means that the MVPD cannot gain much revenue from carrying it. Under pure a la carte and mixed bundling all three networks would be sold, with everyone buying all the networks that they value.[11]

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[11] This example suggests that a profit maximizing firm would use mixed bundling. *But see supra* n. 5.

Figure 5

		Consumer		Total value/ *max revenue*	Profit/loss per bundle*
		Aaron	Betty		
Network Valuations	X	9	5	14	
	Y	5	9	14	
	Z	0	16	16	
Value of bundles and maximum revenue from bundles	*XY*	*14*	*14*	*28*	*8*
	XZ	*9*	*21*	*21*	*1*
	YZ	*5*	*25*	*25*	*5*
	XYZ	*14*	*30*	*30*	*0*

* The cost of each network is assumed to be $10.

6. Example of Including an Economically Inefficient Network in the Bundle

20. This example demonstrates that bundling can lead to an oversupply of economically inefficient programming, as compared to a la carte. Economists consider the production of any good to be inefficient (and thus undesirable) if the benefits it provides to buyers are less than the cost of producing the good. The use of bundling can provide an incentive to carry a network for which the total value to consumers is less than its fixed costs, such that production of the network reduces economic efficiency.

21. We can see this effect in the example below in which networks X and Y have costs of $5 and $9 respectively. In the example, Aaron values networks X and Y at $5 and $3 respectively, and Betty values them at $3 and $5 respectively, yielding a total value of $8 to consumers for each network. If both consumers receive it, producing network X yields a net benefit of $3 (the network value to Aaron and Betty of $8, less the fixed network cost of $5), while producing Y yields $-1 (the network value to Aaron and Betty of $8, less the fixed cost of $9), so producing Y is economically inefficient. Providing just network X alone at a price of $3 yields revenue of $6 and profit of $1. By including network Y in the bundle, and pricing the bundle at $8, the MVPD gets revenue of $16 and profit of $2. Yet network Y costs more than the value it generates for consumers – society is $1 worse off when the MVPD provides it.[12] So, because bundling

[12] Since consumers value it at $8 (which is the most they are willing to pay for it), and the cost of producing it is $9, the net gain to society from producing it is $-1, and economists would consider this to be inefficient production. The $9 spent on producing it would be better put to use elsewhere.

can generate greater revenues, the MVPD has an incentive to add a network whose cost exceeds its total value to consumers. Note that Aaron loses $2 in surplus by buying the bundle at a price of $8 instead of X alone at a price of $3. He is therefore paying $5 more for the addition of a good that he values at only $3. The MVPD has therefore extracted more surplus from consumers by adding to the bundle a network whose production is economically inefficient.

Figure 6

		Consumer		Network Value	Fixed Cost	Net gain/loss to society*
		Aaron	Betty			
Network	X	5	3	8	5	+3
	Y	3	5	8	9	-1
Value of bundle		*8*	*8*			

* Defined as the total network value minus its fixed cost.

7. Example of Bundling Encouraging Inefficient Investments in Quality

22. Bundling can also encourage economically inefficient investments in quality, in which the costs of the investment exceed the consumer benefits. In the example below, Aaron values networks X and Y at $2 and $5 respectively, while Betty values them at $6 and $3 respectively. The MVPD bundles X and Y for a price of $7, yielding revenue of $14. Suppose that network Y has the opportunity to invest in higher quality (called Y' in the table), which raises its value by $2 (to Aaron) at a cost of $3. This would be an economically inefficient investment, since the cost exceeds the benefit of the investment, but it would be a profitable investment because it allows the price of the bundle to be raised to $9, yielding $4 more revenue and hence $1 additional profit. Networks that can raise their value to those consumers who would otherwise place a low value on the bundle, such as Aaron in the example, may have an incentive to raise their quality, even if the increase in quality if inefficient, because doing so may allow them to increase their profits.

Figure 7

		Consumer		Network Value	Change in Fixed Cost	Net gain/loss to society*
		Aaron	Betty			
Network	X	2	6	8		
	Y	5	3	8		
	Y'	7	3	10	+3	-1
Value of bundle XY		*7*	*9*			
Value of bundle XY'		*9*	*9*			

* Defined for the investment in quality in Y, raising the value of Y to Y'.

8. Example of Themed Tiers Enabling Consumers To Lower Costs

23. Themed tiers may help consumers to lower their programming costs by avoiding having to purchase networks they do not watch, as demonstrated by the following example. Aaron values networks X and Y at $6 each but does not value networks Z and W and so places zero value on them. Betty, Charlie, and Darlene, however, all place a positive value on networks X, Y, Z, and W, in each case totaling $17, as set forth in the figure below. Therefore, under pure bundling, the MVPD will provide the large bundle XYZW at $17 and sell it to Betty, Charlie, and Darlene, but not to Aaron.

24. If themed tier XY were offered, the MVPD would want to price it at $12, the maximum price Aaron would pay. Aaron would then be willing to buy the themed tier, while the other three would continue getting the large bundle. Aaron would then purchase MVPD service, paying only $12 versus $17 for the bigger bundle, while avoiding receiving and paying for the networks that he does not watch. The MVPD now earns greater revenue by making some channels available on a themed tier.[13]

[13] This example suggests that a profit maximizing firm would offer themed tiers. *But see supra* n. 5.

Figure 8

		Consumer			
		Aaron	Betty	Charlie	Darlene
Network	X	6	4	3	2
	Y	6	2	6	4
	Z	0	5	6	3
	W	0	6	2	8
Value of bundle	*XYZW*	12	17	17	17
	XY	12	6	8	6

25. An assumption underlying the examples is that the MVPD (or programming distributor) has sufficient market power to raise prices above cost. As noted above, this is probably not an unreasonable assumption given the significant price increases in cable service in recent years.[14] A question arises, however, as to whether it is the MVPD or the programming distributors that have the market power. Ultimately, it appears that the source of the market power might not affect the results of the analysis significantly. This can be demonstrated by reexamining Example 1 and Figure 1.b and considering how prices and sales change depending on whether the upstream wholesale market is competitive, the downstream retail market is competitive, or both are competitive.

26. If the MVPD has market power and the wholesale market is competitive, then the MVPD can purchase programming essentially at cost,[15] in this case at $6. The example works as presented, with the MVPD having an incentive to bundle the networks. The result is that Aaron and Betty each pay $2 more under bundling than under a la carte and Charlie does not purchase any programming.

27. If, on the other hand, the MVPD has no market power, but network Y has market power, the same result occurs, though for somewhat different reasons. Assume that there are many MVPDs competing for customers and content, so that their profits are

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[14] *See Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, 20 FCC Rcd 2718 (2005).

[15] This is a standard economic assumption for competitive markets. "Cost" is generally assumed to include a reasonable profit, so that content providers have an incentive to produce programming. Here we ignore possible revenue streams from advertising.

driven to zero. Assume also that there are many providers of networks of type X, but only one of type Y. The providers of X will compete to get MVPDs to buy their programming, and the price of that programming will be reduced to cost ($6), giving them zero profits. Note that network Y costs only $6, but including Y in a bundle will raise the revenue generated by customers from $6 to $16. Thus, Y can demand up to $10 for its network, far above the cost of its network, for two reasons: (1) it has market power because it is the only provider of its kind of programming, which Betty especially likes; and (2) bundling allows MVPDs to collect greater revenues from customers. Under pure a la carte, Y could demand only the incremental revenue it generates, which is $6. Thus, Y benefits significantly from the use of bundling. In addition, the MVPD might prefer to use a la carte because its customers would prefer it, but it can no longer afford to do so. Since Y is demanding $10 for its networks, only MVPDs that agree to pay this will get its service, and the only way for those MVPDs to cover their costs (which are now $6 + $10 = $16) will be to use bundling, which can generate revenues of $16. Thus, even in a competitive retail market, if some content providers have market power, MVPDs may have an incentive to use bundling to pay for the content they distribute. Pure a la carte thus could reduce the market power not just of MVPDs, but also of content distributors. If all MVPDs offered pure a la carte, Y would have to drop its price from $10 to $6, since no MVPD could afford to pay more than $6.

28. If both retail and wholesale markets are competitive, the price of the bundle is forced down to the point where revenue equals cost, and so in this case the price of the bundle is $6.[16] Aaron and Betty each have consumer surplus of $2, and Charlie does not purchase the bundle. In a competitive market with a la carte, the price for network Y would be $3, but the price for network X would be only $2 (all three consumers purchase at this price, and so revenue again equals cost). Thus, with a la carte, Aaron and Betty each have consumer surplus of $3, and Charlie purchases network X and has consumer

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[16] We assume that when markets are competitive at both levels, an MVPD is able to purchase programming at cost and sets prices such that its profit is zero. Since the cost of the programming in the bundle is $12, the price charged to just cover that cost is $12 divided by the number of buyers. If three people buy the bundle, the price is $4, and if two people buy it, the price is $6. Since Charlie's value for the bundle is only $3, only two people buy the bundle, and so the price is $6.

surplus of $1. This example shows that a move to a la carte can benefit consumers even when both retail and wholesale markets are competitive.

REGULATORY FEES FACT SHEET

Federal Communications Commission
445 12th St., S.W.
Washington, D.C. 20554

July 2005

WHAT YOU OWE – CABLE TELEVISION SYSTEMS FOR FY 2005

Cable television systems operating on October 1, 2004 must pay a regulatory fee per subscriber[1] for all of the community units (CUIDs) in which they operate. The number of basic cable subscribers that you served on December 31, 2004 should be used as the basis from which to calculate your fee payment. You may pay your regulatory fee for all of your basic service subscribers with a single line entry of Form 159 without having to list your individual CUIDs.

Licensees of CARS facilities must pay a regulatory fee for each CARS facility that was operating on October 1, 2004. In instances where a license or authorization is transferred or assigned after October 1, 2004, the fee must be paid by the party that is the licensee or holder of the authorization on the date that the fee payment is due. You may submit a single payment for all of your regulatory fee obligations (i.e., "subscriber fees" and all CARS licenses; however, you must list each individual CARS call sign on Form 159.

TYPE OF FEE	REGULATORY FEE PAYMENT	PAYMENT TYPE CODE
Cable System Subscriber Fee	$0.72 per subscriber	0571
CARS License	$155 per license	0570

NEW LIMITATIONS ON CREDIT CARD TRANSACTIONS

The U.S. Treasury has advised the Commission that it will now reject Credit Card transactions greater than $99,999.99 from a single credit card in a single day, in accordance with U.S. Treasury Bulletin No. 2005-03. If you need to pay $100,000.00 or more, you should use a check, debit, or wire transfer.

[1] Number of Subscribers In a Community Unit = Number of single family dwellings + Number of individual households in multiple dwelling units (e.g., apartments, condominiums, mobile home parks, etc.) paying at the basic subscriber rate + Number of bulk-rate customers + Number of courtesy and free service. (NOTE: Bulk-Rate Customers = total annual bulk rate charge ÷ basic annual subscription rate for individual households).

Special Instructions for Completing FCC Forms 159 & 159-C

In addition to the general Form 159 filing instructions, the following information applies specifically to cable television systems and CARS licensees:

Block (9) - Telephone Number:

- Enter the contact name and telephone number of the specific individual responsible for submitting the payment and supporting Form 159 and Form 159-C.

Block (11) - PAYER FRN:

- Enter the fee payer's FRN number.

Block (21) - APPLICANT FRN:

- If different from payer, enter the applicant's FRN number.

Block (23A) - FCC CALL SIGN/OTHER ID:

- For basic cable television subscriber fees, leave this block blank.

- Enter the call sign for each CARS license. Call signs must be entered in one of the two following formats: for fixed stations, the call sign is generally comprised of three letters, followed by a dash, followed by two or three numbers (e.g. WAL-504). For mobile licenses, the call sign is generally comprised of two letters, followed by a dash, followed by five numbers (e.g. KB-60111). **This Block must be completed for each CARS license.**

Block (24A) - PAYMENT TYPE CODE:

- Enter **0571** when paying a regulatory fee for basic cable television subscribers.

- Enter **0570** when paying a regulatory fee for a CARS license.

Block (25A) - QUANTITY:

- For subscriber fees, enter your aggregate number of basic subscribers that you served on December 31, 2004. For CARS licensees, enter "1" in this block for each call sign.

Block (27A) - TOTAL FEE:

- For subscriber fees (payment type code 0571), multiply the amount in Block 25A (Quantity) by $0.72 and enter the result here. **Enter exact dollars and cents; do not round.**

- For CARS licenses (payment type code 0570) enter $155.00.

Block (28A) - FCC CODE 1: Leave this block blank.

Block (29A) - FCC CODE 2: Leave this block blank.

Block (30) - CERTIFICATION:

- Provide the printed name and signature of an individual owner/licensee or officer attesting to the accuracy and completeness of the information supplied.

Please include a daytime telephone number so that we can contact you if questions arise regarding your payment.

- FCC -

Before the
Federal Communications Commission
Washington, D.C. 20554

The City of Pasadena, California	)	CSR 5441-R
	)	
The City of Nashville, Tennessee	)	CSR 5373
	)	
and	)	
	)	
The City of Virginia Beach, Virginia	)	CSR 5282-R
	)	
Petitions for Declaratory Ruling on Franchise Fee Pass Through Issues	)	

MEMORANDUM OPINION AND ORDER

Adopted: October 1, 2001 **Released: October 4, 2001**

By the Commission: Commissioners Abernathy and Martin issuing a joint statement.

I. INTRODUCTION

1. The City of Pasadena, California ("Pasadena"), the City of Nashville, Tennessee ("Nashville") and the City of Virginia Beach, Virginia ("Virginia Beach") (the "Cities") have filed separate requests with the Commission asking for clarification of whether Federal law authorizes the "pass through" of franchise fees to subscribers on cable television bills based on gross revenues that encompass non-subscriber related revenue, specifically income generated by advertising sales and home shopping commissions. The Cities also question certain itemization practices of cable operators stemming from the pass through of such non-subscriber revenue. These requests are supported by the National Association of Telecommunications Officers and Advisors ("NATOA") and a number of individual municipalities. The requests are opposed by the National Cable and Telecommunications Association ("NCTA") and a number of individual cable operators. The Commission's Local and State Government Advisory Committee ("LSGAC") adopted and filed an Advisory Recommendation supporting the grant of the City of Pasadena's petition.[1]

2. Cable operators have traditionally passed through to subscribers franchise fees based on a percentage of gross revenues. Where cable rates are subject to rate regulation, this pass through is specifically provided for in the Commission's rate rules. Cable operators, such as Charter which serves the City of Pasadena, have begun to itemize and pass through to subscribers franchise fees imposed on non-subscriber revenue sources. This pass through gives rise to the instant proceeding.

[1] Appendix A lists the specific parties filing in support of, or in opposition to, the Pasadena request. Pasadena has informed Commission staff that several local governments informally expressed support for its petition, including: Santa Barbara, CA; Hidden Hills, CA; Malibu, CA; Agoura Hills, CA; Thousand Oaks, CA; Riverside, CA; Norco, CA; Tallahassee, FL; and Albuquerque, NM. Pasadena *ex parte* letter of April 11, 2000. We refer to city commenters as local franchising authorities or "LFAs" where applicable. Intermedia Partners Southeast ("Intermedia") filed an Opposition to the request filed by the City of Nashville. Cox-Comcast filed an Opposition to the request filed by the City of Virginia Beach.

3. The Order concludes that franchise fees based on non-subscriber revenues can properly be passed through by cable operators to subscribers. In addition, the Order finds that cable operators may pass through the entire amount of the franchise fee assessed by the local franchising authority at any time regardless of whether the cable operator passed through the entire amount of the franchise fee at the first opportunity, or subsequently opted to do so. Finally, the Order determines that cable operators are permitted to itemize on a subscriber's monthly bill the full amount assessed by the LFA as a franchise fee, including non-subscriber related revenues.

II. BACKGROUND

4. Three separate but related provisions of the Communications Act ("Act") relating to franchise fees are involved in this proceeding. Section 622(b) limits the amount a cable operator may be required to pay as a franchise fee under the terms of a franchise.[2] The term "franchise fee" includes 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.[3] The Act prohibits Federal agencies from regulating the amount of the franchise fees paid by a cable operator or regulating the use of funds derived from such fees, except as provided in Section 622.[4]

5. Section 623 directs the Commission to adopt regulations, to be applied by local franchise authorities, specifying the process for regulating basic tier and equipment rates where effective competition is absent. In devising the rules governing basic cable service, the Commission was instructed to take into account amounts assessed as franchise fees.[5] In implementing this statutory provision, the Commission permitted the total amount of franchise fees to be accorded external treatment (*i.e.*, added back to the rate after other calculations are performed) at the time the system becomes subject to regulation, rather than only the amount of additional franchise fees incurred after that date. Section 76.924(f)(3) of the Commission's rules provides that the costs of franchise fees shall be allocated among the equipment and the service cost categories in a manner that is most consistent with the methodology of assessment of franchise fees by local authorities.[6]

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[2] 47 U.S.C. § 542(b).

[3] 47 U.S.C. § 542(g)(1).

[4] 47 U.S.C. § 542(i).

[5] 47 U.S.C. § 543(b)(2)(C)(v).

[6] 47 C.F.R. § 76.924(f)(3). The Commission has stated that:

> [c]able operators will be required to identify certain locally incurred costs such as franchise fees and local taxes at the franchise level. Instead of mandating that other costs be identified at any level, we require that cable operators, for purposes of calculating external costs and costs in a cost-of-service showing, identify costs at the level at which they identified the category of costs for accounting purposes on April 3, 1993. . . . Because franchise fee determinations may be revenue, tier, or subscriber sensitive, we require that franchise fees be allocated between tiers and subscribers in a manner most consistent with the way the franchise fee is assessed

6. Section 622(c) permits cable operators to identify as a separate line item on each regular subscriber bill the amount of the total bill assessed to satisfy any franchise fee obligation, stating:

> Each cable operator may identify, consistent with the regulations prescribed by the Commission pursuant to section 623, as a separate line item on each regular bill of each subscriber, each of the following:
>
> (1) The amount of the total bill assessed as a franchise fee and the identity of the franchising authority to which the fee is paid.
> (2) The amount of the total bill assessed to satisfy any requirements imposed on the cable operator by the franchise agreement to support public, educational, or governmental channels or the use of such channels.
> (3) The amount of any other fee, tax, assessment, or charge of any kind imposed by any governmental authority on the transaction between the operator and the subscriber.[7]

7. The legislative history accompanying Section 622 states that a cable operator shall itemize "only [the] direct and verifiable costs" associated with the above-listed categories of costs and should "not include in itemized costs indirect costs."[8] The Conference Report adopted Section 622(c), with the specific amendment that Section 622(c) be construed consistently with the Commission's rate regulations implementing Section 623 of the Cable Act.[9] In implementing this provision, the Commission noted that the

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(continued)

> by franchise authorities. We believe that this overall approach will minimize rate impacts that could otherwise occur if we adopt more definitive requirements at this time.

Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Report and Order and Further Notice of Proposed Rulemaking, 8 FCC Rcd 5631, 5976-7 (1993)(footnote omitted)("*Rate Order*"); *see also Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation and Adoption of a Uniform Accounting System for Provision of Regulated Cable Service,* Second Report and Order, First Order on Reconsideration and Notice of Proposed Rulemaking, 11 FCC Rcd 2220, 2264 (1996); 47 C.F.R. § 76.924(e)(4).

[7] 47 U.S.C. § 542(c). Section 622(f) states that "[a] cable operator may designate that portion of a subscriber's bill attributable to the franchise fee as a separate item on the bill." 47 U.S.C. § 542(f). Section 622(c) of the Act, as adopted in 1984, had a provision discussing cable franchise fee pass through. This section stated that "a cable operator may pass through to subscribers the amount of any increase in a franchise fee, unless the franchising authority demonstrates that the rate structure specified in the franchise reflects all costs of franchise fees and so notifies the cable operator in writing." *See* former Section 622(c), *repealed by* The Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460 (1992).[7] This version of Section 622(c) was repealed by the 1992 Cable Act and replaced with a new provision, as quoted in paragraph 5 above, that permits the itemization of the total fee, rather than just fee increases.

[8] *See* H.R. Rep. 102-628, 102d Cong., 2d Sess. at 86 (1992).

purpose of Section 622(c) was to assure that there were no regulations preventing cable systems from identifying certain governmentally imposed costs on subscriber bills.[10] The Commission held that operators are not required by this provision to undertake any such itemization, nor does the provision, by itself, preclude the itemization of additional costs (whether or not governmentally imposed) or otherwise mandate that subscriber bills have any particular format or content.[11] The Commission noted that the policy of Section 622(c) was to permit subscribers to be fully apprised of the effect of the enumerated governmentally imposed costs on their bills.[12] The Commission believed that the intent of the statute would be frustrated if a franchising authority imposed burdensome additional itemization restrictions on an operator or otherwise attempted to nullify the effect of a Section 622(c) itemization through local regulations.[13]

III. DISCUSSION

8. We are presented three related questions regarding the appropriate regulatory treatment of franchise fees resulting from non-subscriber revenue. First, may such revenues, together with subscriber-related revenue, be passed through to subscribers in accordance with Section 623(b)(2)(C)(v) of the Communications Act and Section 76.924(f)(3) of the Commission's rules? Second, if franchise fees resulting from non-subscriber revenue can be passed through to subscribers, do our rules permit the entire fee, or only increases thereto, to be passed through to subscribers? Third, if such non-subscriber related revenue can appropriately be passed through to subscribers, does Section 622 of the Communications Act permit the amount of the total franchise fee, including non-subscriber related revenue, to be separately itemized on a subscriber's bill?[14] We address each question below.

(continued)

[9] *See* H.R. Conf. Rep. No. 862, 102d Cong., 2d Sess. at 84 (1992).

[10] *See Rate Order*, 8 FCC Rcd at 5967.

[11] *Id.* Section 622(c) affects the format, not the content of subscriber bills. It is intended to disclose costs attributable to governmental authorities and not to directly affect the amount of these costs. *Id.* at 5973.

[12] *Id.* at 5973.

[13] *Id.* The Commission cited the following statement of Senator Lott introducing what became the final version of Section 622(c) as reflecting the objective of this provision:

I would like to offer my amendment . . . dealing with subscriber bill itemization, to give the cable companies an opportunity to itemize these so-called hidden costs to explain to people what is involved in the charges so they will know it is not just the cable company jacking up the prices. . . . The fact is sometimes the rates have gone up because of hidden, unidentified increases in fees or taxes which the cable [company] has to pay and . . . passes on to the consumer. . . "

Id. at 5967, *quoting* 138 Cong. Rec. S569 (Jan. 29, 1992).

[14] While we recognize that the subscriber pass-through amount on franchise fees is limited by the 5% cap set forth in Section 622(b), we do not reach the issue of whether this provision has been breached by any cable operator. We also note that the Commission has not been asked to interpret the statutory definitions of "franchise fee" and "gross revenues" in this case.

9. Pasadena and its supporters, as well as Nashville and Virginia Beach in their separate requests, generally ask that the Commission determine the legality of passing through franchise fees based on gross revenues that include cable advertising revenue and home shopping commissions.[15] The LFAs argue that there is no basis, legal or equitable, for allowing a cable operator to add onto and increase rates based on non-subscriber revenues that are not legitimately connected to the subscriber.[16] NATOA argues that while much of the franchise fee paid by a cable operator is related to cable services in general, the pass through of non-subscriber related revenue has no relationship to basic cable services.[17]

10. The LFAs contend that those portions of the franchise fee payment derived from non-subscriber sources should not be charged to subscribers.[18] Rather, non-subscriber based fees should be allocated to the entities from which the revenues are derived. Pasadena suggests that Charter should absorb the franchise fee on non-subscriber revenue or incorporate it into the rates that advertisers pay for cable advertising time instead of having its subscribers subsidize the cost of franchise fees paid to the LFA based on advertising and home shopping revenue.[19] La Canada Flintridge argues that a subscriber who does not purchase goods from the Home Shopping Network and who does not benefit from increased advertising revenue should not be required to pay a franchise fee based on revenue from these activities.[20] LSGAC argues that because franchise fees are the rent cable operators pay for the use of public rights-of-way, they should not pass through to basic subscribers those rental expenses associated with non-subscriber services.[21]

11. NCTA comments that the Commission has made clear that all franchise fees, regardless of the source of the revenue, may be passed through to subscribers.[22] Comcast contends that Section 622 confirms that Congress intended to provide cable operators with the discretion to pass through all franchise fees to subscribers.[23] Comcast believes that neither Section 622(c) nor (f) condition in any way the right of a cable operator to pass through or itemize franchise fees in their entirety.[24] Comcast believes that the requirement in 622(e) that operators pass through any decrease in franchise fees implies that Congress assumed cable operators would assess the entire franchise fee on subscribers.[25]

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[15] Petition at 16 and Nashville and Virginia Beach, generally; *see also* Burbank Comment at 1; Calabasas Comment at 1; Glendale Comment at 1; La Canada Flintridge Comments at 1; Los Angeles Comments at 2; Milpitas Comments at 1; Monterey Park Comments at 1; North Charleston Comments at 1; Plano Comments at 2; Rutan & Tucker Comments at 3; Temple City at 1.

[16] Los Angeles County Comments at 2; North Charleston Comments at 7.

[17] NATOA Reply at 2.

[18] Glendale Comments at 3; Los Angeles Comments at 6.

[19] Pasadena Reply at 9.

[20] La Canada Flintridge Comments at 2.

[21] *See* LSGAC Advisory Recommendation Number 21 at point 4 (*ex parte* letter filed May 3, 2000).

[22] NCTA Comments at 7, *citing* Public Notice, Cable Television Rate Regulation Questions and Answers on Form 393, Question 31(rel. May 13, 1993) ("the entire amount of franchise fees may be passed through to subscribers").

[23] Joint Comments of Comcast and CoxCom at 3.

[24] *Id.* at 4.

[25] *Id.*

12. LSGAC argues that a cable operator should not allocate 100% of its franchise fee expense to subscribers. It states that the Commission should clarify that cable operators do not have discretion under the rate regulation rules to pass through expenses related to competitive services to the subscribers of monopoly basic services.[26] LSGAC states that Generally Accepted Accounting Principles ("GAAP") require that rent, like any other expense of doing business, be proportionally allocated among the various sources of revenues.[27] It also states that antitrust law and regulatory principles prohibit the use of cross subsidies between competitive and monopoly services, and to allow more than a proportional pass through is to permit an explicit cross subsidy.[28]

13. In response to LGSAC, Charter contends that the Committee cannot contest the fact that operators are permitted to assess their customers the cost of this "rent."[29] Charter states that LGSAC's objection in this proceeding is premised on the fact that a cable operator's "rental" obligation is often expressed in terms of revenue, rather than a flat fee.[30] Charter argues that it is immaterial whether the revenue was generated directly from subscribers, through monthly subscriber fees, or indirectly, through advertising and home shopping revenues; franchise fees are based on all gross revenues and may be passed on to subscribers in their entirety.[31] Charter argues that there is no reason to deny an operator the right to pass through to customers its entire franchise fee cost, regardless of whether that cost is expressed in terms of a flat fee or a gross revenue calculation—the fact that some of the franchise fee obligation is derived from non-subscriber revenues should have no bearing on the subscriber pass through.[32]

14. We first address the question of whether, under any circumstances, franchise fees based on non-subscriber revenue can be passed through to subscribers. The Commission's rate regulation rules provide that rates are to be calculated initially without franchise fees included. After the proper rates are calculated, franchise fees are added on as an "external cost."[33] The rate rules further provide that the "costs of franchise fees shall be allocated among the equipment basket and the service cost categories in a manner that is most consistent with the methodology of assessment of franchise fees by local authorities."[34] These rules have their origin in Section 623(b)(2)(C)(v) of the Communications Act, which provides that in

[26] *See* LSGAC Advisory Recommendation Number 21 at point 5.

[27] *Id.*

[28] *Id.*

[29] Charter's Response to LSGAC's Recommendation at 3.

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Implementation of Sections of the Cable Television and Consumer Protection and Competition Act of 1992: Rate Regulation,* First Order on Reconsideration, Second Report and Order, and Third Notice of Proposed Rulemaking, 9 FCC Rcd 1164, 1209 (1993).

[34] 47 C.F.R. § 76.924(f)(3).

establishing rate rules the Commission shall take into account "the reasonably and properly allocable portion of any amount assessed as a franchise fee. . . ."[35]

15. There is no dispute among the parties to this proceeding, or in relevant precedent, that advertising revenue and home shopping commissions can be considered part of an operator's gross revenues for franchise fee calculation purposes. The Fifth Circuit's decision in *Dallas v. FCC* makes clear that gross revenues are derived from "all money collected" by the cable operator.[36] The initial question presented in this proceeding is whether franchise fees based on such revenues can properly be passed through to subscribers. We find that they can. Section 623 does not expressly speak to this question other than to provide that the Commission shall establish rate regulations that take into account "the reasonably and properly allocable portion of *any amount* assessed as a franchise fee. . . ."[37] In the absence of a specific statutory provision on this matter, we must examine the overall structure of this Section and the Act's legislative history. There is nothing in either the text or legislative history of Section 623 to indicate that Congress intended other than the full amount of the franchise fee to be reflected in a cable operator's rates, or that a specific class of franchise fee should be excluded from such rates. If Congress was concerned about increases in franchise fees, it could have enacted language limiting the pass through to particular sources of gross revenue. It did not expressly do so, and there is no legislative history suggesting that such intent was implied. Indeed, an amendment made to a companion provision of the Act appears to support the opposite inference.[38] We believe that if the cable operator agrees to include non-subscriber revenue in the definition of gross revenues, the operator is permitted to pass through any portion of the total franchise fee, based on that definition, to subscribers.[39] If the local franchising authority includes advertising revenue and home shopping commissions in the definition of gross revenue, Section 623 permits the entire amount of the franchise fee to be passed through to subscribers.

16. We are cognizant of the fact that our decision herein can lead to the result that, as a cable operator's home shopping and advertising revenues increase and consequently the non-subscriber revenue portion of the LFAs franchise fee increases, so too will the rates charged to subscribers. We are nevertheless constrained by our determination that such pass through is permissible under the Communications Act and our rules and that this process is consistent with the political accountability purposes of Section 622. We note that cable operators and LFAs may, through contractual agreement, modify the definition of gross revenues during the franchising process, if no pertinent state or local law otherwise

[35] 47 U.S.C. § 543(b)(2)(C)(v).

[36] The Court provides a litany of references supporting its holding stating, *inter alia*, that "gross revenues is defined by Black's [Law Dictionary] as receipts of a business before deduction for any purpose except those items specifically exempted" and "the term 'all gross revenue'. . . is to be construed in the broadest sense, i.e. all money received." *Dallas v. FCC*, 118 F.3d 393, 395 (5th Cir. 1997).

[37] 47 U.S.C. § 543(b)(2)(C)(v) (emphasis added).

[38] *See infra* at ¶ 19 (discussing the 1992 Cable Act amendment to Section 622(c) of the Communications Act).

[39] One city, during the course of the *Dallas v. FCC* franchise fee litigation, seemingly admitted that a cable operator can pass through the entire franchise fee to subscribers. *See Petition for Review of an Order of the Federal Communications Commission*, Reply Brief of Petitioner, City of Laredo, Texas at 12 (the cable operator has an "admittedly understandable desire to pass through all the effects of an increased expense in its retail price to subscribers—something that the Cable Act and the FCC rate rules allow (but do not require) the operator to do.").

prohibits. If LFAs and cable operators do not want to burden subscribers with higher franchise fee pass throughs, they may expressly omit certain items, such as advertising revenue and home shopping commissions, from the gross revenue definition. If the parties so limit the amount of gross revenues paid to the LFA to exclude non-subscriber revenue, there would be no franchise fee based on these amounts for the cable operator to pass through to subscribers. In such a case and as advocated by Pasadena and the Cities in this proceeding, the cable subscriber would be required to pay a franchise fee pass through based solely on subscriber-related gross revenues.

17. A related matter, raised in some of the filings, involves the second question of whether, under the rate rules, in those situations where there is no dispute that the category of fee involved can be itemized and passed-through, can the entire fee be itemized and passed-through or only increases in such fee. According to Pasadena, Charter has begun billing subscribers for the entire franchise fee amount sixteen years after the operator signed the franchise agreement. Pasadena complains that this action does not comport with the Commission's rate regulation rules because only real changes in external costs may be passed on to subscribers, not a change due to a different method of accounting.[40] Los Angeles County maintains that under Section 76.933, a franchise authority has the power to review and refund an increase in pass-through of franchise fees to subscribers upon determining that the increase exceeds the amount of franchise fees allocable to the basic tier.[41]

18. Charter contends that the fee as specified in the franchise had been the same since the franchise was enacted, but that nevertheless, its method of accounting and payment has changed.[42] Charter maintains that it developed a methodology for estimating franchise fees based upon third party revenues from prior quarters, and has subsequently provided its calculations to the City of Pasadena.[43] Comcast argues that under Pasadena's "use it or lose it" approach, an operator would be required to pass-through the full amount of the franchise fee from the onset of rate regulation or otherwise forfeit the right to pass it through at a later date.[44] Comcast argues that franchise fees form a unique class of external costs that may be passed through to subscribers at any time.[45] NCTA argues that the Commission has determined that franchise fees, unlike other external costs, are to be recovered separate and apart from the maximum permitted subscriber rate, making them outside of the rate regulation formula and always subject to external cost pass-through.[46] NCTA asserts that there is nothing in the rules that prohibits a cable operator that has elected not to recover all of the franchise fee payments to later decide to exercise its statutory and regulatory right to pass the entirety of its payments through and to itemize them on the subscriber's bill.[47]

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[40] Petition at 13, *citing* 47 C.F.R. § 76.922(e)(2)(ii)(A) ("Operators may project for increases in franchise related costs to the extent that they are reasonably certain and reasonably quantifiable.").

[41] Los Angeles Comments at 5, *citing* 47 C.F.R. §76.933. Section 76.933 permits a franchising authority to review basic cable rates and equipment costs.

[42] Charter Comments at 15.

[43] *Id.* at 4.

[44] Joint Comments of Comcast and CoxCom at 9.

[45] *Id.* at 8.

[46] NCTA Comments at 6.

[47] *Id.*

19. We do not agree with the arguments raised by Pasadena and the other local franchising authorities that only fee increases are eligible for pass-through under the Commission's rate rules. It does not matter whether Charter's action in passing through increased franchise fees can be considered a "change" for the purposes of Section 76.922 because, as discussed above, the Commission's rate regulation rules permit cable operators to pass through franchise fees in their entirety as external costs. Indeed, prior to the enactment of the 1992 Cable Act, Section 622(c) expressly limited a cable operator's franchise fee pass through to fee increases and provided that "a cable operator may pass through to subscribers the amount of any increase in a franchise fee, unless the franchising authority demonstrates that the rate structure specified in the franchise reflects all costs of franchise fees and so notifies the cable operator in writing."[48] This version of Section 622(c) was repealed by the 1992 Cable Act and replaced with the current version of Section 622(c) that permits the cable operator to itemize "the amount of the total bill assessed as a franchise fee. . . ."[49] The apparent intent of this amendment was to enable cable operators to pass through to subscribers the entire amount of the franchise fee assessed by the LFA at any time regardless of whether the cable operator passed through the entire amount of the franchise fee at the first opportunity, or subsequently opted to do so.

20. Nor do we find the Commission rule provisions cited by the Cities to be persuasive evidence to the contrary. Section 76.922(e)(2)(ii)(A) provides that cable operators may project increases in related costs to the extent they are reasonably certain and reasonably quantifiable.[50] Section 76.933(g)(5) provides that an LFA regulating the basic service tier may review and order refund of rate increases based on increased franchise fees if such increased rates exceed the increased franchise fee allocable to the basic tier.[51] These rule provisions merely acknowledge the fact that franchise fees can increase over time. The provisions do not, however, stand for the proposition, as asserted by the Cities, that only increases in franchise fees are permitted to be passed through to subscribers, or that cable operators that have elected not to pass through the entire amount of a franchise fee are prohibited from subsequently so doing.

21. We now move to the related issue of whether Section 622 permits a cable operator to itemize the full amount of the franchise fee, including non-subscriber related revenue, on a subscriber's bill. We find that it does. Pasadena and the LFAs generally argue that Charter and other cable operators misrepresent the rate of the franchise fee on subscribers' bills when they itemize and add to subscriber bills fees on non-subscriber revenues. Pasadena maintains that the change in subscriber billing practices undermines subscribers' expectations that the franchise fees they pay will be directly related to the dollar amount of the monthly cable services that they purchase from the cable operator.[52]

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[48] *See* former Section 622(c), *repealed by* The Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460 (1992).

[49] 47 U.S.C. § 542(c).

[50] 47 C.F.R. § 76.922(e)(2)(ii)(A).

[51] 47 C.F.R. § 76.933(g)(5).

[52] Petition at 33.

22. In opposition, Charter maintains that by itemizing the full amount of the franchise fee, subscribers are fully informed of the scope of the franchise fee assessments, which was the purpose intended by Congress in enacting Section 622.[53] Charter argues that line itemization prevents franchising authorities from evading political accountability.[54] NCTA argues that the function of the pass through is to inform subscribers as to what portion of their cable bill goes to the government.[55] NCTA submits that LFAs are preempted from determining the extent to which franchise fees may be identified as a separate line item on monthly bills by Section 622.[56]

23. Fee itemization under Section 622, as is reflected in the legislative history quoted above, is intended to inform subscribers that local elected officials are imposing franchise fees so that there will be a measure of political accountability for fees and fee increases.[57] Section 622 expressly permits the itemization of "the amount of the total bill assessed as a franchise fee"[58] and further provides that the operator may "designate that portion of a subscriber's bill attributable to the franchise fee as a separate item on the bill."[59] We have already concluded that Section 623 permits a cable operator to pass through, as an external cost, the total franchise fee, including non-subscriber related franchise fees, in its regulated rates. The itemization provisions of Section 622 and the rate provisions of Section 623 are intended to work in tandem so that the amount of franchise fee added as an external cost is the same as the amount itemized on a subscriber's bill. Permitting cable operators to itemize on a subscriber's monthly bill the full amount assessed by the LFA, including non-subscriber related revenue, best effectuates this intent.

24. In this proceeding, we have provided clarification regarding the appropriate allocation of non-subscriber related franchise fees. The parties also have raised a variety of peripheral franchise fee matters in their pleadings.[60] We believe that these other matters are not appropriately addressed in the context of this order and are more appropriately resolved in proceedings related to the specific factual circumstances in which they arise.

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[53] Charter Comments at 7.

[54] *Id.* at 11.

[55] NCTA Comments at 11.

[56] *Id.* at 12.

[57] *See supra* n.13 and accompanying text (Statement of Senator Lott).

[58] 47 U.S.C. § 542(c).

[59] 47 U.S.C. § 542(f).

[60] For example, Los Angeles maintains that Charter should provide a detailed projection of non-cable revenues and a description of that accounting process. Los Angeles Comments at 5. This, and similar issues, are more suitable for resolution in the context of a local rate proceeding.

IV. ORDERING CLAUSE

25. Accordingly, **IT IS ORDERED** that the requests of the Cities **ARE DENIED** to the extent indicated herein.

FEDERAL COMMUNICATIONS COMMISSION

Magalie Roman Salas
Secretary

APPENDIX A

COMMENTS IN SUPPORT OF PASADENA

1. Azusa, Duarte, and West Covina, CA (jointly)
2. Burbank, CA
3. Calabasas, CA
4. Glendale, CA
5. La Canada Flintridge, CA
6. Los Angeles County, CA
7. Milpitas, CA
8. Monterey Park, CA
9. Temple City, CA
10. The Communications Support Group (on behalf of unnamed California municipalities)
11. Lexington Fayette Urban County Government, KY
12. Michigan Coalition to Protect Public Rights of Way ("Protec")
13. N. Charleston and Charleston County, NC
14. Plano, Texas
15. Texas Coalition of Cities on Franchised Utility Issues; Fairfax County, VA; Montgomery County, MD; St. Louis, MO; and National Association of Telecommunications Officers and Advisors ("NATOA") (filing jointly)
16. Bowling Green, KY
17. The Local and State Government Advisory Committee ("LSGAC")

COMMENTS IN OPPOSITION TO PASADENA

1. Charter
2. Comcast –Cox (filing jointly)
3. California Cable Television Association ("CCTA")
4. National Cable Television Association ("NCTA")

Separate Statement of Commissioners Kevin Martin and Kathleen Abernathy

Re: The City of Pasadena, California, the City of Nashville, Tennessee, and the City of Virginia Beach, Virginia, Petitions for Declaratory Ruling on Franchise Fee Pass Through Issues

We agree with today's Order that the Communications Act does not prohibit cable operators from itemizing and passing through to their cable television subscribers the full amount of franchise fees, even when those fees are based partially on revenues not related to the subscribers' services. We write separately to emphasize two points.

First, nothing in today's Order prevents local franchising authorities ("LFAs") and cable operators from reaching an agreement through contract to change how franchise fees are calculated or passed through. As the Order explains, "If LFAs and cable operators do not want to burden subscribers with higher franchise fee pass throughs, they may expressly omit certain items, such as advertising revenue and home shopping commissions, from the gross revenue definition." *Order* at ¶17.

Second, nothing in today's Order authorizes a cable operator to collect more money from subscribers as a franchise fee pass-through than the operator ultimately pays as a franchise fee to the LFAs. Thus, if a cable operator unintentionally over-collects from subscribers—due, for instance, to a mis-calculation or estimation of gross revenues—the cable operator must take some action to correct the discrepancy.

With the above two concerns addressed, we support today's Order.

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Vonage Holdings Corporation	)	WC Docket No. 03-211
Petition for Declaratory Ruling Concerning an	)	
Order of the Minnesota Public Utilities	)	
Commission	)	

MEMORANDUM OPINION AND ORDER

Adopted: November 9, 2004 **Released: November 12, 2004**

By the Commission: Chairman Powell and Commissioner Abernathy issuing separate statements; Commissioners Copps and Adelstein concurring and issuing separate statements.

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I. INTRODUCTION

1. In this Memorandum Opinion and Order (Order), we preempt an order of the Minnesota Public Utilities Commission (Minnesota Commission) applying its traditional "telephone company" regulations to Vonage's DigitalVoice service, which provides voice over Internet protocol (VoIP) service and other communications capabilities. We conclude that DigitalVoice cannot be separated into interstate and intrastate communications for compliance with Minnesota's requirements without negating valid federal policies and rules. In so doing, we add to the regulatory certainty we began building with other orders

adopted this year regarding VoIP – the *Pulver Declaratory Ruling*[1] and the *AT&T Declaratory Ruling*[2] – by making clear that this Commission, not the state commissions, has the responsibility and obligation to decide whether certain regulations apply to DigitalVoice and other IP-enabled services having the same capabilities. For such services, comparable regulations of other states must likewise yield to important federal objectives. Similarly, to the extent that other VoIP services are not the same as Vonage's but share similar basic characteristics, we believe it highly unlikely that the Commission would fail to preempt state regulation of those services to the same extent.[3] We express no opinion here on the applicability to Vonage of Minnesota's general laws governing entities conducting business within the state, such as laws concerning taxation; fraud; general commercial dealings; and marketing, advertising, and other business practices. We expect, however, that as we move forward in establishing policy and rules for DigitalVoice and other IP-enabled services, states will continue to play their vital role in protecting consumers from fraud, enforcing fair business practices, for example, in advertising and billing, and generally responding to consumer inquiries and complaints.

2. Our decision today will permit the industry participants and our colleagues at the state commissions to direct their resources toward helping us answer the questions that remain after today's Order – questions regarding the regulatory obligations of providers of IP-enabled services. We plan to address these questions in our *IP-Enabled Services Proceeding*[4] in a manner that fulfills Congress's directions "to promote the continued development of the Internet"[5] and to "encourage the deployment" of advanced telecommunications capabilities.[6] Meanwhile, this Order clears the way for increased investment and innovation in services like Vonage's to the benefit of American consumers.

II. BACKGROUND

3. On September 22, 2003, Vonage filed a petition for declaratory ruling[7] requesting that the Commission preempt an order of the Minnesota Commission imposing regulations applicable to providers of telephone service on Vonage's DigitalVoice.[8]

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[1] *Petition for Declaratory Ruling that pulver.com's Free World Dialup is Neither Telecommunications Nor a Telecommunications Service*, WC Docket No. 03-45, Memorandum Opinion and Order, 19 FCC Rcd 3307 (2004) (*Pulver Declaratory Ruling* or *Pulver*).

[2] *Petition for Declaratory Ruling that AT&T's Phone-to-Phone IP Telephony Services are Exempt from Access Charges*, WC Docket No. 02-361, Order, 19 FCC Rcd 7457 (2004) (*AT&T Declaratory Ruling*).

[3] *See infra* para. 31 and notes 93, 113 (referring to VoIP services of other providers, including facilities-based providers).

[4] *IP-Enabled Services*, WC Docket No. 04-36, Notice of Proposed Rulemaking, 19 FCC Rcd 4863 (2004) (*IP-Enabled Services Proceeding*).

[5] 47 U.S.C. § 230(b)(1).

[6] 47 U.S.C. § 157 nt. (incorporating section 706 of the Telecommunications Act of 1996 (1996 Act)).

[7] *See* Vonage Holdings Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission, WC 03-211 (filed Sept. 22, 2003) (Vonage Petition). The Commission requested and received comment on the Vonage Petition. *See Pleading Cycle Established for Comments on Vonage Petition for Declaratory Ruling*, WC Docket No. 03-211, Public Notice, 18 FCC Rcd 19325 (2003). See Appendix for a list of commenters.

A. Vonage's DigitalVoice Service

4. DigitalVoice is a service[9] that enables subscribers to originate and receive voice communications and provides a host of other features and capabilities that allow subscribers to manage their personal communications over the Internet.[10] By enabling the sending and receiving of voice communications and providing certain familiar enhancements like voicemail, DigitalVoice resembles the telephone service provided by the circuit-switched network. But as described in detail here, there are fundamental differences between the two types of service.

5. First, Vonage customers must have access to a broadband connection to the Internet to use the service.[11] Because Vonage does not offer Internet access services, DigitalVoice customers must obtain a broadband connection to the Internet from another provider.[12] In marked contrast to traditional circuit-switched telephony, however, it is not relevant where that broadband connection is located or even whether it is the same broadband connection every time the subscriber accesses the service. Rather, Vonage's service is fully portable; customers may use the service anywhere in the world where they can find a broadband connection to the Internet.[13] According to Vonage, it does not know where in the world its users are when using DigitalVoice.[14]

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[8] *In the Matter of Complaint of the Minnesota Department of Commerce Against Vonage Holding Corp. Regarding Lack of Authority to Operate in Minnesota*, Docket No. P-6214/C-03-108, Order Finding Jurisdiction and Requiring Compliance (issued Sept. 11, 2003) (*Minnesota Vonage Order*).

[9] DigitalVoice provides VoIP, among other capabilities. Although the Commission has adopted no formal definition of "VoIP," we use the term generally to include any IP-enabled services offering real-time, multidirectional voice functionality, including, but not limited to, services that mimic traditional telephony. *See IP-Enabled Services Proceeding*, 19 FCC at 4866, para. 3 n.7. VoIP services are available in a number of different forms. *See, e.g.*, Minnesota Commission Reply at 3 ("[VoIP] is a technology that has many current applications and potentially many more future applications."); *see also Availability of Advanced Telecommunications Capability in the United States*, GN Docket No. 04-54, Fourth Report to Congress, FCC 04-208, at 24-26 (rel. Sept. 9, 2004) (*Fourth Section 706 Report*) (describing VoIP services generally).

[10] We use the term "Internet" in this Order similarly to how the Commission has used it previously, inclusive of interconnected public, private, managed, and non-managed IP networks. *See, e.g., Pulver*, 19 FCC Rcd at 3309, para. 4 (citing *GTE Telephone Operating Cos., GTE Tariff No. 1, GTOC Transmittal No. 1148*, CC Docket No. 98-79, Memorandum Opinion and Order, 13 FCC Rcd 22466, 22468, para. 5 (1998) (*GTE ADSL Order*)); *see also Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities; Internet Over Cable Declaratory Ruling; Appropriate Regulatory Treatment for Broadband Access to the Internet Over Cable Facilities*, GN Docket No. 00-185; CS Docket No. 02-52, Declaratory Ruling and Notice of Proposed Rulemaking, 17 FCC Rcd 4798, 4799 n.1 (2002) (*Cable Modem Declaratory Ruling*), *aff'd in part, vacated in part, and remanded, Brand X Internet Services v. FCC*, 345 F.3d 1120 (9th Cir. 2003), *stay granted pending cert.* (April 9, 2004), *petitions for cert. filed*, Nos. 04-277 (Aug. 30, 2004), 04-281 (Aug. 27, 2004).

[11] *See* Vonage Petition at 4; Letter from William B. Wilhelm, Jr., Counsel for Vonage, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 03-211, at 2 (filed Oct. 1, 2004) (Vonage Oct. 1 *Ex Parte* Letter) (suggesting a minimum upstream connection speed of 128k).

[12] *See* Vonage Petition at 7, 15; Vonage Reply at 8. According to Vonage, its service operates with any type of broadband connection (*e.g.*, cable modem, digital subscriber line, or satellite), but will not work with dial-up Internet access. *See* Vonage Petition at 4.

[13] *See* Vonage Petition at 4; Vonage Oct. 1 *Ex Parte* Letter at 2.

[14] *See* Vonage Petition at 2, 5, 28-29.

6. Second, Vonage indicates that DigitalVoice requires customers to use specialized customer premises equipment (CPE).[15] Customers may choose among several different types of specialized CPE: (1) a Multimedia Terminal Adapter (MTA), which contains a digital signal processing unit that performs digital-to-audio and audio-to-digital conversion and has a standard telephone jack connection; (2) a native Internet Protocol (IP) phone; or (3) a personal computer with a microphone and speakers, and software to perform the conversion (softphone).[16] Although customers may in some cases attach conventional telephones to the specialized CPE that transmits and receives these IP packets, a conventional telephone alone will not work with Vonage's service.[17]

7. Third, DigitalVoice offers customers a suite of integrated capabilities and features that allows the user to manage personal communications dynamically, including but not limited to real-time, multidirectional voice functionality.[18] In addition to voice, these features include voicemail, three-way calling, online account and voicemail management, and geographically independent "telephone" numbers.[19] Vonage's Real-Time Online Account Management feature allows customers to access their accounts 24 hours a day through an Internet web page to manage their communications by configuring service features, handling voicemail, and editing user information.[20] At the user's discretion, the user may, among other options, play voicemails back through a computer or receive them in e-mails with the actual message attached as a sound file.[21] Using other features, users may request that DigitalVoice ring simultaneously the user's Vonage number plus any other number in the United States or Canada regardless of who provides the service connected with that other number.[22]

8. Among these features, DigitalVoice provides the capability to originate and terminate real-time voice communications. Once the CPE and software are installed and configured, the customer may place or receive calls over the Internet to or from anyone with a telephone number – including another Vonage customer, a customer of another VoIP provider, a customer of a commercial mobile radio service (CMRS) provider, or a user reachable only through the public switched telephone network (PSTN).[23] In any case,

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[15] *See id.* at 5.

[16] *See id.* at 5; Vonage Reply at 8-9; *see also* 8x8 Comments at 8-10. Vonage states that most of its customers use an MTA. In addition to the CPE to convert voice signals, as a practical matter, most users also require a router. *See* Vonage Petition at 5.

[17] *See* Vonage Petition at 5; Vonage Reply at 8 ("[A]n analog telephone device is neither necessary nor sufficient for use with Vonage's service."); *see also* 8x8 Comments at 9.

[18] *See* Vonage Petition at 4; *see also IP-Enabled Services Proceeding*, 19 FCC Rcd at 4866, para. 3 n.7.

[19] *See, e.g.*, Vonage Oct. 1 *Ex Parte* Letter at 4-5; Vonage, *Take Your Number With You* (visited Oct. 28, 2004) <http://www.vonage.com/features.php?feature=traveling>.

[20] *See* Vonage Oct. 1 *Ex Parte* Letter at 4; *see also* Vonage, *Real-Time Online Account Management* (visited Oct. 28, 2004) <http://www.vonage.com/features.php?feature=online_account_mgt>. For example, the voicemail service integrated into DigitalVoice allows the user to access voicemail and select delivery options through interaction with the customer's web account on the Internet.

[21] Vonage is currently adding functionality so that users may customize voicemail controls by scheduling recorded greetings for different hours of the day and different days of the year. *See* Oct. 1 *Ex Parte* Letter at 5; *see also* Vonage, *Voicemail Plus* (visited Oct. 28, 2004) <http://www.vonage.com/features.php?feature=voicemail>.

[22] *See, e.g.*, Vonage, *Call Forwarding* (visited Oct. 28, 2004) <http://www.vonage.com/features.php?feature=call_forwarding>.

[23] *See* Vonage Petition at 6.

the subscriber's outgoing calls originate on the Internet and are routed over the Internet to Vonage's servers. If the destination is another Vonage customer or a user on a peered service, the server routes the packets to the called party over the Internet and the communication also terminates via the Internet.[24] If the destination is a telephone attached to the PSTN, the server converts the IP packets into appropriate digital audio signals and connects them to the PSTN using the services of telecommunications carriers interconnected to the PSTN. If a PSTN user originates a call to a Vonage customer, the call is connected, using the services of telecommunications carriers interconnected to the PSTN, to the Vonage server, which then converts the audio signals into IP packets and routes them to the Vonage user over the Internet.[25] Together, these integrated features and capabilities allow customers to control their communications needs by determining for themselves how, when, and where communications will be sent, received, saved, stored, forwarded, and organized.

9. Fourth, although Vonage's service uses North American Numbering Plan (NANP) numbers as the identification mechanism for the user's IP address, the NANP number is not necessarily tied to the user's physical location for either assignment or use, in contrast to most wireline circuit-switched calls.[26] Rather, as Vonage explains, the number correlates to the user's digital signal processor to facilitate the exchange of calls between the Internet and the PSTN using a convenient mechanism with which users are familiar to identify the user's IP address.[27] In other words, and again in marked contrast to traditional circuit-switched telephony, a call to a Vonage customer's NANP number can reach that customer anywhere in the world and does not require the user to remain at a single location.

B. History of Vonage's Petition

10. In July 2003, the Minnesota Department of Commerce filed an administrative complaint against Vonage with the Minnesota Commission, asserting that Vonage was providing telephone exchange service in Minnesota and was thus subject to state laws and regulations governing a "telephone company." Among other things, the laws and regulations in question require such companies to obtain operating authority, file tariffs, and provide and fund 911 emergency services.[28] The Minnesota Department of Commerce sought an administrative order from the Minnesota Commission to compel Vonage to comply with these state regulatory requirements. In response to the administrative complaint,

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[24]Vonage-to-Vonage calls are not transmitted over the PSTN. *See id.* at 7. Calls from Vonage customers to customers of certain other IP service providers with which Vonage has a peering arrangement also are not transmitted over the PSTN, but solely over the Internet. *See* Vonage Oct. 1 *Ex Parte* Letter at 3-4. In this respect, the communication is similar to communications that occur over Pulver's Free World Dialup (FWD) service between FWD members. *See Pulver*, 19 FCC Rcd at 3309-10, paras. 5-6. If Vonage does not have a peering arrangement with a particular VoIP provider, calls between users of the two services are routed in part over the PSTN but originate and terminate via the Internet. *See* Vonage Oct. 1 *Ex Parte* Letter at 4.

[25]*See* Vonage Petition at 5-8; *see also* 8x8 Comments at 10.

[26]*See* Vonage Petition at 8.

[27]For calls to and from other VoIP users, Vonage could choose to use other identifiers to match the IP address. NANP numbers are not necessarily required for VoIP calls that remain on the Internet and do not connect with the PSTN. *See Pulver*, 19 FCC Rcd at 3309, para. 5 (explaining that Pulver's FWD service uses five or six digit FWD identification numbers rather than NANP numbers); *see also* Vonage Petition at 7-8; Vonage Oct. 1 *Ex Parte* Letter at 3-5.

[28]*See* Minn. Stat. §§ 237.07, 237.16, 237.49, 237.74(12); Minn. Rules §§ 7812.0200(1), 7812.0550(1).

Vonage argued that these state laws and regulations do not apply to it and that, even if they do, they are preempted by the Communications Act of 1934, as amended (Communications Act or Act).[29]

11. In September 2003, the Minnesota Commission issued an order asserting regulatory jurisdiction over Vonage and ordering the company to comply with all state statutes and regulations relating to the offering of telephone service in Minnesota.[30] In so holding, the Minnesota Commission declined to decide whether Vonage's service is a telecommunications service or an information service under the Act. Instead, it found DigitalVoice to be a "telephone service" as defined by Minnesota law, thus subjecting Vonage to the state requirements for offering such a service. In response, Vonage filed suit against the Minnesota Commission in the U.S. District Court for the District of Minnesota. In October 2003, the district court entered a permanent injunction in favor of Vonage.[31] The court determined that Vonage is providing an information service under the Act and that the Act preempts the Minnesota Commission's authority to subject such a service to common carrier regulation.[32] The court concluded that "VoIP services necessarily are information services, and state regulation over VoIP services is not permissible because of the recognizable congressional intent to leave the Internet and information services largely unregulated."[33] In January 2004, the court denied a motion by the Minnesota Commission for reconsideration, and an appeal to the U.S. Court of Appeals for the Eighth Circuit followed. The appeal remains pending.[34]

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[29] *See* Vonage Oct. 1 *Ex Parte* Letter, Exh. 3 at 5-12.

[30] *See, e.g., Minnesota Vonage Order* at 8. While the order states "the Commission will require that Vonage comply with Minnesota Statutes and Rules, including certification requirements and the provisioning of 911 service," the order does not enumerate the statutory and rule provisions to which it is referring other than those specifically listed in note 27 above. *See supra* note 28. We will refer to these requirements, collectively, throughout this Order as either "telephone company regulations" or "economic regulations." It appears, however, that many Minnesota Commission rules other than those specifically mentioned in the *Minnesota Vonage Order* would only apply to Vonage as a result of its status as a certificated entity in Minnesota. *See* Minn. Stat. § 237.16(a). As a result, because, as described below, we specifically preempt Minnesota's certification requirements for DigitalVoice in this Order, regulations applicable to certificated entities would not be applicable to Vonage for DigitalVoice.

[31] *See Vonage Holding Corp. v. Minnesota Pub. Utils. Comm'n*, 290 F. Supp. 2d 993 (D. Minn. 2003), *appeal pending, Vonage Holdings Corp. v. Minnesota Pub. Utils. Comm'n*, No. 04-1434 (8th Cir.). We reject commenters' contentions that we should dismiss the Vonage Petition as moot because the Minnesota district court granted a permanent injunction. *See, e.g.*, Minnesota Commission Comments at 4; Qwest Comments at 2; New York State AG Reply at 3. The Minnesota district court's permanent injunction is currently subject to appeal, and other courts and state commissions have open proceedings considering these issues. Accordingly, we find that this petition continues to present a "controversy" or "uncertainty" regarding the jurisdictional nature of DigitalVoice that may be addressed in a declaratory ruling. *See* 47 C.F.R. § 1.2. We also disagree that these issues are not ripe because Vonage can seek waivers of the Minnesota requirements. *See, e.g.*, MTA Comments at 8. The Minnesota order directs Vonage to comply with Minnesota Statutes and Rules within 30 days without mentioning the possibility of waiver. *See Minnesota Vonage Order* at 9. The possibility of waiver, however, does not eliminate the conflict with our rules and policies.

[32] *See Vonage Holding Corp. v. Minnesota Pub. Utils. Comm'n*, 290 F. Supp. 2d at 996-1003.

[33] *Id.* at 1002.

[34] *See Vonage Holdings Corp. v. Minnesota Pub. Utils. Comm'n*, No. 04-1434 (8th Cir.). The Commission sought a primary jurisdiction referral from the Eighth Circuit on the issues presented in this case. *See* Brief for the United States and the Federal Communications Commission as *Amici Curiae*, *Vonage Holdings Corp. v. Minnesota Pub.*

12. At the same time that it filed suit in the district court in Minnesota, Vonage filed the instant petition with the Commission. Specifically, Vonage's petition for declaratory ruling requests that the Commission preempt the Minnesota Commission's order and find that (1) Vonage is a provider of "information services," and is not a "telecommunications carrier," as those terms are defined in the Act,[35] and (2) state regulation of this service would unavoidably conflict "with the national policy of promoting unregulated competition in the Internet and information service market."[36] In the alternative, Vonage seeks a determination that the Minnesota Commission's order is preempted because it is impossible to separate this service, regardless of its regulatory classification, into distinct interstate and intrastate communications.[37] Vonage also seeks a ruling that certain specific E911 requirements imposed by the Minnesota Commission are in conflict with federal policies.[38] On August 13, 2004, Vonage submitted additional information to the Commission in this matter, requesting that we act expeditiously on its pending petition insofar as it concerned the jurisdictional nature of the service, explaining that such a determination could be rendered independent of the statutory classification of the service.[39]

13. Since Vonage filed its petition, a number of other states have opened proceedings to examine the jurisdictional nature of VoIP services offered in their states.[40] For example, in May 2004, the New York State Public Service Commission (New York Commission) adopted an order finding that Vonage, in offering and providing DigitalVoice in New York, is a "telephone corporation" as defined by New York state law, and is therefore subject to certain requirements.[41] The New York Commission asserted jurisdiction over Vonage and ordered it to obtain state certification and to file a tariff, but permitted Vonage to seek waivers of New York regulations that it deemed inappropriate or with which it was not readily able to comply.[42] Vonage sought, and in July the U.S. District Court for the Southern District of New York granted, a preliminary injunction of the *New York Vonage Order*.[43] The court held that

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Utils. Comm'n, No. 04-1434 (8th Cir. filed Apr. 21, 2004) (requesting a primary jurisdiction referral). The Eighth Circuit has not yet ruled on the primary jurisdiction referral. Oral argument is scheduled for November 17, 2004.

[35]*See* 47 U.S.C. § 153(20) (defining "information service"); 47 U.S.C. § 153(43) (defining "telecommunications"); 47 U.S.C. § 153(44) (defining "telecommunications carrier"); 47 U.S.C. § 153(46) (defining "telecommunications service").

[36]*See* Vonage Petition at 1.

[37]*Id.*

[38]*Id.*; *see also* 8x8 Comments at 15-17.

[39]*See* Letter from William B. Wilhelm, Jr., Counsel for Vonage, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 03-211, 04-36, at 1-2 (filed Aug. 13, 2004) (Vonage Aug. 13 *Ex Parte* Letter).

[40]*See, e.g., Order Instituting Investigation on the Commission's Own Motion to Determine the Extent to Which the Public Utility Telephone Service Known as Voice over Internet Protocol Should Be Exempted from Regulatory Requirements*, Investigation 04-02-007, Order Instituting Investigation (issued Feb. 11, 2004) (initiating a proceeding by the California Public Utilities Commission to investigate VoIP services).

[41]*See Complaint of Frontier Telephone of Rochester, Inc. against Vonage Holdings Corporation Concerning Provision of Local Exchange and Interexchange Telephone Service in New York State in Violation of the Public Service Law*, Case 03-C-1285, Order Establishing Balanced Regulatory Framework for Vonage Holdings Corporation at 10 (issued May 21, 2004) (*New York Vonage Order*).

[42]*See id.* at 17.

[43]*See Vonage Holdings Corp. v. New York State Public Service Comm'n*, 04 Civ. 4306 (DFE) (S.D.N.Y. July 16, 2004) (Order of Magistrate Judge Eaton) (*New York Preliminary Injunction*) (entering a preliminary injunction against the New York Commission's order).

"Vonage has shown that it is likely to succeed on the merits of its claim that the [*New York Vonage Order*] is preempted by federal law"; that "Vonage has demonstrated that the [*New York Vonage Order*] will interfere with interstate commerce"; and that this Commission's guidance, via orders in the *IP-Enabled Services Proceeding* or the instant proceeding, "may aid in final resolution of the matter."[44] The court has scheduled a status conference on December 13, 2004 to consider whether there is a need for further proceedings in this matter, including a determination on Vonage's request for permanent injunctive relief.[45]

III. DISCUSSION

14. We grant Vonage's petition in part[46] and preempt the *Minnesota Vonage Order*.[47] We find that the characteristics of DigitalVoice preclude any practical identification of, and separation into, interstate and intrastate communications for purposes of effectuating a dual federal/state regulatory scheme, and that permitting Minnesota's regulations would thwart federal law and policy. We reach this decision irrespective of the definitional classification of DigitalVoice under the Act, *i.e.*, telecommunications or information service, a determination we do not reach in this Order. Although Congress did not explicitly prescribe the regulatory framework for Internet-based communications like DigitalVoice when it

[44] *Id.* at 2-3.

[45] *See id.* at 3.

[46] We do not determine the statutory classification of DigitalVoice under the Communications Act, and thus do not decide here the appropriate federal regulations, if any, that will govern this service in the future. These issues are currently the subject of our *IP-Enabled Services Proceeding* where the Commission is comprehensively examining numerous types of IP-enabled services, including services like DigitalVoice. *See generally IP-Enabled Services Proceeding*, 19 FCC Rcd 4863. That proceeding will resolve important regulatory matters with respect to IP-enabled services generally, including services such as DigitalVoice, concerning issues such as the Universal Service Fund, intercarrier compensation, 911/E911, consumer protection, disability access requirements, and the extent to which states have a role in such matters. In addition, the Commission recently initiated a rulemaking proceeding to address law enforcement's needs relative to the Communications Assistance for Law Enforcement Act (CALEA), including the scope of services that are covered, who bears responsibility for compliance, the wiretap capabilities required by law enforcement, and acceptable compliance standards. Our decision in this Order does not prejudice the outcome of our proceeding on CALEA. *See Communications Assistance for Law Enforcement Act and Broadband Access and Services*, ET Docket No. 04-295; RM-10865, Notice of Proposed Rulemaking and Declaratory Ruling, 19 FCC Rcd 15676 (2004); *see also* DOJ/FBI Comments at 10-13; DOJ/FBI Reply at 7-10. These issues are complex and critically important matters. While these matters are being comprehensively addressed, however, it is essential that we take action to bring some greater measure of certainty to the industry to permit services like DigitalVoice to evolve. By ruling on the narrow jurisdictional question here, we enable this Commission and the states to focus resources in working together along with the industry to address the numerous other unresolved issues related to this and other IP-enabled and advanced communications services that are of paramount importance to the future of the communications industry. *See, e.g.*, PacWest/RCN Reply at 5; USA DataNet Comments at 2-3 (urging the Commission to act on the Vonage Petition). *But see, e.g.*, DOJ/FBI Comments at 9; Minnesota Commission Comments at 4; Montana Independent Telecommunications Systems Comments at 5; Qwest Comments at 3-4; USTA Comments at 3-4; DOJ/FBI Reply at 5-7; Minnesota Commission Reply at 3; Verizon Reply at 6 (urging the Commission not to act on the Vonage Petition, but instead to decide these issues in a comprehensive rulemaking proceeding).

[47] As we noted above, this Order does not address Minnesota's general laws governing entities conducting business within the state, such as laws concerning taxation; fraud; general commercial dealings; marketing, advertising, billing and other business practices. *See supra* para. 1.

amended the Act in 1996,[48] its statements regarding the Internet and advanced telecommunications capabilities in sections 230 and 706 indicate that our actions here are consistent with its intent concerning these emerging technologies. In addition, we address the fact that multiple state regulatory regimes would likely violate the Commerce Clause because of the unavoidable effect that regulation on an intrastate component would have on interstate use of this service or use of the service within other states. Finally, although we preempt the *Minnesota Vonage Order*, including its 911 requirements imposed as a condition to entry, we fully expect Vonage to continue its efforts to develop a 911 capability as we work toward resolving this important public safety issue in the *IP-Enabled Services Proceeding* as discussed below.[49]

A. Preemption of the *Minnesota Vonage Order*

15. We begin our analysis by briefly examining the distribution of authority over communications services between federal and state agencies under the Act. We then discuss judicial precedent that recognizes circumstances where state jurisdiction must yield to federal jurisdiction through the Commission's authority to preempt state regulations that thwart the lawful exercise of federal authority over interstate communications. Next, we explain our current federal rules and policies for services like DigitalVoice followed by our demonstration of the impossibility of separating DigitalVoice into interstate and intrastate components for purposes of complying with the Minnesota regulations without negating federal policies and directly conflicting with our own regulations. We conclude that preempting the *Minnesota Vonage Order* is compelled to avoid thwarting valid federal objectives for innovative new competitive services like DigitalVoice, finding consistency between our action here and Congress's articulated policies in sections 230 and 706 of the Act.

1. Commission Jurisdiction over DigitalVoice

16. In the absence of a specific statutory provision regarding jurisdiction over services like DigitalVoice, we begin with section 2 of the Act.[50] In 1934, Congress set up a dual regulatory regime for communications services.[51] In section 2(a) of the Act, Congress has given the Commission exclusive jurisdiction over "all interstate and foreign communication" and "all persons engaged . . . in such communication."[52] Section 2(b) of the Act reserves to the states jurisdiction "with respect to intrastate communication service . . . of any carrier."[53]

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[48]Telecommunications Act of 1996, Pub. Law No. 104-104, 110 Stat. 56 (1996) (1996 Act).

[49]Access to emergency services for VoIP services, including 911, is a critical public safety issue. This issue, and the extent to which states may have a role in such matters, will be addressed in the *IP-Enabled Services Proceeding*. We address this issue in a limited manner in this Order only because of the manner in which Minnesota ties its 911 requirements to entry authority. *See infra* paras. 42-44.

[50]*See Bell Atl. Tel. Cos. v. FCC*, 131 F.3d 1044 (D.C. Cir. 1997).

[51]*See generally* 47 U.S.C. § 152.

[52]47 U.S.C. § 152(a). Congress defined "interstate communication" as "communication or transmission . . . from any State, Territory, or possession of the United States. . . to any other State, Territory, or possession of the United States . . . but shall not . . . include wire or radio communication between points in the same State . . . through any place outside thereof, if such communication is regulated by a State commission." 47 U.S.C. § 153(22).

[53]47 U.S.C. § 152(b). "[I]ntrastate communications" is not separately defined in the Act except to the extent it is described in the definition of "interstate communication" as a "wire or radio communication between *points* in the same State." 47 U.S.C. § 153(22) (emphasis added). We note that section 2(b) reserves to the states only matters

17. In applying section 2 to specific services and facilities, the Commission has traditionally applied its so-called "end-to-end analysis" based on the physical end points of the communication.[54] Under this analysis, the Commission considers the "continuous path of communications," beginning with the end point at the inception of a communication to the end point at its completion, and has rejected attempts to divide communications at any intermediate points.[55] Using an end-to-end approach, when the end points of a carrier's service are within the boundaries of a single state the service is deemed a purely intrastate service, subject to state jurisdiction for determining appropriate regulations to govern such service.[56] When a service's end points are in different states or between a state and a point outside the United States, the service is deemed a purely interstate service subject to the Commission's exclusive jurisdiction.[57] Services that are capable of communications both between intrastate end points and between interstate end points are deemed to be "mixed-use" or "jurisdictionally mixed" services.[58] Mixed-use services are generally subject to dual federal/state jurisdiction, except where it is impossible or impractical to separate the service's intrastate from interstate components and the state regulation of the intrastate component interferes with valid federal rules or policies.[59] In such circumstances, the Commission may exercise its authority to preempt inconsistent state regulations that thwart federal objectives, treating jurisdictionally mixed services as interstate with respect to the preempted regulations.[60]

18. Thus, our threshold determination must be whether DigitalVoice is purely intrastate (subject only to state jurisdiction) or jurisdictionally mixed (subject also to federal jurisdiction). The nature of DigitalVoice precludes any suggestion that the service could be characterized as a purely intrastate service.[61] As Vonage has indicated, it has over 275,000 subscribers located throughout the United States,

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connected with "carriers," which means "common carriers" or "telecommunications carriers" under sections 3(10) and 3(44) of the Act. 47 U.S.C. § 153(10), (44). Here, we do not determine whether Vonage is a "carrier"; however, our analysis with respect to section 2(b) assumes that it is. This assumption for purposes of this Order, however, in no way prejudges how the Commission may ultimately classify DigitalVoice.

[54] *See, e.g., Bell Atl. Tel. Cos. v. FCC*, 206 F.3d 1, 3 (D.C. Cir. 2000); *see infra* para. 24 (addressing difficulties with an end-to-end approach for services involving the Internet).

[55] *See, e.g., Pulver*, 19 FCC Rcd at 3320-21, para. 21.

[56] *See* 47 U.S.C. § 152(b)(1).

[57] *See* 47 U.S.C. § 153(22).

[58] *See, e.g., MTS and WATS Market Structure Amendment of Part 67 of the Commission's Rules and Establishment of a Joint Board*, CC Docket Nos. 78-72, 80-286, Memorandum Opinion and Order on Reconsideration and Order Inviting Comments, 1 FCC Rcd 1287 (1987); *Petition for Emergency Relief and Declaratory Ruling Filed by the BellSouth Corporation*, Memorandum Opinion and Order, 7 FCC Rcd 1619, 1620, para. 7 (1992) (*BellSouth MemoryCall*); *Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523, 543 (8th Cir. 1998).

[59] *See Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 368 (1986) (finding a basis for Commission preemption where compliance with both federal and state law is in effect physically impossible) (citing *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132 (1963)); *BellSouth MemoryCall*, 7 FCC Rcd at 1622-23, paras. 18-19.

[60] Indeed, the Eighth Circuit has recently noted the Commission's authority to preempt in the area of jurisdictionally mixed special access services. *See Qwest Corp. v. Minnesota Pub. Utils. Comm'n*, 380 F.3d 367, 374 (8th Cir. 2004) (finding that, with respect to special access services, the Commission "*certainly has the wherewithal to preempt state regulation in this area if it so desires*") (emphasis added).

[61] We need not address in this Order the case of purely intrastate service, which is not the service we have before us in this petition.

each with the ability to communicate with anyone in the world from anywhere in the world.[62] While DigitalVoice clearly enables intrastate communications, it also enables interstate communications. It is therefore a jurisdictionally mixed service,[63] and this Commission has exclusive jurisdiction under the Act to determine the policies and rules, if any, that govern the interstate aspect of DigitalVoice service.[64]

2. Commission Authority To Preempt State Regulations

19. Although the Communications Act establishes dual federal-state authority to regulate certain communications services, courts routinely recognize that there may be circumstances where state regulation would necessarily conflict with the Commission's valid exercise of authority.[65] Where separating a service into interstate and intrastate communications is impossible or impractical, the Supreme Court has recognized the Commission's authority to preempt state regulation that would thwart or impede the lawful exercise of federal authority over the interstate component of the communications.[66]

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[62]*See* Vonage Oct. 1 *Ex Parte* Letter at 2 (explaining that its subscribers have billing addresses in each of the 50 states, the District of Columbia and throughout Canada, that its subscribers regularly use the service from countries outside North America, including "Argentina, Australia . . . and the United Kingdom," and that customers have used the service "from virtually every inhabitable continent in the world").

[63]We analyze DigitalVoice for purposes of preemption as a jurisdictionally mixed service due to its recognized capability to enable communications to occur not only between different states but within a particular state. This notwithstanding, it is possible that the Commission may find, in the context of the *IP-Enabled Services Proceeding*, that this type of service simply has no intrastate component.

[64]*See Louisiana Pub. Serv. Comm'n*, 476 U.S. at 360 (explaining how the Act would seem to divide the world of domestic telephone service into two hemispheres – one comprised of interstate service, over which the Commission has "plenary authority"); *see also Ivy Broad. Co. v. American Tel. & Tel. Co.*, 391 F.2d 486, 490 (2d Cir. 1968) ("The Supreme Court has held that the establishment of this broad scheme for the regulation of interstate service by communications carriers indicates an intent on the part of Congress to occupy the field to the exclusion of state law.").

[65]*See Louisiana Pub. Serv. Comm'n*, 476 U.S. at 375 n.4 (citing *North Carolina Utils. Comm'n v. FCC*, 537 F.2d 787 (4th Cir. 1976), *cert. denied*, 429 U.S. 1027 (1976); *North Carolina Utils. Comm'n v. FCC*, 552 F.2d 1036 (4th Cir. 1977) *cert. denied*, 434 U.S. 874 (1977) (upholding Commission preemption of state regulation because it was not possible to separate the interstate and intrastate components of the asserted Commission regulation)); *see also New York State Comm'n on Cable Television v. FCC*, 749 F.2d 804 (D.C. Cir. 1984) (affirming Commission order preempting state and local entry regulation of satellite master antenna television); *Promotion of Competitive Networks in Local Telecommunications Markets; Wireless Communications Association International, Inc. Petition for Rulemaking to Amend Section 1.4000 of the Commission's Rules to Preempt Restrictions on Subscriber Premises Reception or Transmission Antennas Designed to Provide Fixed Wireless Services; Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Review of Sections 68.104, and 68.213 of the Commission's Rules Concerning Connection of Simple Inside Wiring to the Telephone Network*, WT Docket No. 99-217; CC Docket Nos. 96-98, 88-57, First Report and Order and Further Notice of Proposed Rulemaking; Fifth Report and Order and Memorandum Opinion and Order; Fourth Report and Order and Memorandum Opinion and Order, 15 FCC Rcd 22983, 23031-32, para. 107 (2000) (preempting state regulation of fixed wireless antennas as an impediment to the full achievement of important federal objectives).

[66]*See Louisiana Pub. Serv. Comm'n*, 476 U.S. at 368-69. The Court also said that the "critical question in any pre-emption analysis is always whether Congress intended that federal regulation supersede state law." *Id.* at 369. As summarized by the Supreme Court, federal law and policy preempt state action in several circumstances: (1) where compliance with both federal and state law is in effect physically impossible (citing *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132); (2) when there is outright or actual conflict between federal and state law (citing *Free v. Bland*, 369 U.S. 663 (1962)); (3) where the state law stands as an obstacle to the accomplishment and

The D.C. Circuit, for example, applied this impossibility exception in affirming a Commission order preempting state regulation of the rate a local exchange carrier (LEC) charged an interexchange carrier for a disconnection service.[67] The court explained that Commission preemption of state regulation is permissible when the matter to be regulated has both interstate and intrastate aspects; preemption is necessary to protect a valid federal regulatory objective; and "state regulation would 'negate[ ] the exercise by the FCC of its own lawful authority' because regulation of the interstate aspects of the matter cannot be 'unbundled' from regulation of the intrastate aspects."[68] Such is the case with DigitalVoice service as discussed in detail below.

3. Conflict With Commission Rules and Policies

20. Regardless of the definitional classification of DigitalVoice under the Communications Act, the *Minnesota Vonage Order* directly conflicts with our pro-competitive deregulatory rules and policies governing entry regulations, tariffing, and other requirements arising from these regulations for services such as DigitalVoice.[69] Were DigitalVoice to be classified a telecommunications service, Vonage would be considered a nondominant, competitive telecommunications provider for which the Commission has eliminated entry and tariff filing requirements with respect to services like DigitalVoice.[70] In particular,

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execution of the full objectives of Congress (citing *Hines v. Davidowitz*, 312 U.S. 52 (1941)); (4) when Congress expresses a clear intent to preempt state law; (5) where there is implicit in federal law a barrier to state regulation; and (6) where Congress has legislated comprehensively, thus occupying an entire field of regulation. Additionally, the Supreme Court has held that preemption may result not only from action taken by Congress but also from a federal agency action that is within the scope of the agency's congressionally delegated authority. *Louisiana Pub. Serv. Comm'n*, 476 U.S. at 369 (citing *Fidelity Federal Savings & Loan Ass'n v. De la Cuesta*, 458 U.S. 141 (1982); *Capital Cities Cable, Inc. v. Crisp*, 467 U.S. 691 (1984)).

[67] *See Pub. Serv. Comm'n of Maryland v. FCC*, 909 F.2d 1510 (D.C. Cir. 1990).

[68] *Id.* at 1515 (citing *National Ass'n of Regulatory Util. Comm'rs v. FCC*, 880 F.2d 422, 429-31 (D.C. Cir. 1989); *Illinois Bell Tel. Co. v. FCC*, 883 F.2d 104, 113 (D.C. Cir. 1989); *Public Util. Comm'n of Texas v. FCC*, 886 F.2d 1325, 1329, 1331-33 (D.C. Cir. 1989)).

[69] While we do not rely on it as a basis for our action in this Order, we also note that section 253 of the Act provides the Commission additional preemption authority over state regulations that "prohibit or have the effect of prohibiting the ability of an entity to provide any interstate or intrastate telecommunications service." 47 U.S.C. § 253. *See* Vonage Petition at 28 n.55 (indicating it does not submit its petition under section 253). Were DigitalVoice to be classified as a telecommunications service, however, it is possible that we could find state economic regulation such as that imposed by Minnesota to be a prohibition on the provision of an interstate and intrastate telecommunications services under section 253. *See* Vonage Petition at 11, 28 (describing that it is technically and practically impossible to comply with Minnesota's "telephone company" rules).

[70] *See, e.g., Implementation of Section 402(b)(2)(A) of the Telecommunications Act of 1996; Petition for Forbearance of the Independent Telephone & Telecommunications Alliance*, CC Docket No. 97-11; AAD File No. 98-43, Report and Order and Second Memorandum Opinion and Order, 14 FCC Rcd 11364, 11372-75, paras. 12-16 (1999) (*Section 214 Order*) (granting blanket section 214 authority for new lines of all domestic carriers including dominant carriers like the Bell operating companies (BOCs)); *Policy and Rules Concerning the Interstate, Interexchange Marketplace; Implementation of Section 245(g) of the Communications Act of 1934*, CC Docket No. 96-61, Second Report and Order, 11 FCC Rcd 20730 (1996) (*Interexchange Detariffing Order*) (adopting mandatory detariffing of most domestic interstate, interexchange services); Order on Reconsideration, 12 FCC 15014 (1997); Second Order on Reconsideration and Erratum, 14 FCC Rcd 6004 (1999), *aff'd, MCI WorldCom, Inc. v. FCC*, 209 F.3d 760 (D.C. Cir. 2000); *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor*, First Report and Order, 85 FCC 2d 1 (1980) (subsequent history

in completely eliminating interstate market entry requirements, the Commission reasoned that retaining entry requirements could stifle new and innovative services whereas blanket entry authority, *i.e.*, unconditional entry, would promote competition.[71] State entry and certification requirements, such as the Minnesota Commission's, require the filing of an application which must contain detailed information regarding all aspects of the qualifications of the would-be service provider, including public disclosure of detailed financial information, operational and business plans, and proposed service offerings.[72] The application process can take months and result in denial of a certificate, thus preventing entry altogether.[73] Similarly, when the Commission ordered the mandatory detariffing of most interstate, domestic, interexchange services (including services like DigitalVoice), the Commission found that prohibiting such tariffs would promote competition and the public interest, and that tariffs for these services *may actually harm consumers* by impeding the development of vigorous competition.[74] Tariffs and "price lists," such as those required by Minnesota's statutes and rules, are lengthy documents subject to specific filing and notice requirements that must contain every rate, term, and condition of service offered by the provider, including terms and conditions to which the provider may be subject in its certificate of authority.[75] The Minnesota Commission may also require the filing of cost-justification information or order a change in a rate, term or condition set forth in the tariff.[76] The administrative process involved in entry certification and tariff filing requirements, alone, introduces substantial delay in time-to-market and ability to respond to changing consumer demands, not to mention the impact these processes have on how an entity subject to such requirements provides its service.

21. On the other hand, if DigitalVoice were to be classified as an information service, it would be subject to the Commission's long-standing national policy of nonregulation of information services,[77]

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omitted) (*Competitive Carrier Proceeding*) (adopting regulatory framework based on dominant or nondominant status of carriers).

[71] *See Section 214 Order*, 14 FCC Rcd at 11373, para. 14 ("By its very terms, blanket authority removes regulatory hurdles to market entry, thereby promoting competition."); *id.* at 11373, para. 13 ("Rather than maintaining [entry requirements] that may stifle new and innovative services[,] ... we believe it is more consistent with the goals of the 1996 Act to remove this hurdle.").

[72] *See* Minn. Rule § 7812.0200.

[73] *See* Minn. Stat. § 237.16(c)

[74] *See Interexchange Detariffing Order*, 11 FCC Rcd at 20760, para. 52 (emphasis added) ("[W]e find that not permitting nondominant interexchange carriers to file tariffs with respect to interstate, domestic, interexchange services will enhance competition among providers of such services, promote competitive market conditions, and achieve other objectives that are in the public interest, including eliminating the possible invocation of the filed rate doctrine by nondominant interexchange carriers, and establishing market conditions that more closely resemble an unregulated environment."); *id.* at 20750, para. 37 ("We also adopt the tentative conclusion that in the interstate, domestic, interexchange market, requiring nondominant interexchange carriers to file tariffs for interstate, domestic, interexchange services may harm consumers by impeding the development of vigorous competition, which could lead to higher rates."). We note that certain exceptions to the Commission's mandatory detariffing rules exist; however, these exceptions would not apply to services like DigitalVoice were it to be classified a telecommunications service.

[75] *See* Minn. Stat. § 237.07; *see also, e.g.*, Minn. Rules §§ 7812.0300(6), 7812.0350(6), 7812.2210(2).

[76] *See, e.g.*, Minn. Rule §§ 7812.2210(4),(8).

[77] *See Regulatory and Policy Problems Presented by the Interdependence of Computer and Communication Services and Facilities*, Docket No. 16979, Notice of Inquiry, 7 FCC 2d 11 (1966) (*Computer I NOI*); *Regulatory and Policy Problems Presented by the Interdependence of Computer and Communication Services and Facilities*, Docket No.

particularly regarding economic regulation such as the type imposed on Vonage in the *Minnesota Vonage Order*.[78] In a series of proceedings beginning in the 1960's, the Commission issued orders finding that economic regulation of information services would disserve the public interest because these services lacked the monopoly characteristics that led to such regulation of common carrier services historically. The Commission found the market for these services to be competitive and best able to "burgeon and flourish" in an environment of "free give-and-take of the market place without the need for and possible burden of rules, regulations and licensing requirements."[79]

22. Thus, under existing Commission precedent, regardless of its definitional classification, and unless it is possible to separate a Minnesota-only component of DigitalVoice from the interstate component, Minnesota's order produces a direct conflict with our federal law and policies, and impermissibly encroaches on our exclusive jurisdiction over interstate services such as DigitalVoice. This notwithstanding, some commenters argue that the traditional dual regulatory scheme must nevertheless apply to DigitalVoice *because it is functionally similar* to traditional local exchange and long distance

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16979, Final Decision and Order, 28 FCC 2d 267 (1971) (*Computer I Final Decision*); *Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry)*, Docket No. 20828, Tentative Decision and Further Notice of Inquiry and Rulemaking, 72 FCC 2d 358 (1979) (*Computer II Tentative Decision*); *Computer II Final Decision*, 77 FCC 2d 384 (1980); *Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer Inquiry)*, CC Docket No. 85-229, Report and Order, 104 FCC 2d 958 (1986) (*Computer III*) (subsequent history omitted) (collectively the *Computer Inquiry Proceeding*). In its *Second Computer Inquiry* proceeding, the Commission "adopted a regulatory scheme that distinguished between the common carriage offering of basic transmission services and the offering of enhanced services." *Computer II Final Decision*, 77 FCC 2d at 387; *see also Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Regulatory Review – Review of Computer III and ONA Safeguards and Requirements*, 13 FCC Rcd 6040, 6064, para. 38 (1998). The former services are regulated under Title II and the latter services are not. *See Computer II Final Decision*, 77 FCC 2d at 428-30, 432-43, paras. 113-18, 124-49 (indicating it would not serve the public interest to subject enhanced service providers to traditional common carrier regulation under Title II because, among other things, the enhanced services market was "truly competitive"). The 1996 Act uses different terminology (*i.e.*, "telecommunications services" and "information services") than used by the Commission in its *Computer Inquiry* proceeding, but the Commission has determined that "enhanced services" and "information services" should be interpreted to extend to the same functions, although the definition in the 1996 Act is even broader. *See Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as Amended*, CC Docket No. 96-149, First Report and Order and Further Notice of Proposed Rulemaking, 11 FCC Rcd 21905, 21955-56, para. 102 (1996) (*Non-Accounting Safeguards Order*) (subsequent history omitted) (explaining that all enhanced services are information services, but information services are broader and may not be enhanced services).

[78] *See, e.g., Pulver*, 19 FCC Rcd at 3317-20, paras. 17-20 (explaining the Commission's policy of nonregulation for information services and how the 1996 Act reinforces this policy). This policy of nonregulation refers primarily to economic, public-utility type regulation, as opposed to generally applicable commercial consumer protection statutes, or similar generally applicable state laws. Indeed, the preeminence of federal authority over information services has prevailed unless a carrier-provided information service could be characterized as "purely intrastate," *see California v. FCC*, 905 F.2d 1217, 1239-42 (9th Cir. 1990), or it is possible to separate out the interstate and intrastate components and state regulation of the intrastate component would not negate valid Commission regulatory goals. *See California v. FCC*, 39 F.3d 919 (9th Cir. 1994) (*California III*), *cert. denied*, 514 U.S. 1050 (1995) (affirming Commission preemption of certain state requirements for separation of facilities and personnel in the BOC provision of jurisdictionally mixed enhanced services as state regulations would negate national policy).

[79] *See Computer II Final Decision*, 77 FCC 2d at 425-33, paras. 109-27 (citing *Computer I, Tentative Decision*, 27 FCC 2d at 297-298).

voice service.[80] Were it appropriate to base our decision today on the applicability of Minnesota's "telephone company" regulations to DigitalVoice solely on the functional similarities between DigitalVoice and other existing voice services (as the Minnesota Commission appears to have done),[81] we would find DigitalVoice *far more similar* to CMRS, which provides mobility, is often offered as an all-distance service, and needs uniform national treatment on many issues.[82] Indeed, in view of these differences, CMRS, including IP-enabled CMRS, is expressly exempt from the type of state economic regulation Minnesota seeks to impose on DigitalVoice.[83] Commenters that argue that the Act requires the Commission to recognize state jurisdiction over DigitalVoice to the extent it enables "intrastate" communications to occur completely ignore the considerations that dictate preemption here.[84] Indeed, the fact that a particular service enables communication within a state does not necessarily subject it to state economic regulation. We have acknowledged similar "intrastate" communications capabilities in other services involving the Internet, where for regulatory purposes, treatment as an interstate service prevailed despite this "intrastate" capability.[85]

4. Preemption Based on "Impossibility"

23. In this section, we examine whether there is any plausible approach to separating DigitalVoice into interstate and intrastate components for purposes of enabling dual federal and state regulations to coexist without "negating" federal policy and rules.[86] We find none. Without a practical means to

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[80] *See, e.g.*, ITTA Comments at 10-12; Minnesota Commission Comments at 3; MTA Comments at 13-14; RIITA Comments at 2; Surewest Comments at 4-5; GVNW Reply at 2-3; Minnesota Commission Reply at 4-5, 7; NASUCA Reply at 9, 11-12; Sprint Reply at 2-3. *But see* Verizon Reply at 2-6.

[81] *See Minnesota Vonage Order* at 8 (finding Vonage's service to be "functionally no different than any other telephone service").

[82] Indeed, other commenters note how DigitalVoice is like CMRS. *See, e.g.*, California Commission Comments at 20-22; HTBC Comments at 9.

[83] *See* 47 U.S.C. § 332(c)(3)(A). Pursuant to section 332 of the Act, state and local governments are specifically preempted from regulating the "*entry of or the rates charged* by any commercial mobile service or any private mobile service." *Id.* (emphasis added).

[84] *See, e.g.*, New York Commission Comments at 3; California Commission Comments at 4, 19; NASUCA Reply at 15; OTA/WIT Reply Comment at 8; Sprint Reply at 6-7.

[85] For example, the Commission concluded that some traffic over GTE's asymmetrical digital subscriber line (ADSL) service would, in fact, be terminated in the state where it originated, or even locally, but the service is "an interstate service and is properly tariffed at the federal level." *See GTE ADSL Order*, 13 FCC Rcd at 22466, 22478-79, paras. 1, 22. The Commission left open the possibility that a purely intrastate xDSL service may be offered which would be tariffed at the state level. *See id.* at 22481, para. 27. The Commission similarly determined that cable modem service is an interstate service because the points among which cable modem communications travel are often in different states and countries. *See Cable Modem Declaratory Ruling*, 17 FCC Rcd at 4832, para. 59. The jurisdictionally interstate finding of cable modem service was not an issue on appeal. *See Brand X Internet Services v. FCC*, 345 F.3d 1120. Finally, in *Pulver*, the Commission held that Pulver's "intrastate capabilities" should not remove the service from our jurisdiction. *See Pulver*, 19 FCC Rcd at 3320-22, paras. 20-22.

[86] *See Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. at 368 (holding that the Supremacy Clause of Article VI of the Constitution provides Congress with the power to preempt state law and explaining the numerous bases for preemption); *see also Pub. Serv. Comm'n of Maryland v. FCC*, 909 F.2d at 1515 (citing *Nat'l Ass'n of Regulatory Util. Comm'rs v. FCC*, 880 F.2d at 429-31); *Nat'l Ass'n of Regulatory Util. Comm'rs*, 880 F.2d at 425 ("We conclude that the Commission may only preempt state regulation over intrastate wire communication to the degree

separate the service, the *Minnesota Vonage Order* unavoidably reaches the interstate components of the DigitalVoice service that are subject to exclusive federal jurisdiction. Vonage has no means of directly or indirectly identifying the geographic location of a DigitalVoice subscriber. Even, however, if this information were reliably obtainable, Vonage's service is far too multifaceted for simple identification of the user's location to indicate jurisdiction. Moreover, the significant costs and operational complexities associated with modifying or procuring systems to track, record and process geographic location information as a necessary aspect of the service would substantially reduce the benefits of using the Internet to provide the service, and potentially inhibit its deployment and continued availability to consumers.[87]

24. DigitalVoice harnesses the power of the Internet to enable its users to establish a virtual presence in multiple locations simultaneously, to be reachable anywhere they may find a broadband connection, and to manage their communications needs from any broadband connection. The Internet's inherently global and open architecture obviates the need for any correlation between Vonage's DigitalVoice service and its end users' geographic locations. As we noted above, however, the Commission has historically applied the geographic "end-to-end" analysis to distinguish interstate from intrastate communications.[88] As networks have changed and the services provided over them have evolved, the Commission has increasingly acknowledged the difficulty of using an end-to-end analysis when the services at issue involve the Internet.[89] DigitalVoice shares many of the same characteristics as these other services involving the Internet, thus making jurisdictional determinations about particular DigitalVoice communications based on an end-point approach difficult, if not impossible.[90]

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necessary to keep such regulation from negating the Commission's exercise of its lawful authority over interstate communication service.").

[87]*See* Letter from William B. Wilhelm, Jr. and Ronald W. Del Sesto, Jr., Counsel for Vonage, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 03-211, at 5 (filed Oct. 19, 2004) (Vonage Oct. 19 *Ex Parte* Letter)

[88]*See supra* para. 17.

[89]For example, in attempting to apply an end-to-end analysis to an incumbent LEC's digital subscriber line (DSL) telecommunications service to determine whether federal or state tariffing requirements should attach, the Commission noted that "an Internet communication does not necessarily have a point of 'termination' in the traditional sense." *GTE ADSL Order*, 13 FCC Rcd at 22478-79, para. 22. In a later proceeding involving the provision of Telecommunications Relay Service over the Internet, the Commission similarly noted the difficulty in pinpointing the origination of an IP-Relay call arising over the Internet because Internet addresses do not have geographic correlates equivalent to the PSTN's automatic number identifiers, which are tied to geographic locations, and thus, there is no automatic way to determine whether any call is intrastate or interstate. *See Provision of Improved Telecommunications Relay Services and Speech-to-Speech Services for Individuals with Hearing and Speech Disabilities*, CC Docket No. 98-67, Declaratory Ruling and Second Further Notice of Proposed Rulemaking, 17 FCC 7779, 7784, para. 15 (2002) (*IP-Relay Second FNPRM*). Significantly, as recently as June, the Commission issued yet another Further Notice of Proposed Rulemaking in this proceeding, recognizing the continued technological inability to identify the location of an IP-Relay user. *See Telecommunications Relay Services and Speech-to-Speech Services for Individuals with Hearing and Speech Disabilities*, CC Docket Nos. 90-571, 98-67; CG Docket No. 03-123, Report and Order; Order on Reconsideration; Further Notice of Proposed Rulemaking, 19 FCC Rcd 12475, 12561, para. 221 (2004) (*2004 IP-Relay FNPRM*). In *Pulver*, the Commission concluded that the concept of "end points" and an end-to-end analysis were not relevant to Pulver's Internet-based VoIP information service. *See Pulver*, 19 FCC Rcd at 3316-23, paras. 15-25.

[90]*See* Vonage Petition at 5, 28.

25. In fact, the geographic location of the end user at any particular time is only one clue to a jurisdictional finding under the end-to-end analysis. The geographic location of the "termination" of the communication is the other clue; yet this is similarly difficult or impossible to pinpoint. This "impossibility" results from the inherent capability of IP-based services to enable subscribers to utilize multiple service features that access different websites or IP addresses during the same communication session and to perform different types of communications simultaneously, none of which the provider has a means to separately track or record.[91] For example, a DigitalVoice user checking voicemail or reconfiguring service options would be communicating with a Vonage server. A user forwarding a voicemail via e-mail to a colleague using an Internet-based e-mail service would be "communicating" with a different Internet server or user. An incoming call to a user invoking forwarding features could "terminate" anywhere the DigitalVoice user has programmed. A communication from a DigitalVoice user to a similar IP-enabled provider's user would "terminate" to a geographic location unknown either to Vonage or to the other provider.[92] These functionalities in all their combinations form an integrated communications service designed to overcome geography, not track it. Indeed, it is the total lack of dependence on *any* geographically defined location that most distinguishes DigitalVoice from other services whose federal or state jurisdiction is determined based on the geographic end points of the communications.[93] Consequently, Vonage has no service-driven reason to know users' locations,[94] and

[91] *See, e.g.*, Vonage Oct. 19 *Ex Parte* Letter at 4-5 (explaining that in addition to having no way to determine a geographic origination point, determining a geographic destination is not possible either); *see also* Letter from Glenn T. Reynolds, BellSouth Corp., to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 04-36; 03-211, Attach. at 6-12 (filed Oct.26, 2004) (BellSouth Oct. 26 *Ex Parte* Letter) (explaining the multitude of simultaneous capabilities during a single communication that makes a point of destination unknown); Letter from Howard Symons, Counsel for NTCA, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 03-211, 04-36 Attach. at 2-3 (filed Oct.28, 2004) (NCTA Oct. 28 *Ex Parte* Letter) (describing the core integrated features that "cable VoIP" provides to subscribers); Letter from Adam D. Krinsky, Counsel for CTIA, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 04-36; 03-211, (filed Oct.25, 2004) (CTIA Oct. 25 *Ex Parte* Letter) (explaining that IP-enabled services do not have definable termination points).

[92] *See* Vonage Oct. 19 *Ex Parte* Letter at 4-5.

[93] We note that these integrated capabilities and features are not unique to DigitalVoice, but are inherent features of most, if not all, IP-based services having basic characteristics found in DigitalVoice, including those offered or planned by facilities-based providers. *See infra* note 113 for a brief summary of these basic characteristics; *see also, e.g.*, Letter from Kathleen Grillo, Verizon, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 03-211 at 1-3 (filed Nov. 1, 2004) (Verizon Nov. 1 *Ex Parte* Letter) (describing Verizon's VoiceWing service); Letter from Cronan O'Connell, Qwest, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 03-211 (filed Sept. 27, 2004) (Qwest Sept. 27 *Ex Parte* Letter) (describing Qwest's VoIP architecture and service); Letter from Judy Sello, AT&T, to Marlene H. Dortch, Secretary, FCC, WC Docket No. 03-211 at 1-4, (filed Oct. 21, 2004) (AT&T Oct 21 *Ex Parte* Letter) (describing AT&T's CallVantage service); Letter from James K. Smith, Executive Director – Federal Regulatory, SBC, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 03-211, 04-29, 04-36, Attach. at 4-11 (filed Oct. 8, 2004) (SBC Oct. 8 *Ex Parte* Letter) (describing SBC's VoIP architecture and service); Letter from Glenn T. Reynolds, Vice President – Federal Regulatory, BellSouth, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 03-211, 04-36, Attach. at 6-12 (filed Oct. 26, 2004) (BellSouth Oct. 26 *Ex Parte* Letter) (describing BellSouth's VoIP architecture and service); Letter from Glenn T. Reynolds, Vice President – Federal Regulatory, BellSouth, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 03-211, 04-36, Attach. at 4 (filed Oct. 7, 2004) (BellSouth Oct. 7 *Ex Parte* Letter) (describing BellSouth's VoIP architecture and service); Letter from Howard J. Symons, Counsel for National Cable & Telecommunications Association (NCTA), to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 03-211, 04-36, Attach. at 3-5 (filed Oct. 28, 2004) (NCTA Oct. 28 *Ex Parte* Letter) (describing cable VoIP architecture).

Vonage asserts it presently has no way to know.[95] Furthermore, to require Vonage to attempt to incorporate geographic "end-point" identification capabilities into its service solely to facilitate the use of an end-to-end approach would serve no legitimate policy purpose.[96] Rather than encouraging and promoting the development of innovative, competitive advanced service offerings,[97] we would be taking the opposite course, molding this new service into the same old familiar shape.

26. In the absence of a capability to identify *directly* DigitalVoice communications that originate and terminate within the boundaries of Minnesota, we still consider whether some method exists to identify such communications *indirectly*, such that Minnesota's regulations could nonetheless apply to only that "intrastate" usage such as voice calls between persons located in the same state.[98] For example, assume Minnesota were to use DigitalVoice subscribers' NPA/NXXs as a proxy for those subscribers' geographic locations when making or receiving calls. If a subscriber's NPA/NXX were associated with Minnesota under the NANP, Minnesota's telephone company regulations would attach to every DigitalVoice communication that occurred between that subscriber and any other party having a Minnesota NPA/NXX. But because subscribers residing anywhere could obtain a Minnesota NPA/NXX, a subscriber may never be present in Minnesota when communicating with another party that is, yet Minnesota would treat those calls as subject to its jurisdiction.[99]

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[94] *See American Libraries Ass'n v. Pataki*, 969 F. Supp. 160, 170 (S.D.N.Y. 1997) ("Internet protocols were designed to ignore rather than document geographic location.").

[95] We acknowledge that certain geolocation products may be capable of identifying, to some degree, the geographic location of a Vonage user in the future, *see, e.g.*, Sprint Reply at 7, but the record does not reflect that such information is readily obtainable at this time. *See, e.g.*, 8x8 Comments at 14-15. Should Vonage decide in the future to incorporate geolocation capabilities into its service to facilitate additional features that may be dependent on reliable location determining capabilities, *e.g.*, E911-type features or law enforcement surveillance capabilities, this would not alter the fact that the service enables the user's location to change continually. *See* Vonage Oct. 19 *Ex Parte* Letter at 3-6 (explaining how user location information for emergency services purposes would have no relevance to an end to end jurisdictional analysis for DigitalVoice).

[96] *See Pulver*, 19 FCC Rcd at 3320-21, para. 21 ("Attempting to require Pulver to locate its members for the purpose of adhering to a regulatory analysis that served another network would be forcing changes on this service for the sake of regulation itself, rather than for any particular policy purpose.").

[97] *See, e.g.*, Letter from Staci L. Pies, The VON Coalition, to Marlene H. Dortch, Secretary, FCC, CC Docket No. 01-92; WC Docket Nos. 02-361, 03-211, 03-266, 04-36, Attach. at 1 (filed Aug. 19, 2004) (VON Coalition Aug. 19 *Ex Parte* Letter).

[98] Where the Commission has found it difficult to apply an end-to-end approach for jurisdictional purposes, it has proposed or adopted proxy or allocation mechanisms to approximate an end-to-end result. *See, e.g., GTE ADSL Order*, 13 FCC Rcd at 22479, para. 23 (applying the 10% rule for determining interstate jurisdiction for federal tariffing purposes); *IP-Relay Second FNPRM*, 17 FCC Rcd at 7784, para. 15 (proposing either an allocator to approximate the mix of interstate/intrastate traffic or a user self-identification mechanism to identify its end-point location); *2004 IP-Relay FNPRM*, 19 FCC Rcd at 12561-64, paras. 221-30 (proposing either user-registration or allocation mechanisms to determine interstate or intrastate use; asking whether, in the alternative, all IP-Relay calls should simply be deemed interstate). We find a 'percentage' proxy to be unhelpful in addressing the conflict between the federal and state regulatory regimes (in particular, the tariffing and certification requirements) at issue in this proceeding, because using such a proxy would not avoid frustration of the Commission's policy objectives discussed above. *See supra* section III.A.3. *But see, e.g.*, MTA Comments at 10.

[99] In this example, if we further assume Minnesota requires entry certification for Vonage, but has an entry condition that Vonage cannot meet, Vonage could be subject to state sanctions for "operating" in the state without authority to

27. Similarly, if a Minnesota NPA/NXX subscriber residing in Minnesota used its service outside the state to call someone in Minnesota, that call would appear to be an intrastate call when it is actually interstate. Some commenters suggest that because Vonage markets DigitalVoice to provide "local" and "long distance" calls it surely has an ability to distinguish between intrastate and interstate calls.[100] These commenters fail to recognize that these calls are not "local" and "long distance" in the sense that they are for traditional wireline telephone services. Rather, like we have seen with the proxy example above, Vonage describes these calling capabilities for convenience in terms that its subscribers understand. A DigitalVoice call that would be deemed "local," for example, is actually a call between two NPA/NXXs associated with particular rate centers in a particular state, yet when the actual communication occurs one or both parties can be located outside those rate centers, outside the state, or even on opposite ends of the world.

28. We further consider whether Minnesota could assert jurisdiction over DigitalVoice communications based on whether the subscriber's billing address or address of residence are in Minnesota. This too fails. When a subscriber with a Minnesota billing address or address of residence uses DigitalVoice from any location outside the state to call a party located in Minnesota, Minnesota would treat that communication as "intrastate" based on the address proxy for that subscriber's location, yet in actuality it would be an interstate call.[101]

29. These proxies are very poor fits, yet even their implementation would impose substantial costs retrofitting DigitalVoice into a traditional voice service model for the sole purpose of making it easier to apply traditional voice regulations to only a small aspect of Vonage's integrated service.[102] Forcing such changes to this service would greatly diminish the advantages of the Internet's ubiquitous and open nature that inspire the offering of services such as DigitalVoice in the first instance.[103] Indeed, Vonage would have to change multiple aspects of its service operations that are not nor were ever designed to incorporate geographic considerations, including modifications to systems that track and identify subscribers' communications activity and facilitate billing; the development of new rate and service structures; and sales and marketing efforts,[104] just for regulatory purposes.[105] The Commission has previously recognized the significant efforts and inefficiency to attempt to separate out an intrastate

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the extent any of its customers nationwide obtain Minnesota NPA/NXXs and use the service to communicate with someone in Minnesota even though that subscriber never had a physical presence in Minnesota.

[100] *See, e.g.*, NASUCA Reply at 15.

[101] In this example, if we further assume Minnesota has imposed a specific rate requirement on DigitalVoice's intrastate communications, this rate requirement would apply to all DigitalVoice communications made by that subscriber to someone in Minnesota even though many of those communications are interstate under the Act.

[102] *See Pulver*, 19 FCC Rcd at 3321-23, paras. 22, 24 (finding it similarly impossible to separate Pulver's VoIP service).

[103] *See, e.g.*, Vonage Oct. 19 *Ex Parte* Letter at 6.

[104] In reviewing a challenge to a Commission requirement for BOC joint CPE/service marketing because it would "surely 'affect' charges for" and regulate "intrastate communications services," and preemption of inconsistent state regulation, the D.C. Circuit affirmed the Commission stating that "[e]ven if [it] were a purely intrastate service, the FCC might well have authority to preemptive regulate its marketing if – as would appear here – it was typically sold in a package with interstate services. Marketing realities might themselves create inseparability." *Illinois Bell Tel. Co. v. FCC*, 883 F.2d 104, 112-13 & n.7 (D.C. Cir. 1989) (referencing *Louisiana Pub. Serv. Comm'n*, 476 U.S. 355).

[105] *See generally* Vonage Oct. 19 *Ex Parte* Letter.

component of other services for certain regulatory purposes where the provider, like Vonage here, *had no service-driven reason to incorporate such capability into its operations.*[106] We have declined to require such separation in those circumstances, treating the services at issue as jurisdictionally interstate for the particular regulatory purpose at issue and preempting state regulation where necessary.[107] For example, in preempting a state regulation specifying default per line blocking of a customer's "Caller ID" for intrastate calls based on "impossibility," the Commission found that "we need not demonstrate absolute future impossibility to justify federal preemption here. We need only show that interstate and intrastate aspects of a regulated service or facility are inseverable as a practical matter in light of prevailing technological and economic conditions."[108]

30. In the case of DigitalVoice, Vonage could not even avoid violating Minnesota's order by trying *not* to provide intrastate communications in that state.[109] For the same reasons that Vonage cannot identify a communication that occurs within the boundaries of a single state, it cannot prevent its users from making such calls by attempting to block any calls between people in Minnesota.[110] Indeed, Vonage could not avoid similar "intrastate" regulations if imposed by any of the other more than 50 separate jurisdictions. Due to the intrinsic ubiquity of the Internet, *nothing short of Vonage ceasing to offer its service entirely* could guarantee that any subscriber would not engage in some communications where a

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[106]*See MTS and WATS Market Structure, Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board,* CC Docket Nos. 78-72, 80-286, Decision and Order, 4 FCC Rcd 5660, n.7 (1989) (*MTS/WATS Market Structure Separations Order*) (finding that "mixed use" special access lines carrying more than a *de minimis* amount of interstate traffic to private line systems are subject to the Commission's jurisdiction for jurisdictional separations purposes because separating interstate from intrastate traffic on many such lines could not be measured without "significant additional administrative efforts"); *see also Qwest Corp. v. Minnesota Pub. Utils. Comm'n,* 380 F.3d 367, 374 (finding that the Commission's preemptive intent concerning the *de minimis* rule relates to cost allocation for ratemaking purposes rather than plenary regulatory authority but stating that the Commission "*certainly has the wherewithal to preempt state regulation in this area if it so desires*") (emphasis added); *BellSouth MemoryCall,* 7 FCC Rcd at 1620, para. 7 (preempting order of a state commission imposing regulatory conditions on the offering of the intrastate portion of a jurisdictionally mixed service because of the expense, operational, and technical difficulties associated with identifying the intrastate portion and the effect it would likely have on the provider's continued offering of the interstate portion).

[107]*See, e.g., MTS/WATS Market Structure Separations Order,* 4 FCC Rcd 5660, n.7; *BellSouth MemoryCall,* 7 FCC Rcd at 1620, para. 7

[108]*See Rules and Policies Regarding Calling Number Identification Service – Caller ID,* Memorandum Opinion and Order on Reconsideration, Second Report and Order and Third Notice of Proposed Rulemaking, 10 FCC Rcd 11700, 11727-28, para. 77 (1995) (citing *California v. FCC,* 39 F.3d 919 (9th Cir. 1994)), *aff'd, California v. FCC,* 75 F.3d 1350 (9th Cir. 1996). The Ninth Circuit affirmed the Commission's preemption in this case, finding it to fit within the impossibility exception. *See California v. FCC,* 75 F.3d at 1360. Indeed, when possible, this Commission prefers that economic and market considerations drive the development of technology, rather than regulatory requirements. *See, e.g., Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers; Implementation of the Local Competition Provisions of the Telecommunications Act of 1996; Deployment of Wireline Services Offering Advanced Telecommunications Capability,* Order on Reconsideration, CC Docket Nos. 01-338, 96-98, 98-147, FCC 04-248, para. 19 (rel. Oct. 18, 2004) (concluding that decision regarding "which broadband technologies to deploy is best left to . . . the market . . . . We decline to second-guess or skew those technology choices . . . .").

[109]*See* Vonage Petition at v, 31; *see also American Libraries Ass'n v. Pataki,* 969 F. Supp. at 171 (explaining that no aspect of the Internet can fairly be closed off to users from any state).

[110]*See* Vonage Petition at v, 31.

state may deem that communication to be "intrastate" thereby subjecting Vonage to its economic regulations absent preemption.

31. There is, quite simply, no practical way to sever DigitalVoice into interstate and intrastate communications that enables the *Minnesota Vonage Order* to apply only to intrastate calling functionalities without also reaching the interstate aspects of DigitalVoice, nor is there any way for Vonage to choose to avoid violating that order if it continues to offer DigitalVoice anywhere in the world.[111] Thus, to whatever extent, if any, DigitalVoice includes an intrastate component, because of the impossibility of separating out such a component, we must preempt the *Minnesota Vonage Order* because it outright conflicts with federal rules and policies governing interstate DigitalVoice communications.

32. Indeed, the practical inseverability of other types of IP-enabled services having basic characteristics similar to DigitalVoice would likewise preclude state regulation to the same extent as described herein. Specifically, these basic characteristics include: a requirement for a broadband connection from the user's location; a need for IP-compatible CPE; and a service offering that includes a suite of integrated capabilities and features, able to be invoked sequentially or simultaneously, that allows customers to manage personal communications dynamically, including enabling them to originate and receive voice communications and access other features and capabilities, even video.[112] In particular, the provision of tightly integrated communications capabilities greatly complicates the isolation of intrastate communication and counsels against patchwork regulation. Accordingly, to the extent other entities, such as cable companies, provide VoIP services,[113] we would preempt state regulation to an extent comparable to what we have done in this Order.

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[111] *See Public Util. Comm'n of Texas v. FCC*, 886 F.2d 1325 (citing *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 375, the court upheld preemption of a Texas Public Utility Commission order prohibiting an incumbent LEC from providing interconnection to the PSTN to a customer where the FCC cannot "separate the interstate and the intrastate components of [its] asserted regulation."); *Public Serv. Comm'n of Maryland v. FCC*, 909 F.2d at 1515 (citing *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 375, to uphold Commission's preemption of a state commission's prescribed rates for LEC charges to interexchange carriers for customer disconnections based on the impossibility exception).

[112] *See, e.g.*, SBC Oct. 8 *Ex Parte* Letter, Attach. at 4-11; BellSouth Oct. 26 *Ex Parte* Letter, Attach. at 6-12; BellSouth Oct. 7 *Ex Parte* Letter, Attach. at 4.

[113] *See, e.g.*, Letter from J.G. Harrington, Counsel for Cox Communications, Inc., to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 03-211, 04-36, at 1-2 (filed Oct. 27, 2004) ("This network design also permits providers to offer a single, integrated service that includes both local and long distance calling and a host of other features that can be supported from national or regional data centers and accessed by users across state lines. . . . In addition to call setup, these functions include generation of call announcements, record-keeping, CALEA, voice mail and other features such as *67, conferencing and call waiting. ... [T]here are no facilities at the local level of a managed voice over IP network that can perform these functions."); Letter from Henk Brands, Counsel for Time Warner Inc., to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 03-211, 04-36, at 2, 9 (filed Oct. 29, 2004) (Time Warner Oct. 29 *Ex Parte* Letter) ("[T]he Commission should take a broader approach by recognizing additional characteristics of IP-based voice services and extend the benefits of preemption to all VoIP providers. . . . [B]y its nature, VoIP is provided on a multistate basis, making different state regulatory requirements particularly debilitating."); NCTA Oct. 28 *Ex Parte* Letter, Attach. at 1 ("Cable VoIP offers consumers an integrated package of voice and enhanced features that are unavailable from traditional circuit-switched service. . . . A cable company may have no idea whether a customer is accessing these features from home or from a remote location. The integral nature of these features and functions renders cable VoIP service an interstate offering subject to exclusive FCC jurisdiction. . . . Not every cable VoIP service has the same mix of features and functionalities . . . , but all cable VoIP offers the types of enhancements that render it an interstate service. Similarly, while the network architecture

5. Policies and Goals of the 1996 Act Consistent With Preemption of Minnesota's Regulations

33. We find that Congress's directives in sections 230 and 706 of the 1996 Act are consistent with our decision to preempt Minnesota's order. As we have noted, Congress has included a number of provisions in the 1996 Act that counsel a single national policy for services like DigitalVoice.[114]

34. Congress's definition of the Internet in the Act recognizes its global nature.[115] In addition to defining the Internet in section 230 of the Act, Congress used section 230 to articulate its national Internet policy. There, Congress stated that "[i]t is the policy of the United States - to preserve the vibrant and competitive free market that presently exists for the Internet and other interactive computer services, unfettered by Federal or State regulation."[116] We have already determined in a prior order that section 230(b)(2) expresses Congress's clear preference for a national policy to accomplish this objective.[117] In *Pulver*, we found this policy to provide support for preventing state attempts to promulgate regulations that would apply to Pulver's service.[118] While we found Pulver's FWD service to be an information

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of each cable VoIP system will not be identical, they share the same centralized network design that impart an interstate nature."); Letter from Daniel L. Brenner, Senior Vice President, Law & Regulatory Policy, NCTA, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 03-211, 04-36, Attach. at 1 (filed Oct. 27, 2004) ("Functions integral to every call, such as CALEA compliance, voicemail recording, storage, and retrieval, call record-keeping, 3-way calling and other functions are provided from these central facilities. These facilities are often located in a state different from the origin of the call.").

[114] *See supra* para. 14; *see also, e.g.*, BellSouth Comments at 3; SBC Comments at 2; VON Coalition Comments at 13; MCI/CompTel Reply at 11; VON Coalition Aug. 19 *Ex Parte* Letter, Attach at 12-13; Time Warner Oct. 29 *Ex Parte* Letter at 8-9; Letter from Carolyn W. Brandon, Vice President, Policy, CTIA, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 03-211, 04-36, at 2 (filed Nov. 2, 2004).

[115] In section 230(f) of the Act, Congress describes the Internet as "an *international* network of federal and non-federal interoperable packet switched data networks." *See* 47 U.S.C. § 230(f)(1) (emphasis added). Similarly, in section 231, the Internet is defined in terms of computer facilities, transmission media, equipment and software "comprising the interconnected *worldwide* network of computer networks." 47 U.S.C. § 231(e)(3) (emphasis added). Courts have similarly described it. *See, e.g., Reno v. ACLU*, 521 U.S. 844, 849 (1997) ("The Internet is an international network of interconnected computers."); *see also Zeran v. America Online, Inc.*, 129 F.3d 327, 334 (4th Cir. 1997) (stating that section 230 represents Congress's approach to a problem of national and international dimension "whose international character is apparent"). DigitalVoice is a service that falls squarely within the phrase "Internet and other interactive computer services" as defined in sections 230(f)(1) & 230(f)(2), contrary to the claims of some commenters. *See* Minnesota Independent Coalition Comments at 5 (claiming 230(f) definitions pertain to content services which DigitalVoice does not meet). While we do not decide the classification of DigitalVoice today so as to specify what type of "interactive computer service" it is under section 230(f)(2), that determination is unnecessary for purposes of demonstrating its nexus to section 230. DigitalVoice is unquestionably an "Internet" service as defined in section 230(f)(1), a definition which is not limited to any particular content as we discuss in more detail below.

[116] 47 U.S.C. § 230(b)(2).

[117] *See Pulver*, 19 FCC Rcd at 3319, para. 18 n.66.

[118] *See id.* We found Pulver's FWD service to be an information service – a determination which further supported a national federal regulatory regime for that service. Indeed, were we to reach a similar statutory "information service" classification determination for DigitalVoice in this Order, there would be no question that Congress intended it to remain free from state-imposed economic, public-utility type regulation, consistent with the Commission's long-standing policy of non-regulation for information services. *See id.* at 3317-22, paras. 17-22. In *Pulver*, we explained that through codifying the Commission's decades old distinction between "basic services" and

service, the Internet policy Congress included in section 230 is indifferent to the statutory classification of services that may "promote its continued development."[119] Rather, it speaks generally to the "Internet and other interactive computer services," a phrase that plainly embraces DigitalVoice service.[120] Thus, irrespective of the statutory classification of DigitalVoice, it is embraced by Congress's policy to "promote the continued development" and "preserve the vibrant and competitive *free* market" for these types of services.[121]

35. While the majority of those commenting on the applicability of section 230 in this proceeding share this view,[122] others claim that section 230 relates only to content-based services and DigitalVoice is not the type of content-based service Congress intended to reach.[123] We are cognizant, as we must be, of context as we review the statute, but we look primarily to the words Congress chose to use.[124] While we acknowledge that the title of section 230 refers to "offensive material," the general policy statements regarding the Internet and interactive computer services contained in the section are not similarly confined to offensive material. In the case of section 230, Congress articulated a very broad policy regarding the "Internet and other interactive computer services" without limitation to content-based services. Through codifying its Internet policy in the Commission's organic statute, Congress charges the Commission with the ongoing responsibility to advance that policy consistent with our other statutory obligations. Accordingly, in interpreting section 230's phrase "unfettered by Federal or State regulation," we cannot permit more than 50 different jurisdictions to impose traditional common carrier economic regulations such as Minnesota's on DigitalVoice and still meet our responsibility to realize Congress's objective.

"enhanced services" as "telecommunications services" and "information services," respectively, in the 1996 Act, and by specifically excluding information services from the ambit of Title II, Congress indicated, consistent with the Commission's long-standing policy of nonregulation, that information services not be regulated. *See id.* at 3318-19, para. 18; *see also Non-Accounting Safeguards Order*, 11 FCC Rcd at 21955-56, para. 102; *IP-Enabled Services Proceeding*, 19 FCC Rcd at 4879-81, 4890-91, paras. 25-27, 39. While Congress has indicated that information services are not subject to the type of regulation inherent in Title II, Congress has provided the Commission with ancillary authority under Title I to impose such regulations as may be necessary to carry out its mandates under the Act. Although the Commission has clear authority to do so, it has only rarely sought to regulate information services using its Title I ancillary authority. *See Implementation of Section 255 and 251(a)(2) of the Communications Act of 1934, as Enacted by the Telecommunications Act of 1996; Access to Telecommunications Service, Telecommunications Equipment and* Customer *Premises Equipment by Persons with Disabilities*, WT Docket No. 96-198, Report and Order and Further Notice of Inquiry, 16 FCC Rcd 6417 (1999).

[119] 47 U.S.C. § 230(b)(1).

[120] 47 U.S.C. § 230(b)(1), (2) (emphasis added). Indeed, the communications that occur when a subscriber uses the DigitalVoice service are Internet communications, no less than e-mail, instant messaging, or chat rooms. *See, e.g.*, VON Coalition Aug. 19 *Ex Parte* Letter, Attach at 2. Although DigitalVoice may be functionally similar in some respects to voice communications that are not dependent upon the Internet, this does not change the fact that *DigitalVoice is an Internet-based communications service. See also supra* note 115.

[121] 47 U.S.C. § 230(b)(1), (2) (emphasis added).

[122] *See, e.g.*, MCI/CompTel Comments at 11; Motorola Comments at 12; SBC Comments at 2-4; VON Coalition Comments at 13; AT&T Reply at 2; Vonage Aug. 13 *Ex Parte* Letter, Attach. at 3; VON Coalition Aug. 19 *Ex Parte* Letter, Attach. at 13.

[123] *See, e.g.*, California Commission Comments at 15-17; Minnesota Independent Coalition Comments at 4-6; MTA Comments at 6.

[124] *See* 47 U.S.C. § 230.

36. We are also guided by section 706 of the 1996 Act, which directs the Commission (and state commissions with jurisdiction over telecommunications services) to encourage the deployment of advanced telecommunications capability to all Americans by using measures that "promote competition in the local telecommunications market" and removing "barriers to infrastructure investment."[125] Internet-based services such as DigitalVoice are capable of being accessed only via broadband facilities, *i.e.*, advanced telecommunications capabilities under the 1996 Act,[126] thus driving consumer demand for broadband connections, and consequently encouraging more broadband investment and deployment consistent with the goals of section 706.[127] Indeed, the Commission's most recent *Fourth Section 706 Report* to Congress recognizes the nexus between VoIP services and accomplishing the goals of section 706.[128] Thus, precluding multiple disparate attempts to impose economic regulations on DigitalVoice that would thwart its development and potentially result in it exiting the market will advance the goals and objectives of section 706.

37. Allowing Minnesota's order to stand would invite similar imposition of 50 or more additional sets of different economic regulations on DigitalVoice, which could severely inhibit the development of this and similar VoIP services.[129] We cannot, and will not, risk eliminating or hampering this innovative advanced service that facilitates additional consumer choice, spurs technological development and growth of broadband infrastructure, and promotes continued development and use of the Internet. To do so would ignore the Act's express mandates and directives with which we must comply, in contravention of the pro-competitive deregulatory policies the Commission is striving to further.

B. Commerce Clause

38. We note that our decision today is fully consistent with the Commerce Clause of the United States Constitution. The Commerce Clause provides that "[t]he Congress shall have Power ... [t]o regulate Commerce ... among the several States."[130] As explained by the Supreme Court, "[t]hough

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[125] 47 U.S.C. § 157 nt. Section 706 of the 1996 Act is located in the notes of section 7 of the Communication Act. To implement section 706's mandate, the Commission has considered, among other things, whether its rules promote the delivery of innovative advanced services offerings. *See Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket Nos. 01-338, 96-98, 98-147, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd 16978 (2003) (*FNPRM*), *corrected by* Errata, 18 FCC Rcd 19020 (2003), *aff'd in part, remanded in part, vacated in part, United States Telecom Ass'n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004), *cert. denied sub nom. Nat'l Ass'n Regulatory. Util. Comm'rs v. United States Telecom Ass'n*, 73 USLW 3234 (U.S. Oct. 12, 2004) (Nos. 04-12, 04-15, 04-18). We find that our actions in this ruling are also consistent with this provision of the Act.

[126] *See* 47 U.S.C. § 157 nt. (c)(1) (defining "advanced telecommunications capability").

[127] *See* 8x8 Comments at 5; VON Coalition Aug. 19 *Ex Parte* Letter, Attach at 7-8.

[128] *See Fourth Section 706 Report* at 38 ("[S]ubscribership to broadband services will increase in the future as new applications that require broadband access, *such as VoIP*, are introduced into the marketplace, and consumers become more aware of such applications.") (emphasis added); *see also id.* at 3 (Statement of Chairman Powell) ("Disruptive VoIP services are acting as a demand-driver for broadband connections, lighting the industry's fuse, and exciting a moribund market."); APT Comments at 2; Motorola Comments at 12.

[129] *See Pulver*, 19 FCC Rcd at 3319-20, para. 19; *see also American Libraries Ass'n v. Pataki*, 969 F. Supp. at 183 ("Haphazard and uncoordinated state regulation [of the Internet] can only frustrate the growth of cyberspace.").

[130] U.S. Const. art. 1, § 8, cl. 3.

phrased as a grant of regulatory power to Congress, the Clause has long been understood to have a 'negative' aspect that denies the States the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce."[131] Under the Commerce Clause jurisprudence, a state law that "has the 'practical effect' of regulating commerce occurring wholly outside that [s]tate's borders" is a violation of the Commerce Clause.[132] In addition, state regulation violates the Commerce Clause if the burdens imposed on interstate commerce by state regulation would be "clearly excessive in relation to the putative local benefits."[133] Finally, courts have held that "state regulation of those aspects of commerce that by their unique nature demand cohesive national treatment is offensive to the Commerce Clause."[134]

39. Minnesota's regulation likely has "the 'practical effect' of regulating commerce occurring wholly outside that [s]tate's borders."[135] Because the location of Vonage's users cannot practically be determined,[136] Vonage would likely be required to comply with Minnesota's regulation for all use of DigitalVoice – including communications that do not originate or terminate in Minnesota, or even involve facilities or equipment in Minnesota – in order to ensure that it could fully comply with the regulations for services in Minnesota. And, as we have explained above, this would likely be the result even if Vonage elected to discontinue seeking subscribers in Minnesota, given that end users could use the service from any broadband connection in Minnesota.[137] While states can and should serve as laboratories for different regulatory approaches, we have here a very different situation because of the nature of the service – our federal system does not allow the strictest regulatory predilections of a single state to crowd out the policies of all others for a service that unavoidably reaches all of them. For these reasons,

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[131] *Oregon Waste Sys. v. Dep't of Envtl. Quality*, 511 U.S. 93, 98 (1994) (citations omitted); *see also PSINet, Inc. v. Chapman*, 362 F.3d 227, 239 (4th Cir. 2004) (quoting *General Motors Corp. v. Tracey*, 519 U.S. 278, 287 (1997)); *American Libraries Ass'n v. Pataki*, 969 F. Supp. at 173 (holding that the Internet is an instrument of "interstate commerce" under the Commerce Clause).

[132] *Healy v. Beer Institute*, 491 U.S. 324, 332 (1989); *see also Cotto Waxo Co. v. Williams*, 46 F.3d 790, 793 (8th Cir. 1995) ("Under the Commerce Clause, a state regulation is *per se* invalid when it has an 'extraterritorial reach,' that is, when the statute has the practical effect of controlling conduct beyond the boundaries of the state. The Commerce Clause precludes application of a state statute to commerce that takes place wholly outside of the state's borders.") (emphasis added) (citation omitted).

[133] *See Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970); *see also Cotto Waxo Co. v. Williams*, 46 F.3d at 793 ("[I]f the challenged statute regulates evenhandedly, then it burdens interstate commerce indirectly and is subject to a balancing test. Under the balancing test, a state statute violates the Commerce Clause only if the burdens it imposes on interstate commerce are 'clearly excessive in relation to the putative local benefits.'") (citation omitted).

[134] *American Libraries Ass'n v. Pataki*, 969 F. Supp. at 169 (citing *Wabash, St. Louis & Pac. Ry. Co. v. Illinois*, 118 U.S. 557 (1886)); *see id.* at 181 ("The courts have long recognized that certain types of commerce demand consistent treatment and are therefore susceptible to regulation only on a national level."); *American Civil Liberties Union v. Johnson*, 194 F.3d 1149, 1162 (10th Cir. 1999).

[135] *Healy v. Beer Institute*, 491 U.S. at 332; *see also American Libraries Ass'n v. Pataki*, 969 F. Supp. at 173-74, 177; *American Booksellers Found. v. Dean*, 342 F.3d 96, 103 (2d Cir. 2003) (acknowledging that because of "the Internet's boundary-less nature," regulations of Internet communications may not be "wholly outside" a state's borders, but nonetheless may impose extraterritorial regulation in violation of the Commerce Clause).

[136] *See supra* para. 5.

[137] *See supra* para. 30.

Minnesota's regulation would likely have the "practical effect" of regulating beyond its borders and therefore would likely violate the Commerce Clause.[138]

40. In addition, we believe the burdens imposed on interstate commerce by the Minnesota Commission's regulation would likely be "clearly excessive in relation to the putative local benefits."[139] The Minnesota regulation would impose significant burdens on interstate commerce.[140] As discussed above, even if it were relevant and possible to track the geographic location of packets and isolate traffic for the purpose of ascertaining jurisdiction over a theoretical intrastate component of an otherwise integrated bit stream, such efforts would be impractical and costly.[141] At the same time, we believe that the local benefits of state economic regulation would be limited. In a dynamic market such as the market for Internet-based services, we believe that imposing this substantial burden on Vonage would serve no useful purpose and would almost certainly be significant and negative for the development of new and innovative interstate Internet-based services.

41. Finally, DigitalVoice, like other Internet services, is likely the type of commerce that is of such a "unique nature" that it "demand[s] cohesive national treatment" under the Commerce Clause.[142] Because DigitalVoice is not constrained by geographic boundaries and cannot be excluded from any particular state, inconsistent state economic regulation could cripple development of DigitalVoice and services like it. If Vonage's DigitalVoice service were subject to state regulation, it would have to satisfy the requirements of more than 50 jurisdictions with more than 50 different sets of regulatory obligations.[143]

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[138] *See* Vonage Petition at 29 ("Vonage has no way of assuring that it is in compliance with the [*Minnesota Vonage Order*] unless it blocks a substantial amount of interstate traffic as well."); *id.* at 31 ("[S]ince *any* Vonage customer could, in theory, travel to Minnesota at any time and connect their MTA computer to a broadband Internet connection, Vonage could never prevent *all* intrastate Minnesota use of its service unless it blocked *all* interstate 'calls' as well.") (emphasis in original); *id.* at 25, 27; *see also American Libraries Ass'n v. Pataki*, 969 F. Supp. at 171 ("[N]o aspect of the Internet can feasibly be closed off to users from another state.").

[139] *See Pike v. Bruce Church, Inc.*, 397 U.S. at 142; *see also Cotto Waxo Co. v. Williams*, 46 F.3d at 793. *See generally* Michael A. Bamberger, *The Clash Between the Commerce Clause and State Regulation of the Internet*, Internet Newsletter, Apr. 2002 (explaining that "[f]or the most part, courts have analyzed the constitutionality of state Internet regulation under the test employed by the *Pike* court") (emphasis added).

[140] Indeed, one federal court has already determined, in the specific context of Vonage, that state entry regulation of DigitalVoice would interfere with interstate commerce. *See New York Preliminary Injunction* at 2; *see also American Booksellers Found. v. Dean*, 342 F.3d at 104 ("We think it likely that the [I]nternet will soon be seen as falling within the class of subjects that are protected from State regulation because they 'imperatively demand [] a single uniform rule.'") (citing *Cooley v. Bd. of Wardens*, 53 U.S. 299 (1851)).

[141] *See supra* para. 29; *see also American Libraries Ass'n v. Pataki*, 969 F. Supp. at 170 ("The Internet is wholly insensitive to geographic distances. . . . Internet protocols were designed to ignore rather than document geographic location . . . .").

[142] *American Libraries Ass'n v. Pataki*, 969 F. Supp. at 69 (citing *Wabash, St. Louis & Pac. Ry. Co. v. Illinois*, 118 U.S. 557); *see also American Civil Liberties Union v. Johnson*, 194 F.3d at 1162 ("As we observed, . . . certain types of commerce have been recognized as requiring national regulation. . . . The Internet is surely such a medium.").

[143] *See also American Libraries Ass'n v. Pataki*, 969 F. Supp. at 169 ("The menace of inconsistent state regulation invites analysis under the Commerce Clause of the Constitution, because that clause represented the framers' reaction to overreaching by the individual states that might jeopardize the growth of the nation - and in particular, the national infrastructure of communications and trade - as a whole.") (citing *Quill Corp. v. North Dakota*, 504 U.S. 298, 312 (1992)).

As discussed above, because of the unbounded characteristics of the Internet, Vonage would likely be required in practical effect to subject its service to all customers across the country to the regulations imposed by Minnesota. Moreover, state regulation of Internet-based services, such as DigitalVoice, would make them unique among Internet services as the only Internet service to be subject to such state obligations. Indeed, allowing the imposition of state regulation on Vonage would likely eliminate any benefit of using the Internet to provide the service. The Internet enables individuals and small providers to reach a global market simply by attaching a server to the Internet; requiring Vonage to submit to more than 50 different regulatory regimes as soon as it did so would eliminate this fundamental advantage of Internet-based communication. Thus, services, such as DigitalVoice, are likely of a "unique nature" that "demand[s] cohesive national treatment," and therefore, inconsistent state regulations would likely violate the Commerce Clause.[144]

C. Public Safety Issues

42. As discussed above, we preempt the *Minnesota Vonage Order* because it imposes entry and other requirements on Vonage that impermissibly interfere with this Commission's valid exercise of authority. As Vonage indicates in its Petition, Minnesota includes as one of its entry conditions the approval of a 911 service plan "comparable to the provision of 911 service by the [incumbent] local exchange carrier."[145] In the *Minnesota Vonage Order*, the Minnesota Commission specifically subjected Vonage to this requirement.[146] Because Minnesota inextricably links pre-approval of a 911 plan to becoming certificated to offer service in the state, the application of its 911 requirements operates as an entry regulation. Vonage explains that there is no practicable way for it to comply with this requirement: it

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[144]Federal court decisions applying the Commerce Clause to state regulation of Internet services have come to similar conclusions. In *American Libraries Ass'n v. Pataki*, a leading case on this issue, a federal district court struck down a New York state statute making it a crime to disseminate indecent material to minors over the Internet. The court held that the New York law violated the Commerce Clause because it (1) overreached by seeking to regulate conduct occurring outside its borders; (2) imposed burdens on interstate commerce that exceeded any local benefit; and (3) subjected interstate use of the Internet to inconsistent regulations. *See American Libraries Ass'n v. Pataki*, 969 F. Supp. at 183-84. In several subsequent cases, federal courts of appeal expressly adopted these holdings. *See PSINet, Inc. v. Chapman*, 362 F.3d 227; *American Booksellers Found. v. Dean*, 342 F.3d 96; *American Civil Liberties Union v. Johnson*, 194 F.3d 1149; *see also American Libraries Ass'n v. Pataki*, 969 F. Supp. at 182 ("The Internet . . . requires a cohesive national scheme of regulation so that users are reasonably able to determine their obligations.").

We also note examples from other network-based industries where, although an intrastate component may exist, state authority must nonetheless yield to exclusive federal jurisdiction in the area of economic or other state regulations affecting interstate commerce. For example, in the case of railroads, the Supreme Court struck down a state regulation regarding the length of trains, holding that "examination of all the relevant factors makes it plain that the state interest is outweighed by the interest of the nation in an adequate, economical and efficient railway transportation service, which must prevail." *Southern Pac. Co. v. Arizona*, 325 U.S. 761, 783-84 (1945). Similarly, in trucking cases, the Supreme Court has invalidated state laws regulating the length of trucks under the Commerce Clause when the regulation imposes a burden on interstate trucking that is not outweighed by the local interest. *See Raymond Motor Transportation, Inc. v. Rice*, 434 U.S. 429 (1978); *Kassel v. Consolidated Freightways Corp.*, 450 U.S. 662 (1981). In another transportation case, the Court struck down an Illinois law mandating a particular type of mudguards on trucks operating in the state, concluding that the regulation imposed significant burdens on interstate trucking with no countervailing benefits. *See Bibb v. Navajo Freight Lines, Inc.*, 359 U.S. 520 (1959).

[145]*See* Vonage Petition at 25 (citing Minn. Rule § 7812.0550 subp. 1).

[146]*See Minnesota Vonage Order* at 8.

cannot today identify with sufficient accuracy the geographic location of a caller, and it has not obtained access in all cases to incumbent LEC E911 trunks that carry calls to specialized operators at public safety answering points (PSAPs).[147] Under the Minnesota "telephone company" rules, therefore, this requirement bars Vonage from entry in Minnesota. To that extent, this requirement is preempted along with all other entry requirements contained in Minnesota's "telephone company" regulations as applied to DigitalVoice.[148] Although we preempt Minnesota from imposing its 911 requirements on Vonage as a condition of entry, this does not mean that Vonage should cease the efforts it has undertaken to date and we understand is continuing to take both to develop a workable public safety solution for its DigitalVoice service and to offer its customers equivalent access to emergency services.

43. There is no question that innovative services like DigitalVoice are having a profound and beneficial impact on American consumers.[149] While we do not agree with unnecessary economic regulation of DigitalVoice designed for different services, we do believe that important social policy issues surrounding services like DigitalVoice should be considered and resolved.[150] Access to emergency services, a critically important public safety matter, is one of these important social policy issues. In this proceeding, Vonage has indicated that it is devoting substantial resources toward the development of standards and technology necessary to facilitate some type of 911 service, working cooperatively with Minnesota agencies and other state commissions, public safety officials and PSAPs, the National Emergency Number Association (NENA), and the Association of Public-Safety Communications Officials (APCO).[151] Moreover, it has demonstrated that it is offering its version of 911 capability to all its customers, including those in Minnesota, and has provided us information indicating what actions its customers must take to activate this 911 capability.[152] We are also aware that Vonage recently announced the successful completion of an E911 trial in Rhode Island, a state that has not, to our knowledge, attempted to regulate DigitalVoice. In collaboration with the State of Rhode Island, Vonage has developed a technical solution to deliver a caller's location and call back number to emergency service personnel for 911 calls placed in that state by DigitalVoice users.[153] We fully expect Vonage to continue

[147] *See* Vonage Petition at 8-9, 24-25.

[148] *See supra* paras. 20-22 (explaining preemption of entry requirements). Indeed, Vonage notes in its petition that "[I]f the Commission preempts Minnesota's certificate requirement . . . this issue [911 comparability to an incumbent LEC] will be moot." *See* Vonage Petition at 25. Similarly, to the extent the Minnesota Commission demands payment of 911 fees as a condition of entry, that requirement is preempted.

[149] *See* VON Coalition Aug. 19 *Ex Parte* Letter at 4.

[150] As explained above, these issues are currently being considered in pending proceedings before this Commission. *See supra* note 46. *See also, e.g.*, Minnesota Commission Comments at 4; Surewest Comments at 12; Texas 911 Agencies Comments at 2-3 (urging the Commission to consider public safety issues related to VoIP services).

[151] *See* NENA Reply at 1-2; Vonage Aug. 13 *Ex Parte* Letter at 1-2; Minnesota Statewide 911 Program Comments at 4.

[152] In offering its "911" capability to its customers, Vonage has provided the Commission information regarding how and what it tells its customers about its limited 911 capabilities such that its customers are fully aware of those limitations when they subscribe to the service and clearly understand that it is not a comparable emergency service to the 911 capability they obtain with local exchange service. We fully expect Vonage to continue providing customers information such as this about its "911" capability. *See* Vonage Oct. 1 *Ex Parte* Letter at 3-4 & Exhibit 10.

[153] *See* Letter from William B. Wilhelm, Jr. and Ronald W. Del Sesto, Jr., Counsel for Vonage, to Marlene H. Dortch, Secretary, FCC, WC Docket Nos. 03-211, 04-36, at 1 (filed Oct. 14, 2004).

its 911 development efforts and to continue to offer some type of public safety capability during the pendency of our *IP-Enabled Services Proceeding*.[154]

44. We emphasize that while we have decided the jurisdictional question for Vonage's DigitalVoice here, we have yet to determine final rules for the variety of issues discussed in the *IP-Enabled Services Proceeding*. While we intend to address the 911 issue as soon as possible, perhaps even separately, we anticipate addressing other critical issues such as universal service, intercarrier compensation, section 251 rights and obligations,[155] numbering, disability access, and consumer protection in that proceeding.[156]

45. Furthermore, we acknowledge that a U.S. District Court in New York has recently ordered Vonage "to continue to provide the same emergency 911 calling services currently available to Vonage customers" within that state[157] and to "make reasonable good faith efforts to participate on a voluntary basis" in workshops pertaining to the development of VoIP 911 calling capabilities.[158] Because DigitalVoice is a national service for which Vonage cannot single out New York "intrastate" calls (any more than it can Minnesota "intrastate" calls), as a practical matter, the District Court's order reaches DigitalVoice wherever it is used.[159] Thus, we need not be concerned that as a result of our action today, Vonage will cease its efforts to continue developing and offering a public safety capability in Minnesota. The District Court order ensures that these efforts must continue while we work cooperatively with our state colleagues and industry to determine how best to address 911/E911-type capabilities for IP-enabled services in a comprehensive manner in the context of our *IP-Enabled Services Proceeding*.[160]

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[154]We look beyond Vonage's efforts of today, however, toward work that remains to be done in the area of 911 and the opportunities that this new technology presents for public safety. To that end, we are aware of the six principles NENA has advanced: (1) establish a national E911 VoIP policy; (2) encourage vendor and technology neutral solutions and innovation; (3) retain consumer service quality expectations; (4) support dynamic, flexible, open architecture system design process for 911; (5) develop policies for 911 compatible with the commercial environment for IP communications; and (6) promote a fully funded 911 system. *See* National Emergency Number Association, *E9-1-1, Internet Protocol & Emergency Communications*, Press Release (Mar. 22, 2004). We applaud NENA's vision in establishing these principles to support a process to "promote a fully functional 9-1-1 system that responds any time, anywhere from every device." *See id.*. We endorse these principles because they provide a sound blueprint for the development of a national 911 solution for VoIP services and we encourage all VoIP providers and industry participants to work toward their realization.

[155]We note that nothing in this Order addressing the Commission's jurisdictional determination of or regulatory treatment of particular retail IP-enabled services impacts competitive LEC access to the underlying facilities on which such retail services ride. *See* Letter from Jason D. Oxman, General Counsel, Association for Local Telecommunications Services, to Marlene Dortch, Secretary, FCC, WC Docket Nos. 04-29, 04-36 (filed Nov. 2, 2004).

[156]*See supra* note 46.

[157]*See New York Preliminary Injunction* at 3. We note that Vonage's "emergency 911 calling service" is not a service that is provided pursuant to the New York Commission's rules or any other state commission's rules. This is a service Vonage has voluntarily undertaken in response to consumer demand.

[158]*See New York Preliminary Injunction* at 4.

[159]We recognize that Vonage's 911 capability relies on the cooperation of its customers in accurately registering and re-registering their user location when they move about with the service.

[160]*See IP-Enabled Services Proceeding*, 19 FCC Rcd at 4897-901, paras. 51-57.

IV. CONCLUSION

46. For the reasons set forth above, we preempt the *Minnesota Vonage Order*. As a result, the Minnesota Commission may not require Vonage to comply with its certification, tariffing or other related requirements as conditions to offering DigitalVoice in that state. Moreover, for services having the same capabilities as DigitalVoice, the regulations of other states must likewise yield to important federal objectives. To the extent other entities, such as cable companies, provide VoIP services, we would preempt state regulation to an extent comparable to what we have done in this Order.

V. ORDERING CLAUSES

47. Accordingly, IT IS ORDERED, pursuant to sections 1, 2, 3, 4(i) and 303(r) of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151-53, 154(i), 303(r), and section 1.2 of the Commission's rules, 47 C.F.R. § 1.2, that Vonage's Petition for Declaratory Ruling IS GRANTED in part and the *Minnesota Vonage Order* IS PREEMPTED.

48. IT IS HEREBY FURTHER ORDERED, pursuant to section 1.103(a) of the Commission's rules, 47 C.F.R. § 1.103(a), that this Memorandum Opinion and Order SHALL BE EFFECTIVE upon release.

FEDERAL COMMUNICATIONS COMMISSION

Marlene H. Dortch
Secretary

APPENDIX
LIST OF COMMENTERS

Comments in WC Docket No. 03-211

Comments	Abbreviation
8x8, Inc.	8x8
Alliance for Public Technology	APT
Association of Public-Safety Communications Officials	APCO
Beacon Telecommunications Advisors, LLC	Beacon
BellSouth Corporation	BellSouth
California Public Utilities Commission	California Commission
CenturyTel, Inc.	CenturyTel
Cinergy Communications Company	Cinergy
Cisco Systems, Inc.	Cisco
Dr. Robert A. Collinge	Collinge
Communications Workers of America	CWA
DJE Teleconsulting, LLC	DJE Teleconsulting
Frontier and Citizens Telephone Companies	Frontier/Citizens
The High Tech Broadband Coalition	High Tech Broadband Coalition
ICORE, Inc.	ICORE
Independent Telephone and Telecommunications Alliance	ITTA
Iowa Utilities Board	Iowa Commission
Level 3 Communications, LLC	Level 3
MCI CompTel	MCI/CompTel
Metropolitan 911 Board	Metropolitan 911 Board
Minnesota Attorney General's Office	Minnesota AG
Minnesota Department of Commerce	Minnesota Department of Commerce
Minnesota Independent Coalition	Minnesota Independent Coalition
Minnesota Public Utilities Commission	Minnesota Commission
Minnesota Statewide 911 Program	Minnesota Statewide 911 Program
Montana Independent Telecommunications Systems	Montana Independent Telecommunications Systems
Montana Telecommunications Association	MTA
Motorola, Inc.	Motorola
National Association of State Utility Consumer Advocates	NASUCA
National Exchange Carrier Association	NECA
National Telecommunications Cooperative Association	NTCA
New York State Department of Public Service	New York Commission
Organization for the Promotion and Advancement of Small Telecommunications Companies	OPASTCO
PAETEC Communications, Inc.	PAETEC
Public Utilities Commission of Ohio	Ohio Commission
Qwest Communications International Inc.	Qwest
Rural Iowa Independent Telephone Association	RIITA

SBC Communications Inc.	SBC
Sprint Corporation	Sprint
SureWest Communications	SureWest
Telcom Consulting Associates, Inc.	TCA
Texas Commission on State Emergency Communications and Texas Emergency Communications Districts	Texas 911 Agencies
Texas Coalition of Cities for Utility Issues	TCCFUI
Time Warner Telecom, Inc.	Time Warner Telecom
USA DataNet	USA DataNet
U.S. Department of Justice Federal Bureau of Investigation	USDOJ/FBI
United States Telecom Association	USTA
The Verizon Telephone Companies	Verizon
The Voice on the Net Coalition	VON Coalition
Warinner, Gesinger & Associates, LLC	WG&A
Washington Enhanced 911 Program	Washington E911 Program

Replies in WC Docket No. 03-211

Replies	**Abbreviation**
8x8, Inc.	8x8
AT&T Corp.	AT&T
BellSouth Corporation	BellSouth
Earthlink, Inc.	Earthlink
GVNW Consulting, Inc.	GVNW
Inclusive Technologies	Inclusive Technologies
Iowa Utilities Board	Iowa Commission
MCI CompTel	MCI/CompTel
Michigan Public Service Commission	Michigan Commission
Minnesota Public Utilities Commission	Minnesota Commission
Montana Telecommunications Association	MTA
National Association of Regulatory Utility Commissioners	NARUC
National Association of State Utility Consumer Advocates	NASUCA
National Association of Telecommunications Officers and Advisors National League of Cities The National Association of Counties The Alliance for Community Media	NATOA *et al.*
National Emergency Number Association	NENA
Attorney General of the State of New York	New York State AG
Oregon Telecommunications Association Washington Independent Telephone	OTA/WIT
PacWest Telecom, Inc. RCN Corporation	PacWest/RCN
Pennsylvania Public Utility Commission	Pennsylvania Commission
Sprint Corporation	Sprint

Telecommunications for the Deaf, Inc.	TDI
Texas Coalition of Cities for Utility Issues	TCCFUI
U.S. Department of Justice Federal Bureau of Investigation	USDOJ/FBI
The Verizon Telephone Companies	Verizon
Vonage Holdings Corp.	Vonage

STATEMENT OF CHAIRMAN MICHAEL K. POWELL

Re: Vonage Holdings Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission, Memorandum Opinion and Order in WC Docket No. 03-211.

Since 1870 home telephone service has been essentially the same—two phones connected by a wire. This landmark order recognizes that a revolution has occurred. Internet voice services have cracked the 19th Century mold, to the great benefit of consumers. VoIP services certainly enable voice communications between two or more people, just as the traditional telephone network does, but that is where the similarity ends. Internet voice is an internet application that takes its place alongside email and instant messaging as an incredibly versatile tool for communicating with people all over the world. As such it has truly unique characteristics.

Internet Voice is More Personal: VOIP services allow people to dynamically structure the way they communicate and to customize and personalize messages in a way that is impossible with traditional telephones. Just as consumers personalize their cell phones with ring tones, pictures and applications, the same is possible with internet voice. Consumers have come to expect technology to be tailored to their preferences—"My Amazon," "My Tivo," "My Ipod." Internet voice, ushers in the era of "My Telephone." Adding enhancements to voice is no longer a highly complex and expensive modification to the network – now it is just a matter of adding to the next software release.

Internet Voice is Cheaper: Consumers always want to pay less and VOIP promises enormous value. Because of the efficient technology and underlying economics of the service, Consumers can expect flat rate prices, for unlimited services and features. Just as consumers have responded strongly to buckets of minutes at low fixed prices in mobile phone service, the same characteristics will bring these innovative pricing models to the wired phone world. The proof is in the pudding, VOIP is barely a few years old as a retail offering and providers have already cut prices several times to compete for consumers. VoIP providers have begun offering local and long-distance calling plans for as low as $14.99 and $19.99 per month. Most recently, Vonage and AT&T slashed the monthly prices of their unlimited local and long-distance calling plans by $5 per month. If we let competition and innovation rage, unencumbered by the high cost of regulation, Consumers can expect more of the same—lower prices, more choice, and more innovative offerings.

Internet Voice is Global: Today's decision lays a jurisdictional foundation for what consumers already know – that the Internet is global in scope. The genius of the Internet is that it knows no boundaries. In cyberspace, distance is dead. Communication and information can race around the planet and back with ease. The Order recognizes that several technical factors demonstrate that VoIP services are unquestionably interstate in nature. VoIP services are nomadic and presence-oriented, making identification of the end points of any given communications session completely impractical and, frankly, unwise. In this sense, Internet applications such as VoIP are more border busting than either long distance or mobile telephony– each inherently, and properly classified, interstate services.

To subject a global network to disparate local regulatory treatment by 51 different jurisdictions would be to destroy the very qualities that embody the technological marvel that is the Internet. The founding fathers understood the danger of crushing interstate commerce and enshrined the principle of federal jurisdiction over interstate services in the commerce clause of the U.S. Constitution. In the same vein, Congress rightly recognized the borderless nature of mobile telephone service and classified it an interstate communication. VOIP properly stands in this category and the Commission is merely affirming the obvious in reaching today's jurisdictional decision.

This is not to say that there is no governmental interest in VOIP. There will remain very important questions about emergency services, consumer protections from waste, fraud and abuse and recovering the fair costs of the network. It is not true that states are or should be complete bystanders with regard to these issues. Indeed, there is a long tradition of federal/state partnership in addressing such issues, even with regard to interstate services. For example, in long distance services, the FCC and state commissions have structured a true partnership to combat slamming and cramming. We have also worked closely with the states to strike a balance in the area of do-not-call enforcement. In the mobile services area, the FCC has worked closely with states on E911 implementation. With regard to critical 911 capability for VOIP, I note already that several Internet voice providers have entered into an agreement with the National Emergency Number Association to extend 911 capabilities to Internet voice services to "promote a fully functional 9-1-1 system that responds any time, anywhere from every device." Efforts such as these are essential to educating policy makers and providing a basis for solutions to complex technical problems. These can and will serve as models for VOIP.

While today's item preempts an order of the Minnesota Commission applying its traditional "telephone company" regulations to Vonage's DigitalVoice service, it is important that I emphasize that the Commission expresses no opinion here on the applicability to Vonage of state's general laws governing entities conducting business within the state, such as laws concerning taxation; fraud; general commercial dealings; marketing and advertising. Just as this ruling does not alter traditional state powers, we do not alter facilities-based competitor rights, or state authority pursuant to section 252 of the Act. It is my hope that the Commission's decision today will focus the debate and permit our colleagues in the industry and at the state commissions to direct their resources toward helping the Commission answer the important questions that remain after today's Order.

STATEMENT OF COMMISSIONER KATHLEEN Q. ABERNATHY

Re: Vonage Holdings Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission, Memorandum Opinion and Order in WC Docket No. 03-211.

This decision provides much-needed clarity regarding the jurisdictional status of Vonage's DigitalVoice service and other VoIP services. By fencing off these services from unnecessary regulation, this Order will help unleash a torrent of innovation. Indeed, by facilitating the IP revolution, rather than erecting roadblocks, our action will drive greater broadband adoption and deployment, and thereby promote economic development and consumer welfare.

There is no doubt that VoIP services of the type provided by Vonage are inherently interstate in nature. As the Order describes in detail, several factors combine to make it impossible to isolate any intrastate-only component of such services. These factors include the architecture of packet-switched networks and the enhanced features that are offered as an integral part of VoIP services. Together, these attributes necessarily result in the interstate routing of at least some packets. These services are also marked — in striking contrast to circuit-switched communications — by a complete disconnect between the subscriber's physical location and the ability to use the service. A subscriber's physical location is not only unknown in many instances, but also completely irrelevant. Allowing state commissions to impose traditional public-utility regulations on these interstate communications services would frustrate important federal policy objectives, including the congressional directive to "preserve the vibrant and competitive free market that presently exists for the Internet and other interactive computer services, unfettered by Federal or State regulation."[1]

Thus, while I do not lightly arrive at any decision to preempt state regulatory authority, I believe it is imperative for the Commission to do so here. Allowing the Minnesota utility regulations — or comparable state regulations — to stand would authorize a single state to establish default national rules for all VoIP providers, given the impossibility of isolating any intrastate-only component. Equally troubling is the prospect of subjecting providers of these innovative new services — which are being rolled out on a regional, national, and even global scale — to a patchwork of *inconsistent* state regulations. In short, failure to preempt state utility regulations would likely sound the death knell for many IP-enabled services and would deprive consumers of the cost savings and exciting features they can deliver.

As necessary as preemption may be, I want to underscore my view that our assertion of exclusive federal jurisdiction still permits states to play an important role in facilitating the rollout of IP-enabled services. To begin with, as the Order makes clear, states will continue to enforce generally applicable consumer protection laws, such as provisions barring fraud and deceptive trade practices. Moreover, I have often emphasized that, even where the FCC alone possesses the ultimate decisionmaking authority, this Commission and state regulators can and should collaborate in the development of sound policy — much as we have done through our Federal-State Joint Boards and Joint Conferences, the approval of Section 271 applications, and in other contexts. Indeed, I am encouraged that an increasing number of state commissioners agree that "preemption . . . does not preclude collaboration with States on key issues including public safety, consumer protection and reform of intercarrier compensation and universal service."[2] These state commissioners further note that "clearly establishing the domain in which the

[1] 47 U.S.C. § 230(b)(2).

[2] Letter of Gregory Sopkin, Chairman, Colorado Public Utilities Commission; Thomas Welch, Chairman, Maine Public Utilities Commission; Jack Goldberg, Vice-Chairman, Connecticut Department of Public Utility Control;

regulatory treatment of IP-enabled services will be determined will facilitate resolution of these issues in a more streamlined manner and with less incentive for costly and protracted litigation."[3]

I also want to acknowledge the concerns expressed by commenters who argued that the Commission should resolve outstanding questions about access to E911, the preservation of universal service, and other important policy matters before addressing this jurisdictional issue. Ideally, the Commission would have decided the jurisdictional issue in tandem with the various rulemaking issues. But the decision of several states to impose utility regulations on VoIP services, and the ensuing litigation arising from such forays, makes it imperative for the Commission to establish our exclusive jurisdiction as the first order of business. This Commission runs significant risks if we remain on the sidelines and leave it to the courts to grapple with such issues of national import without the benefit of the expert agency's views.[4] Looking ahead, I agree that the Commission should proceed with the rulemaking on IP-enabled services as expeditiously as possible. We should adopt rules to the extent necessary to ensure the fulfillment of our core policy goals, including access to E911, the ability of law enforcement to conduct lawful surveillance, access for persons with disabilities, and the preservation of universal service. And we should provide a thorough and careful analysis of whether IP-enabled services are information services or telecommunications services, given the potentially far-reaching implications of that classification.

Finally, by the same token, I sympathize with parties who contend that the Commission should conclusively resolve the jurisdictional status of *all* VoIP services, rather than limiting our analysis to a subset of VoIP. I have endeavored to make our jurisdictional analysis as inclusive as possible, given the state of the record and the scope of the Declaratory Ruling Petition. This Order should make clear the Commission's view that all VoIP services that integrate voice communications capabilities with enhanced features and entail the interstate routing of packets — whether provided by application service providers, cable operators, LECs, or others — will not be subject to state utility regulation.

James Connelly, Commissioner, Massachusetts Department of Telecommunications & Energy; Charles Davidson, Commissioner, Florida Public Service Commission; Susan Kennedy, Commissioner, California Public Utilities Commission; and Connie Murray, Commissioner, Missouri Public Service Commission, at 6 (November 2, 2004).

[3] *Id.*

[4] *Cf. Brand X Internet Service v. FCC*, 345 F.3d 1120 (9th Cir. 2003), *petition for cert. filed* (Aug. 27, 2004) (No. 04-281).

CONCURRING STATEMENT OF COMMISSIONER MICHAEL J. COPPS

Re: *Vonage Holdings Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission*, Memorandum Opinion and Order (WC Docket No. 03-211)

We all marvel at the tremendous and transformative potential of IP services. They have the power significantly to remake the telecommunications landscape by flooding the market with innovative new services and providers. But to unleash the full potential of this new technology and to ensure that these services succeed, we need rules of the road—clear, predictable and confidence-building.

Today's decision finds that VoIP services like Vonage's DigitalVoice have an undeniably interstate character. That's fine as far as it goes—but it doesn't go very far. Proclaiming the service "interstate" does not mean that everything magically falls into place, the curtains are raised, the technology is liberated, and all questions are answered. There are, in fact, difficult and urgent questions flowing from our jurisdictional conclusion and they are no closer to an answer after we act today than they were before we walked in here. So rather than sailing boldly into a revolutionary new Voice Over communications era, we are, I think, still lying at anchor. By not supplying answers, we are clouding the future of new technology that has the power to carry us over the horizon.

So I can only concur in today's decision. While I agree that traditional jurisdictional boundaries are eroding in our new Internet-centric world, we need a clear and comprehensive framework for addressing this new reality. Instead the Commission moves bit-by-bit through individual company petitions, in effect checking off business plans as they walk through the door. This is not the way we should be proceeding. We need a framework for all carriers and all services, not a stream of incremental decisions based on the needs of individual companies. We need a framework to explain the consequences for homeland security, public safety and 911. We need a framework for consumer protection. We need a framework to address intercarrier compensation, state and federal universal service, and the impact on rural America. But all I see coming out of this particular decision is . . . more questions.

The Commission's constricted approach denies consumers, carriers, investors and state and local officials the clarity they deserve. These are not just my musings. A growing chorus of voices is urging the Commission to stop its cherry-picking approach to VoIP issues. When the National Governors Association, the Association of Public Safety Communications Officials, the National Association of Counties, the National League of Cities, the United States Conference of Mayors, the Communications Workers of America, AARP, the Independent Telephone and Telecommunications Alliance, the National Telecommunications Cooperative Association, the Organization for the Promotion and Advancement of Small Telecommunications Companies, the Western Telecommunications Alliance, the National Association of Regulatory Utility Commissioners, the National Association of Telecommunications Officers and Advisors, the National Consumers League and local directors of 911 service in cities and counties around the country all suggest that moving ahead in piecemeal fashion is irresponsible, I think we should take heed.

I want to point to language in this item—albeit it's in a footnote—that warns people not to draw unwarranted conclusions from the narrow jurisdictional finding that we make. What we do today should not be interpreted as anything more than it is. Yes, Vonage's DigitalVoice service has an interstate character. But what exactly that entails we do not say. All that important work lies ahead. Wouldn't it be sad if we were to let it go at this, pretending we have done something truly responsive to the questions that need to be answered, and then not proceed to tackle the related issues quickly and comprehensively? And wouldn't it be tragic if the blunt instrument of preemption was permitted to erode our partnership

with the states? We have worked long and hard to nourish a common federal-state commitment to a pro-competitive telecommunications environment. This is no time to abandon that commitment.

Sometimes I wonder what the strategy is in this Commission's approach to VoIP. Some warn that it may be a camel's nose under the tent strategy, proceeding inch-by-inch to far-reaching conclusions that a more straight-forward approach could not sustain. I hope that is not the case and this decision should not be so interpreted. What I hope this decision does is to force us finally to face up to the larger issues. We are, after all, face-to-face here with issues that go to the very core of our statutory responsibilities. These issues can't be ducked and they can't be dodged if we are truly serious about these technologies realizing their full transformative potentials. So I'll withhold my approval for that happy day when we step up to the plate and begin answering the hard questions about what these technologies and services are and how they fit into America's communications landscape.

CONCURRING STATEMENT OF JONATHAN S. ADELSTEIN

Re: Vonage Holdings Corporation Petition for Declaratory Ruling Concerning an Order of the Minnesota Public Utilities Commission, WC Docket No. 03-211, FCC 04-267 (2004).

While this Order rightly acknowledges the importance and unique qualities of Internet-based services, including Voice over Internet Protocol (VoIP) services, I am concerned that the Commission overlooks important public policy issues that will impact consumers across our country, and particularly in Rural America.

I concur to this item because it appropriately recognizes the unique nature of many IP-enabled services and the importance of reducing barriers to entry for Internet-based services. Indeed, I share my colleagues' enthusiasm for the promise of Internet Protocol (IP)-enabled services. All indications are that IP is becoming the building block for the future of telecommunications and its use is integral to the explosion of choices for consumers. It is becoming increasingly apparent that IP-based services will play an important role in our global economic competitiveness, by enabling economic productivity, providing a platform for innovation, and driving demand for broadband facilities. Whether through PDA phones, voice through Instant Messaging, or countless other innovative services, this technology is giving customers far greater control over, and flexibility in the use of, their communications services. With that control, consumers can convert messages with ease from voice-to-text and back, and can take their IP-services wherever they go. Though I am not comfortable with all of the analysis in this item, the Order reasonably reflects the unique qualities of Vonage's service and recognizes the challenges that this service poses for the Commission's traditional jurisdictional analysis.

Where this Order falls short is its failure to account in a meaningful way for essential policy issues, including universal service, public safety, law enforcement, consumer privacy, disabilities access, and intercarrier compensation, and the effect of our preemption here. In February of this year, we opened a VoIP-specific rulemaking proceeding to address not only the issue raised here, the jurisdiction of IP-based services, but to address the broader implications of VoIP services in a comprehensive and coordinated fashion. At that time, we acknowledged the social importance of these Congressionally-mandated policy objectives and the need to assess the potentially disparate impact of our decisions on particular communities. I am concerned that this Order may have dramatic implications for these Congressional objectives, yet we afford them no meaningful or comprehensive consideration here. I am also concerned that our inability to specify the exact parameters of the services at issue and the breadth of our preemption will have unintended effects, including effects on incentives for investment in these technologies, that could have been avoided with a more comprehensive approach. I highlight, below, two of the most pressing concerns – universal service and public safety.

The Act charges this Commission with maintaining universal service, which is crucial in delivering communications services to our nation's schools, libraries, low income consumers, and rural communities. Universal service has been the cornerstone of telecommunications policy for over 70 years and has enabled this country to enjoy unparalleled levels of access to essential communications services. That access has improved our economic productivity and our public safety in immeasurable ways and has been vital in fostering economic development in rural and underserved areas. The Act also expressly permits States to adopt consistent approaches to preserve and advance universal service. At least 24 States have answered that call, disbursing over $1.9 billion annually from their own universal service programs. Many of those States and other commenters express legitimate concern that our decision here could increase pressure on the federal universal service mechanisms and could potentially lead to rate increases for rural and low income consumers. With those reasons in mind, I've called for the Commission to quickly convene a universal service solutions summit modeled after the ones we've held

for other public policy issues. Regrettably, this item does not acknowledge its potential impact on those programs, nor does it propose any solutions, or even make firm commitments to resolving these issues. We are left to hope that these unaddressed issues do not gridlock or curtail the full reach of the promised IP superhighway.

I also have reservations about our preemption of a State's efforts to ensure the public safety of its citizens, based here on the linkage of the 911 requirement with a State certification. Our approach of overriding States' public safety efforts without clear federal direction takes us into a dangerous territory in which consumers may come to rely on services without the benefit of the critical safety net that they have come to expect.

Ultimately, I cannot fully endorse an approach that leaves unanswered so many important questions about the future of communications services for so many Americans. Rural and low-income Americans, the countless governmental and public interest groups who have expressed concern about our piecemeal approach, and the communications industry, itself, all deserve more from this Commission. If this Commission is to ensure that innovative services are widely available and also achieve the important public policy goals that Congress has articulated, the Commission must begin to wrestle in earnest with difficult issues that are largely ignored this Order. We simply cannot afford to slow roll these issues.

2005-2006

REVENUE LAWS STUDY COMMITTEE

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Consumer Federation of America

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PUBLISHER OF
CONSUMER REPORTS

THE CONTINUING ABUSE OF MARKET POWER BY THE CABLE INDUSTRY:

RISING PRICES, DENIAL OF CONSUMER CHOICE, AND DISCRIMINATORY ACCESS TO CONTENT

February 2004

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THE CONTINUING ABUSE OF MARKET POWER BY THE CABLE INDUSTRY:

RISING PRICES, DENIAL OF CONSUMER CHOICE, AND DISCRIMINATION IN ACCESS

EXECUTIVE SUMMARY

Eight years after the passage of the Telecommunications Act of 1996, which deregulated cable prices, this study shows that cable operators still possess market power in the multichannel video market. The result is price increases that far exceed the rate of inflation – almost three times faster than inflation in recent years –and the continued restriction of consumer choice to a small number of ever larger, ever more expensive bundles. The cost imposed on consumers by this abuse of market power is between $4.5 and $6 billion per year, compared to what prices would be in a competitive market.

Cable operators attempt to obscure the existence and abuse of market power with two arguments. First they claim that programming costs explain the massive increase in the price of basic and expanded basic service. Second, they claim that consumers are getting much greater value for their dollar; so that quality adjusted prices have declined. Neither claim stands up to close scrutiny.

EXERCISE OF MARKET POWER ON THE SUPPLY SIDE

Prices

Econometric studies by the General Accounting Office and the Federal Communications Commission show that where cable faces direct head-to-head overbuilder competition the price of cable service is much lower.

- A recent GAO report found that in situations where cable faces competition overbuilders, prices are 15% lower. Econometric analyses have consistently found this result of a decade. Unfortunately, less than two percent of cable customers enjoy the benefits of that competition.

- A recent GAO analysis found that a cable system owned by a large national operator has prices that are over 5 percent higher than if it is not. FCC econometric models show even larger effects.

- When the FCC models add in a specific variable for regional clustering, a dramatic trend in the industry, they find that clustering has an added effect of further raising price.

- The vast majority of cable subscribers are now served by one of a handful of huge-multiple system operators that have expanded their grip on the industry through mergers and clustering, who adds as much as an additional 8 percent to the consumers bill.

Market Structure

Cable's market power stems from a lack of effective competition. Even at the national level, the multichannel video market has become concentrated; the problem is much greater at the local level.

- In markets where 98 percent of Americans live, a single cable operator dominates multichannel video distribution with a market share that exceeds 80 percent.

The largest cable operators never compete with one another. Instead they have grown to huge national firms through mergers using swaps of systems to create regional clusters that undermine the ability of overbuilders to launch competition. Large operators and clustered systems have more muscle to thwart competition and impose price increases.

- They can distribute programming terrestrially and refuse to make it available to competing distribution systems. This is becoming increasingly important as vertically integrated companies dominate "must have" regional sports programming.

- They can extract exclusivity deals from independent programmers, thereby denying programming to competing distribution media.

- They have more leverage over local governments to obstruct the entry of overbuilders

Direct Broadcast Satellite does not have a significant or substantial ability to discipline cable pricing abuse. Satellite is a niche product that has had its greatest success in areas where cable was unavailable or among customers who wanted high quality digital services with large numbers of channels (before cable could offer such a package).

- Cable has surpasses satellite in the number of subscribers to digital video service.

- It is bundling high-speed Internet and basic cable service to further erode the ability of satellite to compete.

Discrimination in Access

Cable operators discriminate against unaffiliated service providers in both the video and the high-speed Internet product space. Cable operators are 64 percent more likely to carry networks that they own, than the networks provided by others. Broadcasters have used their retransmission rights to also gain preferential carriage deals for their shows. As a result, independent programmers are placed at a severe disadvantage.

Cable operators dominate the residential market for advanced high-speed Internet access, with an 83 percent market share. By refusing to allow unaffiliated Internet Service Providers to compete for Internet access customers over the cable modem platform, cable operators have foreclosed a critical high-end market, which dramatically reduces competition for Internet service. Virtually no voluntary carriage agreements have been signed by cable operators.

Cash Flow

A close look at cable's financial operations shows that rising costs cannot explain the rising price of traditional video services.

- In the aggregate, price increases far exceed the increase in programming costs.
- An allocation of non-programming operating costs based on historical patterns shows that operating cash flow from traditional video services has increased by approximately 70 percent on a per subscriber basis since the passage of the Telecommunications Act.

Sale of advanced services, digital tiers and high speed Internet, which were the motivation behind the recent system upgrades, has skyrocketed. The upgrades are paying for themselves.

- High-speed Internet is now the second largest income stream and digital tiers are the third largest streams of income for the cable operators, bringing in a combined $10 billion per year.

The Shape of Market Power on the Demand Side

Cable operators claim that adding more channels to their bundles increases the value of he package. Unfortunately, consumers are not given a choice of which channels to purchase. They must take nothing, almost nothing (basic) or almost everything (expanded basic). With the addition of the digital tier, they have another option, but cable operators have been moving popular channels (like HBO) to the digital tier to drive consumer bills up even farther.

Because the cable operators restrict consumer choice to this small set of bundles, it is impossible to know how consumer welfare has changed and wrong to claim that every show adds equally to consumer value.

- The average consumer watches about 17 channels regularly, but the bundles have four times that number.

- The top twenty shows account for approximately three quarters of all viewing.

- Almost nobody watches the bottom 30 channels in the bundle. Only about one out of every 250 households where these shows are available watches them on any given day.

The economics literature has long recognized that bundling by firms possessing market power can be anti-consumer and anticompetitive. When different consumers have strong preferences for different channels, putting them into bundles forces each consumer to pay for many channels he or she does not want in order to get the channels he or she does want.

A detailed analysis of one of the most popular and expensive channels, ESPN, which has been a focal point of controversy, shows that approximately four-fifths of cable subscribers would not pay the price of ESPN if they were given a choice. By forcing consumers to pay for the show in a bundle, wealth is transferred from consumers to cable operators (and the programmer).

A recent analysis that claims that the BLS over states price increase and that prices have fallen on a quality adjusted basis is riddled with analytic and measurement errors. The analysis double counts the quantity of programming and vastly overvalues the shift from viewing over the air to viewing cable. Watching an hour rerun of the same show on cable, instead of a broadcast station is assumed to increase consumer value by one hour, even though the exact same show is watched. Correcting these errors shows that the BLS cable price index yields, at best a lower limit on the quality adjusted price increases.

- In contrast to the 15 percent real decline that the NCTA analysis claims, the BLS shows a 27 percent increase. The actual quality adjusted price increase could be as high as 40 percent.

The embedded base of excess prices and the entrenched market power of the cable operators, reinforced against satellite and extending into the high-speed Internet, confront policy makers with a critical problem. After two decades of abuse, and eight years after the Telecom Act of 1996, it is clear that policymakers made a mistake in deregulating cable. It is time for policymakers to take steps to promote real competition and protect consumers from further abuse.

I. INTRODUCTION

A. PURPOSE

Proceedings at the Federal Communications Commission (FCC),[1] a series of General Accounting Office (GAO) reports[2] and contract negotiations between cable operators and programmers[3] have stimulated an unprecedented round of finger pointing and release of data about the cable television industry. The goal is to justify and/or place blame for the dramatically increasing price of cable service.[4] Cable operators claim the programmers made them do it. Programmers have fired back, suggesting that basic rates have been increasing to support the rollout of advanced video and new, non-video services. The finger pointing drives home a simple point: consumers are paying a dramatically higher price for their monthly cable service. Or, are they?

Several of the existing industry studies are framed as responses to consumer analyses that have documented the abuse of market power by cable operators. Comcast[5] and the National Cable Telecommunications Association (NCTA)[6] assert that when consumer advocates complain about the total price of cable service, they are failing to take into account that the monthly bill includes more networks and are confusing real prices with nominal prices. NCTA goes so far as to offer a new approach to indexing cable prices as an alternative to the Bureau of Labor Statistics (BLS) cable Consumer Price Index (CPI). The FCC's *Tenth Annual Report (In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming)* cites this analysis as further support for its conclusion that competition in the multichannel video market is robust and repeats the industry arguments.[7]

This paper shows that the most frequent complaint voiced by consumer advocates – that cable "rates have risen and continue to rise almost three-times faster than inflation,"[8] – is correct. The consumer advocate comparison of cable rates to inflation states the numerator and the denominator of the real fraction in a fashion that is more meaningful to consumers and policymakers because it gives the reference points. Moreover, the paper argues that, if anything, the BLS cable price index is more likely to be understating price increases than overstating them.

The bottom line is that the market power-based abuse of consumers by cable operators has been growing since the passage of the Telecommunications Act of 1996. After two decades of blatant abusive pricing, cable operators have begun to encounter some resistance, so increases may slow, but that does not mean the abuse will be reduced or eliminated. In response to criticism, the cable operators have simply launched new bundling strategies that shift the focal point of price increases and anticompetitive harm to other areas.

B. THE FCC'S FAILURE TO ASK THE HARD QUESTIONS

The FCC's Annual Reports have steadfastly refused to address the serious questions raised about the cable market in a rigorous manner, but the *Tenth Annual Report* sinks to new lows. The FCC cannot even figure out how many cable subscribers there are. The two sources on which it relies for data (it never generates its own independent data) disagree by almost five million subscribers. In response, the FCC takes a most remarkable approach – it uses both sets of numbers – the lower figure for its financial analysis and the higher figure for its assessment of

competing technologies (contrast Tables 1 and 4 to Table B-1). The *Ninth Annual Report* used the higher figure for both the financial and the competitive assessment analyses.

As with most analyses at the Commission these days, slipping the lower figure into this report may be strategically motivated. If the FCC uses the higher figure and growth persists at the rate implicit in those figures, by this time next year cable will be well above 70 percent of the TV market. This is a threshold that would trigger petitions to the FCC to regulate cable. If the FCC shifts to the lower figure, or claims the conflict between the two creates uncertainty, the regulation trigger would be put off several years. Here, as elsewhere, the failure of the FCC to develop solid independent data may harm consumers substantially.

The FCC recognizes the dramatic increase in cable prices, but, like the industry, it emphasizes that "concurrently with these rate increases, however, the number of video and non-video services increased, including a substantial increase in the number of video channels, increased use of cable (as measured by a substantial increase in cable viewership), and the addition of advanced service offerings which, of course, are paid for separately by consumers."[9] Unfortunately, the FCC admits that its approach to measuring prices cannot address the fundamental issue, since it is based on an assumption that this paper shows to be doubtful – "Per channel rates, however, value all additional channels the same even if consumers do not want new channels that are added to cable systems."[10] This paper shows that such an assumption is contradicted by consumer behavior. The cable video industry's bundling harms consumers.

The FCC regurgitates the industry claim that rising programming costs have driven basic rate increases, but does not examine the contradictory evidence embedded in its own numbers. For example, it notes that programming costs went from $7.5 billion in 1998 and will exceed $9 billion in 2003. [11] It later cites a figure of $9.2 billion for 2002.[12] Over the 1998-2003 period, revenues for basic and expanded basic services increased by $7.3 billion. Thus, three quarters of the price increases cannot be explained by rising programming costs. Price increases exceeded programming cost increases by more than $5 billion.

The challenge of explaining away the excessive rate increase for basic and expanded basic service is made all the more difficult in light of the dramatic increase in revenues from advanced services. The FCC notes that dramatic rise of advanced service revenues citing "Kagan World Media reports it was high-margin, high-speed-data services that drove operating cash flow growth in 2002."[13] Moreover, it notes that Kagan sees this trend growing in 2003, since "they expect high-speed data service 'to contribute 12.4% to total residential revenue, the largest piece of the revenue pie after basic service."[14] Digital tier services are the third largest revenue stream for cable operators, having surpassed local advertising for the first time in 2003.[15] The fact that these two advanced services now bring in $10 billion in revenue should force the Commission to challenge the claim that basic and expanded basic prices had to rise to pay for the upgrade of the system. This issue, which the Commission has never addressed, is a central theme of this report.

The FCC's report goes on to claim that the bundling of advanced services with basic service "may provide some discount on basic or expanded basic,"[16] a proposition it does not even attempt to analyze, let alone prove. This paper shows that this bundling is anti-competitive.

The FCC notes several cable industry milestones in this report, but fails to follow up on them. For example, it notes that the national Multichannel Video Programming Distribution (MVPD) market exceeds the threshold for a moderately concentrated market as defined by the Department of Justice/Federal Trade Commission *Merger Guidelines*. The FCC hastens to add that "it is unclear whether this is a potential competitive problem, because the delivery market is local, not national and because the main competitors to cable in both the upstream and downstream markets continue to grow in size."[17] This observation is not comforting for several reasons.

As has traditionally been the case, the FCC makes no effort to assess the level of concentration in the local market. If it did so, it would find that local MVPD markets are generally six times as concentrated as the national market on which it focuses.[18] Here the FCC encounters another contradiction. It continues to maintain that the clustering strategies of large multiple system operators might benefit consumers,[19] even though the Commission's own analysis has consistently shown that clustering results in higher prices.[20]

While it is true that the MVPD market is expanding, the FCC fails to note that its competitive assessment analysis shows that cable operators added more subscribers than all the other MVPD competitors combined.[21] (Of course, the FCC may erase this observation by switching the numbers next year.) Moreover, the FCC fails to note that cable surpassed satellite in the number of digital subscribers for the first time in 2003.[22] Thus, the competitive threat from satellite that the FCC claims should ease our concern about concentration in the cable market may be subsiding, if it ever existed. In fact, this paper reviews the evidence that satellite has failed to discipline cable's pricing abuse.

The FCC's simplistic parroting of the industry arguments and failure to conduct rigorous, independent analysis continues to disserve consumers. As cable prices mount and the industry extends its market power into new areas, "congress and American consumers deserve a better effort from the FCC."[23]

II. THE SUPPLY SIDE

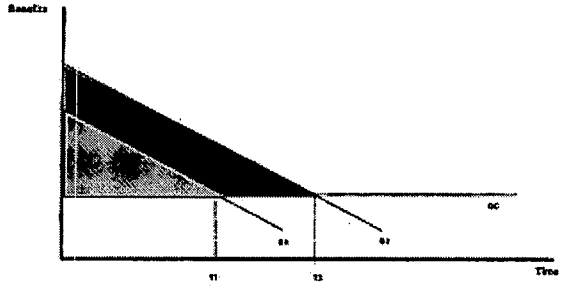
A. MARKET POWER 101

All of the industry studies, as well as the FCC report, ignore the fundamental public policy issues raised by the consumer analysis. Simply put, every dog has his day and every monopolist has his profit-maximizing price. Unlike the hapless canine, however, who goes back to a dog's life when his day is done, when the monopolist hits his profit-maximizing price, he goes on collecting excess profits. The abuse of consumers persists. What the cable industry economists have done in their recent papers defending cable industry prices is to focus on the scraps of consumer surplus left on the table by cable operators and ignore the submerged danger, the transfer of wealth and deadweight efficiency loss that result from the abuse of market power.[24]

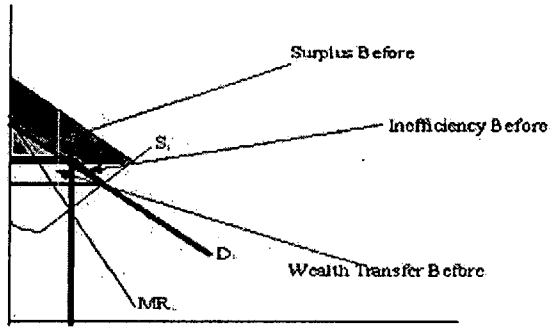
Launching from the simple observation that every monopolist leaves a little surplus in consumers' pockets, the cable industry analyzes the tip of the market power iceberg (see Exhibit 1a).[25] The shaded area in Exhibit 1a is the focal point of the NCTA paper. Consumer surplus (or

EXHIBIT 1:
Consumer Surplus

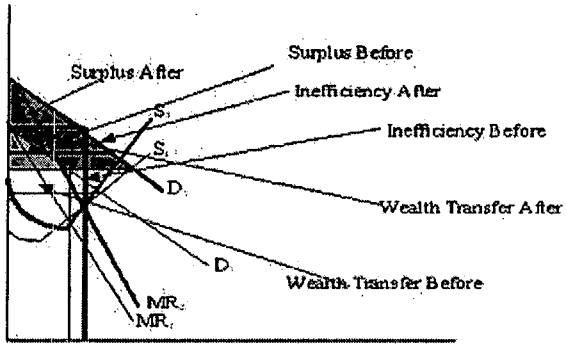
a) NCTA'S Simplistic Analysis



b) Consumer surplus is the tip of the market power iceberg



c) Change in supply and demand with market power persisting



consumer benefits as the paper calls them) is measured as the difference between the value of a service to the consumer (as indicated by the demand curve) and the price the consumer pays for the service. If the value exceeds the price, the consumer buys the product.

Exhibit 1b places the consumer surplus analysis in the framework of the complete picture of cable pricing[26] as a classic diagram of the exercise of market power over price.[27] It is well known in economics that the monopolist sets his price at the point where marginal revenue equals marginal cost. Even at that price there are consumers who are willing to pay the price because the value of the service exceeds the price for them, but consumers are still paying too high a price for the service. The monopolists have captured part of the consumer surplus and transferred it to their pockets (wealth transfers). Also, there are some consumers who give up cable or do not take it, when they would have if the price had been at a competitive level. Their loss is a deadweight efficiency loss. Because the elasticity of demand for cable service is low, wealth transfers are large relative to efficiency losses.

The monopolist can do various things to increase his profits when he hits the profit-maximizing price (see Exhibit 1c).[28] He can stimulate demand by adding value or by bundling. He can shift the supply curve by lowering his cost or changing his cost structure (and pocket an extra share of the cost savings because he does not face competition). Either or both of these may appear to be welfare enhancing because the quantity consumed increases, but the abuse actually may be increasing on a relative basis because more consumer surplus is being extracted.[29] The relative size of the effects depends on the specific supply and demand curves. This is an empirical question. As depicted in Exhibit 1c, this paper demonstrates that both the total profit and the rate of profit on traditional video services have increased since the passage of the 1996 Act.

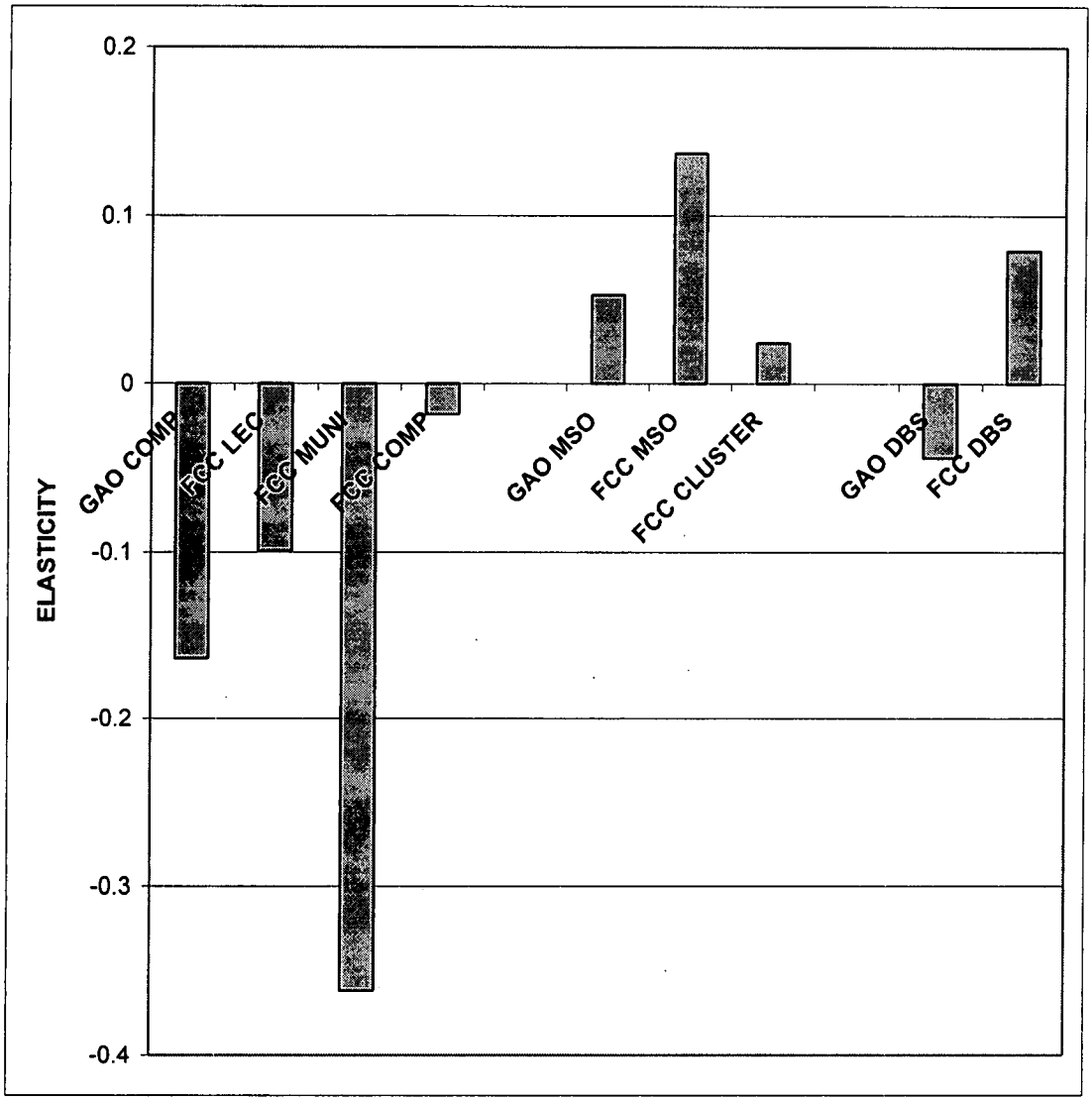
B. GAO's Video Market Structure Analysis

The critical first question that must be answered is simple – is there evidence that market power is being exercised on the supply side? The GAO provides an affirmative answer. The GAO report affirms each of the supply-side problems of the multichannel video market that has afflicted the American public since the industry was prematurely deregulated in 1984 and further deregulated in 1996. Exhibit 2 shows the elasticities for dummy variables measuring various structural characteristics that affect the extent of competition, which were included in the regression analyses conducted by the GAO and the FCC.

1. Horizontal Market Power

Head-to-head, wireline competition is the only market structure feature that significantly disciplines monopolistic pricing. In its most recent report, the GAO finds that head-to-head, wireline competition between cable operators lowers prices by 15 percent for basic and expanded basic service.[30] Its earlier report had found a 17 percent difference.[31] Ironically, the *Tenth Annual Report* notes that the first report on cable competition found that head-to-head competition lowered prices by 16 percent.[32] Recent FCC econometric models, which identified three types of head-to-head competitors (local exchange carriers (LECs), publicly owned systems (munis) and other private overbuilders (comp)), have consistently found large price effects from head-to-head, wireline competition.[33] Unfortunately, less than two percent of American

EXHIBIT 2:
Impact Of Market Structure Characteristics On Monthly Rates
(Regression Coefficients, dummy variables)



Sources: Federal Communications Commission, *Report on Cable Prices,* April 4, 2002, Attachment D-1; General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry,* October 2003, Appendix IV, Table 3.

households enjoy the benefit of head-to-head, wireline competition.[34] The result is an abuse of market power that costs the American public about $4.5 billion per year in cable rates alone.[35]

Bigger monopolies are worse when it comes to consumer prices. In the GAO analysis, if a cable system is part of a large national operator, its prices are 5.4 percent higher than if it is not.[36] The GAO called this horizontal concentration. FCC econometric models have been finding this to be the case for several years, with even larger effects of being part of a multiple system operator (MSO).[37] When the FCC models add in a specific variable for regional clustering, a dramatic trend in the industry, they find that clustering has an added effect of further raising price.[38] Being served by one of the mega-multiple system operators, who have been expanding their grip on the industry through mergers and clustering, drives prices higher by more than 5 percent and perhaps as much as 8 percent. Thus, there could be as much as an additional $1.5 billion in consumer savings that could be wrung out of the cable market if it were deconcentrated.

The important implication is that the theory used to allow large cable operators to become larger is not supported by the empirical evidence.[39] That theory claimed that the combination of larger, clustered systems would create efficiency-based cost savings that would be passed on to the public because one big monopolist is no worse that two, contiguous smaller ones. Since large incumbents never overbuild one-another and compete, this theory claimed there was little to be lost. The econometric evidence suggests that there is considerable harm. It turns out that large operators and clustered systems have more muscle to thwart competition and impose price increases. They can distribute programming terrestrially and extract exclusivity deals from independent programmers, thereby denying programming to competing distribution media (overbuilders and satellite). They have more leverage over local governments to obstruct the entry of overbuilders.

The large incumbent cable operators never competed by overbuilding a neighbor, they grow by merger. Policymakers surrendered to the cable urge to merge too easily. If cable operators knew they could not grow through mergers and really cared about size, they might compete by overbuilding one another.[40]

Intermodal competition – between cable and satellite – does not effectively discipline cable's pricing power. In contrast to head-to-head, wireline competition, which lowers cable bills by $5 per month, competition from satellite lowers bills by a mere $.15, according to the GAO.[41] In other words, head-to-head, wireline competition is almost 40 times as effective as intermodal competition when it comes to price. In fact, in the GAO report, even satellite's very modest pricing effect is not statistically significant by traditional standards. It fails at the 5 percent level of significance. The FCC's econometric analysis does not find even this small price effect. It finds a statistically significant effect in the opposite direction.[42]

To the extent that satellite has any competitive effect, it drives cable operators to offer more channels, but this effect stems from the decision of satellite to offer local programming. Where satellite offers local programming, cable operators offer about 5.4 percent more cable channels. Thus, satellite appears as a niche product that cannot discipline cable pricing abuse for the vast majority of cable subscribers who take only basic and expanded basic.[43]

Exhibit 3 explores the implications of the most recent econometric findings on horizontal market power. Using the traditional measure of market power and the standard measure of the pricing abuse that results – the Lerner Index – it explores the relationship between the number and size of firms in cable markets and the mark-up of price over cost. A more advanced approach uses the level of concentration in the market (as measured by the HHI) in the Lerner Index instead of the simple number of firms. The mark-up of price above cost is inversely related to the extent of competition and the market elasticity of demand. The more competitive the market and the more elastic the demand, the less the ability to increase price. The analysis uses the econometric estimate of the elasticity of demand and the implicit levels of concentration The econometric estimate of a 20 percent mark-up from a lack of head-to-head competition and horizontal concentration is consistent with, even a conservative estimate of, the pricing power suggested by the market structural conditions (demand elasticity and market shares) implicit in both the GAO and the FCC analyses.

2. Vertical Market Power

Vertical relationships are exploited by cable operators. GAO finds that cable operators are majority owners of one-fifth of the top 90 national networks. The GAO does not find price discrimination but it does find discrimination in carriage. That is, cable operators do not pay themselves more for their own shows, but they are much more likely to air them. The effect is quite large. Cable operators are 64 percent more likely to carry the programming in which they have a majority ownership stake. Cable operators who have a stake in programming also carry fewer channels overall. This result is consistent with prior academic studies.[44]

A one-fifth share of the most popular programs is a very substantial stake in the programming market and it blunts cable operators' incentive to resist price increases. Cable operators own minority stakes in other networks. With their market power at the point-of-sale, cable operators know that they can pass costs through to consumers and they can assure that their own programs are carried much more frequently than those of others, thereby gaining a disproportionate share of the overall increase in programming costs.

While no cable operator had pricing power in the programming market until recently, Comcast appears to have gained pricing power as a large purchaser of programming. Having achieved a large enough market share, it now has monopsony power over sellers of programming. Comcast is squeezing programmers to lower their fees at the same time it is announcing price increases for basic and expanded basic. It is both reallocating rents from programmers to itself[45] and increasing the rents collected from consumers.[46]

Rights of carriage matter a great deal in the cable industry. The decision of Congress to give broadcasters must carry/retransmission rights has enabled the broadcasters to gain a significant advantage for their programming, in terms of carriage. Programs owned by broadcasters are 41 percent more likely to be carried by cable operators. Clearly, independent programmers are at a severe disadvantage, as has been demonstrated time and again. Although the GAO report concludes that 38% of the cable networks are majority owned by non-cable, non-broadcast firms, a much smaller percentage, less than 20 percent, do not have a least some minority ownership of broadcasters or cable operators.

EXHIBIT 3:
Comparison of Empirical Estimates of Mark-Up
Using Alternative Measures of Concentration and Dummy Variables

SOURCE	CONCENTRATION MEASURES		
	Non-competitive	Competitive	
FCC ($E_d = 2.2$)	HHI = 6800	HHI = 3912	Δ L
	45.1	17.8	-27.3
DIRECT ESTIMATE			
Head-To-Head			- 9.1
Concentration			-25.6
Total			-34.1
GAO ($E_d = 1.54$)	HHI = 7312	HHI = 3418	
	47.4	22.2	-27.3
DIRECT ESTIMATE			
Head-To-Head			-15.1
Concentration			- 5.4 to –8.0
Total			-20.5 to 23.5

Sources: Federal Communications Commission, *Report on Cable Prices,* April 4, 2002, Attachment D-1; U.S. General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry,* October 2003, Appendix IV, Table 3. Viscusi, W. Kip, John M. Vernon and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust* (Cambridge, MA: MIT Press, 2001), pp. 102-108, 147-149, 258-259. Lerner Index:

$$L = S_i \frac{(P_m - MC)}{P_m} = \frac{HHI}{10000} * \frac{1}{E_d} \text{ (Nash Equilibrium)}$$

While discrimination in carriage has implications for the pricing issue that is the central concern of this paper, it has much broader implications for public policy in the multichannel video market. Public policy has expressed a concern about promoting independent production and ensuring a diversity of content for decades. Two pending proceedings at the FCC directly involve the question of how concentration of ownership and the exercise of market power in the form of discriminatory access to distribution affect the content available to the public. In the horizontal limits proceeding, the FCC is charged with setting a limit on the market reach of a single cable operator.[47] Similarly, in several of the media ownership proceedings the market reach of broadcasters (and the availability of cable as a distribution technology) is a central concern. The conclusion is overwhelmingly clear. Those who have Congressionally mandated rights of carriage are able to have their shows aired, those who do not have almost no chance of success.

C. High-Speed Internet

Although high-speed Internet raises many important issues, from the point of view of video services pricing, it plays two important roles.

First, it is cited by the industry and analyses as one of the causes for the increase in cable prices. Since the plant upgrade supports other streams of revenue, the GAO cautions, "[f]irst, depreciation expenses (and therefore infrastructure investment) represent a joint (or common) expense for both video-based and Internet-based services. Because these expenses are associated with more than one service, it is unclear how much of this cost should be attributed to video-based services. Second, cable operators are enjoying increased revenues from these non-video sources."[48] The same is true for operating expenses. A large part of the increased expense is associated with the selling and servicing of advanced video, Internet and telephone service that "have been spread across the entire revenue base – i.e. they are reflected in the prices paid by basic cable subscribers."[49]

Looking at a short period, 1999 to 2002, the GAO finds that revenues from Internet services alone are already almost equal to the increased depreciation expense of the cable plant upgrade. The GAO estimates that capital costs (depreciation expenses) have increased by $80 per subscriber, while Internet-only revenues increased by $74.[50]

Second, cable operators have rapidly achieved positive cash flow from high-speed Internet services because of weak competitive forces. Cable operators are aggressively bundling high-speed Internet with video services to gain competitive leverage. Their market power over high-speed Internet access gives them an important anticompetitive tool. Cable has foreclosed competition for Internet access service over its platform.[51] Controlling the platform diminishes the potential competition from video streaming over the Internet[52] and becomes a lever against competition from other distribution technologies. Cable has an 83 percent market share of the residential advanced high-speed Internet market.[53] Moreover, cable provides overwhelmingly (87 percent) advanced service, while DSL is overwhelmingly (67 percent) not advanced.

Discrimination was even more brutal in the Internet space as cable operators applied their business model to high-speed Internet access. Only a consent decree forced Time Warner to allow modest access, and intense scrutiny forced AT&T to make some minor concessions, but

the recent AOL/AT&T carriage agreement is thoroughly anticompetitive.[54] AOL has been unable to actually execute any carriage agreements with cable companies.[55] Cable operators do not sell ISP services outside of their service territories where they have the leverage of their market power over cable facilities.

With intramodal competition foreclosed, cable faces only weak intermodal competition. Cable has scoffed at the modest discounting efforts of the telecommunications-based DSL service providers.[56] In fact, Comcast raised the price of stand-alone high-speed Internet on its newly acquired AT&T systems. The reason cable can ignore intermodal competition is simple; those discounted services are substantially more expensive on a megabit basis (see Exhibit 4). The cable operators ignore DSL pricing moves and harp on speed superiority in their advertising. Exhibit 4 also shows why dial up is not a substitute for high-speed access. It is far more expensive on a megabit basis. Moreover, dial-up lacks the other key feature of high-speed service -- it is not always on. This distinction led the Justice Department to declare early on that high-speed Internet is a separate product from dial-up.[57]

Satellite lacks the ability to offer a bundle of video and high-speed Internet to compete effectively with cable. Cable recognizes this and is aggressively bundling high-speed Internet with basic cable service – offering a 25 percent discount on a bundle of basic cable and Internet compared to stand alone Internet service.[58]

Looking carefully at specific product and geographic markets reveals little competitive overlap of different facilities (see Exhibit 5).[59] Intermodal competition is weak at best. Technological differences give different facilities an edge in different customer and geographic markets.[60] Cable dominates the advanced residential high-speed Internet market, with a 75 percent market share for residential market of speeds of greater than 200kbps in both directions.[61] DSL, as deployed, is ill suited to multimedia video applications,[62] but DSL dominates the non-residential market with a 95 percent market share because businesses are disinclined to use cable.[63] For the next generation telephone network technologies, "most experts agree that the VDSL business case isn't for everyone and won't[64] realize its full revenue potential for decades."[65]

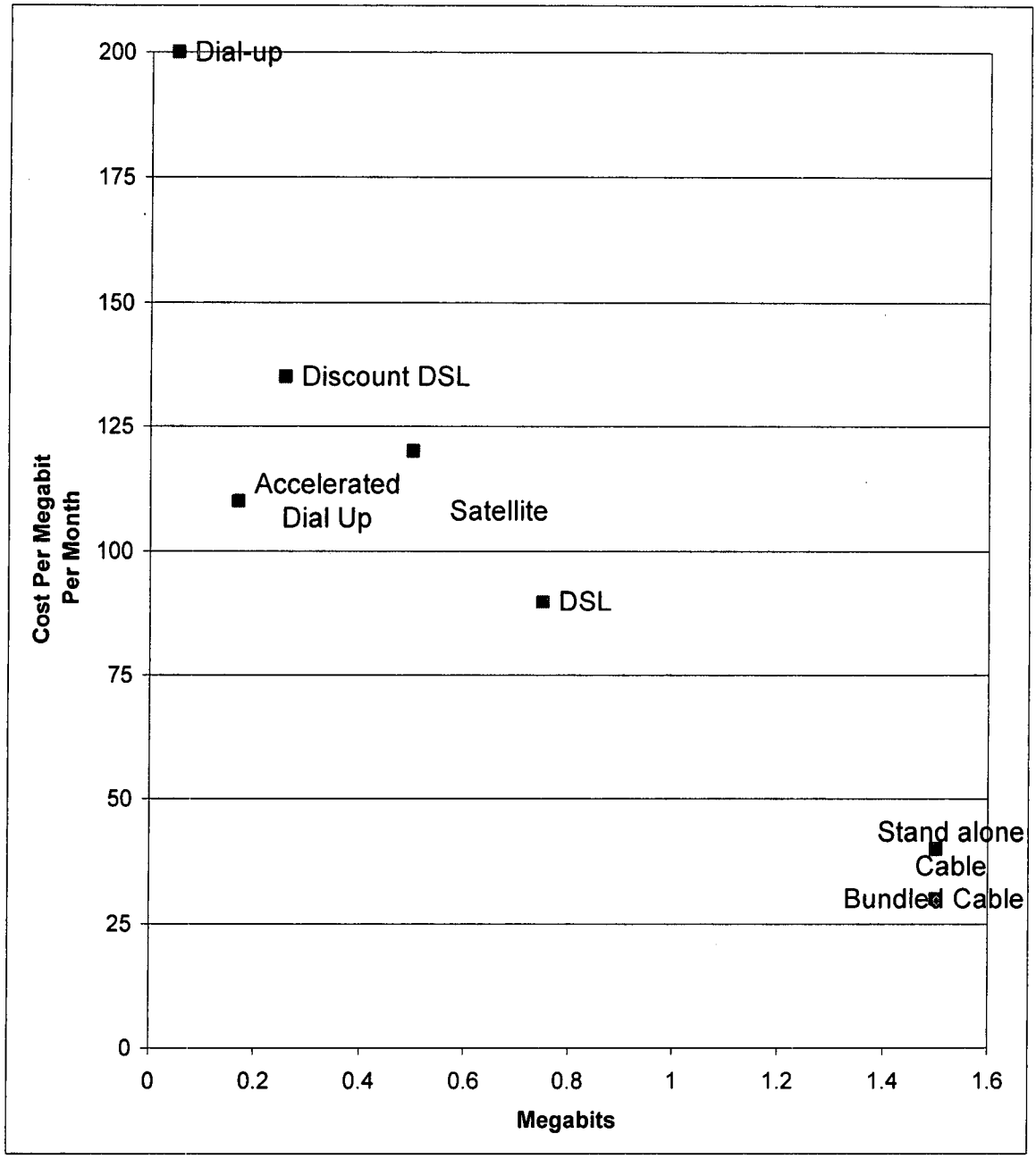
However, cable operators devote less than two percent of the capacity of their systems to cable modem service. They could easily expand that if they so desired. This gives them an immense advantage over telephone companies.[66]

D. Cash Flow Analysis

1. All Revenues, All Costs

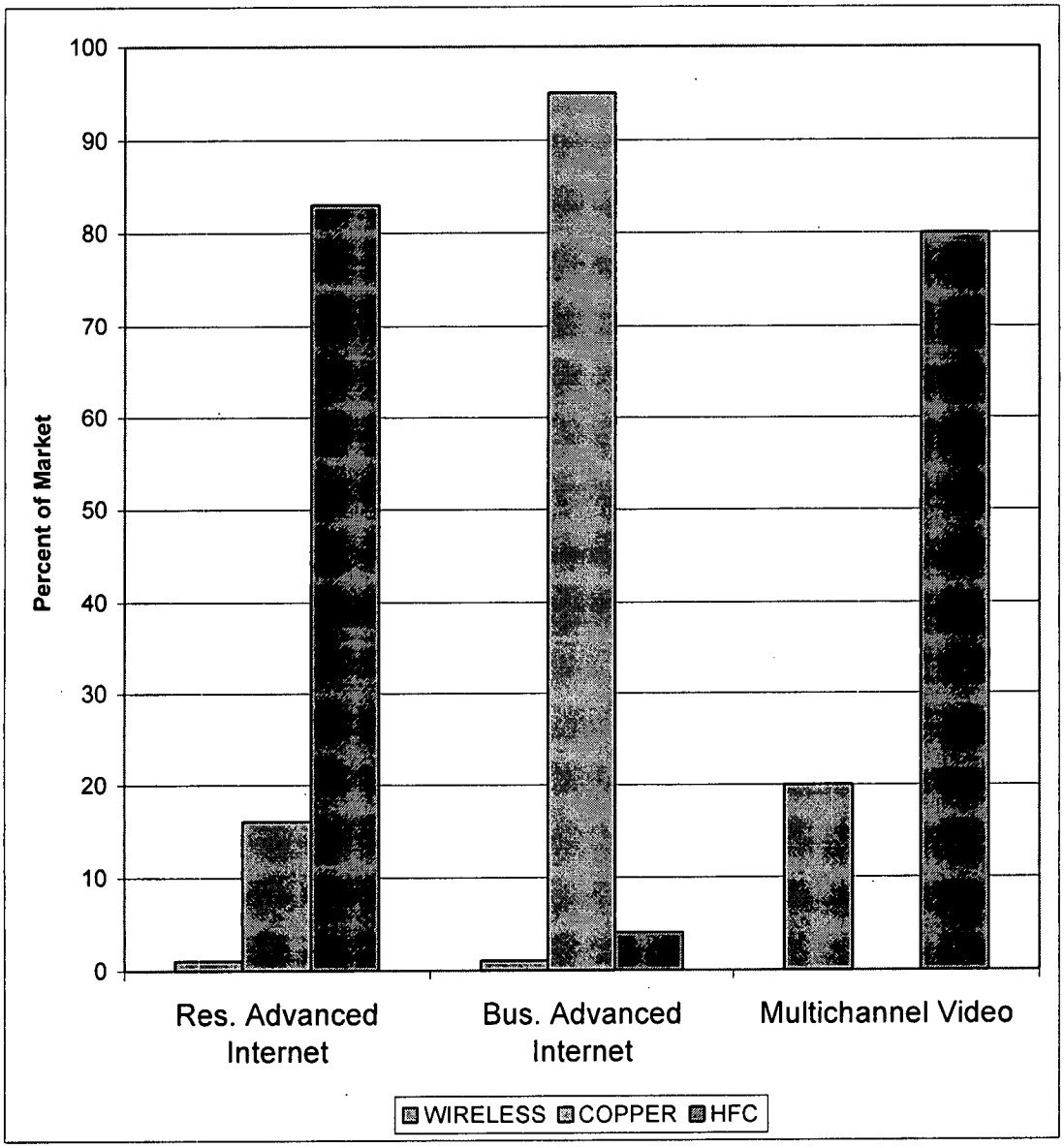
To assess whether the rate increases of recent years have been abusive, I analyze cash flow. I use 1995 as the base year, since the Telecommunications Act of 1996 was signed in early February. For several reasons, it is important to capture this whole period. Industry analyses, including that of the GAO, choose a very short time frame, 1999 to 2002, and miss critical factors.[67]

EXHIBIT 4:
The Price of High-Speed Internet Service



Source: Calculated by author from web site visits.

EXHIBIT 5:
Market Segmentation Of Services Between Technologies



Source: Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table B-7; Ninth Annual Report, December 2002, Table Appendix B. *High-Speed Services for Internet Access,* December 2003, Table 1, 2 and 4; *Local Telephone Competition: Status as of December 31, 2002*, June 2003, Tables 1, 13; NCTA, Overview 2003: Mid-Year, p. 1.

First, the upgrade of the cable plant began well before 1999, as did the post-1996 Act rate increases. By 1999, the cable industry had already upgraded one-third of its plant. Rates for basic + expanded service had already increased by 50 percent and net operating income (operating revenue minus operating costs) had increased by over 25 percent. In fact, just one year after the passage of the Telecommunications Act of 1996 the issue of cable rate increases had already arisen. The FCC's January 1997 cable price report noted that "the Cable CPI increased at a 3.7% compound annual rate from January 1995 to December 1995, and at a 8.5% compound annual rate for the eleven months from January 1996 to November 1996."[68] The song and dance about the causes of the increases had already begun, when the Commission declared:

> we note from anecdotal evidence reported in both the trade press and the general news media that cable operators have attributed the recent increases in cable rates to higher programming costs, system upgrades which provide additional channels, and the pass through of the effects of general inflation on operators' costs.[69]

Second, the GAO report does not examine all of the revenues and costs consistently, since it never factors in advertising revenue. It appears to underestimate an important source of revenue, digital tier revenue, and an important cost stream, non-programming operating expenses. The GAO did not break out the revenues from advanced video services that are also made possible by the upgrade.

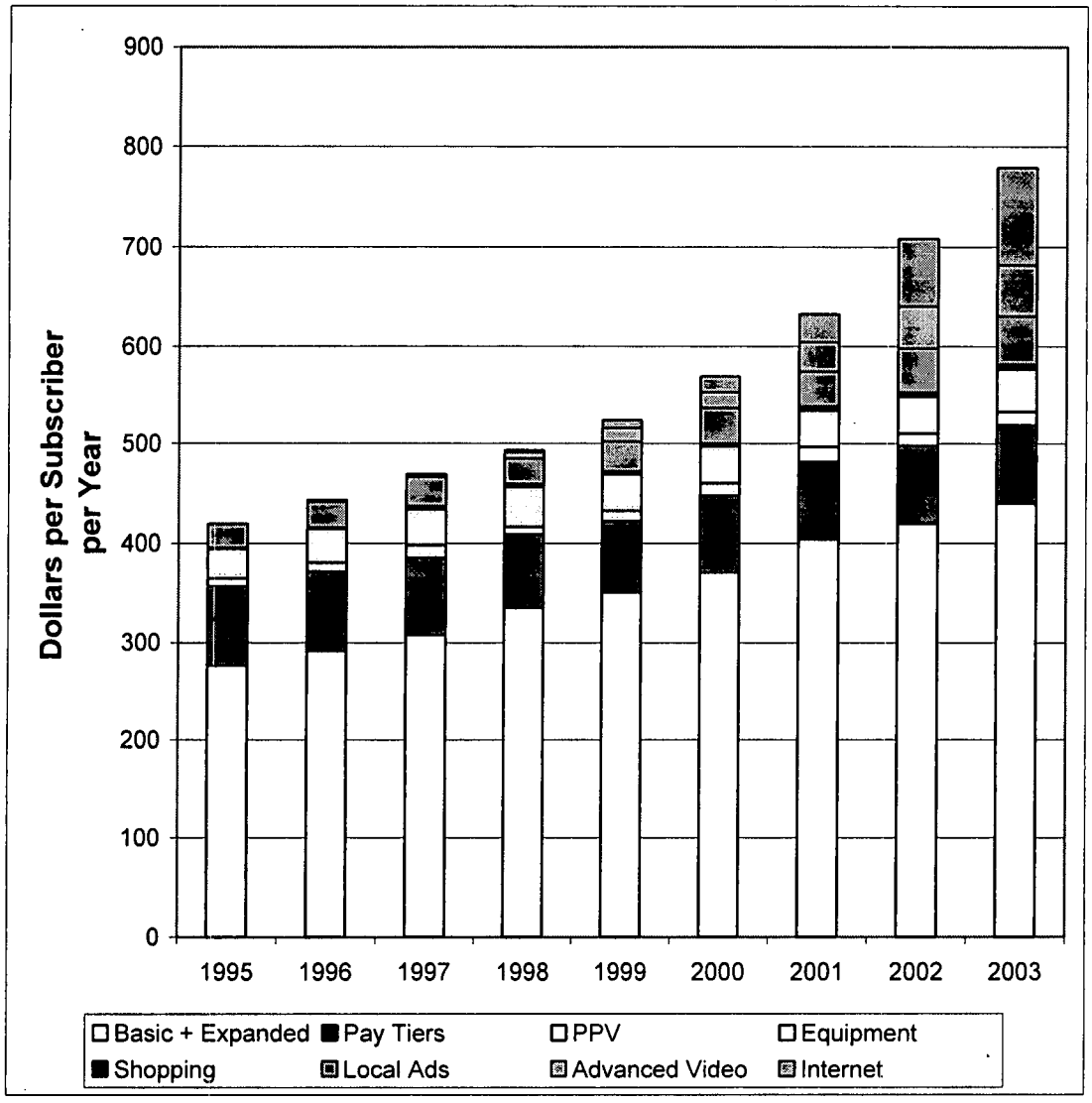
Third, the upgrade of the physical plant was largely (80 percent) complete by year-end 2002 and capital outlays dropped off dramatically in 2003.[70] Since penetration of high speed Internet is in its early stages, and advanced video services have not yet fully penetrated, cable operators are set to reap huge profits as advanced digital video and Internet services penetrate the market. In other words, capital costs are set to decline sharply, while revenues from the services that are supported by those capital costs are increasing sharply.

For the eight-year period (1995-2003), there has been a $360 increase in revenues per subscriber per year (see Exhibit 6).[71] Revenues per subscriber per year have almost doubled, while the number of subscribers has increased by 10 percent. There for total revenues in absolute value have more than doubled. [72] The new services (advanced video and Internet and to a much lesser extent cable telephony) have come to play a large role in total revenue, projected to make up about one-fifth of the total in 2003. Operating cash flow per subscriber (operating revenues minus operating costs) increased by $140 from 1995 to 2003. This is an increase of 77 percent per subscriber and 90 percent in absolute terms. This is cash flow that is available for capital service and excess profits.

2. Cash Flow for Traditional Video Services

The GAO cautions that it is difficult to apportion capital costs between the traditional video business and the new lines of business. The same is true with operating expenses. An expert for Cox recognizes the problem, but conveniently punts:

EXHIBIT 6:
Increasing Revenues Per Subscriber



Source: Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table B-7; Ninth Annual Report, December 2002, Table 4; Tenth Annual Report, Table 4.

> In particular, it seems likely that a relatively large share of increased capital costs and perhaps also operating costs may have been incurred in order to permit firms to offer more advanced products than expanded basic service, such as digital tiers of service (including pay per view and video on demand), broadband internet connections and telephony.
>
> In my opinion, any attempt to allocate a portion of those cost increases to basic analog service (in order to determine if prices for expanded basic service have risen by more than would have been sufficient to cover all cost increases of expanded basic service) would require a long list of assumptions which would be open to question and controversy.[73]

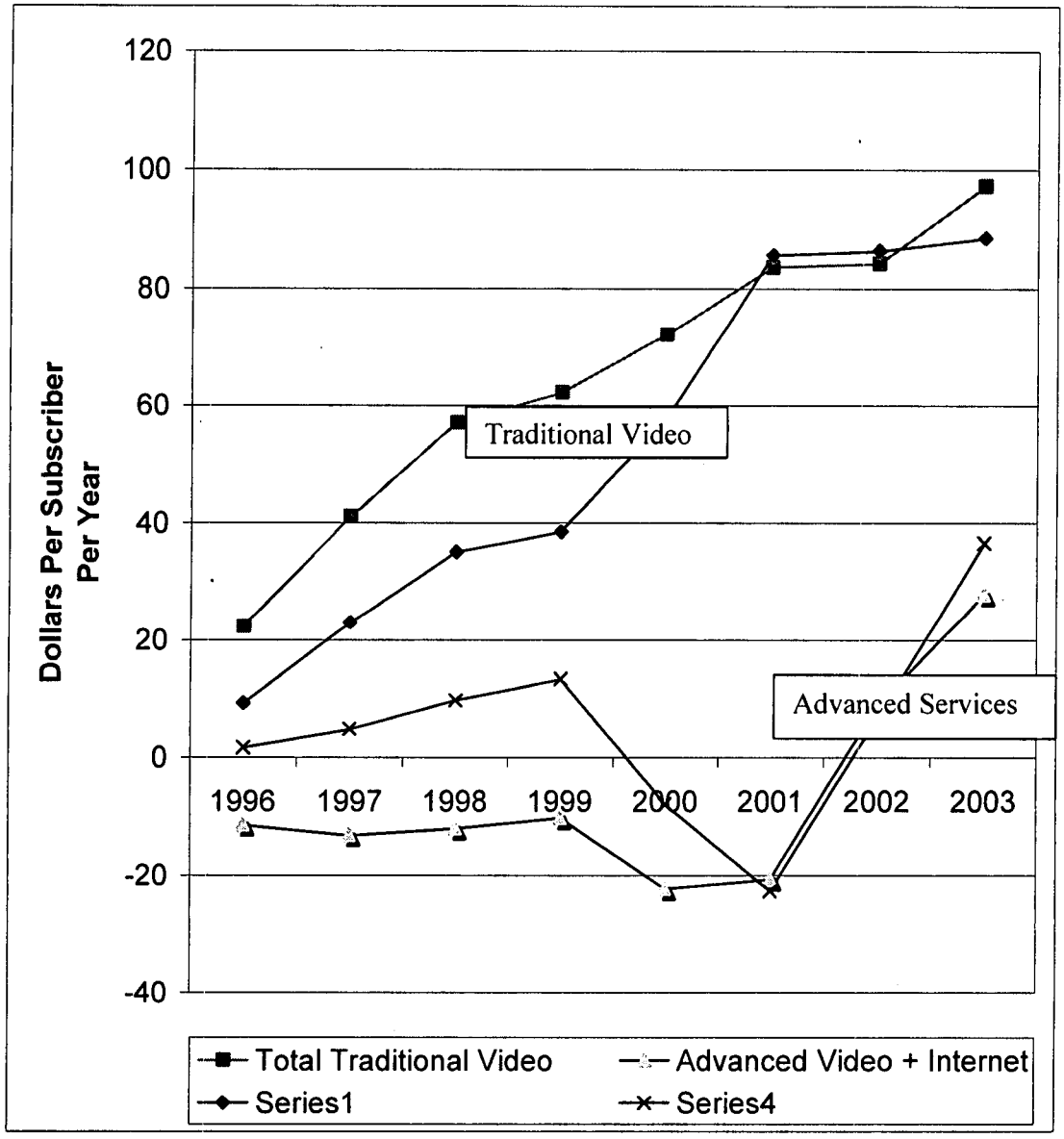
Considering a plausible scenario to assess the run-up in cash flow from traditional video businesses shows why the cable industry chooses not to show how much the cost of basic and expanded basic service have increased.[74] Between 1995 and 1998, before advanced video and Internet were being widely sold to the public, operating expenses increased by about 4.5 percent per year.[75] Between 1998 and 2002, operating costs increased by over 14 percent per year, more than three times the rate prior to the aggressive marketing of advanced and Internet services. There is good reason to believe that the increase in operating expenses was not due to traditional video services.

From 1995 to 1998, cable operators added 3.3 million basic subscribers, just about as many as they added from 1998 to 2002.[76] From 1995 to 1998, cable operators added 117 new advertiser supported cable networks, over 50 percent more such networks than they added from 1998 to 2002.[77] Thus a substantial expansion of subscribers and traditional video services occurred with modest increases in operating costs.

There is no doubt that after 1998, operating costs to support advanced video and Internet services increased sharply. One can argue that there was some increase in non-programming operating costs attributable to basic and expanded basic, but little of the capacity added to cable systems was devoted to that purpose. Full upgrades add the equivalent of 70 or more 6-megahertz channels, only 10 of which have been dedicated to basic and expanded basic tiers of service. A cautious approach shows the impact.

Exhibit 7 splits the cash flow into two streams. One stream is made up of traditional video (basic+expanded+pay tiers+pay per view+equipment+shopping+local advertising). The other stream is made up of advanced video and Internet. Operating cost increases have been apportioned under the following two sets of assumptions. All of the pre-1999 operating cost increases are attributed to traditional video. In one scenario, forty percent of the post-1999 operating cost increases is attributed to traditional video. This figure is suggested by an analysis prepared for ESPN, which estimates that the increase in programming costs in 1999 to 2002 was equal to 32 percent of the total increase in operating costs.[78] In the second scenario, the post-1999 increase is assumed to be 4.5 percent (the pre-1999 rate) plus $1 additional each year for 2000-2003, which is the average annual increase in programming costs per subscriber in the 1999 to 2002 period. In both cases, the results are similar.

EXHIBIT 7:
Cumulative Increases in Cash Flow Per Subscriber
From Traditional and Advanced Cable Services



Source: Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table B-7; Ninth Annual Report, December 2002, Table 4; Seventh Annual Report, p. 102. Tenth Annual Report, Table 4. See text for assumptions.

Cash flow grew sharply from traditional video service through 2001 and then leveled out at a very high level. The leveling is due to a combination of increasing programming costs and continually mounting non-programming operating costs attributed to traditional video. Non-programming operating expenses for traditional video are not likely to continue to rise at the assumed rate, certainly not for traditional video services. Therefore, the increase in the cash flow is likely to be permanent. Cash flow from traditional services increased as a percentage of revenue from those services. Cash flow from advanced video and Internet services was slightly positive early. It became negative with the major roll out of Internet services, but became sharply positive in 2003.

The market structure and financial analysis in this section present a strong case that the conceptualization of the supply-side of the market in Exhibit 1 is correct. There is a continuing exercise of market power over traditional video services. Both the absolute size and the rate of profits on traditional video services appear to have increased over the period. In this sense, the consumer complaint about rising cable rates is fully justified.

III. THE DEMAND-SIDE

If consumer surplus is also growing rapidly, however, then that might blunt the public policy concern. NCTA seeks to demonstrate that there was a substantial increase in consumer surplus by claiming that the real price of quality-adjusted service has declined. Thomas Hazlett makes a similar claim, based primarily on the growth of subscribers and channels.[79] In this section, I demonstrate that this basic claim is incorrect and the whole welfare improvement argument overstated.

A. Estimation of Quantity Adjusted Price Changes

The cable industry estimates involve a series of analytic errors of commission and omission and the general claims of increases in consumer welfare have several fundamental flaws. First, there is a misspecification of the units of analysis. Referring to Exhibit 1, the quantity of cable consumed (measured on the X-axis) is counted by NCTA as the total number of viewing hours. Since the X-axis is the total amount of consumption, the amount paid (measured on the Y-axis) should be the total amount paid for the products consumed. However, for the Y-axis in their welfare calculation, NCTA uses the BLS consumer price index for services. NCTA recognizes, however, **that the BLS index has already been adjusted downward for increases in the quantity of channels available and other factors**. Therefore, the NCTA double counts quantity changes. In the analysis below, I use the actual price paid for the total bundle of programs.[80]

Second, NCTA chooses to start its analysis eighteen months after the passage of the Telecommunications Act of 1996, conveniently excluding eighteen months of the most rapid rate increases in the history of the industry. Third, there would also appear to be a mismatch between the estimate of increased viewing and the estimate of declining prices. Since viewing numbers are seasonal and January is roughly the mid-point of the season, I use January prices.[81]

The cable industry estimates that in the 1995/1996 season, the average cable household watched 23.4 hours of advertiser supported cable networks per week (see Exhibit 8). I estimate

EXHIBIT 8:
Cost of Viewing, 1996 & 2003

Market Condition	Viewing Hours	Monthly Cost	Cost/ Viewing Hour Nominal	Cost/ Viewing Hour Real	
1/1/96 Noncompetitive	23.4	$22.60	$.966	$.966	
1/1/03 Noncompetitive switching has full value	34.7	41.60	1.198	1.019	
				% Increase in Viewing Cost Nominal	
1/1/96 Noncompetitive	23.4	$22.60	$.966	} 48.2	
1/1/03 Noncompetitive switching valued ½ at the margin	29.05	41.60	1.432		
1/1/96 Noncompetitive	23.4	$22.60	$.966	} 1.66	
1/1/03 Noncompetitive switching valued ¼ at the margin	26.0	41.60	1.60		
BLS INCREASE (1/1/96 to 1/1/03)				48.5	

Source: For hours of viewing, Cable TV Advertising, Weekly Viewing of Ad-Supported Cable per Cable Household, and Source: NCTA, Steven S., *Assessing Quality Adjusted Changes in the Real Price of Basic Cable Service,* attached to Comments of the National Cable Telecommunications Association, in Federal Communications Commission, *In Re: The Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming,* MB Docket No. 03-172, September 11, 2003, p. 12. Cable prices for noncompetitive systems from Federal Communications Commission, *Report on Cable Prices,* January 2, 1997, p. 12, May 7, 1999, p. 9; June 15, 2000, p. 9; Feb 14, 2001; 9; April 4, 2002, *p. 8;* July 8, 2003, p. 10; General Price increases from Bureau of Labor Statistics, Consumer Price Index.

that in January 1996, which coincidentally is the month before the 1996 Telecommunications Act was signed, the average monthly bill was $22.60. The average cost per weekly viewing hour to the consumer was $.966. The cable industry estimates that in the 2002/2003 season, the average cable household watched 34.7 hours of advertiser supported cable networks per week. I estimate the average price in January 2003 to be $41.60 per month. The average cost per weekly viewing hour was $1.199. That is a nominal increase of 24 percent. Inflation over the period was 17.7 percent, so the real increase was 5.5 percent. This is a very different picture than the 15 percent decline that NCTA claims by double counting quality improvements.

B. Bundling, the Demand Curve and Consumer Surplus

These simple math problems are compounded by conceptual issues. Bundling is the central character in the current drama surrounding cable prices and this wreaks havoc with the NCTA estimate of consumer welfare. The failure of cable operators to offer cable channels on an unbundled basis makes it difficult to divine the demand curve for individual channels. NCTA mentions, in passing, that viewing is not evenly distributed, but that does not influence its calculation. NCTA assumes (or at least uses in every example and hypothetical case) that demand is linear and that elasticity does not change over time. Both of these assumptions are dubious at best. Cox assumes demand is linear, equal and uncorrelated across individual channels to work its example of consumer benefit from bundling.[82] This, too, is dubious, at best.

At least Cox recognizes that there are conditions under which bundling results in consumer harm. The conditions are:

> related to a firm's motivation to try to charge different consumers different prices for the same product depending upon what they are willing to pay for it. The essential idea is that when there is some negative correlation between individual consumers' valuation of different products, that firm can sometimes charge higher prices to everyone by bundling goods together.[83]

Although Cox notes that: "it is easy to create examples where bundling can make consumers worse off but equally easy to create examples where bundling makes consumers better off," it ignores the problem.[84] Bundling demands greater attention.

Comcast's approach provides a useful starting point. It presents cable bundling as a greengrocer who sells tomatoes for $2 per pound, but who might also sell five pounds for $7.50. The tomatoes are cheaper on a per unit basis in the bundle (a volume discount) although the total bill is greater. The fundamental problem is that greengrocers invariably give the consumer a wide range of choices. The consumer can buy half a pound of tomatoes, or three pounds, or take the five-pound discount, as his or her needs may dictate. Cable operators do not give consumers that much choice.

In fact, cable operators give consumers almost no choice. Essentially cable consumers have three choices – take nothing, take almost nothing (basic), or take almost everything (expanded basic). If I really need two pounds of tomatoes for my spaghetti sauce, I have to take all five pounds and most of the other fruits and vegetables, even though the rest of it is of little value to me.[85] My next door neighbor, who really needs two pounds of apples for her pie, is

forced to buy five pounds of apples and the tomatoes and all the other fruits and vegetables, too. We both end up paying a higher price and, given the nature of the commodity, we cannot recapture the surplus through trade. It is conceivable that we could split the cost, but then I have to have my neighbors in my house all the time. If we buy one subscription and try to run a wire (or a wireless network) between our houses, the cable operators have us arrested for stealing their signal.

NCTA's welfare analysis assumes a full hour of increased welfare when a consumer shifts from watching a broadcast show to watching a cable show. That is, if a consumer watches a rerun of "Law and Order" on USA, instead of NBC, NCTA claims the full hour as an increase in the consumer's welfare. There may be little welfare gain. If the consumer had shifted from watching "West Wing" to watching "Law and Order," one could argue that there is a welfare gain, but it is only the marginal difference between the two. Because the shows are all forced into the bundle, we cannot tell what consumers would pay for them on a stand-alone basis.

If total hours of viewing had increased as much as cable viewing, the assumption that every hour watched on cable represents a full hour of gained consumer welfare would be more plausible, but that is not the case. The increase in total viewing is considerably less than the increase in cable viewing. In contrast to the 5.7 percent per year increase claimed by cable operators for viewing of advertiser supported cable networks, the FCC cites estimates of less than a 1.5 percent per year increase in viewing over a similar period,[86] while others show less than a one percent per year increase. A well respected industry source that estimates both total TV viewing hours and basic/expanded cable network viewing hours puts the total increase at 25 percent of the cable switching increase.[87] Even if we assume that the entirety of increased TV viewing occurred in cable households, we would still conclude that the net increase in viewing was equal to slightly over one-third of the total increase in cable network viewing.

If we assume that the actual increase in consumer welfare is equal to half the total increase in cable viewing (leaving some room for a marginal increase due to switching), the quality-adjusted cost would be $1.432 (see Exhibit 8). The increase in the price over the 1996 – 2003 period would be 48 percent. Interestingly, the quantity and quality adjusted price as reported by the BLS increased by 49 percent over this period. If the increase in value in viewing were equal only to the increase in total viewing (i.e. valued ¼ at the margin), the effective price increase would be 66 percent over this period, almost fifty percent higher.

The case against the BLS price index is not convincing. In fact, the BLS may be over-adjusting for quantity and quality because many channels are forced into the bundle that few people are watching. The top 10 cable programs account for 50 percent of all viewing that is significant enough to be registered by Nielsen. The top 20 shows account for 75 percent of all such viewing. The GAO reports that the typical household watches only 17 channels. People are being forced to buy a lot of shows they don't watch to get the ones they want. Although the bottom 30 shows that register on the Nielsen scale pass an average of just under 70 million homes, only about a quarter of a million households watch them during any given day. For every one household watching, approximately 250 who are forced to pay for it in the bundle are not. For the bottom two shows, the ratio is 1 to 800. Over 250 additional cable networks do not capture enough viewers to even register on the Nielsen scale.[88]

A recent study by Deutsche Bank of the Cox – ESPN controversy reinforces the conclusion that bundling leads NCTA to overestimate the welfare gains (see Exhibit 9).[89] ESPN is one of the most popular and the most expensive cable networks, yet seventy-eight percent of respondents said that they would not pay $2 per month for it if they were given the choice. Cox confirms this estimate, noting that less than a quarter of its subscribers are "avid sports fans."

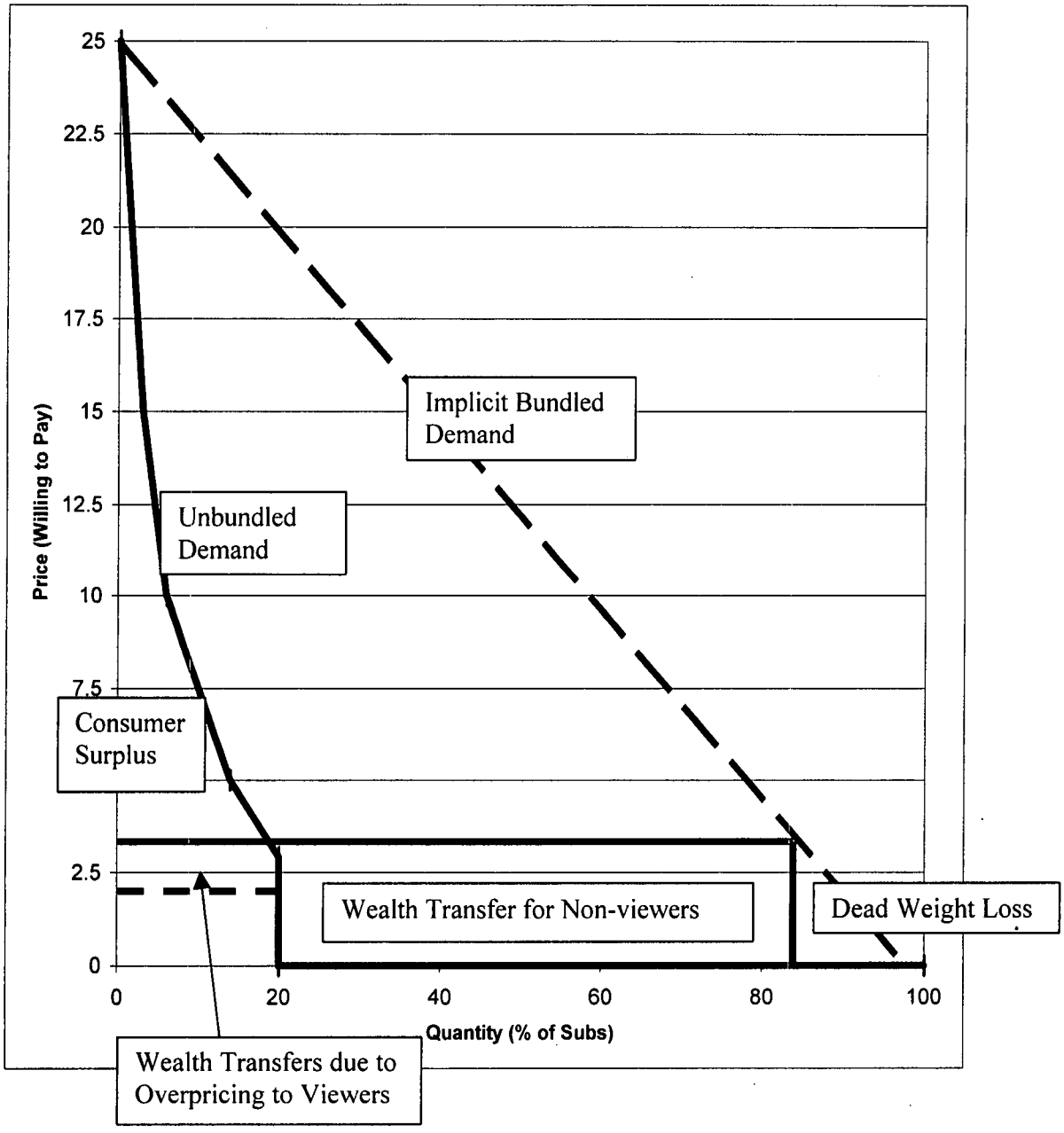
There is good reason to believe that the elasticity of demand for ESPN alone is a lot higher than for the bundle and that the bundling of sports programming into the most popular package is harming consumers. The three-quarters of cable viewers who say they would not pay $2 dollars for ESPN, likely the three-quarters who are less than avid sports fans, are paying over $1.5 billion for it in the bundle (at Cox's cost).[90] Exhibit 9 shows the wealth transfers and efficiency losses associated with ESPN. For every one dollar of consumer surplus, there is at least one dollar of wealth transfer. This does not include the wealth transfers associated with the overpricing of ESPN to those who would take it, which may equal another quarter of the consumer surplus. The deadweight efficiency losses are an additional cost associated with this anti-consumer bundling.

IV. LONG-TERM TRENDS

A. PRICE

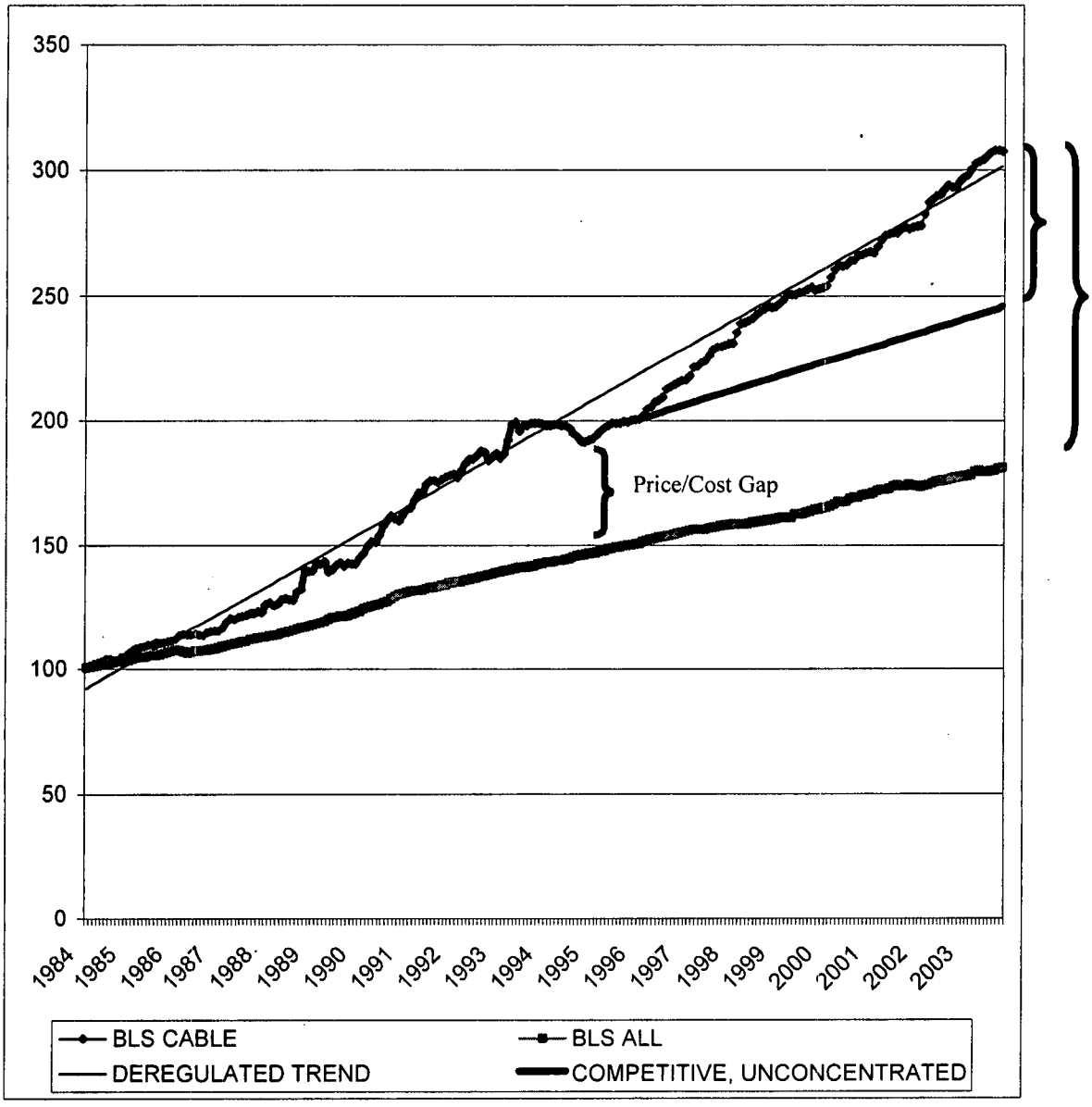
NCTA's hours of viewing approach to consumer welfare analysis vastly overstates the gain in welfare and the BLS number of channels approach may well be overstating the quality adjustment. Given this conclusion, it is instructive to note the long-term trends of cable pricing. I have pointed out that the FCC was already being challenged to explain dramatic rate increases in the January 1997 report on cable pricing. In that report, the Commission reproduced a graph it had used to show that rate regulation in the 1993-1995 period had shielded consumers from price increases (see Exhibit 10). The trend line and the price line, extended through September 2003, show that the Commission had squeezed out a small part of the excess profits during the short period of rate regulation, but the 1996 Act launched the industry on a trajectory that not only recaptured what had been lost during the short period of partial regulation, but has gone beyond what it had been extracting in the past. This reaffirms the depiction in Exhibit 1.

EXHIBIT 9:
Wealth Transfer and Consumer Surplus For ESPN



Source: Deutsche Bank, *Walt Disney Company*, October 27, 2003, p. 16.

EXHIBIT 10:
Long Term Price Trends



Source: Bureau of Labor Statistics, CPI. Deregulated trend is a linear projections of January 1983- April 1993, Competitive, unconcentrated from Exhibit 15.

B. Quantity

The aggressive bundling of cable programming, across video tiers and now between video and non-video services, complicates the consumer welfare analysis enormously. The claim that regulation hurt consumers is simply wrong. The number of subscribers has grown virtually every year since the inception of the industry (see Exhibit 11).

A model that uses the long-term trend in income growth and price changes to predict cable subscribers explains 96 percent of the variance in cable growth. It suggests that cable subscription performed somewhat better than expected in the early-mid 1990, when rates were regulated momentarily, but somewhat worse than expected since rates were fully deregulated. Adding in competitive satellite (i.e. the number of satellite subscribers who live in areas where cable is available)[91] fills the gap somewhat, but at the end of the period, there are fewer households subscribing than projected. This is the deadweight inefficiency we would expect to see as a result of the aggressive price increases and bundling of recent years. It is exactly the opposite of what the cable industry experts claim.

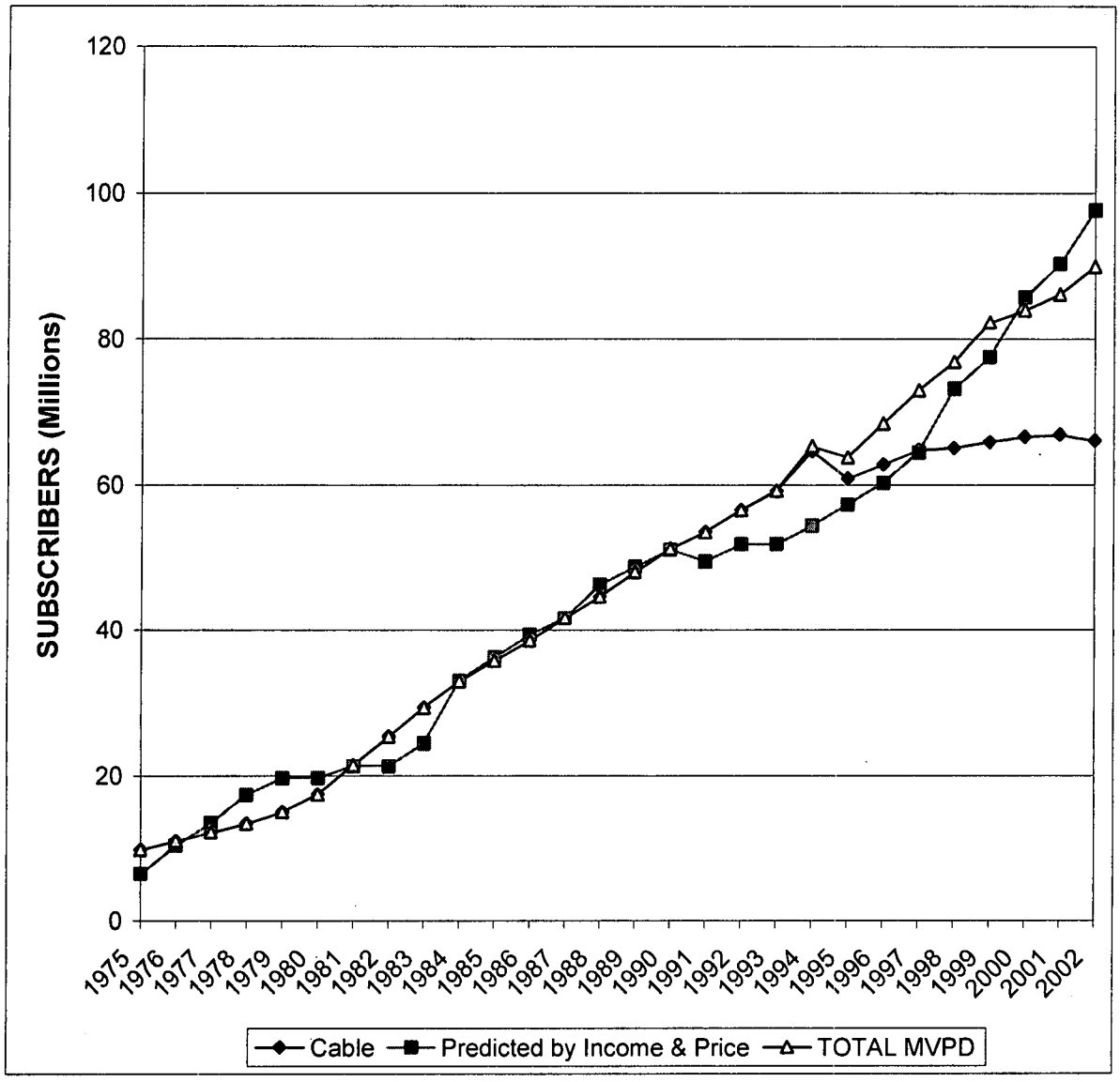
V. Conclusion

The basic comparison that consumer advocates have made to reflect the pain inflicted by cable operators – that cable prices have been rising at almost three times the rate of inflation – is a solid and proper way to state the problem. The complaint that prices are rising too fast is valid – reflected in the increasing cash flow thrown off from traditional video services. There is no doubt that consumers are being harmed by a lack of effective competition for cable. That cable operators have ridden the wave of rising incomes and changing technologies does not demonstrate the positive quality of their pricing/bundling strategy. The claim that deregulation helps consumers because consumer welfare has increased begs the question of whether abuse of consumers has increased even more rapidly.

The possibility of anti-consumer bundling has long been recognized in the economics literature. The data suggests that cable operators have pushed prices into the range where there is price resistance (i.e., the more elastic portion of the demand curve). That does not mean the abuse has stopped, it simply means it may not grow as quickly as in the past, but cable operators are aggressively finding ways to keep their producer surplus growing, like rebundling (retiering) programming to drive penetration of digital tiers.[92] The recognition of the possibility of anticompetitive bundling in a dynamic or strategic sense is more recent, but no less important, especially as cable market power is "swung" into the high-speed Internet.[93]

Bundling is one of the strategies that monopolists use to extract consumer surplus and the evidence is consistent with such an interpretation in this case. Public policy might attack bundling, but policy that controlled the rents directly would be preferable. Of course, real competition would be better still, but after two decades of failure of competition to develop and with the cable operators extending the anticompetitive, anti-consumer business model to the Internet, the need for action is critical.

EXHIBIT 11:
Income Growth as a Predictor of Cable Subscription



Sources: Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Tenth Annual Report, January 5, 2004, Table 1; Ninth Annual Report, December 2002, Table B-1; Sixth Annual Report, Table C-1; for 1995 through 2002; Paul Kagan Associates, *History of Cable TV Subscribers and Revenues,* 1997, for pre-1995; Income is real, per capita disposable income from *Economic Report of the President* (February 2003), p. 313.

ENDNOTES

[1] Federal Communications Commission, In Re: The Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 03-172.

[2] U.S. General Accounting Office (U.S. GAO), Issues Related to Competition and Subscriber Rates in the Cable Television Industry, October 2003; Telecommunications: Issues in Providing Cable and Satellite Television Service, October 15, 2003.

[3] Fabrikant, Geraldine and Bill Carter, "Cable's New Giant Flexes His Muscles," *New York Times,* October 20, 2003; "Testimony of James O. Robbins," *Senate Commerce Committee,* May 6, 2003.

[4] Eisenach, Jeffrey A. and Douglas A. Truehart, *Rising Cable Rates: Are Programming Costs the Villain?*, supported by ESPN, Inc., October 23, 2003 (hereafter ESPN); Economists Inc., *Consumer, Operator, and Programmer Benefits from Bundling Cable Networks,* July 2002; Rogerson, William P., *Cable Program Tiering: A Decision Best and Properly Made by Cable System Operators, Not Government Regulators,* November 10, 2003, funded by Cox (hereafter Cox); *Correcting the Errors in the ESPN/CAP Analysis Study on Programming Cost Increases*, November 11, 2003, prepared for Cox Communications (Cox II).

[5] Katz, Michael, *An Economic Analysis of the Claims made by Dr. Mark Cooper in "Cable Mergers, Monopoly Power and Price Increases,"* Commissioned by Comcast Corporation, July 28, 2003 (hereafter Comcast). The target of the Comcast paper is a short study prepared in January 2003 entitled *Cable Mergers, Monopoly Power and Price Increases* (Washington, DC: Consumer Federation of America and Consumers Union, January 2003). This critique ignores several much longer documents including Consumer Federation of America, "Comments of the Consumer Federation of America, Consumers Union, Center for Digital Democracy, The Office of Communications of the United Church of Christ, Inc., National Association of Telecommunications Officers and Advisors, Association for Independent Video Filmmakers, National Alliance for Media Arts and Culture, and the Alliance for Community Media," 2002; and "Reply Comments of the Consumer Federation of America, Consumers Union, Center for Digital Democracy, and Media Access Project," 2003; Federal Communications Commission, *In the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992, Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996, The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules, Review of the Commission's Regulations Governing Attribution of Broadcast and Cable/MDS Interests, Review of the Commission's Regulations and Policies Affecting Investment in the Broadcast Industry, Reexamination of the Commission's Cross-Interest Policy*, CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154; and Cooper, Mark, *Cable Mergers and Monopolies: Market Power in Digital Communications Networks* (Economic Policy Institute, 2002).

[6] Wildman, Steven S., *Assessing Quality Adjusted Changes in the Real Price of Basic Cable Service,* attached to Comments of the National Cable Telecommunications Association, in Federal Communications Commission, *In Re: The Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket No. 03-172, September 11, 2003 (hereafter NCTA).

[7] Federal Communications Commission, *Tenth Annual Report (In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming)* Washington, DC, January 28, 2004 (hereafter Tenth Annual Report).

[8] "Testimony of Gene Kimmelman," *Senate Commerce Committee,* May 6, 2003, cited in ESPN, p. 4.

[9] *Tenth Annual Report,* para. 10.

[10] *Tenth Annual Report,* para 139.

[11] *Tenth Annual Report*, para 30.

[12] *Tenth Annual Report,* para 31.

[13] *Tenth Annual Report*, note 73.

[14] *Tenth Annual Report, note 203.*

[15] *Tenth Annual Report,* Table 4.

[16] *Tenth Annual Report,* footnote 11.

[17] *Tenth Annual Report*, para. 140.

[18] Cooper, Mark, *Media Ownership Democracy in the Digital Information Age* (Stanford: Center for Internet and Society, 2003), Chapter 6.

[19] *Tenth Annual Report*, para. 136.

[20] *Tenth Annual Report,* para 130-132.

[21] See *Tenth Annual Report*, Table B-1.

[22] Compare *Tenth Annual Report*, para 41 and 65.

[23] *Joint Statement of Commissioners Michael J. Copps and Jonathan S. Adelstein, Concurring"* January 28, 2004.

[24] The only evidence that the industry paper gives on market power is provided by Comcast, which points to one indicator of market power, Tobin's q (the system sales price in comparison to the reproduction cost). Citing numbers from the Federal Communications Commission, *Ninth Annual Report, In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket No. 92-145, December 31, 2002, p. 16), Comcast points out that (p. 19): the "National Average Dollar Value Per Subscriber *declined* dramatically, falling from a peak of $5755 in 2000 to $2196 in January through June 2002." This statement fails to take into account the dramatic difference in the nature of the systems being transacted. The average number of subscribers transacted in the peak year Comcast cited was over 250,000 per system in 45 transactions for a total of over $66 billion. The average number of subscribers in the first half of 2002 was only 32,000 in 12 transactions for a total of less than $1 billion. If we compare small systems transacted in 2000 to the small systems transacted in 2002, we get a very different picture; see Federal Communications Commission, *Seventh Annual Report, In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, CS Docket No. 00-132, January 8, 2001, Table C-5. For example, there were 39 transactions in 2000 for systems with fewer than 100,000 subscribers. The average system price was approximately $2,666 per subscriber. Thus, the system price has declined by about 18 percent, which is modest compared to the stock market declines (see Couper, Elise A, John P. Hejkal, and Alexander L. Wolman, "Boom and Bust In Telecommunications," *Economic Quarterly,* Fall 2003. The analysis also does not account for a decline in the reproduction costs, was also evident.

[25] Comcast, p. 14, states the proposition as follows: "As long as the increase in the monthly fee is less than the amount by which consumers value the new programming, they will be better off at the new 'higher' price coupled with the additional programs."

[26] Scherer, F. M. and David Ross, *Industrial Market Structure and Economic Performance* (Boston: Houghton Mifflin, 1990), pp. 21 – 29.

[27] Comcast, pp. 12-13; Cox, Appendix, uses this model as well.

[28] Industry defenders frequently claim that rising prices cannot be caused by market power, since in frictionless theory the monopolist would immediately ascertain his profit-maximizing price and charge it (Comcast p. 14, Hazlett, Thomas, *Cable TV: Has Deregulation Failed?*, Manhattan Institute for Policy Research, November 21, 2003). Reality, of course is more complicated than that. Monopolists price politically, searching for what they can get away with before they evoke a reaction, especially in an industry whose rapacious behavior caused it to be reregulated once.

[29] Cox, Appendix, argues that allowing the monopolist to reallocate rents from programmers will increase its rate of profit as well as consumer welfare under some circumstances.

[30] U.S. GAO, 2003, Appendix IV.

[31] U.S. GAO, 2002.

[32] *Tenth Annual Report,* para. 83, citing *First Annual Report,* para. 57.

[33] Federal Communications Commission, *Report on Cable Prices,* April 4, 2002, Attachment D-1; February 14, 2001, Attachment D-1; June 2000, Attachment D-1; May 7, 1999, C-1.

[34] *Tenth annual Report,* para. 16.

[35] I assume that 98 percent of cable subscribers lack head-to-head competition (Federal Communications Commission, *In the Matter of the Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming: Ninth Annual Report,* MB Docket No. 02-145, December 31, 2002, para. 115) and 90 percent of those take expanded basic service (ESPN, p. 2). Therefore, 62 million cable households are the victims of abuse of market power. Their bills could be reduced by $8 per month as a result of genuine head-to-head competition and deconcentration of the industry.

[36] U.S. GAO, 2003, Appendix IV.

[37] FCC, *Report on Cable Prices,* April 4, 2002, Attachment D-1; February 14, 2001, Attachment D-1; June 2000, Attachment D-1; May 7, 1999, C-1.

[38] FCC, *Report on Cable Prices,* February 14, 2001, Attachment D-1; June 2000, Attachment D-1.

[39] *Tent Annual Report,* para 132. Comcast once again has failed to notice the consistent empirical evidence that finds size and clustering increase prices, contradicting their claim that (pp. 18-19) "there is no reason to think that consolidation of cable ownership at the national level will affect actual competition among cable system operators. Ironically, cable industry experts find that mergers of some monopolists matter (John B. Hayes, Jith Jayaratne, and Michael L. Katz, *An Empirical Analysis of the Footprint Effects of Mergers Between Large ILECS,* April 1, 1999, p. 1; citing "Declaration of Michael L. Katz and Steven C. Salop," submitted as an attachment to *Petition to Deny of Spring Communications Company L.P,* in *Ameritech Corp. and SBC Communications, Inc., for Consent to Transfer of Control,* CC Dkt. No. 98-141 (filed Oct. 15, 1998) and *Petition to Deny of Spring Communications Company L.P,* in *GTE Corporation and Bell Atlantic Corporation for Consent to Transfer of Control,* CC Docket. No. 98-184 (filed Nov. 23, 1998)) and that size and alternative distribution opportunities affect bargaining (see Rogerson, William P. "A Further Economic Analysis of the News Corp. Takeover of DirecTV," *In the Matter of General Motors Corporation, Hughes Electronics Corporation, and the News Corporation Limited Application to Transfer Control of FCC Authorizations and Licenses Held by Hughes Electronics Corporation to the News Corporation Limited,* MB Docket NO. 03-124, August 4, 2003).

[40] Cooper, 2002, Chapter 7.

[41] U.S. GAO, 2003, Appendix IV.

[42] FCC, *Report on Cable Prices,* April 4, 2002, Attachment D-1.

[43] Cooper, 2002, pp. 21-32.

[44] See Cooper, 2002, pp. 44-47.

[45] Fabricant and Carter.

[46] Cox, Appendix A shows cable profits rising as programming costs fall.

[47] , "Comments of the Consumer Federation of America, et. al , *In the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992, Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996, The Commission's Cable Horizontal and Vertical Ownership Limits and Attribution Rules, Review of the Commission's Regulations Governing Attribution of Broadcast and Cable/MDS Interests, Review of the Commission's Regulations and Policies Affecting Investment in the Broadcast Industry, Reexamination of the Commission's Cross-Interest Policy,* CS Docket No. 98-82, CS Docket No. 96-85, MM Docket No. 92-264, MM Docket No. 94-150, MM Docket No. 92-51, MM Docket No. 87-154

[48] U.S. GAO, 2003, p. 27.

[49] ESPN, p. 9.

[50] Cox critics ESPN for comparing current revenues to total capital, a criticism that applies to Comcast even more forcefully, since ESPN at least reports annualized increases in debt costs, whereas Comcast provides no similar calculation. ESPN/s reporting of debt service misses the point, however, since part of the debt was incurred to fund acquisitions, not capital expenditures.

[51] Only a consent decree forced Time Warner to allow modest access, and intense scrutiny forced AT&T to make some minor concessions, but the recent AOL/AT&T carriage agreement is thoroughly anticompetitive. "A New Model for AOL May Influence Cable's Future," *New York Times,* August 26, 2002, p. C1; Gilmore, Dan, "AOL Capitulates, Gives Up Struggle for 'Open Access'," *San Jose Mercury News,* September 1, 2002.

[52] Cooper, Mark, "Open Access to the Broadband Internet: Technical and Economic Discrimination in Closed, Proprietary Networks," 71 *University of Colorado Law Review*, 71: 2000;

[53] Federal Communications Commission, *High-Sped Service for Internet Access: Status as of June 30, 2003,* December 2003, Table 4.

[54] "A New Model for AOL May Influence Cable's Future," *New York Times,* August 26, 2002, p. C.1; Gilmore, Dan, "AOL Capitulates, Gives Up Struggle for 'Open Access'," *San Jose Mercury News,* September 1, 2002.

[55] Hu, Jim, "AOL's Unrequited Cable Love," *CNET News.com,* January 26, 2004.

[56] Latour, Almar and Peter Grant, "Verizon May Set Off Price War," *Wall Street Journal,* May 5, 2003.

[57] *U.S. Department of Justice v. AT&T Corp and MediaOne Group, Inc.,* May 26, 2000.

[58] Conquering the high-speed Internet access as a neighbor market of video has additional advantages in preserving market power in the primary market (see for example, Carlton, Dennis W. and Michael Waldman, "The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industry," *Rand Journal of Economics*, Summer, 2002; Rubinfield, Daniel L. and Hal J. Singer, *Open Access to Broadband Networks: A Case Study of the AOL/Time Warner Merger*, 16 Berkeley Tech. L.J. 631, 2001; Ordover, Lansuz A. and Robert D. Willig, "Access and Bundling in High Technology Markets," in Jeffrey A. Eisenach and Thomas M. Lenard (eds.), *Competition, Innovation And The Microsoft Monopoly: Antitrust And The Digital Marketplace* (Washington, D.C.: Progress and Freedom Foundation, 1999); Salop, Steven C., "Using Leverage to Preserve Monopoly," in Jeffrey A. Eisenach and Thomas M. Lenard (eds.), *Competition, Innovation And The Microsoft Monopoly: Antitrust And The Digital Marketplace* (Washington, D.C.: Progress and Freedom Foundation, 1999). Bundling basic video with Internet access has the effect of undermining competition for video services (by driving basic into households and reducing the value of satellite). Bundling video content with Internet access reduces competition for video services, (See, e.g., Comments of the Competitive Broadband Coalition, *Implementation of the Cable Television Consumer Protection and Competition Act of 1992*, Cable Services Bureau Dkt. No. 01-290, at 10-11 [Dec. 3, 2001]). Bundling also raises barriers to entry by forcing competitors to build larger packages to compete: "AT&T is refusing to sell HITS to any company using DSL technology to deliver video services over existing phone lines because such companies would directly compete with AT&T's entry into the local telephone market using both its own cable systems and the cable plant of unaffiliated cable operators. AT&T simply does not want any terrestrial based competition by other broadband networks capable of providing bundled video, voice and data services." (Comments of the American Cable Association In the Matter of: Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition in Video Programming Distribution: Section 628(c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition, CS Docket No. 01-290 [filed Dec. 3, 2001]).

[59] "Initial Comments of the California ISP Association, Inc.," *Further Notice of Proposed Rulemaking in the Matter of the Computer III Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Regulatory Review – Review of Computer II and ONA Safeguards and Requirements*, Federal Communications Commission, CC Docket No. 95-20, 98-10, DA 01-620, April 16, 2001 (hereafter CISPA, 2001a), p. 7; "Comments of DirecTV Broadband, Inc," *In the Matter of Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities, Universal Service Obligations of Broadband Providers, Computer III Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Regulatory Review – Review of Computer II and ONA Safeguards and Requirements*, Federal Communications Commission, CC Docket No. 02-33, 95-20, 98-10, May 3, 2002, p. 5; "Comments of Cbeyond, et al.," *In the Matter of Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities, Universal Service Obligations of Broadband Providers,*

Computer III Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Regulatory Review – Review of Computer II and ONA Safeguards and Requirements, Federal Communications Commission, CC Docket No. 02-33, 95-20, 98-10, May 3, 2002 (Hereafter Cbeyond, et al., 2002), pp. 27-28.

[60] National Research Council report entitled *Broadband: Bringing Home the Bits*, (Washington, D.C.: National Academy Press, 2002), pp. 21, 152-154.

[61] Federal Communications Commission, High-Speed Services for Internet Access, June 2003, Tables 1, 2; Local Telephone Competition: Status as of December 31, 2002, June 2003, Tables 1, 13; NCTA, Overview 2003: Mid-Year, p. 1.

[62] Young, Shawn and Peter Grant, "How Phone Firms Lost to Cable in Consumer Broadband Battle," *Wall Street Journal,* March 13, 2003.

[63] "Comments of Ad Hoc Telecommunications Users Committee," *In the Matter of Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services*, Federal Communications Commission, CC Docket No. 01-337, March 1, 2002, pp. 18-19.

> Cable modem service presents serious security and reliability issues that, while present for residential users, are of far greater concern when used to support business applications... In addition, service quality for cable modem service not equivalent to ILEC standards... Additionally cable modem transmission speeds are not consistent, due to the "shared platform" architecture... Finally, cable modem platforms do not offer business customers a sufficient level of security

[64] Cable modem service presents serious security and reliability issues that, while present for residential users, are of far greater concern when used to support business applications... In addition, service quality for cable modem service is not equivalent to ILEC standards... Additionally cable modem transmission speeds are not consistent, due to the "shared platform" architecture... Finally, cable modem platforms do not offer business customers a sufficient level of security.

[65] Kuhl, Craig, "Writing the Business Case for VDSL," *CED,* April 2000. Extensive documentation of the technology difference is provided in Cooper, Mark, *Transforming the Information Superhighway into a Private Toll Road* (Washington, DC: Consumer Federation of America, October 1999).

[66] Hazlett, Thomas W. and George Bittlingmayer. *The Political Economy of Cable "Open Access."* Joint Center, Working Paper 01-06, May, argue that there is a strategic under allocation of capacity to high-speed Internet.

[67] Cox, Comcast and ESPN also focus on a short time frame.

[68] Federal Communications Commission, *Report on Cable Prices*, In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection Act of 1992, Statistical Report on Average Rates for Basic Service, Cable Programming and Equipment, MM Docket No. 92-226, January 2, 1997, p. 7.

[69] Id., p. 7.

[70] U.S. GAO, 2003, p. 26.

[71] Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table B-7; Ninth Annual Report, December 2002, Table 4.

[72] I report both revenue per subscriber and the total revenue because some costs are not incurred on a per subscriber basis.

[73] Cox II, p. 8.

[74] The GAO cautions that it is difficult to apportion capital costs between the traditional video business and the new lines of business. The same is true with operating expenses. The expert for Cox, recognizes the problem, but conveniently punts. Cox II, p. 8,

> In particular, it seems likely that a relatively large share of increased capital costs and perhaps also operating costs may have been incurred in order to permit firms to offer more advanced products

than expanded basic service, such as digital tiers of service (including pay per view and video on demand), broadband internet connections and telephony.
In my opinion, any attempt to allocate a portion of those costs increases to basic analog service (in order to determine if prices for expanded basic service have risen by more than would have been sufficient to cover all cost increases of expanded basic service) would require a long list of assumptions which would be open to question and controversy.

[75] Federal Communications Commission, *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming,* Ninth Annual Report, p. 15; Seventh Annual Report; NCTA, *Cable Pricing: Value and Cost*, May 2003.

[76] Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table C-1; Ninth Annual Report, December 2002, Table B-1.

[77]NCTA, Overview 2003: Mid-Year, p. 12.

[78] ESPN, p. 12.

[79] Hazlett.

[80] Thinking about the cost of viewing to the public leads to another conceptual problem in the NCTA and Comcast analyses, one that has been recently highlighted by the ESPN analysis. ESPN points out they improve quality and increase audiences to increase their ability to sell advertising, as well as get more subscription revenues. Cox II, p. 6, nets advertising out from the cost of programming cable operators incur. That may make sense from the cable operator point of view, but not necessarily from the consumer point of view. Consumers have to watch the commercials and, ultimately, the cost turns up in the goods and services they buy. From a total social welfare analysis, the cost of advertising needs to be attributed to the cost of the total viewing time. The advertising revenue can be handled in a variety of ways, but it cannot be ignored.

[81] Unfortunately, in 1996 the FCC shifted from a January cable price to a June cable price in its annual reports on cable prices. However, we can use the CPI to interpolate from June to January and only slightly underestimate the actual price increase (since quality adjustments over any short six month period are relatively minor). To the extent the industry was adding channels, this approach underestimates the price increase.

[82] Cox, Appendix.

[83] Cox, p. 13

[84] Cox, p. 13,

since regulation is costly and can create other distortions, the fact that this type of bundling cannot be shown to be systematically harmful to consumers is sufficient reason for most economists to conclude that there is no reason to regulate this type of bundling

[85] The example offered by Cox assumes that all fruits and vegetables are equally valuable to consumers in exactly the same quantities.

[86] Levy, Jonathan, Marcelino Ford-Levine and Anne Levine, *Broadcast Television: Survivor in a Sea of Competition* (Federal Communications Commission, OPP Working Paper, September 2002), p. 62; Albararan, Alan and Angel Arrese, "Time and Media Markets: An Introduction," in Albararan and Arrese (Eds.), *Time and Media Markets* (Mahwah, NJ: Lawrence Earlbaum Associates, 2003), p. 2.

[87] Veronis Suchler Stevenson, *Communications Industry Report: Forecast Summary, 2003*, p. 48.

[88] The explanations that cable industry executives gave the GAO for the social welfare superiority of bundling assume that advertisers irrationally pay for homes passed, rather than eyeballs watching, and that consumers maximize their welfare by subsidizing their neighbor's viewing habits. Those claims are inconsistent with the data in this paper (U.S. GAO, 2003, pp. 34-37).

[89] Deutsche Bank, *Walt Disney Company*, October 27, 2003.

[90] This assumes that the non-avid sports fans would pay nothing for it, given the choice.

[91] Cooper, 2002, pp. 26-32.

[92] USPIRG, *The Failure of Cable Deregulation: A Blueprint for Creating a Competitive, Pro-consumer Cable Television Marketplace* (August 2003), pp. 18-19.

[93] Carlton and Waldman.

Before the
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	)	
	)	
Annual Assessment of the Status of Competition	)	MB Docket No. 05-255
in the Market for the Delivery of Video	)	
Programming	)	

TWELFTH ANNUAL REPORT

Adopted: February 10, 2006 **Released: March 3, 2006**

Comment Date: April 3, 2006
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By the Commission: Chairman Martin, Commissioners Copps, Adelstein, and Tate issuing separate statements.

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I. INTRODUCTION

1. As required by Section 628(g) of the Communications Act of 1934, as amended, this is the Commission's twelfth annual report (*2005 Report*) to Congress on the status of competition in the market for the delivery of video programming.[1] Congress imposed this annual reporting requirement in the Cable Television Consumer Protection and Competition Act of 1992 (1992 Cable Act)[2] as a means of obtaining information on the competitive status of the market for the delivery of video programming.

A. Scope of this Report

2. Consistent with the statutory purpose, we report on developments in the market for the delivery of video programming and on the factors that have facilitated or impeded changes in the competitive environment over the past year. We present information and analysis regarding changes in the market since the *2004 Report*, and we describe how those changes affect the current state of the market. The information and analysis provided in this *Report* are based on information submitted by

[1] The Commission's previous reports appear at: *Implementation of Section 19 of the 1992 Cable Act (Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming)*, *1994 Report*, 9 FCC Rcd 7442 (1994); *1995 Report*, 11 FCC Rcd 2060 (1996); *1996 Report*, 12 FCC Rcd 4358 (1997); *1997 Report*, 13 FCC Rcd 1034 (1998); *1998 Report*, 13 FCC Rcd 24284 (1998); *1999 Report*, 15 FCC Rcd 978 (2000); *2000 Report*, 16 FCC Rcd 6005 (2001); *2001 Report*, 17 FCC Rcd 1244 (2002); *2002 Report*, 17 FCC Rcd 26901 (2002); *2003 Report*, 19 FCC Rcd 1606 (2004); and *2004 Report*, 20 FCC Rcd 2755 (2005). *See* Communications Act of 1934 § 628(g), 47 U.S.C. § 548(g).

[2] Pub. L. No. 102-385, 106 Stat. 1460 (1992).

commenters in response to a *Notice of Inquiry* (*Notice*) in this docket,[3] publicly available data, and filings in various Commission proceedings. Although the *Notice* asked commenters to provide certain kinds of data and other information, we do not require commenters to do so, nor do we audit the data that are provided.

3. The market for the delivery of video programming services is served by a number of operators using a wide range of distribution technologies. In Section II, we examine each of these delivery technologies, and the services provided over them, and we assess their ability to provide competitive services in the multichannel video market. Specifically, we examine the cable television industry, and other established multichannel video programming distributors (MVPDs), including direct broadcast satellite (DBS) providers, home satellite dishes (HSDs), and broadband service providers (BSPs), as well as broadcast television service. We also examine other wireline video providers, including local exchange carriers (LECs), which have initiated commercial services using copper-based, fiber, and hybrid-fiber coaxial cable distribution technologies for video programming, and electric and gas utilities. In addition, we address wireless video services, including services provided by private cable operators (PCOs), wireless cable systems using frequencies in the broadband radio and educational broadband services (wireless cable), and services offering video programming delivered over commercial mobile radio systems (CMRS). We also examine Internet-based video services. Finally, we review home video sales and rentals. In Section III, we examine market structure and competition, evaluating ownership trends in the multichannel video marketplace, vertical integration between programming services and distribution systems, issues pertaining to access to programming, and competitive issues in small and rural markets and multiple dwelling units (MDUs). We also address numerous technical issues (Section IV) regarding navigation and reception devices and emerging services. Finally, we survey developments in foreign markets (Section V).

B. Summary

1. The Current State of Competition: 2005

4. Americans are voracious consumers of media services, spending close to 30 percent of their day engaged in some activity involving media, with television viewing the dominant media activity.[4] For the September 2004 – September 2005 television season, the average household tuned into television for 8 hours, 11 minutes a day.[5] This is almost three percent higher than the previous season, over 12 percent higher than 10 years ago, and the highest level observed since television viewing was first measured by Nielsen Media Research in the 1950s.[6] Within the same period, the average person watched 4 hours, 32 minutes each day, again a record high.[7]

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[3] *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, 20 FCC Rcd 14117 (2005) (*Notice*). Where possible, we requested data as of June 30, 2005. Appendix A lists commenters and the abbreviations by which they are identified herein.

[4] *Study: Average Person Spends More Time Using Media than Anything Else*, Radio Business Report, Sept 5, 2005, available at http://www.rbr.com/tvepaper/pages/september05/05-190_news1.html, citing the Middletown Media Studies 2 from Ball State University.

[5] Nielsen Media Research, *Nielsen Reports Americans Watch TV at Record Levels* (press release), Sept. 29, 2005. Nielsen's estimates are based on its National People Meter service.

[6] *Id.*

[7] *Id.* Children and teens are spending an increasing amount of time using new media. Young people are exposed to 8 hours and 33 minutes of media content each day; 3 hours and 51 minutes of which are spent watching television and videos. Kaiser Family Foundation, *Media Multitasking – Changing the Amount and Nature of Young People's Media Use* (press release), Mar. 9, 2005.

5. Competition in the delivery of video programming services has provided consumers with increased choice, better picture quality, and greater technological innovation. In particular, the effect of DBS competition has resulted in the addition of networks to cable operators' channel line ups, although it has only lowered cable rates slightly.[8] We find that almost all consumers have the choice between over-the-air broadcast television, a cable service, and at least two DBS providers. In some areas, consumers also may have access to video programming delivered by emerging technologies, such as digital broadcast spectrum, fiber to the home, or video over the Internet. In addition, through the use of advanced set-top boxes and digital video recorders, and the introduction of new mobile video services, consumers are now able to maintain more control over what, when, and how they receive information. Further, MVPDs of all stripes are offering nonvideo services in tandem with their traditional video services.

2. General Findings

6. The MVPD market has continued to grow. While the largest MVPD remains a cable operator, cable subscribership declined slightly since the *2004 Report*. The second and third largest MVPDs now are DBS operators. In addition, other delivery technologies continue to serve small numbers of subscribers in limited areas. LECs, such as SBC[9] and Verizon, who continue to partner with DBS providers to offer video service, have spent the past year preparing to offer video in their operating areas and are building out their facilities to add video offerings.

7. Large numbers of consumers continue to subscribe to cable service, which commands approximately 69 percent of all MVPD households. Cable operators have responded to the growth of DBS and its competitive service offerings by, among other things, expanding their channel line ups and bundling video service with other service offerings, such as cable modem service or telephone service. The number of cable subscribers selecting digital tiers and advanced services not offered by DBS continues to grow. These competitive efforts are matched by DBS operators' offering of local broadcast channels, additional sports and international programming, and advanced set-top boxes with digital video recorder (DVR) capabilities. Similarly, broadband service providers continue to offer a triple play of video, voice and Internet access service, which is proving to be price competitive with cable. Among our findings in rural and small markets are that LECs are upgrading their traditional copper facilities to digital subscriber line (DSL) and fiber-based platforms to allow them to offer a suite of video, telephone, and data services.

3. Specific Findings

8. The number of TV households and the number of MVPD subscribers increased in the past year. As of June 2005, there were 109.6 million TV households, compared to 108.4 million in June 2004. Of that number, approximately 94.2 million TV households, or almost 86 percent of TV households subscribe to an MVPD service, as compared to 92.3 million, or 85.1 percent as of June 2004. Cable serves the largest percentage of MVPD subscribers, but cable's share of the MVPD market continued to decline. As of June 2005, 69.4 percent of MVPD subscribers received video programming from a franchised cable operator, as compared to 71.6 percent as of June 2004.[10] DBS subscribers

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[8] *See* paras. 41 *infra.*

[9] Following its acquisition of AT&T Corp., SBC changed its name to AT&T Inc. We continue to refer to the company as SBC, the name under which it submitted its filings in this proceeding. *See* AT&T Inc., *New AT&T Launches* (press release), Nov. 18, 2005.

[10] This percentage is the result of adding together the number of subscribers to all MVPD services and calculating the percentage of this total represented by cable subscribers. *See* Appendix B, Table B-1. The 70/70 test, referred to in para. 12, *infra*, measures the share of cable subscribers to systems with 36 or more channels as a percent of homes to which cable systems with 36 or more channels are available.

comprise the second largest group of MVPD households, representing 27.7 percent of total MVPD subscribers as of June 2005, compared to 25.1 percent in June 2004, an increase of more than 10 percent. The competitive presence of MVPDs other than cable or DBS declined. The number of MVPD subscribers choosing all other delivery technologies decreased, representing 2.9 percent of all subscribers in June 2005, as compared to 3.3 percent in June 2004.

9. In 2005, the four MVPDs with the largest subscribership served 63 percent of all MVPD subscribers, while in 2004, the top four served 58 percent of all subscribers. The share of subscribers served by the top ten MVPDs also increased from approximately 85 percent in 2004 to 88 percent in 2005. Relatively few consumers have a second wireline alternative, such as an overbuild cable system. BSPs, which typically operate overbuild systems, reported no appreciable change in subscribership since last year, maintaining total subscribership of approximately 1.4 million.

10. ***Cable Service***. The number of basic cable subscribers declined slightly, falling from 66.1 million in June 2004 to 65.4 million in June 2005. Cable penetration (*i.e.*, subscribers/homes passed) declined in 2004, as the number of subscribers decreased and the number of homes passed increased.

11. Cable revenue was projected to grow 10.8 percent in 2005 to $66.5 billion. Much of the increase in revenue comes from advanced services, especially high-speed Internet service and digital cable services, and from higher basic cable rates. In addition to traditional analog video services, many cable operators offer subscribers one or more advanced video services, including digital video, video-on-demand, digital video recorders, and high-definition television; and nonvideo advanced services, including high-speed Internet access and telephony (circuit-switched telephony and/or voice over Internet protocol telephony). At year-end 2004, according to industry reports, 96 percent of all cable homes passed were offered digital video services, 93 percent were offered high-speed Internet access services, and telephony service (both VoIP and circuit-switched) was available to 38 percent of homes passed by cable.

12. Section 612(g) of the Communications Act provides that when cable systems with 36 or more activated channels are available to 70 percent of households within the United States and when 70 percent of those households subscribe to them, the Commission may promulgate any additional rules necessary to promote diversity of information sources. Data submitted in the record this year raises questions as to whether the so-called "70/70 test" has been satisfied. Accordingly, the Commission is seeking further public comment on the best methodologies and data for measuring the 70-percent thresholds and, if the thresholds have been met, what action might be warranted to achieve the statutory goals.

13. ***Direct-to-Home (DTH) Satellite Service (DBS and Home Satellite Dish, or HSD)***. As of June 2005, approximately 26.1 million U.S. households subscribed to DBS service. This represents an increase of 12.8 percent over the approximately 23.2 million DBS subscribers we reported last year. DBS accounts for approximately 27.7 percent of all U.S. MVPD subscribers. DBS operators continue to add local-into-local broadcast television service. In 167 of 210 television markets (*i.e.*, designated market areas, or DMAs), covering 96 percent of all U.S. TV households, at least one DBS provider offers the signals of local broadcast stations (local-into-local service). As of June 2005, there were 206,358 households authorized to receive HSD service, a decrease of 38.5 percent from the 335,766 we reported last year.

14. ***Other Wireline MVPD Services***. For the purposes of this report, we consider broadband service providers (BSPs) to be newer firms that are building state-of-the-art, facilities-based networks to provide video, voice, and data services over a single network. As of June 2005, BSPs served approximately 1.4 million subscribers, representing 1.5 percent of all MVPD households. Electric and gas utilities also provide MVPD and other services. Reports indicate that 616 public power entities offer some kind of broadband services, serving about 14 percent of total households in the United States. Of those, 102 offered video service, 128 offered high-speed Internet access, 52 offered local telephone

service, and 42 offered long distance telephone service. Of the 102 offering video services, 10 are offering video-on-demand (VOD).

15. Incumbent local exchange carriers (ILECs) have reported plans to provide video service via asymmetric digital subscriber line (ADSL), very high-speed digital subscriber line (VDSL), or fiber to the home (FTTH) or fiber to the node (FTTN).[11] There are 652 communities in 46 states currently served at least in part by FTTH networks, with 322,700 "connected homes." The larger LECs have accelerated their plans to roll out video services using DSL and fiber-based distribution platforms. Verizon is deploying an FTTH network under the brand name "FiOS" that will allow delivery of multichannel video services in addition to telephony and high-speed Internet access service at speeds above those of ADSL technology. Verizon has received franchises from local communities in California, Florida, Virginia, Texas, Massachusetts, and Maryland. It began offering multichannel video service in Keller, Texas, in September 2005, and now offers service to more than a dozen Texas communities; in Herndon, Virginia, in November 2005; and in Temple Terrace, Florida, in December 2005. SBC is planning to deploy an IP-enabled broadband network called "Project Lightspeed" using both FTTN and FTTH to deliver video and other services to residential customers. SBC reports that the network will be available to 18 million homes nationwide within three years. Qwest and a number of smaller incumbent LECs are offering, or preparing to offer, MVPD service over existing telephone lines using VDSL or ADSL technologies.

16. ***Wireless Services***. Wireless cable systems provide video competition to incumbent cable operators only on a limited basis. The number of wireless cable subscribers has declined steadily from a peak of 1.2 million in 1996 to approximately 100,000 as of March 2005, down from an estimated 200,000 subscribers in April 2004. Several major cellular telephone companies are offering video services through handheld devices such as mobile telephones.[12] Verizon Wireless rolled out V-Cast, a service that offers video programming to cellular telephone users, in February 2005, and Sprint Nextel offers news, video clips, and other content in real time over their cellular phones. In addition, PCOs, also known as satellite master antenna (SMATV) systems, continue to serve a small number of MVPD subscribers, either through their own facilities or through partnership arrangements with DBS operators. PCO subscribership has declined to one million subscribers this year, a decrease of 9.1 percent from last year's 1.1 million.

17. ***Broadcast Television Service***. In this year's *Report*, we find that there are almost 15.4 million U.S. TV households that do not subscribe to an MVPD service and thus rely solely on over-the-air broadcast television for their video programming. In addition, we note that many households that subscribe to an MVPD also rely on over-the-air signals to receive broadcast programming on some of their television sets.[13] They represent 14 percent of all U.S. TV households. From June 30, 2004 to June 30, 2005, the number of commercial and noncommercial television stations has remained unchanged at 1,747. As of October 2005, more than 1,537 stations nationwide are on the air with DTV operations, including all 119 of the top-four network affiliates in the top 30 television markets. The major broadcast

[11] Fiber to the node (also known as fiber to the neighborhood) is a hybrid network architecture involving optical fiber from the carrier network, terminating in a neighborhood cabinet (or "node"), which converts the signal from optical to electrical. The connection from the cabinet to the user premises is provided over unshielded twisted pair (UTC) or coaxial cable. While fiber to the house is preferable in terms of overall performance, it is more expensive to deploy than fiber to the node. *See* Harry Newton, NEWTON'S TELECOM DICTIONARY (CMP Books, 17th ed., 2001), at 296.

[12] In general, wireless carriers are providing video in clip form, allowing users to select segments of news, sporting event recaps, weather reports and music videos, although full-length video is available. *See, e.g.,* Verizon, http://getitnow.vzwshop.com/ index.aspx?id=vcast video. *See also* paras. 134, 231-2 *infra.*

[13] *See* Media Bureau, Staff Report Concerning Over-the-Air Broadcast Television Viewers, MB Docket 04-210, Feb. 28, 2005 (*OTA Report*).

networks (ABC, CBS, Fox, and NBC) now provide their most popular programming in high-definition. Hundreds of local stations are using their digital channels to provide multicast programming, including news, weather, sports, religious material, music videos and coverage of local musicians and concerts, as well as foreign language programming. As of May 2005, cable operators were carrying commercial broadcasters' multicast programming in more than 50 markets (including at least seven of the top 10 markets).[14]

18. ***Internet Video.*** The amount of web-based video provided over the Internet continues to increase significantly each year. The overall number of homes with access to the Internet continues to grow, as does the number of Americans who access the Internet via a high-speed broadband connection. As of June 2005, there were approximately 33.7 million high-speed residential Internet access subscribers, representing approximately 48 percent of the 70.3 million residential Internet subscription households. As of January 2005, an average of 14 percent of all Americans had watched some form of streaming video in the preceding month, and approximately eight percent of Americans had accessed streaming video content in the preceding week.

19. ***Home Video Sales and Rentals.*** The sale and rental of home videos, including videocassettes and DVDs, offer consumers an alternative to the premium and pay-per-view offerings of MVPDs. Video-on-demand services provided by cable, DBS, and Internet providers have emerged, in turn, as competitive alternatives to home video. Nine out of 10 TV households have at least one VCR, and an estimated 80 million households have DVD capability, representing nearly three-quarters of all U.S. households.

20. ***Cable System Ownership.*** Between July 2004 and June 2005, a total of 22 MVPD transactions were announced.[15] Together these transactions were valued at approximately $48.7 billion and affected approximately 12.7 million subscribers. At the end of 2004, there were 118 clusters with approximately 51.5 million subscribers compared to 108 clusters and approximately 53.6 million subscribers at the end of 2003 (although due to a change in methodology, these figures are not directly comparable). In the largest cluster size category (over 500,000 subscribers), the number of clusters remained constant at 29 between 2003 and 2004.

21. ***Video Programming Services.*** In 2005, using additional data resources, we identified 531 satellite-delivered national programming networks, an increase of 143 networks over the 2004 total of 388 networks. Of the 531 networks, 116 networks (21.8 percent) were vertically integrated with at least one cable operator. Five of the top seven cable operators (*i.e.*, Comcast, Time Warner, Cox, Charter, and Cablevision) hold ownership interests in satellite-delivered national programming networks. All of the vertically integrated networks are owned in whole or in part by one or more of these companies. Of the 531 national nonbroadcast networks we have identified, 274, or 51.6 percent, that are not affiliated with any cable operator or other media entity. There are 107 national, satellite-delivered nonbroadcast networks that are owned by a DBS operator or one or more national broadcast networks (*i.e.*, Fox, ABC, CBS, NBC Universal, and Univision) and that are not also owned by a cable operator. These networks represent 20.2 percent of the 531 national nonbroadcast networks we have identified, and 25.8 percent of the 415 networks that are unaffiliated with a cable operator. Twenty-two national nonbroadcast networks, not owned by a cable MSO, are vertically integrated with a DBS provider. During the 2004-2005 television season, more than half of all prime time viewers watched ad-supported nonbroadcast networks, the second consecutive year that these networks, combined, have topped all national broadcast networks,

[14] This does not necessarily include all multicast programming available from broadcasters in all markets and may include only carriage of special events in certain markets. For example, several cable operators agreed to carry CBS stations' extra coverage of the 2005 NCAA men's college basketball tournament on multicast channels.

[15] These figures are for announced transactions, including the sale of Adelphia's assets to Comcast and Time Warner currently under review by the Commission.

combined, for an entire TV season. Of the 15 top-rated prime time nonbroadcast networks, three are vertically integrated with a cable operator. The remaining 12 networks are owned by other media entities. In addition, six of the top 20 nonbroadcast networks (ranked by subscribership) are vertically integrated with a cable operator. Of the other 14 networks, one is C-SPAN, which is funded, but not directly owned or controlled, by MVPDs; 12 are affiliated with noncable media entities; and one is unaffiliated.

22. In 2005, we identified 96 regional networks, the same number that we identified in 2004. Many, but not all, regional networks are delivered by satellite. These networks provide programming of local or regional interest and are distributed to subscribers of one or more MVPDs in an area. A number of regional networks offer local news or sports programming, but some provide more general programming, such as religious or ethnic programming. Of the 96 regional networks we identified, 44 networks, or 45.8 percent, were vertically integrated with at least one cable multiple system operator (MSO). We continue to monitor the availability of sports programming. There are 37 regional sports networks, representing 38.5 percent of all regional networks, devoted to sports programming, as compared to the 38 we reported last year. Of the 37 regional sports networks, 17, or 45.9 percent, are vertically integrated with a cable MSO. In addition, News Corp., which holds an interest in DBS operator DIRECTV, is affiliated with 16 regional sports networks.

23. ***Consumer Equipment and Technical Developments***. The sale of DTV consumer electronics continues to accelerate. For 2005, industry estimates indicate that 8.2 million HD-ready monitors will be shipped to retailers. CEA reports that during the first six months of 2005, DTV products sold at a faster rate than during any previous comparable period of time, with 3.8 million DTV products sold, a 40 percent increase in unit sales from the same time period in 2004. In 2005, the average retail price of a DTV set was expected to drop to $1,189 from $1,489 in 2004, down from the average price of $3,147 in 1998. CEA states that currently several DTV models are available for under $700, and it expects that soon there will be DTV sets that sell for as low as $400.

24. The development and deployment of CableCARDs continued in 2005. CableCARDs permit the reception of one-way secured digital cable services without the addition of a set-top box. As of November 30, 2005, there were 375 certified or verified models of CableCARD products collectively offered by 22 manufacturers, up from 60 models offered by 11 manufacturers the previous year. One-way CableCARDs have been deployed to more than 90,000 subscribers by the ten largest MSOs.

25. The video industry is evaluating the use of advanced compression technologies, such as MPEG-4/H.264 and Microsoft's VC-1, to replace the MPEG-2 standard in order to decrease the amount of bandwidth required to transmit digital video. For example, DIRECTV is using MPEG-4 to provide HD local-into-local in a number of markets. These advances are expected to allow existing video delivery services to provide more programming and to decrease barriers to entry for new entrants to the MVPD market.

26. ***Foreign Markets***. In foreign markets, a number of incumbent operators and new entrants are providing Internet protocol television (IPTV) over DSL. Services are offered generally through a "triple play" service package of video, telephone and broadband Internet access. Operators also offer a wide selection of a la carte and themed video programming packages.

II. COMPETITORS IN THE MARKET FOR THE DELIVERY OF VIDEO PROGRAMMING

A. Cable Television Service

27. This section addresses the performance of cable television system operators during the past year.[16] First, we report on the general performance of the industry, including subscriber levels, availability of basic services, viewership, and cable rates. Second, we discuss the cable industry's financial performance, including its revenue, cash flow status, stock valuations, and system transactions. Third, we examine the cable industry's acquisition and disposition of capital. Lastly, we address the growth of advanced video services, including digital and high-definition television, video-on-demand, and digital video recorders; and nonvideo advanced services, including high-speed Internet access and voice over Internet protocol telephony.

1. General Performance

28. The number of subscribers to basic cable service[17] and premium cable service[18] declined in 2004. Basic cable penetration, the ratio of the number of basic cable subscribers to the number of homes passed,[19] declined in 2004 and is estimated to have declined further in the first half of 2005. By many other measures, however, general cable industry performance increased across the board. For example, premium service subscriptions[20] and subscriptions to digital video service increased.[21] Although basic cable penetration decreased in 2004, homes passed increased during the same period. Channel capacity[22] and deployment of video-on-demand,[23] digital video recorders,[24] and high-definition service all

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[16] A cable system operator is "any person or group of persons (A) who provides cable service over a cable system, and directly or through one or more affiliates owns a significant interest in such cable system; or (B) who otherwise controls or is responsible for, through any arrangement, the management and operation of such a cable system." 47 U.S.C. § 522(5).

[17] Basic cable service, also referred to as the basic service tier (BST), is the level of cable television service that must be taken by all cable television subscribers. The content of basic cable service varies among cable systems but, pursuant to the Communications Act, must include all local television signals and public, educational, and governmental access channels and, at the discretion of the cable operator, may include other video services. Expanded basic cable service, also referred to as the cable programming service tier (CPST) for purposes of rate regulation, offers additional video channels on one or more service tiers. 47 U.S.C. § 543(b)(7); 47 U.S.C. § 543 (k)(2).

[18] Premium services are nonbroadcast networks provided by a cable operator on a per-channel basis for an extra monthly fee. Pay-per-view (PPV) services are nonbroadcast networks provided on a per program basis. PPV service is a separate category from premium service.

[19] Homes passed is the total number of households capable of receiving cable television service.

[20] Premium service subscriptions are the number of premium services to which homes are subscribing (also known as pay units).

[21] Digital cable service refers to digitally compressed video channels offered on digital service tiers. Every subscriber of a cable system must subscribe to the basic tier in order to subscribe to any other tier of video service or to purchase any other video service. 47 C.F.R § 76.920.

[22] Channel capacity is bandwidth dedicated to video use. Video channel capacity can be increased or decreased on any given system simply by using more or less bandwidth for other services, such as high-speed Internet access services or cable telephony.

[23] Video-on-demand (VOD) allows subscribers to select at any time movies and other programs they wish to view from a selection of titles stored on a remote server.

[24] Digital video recorders (DVRs) use a hard disk drive to record video programs.

increased during 2004 and the first half of 2005.[25] Deployment of nonvideo advanced services, such as high-speed Internet access service and telephone service, also increased during this period.

29. ***Cable's Capacity to Serve Television Households.*** A widely used industry measurement of cable availability is the percentage of homes with a television that are passed by a cable system. The calculation of cable availability has been a subject of controversy.[26] The number of homes passed depends on the data source used, and the percentage of homes passed varies based on the universe used for the comparison.[27]

30. According to NCTA, at the end of 2004, cable systems passed 108.2 million occupied homes with a television, and 109.6 million homes had a television.[28] Thus, NCTA estimates that at the end of 2004, cable systems passed approximately 99 percent of homes with a television.[29] We continue to use, as we have in the past, data derived from Kagan World Media (homes passed by cable systems) and Nielsen Media Research (total TV households) for historical consistency. We present these data to indicate trends, rather than as an absolute measure of cable availability. Kagan estimates that at the end of 2004, 109.6 million households had at least one television, and cable systems passed 108.6 million occupied homes (not all of them with a television).[30] Using Kagan's numbers, at the end of 2004, the percentage of occupied homes with a television that were passed by a cable system was approximately 99 percent, which is consistent with NCTA's estimate.[31]

31. Section 612(g) of the Communications Act provides that at such time as cable systems with 36 or more activated channels are available to 70 percent of households within the United States and are subscribed to by 70 percent of those households, the Commission may promulgate any additional rules necessary to promote diversity of information sources.[32] As discussed below, data submitted in the

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[25] High-definition (HD) service provides television signals with greater detail and fidelity than provided by the National Television Systems Committee (NTSC) system. The high-definition picture has approximately twice the visual resolution as NTSC. High-definition service also supports 5.1 channel Dolby Digital surround sound.

[26] *See Application of EchoStar Communications Corporation, General Motors Corporation, and Hughes Electronics Corporation, Transferors and EchoStar Communications Corporation, Transferee*, 17 FCC Rcd 20559, 20611-12 ¶¶ 122-25 (2002) (*EchoStar-Hughes HDO*) (designating for hearing the issue of the precise number of households that are not served by a cable operator, the number served by a low-capacity cable system, and the number served by a high-capacity cable system).

[27] Homes passed data evaluated in the context of our review of the EchoStar-DIRECTV merger application indicated that the number of homes not passed by cable might vary from four percent to 21.28 percent depending on the estimation methods. *EchoStar-Hughes HDO*, 17 FCC Rcd at 20612 ¶ 124 and n.356.

[28] NCTA, *Industry Statistics*, Cable Developments 2005, at 5. NCTA's estimate of 108.2 million occupied homes with a television that were passed by a cable system is a projection, not a current estimate, from Kagan Research, LLC, Broadband Cable Financial Databook, Aug. 2004, at 11. NCTA's estimate of 109.6 million homes with a television comes from Nielsen Media Research (January 2005).

[29] NCTA, *Industry Statistics*, Cable Developments 2005, at 5. NCTA calculated the 99 percent figure as follows: 108.2 million/109.6 million = 98.7 percent.

[30] Kagan Research, LLC, Broadband Cable Financial Databook, Aug 2005 (Cable Databook), at 11. Occupied homes passed by cable systems equals total cable homes passed times percent of total housing units that are occupied (108.6 million = 120.7 million x (111.4 million/123.8 million)). Cable Databook at 11 and 13.

[31] The 99 percent estimate is derived as follows: 108.6 million/109.6 million = 99.1 percent. Since the numerator includes homes that may not have a television, the calculation may overstate cable availability.

[32] 47 U.S.C. § 532(g). This provision was added to the Communications Act by the Cable Communications Policy Act of 1984, Pub. L. No. 98-549, 98 Stat. 2779.

record this year raises questions as to whether the so-called "70/70 test" has been satisfied.[33] Accordingly, we are seeking additional input to help the Commission further consider this issue.

32. Current Census Bureau data indicate that there are 107,850,000 occupied housing units.[34] According to Warren Communications News (Warren), there are 93,077,522 occupied homes passed by cable systems with 36 or more channels.[35] Thus, based on these data sources, cable systems with 36 or more channels are available to 86.3 percent (93,077,522/107,850,000) of occupied households.[36] No commenter provided any conflicting data relevant to the first prong of the test, and so there appears to be no serious disagreement that this prong of the analysis has been satisfied.

33. With respect to the second prong of the analysis, however, the record is less clear. At least one commenter has submitted a statistical analysis that suggests the cable subscription threshold has been satisfied, while other measures indicate that current cable subscribership falls just short of the statutory mark. SBC believes the second prong of the benchmark may have been met. Specifically, SBC calculates that 77.2 percent of all households passed by cable systems with 36 or more channels subscribe to these cable systems.[37] Using figures estimated by the Commission and NCTA, SBC asserts that 65,155,440 households subscribe to cable systems with 36 or more channels.[38] SBC derives this figure from NCTA's estimate that 73,219,360 households subscribed to cable as of February 2005,[39] and the Commission's calculation in last year's *Report*, using Warren data as of October 2004, that 8,063,920 households subscribed to cable systems with fewer than 36 channels.[40] SBC subtracts the Commission's estimate from NCTA's estimate (73,219,360 – 8,063,920 = 65,155,440).[41] SBC then divides its estimate of households that subscribe to cable systems offering 36 or more channels by Warren's October 2004 estimate, cited in the *2004* Report, that 84,415,707 households homes were passed by cable systems with 36 or more channels.[42] This calculation produces a figure of 77.2 percent (65,155,440/84,415,707 = 0.772). SBC acknowledges that its data for households passed by cable systems and cable subscribers differ from the data used by the Commission to determine whether the statutory trigger has been met.[43]

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[33] We observe that each data source provides different estimates of the number of occupied homes, the number of homes passed by cable systems, and the number of basic cable subscribers. Some data sources identify cable systems with 36 or more channels, while other data sources report estimates for all cable systems without distinguishing between those with 36 or more channels and those with less than 36 channels.

[34] U.S. Census Bureau, *Census Bureau Reports on Residential Vacancies and Homeownership* (press release), July 28, 2005, Table 3. *See* http://www.census.gov/hhes/www/housing/hvs/qtr205/q205prss/pdf (visited Sept. 20, 2005).

[35] Warren Communications News, *Custom Report: From Television and Cable Factbook Online Datasets*, Sept. 21, 2005.

[36] *Id.* Warren defines homes passed as the total number of homes passed by cable systems having the potential of being served by a cable operator promptly. Specifically, the homes passed must be occupied and are assumed to have a television.

[37] *See* SBC Reply Comments at 15.

[38] *Id.*

[39] *See* NCTA, at http://www.ncta.com/Docs/ PageContent.cfm?pageID=86 (visited Oct. 21, 2005). NCTA's website indicates that Nielsen Media Research is the source for this subscriber number.

[40] *See 2004 Report*, 20 FCC Rcd 2768 ¶ 20. The Commission's estimate is calculated using data from Warren Communications News, *Custom Report: From Television and Cable Factbook Online Datasets*, Oct. 19, 2004.

[41] *See* SBC Reply Comments at 15.

[42] *See 2004 Report*, 20 FCC Rcd 2768 ¶ 20. The Commission's data source was Warren Communications News, *Custom Report: From Television and Cable Factbook Online Datasets*, Oct. 19, 2004.

[43] SBC Reply Comments at 14-16. SBC acknowledges, however, that different data sources produce different results and that calculations based on available data may not be definitive.

To better determine whether the statutory trigger has been met, SBC asks the Commission to insist that the cable industry provide "the relevant data calculated on a consistent and transparent basis."[44]

34. In contrast several other calculations indicate that the second prong of the 70/70 test has not been met. Warren estimates that of the occupied U.S. homes passed by cable systems with 36 or more channels, 63,145,124 of those households subscribe to cable service offered by such systems.[45] As a percentage measure, then, the Warren data indicates that 67.8 percent of homes passed (63,145,124/93,077,522) subscribe to these systems.[46] As alternatives, data from the *2005 Price Survey* and the *Annual Report of Cable Television Systems* (FCC Form 325) could be used to estimate the second prong of the 70/70 benchmark. Neither source, however, indicates that the second element of the test has been met. From the 2005 Price Survey sample, the Commission staff estimates that the subscribers to systems with 36 or more channels as a percent of the homes passed by such systems is 56.3 percent, compared to 58.8 percent using data from the 2004 Price Survey sample.[47] Based on the Form 325 sample, our staff estimates that this figure is 54 percent, compared to 54.7 percent reported last year.[48] NCTA has arrived at still other measures. Using Warren, Nielsen, and Kagan data, NCTA submitted estimates of the second prong of the 70/70 benchmark ranging from 63.3 percent to 68.9 percent.[49]

35. We recognize that the available data sources have some limitations because the reported cable penetration rates are not calculated from a complete census of cable systems.[50] Each reported

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[44] SBC Reply Comments at 16.

[45] Warren Communications News, *Custom Report: From Television and Cable Factbook Online Datasets*, Sept. 30, 2005.

[46] *Id.* Warren reports that of the 66,300,059 cable subscribers in the United States, 63,145,124 subscribe to cable systems with 36 or more channels. Thus, there are 3,154,935 (66,300,059 – 63,145,124 = 3,154,935) subscribers to cable systems with fewer than 36 channels.

[47] Section 623(k) of the 1992 Cable Act, Pub. L. No. 102-385, 106 Stat. 1460, codified at 47 U.S.C. § 543(k), requires the Commission to publish annually a statistical report on average rates for the cable basic service tier, cable programming tier, and equipment. The information and analysis provided in the report are based on the Commission's survey of a random sample of cable systems. The survey collects data on cable system subscribership, channel capacity, and homes passed. *See, e.g., Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992, Statistical Report on Average Prices for Basic Service, Cable Programming Services, and Equipment*, 20 FCC Rcd 2718 (2005). Using data from the annual Price Survey sample, we calculate subscriber-weighted estimates, taking into account our sampling procedures, in the same manner that we use for our report on cable rates.

[48] 47 C.F.R § 76.403 requires that cable television systems notified by the Commission shall file FCC Form 325 (Annual Cable Report) soliciting general information and frequency and signal distribution information. Form 325 data for filing year 2004 is as of December 31, 2004. All systems with more than 20,000 subscribers and a randomly selected sample of smaller systems are required to file the Form 325. The Commission based last year's Form 325 estimate on data for June 30, 2003. The estimates reported here are unadjusted figures from the data reported in Form 325 submissions.

[49] *See* Letter from Daniel L. Brenner, Senior Vice President, Law & Regulatory Policy, NCTA, to Marlene H. Dortch, Secretary, FCC, Dec. 15, 2005, at 2 (providing estimates using Warren, Nielsen, and Kagan homes passed and subscriber statistics). NCTA estimates that the penetration rate for cable systems with 36 or more channels is 68.9 percent using October 2004 Warren data and 63.3 percent using both sample and adjusted Nielsen FOCUS data. NCTA also submits Kagan data to calculate a cable penetration rate of 53.1 percent for all cable systems to demonstrate that the Warren data understate the number of homes passed by cable systems with more than 36 channels. NCTA claims that all three data sources demonstrate that the penetration rate is below the 70 percent threshold. *Id.*

[50] Warren's database includes information on the majority of, but not all, cable systems. The Price Survey uses a stratified random sample based on system size. The Form 325 data are collected from all cable systems with more (continued....)

penetration rate is an estimate, subject to some variation from the actual penetration rate. The limitations of the data sources do not appear to affect the determination with respect to the first prong of the 70/70 test, which is higher than the threshold regardless of the data source used for the calculation. The question of whether the second prong has been met is less clear since at least one party finds that the benchmark has been exceeded and some other estimates, while under 70 percent, are very close to that threshold. Given these circumstances and the fact that all available data sources are imprecise to some extent, it is possible that the second prong of the 70/70 benchmark has been met.

36. In light of the significance of this issue and commenters' disagreements as to whether the statutory standard has been satisfied, the Commission is seeking further public comment on the best methodologies and data for measuring the 70-percent thresholds. For example, controversy has arisen in other proceedings regarding how the Commission should define whether a cable system is available to a household.[51] The question of how to define a household for purposes of the 70/70 test has also arisen.[52] Should we include only households that are occupied? Should we include only households that contain a television set? How should we determine whether a household subscribes to a cable system? Should we include only households that subscribe to the basic tier of video services, thereby excluding those households that subscribe only to non-video services?[53] We also seek comment on SBC's suggestion that the Commission should require the cable industry to provide "the relevant data on a consistent and transparent basis."[54] We also invite comment on what, if any, additional action should be undertaken to achieve the statutory goals, should we find that the thresholds have been met.[55] As a preliminary matter, we ask commenters who advocate that the Commission promulgate additional rules to address the scope of our statutory authority under Section 612(g) to do so. We also ask commenters who advocate the promulgation of additional regulations to provide a detailed description of the suggested regulations and of their potential costs and benefits. Deadlines for public comment on these questions are provided in the final section of this Report.

37. ***Subscribership***. The number of basic cable subscribers declined slightly from 66 million in 2003 to 65.4 million in 2004, as shown in Table 1 below. Kagan estimated that the number of basic cable subscribers would remain unchanged at 65.4 million basic subscribers at year-end 2005.[56]

(Continued from previous page) ———————————
than 20,000 subscribers and a 5 percent sample of systems with fewer than 20,000 subscribers. SBC's estimate combines data from several publicly available data sources.

[51] *See EchoStar-Hughes HDO*, 17 FCC Rcd at 20611-12 ¶¶ 122-25. *See also 2004 Video Competition Report*, 20 FCC Rcd at 2766-68 ¶¶ 18-20; and *2003 Report*, 19 FCC Rcd at 1620-21 ¶¶ 21-22.

[52] *2004 Video Competition Report*, 20 FCC Rcd at 2766-68 ¶¶ 18-20; and *2003 Video Competition Report*, 19 FCC Rcd at 1620-21 ¶¶ 21-22.

[53] We recognize that at the time that Congress drafted Section 612, very few cable operators were providing services beyond multichannel video offerings.

[54] SBC Reply Comments at 16.

[55] Should our analysis of the further public input here indicate that Commission action under Section 612(g) may be warranted, we will issue a Notice of Proposed Rulemaking to seek comment prior to adoption of any potential new regulations.

[56] Cable Databook at 11.

TABLE 1: Cable Television Industry Growth: 1999 - June 2005 (in millions)[57]

Year	TV Households (TH)[58]		Homes Passed (HP)[59]		Basic Subscribers (Subs)[60]		HH Passed by Cable (HP/TH)	HHs Subscribing (Subs/TH)	U.S. Penetration (Subs/HP)
	Total	% Change Over Prior Yr	Total	% Change Over Prior Yr	Total	% Change Over Prior Yr			
1999	100.8	1.4%	97.6	2.1%	65.9	1.2%	96.8%	65.4%	67.5%
2000	102.2	1.4%	98.9	1.3%	66.6	1.1%	96.8%	65.2%	67.3%
2001	104.4	2.2%	100.6	1.7%	66.9	0.5%	96.4%	64.1%	66.5%
2002	106.7	2.2%	103.4	2.8%	66.1	-1.2%	96.9%	61.9%	63.9%
2003	108.4	1.6%	106.0	2.5%	66.0	-0.2%	97.8%	60.9%	62.3%
2004	109.6	1.1%	108.6	2.5%	65.4	-0.9%	99.1%	59.7%	60.2%
June 2005	109.6	0.0%[61]	109.7	1.0%	65.4	0.0%	100.1%	59.7%	59.6%

38. Although the number of basic subscribers was unchanged for the second quarter of 2005, as shown in Table 2, cable companies continue to experience variations in the number of basic subscribers they serve.

[57] Historical data in this table may differ from that previously reported because some data have been updated by Kagan. *See* Cable Databook at 9, 11.

[58] The 2004 and estimated June 2005 TV Household numbers are reported by Kagan Research, LLC as total U.S. TV households. The numbers are derived from Nielsen Media Research and Kagan estimates. *Id.* at 11.

[59] Kagan reports the 1999 through 2004 homes passed numbers as occupied cable homes passed. The June 2005 homes passed estimate is an average calculated from the actual 2004 and the projected 2005 numbers for occupied cable homes passed. *Id.* at 9, 11.

[60] Kagan reports the 1999 through 2004 basic subscriber numbers as basic subscribers. The June 2005 basic subscriber estimate is an average calculated from the actual 2004 and the projected 2005 numbers for total basic cable subscribers. *Id.*

[61] Percentage change columns in this row are from December 2004 to June 2005.

Table 2: Top MSOs' Basic Cable Subscribers – 2003 to June 2005[62]

Operator	Year End (YE) 2003	YE 2004	Gain/(Loss) YE 03-YE 04	June 2005	Gain/(Loss)YE 04 to June 2005
Comcast[63]	21,540,000	21,548,000	8,000	21,448,000[64]	(100,000)
Time Warner[65]	10,919,000	10,884,000	(35,000)	10,905,000[66]	21,000
Cox[67]	6,285,236	6,287,395	2,159	6,283,122	(4,273)
Charter[68]	6,200,500	5,991,500	(209,000)	5,943,100	(48,400)
Cablevision[69]	2,944,694	2,963,001	18,307	3,005,558	42,557

[62] Subscriber data reported here are those reported to the SEC and may differ from subscriber numbers reported for other purposes.

[63] Comcast Corp., *Comcast Reports Fourth Quarter and Year End 2004 Results* (press release), Feb. 3, 2005. Pro forma subscriber data excludes the results of the 314,000 cable subscribers sold to Bresnan Communications in March 2003 and excludes the results of the net reduction of 16,000 subscribers associated with the cable systems exchanged with Insight Communications in February 2003. Pro forma subscriber data includes the results of the 30,000 cable subscribers acquired from US Coastal Cable in April 2004 and 54,000 subscribers acquired in various small acquisitions during the periods presented. *Id.* The pro forma methodology permits an estimate of the number of Comcast's subscribers after Jan. 1, 2003, as if it had sold the cable systems to Bresnan Communications, exchanged the cable systems with Insight Communications, and bought the cable systems from US Coastal Cable on Jan. 1, 2003. For second quarter 2005 results, *see* Comcast Corp., *Comcast Reports Second Quarter 2005 Results* (press release), Aug. 2, 2005. Pro forma subscriber data include the results of the 30,000 subscribers acquired from US Coastal Cable in April 2004 and 60,000 subscribers acquired in various small acquisitions during the periods presented. *Id.* The pro forma methodology permits an estimate of the number of Comcast's subscribers after Jan. 1, 2004, as if it had owned the cable systems acquired from US Coastal Cable on Jan. 1, 2004.

[64] In addition to its wholly owned systems reported here, Comcast holds an attributable interest in systems serving approximately an additional 4.6 million subscribers through partnership and other ownership interests. *See* Application and Public Interest Statement of Adelphia Communications Corporation, Time Warner Inc., and Comcast Corporation, MB Docket No. 05-192 (filed May 18, 2005), at 14 n.27.

[65] Time Warner Inc., *Time Warner Reports Results for 2004 Full Year and Fourth Quarter* (press release), Feb. 4, 2005. Time Warner indicates that its subscriber data include "all subscribers at both consolidated entities and investees accounted for under the equity method of accounting that are managed by the Company." *Id.* at 29. For second quarter 2005 results, *see* Time Warner Inc., *Time Warner Inc. Reports Second Quarter 2005 Results* (press release), Aug. 3, 2005. Time Warner gained 26,000 basic cable subscribers in the first quarter of 2005 and lost 5,000 basic cable subscribers in the second quarter of 2005. *See also* Time Warner Inc., *Time Warner Inc. Reports First Quarter 2005 Results* (press release), May 4, 2005.

[66] In addition to its wholly owned systems reported here, Time Warner holds an attributable interest in systems serving approximately an additional 2.2 million subscribers. *See* Application and Public Interest Statement of Adelphia Communications Corporation, Time Warner Inc., and Comcast Corporation, MB Docket No. 05-192 (filed May 18, 2005), at 10-11, 73.

[67] Cox Communications Inc., *Cox Communications Announces Fourth Quarter and Full-Year Financial Results for 2004* (press release), Mar. 16, 2005. Subscriber data are based on the number of subscribers who receive analog or digital video service. *Id.* For second quarter 2005 results, *see* Cox Communications Inc., *Cox Communications Announces Second Quarter and Year-to-Date Financial Results for 2005* (press release), Aug. 9, 2005.

[68] Charter Communications Inc., *Charter Reports Fourth Quarter and Annual 2004 Financial and Operating Results* (press release), Mar. 1, 2005. Charter's subscribers include all persons that Charter's billing records show as receiving service (regardless of their payment status), except for complimentary accounts (such as Charter's (continued....)

39. Cable penetration (*i.e.*, subscribers/homes passed) declined in 2004, as the number of subscribers decreased and the number of homes passed increased. Kagan estimated that cable penetration would decline further in the first half of 2005. The ratio of cable subscribers to television households also declined in 2004, as the number of subscribers decreased and the number of television households increased.[70]

40. For the second year in a row, the number of homes subscribing to premium cable services declined from 28.3 million in 2003 to 28.1 million in 2004, as shown in Table 3 below. At the end of 2004, approximately 43 percent of cable's 65.4 million subscribers also subscribed to premium services.[71] The number of premium services to which homes are subscribing (also known as pay units), however, increased from to 83.4 million in 2003 to 90.8 million in 2004.[72] While cable systems sold premium cable services to fewer homes, the total revenue received from premium services also increased 6.2 percent in 2004.[73] Cable systems sold premium cable services to fewer homes, but the average number of subscriptions per premium subscriber increased, from an average 2.9 subscriptions per subscribing household in 2003 to an average 3.2 subscriptions per subscribing household in 2004.[74]

(Continued from previous page) ———————————
employees). Pro forma subscriber data reflect the sales of systems to Atlantic Broadband Finance, LLC in Mar. and April 2004 and WaveDivision Holdings, LLC, which closed in Oct. 2003, as if they both occurred as of Jan. 1, 2003. *Id.* The pro forma methodology permits an estimate of the number of Charter's subscribers after Jan. 1, 2003, as if Charter sold the cable systems to Atlantic Broadband Finance, LLC and WaveDivision Holdings on Jan. 1, 2003. For second quarter 2005 results, *see* Charter Communications Inc., *Charter Communications Reports Second Quarter 2005 Financial and Operating Results* (press release), Aug. 2, 2005.

[69] Cablevision Systems Corp., *Cablevision Systems Corporation Reports Fourth Quarter and Full Year 2004 Results* (press release), Feb. 23, 2005; Cablevision Systems Corp., *Cablevision Systems Corporation Reports Second Quarter 2005 Results* (press release), Aug. 9, 2005.

[70] From the end of 2004 to the end of June 2005, the ratio of cable subscribers to TV households was calculated to remain unchanged at 59.7 percent. This calculation is the result of holding the number of TV households constant at 109.6 million over the entire 2004-2005 season and assuming that the number of basic subscribers will remain unchanged at 65.4 million from January 2004 to June 2005. Cable Databook at 11.

[71] Cable Databook at 9.

[72] *Id.*

[73] *Id.* at 8.

[74] *Id.* at 9.

TABLE 3: Premium Cable Services: 1999 - 2004 (in millions)[75]

Year	Premium Cable Service Subscribers (Pay HH)		Premium Cable Service Subscriptions (Pay Units)		Average Number of Subscriptions	
	Total	% Change Over Prior Year	Total	% Change Over Prior Year	Pay Units/ Pay HH	% Change Over Prior Year
1999	28.0	0.7%	60.2	2.7%	2.2	4.8%
2000	28.5	1.8%	66.8	11.0%	2.3	4.5%
2001	29.0	1.8%	75.6	13.2%	2.6	13.0%
2002	29.3	1.0%	81.1	7.3%	2.8	7.7%
2003	28.3	-3.4%	83.4	2.8%	2.9	3.6%
2004	28.1	-0.7%	90.8	8.9%	3.2	10.3%

41. ***Cable Rates***. Several studies, most notably several released by the U.S. Government Accountability Office (GAO), have shown that competition constrains cable prices. For example, in 2003, GAO found that competition to an incumbent cable operator from a wireline provider resulted in cable rates that were "substantially lower (by 15 percent)" than in markets without this competition.[76] In this study, GAO also concluded that DBS competition had lowered cable rates slightly, although the more pronounced competitive effect of DBS was the addition of nonbroadcast networks to cable operators' channel line-ups.[77] In 2004, GAO examined six market pairs to assess the impact of a BSP overbuilder. In each market pair, one market was served by a BSP overbuilder, and the other market was not. The market pairs were chosen based on their similarities in terms of size and demographics.[78] GAO found that communities with overbuild competition experience lower rates (an average of 23 percent lower for basic cable) and higher quality service.

42. ***Cable Industry Revenue***. Total revenue grew to $60.0 billion in 2004, as shown in Table 4 below.[79] This represents a 10.4 percent increase over the 2003 total revenues of $54.4 billion. Cable revenue is projected to grow 10.8 percent in 2005 to $66.5 billion. Much of the increase in revenue comes from advanced services, especially high-speed Internet service and digital cable services, and from

[75] Historical data included in this table may differ from those previously reported because some data have been updated by Kagan. *See* Cable Databook at 9. The 1999 through 2004 premium cable service subscribers (Pay HH) numbers are reported by Kagan as pay subscribers. *Id.* at 9. The 1999 through 2004 premium cable service subscriptions (Pay Units) numbers are reported by Kagan as the sum of premium units and mini-pay units (defined as a service or pay TV that programs less than eight hours per day). Premium units include HBO, Cinemax, Showtime, Movie Channel, Starz, and Playboy. Mini-pay units include Sundance, Flix, and Encore. *Id.* at 9.

[76] *See* U.S. General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8, Oct. 2003, at 3, 9.

[77] *Id.* at 3, 9-10.

[78] *See* U.S. General Accounting Office, *Telecommunications: Wire-Based Competition Benefited Consumers in Selected Markets*, GAO-04-241, Feb. 2004.

[79] The $60 billion of revenue generated by the cable industry is about one-fifth the $291 billion of revenue generated by the telephone industry. Industry Analysis and Technology Division, Wireline Competition Bureau, Federal Communications Commission, *Telecommunications Industry Revenues: 2003* (rel. Mar. 1, 2005).

higher basic cable rates, which are regulated by local communities.[80] Average monthly residential revenue per subscriber grew from $66.22 in 2003 to $72.87 in 2004 and is projected to increase to $80.33 in 2005.[81] As shown in Table 4, all revenue categories increased, except revenue from installation/miscellaneous, which decreased 9.6 percent in 2004 but is expected to increase by 6.6 percent in 2005.[82]

43. ***Cable Industry Cash Flow.*** Cash flow (generally expressed as earnings before interest, taxes, depreciation, and amortization, or EBITDA) is often used to assess the financial position of cable firms and other companies in capital intensive industries.[83] Cash flow from operations is the net result of cash inflows from operations (revenue) and cash outflows from operations (expenses). Cash flow from operations indicates a firm's ability to meet its net financial and investment obligations and thus does not include noncash charges to net income such as depreciation and amortization. As Table 4 shows, cash flow from operations increased during 2004.[84] In addition, cash flow as a percentage of revenue (cash flow margin) increased in 2004. That is, cash flow increased at a greater rate than revenue, indicating that revenues grew faster than operating expenses during 2004.

[80] Kagan estimated that total revenue from residential subscribers would grow from $57.5 billion in 2004 to $63.1 in 2005. Kagan expected total revenue from business subscribers to grow from $2.6 billion in 2004 to $3.4 in 2005. Cable Databook at 13.

[81] Cable Databook at 4.

[82] We note that installation/miscellaneous varies from year to year. It includes installation revenues and any other revenues reported by Kagan, but not included in the categories listed separately on Table 5.

[83] The cable industry has long used a cash flow valuation model. Cash flow valuation is an effective tool for valuing companies that have negative net income because they are building out capital infrastructure and accruing significant long-term debt early in their life-cycle. The traditional measurement of cash flow, a measure of operating profit, has evolved into EBITDA, which ignores the expenses of interest, taxes, depreciation and amortization, whereas the standard valuation model, net income, includes them. In the past year, free cash flow (FCF) has largely replaced EBITDA as a critical valuation metric of choice among industry analysts. Although a standardized definition of FCF does not exist, FCF essentially takes into account the periodic interest that must be paid on debt. Some analysts more recently have suggested that the cable industry should be valued on the traditional net income model, and not cash flow or its various proxies (EBITDA or FCF) because the industry has now reached a stage of maturation that would justify use of more traditional valuation metrics. *See 2003 Report*, 19 FCC Rcd at 1627 ¶ 28 and n.72.

[84] Kagan reports that it was high-speed data service that drove operating cash flow growth in 2004. Cable Databook at 7. *See also* Kagan Research, LLC, *HSD – Cable's Growth Driver*, Cable TV Investor: Deals and Finance (Cable TV Investor), Apr. 26, 2005, at 8.

Table 4: Cable Industry Revenue and Cash Flow: 2003 – 2005[85]

	2003	2004	03-04	2005	04-05
	Total	Total	% Change	Est. Total	% Change
Basic Subscribers (mil.)	66.0	65.4	-0.9%	65.4	0.0%
Revenue Segments (mil.)					
Basic Service and CPST Tiers	$29,000	$30,080	3.7%	$31,125	3.5%
Premium (Pay) Tiers	$5,891	$6,255	6.2%	$6,412	2.5%
VOD/Pay-Per-View[86]	$976	$1,279	31.0%	$1,527	19.4%
Local Advertising	$3,143	$3,527	12.2%	$3,950	12.0%
Home Shopping	$307	$329	7.2%	$358	8.8%
Total Digital Tier	$3,396	$3,966	16.8%	$4,526	14.1%
High-speed Internet	$6,772	$8,943	32.1%	$11,172	24.9%
DVR Service	$36	$150	316.7%	$405	170.0%
Circuit Switch and VoIP	$1,511	$1,660	9.9%	$2,240	34.9%
Installation/Miscellaneous[87]	$1,421	$1,285	-9.6%	$1,370	6.6%
Business Services	$1,911	$2,551	33.5%	$3,411	33.7%
Total Revenue (mil.)	**$54,364**	**$60,025**	**10.4%**	**$66,496**	**10.8%**
Revenue Per Subscriber	$823.70	$917.81	11.4%	$1016.76	10.8%
Operating Cash Flow (mil.)	**$20,875**	**$23,410**	**12.1%**	**$25,933**	**10.8%**
Cash Flow per Subscriber	$316.29	$357.95	13.2%	$396.53	10.8%
Cash Flow/Total Revenue	**38.4%**	**39.0%**	**1.6%**	**39.0%**	**0.0%**

44. ***Programming Costs***. Cable operators' combined program expenditures reached $12.68 billion in 2004 compared to $11.46 billion in 2003.[88] This represents expenditures for existing nonbroadcast networks and expenditures for new nonbroadcast networks.[89] In addition to expenditures for national nonbroadcast networks, cable companies produced or acquired local and regional programming, including cable news and public affairs networks. Included in the $12.68 billion in

[85] Home shopping, digital video recorder, business revenue, and installation/miscellaneous data for 2003 come from Kagan Research, LLC, Broadband Cable Financial Databook, Aug. 2004, at 8-13. All other data come from the Cable Databook at 8-13 and 150. Historical data included in this table may differ from those previously reported because some data have been updated by Kagan.

[86] Includes VOD, subscription-video-on-demand (SVOD), near-video-on-demand (NVOD), and PPV.

[87] Installation/Miscellaneous revenue includes revenues derived from basic installation and pay installation, high-definition television, interactive games, home networking, and equipment charges. We note that there is often no additional cost for the standard-definition version of HDTV channels. In many cases, MSOs charge for HDTV channels that are not offered in a standard-definition version. Some MSOs do not charge higher prices for an HD set-top box, but most apply a professional installation fee. *See* Time Warner Cable, at http//ww.timewarnercable.com/ corporate/products/digitalcable/hdtv.html (visited Oct. 7, 2005); Cablevision Systems Corp., at http://www.io.tv/ index.jhtml?pageType=hdtv (visited Oct. 7, 2005); Comcast Corp., at http://comcast.p.delivery.net/m/p/com/ mic/HD_Index.asp (visited Oct. 7, 2005); Charter Communications, at http://www.charter.com/products/hdtv/ hdtv.aspx (visited Oct. 7, 2005).

[88] NCTA Comments at 40. NCTA's calculation of programming expenditures includes license fees, copyright fees, and investments in local programming.

[89] In 2005, we have identified 531 nonbroadcast networks. *See* para. 157 *infra*.

program expenditures are copyright fees of $132.4 million in 2004 for broadcast signal carriage pursuant to Section 111 of the Copyright Act.[90]

45. ***Cable System Transactions***. The aggregate value of cable systems sold in any year depends on the number of transactions, the size of the cable systems involved, and the price paid. As shown in Table 5 below, there were 21 cable transactions in 2004, covering more than 2.7 million basic subscribers and representing an aggregate value of $10.6 billion.[91] The acquisition of Cox Communications by Cox Enterprise Inc. for $9.0 billion ($3,846 per subscriber) accounted for most of the dollar value.[92] Most of the transactions, however, involved small rural cable systems with an average value of $1,730 per subscriber.[93] The average value per subscriber for the 21 systems sold in 2004 was $3,906.[94] In the first six months of 2005, there were nine proposed, but not necessarily completed, cable system transactions, representing an aggregate value of $38.4 billion. Transactions during the first six months of 2005 included the proposed acquisition of Adelphia by Comcast and Time Warner for approximately $17.7 billion ($3,690 per subscriber), and the Dolan family group's proposed and recently rescinded acquisition of Cablevision for approximately $13 billion ($4,377 per subscriber).[95] In another transaction involving the privatization of a major cable system, Insight Communications recently reached agreement to sell its cable systems to Insight Acquisition Corp.[96]

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[90] Copyright Act, 17 U.S.C. § 111 *et seq.* Copyright Office, Library of Congress, *Licensing Division Report of Receipts*, Sept. 13, 2005. Copyright fees are due on a specific date, but are collected on a rolling basis.

[91] Cable Databook at 171.

[92] Cox Enterprise Inc. acquired the 38 percent of Cox Communications it did not already own. *Id.*

[93] Cable TV Investor, Jan. 31, 2005, at 8.

[94] Cable Databook at 171. Analysis of transactions over the past six years shows that smaller systems sold for an average of $1,731 per subscriber and larger systems sold for an average of $4,445 per subscriber. *Id.*

[95] *Adelphia Deal: More Efficient Industry, Attractive Price*, Cable TV Investor, Apr. 26, 2005, at 1-3; *Dolans Bid To Take Cablevision Private for $4,377/Sub,* Cable TV Investor, June 30, 2005, at 8. Adelphia reached agreements for Time Warner and Comcast to acquire substantially all of the assets of Adelphia for $12.7 billion in cash and 16 percent of Time Warner Cable's common equity. The applications of Adelphia, Comcast, and Time Warner to transfer control of and/or assign Adelphia's Commission licenses are pending before the Commission. *Applications for Consent to the Assignment and/or Transfer of Control of Licenses, Adelphia Communications Corporation, Assignors, to Time Warner Cable Inc., Assignees; Adelphia Communications Corporation, Assignors and Transferors, to Comcast Corporation, Assignees and Transferees; Comcast Corporation, Transferor, to Time Warner Inc., Transferee; Time Warner Inc., Transferor, to Comcast Corporation, Transferee, Applications and Public Interest Statement*, MB Docket No. 05-192 (filed May 18, 2005). *See also* Adelphia Communications Corp., *Adelphia Communications to be Acquired by Time Warner and Comcast* (press release), Apr. 21. 2005. Cablevision Systems Corp., *Response from Cablevision Systems Corporation Regarding Proposal by the Dolan Family Group* (press release), June 22, 2005. On Oct. 25, 2005, the Dolan Family Group withdrew their June 19, 2005, proposal to acquire the cable and telecommunications businesses of Cablevision because they were unable to reach agreement with Cablevision on the terms of their proposal. Dolan Family Group, *Dolan Family Group Withdraws Cablevision Going Private Proposal and Recommends That the Board of Directors Consider a Special Pro Rata Dividend of $3 Billion* (press release), Oct. 25, 2005, at http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=109&STORY=/www/story/10-25-2005/0004193917&EDATE= (visited Nov. 15, 2005). *See also* Cablevision Systems Corp., *Cablevision Statement on Dolan Family Group Proposal* (press release), Oct. 25, 2005, at http://www.cablevision.com/index.jhtml?page Type=financial_news (visited Nov. 15, 2005).

[96] Insight Communications Co., Inc., *Insight Communications and Insight Acquisition Corp. Enter into Definitive Merger Agreement* (press release), July 29, 2005.

TABLE 5: System Transactions: 2002 - June 2005[97]

	2002	2003	2004	Jan-June 2005
Number of Systems Sold	24	34	21	9
Total Number of Subscribers Sold	607,446	650,759	2,701,552	10,143,967
Average Number of Subscribers per System Sold	25,310	19,140	128,645	1,127,107
Total Number of Homes Passed Sold	1,163,765	1,132,772	4,626,831	19,156,872
Average Number of Homes Passed per System Sold	48,490	33,317	220,325	2,128,541
Total Dollar Value (mil.)	$1,381	$1,495	$10,554	$38,398
Average Value (mil.) of System Sold	$57.5	$44.0	$502.6	$4,266
National Average Dollar Value Per Subscriber	$2,273	$2,297	$3,906	$3,785
Dollar Value Per Home Passed	$1,186	$1,319	$2,281	$2,004
Cash Flow Multiple	11.2	9.5	9.4	11.0

46. ***Stock Prices***. Cable stock prices, as measured by the Kagan Cable MSO Average,[98] gained 28.8 percent from June 2004 to June 2005, while the S&P 500 gained 5.8 percent, and the NASDAQ gained 1.7 percent.[99] At the end of June 2005, cable stocks were trading at 8.5 times cash flow, which was unchanged from the historic low of 8.5 times cash flow reported at the end of June 2004.[100] One analyst reported that cable stocks have not risen because cable investors are concerned about the entry of telephone companies into the video delivery market and price reductions by telephone companies for their high-speed Internet service.[101]

2. Capital Acquisition and Disposition

47. ***Industry Financing***. Table 6 shows the amount of financing raised per year by source. In past years, much of the money raised by cable operators was for upgrading and rebuilding cable systems. With the upgrading and rebuilding nearing completion, the majority of money raised in 2004 was for refinancing.[102] Kagan reports that only small rural cable companies are still borrowing for upgrading and rebuilding their systems.[103] In 2004, cable companies reduced public debt by $4.9 billion.

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[97] Data for 2004 come from *Cable System Sales Summary (Annually Through December)*, Cable TV Investor, Jan. 31, 2005, at 9. Data for January to June 2005 come from *Cable System Sales Summary*, Cable TV Investor, July 29, 2005, at 15. The numbers for January to June 2005 include all announced and proposed deals. Historical data included in this table may differ from those previously reported because some data have been updated by Kagan. *See* Cable Databook.

[98] The Kagan Cable MSO Average includes the following companies (stock symbol): Adelphia (ADELQ), Rogers B (US$) (RG), Charter (CHTR), Cable & Wireless (CWP), Alaska Comm. Sys. (ALSK), Washington Post (WPO), General Comm. (GNCMA), Mediacom (MCCC), Time Warner (TWX), Liberty Media A (L), NTL (NTLI), Comcast (CMCSA), Comcast Special A (CMCSK), Pegasus (PGTV), Telewest (TLWT), Insight (ICCI), Cablevision (CVC), and Liberty Media B (LMCB).

[99] Cable TV Investor, July 29, 2004, at 23; Cable TV Investor, July 29, 2005, at 19, 23.

[100] Cable *MSOs: Private Market Valuations*, Cable TV Investor, June 30, 2005, at 12; *Kagan Multichannel Projections: There's Life After DBS and Telco Competition*, Cable TV Investor, July 29, 2004, at 1.

[101] *How Important are Telco Franchising Gains?*, Cable TV Investor, July 29, 2005, at 1-2.

[102] Cable Databook at 149.

[103] *Id.*

Some companies began repurchasing stock.[104] As a result, Kagan reports that net equity raised by the cable industry was negative for the first time since it began tracking cable financings in 1982.[105]

TABLE 6: Acquisition of Capital: 1999 - June 2005 ($ in millions)[106]

	Private Debt		Net New Public Debt		Private Equity (Pvt. Placement/VC)		Public Equity (Common/Preferred)		
Year	Amount Raised	% of Total Raised in Year	Amount Raised	% of Total Raised in Year	Amount Raised	% of Total Raised in Year	Amount Raised	% of Total Raised In Year	Total Capital Raised In Year
1999	$34,358	51.9%	$18,610	28.1%	$5,385	8.1%	$7,799	11.8%	$66,152
2000	$7,255	60.3%	$4,288	35.7%	$101	0.8%	$380	3.2%	$12,024
2001	$6,668	31.4%	$10,678	50.2%	$623	2.9%	$3,282	15.4%	$21,251
2002	$2,544	25.2%	$3,942	39.0%	$15	0.1%	$3,608	35.7%	$10,109
2003	$1,791	66.5%	$734	27.2%	$116	4.3%	$54	2.0%	$2,695
2004	$12,674	159.7%	-$4,863	-61.3%	$125	1.6%	$0	0%	$7,936
Jan-June 2005	$270	28.7%	$663	70.4%	$9	0.9%	$0	0%	$942

48. ***Capital Expenditures/Capital Investment.*** Over the last decade, cable companies have invested heavily to rebuild and upgrade cable systems.[107] NCTA states that cable operators have invested almost $100 billion since 1996 to replace coaxial cable with fiber optic technology and install new digital equipment in homes and system headends.[108] These investments have enabled cable operators to offer more channels of basic and digital cable services, premium movie services, pay-per-view service, high-definition service, high-speed Internet access services, CD-quality music, cable telephony, and more personalized programming options. According to NCTA, the cable industry's investment in broadband two-way networks makes available a number of advanced services on virtually every cable system today.[109] Kagan reports that at year-end 2004, 96 percent of all cable homes passed were offered digital video services and 93 percent were offered high-speed Internet access services.[110] Total capital

[104] For example, Comcast completed a $1.3 billion stock repurchase. Comcast Corp., *Comcast Reports Fourth Quarter and Year End 2004 Results* (press release), Feb. 3, 2005.

[105] Cable Databook at 149. Kagan reports that no money was raised through public equity, $125 million was raised through private equity, and approximately $1.315 billion was spent by cable companies to buy back stock shares. Thus, net equity declined approximately $1.190 billion. *Id.* at 154.

[106] Data for 2004 come from Cable Databook at 154. Data for January 2005 to June 2005 come from Cable TV Investor, July 29, 2005, at 13. Historical data included in this table may differ from those previously reported because some data have been updated by Kagan. *See* Cable Databook at 154.

[107] Rebuilds are significant improvements made to existing systems that do not retain much of the old system plant and equipment. Upgrades are improvements to existing cable systems that do not require the replacement of the entire existing plant and equipment.

[108] NCTA Comments at 25. Kagan estimates annual cable infrastructure expenditures from 1996 to 2005 that total approximately $104.2 billion. *See* Cable Databook at 150.

[109] NCTA Comments at 25.

[110] *Advanced Services Spread Across Cable Systems,* Cable TV Investor, Apr. 26, 2005, at 5.

expenditures were $10.1 billion in 2004, and Kagan projects that they will increase to $10.3 billion in 2005.[111]

49. With the rebuilding and upgrading of cable systems nearing completion, cable operators are reducing capital expenditures on system upgrades. At the same time, however, as shown in Table 7, they are increasing capital expenditures on customer premises equipment upgrades.

Table 7: Capital Expenditures by Major MSOs (millions)

Operator	*2004*			*2005*		
	Total	***Plant Upgrades***	***Customer Premises Equipment***	**Total Jan. - June**	***Plant Upgrades***	***Customer Premises Equipment***
Comcast[112]	$3,600	$902	$1,500	$1,800	$167	$932
Time Warner[113]	$1,700	$139	$719	$899	$69	$431
Cox[114]	$1,400	$87	$528	$661	**NA**	**NA**
Charter[115]	$924	$49	$451	$542	$22	$228
Cablevision[116]	$574	$12	$429	$316	$3	$227

3. Advanced and Other Services

50. In addition to traditional analog video services, most cable operators offer subscribers advanced video services, including digital video, video-on-demand, digital video recorders, and high-definition television; and nonvideo advanced services, including high-speed Internet access and telephony (circuit-switched telephony and/or voice over Internet protocol telephony).[117] Mid-sized and smaller

[111] Cable Databook at 150. *But see* NCTA projection that total capital expenditures will decrease from $10.1 billion in 2004 to $9.6 billion in 2005. NCTA, *Industry Statistics*, Cable Developments 2005, at 10.

[112] Comcast Corp., *Comcast Reports Fourth Quarter and Year End 2004 Results* (press release), Feb. 3, 2005; Comcast Corp., *Comcast Reports Second Quarter 2005 Results* (press release), Aug. 2, 2005.

[113] Time Warner Inc., *Time Warner Reports Results for 2004 Full Year and Fourth Quarter* (press release), Feb. 4, 2005; Time Warner Inc., *SEC Form 10-Q Quarterly Report for the Period Ending June 30, 2005*, at 31.

[114] Cox Communications Inc., *Cox Communications Announces Fourth Quarter and Full-Year Financial Results for 2004* (press release), Mar. 16, 2005; Cox Communications Inc., *Cox Communications Announces Second Quarter and Year-to-Date Financial Results for 2005* (press release), Aug. 9, 2005. For second quarter 2005 results, Cox did not report capital expenditures devoted to plant upgrades and CPE.

[115] Charter Communications Inc., *Charter Reports Fourth Quarter and Annual 2004 Financial and Operating Results* (press release), Mar. 1, 2005; Charter Communications Inc., *Charter Communications Reports Second Quarter 2005 Financial and Operating Results* (press release), Aug. 2, 2005.

[116] Cablevision Systems Corp., *Cablevision Systems Corporation Reports Fourth Quarter and Full Year 2004 Results* (press release), Feb. 23, 2005; Cablevision Systems Corp., *Cablevision Systems Corporation Reports Second Quarter 2005 Results* (press release), Aug. 9, 2005.

[117] Subscription data for advanced services shown in this *Report* are primarily for residential service, but also may include some small business service. For example, Comcast offers a business Internet service for teleworkers called Comcast Teleworker, and a business Internet service for small to medium-sized businesses called Comcast Workplace. Similarly, Time Warner also offers a business Internet service called Road Runner Business Class to small and medium-sized businesses, home offices, and telecommuters. Subscribers to these services are included in the reported numbers. Cable companies also sold $2.6 billion in services to business in 2004 under separately run subsidiaries. For example, Cox Business Services offers high-speed Internet access, local and long distance telephone, advanced voice and data transport to businesses of all sizes; and Charter Business offers high-speed (continued....)

cable operators also are deploying advanced services. Our review of six mid-sized and smaller cable operators shows that all offer digital cable service and high-speed Internet service and many offer video-on-demand, digital video recorders, high-definition television, and telephone service.

51. ***Digital Video Services***. Most cable operators offer digitally compressed video channels to cable subscribers. Digital cable subscribers typically rent a digital set-top box from the cable company and receive some free digital video service. Digital cable subscribers obtain video programming by purchasing one or more digital service tiers. Digital tiers provide a variety of programming similar to basic tiers or theme tiers, such as a movie tier, a sports tier, and a non-English-language tier. Digital cable subscribers may also purchase one or more premium digital tiers, such as HBO, Showtime, Cinemax, The Movie Channel, Starz!, and international programming.[118] A high-definition service tier also is available to many digital cable subscribers.[119] In addition, cable operators are offering interactive digital services to digital cable subscribers, such as digital video recorders and video-on-demand.[120] All of these digital services are available to subscribers with analog televisions that use a digital set-top box that converts digital signals to analog.[121] Data from the Form 325 for 2004 indicates that nearly 94 percent of homes passed have access to digital video and 84 percent of systems have digital video capability.[122] Approximately 96 percent of all cable homes passed had access to digital video services at the end of 2004 according to Kagan.[123] There were 25.4 million digital cable subscribers at the end of 2004, compared to 22.5 million at the end of 2003, a 12.9 percent increase.[124] At the end of June 2005, the number of digital cable subscribers rose to 26.3 million and the number was projected to increase to 28.2 million by the end of 2005.[125]

(Continued from previous page) ———————————
Internet access services and video services to small and large businesses. Small operators also offer advanced services to business customers. Bresnan, for example, provides high-speed Internet access, voice and data transport and video to large and small businesses under its Bresnan Business Services subsidiary; Susquehanna Communications offers businesses advanced communications services, including local and long distance telephone services, high-speed Internet access, and data transport and video; and Sunflower Broadband offers Sunflower Broadband Business Services providing high-speed Internet, telephone service, and professional IT support. Cable Databook at 13; Comcast Corp., at http://work.comcast.net/ (visited Sept. 26, 2005); Time Warner, Inc., at http://www.timewarnercable.com/ corporate/products/highspeedinternet/default.html (visited Sept. 26, 2005); Cox Communications, Inc., at http://www.coxbusiness.com/index.html (visited Sept. 26, 2005); Charter Business, at http://www.charter-business.com (visited Sept. 26, 2005); Bresnan Communications, at http://www.bresnan.com/ unst/products/business (visited Sept. 26, 2005); Susquehanna Communications, at http://www.suscom.com/ home/business.php (visited Sept. 26, 2005); Sunflower Broadband, at http://www.sunflowerbroadband.com/business (visited Sept. 26, 2005).

[118] To receive a digital premium channel, a subscriber must subscribe to the premium channel. For example, to receive digital HBO, a subscriber must subscribe to HBO.

[119] The high-definition service tier requires a high-definition set-top box or CableCARD. Most high-definition programming is available at no additional charge. For example, the high-definition service from the broadcast networks is often available at no additional charge. In addition, high-definition service from a premium channel often is included with a subscription to the premium channel. Other high-definition programming may require additional fees.

[120] The digital video recorder service offered by cable operators requires a DVR set-top box.

[121] NCTA Comments at 26-27.

[122] 2004 FCC Form 325 data.

[123] *Advanced Services Spread Across Cable Systems*, Cable TV Investor, Apr. 26, 2005, at 5.

[124] Cable Databook at 11; Kagan Research, LLC, Broadband Cable Financial Databook, Aug. 2004, at 11.

[125] *See* NCTA, at http://www.ncta.com/Docs/PageContent.cfm?pageID=91 (visited Oct. 20, 2005); *Broadband Evolution 2004-2015*, Cable TV Investor, June 30, 2005, at 2.

52. As shown in Table 8 below, as of June 2005, the top cable operators' digital subscriber counts equal 41% to 58% of their total basic cable subscribers.

Table 8: Digital Cable Subscribers for Top MSOs (in millions)

Operator	2004		2005	
	Digital Subscribers	% Basic Cable Subs	Digital Subscribers	% Basic Cable Subs
Comcast[126]	8.6	40%	9.1	43%
Time Warner[127]	4.8	44%	5.1	46%
Cablevision[128]	1.5	50%	1.7	58%
Cox[129]	2.4	38%	2.6	41%
Charter[130]	2.7	45%	2.7	45%

53. NCTA reports that, in January 2005, cable operators were carrying the digital broadcast signals – including high-definition and multicast signals – of 504 unique broadcast television stations.[131] In January 2005, NCTA reached an agreement with the Association of Public Television Stations to ensure that the digital service – including multicast channels – offered by local public television stations would be available to most cable subscribers.[132] Comcast has agreements to carry local multicast digital signals with over 200 commercial broadcast stations in 72 DMAs.[133] In addition, Comcast has agreed to carry the multicast digital signals of noncommercial broadcasters and expected to be carrying the digital signals of 58 noncommercial broadcast stations in 62 markets in the fall of 2005.[134]

54. In 2003, the Commission adopted rules based on an agreement between consumer electronics companies and cable operators that enable television sets to be built with "plug-and-play" functionality for one-way digital cable services, which include typical cable video services and premium channels such as HBO and Showtime.[135] For these services, consumers are able to plug their cable

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[126] Comcast Corp., *Comcast Reports Second Quarter 2005 Results* (press release), Aug. 2, 2005; Comcast Corp., *Comcast Reports Fourth Quarter and Year End 2004 Results* (press release), Feb. 3, 2005.

[127] Time Warner Inc., *Time Warner Inc. Reports Second Quarter 2005 Results* (press release), Aug. 3, 2005; Time Warner Inc., *Time Warner Reports Results for 2004 Full Year and Fourth Quarter* (press release), Feb. 4, 2005.

[128] Cablevision Systems Corp., *Cablevision Systems Corporation Reports Second Quarter 2005 Results* (press release), Aug. 9, 2005; Cablevision Systems Corp., *Cablevision Systems Corporation Reports Fourth Quarter and Full Year 2004 Results* (press release), Feb. 23, 2005.

[129] Cox Communications Inc., *Cox Communications Announces Fourth Quarter and Full-Year Financial Results for 2004* (press release), Mar. 16, 2005; Cox Communications Inc., *Cox Communications Announces Second Quarter and Year-to-Date Financial Results for 2005* (press release), Aug. 9, 2005.

[130] Charter Communications Inc., *Charter Reports Second Quarter 2005 Financial and Operating Results* (press release), Aug. 1, 2005; Charter Communications Inc., *Charter Reports Fourth Quarter and Annual 2004 Financial and Operating Results* (press release), Mar. 1, 2005.

[131] NCTA Comments at 26-28.

[132] NCTA Comments at 28; APTS Comments at 2. *See also* NCTA, *Public Television and Cable Announce Major Digital Carriage Agreement* (press release), Jan. 31, 2005.

[133] Comcast Comments at 45.

[134] *Id.*

[135] *Implementation of Section 304 of the Telecommunications Act of 1996, Commercial Availability of Navigation Devices, Compatibility between Cable Systems and Consumer Electronics Equipment*, 18 FCC Rcd 20885 (2003).

directly into their digital television set without the need for a set-top box. Consumers, however, must obtain a security card (often called a CableCARD), from their local cable operator, to be inserted into the television set. Approximately 90,000 one-way CableCARDs have been deployed.[136]

55. Consumers still need a set-top box to receive two-way services (*e.g.*, video-on-demand), and the cable and consumer electronics industries continue to work on an agreement for two-way "plug-and-play" functionality.[137] Samsung Electronics recently achieved CableLabs Certified status for an OpenCable Application Platform (OCAP) enabled interactive digital television set that can connect directly to the cable system, and receive current advanced and premium cable services.[138] The television set is currently in trials with Time Warner in North Carolina.[139] Consumer electronics manufacturers are selling digital cable-ready television sets with over-the-air integrated DTV tuners as well as cable tuners.[140] Industry sources indicate that two-way digital devices will soon be available in retail stores.[141]

56. ***Video-on-Demand (VOD)***. VOD allows subscribers to order video programs from a central server at any time of day, and to fast-forward, rewind, and pause the programs.[142] In most cases, subscribers receive unlimited viewing of a VOD program for 24 hours. Some cable operators also offer subscription video-on-demand (SVOD) where subscribers pay a monthly fee for unlimited access to a library of pre-selected programs. Other cable operators offer near video-on-demand (NVOD) which typically features a schedule of popular movies and events offered on a staggered-start basis (*e.g.*, every 15 to 30 minutes). Cable companies view VOD as a competitive service to DVD/VHS rentals and a means to help reduce subscriber churn. At year-end 2004, VOD service was available to 73 percent of

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[136] NCTA reports that 90,000 CableCARDs have been deployed by the 10 largest cable operators. *See* Letter from Neal M. Goldberg, General Counsel, NCTA, to Marlene H. Dortch, Secretary, FCC, CS Docket No. 97-80 (Dec. 29, 2005), at 1.

[137] *See* para. 211 *infra*. For a description of the progress of negotiations between the consumer electronics and cable industries, *see* Consumer Electronics Association, Joint Status Report of the Consumer Electronics Association and the National Cable & Telecommunications Association, Oct. 14, 2005, at http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6518169296 (visited Oct. 21, 2005). *See also* Paul Gluckman, *Talks Progress on 2-Way Plug & Play, But Much Remains Undone, Report Says*, COMMUNICATIONS DAILY, Oct. 17, 2005.

[138] CableLabs, *Samsung Electronics Gains CableLabs Certification on 2-Way Digital Television* (press release), Aug. 23, 2005.

[139] Samsung, *Samsung and Time Warner Cable Depoly World's First Interactive OCAP TV* (press release), Jan. 11, 2006.

[140] CEA Comments at 5. With most cable systems, use of the digital cable-ready television set requires that cable subscribers obtain a CableCARD containing security and other circuitry for particular local cable systems. The CableCARD is a removable security module which, when inserted into an OpenCable certified device, enables delivery of digital cable service and other services. CableCARDs are provided directly by the cable operator to customers who request them. CableLabs, at http://www.cablelabs.com/news/glossary.html#C (visited Sept 27, 2005). *See* para. 211 *infra*.

[141] *See* Ed Bott, *More Two-Way CableCARD Products*, ED BOTT'S MEDIA CENTRAL, Sept. 29, 2005, at http://www.edbott.com/mediacenter/archives/more-two-way-cablecard-products (visited Oct. 8, 2005). *See also* Greg Tar, *Samsung Readies Two-Way Cable Products*, TWICE, Aug. 22, 2005, at http://www.twice.com/article/CA6250081.html?verticalid=820&industry=Video&industryid=23099&pubdate=08/22/2005 (visited Oct. 8, 2005).

[142] VOD differs from PPV. PPV is a pay television service for which cable subscribers pay a one time fee for each program viewed. The programs are generally available at pre-set times and in some cases are time shifted across several channels to increase the opportunity for viewing. Once initiated, the program cannot be paused, rewound or fast-forwarded.

homes passed by cable systems.[143] At year-end 2004, there were 19.5 million VOD-enabled digital capable households and this is projected to grow to 23.9 million by the end of 2005.[144]

57. Comcast's VOD service, which is available to 87 percent of Comcast subscribers, allows digital cable subscribers to choose from a menu of more than 3,500 programs, at any given time, with most of these programs available free.[145] Comcast says its VOD service is growing rapidly, and it expected subscribers to order 1.5 billion VOD programs in 2005.[146] Comcast's VOD content includes the recently launched PBS Kids Sprout on Demand, independent films, multicultural programs, movies, and newscasts from local broadcast stations.[147] Comcast's "Select on Demand" service provides 15 VOD channels, each a collection of original programming organized by particular themes.[148] By the end of March 2005, Cox's VOD service had been deployed in eight markets and was available to about half of Cox's digital subscribers.[149] Cox's VOD service provides access to 600 hours of content, including 100 hours of free programming.[150] Time Warner's VOD service is available in all of its 31 cable operating divisions.[151] With Time Warner's Premiums on Demand VOD service, digital cable subscribers who also subscribe to a premium channel (*i.e.*, HBO, Showtime, Cinemax, or the Movie Channel) receive unlimited access to movies offered on the premium movie channels for a monthly fee.[152] With Time Warner's Movies on Demand VOD service, digital cable subscribers may access hundreds of movies for a rental fee.[153] Cablevision's VOD service provides over 200 hours of free programming and subscriptions to HBO on Demand, Cinemax on Demand, Anime Network on Demand, Showtime on Demand, Disney Channel on Demand, Playboy TV on Demand, and IFC Uncensored on Demand, which offers independent films and original series.[154] Charter's VOD service offers thousands of movies including those available through premium channels like HBO On Demand and Showtime on Demand.[155]

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[143] *Advanced Services Spread Across Cable Systems*, Cable TV Investor, Apr. 26, 2005, at 5.

[144] Cable Databook at 12.

[145] Comcast Comments at 48. For an overview of Comcast's VOD service, *see* http://www.comcast.com/Benefits/CableDetails/ Slot5PageOne.asp (visited Sept. 27, 2005). *See also* Comcast Corp., at http://www.cmcsk.com/phoenix.zhtml?c=147565&p=irol-digital (visited Sept. 29, 2005).

[146] Jonathan Make, *Comcast Customers Will Use Its VOD Service 50% More Times by Year-End*, COMMUNICATIONS DAILY, Sept. 20, 2005.

[147] Comcast Comments at 48-49.

[148] For example, Select On Demand's "Wheels and Wings" channel focuses on content for car enthusiasts, while "Anime Selects" offers an array of animation programs. Comcast Comments at 51.

[149] The eight markets are: San Diego, California; Oklahoma City, Oklahoma; Hampton Roads, Virginia; Las Vegas, Nevada; New Orleans, Louisiana; Omaha, Nebraska; New England (markets in Connecticut and Rhode Island); and Orange County, California. Cable TV Investor, July 29, 2005, at 3.

[150] *Id.* For an overview of Cox VOD service, *see* http://www.cox.com/DigitalCable/ondemand (visited Sept. 27, 2005).

[151] Each of Time Warner's cable operating divisions is a cluster of cable franchises.

[152] For an overview of Time Warner's Premiums on Demand VOD service, *see* http://www. timewarnercable.com/corporate/products/digitalcable/premiumsondemand.html (visited Sept. 27, 2005).

[153] For an overview of Time Warner's Movies on Demand VOD service, *see* http://www.timewarnercable.com/corporate/ products/digitalcable/moviesondemand.html (visited Sept. 27, 2005).

[154] For an overview of Cablevision's VOD service, *see* http://www.io.tv/index.jhtml?pageType= on_demand (visited Sept. 27, 2005).

[155] For an overview of Charter's VOD service, *see* http://www.charter.com/services/ondemand/ ondemand.aspx (visited Sept. 27, 2005).

58. ***Digital Video Recorders (DVRs)***. DVR service allows subscribers to record programs onto a hard drive located in a set-top box, which can then be played back at any time. DVR features include fast-forward, rewind, and the ability to pause live television. While early units were marketed independently, cable and satellite operators are integrating DVR functionality into their digital set-top boxes.[156] At the end of 2004, DVR service was available to 79 percent of the homes passed by cable systems and there were 1.8 million subscribers equipped with integrated DVRs.[157] Many cable and satellite operators use dual-tuner DVRs which enable subscribers to record one or more programs while watching another program.

59. Comcast's dual-tuner DVR service is available in all Comcast's markets and can be purchased by digital cable subscribers for an additional $9.95 per month.[158] More than 575,000 households subscribe to Comcast's DVR service.[159] In March 2005, Comcast and TiVo announced a partnership to offer TiVo-based DVR service to Comcast subscribers.[160] DIRECTV, however, recently began to transition from TiVo's DVR hardware toward an in-house DVR product.[161] Cox's DVR service is available in Cox's upgraded service areas and costs $9.99 per month.[162] In Northern Virginia, Cox is testing and planning to offer multi-room DVR service in 2006 that delivers DVR service to several televisions in a household with a single DVR set-top box.[163] At the end of June 2005, the number of subscribers to Time Warner's DVR service had grown to 1.1 million from 862,000 at the end of 2004, representing 22 percent of the company's digital cable subscribers.[164] Time Warner's DVR service is available to digital cable subscribers for $9.95 per month. Cablevision's DVR service is also available to digital cable subscribers for $9.95 per month. Charter dual-tuner DVR service is available in limited Charter service areas for $9.99 per month.[165]

60. ***High-Definition Television (HDTV)***. HDTV features dramatically improved, highly detailed picture quality, improved audio quality, and a wide-screen display.[166] For subscribers to receive the high-definition service tier, most cable companies require subscription to the digital service and use of a high-definition set-top box.[167] To obtain the full visual effect of HDTV, a cable subscriber also needs

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[156] At the end of June 2005, there were approximately 8.3 million subscribers to DVR services in the U.S. *See* Nick Wingfield, *TiVo Slashes Recorder Price in Half, $50*, WALL STREET JOURNAL, Sept. 7, 2005, at D1. TiVo, the leading seller of DVRs, has almost 3.6 million subscribers, although its lead is vanishing as cable and satellite operators are offering their own DVRs to subscribers. *Id. See also* Joe Mandese, *DVR Threat Gets Downgraded*, BROADCASTING & CABLE, Sept. 12, 2005, at 20.

[157] *Advanced Services Spread Across Cable Systems*, Cable TV Investor, Apr. 26, 2005, at 5.

[158] Comcast Corp., at http://www.cmcsk.com/phoenix.zhtml?c=147565&p=irol-digital (visited Sept. 29, 2005).

[159] Comcast Comments at 52.

[160] Comcast Corp., *Comcast and TiVo Announce Strategic Partnership* (press release), Mar. 15, 2005.

[161] Jane L. Levere, *In a Challenge to TiVo, DirecTV Promotes Its Own Box*, NEW YORK TIMES, Oct. 7, 2005, at http://www.nytimes.com/2005/10/07/business/07adco.html (visited Oct. 27, 2005).

[162] *See* Cox Communications, at http://www.cox.com/Fairfax/Digitalcable/dvrfaqs.asp (visited Oct. 4, 2005).

[163] *Cox Turns Attention to Advanced Video Services*, Cable TV Investor, July 29, 2005, at 3.

[164] Time Warner Inc., *Time Warner Inc. Reports Second Quarter 2005 Results* (press release), Aug. 3, 2005; Time Warner Inc., *Time Warner Reports Results for 2004 Full Year and Fourth Quarter* (press release), Feb. 4, 2005.

[165] *See* Charter Communications, at http://www.charter.com/services/dvr/dvr.aspx (visited Oct. 4, 2005).

[166] HDTV service typically includes a mix of broadcast, basic cable, and premium nonbroadcast networks.

[167] *See* Comcast, at http://comcast.p.delivery.net/m/p/com/mic/HD_Index.asp (visited Oct. 20, 2005); Cox, at http://.cox.com/Fairfax/digitalcable/hdtvrates.asp (visited Oct. 7, 2005); Time Warner, at http://timewarnercable.com/corporate/products/digitalcable/hdtv.html (visited Sept. 30, 2005); Cablevision, at (continued....)

an HDTV set. HDTV service from networks that have standard-definition or analog counterparts, including ABC, NBC, CBS, FOX, PBS, WB, UPN, and TNT, is often offered at no additional charge to HDTV subscribers. HDTV service from premium channels, including HBO and Showtime, is usually offered at no additional charge over the cost of subscriptions to those networks. Other programming, including programming offered only in HDTV, may be offered at an additional monthly fee. At the end of 2004, HDTV service was available to 87 percent of homes passed by cable service (approximately 92 million households).[168] Approximately 2.3 million cable subscribers were equipped with HDTV set-top boxes.[169] A total of 184 (out of 210) DMAs, including all of the top 100 DMAs, were served by at least one cable system offering HDTV service.[170] Twenty-three nonbroadcast networks offer HDTV service.[171]

61. Comcast's HDTV service is available in 72 markets, representing 94 percent of the homes passed by Comcast's cable systems.[172] Subscribers with a digital set-top box can upgrade to an HDTV set-top box for an additional $5 monthly fee.[173] Comcast offers its HDTV subscribers high-definition local broadcast signals, including the signals of affiliates of ABC, NBC, CBS, and PBS, and cable networks ESPN HD, INHD and INHD2.[174] At no additional cost, Comcast's premium network subscribers can watch HBO HD, Showtime HD, Starz HD and Cinemax HD.[175] Cox's digital cable subscribers can upgrade to an HDTV set-top box for an additional $6.50 per month.[176] At no additional charge, Cox HDTV service offers high-definition local broadcast signals, including the signals of affiliates of ABC, NBC, CBS, FOX, and PBS, as well as Discovery HD Theater, ESPN HD, INHD1, INHD2, and NBC Universal HDTV.[177] HBO HDTV and Showtime HDTV are included at no additional charge to those with HBO and Showtime subscriptions.[178] Time Warner's digital cable subscribers can upgrade to an HDTV set-top box for no additional charge.[179] Time Warner offers HDTV subscribers

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http://www.io.tv/index.jhtml?pageType=hdtv (visited Oct. 20, 2005); Charter, at http://www.charter.com/products /hdtv/hdtv.aspx (visited Oct. 7, 2005).

[168] *Advanced Services Spread Across Cable Systems*, Cable TV Investor, Apr. 26, 2005, at 5. *See also* NCTA Comments at 26.

[169] *Advanced Services Spread Across Cable Systems*, Cable TV Investor, Apr. 26, 2005, at 5.

[170] NCTA Comments at 26.

[171] *Id.* at 27. These include Cinemax HDTV, Comcast SportsNet HDTV, Discovery HD Theater, ESPN HD, ESPN2 HD, FSN HD, HBO HD, HDNet, HDNet Movies, INHD, INHD2, MSG Networks in HD, NBA TV, NFL Network HD, Outdoor Channel 2 HD, Showtime HD, Spice HD, STARZ! HDTV, The Movie Channel HD, TNT in HD, Universal HD, and YES-HD.

[172] Comcast Comments at 47-48.

[173] *Id.*

[174] *See* Comcast, at http://www.comcast.com/Benefits/CableDetails/Slot4PageOne.asp (visited Oct 6, 2005).

[175] *Id.* Comcast also offers regional sports networks in high-definition, including Comcast SportsNet Philadelphia, Mid-Atlantic, Chicago, and West. In addition, Comcast offers high-definition VOD service. A monthly equipment charge applies for an HDTV-enabled digital cable set-top box. *See* http://www.cmcsk.com/ phoenix.zhtml?c=147565&p=irol-digital (visited Sept. 30, 2005).

[176] Cox subscribers pay $3.50 per month for a digital set-top box and $10 per month for an HDTV set-top box. *See* Cox Communications, at http://www.cox.com/fairfax/rates.asp (visited Oct. 7, 2005).

[177] *See* Cox Communications, at http://www.cox.com/fairfax/digitalcable/hdtvrates.asp (visited Oct. 7, 2005).

[178] *Id.*

[179] *See* Time Warner, at http://www.timewarnercable.com/albany/products/hdtv/default.html (visited Oct. 6, 2005).

high-definition local broadcast signals, including the signals of affiliates of ABC, CBS, NBC, and PBS.[180] Time Warner also offers HDTV service from HBO and Showtime at no extra charge to subscribers of these premium networks.[181] Cablevision's digital cable subscribers may upgrade to an HDTV set-top box at no additional cost over the standard set-top box rental fee.[182] Cablevision's subscribers with HDTV set-top boxes have access to 18 HDTV networks at no additional charge over the standard-definition version of the networks.[183] The networks include local affiliates of ABC, CBS, NBC, PBS, WB, and FOX.[184] Other networks include MSG Network, FSN New York, YES Network, ESPN, Universal HD, HBO, Showtime, Cinemax, Starz, The Movie Channel, and INHD.[185] Charter offers HDTV service in more than 33 markets.[186] Charter's HDTV set-top box costs $3 more a month than its standard digital set-top box.[187] At no additional charge, Charter offers the HDTV service from local affiliates of ABC, CBS, and NBC.[188] Charter also offers HDTV service from Discovery HD, ESPN HD, HDNet, HDNet Movies, HBO HD to HBO subscribers, and Showtime HD to Showtime subscribers.[189]

62. ***High-Speed Internet Access Service.*** FCC Form 325 data from 2004 indicates that more than 93 percent of homes passed have access to high-speed Internet service. Approximately 80 percent of systems offer high-speed Internet service.[190] By the end of June 2005, the number of subscribers to high-speed Internet service offered by cable operators had grown to 23 million households.[191] Residential high-speed Internet access service is a principal driver of cable industry revenue growth, generating $8.9 billion in 2004.[192] It is projected to generate $11.2 billion in 2005.[193] Cable, DSL, wireline, and wireless technologies provided high-speed Internet access service to 35.3 million residential and small business subscribers at the end of 2004.[194] By January 2005, the U.S. had 11.4 broadband connections for every 100 inhabitants.[195] Coaxial cable technology provided 60.3 percent of that total, DSL technology

[180] *See* Time Warner, at http://www.timewarnercable.com/corporate/products/digitalcable/hdtv.html (visited Sept. 30, 2005).

[181] *Id.*

[182] Cablevision Systems Corp., *iO Adds WB11-HD to Industry-Leading High-Definition Line-Up* (press release), July 18, 2005.

[183] *Id.*

[184] *Id.*

[185] *Id.*

[186] *See* Charter Communications, Inc., at http://www.charter.com/products/hdtv/hdtv.aspx (visited Oct. 7, 2005).

[187] *Id.*

[188] *Id.*

[189] *Id.*

[190] 2004 FCC Form 325 data.

[191] NCTA Comments at 31.

[192] *10-Year Projections: Cable's Growth Story Persists*, Cable TV Investor, June 30, 2005, at 2-3. *See also* Table 4 *supra.*

[193] *Id.*

[194] FCC, *High-Speed Services for Internet Access: Status as of December 31, 2004,* July 2005, at Chart 6. This report and previous releases of the *High-Speed Services for Internet Access* report are available at http://www.fcc.gov/wcb/iatd/comp.html (visited Nov. 15, 2005).

[195] *See* Global Broadband Penetration per 100 Inhabitants, International Telecommunications Union, at http://www.itu.int/osg/spu/newslog/ITUs+New+Broadband+Statistics+For+1+January+2005.aspx (visited Oct. 28, 2005).

provided 37.2 percent, and other wireline and wireless technologies provided the remaining 2.5 percent.[196] Cable's share has declined from 63.2 percent at the end of 2003 while DSL's share has increased from 34.3 percent at the end of 2003.[197] High-speed data services using cable modems now enable the delivery of emerging video services, such as Internet video and video-on-demand.[198]

63. Most cable operators provide high-speed Internet service with one proprietary Internet Service Provider (ISP) specifically created and owned by the cable operator.[199] For example, Cablevision offers high-speed Internet service under the brand Optimum Online; Comcast offers the service under the "Comcast High-Speed Internet" brand name; Charter offers the service under the "Charter High-Speed" brand name; and Cox offers the service under the "Cox High Speed Internet" brand name. Some cable operators, however, offer their high-speed Internet service subscribers the ability to use unaffiliated ISPs. For example, Time Warner Cable offers its subscribers multiple ISPs, including its own Road Runner Internet access service with AOL for $49.95, Earthlink for $44.95, and Stic.Net for $44.95.[200]

64. As of June 30, 2005, Comcast's high-speed Internet access service was available to 40.8 million homes, or 98.9 percent of homes passed by Comcast's systems.[201] On June 30, 2005, Comcast had 7.7 million subscribers to its high-speed Internet access service, representing a penetration rate[202] of 18.9 percent, up from the 7 million high-speed Internet subscribers Comcast reported at the end of 2004.[203] At the end of June 2005, Cox's high-speed Internet service had grown to 2.8 million subscribers,

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[196] FCC, *High-Speed Services for Internet Access: Status as of December 31, 2004,* July 2005, at Chart 6. This report and previous releases of the *High-Speed Services for Internet Access* report are available at http://www.fcc.gov/wcb/iatd/comp.html (visited Nov. 15, 2005).

[197] FCC, *High-Speed Services for Internet Access: Status as of December 31, 2003,* June 2004, at Chart 6. This report and other releases of the *High-Speed Services for Internet Access* report are available at http://www.fcc.gov/wcb/iatd/comp.html (visited Nov. 15, 2005).

[198] *See* paras. 135-39 *infra.*

[199] *See 2001 Report*, 17 FCC Rcd at 1266-67 ¶¶ 46-47 and n.136; *see also Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities, Internet Over Cable Declaratory Ruling, Appropriate Regulatory Treatment for Broadband Access to the Internet Over Cable Facilities, Declaratory Ruling and Notice of Proposed Rulemaking*, 17 FCC Rcd 4798 (2002) (*High-Speed Access Declaratory Ruling and NPRM*). In the *High-Speed Access Declaratory Ruling and NPRM*, the Commission concluded that "cable modem service, as it is currently offered, is properly classified as an interstate information service, not as a cable service, and that there is no separate offering of telecommunications service." *High-Speed Access Declaratory Ruling and NPRM*, 17 FCC Rcd at 4802 ¶ 7. *See AT&T v. City of Portland*, 216 F.3d 871 (9th Cir. 2000). *See also Brand X Internet Services v. FCC*, 345 F.3d 1120 (9th Cir. 2003), *reversed and remanded, National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 125 S. Ct. 2688 (2005).

[200] *See* Time Warner Cable, at http://www.timewarnercable.com/houston/products/cable /packagesandpricing.html?menu=CustomerService (visited Oct. 11, 2005). *See also* http://www.timewarnercable.com/houston/products/internet/earthlink.html (visited Oct. 11, 2005).

[201] Comcast Corp., *Comcast Reports Second Quarter 2005 Results* (press release), Aug. 2, 2005.

[202] Although there is no standard method for reporting penetration rates for advanced services, high-speed Internet service penetration rates usually are calculated by dividing the number of high-speed Internet subscribers by the number homes passed where high-speed Internet service is available. This is the method often used when high-speed Internet services are not yet available to every home passed by a cable system. Cablevision, however, has completed its system upgrade and makes high-speed Internet service available to all homes passed by its cable systems. As such, Cablevision calculates its penetration rate for high-speed Internet service by dividing the number of high-speed Internet service subscribers by the number of homes passed by its cable system.

[203] Comcast Corp., *Comcast Reports Second Quarter 2005 Results* (press release), Aug. 2, 2005; Comcast Corp., *Comcast Reports Fourth Quarter and Year End 2004 Results* (press release), Feb. 3, 2005.

representing a 26.9 percent penetration rate, compared to the 2.6 million high-speed Internet access subscribers Cox reported for year end 2004.[204] Time Warner reported that it had 4.3 million high-speed Internet subscribers the end of June 2005, representing a penetration rate of 22 percent, compared to 3.9 million high-speed Internet subscribers at year-end 2004.[205] As of June 30, 2005, Cablevision had 1.5 million high-speed Internet subscribers and a penetration rate of 34 percent, up from the 1.4 million high-speed Internet subscribers reported for December 31, 2004.[206] Charter's high-speed Internet service had grown to more than 2 million subscribers at the end of June 2005, a penetration rate of 18 percent, compared to the 1.9 million high-speed Internet subscribers reported at the end of 2004.[207]

65. Over the past year, many cable operators have increased the speed of their high-speed Internet services as well as experimented with lower-priced tiers of service, some as low as $25 per month.[208] Most cable operators are now offering 4 to 6 Mbps downstream and additional high-speed Internet tiers with even faster speeds.[209] NCTA says that the cable industry has developed technical specifications that will enable operators to continue increasing Internet service speeds to 160 Mbps downstream and 60 Mbps upstream.[210] Cable operators also offer a variety of features with their high-speed Internet services, including increased storage capacity; multiple e-mail accounts; integrated security suites with anti-virus, anti-spyware, and firewall protection; pop-up blocking and spam filtering; video e-mail; specialized content; and home networking for multiple devices.[211] Comcast offers 6 Mbps downstream and 384 Kbps upstream for $42.95 per month and 8 Mbps downstream and 768 Kbps upstream for premium service subscribers.[212] For no additional charge, Comcast also provides broadband security services.[213] Cox offers security software, pop-up blocker, antivirus protection and speeds of 5 Mbps downstream and 2 Mbps upstream for $39.95 per month; it offers speeds of 15 Mbps downstream and 2 Mbps upstream for $54.95 per month.[214] Time Warner's high-speed Internet service provides 5 Mbps downstream for $39.95 per month.[215] Cablevision's high-speed Internet service provides up to 10

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[204] Cox Communications Inc., *Cox Communications Announces Second Quarter and Year-to-Date Financial Results for 2005* (press release), Aug. 9, 2005; Cox Communications Inc., *Cox Communications Announces Fourth Quarter and Full-Year Financial Results for 2004* (press release), Mar. 16, 2005.

[205] Time Warner Inc., *Time Warner Inc. Reports Second Quarter 2005 Results* (press release), Aug. 3, 2005; Time Warner Inc., *Time Warner Reports Results for 2004 Full Year and Fourth Quarter* (press release), Feb. 4, 2005.

[206] Cablevision Systems Corp., *Cablevision Systems Corporation Reports Second Quarter 2005 Results* (press release), Aug. 9, 2005; Cablevision Systems Corp., *Cablevision Systems Corporation Reports Fourth Quarter and Full Year 2004 Results* (press release), Feb. 23, 2005.

[207] Charter Communications Inc., *Charter Reports Second Quarter 2005 Financial and Operating Results* (press release), Aug. 1, 2005; Charter Communications Inc., *Charter Reports Fourth Quarter and Annual 2004 Financial and Operating Results* (press release), Mar. 1, 2005.

[208] Marguerite Reardon, *Comcast Revs Up Downloads*, CNET, July 12, 2005, at http://news.com.com/Comcast+revs+up+downloads/2100-1034_3-5785081.html?tag=st.rn (visited Oct. 25, 2005).

[209] NCTA Comments at 35.

[210] *Id.*

[211] *Id.* at 35-36.

[212] Comcast Comments at 53. *See also* Comcast Corp., at http://www.comcast.com/Benefits CHSIBenefits.asp?LinkID=51 (visited Oct. 20, 2005).

[213] *Id.*

[214] *See* Cox, at http://www.cox.com/Fairfax/HighSpeedInternet (visited Oct. 7, 2005).

[215] The price applies to customers that subscribe to both high-speed internet service and digital cable service. Time Warner Cable, at http://www.timewarnercable.com/houston/products/internet/default.html (visited Oct. 7, 2005).

Mbps downstream for $44.95 per month.[216] Cablevision is marketing 50 Mbps, expandable to 100 Mbps, for commercial subscribers. Cablevision's high-speed Internet service also provides software that scans for computer viruses.[217] Charter's high-speed Internet subscribers receive 3 Mbps downstream and 256 Kbps upstream, antivirus protection and firewall software for approximately $40 per month.[218]

66. ***Telephony Offered by Cable Operators.*** Although some cable companies have been providing traditional circuit-switched telephony for years, the cable industry is now using digital technology to provide voice-over-Internet protocol (VoIP) services.[219] At the end of 2004, cable telephony service, both VoIP and circuit-switched, was available to 38 percent of the homes passed by cable.[220] At the end of 2004, there were 3.6 million subscribers to cable telephone service, with 3 million subscribers being served by circuit-switched service and 600,000 subscribers being served by VoIP service.[221] At the end of June 2005, there were 1.2 million subscribers to cable's VoIP service.[222] Most cable operators offer discounts for VoIP when it is bundled with other cable services.[223] For example, Cox charges $49.95 for stand-alone VoIP service, $44.95 when subscribers take a two-product bundle from Cox, and $39.95 when subscribers take a three-product bundle from Cox.[224]

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[216] Cablevision Systems Corp., at http://www.cablevision.com/index.jhtml?pageType=ool_product (visited Oct. 7, 2005).

[217] Cablevision Systems Corp., *Latest Value Enhancement from Optimum Online: Essential PC Maintenance Protection for PC Care at No Additional Cost* (press release), Sept. 7, 2005.

[218] Charter Communications Inc., at http://www.charter.com/products/highspeed/highspeed.aspx (visited Oct. 7, 2005).

[219] A circuit-switched cable telephony voice call and an IP telephony voice call provided by a cable operator both begin with special equipment that connects a household's twisted pair infrastructure with the cable infrastructure. Cable circuit-switched telephony, however, eventually turns the call over to the public switched telephone network (PSTN), while IP telephony turns the call over to an Internet IP gateway for IP processing onto the PSTN or a managed IP Network. IP telephony processes voice telephone calls much like data on the Internet; that is, digitized pieces of data are divided into discrete packets and are transported over an IP network following any path that does not resist transfer.

[220] *Advanced Services Spread Across Cable Systems*, Cable TV Investor, Apr. 26, 2005, at 5. One analysis shows that cable operators offered VoIP service to 16.9 million homes, or 15 percent of all households at the end of 2004. The analysis also projects that VoIP service will be available to 46.2 million homes, or 41 percent of all households, by the end of 2005. Craig Moffett, *et. al.*, *Quarterly VoIP Monitor: How High is Up for Cable VoIP?*, Bernstein Research Call, Sanford C. Bernstein & Co., Mar. 24, 2005, at 1. Cable companies also are adding mobile phone service to their telephony offerings. Anne Veigle, Howard Buskirk, *Cable Likely to Pursue Deals Similar to Time Warners' Sprint Offering*, COMMUNICATIONS DAILY, Dec. 30, 2004. Time Warner began marketing Sprint mobile phones to its subscribers in Kansas City, Missouri. Jim Hu, *Time Warner Cable Begins Cell Phone Trials*, CNET, Mar. 31, 2005, at http://news.com.com/Time+Warner+Cable+begins+cell+phone+trials/2100-1039_3-5648954.html (visited Oct. 14, 2005). Cablevision also reached agreement to sell Sprint's wireless telephone service. Harry Berkowitz, *Cablevision, Sprint Team Up*, CED, May 3, 2005, at http://www.cedmagazine.com/cedailydirect/2005/0505/cedaily050503.htm (visited Oct. 17, 2005). Comcast, Time Warner, Cox, and Advanced/Newhouse have reached an agreement with Sprint Nextel to deliver cellular phone service to their cable subscribers. Yuki Noguchi, *5 Firms to Link Cable and Cell Phones*, WASHINGTON POST, Nov. 3, 2005, at http://www.washingtonpost.com/wp-dyn/content/article/2005/11/02/AR2005110200609.html (visited Jan. 17, 2006).

[221] *The Evolution of Cable: 1955-2004*, Cable TV Investor, July 29, 2005, at 4.

[222] NCTA Comments at 37.

[223] *Id.* at 38.

[224] Cox's VoIP service includes unlimited local and nationwide calling plus these features: Call Forwarding, Call Waiting, Speed Dial 8, Caller ID, Three-Way Calling, Call Return, Busy Line Redial, Selective Call Acceptance, Selective Call Rejection, Call Forwarding – Busy, Call Forwarding – No Answer, Call Forwarding of Call Waiting, (continued....)

67. Comcast is a facilities-based provider of cable telephone services that serves approximately 1.2 million subscribers in 18 markets with circuit-switched phone service.[225] In early 2005, Comcast began offering VoIP service to subscribers in Boston, Massachusetts; Chicago, Illinois; Hartford, Connecticut; Philadelphia, Pennsylvania; and Portland, Oregon, and it plans to deploy VoIP in additional markets in 2006.[226] Comcast's VoIP service is a primary service that offers E911 capability and provides battery backup power for up to eight hours.[227] As the largest cable telephone service provider in the nation, Cox has more than 1.4 million residential telephone subscribers using both circuit-switched and VoIP technologies.[228] Cox offers VoIP service in five markets and by the end of 2005, Cox planned to extend its VoIP service to Las Vegas, Nevada; Macon, Georgia; Central Florida (includes Gainesville and Ocala, Florida); Gulf Coast Florida (includes Fort Walton Beach and Pensacola, Florida); and Topeka, Kansas.[229] Cox provides what it calls a "lifeline service" that includes E911 service as a standard feature in all of its telephone markets and back-up power so that its digital phone service continues to work during a power outage.[230] Time Warner has deployed VoIP service to all 31 of its divisions and, as of September 30, 2005, had 854,000 VoIP subscribers.[231] Time Warner's VoIP service includes E911 service but does not include back-up power and will not function during a power outage.[232] Cablevision's VoIP service is available to 4.4 million homes and at the end of June 2005 the service had 478,000 subscribers, up from the 272,688 subscribers reported at the end of 2004.[233] Cablevision's VoIP service provides E911 service. It uses household electrical power and will not operate if the power in the home goes out.[234] Cablevision offers VoIP subscribers a battery back-up option that allows several hours of continued operation in the event of a power outage.[235] The network remains powered for several hours during a loss of electrical current, so with the battery back-up option VoIP subscribers continue to have service during an electrical interruption as long as they are not using electric telephones.[236] Charter offers

(Continued from previous page)
Priority Ringing, Long Distance Alert, Call Waiting ID, Selective Call Forwarding, and Voice Mail (optional). *See* Cox Communications Inc., at http://www.cox.com/Fairfax/telephone/rates.asp (visited Oct. 21, 2005).

[225] *See* Comcast Corp., at http://www.cmcsk.com/phoenix.zhtml?c=147565&p=irol-telephone (visited Oct. 11, 2005).

[226] Comcast Comments at 52.

[227] *See* Comcast Corp., at http://www.cmcsk.com/phoenix.zhtml?c=147565&p=irol-telephone (visited Oct. 11, 2005).

[228] Cox Communications Inc., *Cox Names New 2005 Telephone Markets* (press release), Aug. 1, 2005.

[229] *Id.*

[230] *Id.*

[231] Letter from Arthur H. Harding, Counsel for Time Warner, Inc., to Marlene H. Dortch, Secretary, FCC, MB Docket No. 05-192 (Nov. 10, 2005) at 4.

[232] *See* Time Warner Cable, at http://www.timewarnercable.com/CustomerService/FAQ/TWCFaqs.ashx?faqID=1178&MarketID=19&CatID=1392 (visited Oct. 11, 2005).

[233] Cablevision Systems Corp., *Optimum Voice Adds Valuable New Features, Debuts Enhanced and User-Friendly Web Portal* (press release), Aug. 17, 2005; Cablevision Systems Corp., *Cablevision Systems Corporation Reports Fourth Quarter and Full Year 2004 Results* (press release), Feb. 23, 2005.

[234] Cablevision Systems Corp., *Optimum Voice Adds Valuable New Features, Debuts Enhanced and User-Friendly Web Portal* (press release), Aug. 17, 2005.

[235] *Id.*

[236] *See Cablevision Integrates Home Security Systems in VoIP Service*, CONVERGE NETWORK DIGEST, June 29, 2005, at http://www.convergedigest.com/searchdisplay.asp?ID=15207&SearchWord=cablevision (visited Oct 28, 2005).

telephone service to 45,400 subscribers using VoIP in most markets.[237] Charter's VoIP service provides E911 service, and Charter's network has a built-in emergency battery backup that provides telephone service for most customers for eight to ten hours.[238] In addition, between January 10, 2005, and October 11, 2005, Adelphia engaged in a limited trial of VoIP services in the Colorado Springs, Colorado, area. Adelphia reports that it has no plans to conduct further trials or provide VoIP service during the pendency of its proposed sale to Comcast and Time Warner.[239]

68. ***Mid-sized and Smaller Cable Operators.*** The FCC Form 325 samples cable systems with between 5,000 and 20,000 subscribers and also surveys a sample of systems with fewer than 5,000 subscribers. Findings from data collected for 2004 show that in these smaller systems high-speed data service, digital cable service, and telephony are being offered. In particular, for systems with 5,000 or fewer subscribers, 33 percent offer high-speed Internet service, 45 percent offer digital cable service, 3 percent offer telephony services and 16 percent have cable plants with capacities of 750 MHz or greater. For systems with between 5,000 and 20,000 subscribers, 94 percent offer high-speed Internet service, 94 percent offer digital cable service, 6 percent offer telephony services and 68 percent have capacities of 750 MHz or greater.[240]

69. This year we examined six mid-sized and smaller cable operators to identify the advanced services they provide.[241] All provide high-speed Internet service. All provide digital video service but not all offer VOD, HDTV, and DVR service. Most provide telephone service and some use VoIP technology.[242] Bresnan Communications serves over 300,000 subscribers in Colorado, Montana, Wyoming, and Utah, offering a full range of advanced services that include digital video service, VOD, HDTV, DVR, high-speed Internet service, and digital telephone service to residential and business subscribers over an upgraded fiber-optic coaxial network.[243] Service Electric Cable TV &

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[237] Charter Communications Inc., *Charter Reports Fourth Quarter and Annual 2004 Financial and Operating Results* (press release), Mar. 1, 2005; Charter Communications, at http://www.charter.com/products/telephone/telephone.aspx (visited Sept. 15, 2005).

[238] Charter Communications Inc., *Inland Empire and High Desert Residents Will be First in California to Experience Charter Telephone Service* (press release), Oct. 5, 2005.

[239] Letter from Angie Kronenberg, Counsel for Adelphia, to Marlene H. Dortch, Secretary, FCC, MB Docket No. 05-192 (Dec. 22, 2005) at 161. *See also* n.95 *supra* (application for transfer of control of Adelphia to Comcast and Time Warner).

[240] 2004 FCC Form 325 data.

[241] The six mid-sized and smaller cable companies include Bresnan Communications, Service Electric Cable TV & Communications, Susquehanna Communications, Buckeye CableSystem, US Cable Group, and Sunflower Broadband. S*ee also* Michael Hopkins, *Thriving (Albeit Small) Empires: Independent MSOs Retool Systems, Expand Offerings in Highly-Competitive Markets*, THE BRIDGE, Sept. 30, 2005.

[242] Cable operators have signed agreements with telephone companies to assist in the provision of VoIP. For example, Sprint Corporation provides VoIP provisioning, switching, interconnections with the public switched telephony network, enhanced 911 services, local number portability, and directory assistance to Massillon Cable TV Inc., Wave Broadband, and Blue Ridge Communications. Karen Brown, *Sprint Lands Trio of Cable Deals, Passes Milestone*, CED, Apr. 4, 2005, at http://www.cedmagazine.com/cedailydirect/2005/ 0405/cedaily050404.htm#6 (visited Oct. 14, 2005).

[243] *See* Bresnan Communications, at http://www.bresnan.com/unst/about (visited Sept. 19, 2005). Bresnan's first VoIP market was Grand Junction, Colorado where service began in February 2005. K.C. Neel, *Triple-Play Junction: Grand Junction System is the Jewel of Bresnan's Eye*, MULTICHANNEL NEWS, Feb. 28, 2005, at http://www.multichannel.com/article/CA506703.html?display=Search+Results&text= Triple%2DPlay+Junction (visited Oct. 14, 2005).

Communications serves approximately 280,000 subscribers in Pennsylvania and New Jersey.[244] Service Electric offers digital video service, HDTV, DVR, high-speed Internet service, and digital telephone service to residential and business subscribers.[245] Service Electric does not offer VOD service. Susquehanna Communications serves approximately 233,000 subscribers in Pennsylvania, New York, Illinois, Indiana, Maine, and Mississippi.[246] An advanced hybrid fiber optic and coaxial network is in place or under construction in nearly 93 percent of Susquehanna Communications' service area and is expected to be fully deployed in the next two years.[247] Susquehanna Communications offers digital video service, HDTV, DVR, high-speed Internet service, and digital telephone service to residential and business subscribers.[248] Susquehanna Communications does not offer VOD service. Buckeye CableSystem serves approximately 149,000 subscribers in Ohio, Michigan, and New York.[249] Buckeye CableSystem offers digital video service, VOD, HDTV, DVR, high-speed Internet service, and residential telephone service.[250] US Cable Group serves over 140,000 subscribers in Minnesota, Wisconsin, South Carolina, Georgia, Florida, Missouri, Texas, New Mexico, Colorado, and New Jersey.[251] US Cable Group offers digital video service to over 90 percent of homes passed.[252] US Cable Group also offers high-speed Internet service.[253] US Cable Group does not offer VOD, HDTV, DVR, or residential telephone service. Sunflower Broadband operates cable systems in Kansas and offers digital video service, VOD, HDTV, DVR, high-speed Internet service, and digital telephone service to residential and business subscribers.[254] In May 2005, Sunflower Broadband became one of the first cable companies in the country to offer an all digital channel line-up.[255] Digital cable subscribers can now see all channels with digital quality picture and sound.[256]

B. Direct-to-Home Satellite Services

1. Direct Broadcast Satellite

70. DBS service is provided via satellite to small parabolic "dish" antennas located at the individual residences of consumers or at business or educational organizations.[257] Three operators

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[244] *See* Service Electric Cable TV & Communications, at http://www.sectv.com/comp.shtml (visited Sept. 19, 2005). *See also* NCTA, *Top 25 MSOs Ranked by Number of Customers*, Cable Developments 2005, at 24.

[245] *See* Service Electric Cable TV & Communications, at http://www.sectv.com/prod.shtml (visited Sept. 19, 2005).

[246] *See* Susquehanna Communications, at http://www.suscom.com/about/pfaltzgraff.php (visited Sept. 19, 2005).

[247] *Id.*

[248] *See* Susquehanna Communications, at http://www.suscom.com/home (visited Oct. 6, 2005).

[249] *See* Buckeye CableSystem, at http://www.buckeyecablesystem.com/index.html#indtop (visited Oct. 6, 2005). *See also* NCTA, *Top 25 MSOs Ranked by Number of Customers*, Cable Developments 2005, at 24.

[250] *See* Buckeye CableSystem, at http://www.buckeyecablesystem.com/main_tol.html (visited Oct. 6, 2005).

[251] *See* US Cable Group, at http://www.uscablegroup.com/operating_companies.htm (visited Sept. 19, 2005).

[252] *See* US Cable Group, at http://www.uscable.com/aboutus.htm (visited Sept. 19, 2005).

[253] *Id.*

[254] *See* Sunflower Broadband, at http://www.sunflowerbroadband.com (visited Sept. 19, 2005).

[255] *Id.*

[256] *Id.*

[257] We define the Direct Broadcast Satellite Service as "[a] radiocommunication service in which signals transmitted or retransmitted by space stations, using frequencies specified in § 25.202(a)(7), are intended for direct reception by the general public. For the purposes of this definition, the term direct reception shall encompass both individual reception and community reception." 47 C.F.R. § 25.201. *See also 2004 Report*, 20 FCC Rcd at 2792 ¶ 53. We (continued....)

provide DBS service: DIRECTV, EchoStar (marketed as the DISH Network), and Dominion Video Satellite, Inc. (marketed as Sky Angel).[258]

71. Last year we reported on the Cablevision subsidiary Rainbow DBS, which began providing MVPD services under the VOOM brand name in October 2003. In December 2004, the Cablevision Board of Directors decided to pursue "strategic alternatives" for the Rainbow DBS assets. In January 2005, Cablevision reached an agreement with EchoStar to sell its Rainbow 1 satellite, located at the 61.5° W.L. orbital position; Commission licenses to construct, launch and operate DBS services over 11 channels at the 61.5° W.L. orbital position; and contents of Rainbow DBS' ground facility in Black Hawk, South Dakota. Cablevision continued to explore uses for VOOM's programming.[259] Subsequently, Rainbow DBS ended its VOOM service, which had attained a total subscribership of approximately 26,000 homes, and announced that it was launching a new HD programming service with 21 channels, 10 of which EchoStar agreed to carry initially, with all 21 being available to EchoStar subscribers by 2006.

72. ***Subscribership.*** As of June 2005, approximately 26.12 million U.S. households subscribed to DBS service. This represents an increase of 12.8 percent over the 23.16 million DBS subscribers we reported last year.[260] DBS accounts for approximately 27.7 percent of all U.S. MVPD subscribers.[261] Analysts attribute DBS' continued growth to the increase in local-into-local broadcast stations; service enhancements, including multiple room viewing solutions and HDTV; and the ability to co-market DSL service.[262] In terms of subscriber penetration, DBS penetration initially occurred primarily in rural and small markets, but as a recent GAO study found, since 2001, DBS penetration has grown rapidly and increased in suburban and urban areas.[263] According to GAO, the DBS penetration rate was over 36 percent in areas where cable operators did not provide advanced services, such as digital cable, cable modem service and telephone service, compared with approximately 16 percent in areas where cable operators provided one or more such services, but not all, and only 14 percent in areas where cable operators provided all three advanced services.[264] GAO also reported that the DBS penetration rate

(Continued from previous page)
note that this definition of DBS does not cover services offered in the Ka-band, although DBS operators have indicated that they plan to use this frequency band to provide future direct-to-home video services to subscribers.

[258] Dominion holds licenses for eight channels at the 61.5° W.L. orbital position.

[259] Cablevision Systems Corporation, *Cablevision to Sell Rainbow Direct Broadcast Satellite and Certain Related Assets to EchoStar for $200 Million* (press release), Jan. 20, 2005.

[260] *See 2004 Report*, 20 FCC Rcd at 2792 ¶ 54.

[261] *See* Appendix B, Table B-1 *infra*.

[262] Doug Shapiro, *4Q Wrap-Up: Connecting the Pixels*, Banc of America Securities Equity Research, Mar. 23, 2005. Shapiro also credits DIRECTV's mandatory set-top box security upgrade for improving DIRECTV's subscriber growth. Last year, we reported that analysts attributed DBS growth to an increase in niche programming, increased availability of local broadcast stations, and free set-top box equipment. *2004 Report*, 20 FCC Rcd at 2792 ¶ 54.

[263] *See* U.S. Government Accountability Office, *Direct Broadcast Satellite Subscribership Has Grown Rapidly, but Varies Across Different Types of Markets*, GAO-05-257, Apr. 2005. According to GAO, in 2001, DBS penetration rates were nearly 26 percent in rural areas, 14 percent in suburban areas, and about 9 percent in urban areas. By 2004, DBS penetration rates had increased to approximately 29 percent in rural areas, 18 percent in suburban areas, and 13 percent in urban areas. Over the 2001 to 2004 time frame, the DBS penetration rate grew about 50 percent and 32 percent in urban and suburban areas, respectively, compared with a growth rate of 15 percent in rural areas. *Id.* at 3.

[264] *Id.* at 11.

is 12 percent higher in areas where DBS customers can receive local-into-local service than where local-into-local is not available.[265]

73. DIRECTV is the largest DBS provider and second largest MVPD. DIRECTV served 14.67 million subscribers as of June 2005, an increase of 1.63 million, or 12.5 percent, from the 13.04 million subscribers as of June 2004.[266] EchoStar is the second largest DBS provider and third largest MVPD, with approximately 11.45 million subscribers as of June 30, 2005, an increase of 13.1 percent over the 10.12 million subscribers a year earlier.[267] Dominion Video Satellite's Sky Angel service serves fewer than one million subscribers and provides 20 family and religion-oriented channels.[268]

74. ***Service and Equipment Pricing***. DIRECTV and EchoStar offer numerous programming packages. DIRECTV offers three English language programming packages and four Spanish language programming packages.[269] EchoStar offers five English language and three Spanish language program packages.[270] EchoStar and DIRECTV also offer packages to subscribers in Hawaii and Alaska.[271] Sky Angel service is not available in Hawaii or Alaska. In February 2005, EchoStar raised the prices on its English language program packages by an average of 6.5 percent, citing an increase of seven percent in programming costs.[272] EchoStar did not raise the price of its three Spanish language packages.[273]

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[265] *Id.* at 15.

[266] The DIRECTV Group, Inc., *SEC Quarterly Report Form 10-Q Pursuant to Section 13 or 15(d) of the Securities Act of 1934 for the Quarterly Period Ended June 30, 2005*, at 40.

[267] EchoStar Communications Corp., *SEC Quarterly Report Form 10-Q Pursuant to Section 13 or 15(d) of the Securities Act of 1934 for the Quarterly Period Ended June 30, 2005*, at 25.

[268] Sky Angel's subscribership was provided in a telephone conversation with Nancy Christopher, Vice President, Public Relations, Dominion Video Satellite. We have reported previously that Sky Angel had approximately one million subscribers. *See, e.g., 2002 Report*, 17 FCC Rcd at 26930 ¶ 59.

[269] DIRECTV's Total Choice package, which includes over 135 channels of nonbroadcast programming and local broadcast stations, costs $41.99 per month; Total Choice Plus, which includes 155 channels of nonbroadcast programming and local broadcast stations, costs $45.99 per month; and Total Choice Premier, which includes over 215 channels of nonbroadcast programming and local broadcast stations, costs $93.99 per month. If local broadcast stations are not available in a particular market, DIRECTV deducts $3.00 per month from the price of the package.

[270] EchoStar Comments at 15; EchoStar Communications Corp., Programming, at http://www.dishnetwork.com/content/ programming/packages/index.shtml.

[271] EchoStar requires the purchase of an additional dish in order to receive certain channels in Alaska and Hawaii. EchoStar broadcasts the majority of its basic and premium programming from its satellites located at the 119° and 110° W.L. orbital locations. According to EchoStar, customers residing in Alaska or Hawaii are not able to receive the 110° satellite signal or any of the channels broadcast from this satellite with EchoStar's standard 20-inch dish. It offers a 24-inch satellite dish to subscribers in Alaska and Hawaii. Nevertheless, some programming is entirely inaccessible. *See* EchoStar Communications Corp., at http://www.dishnetwork.com/content/programming/packages/ hawaii/top_60_120/index.shtml. According to DIRECTV, its service offerings in Hawaii are identical to the national programming available on the mainland. *See* Letter from Stacy Fuller, Vice President, Regulatory Affairs, DIRECTV, to Marlene H. Dortch, Secretary, FCC, MB Docket No. 03-82 (Nov. 16, 2005).

[272] *Ergen Laments Price Jump, Hints at DISH HD Future*, SKYREPORT, Jan. 11, 2005. EchoStar's America's Top 60 with local channels programming package price increased $2.00 per month, or 6.7 percent, to $31.99; America's Top 120 and America's Top 180 without local channels increased $3.00, or 8.5 percent, to $37.99 and, 6 percent, to $47.99, respectively. The America's 'Everything' Package increased $4.00 per month, or 5 percent, to $81.99. One analyst described EchoStar's price increases as larger than the percentage price increases of large cable operators in 2004 because EchoStar's increases applied to its entire video package, including channels that would be available on cable operators' digital tiers, while cable operators' price increases tend to affect their basic video tiers. George (continued....)

75. Subscribers to DBS service need a satellite dish and a set-top box. EchoStar and DIRECTV continue to rely on discounted set-top box equipment, free satellite dishes, and free installation to attract new customers.[274] With respect to equipment, DIRECTV and EchoStar offer a wide range of set-top box receivers. EchoStar's Digital Home Advantage plan offers discounts on programming packages based on the number of receivers the subscriber leases.[275] DIRECTV states that it does not lease equipment,[276] but it is reported to be considering introducing a leasing model for its equipment in early 2006.[277]

76. ***Availability of Local Broadcast Stations.*** Local broadcast television station availability is approaching 100 percent for both EchoStar and DIRECTV. In 167 of 210 television markets (*i.e.*, designated market areas, or DMAs), which represent 96 percent of all U.S. television households, at least one DBS provider offers the signals of local broadcast stations (local-into-local service).[278] EchoStar offers local-into-local service in 162 DMAs and Puerto Rico, representing approximately 95 percent of U.S. television households.[279] DIRECTV offers local-into-local service in 134 markets, representing 93 percent of U.S. television households.[280] EchoStar charges an additional $5.99 where the major four broadcasting networks are available, whereas DIRECTV's program packages automatically include local broadcast signals where it offers local-into-local service.[281]

(Continued from previous page)
Mannes, *EchoStar Launches Price Hike*, TheStreet.com, Jan. 5, 2005, citing Sanford Bernstein analyst Craig Moffett.

[273] DISH Latino with 30 channels and local broadcast stations is $29.99 per month; DISH Latino DOS with 120 channels and local broadcast stations is $39.99 per month; and DISH Latino MAX with over 160 channels and local broadcast stations is $49.99 per month. *See* EchoStar Comments at 15.

[274] The cost of discounted equipment is reflected in DIRECTV's and EchoStar's subscriber acquisition cost (SAC), which describes the cost of acquiring a new subscriber. For example, as of June 30, 2005, EchoStar's SAC was $667 per subscriber, up 16 percent from a year ago; DIRECTV's SAC was $646 per subscriber, up almost 5 percent from a year ago. Christy Rickard, *DBS Net Adds Down, Profits Up*, The DBS Report (Kagan Research LLC), Aug. 29, 2005, at 3.

[275] For example, EchoStar's America's Top 120 Digital Home Advantage package costs $42.99 per month for up to two televisions and increases to $47.99 for subscribers using three or four multi-room receivers. In addition, under this plan, EchoStar charges $4.98 per month per multi-room receiver. *See* EchoStar Communications Corp., at http://wwwidshnetwork.com/images/getdish/ promotions/dha/dha_price.gif.

[276] DIRECTV Comments at 18.

[277] Linda Moss, *DIRECTV Opts For a Leasing Model*, MULTICHANNEL NEWS, Jan. 23, 2006.

[278] Based on Nielsen's 2004-2005 U.S. Television Households in 210 DMAs. Last year, we reported that at least one DBS provider offered local broadcast stations in 155 of 210 DMAs. *2004 Report*, 20 FCC Rcd at 2795 ¶ 58.

[279] In 64 DMAs, EchoStar requires the use of a "SuperDISH," which enables customers to receive signals from three orbital locations, the third of which allows customers to receive local programming. *See* EchoStar Satellite, LLC, http://www.dishnetwork.com/content/programming/locals/index.asp.

[280] The DIRECTV Group, Inc., Local Channel Markets, at http://www.directv.com/DTVAPP/see/ LocalChannels_markets.jsp. In 60 of these markets, DIRECTV requires the use of a DIRECTV Multi-Satellite System, and in 26 markets, it requires the use of a second 18-inch DIRECTV dish. In October 2005, DIRECTV announced that it would offer local broadcast channels in Mankato and Rochester, Minnesota, and Zanesville, Ohio by the end of 2005. *See* The DIRECTV Group, Inc., *DIRECTV Will Offer Local Channels in Three More Markets by Year-End* (press release), Oct. 13, 2005. The DIRECTV Group serves Puerto Rico through its DIRECTV Latin America subsidiary, which offers local stations.

[281] EchoStar Comments at 15. EchoStar charges $4.99 where only three of the four major networks are offered, and it charges $3.99 where only two of the four are offered.

77. ***Regulatory Issues.*** On December 8, 2004, the Satellite Home Viewer Extension and Reauthorization Act of 2004 (SHVERA) was enacted.[282] The Commission continues to implement the provisions of SHVERA related to the carriage of broadcast signals by DBS operators. In June 2005, pursuant to SHVERA, the Commission extended reciprocal good-faith bargaining obligations for retransmission consent negotiations to cable and satellite operators.[283] In August 2005, in accordance with SHVERA, the Commission ordered that DBS operators provide analog signals to Alaska and Hawaii, and specified that carriage elections for analog and digital signals must be made by October 1, 2005, and April 1, 2007, respectively, in order to meet the statutory requirement that satellite carriers provide these signals to substantially all of their subscribers in each station's local market by December 8, 2005 for analog signals and by June 8, 2007 for digital signals.[284] In September 2005, pursuant to SHVERA, the Commission submitted a report to Congress on the impact on competition in the MVPD market of the current retransmission consent provisions and the network nonduplication, syndicated exclusivity, and sports blackout rules, including the effect of those rules on the ability of rural cable operators to compete with the DBS industry in the provision of digital broadcast television signals to consumers.[285] The Commission did not recommend any changes to the statutory provisions relating to those Commission rules.[286] In November 2005, pursuant to SHVERA, the Commission established rules and regulations by which satellite carriers may offer Commission-determined "significantly viewed" signals of out-of-market (or "distant") broadcast stations to subscribers.[287] In December 2005, pursuant to Section 204(b) of SHVERA, the Commission submitted a Report to Congress concerning the digital signal strength standard and the signal testing procedures used to identify whether a household is

[282] Pub. L. No. 108-447, 118 Stat 2809 (2004) (codified in scattered sections of 17 and 47 U.S.C.). SHVERA was enacted as Title IX of the Consolidated Appropriations Act, 2005. SHVERA extended certain provisions of the Satellite Home Viewer Improvement Act, primarily those pertaining to the distant signal copyright license and retransmission consent negotiations, for five years. It also added new provisions to the Communications and Copyright Acts pertaining to the retransmission by DBS of distant broadcast signals, including the option to carry broadcast stations deemed "significantly viewed" by the Commission. As required by the Satellite Home Viewer Improvement Act of 1999 (SHVIA), the Commission established rules to implement carriage of broadcast signals, retransmission consent, and program exclusivity with respect to satellite carriage of broadcast stations. SHVIA provides DBS carriers with the opportunity to carry local stations in a Designated Market Area (DMA) pursuant to a statutory copyright license similar to the one provided cable operators. If a DBS operator selects this option in a DMA, however, it must carry all the local stations in the DMA, effective January 1, 2002. *See also Implementation of the Satellite Home Viewer Improvement Act 1999: Broadcast Signal Carriage Issues, Retransmission Consent Issues*, 16 FCC Rcd 1918 (2000); *Implementation of the Satellite Home Viewer Improvement Act of 1999: Broadcast Signal Carriage Issues*, 16 FCC Rcd 16544 (2001); *Implementation of the Satellite Home Viewer Improvement Act of 1999: Retransmission Consent Issues: Good Faith Negotiation and Exclusivity*, 16 FCC Rcd 15599 (2001).

[283] *Implementation of Section 207 of the Satellite Home Viewer Extension and Reauthorization Act of 2004, Reciprocal Bargaining Obligation*, 20 FCC Rcd 10339 (2005).

[284] *Implementation of the Satellite Home Viewer Extension and Reauthorization Act of 2004 to Amend Section 338 of the Communications Act*, 20 FCC Rcd 14242 (2005). SHVERA amended certain rules concerning the carriage of local television broadcast stations by satellite carriers, specifically by requiring satellite carriers to carry the analog and digital signals of television broadcast stations in local markets in states that are not part of the contiguous United States.

[285] *Retransmission Consent and Exclusivity Rules: Report to Congress Pursuant to Section 208 of the Satellite Home Viewer Extension and Reauthorization Act of 2004*, Sept. 8, 2005.

[286] *Id.* at ¶ 86.

[287] *See Implementation of the Satellite Home Viewer Extension and Reauthorization Act of 2004, Implementation of Section 340 of the Communications Act*, 20 FCC Rcd 17278 (2005).

"unserved" for purposes of the satellite statutory copyright license for distant digital signals.[288] The Commission is currently undertaking a number of other rulemaking proceedings to implement SHVERA.[289]

78. ***Satellite Fleet Developments and Video Capacity.*** DIRECTV launched new satellites this year. In October 2005, DIRECTV took on-orbit delivery of SPACEWAY F1, which was launched in April 2005 and which is the first of four Ka-band satellites that DIRECTV will use to distribute local HD broadcast signals into several large markets.[290] In November 2005, DIRECTV also launched SPACEWAY F2.[291] Together, SPACEWAY F1 and SPACEWAY F2 are expected to provide local digital and HD signals to approximately 24 markets, representing 45 percent of U.S. television households.[292] DIRECTV states that the combined capacity of the four satellites will enable DIRECTV to retransmit more than 150 national channels in high-definition and the digital signals of approximately 1,500 local broadcast stations.[293] In order for DIRECTV subscribers to access programming transmitted by the new satellites, they will have to upgrade to a new satellite dish and HD compatible set-top box.[294] In May 2005, DIRECTV launched DIRECTV 8, a Ku/Ka-band hybrid satellite that will supplement DIRECTV's existing satellite fleet and will replace an older DIRECTV satellite, which will function as a back-up satellite, at the 101° W.L. orbital location.[295] In early 2006, EchoStar is expected to launch its

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[288] *See Report to Congress, The Satellite Home Viewer Extension and Reauthorization Act of 2004, Study of Digital Television Field Strength Standards and Testing Procedures,* 20 FCC RCd 19504 (2005). In the Report, the Commission concluded that it did not need to make changes to the digital television field strength standards. We did determine, however, that a rulemaking proceeding should be conducted to specify procedures for measuring the field strength of digital television signals at individual locations that are generally similar to the current procedures for measuring the field strength of analog television stations. We also concluded that the existing, Individual Location Longley-Rice model should be used for predicting whether a household is unserved by digital television signals.

[289] *See Implementation of the Satellite Home Viewer Extension and Reauthorization Act of 2004, Procedural Rules,* 20 FCC Rcd 7780 (2005) (amending rules as specified in SHVERA).

[290] *See* The DIRECTV Group, Inc., *Boeing Delivers Next-Generation Commercial Satellite to DIRECTV, Inc.* (press release), Oct. 10, 2005. *See also* The DIRECTV Group, Inc., *DIRECTV's Spaceway F1 Satellite Launches New Era in High-Definition Programming; Next Generation Satellite Will Initiate Historic Expansion of DIRECTV Programming* (press release), Apr. 26, 2005.

[291] *Spaceway Bird Finally Takes Flight,* SATELLITE BUSINESS NEWS FAXUPDATE, Nov. 18, 2005.

[292] According to DIRECTV, Spaceway 1 and Spaceway 2 will have the capacity for more than 500 local HD broadcast channels. Two other satellites to be launched in early 2007 will have combined capacity for more than 1,000 local HD broadcast channels and more than 150 national HD channels. All four satellites will use spot-beam technology to deliver local channels. *See* John Mansell, *New Strategies for DIRECTV and EchoStar,* The DBS Report (Kagan Research), Jan. 24, 2005, at 8; The DIRECTV Group, Inc., *DIRECTV Announces First 12 Markets to Receive Local Channels in High-Definition This Year* (press release), Jan. 6, 2005; The DIRECTV Group, Inc., *DIRECTV Spaceway F2 Satellite Will Expand Local Digital/HD Services for DIRECTV Customers* (press release), May 25, 2005.

[293] DIRECTV Comments at 4.

[294] The DIRECTV Group, Inc., *DIRECTV Announces First 12 Markets to Receive Local Channels in High-Definition This Year* (press release), Jan. 6, 2005. According to DIRECTV, it will transmit all local HD and other new services using MPEG-4 AVC, a new standard in digital video compression, and advanced modulation that it states will improve DIRECTV's Ka-band capacity. To receive the HD programming, subscribers will require a new, slightly larger dish antenna and a new HD set-top box compliant with the MPEG-4 standard.

[295] The DIRECTV Group, Inc., *DIRECTV 8 Satellite Will Strengthen Service to DIRECTV Customers* (press release), May 22, 2005.

Echo X satellite at the 129° W.L. orbital location, which will be used to eliminate the need for some of its subscribers to use multiple dishes to receive programming.[296]

2. Home Satellite or Large Dish Service

79. The home satellite dish (HSD), or large dish, segment of the satellite industry is the original satellite-to-home service offered to consumers. It involves the home reception of analog signals transmitted by satellites operating in the C- and Ku-band frequencies, generally referred to here as C-band. Satellites in the C-band frequency are used primarily to transmit programming to cable operators via C-band receiving dishes at the cable operator's central technical facility or "headend." To be authorized to receive one or more scrambled channels, an HSD owner must purchase an integrated receiver-decoder from an equipment dealer and then pay a monthly or annual subscription fee to a program packager.[297]

80. As of June 2005, there were 206,358 households authorized to receive HSD service, a decrease of 38.5 percent from the 335,766 we reported last year.[298] By one estimate, an additional 100,000 households watch unscrambled channels.[299] In addition, two C-band program packagers have reported the number of subscribers they serve: National Programming Service, LLC (NPS) states that it provides service to approximately 100,000 customers, and Superstar/Netlink reports that it serves approximately 170,000 subscribers.[300] We observe that, combined, these subscriber counts exceed what has been reported by Motorola's Access Control Center and thus raise a question about the actual number of C-band subscribers.

81. Motorola introduced a digital home satellite dish solution called 4DTV, which enables C-band customers to receive digital only satellite channels in addition to available analog programming.[301] 4DTV allows customers to receive four types of programming: (1) free, unscrambled analog channels and so-called "wild feeds;" (2) VideoCipher II Plus subscription services; (3) free DigiCipher II services; and

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[296] EchoStar Communications Corp., *Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended September 30, 2005*, at 13.

[297] HSD systems are typically designed to receive programming from several different satellites at several different orbital locations. Most HSDs include motors that permit the receiving dishes to rotate and receive signals from these many satellites. Space considerations and zoning regulations restrict many viewers' ability to install the large antenna needed for HSD reception.

[298] *C-Band Decline Continues*, Satellite Business News FAXUpdate, July 6, 2005. The number is based on a report from Motorola's Access Control Center, which oversees authorizations and de-authorizations of satellite receivers using Motorola's proprietary conditional access systems.

[299] Jeffrey Krauss, *The End of the Big, Ugly Dish?*, CED Magazine, June 2005, at http://www.cedmagazine.com/ced/2005/0605/06cc.htm.

[300] Comments of National Programming Service and Reply Comments of EchoStar Acquisition L.L.C filed in *2000 Biennial Regulatory Review Streamlining and Other Revisions of Part 25 of the Commission's Rules Governing the Licensing of, and Spectrum Usage by, Satellite Network Earth Stations*, 20 FCC Rcd 5593 (2005) (*2000 Satellite Biennial*). In April 2004, EchoStar purchased Superstar/Netlink Group, LLC. *See 2004 Report*, 20 FCC Rcd at 2799 ¶ 64, n. 342.

[301] 4DTV is Motorola's proprietary digital television receive-only communications satellite receiver box and uses the Motorola DigiCipher II, or DCII, standard of signal encryption and compression. 4DTV receivers are also capable of receiving analog satellite transmissions. *See* Motorola, Inc., at http://www.4dtv.com/ (visited Jan. 14, 2005). VideoCipher is the conditional access system used by most C-band receivers to decode subscription based and premium satellite TV channels. DigiCipher II, or DCII, is Motorola's proprietary video distribution system that is used by most digital satellite channels.

(4) subscription-based DigiCipher II channels. The price of 4DTV digital receivers has decreased, retailing for approximately $550.00 today, compared with $800.00 last year.[302]

82. In March 2005, the Commission issued a notice of proposed rulemaking concerning technical changes to its earth station rules, including a proposal to prohibit analog video transmission in the C-band, with a one-year transition period.[303] This proceeding is pending.

3. Satellite-Based Advanced Services

83. ***Broadband Satellite Services.*** WildBlue, a new satellite-based two-way broadband Internet service provider, initiated service on the Telesat Anik F2 Ka-band "spot beam" satellite, which was launched in July 2004.[304] In June 2005, WildBlue acquired its first subscriber.[305] WildBlue offers three service packages for residential subscribers ranging in price from $49.95 to $79.95, with download speeds from 512 Kbps to 1.5 Mbps and upload speeds from 128 Kbps to 256 Kbps.[306] WildBlue's equipment retails for $299.00 plus required professional installation cost of $179.95.[307] Hughes Network Systems' continues to offer DIRECWAY's satellite-based, two-way, high-speed Internet access to consumers.[308] As of June 30, 2005, DIRECWAY had approximately 253,000 residential and business customers.[309] In September 2005, DIRECWAY introduced new modems, which DIRECWAY claims will deliver faster download and upload rates, and new pricing plans for residential and business subscribers.[310] Existing DIRECTV subscribers cannot use their DIRECTV dish to receive DIRECWAY

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[302] *2004 Report*, 20 FCC Rcd at 2799 ¶ 65. The price of a receiver is often significantly discounted with the purchase of a programming package. For example, C-band programming provider Skyvision offers the Motorola 4DTV DSR922 receiver, with a retail price of $550.00, for $399.00 with the purchase of a programming package. *See* Skyvision, Inc., at http://www.skyvision.com/store/mi4509029.html.

[303] *2000 Satellite Biennial*, 20 FCC Rcd at 5625 ¶ 88.

[304] WildBlue is a joint venture of the National Rural Telecommunications Cooperative, Intelsat, Ltd., Liberty Media Corporation, and Kleiner Perkins Caufield and Byers, a venture capital firm.

[305] WildBlue Communications Inc., *WildBlue Installs First Customer* (press release), June 3, 2005.

[306] WildBlue offers two business plans for $69.95 and $79.95 with download speeds of 1.0 Mbps and 1.5 Mbps, respectively, and upload speeds of 200 Kbps and 256 Kbps, respectively.

[307] WildBlue Communications, Inc., Packages and Pricing, at http://www.wildblue.com/forYourHome/index.jsp.

[308] In December 2004, The DIRECTV Group agreed to sell 50 percent of its subsidiary, Hughes Networks Systems, to SkyTerra Communications Inc., an affiliate of Apollo Management, L.P., a New York-based private equity firm. The transaction closed in April 2005. *See* The DIRECTV Group, Inc., *SkyTerra Communications to Acquire 50 Percent of Hughes Network System from THE DIRECTV Group* (press release), Dec. 6, 2004; Hughes Network Systems, LLC, *SkyTerra Communications and The DIRECTV Group Complete New Ownership Structure for Hughes Network Systems* (press release), Apr. 25, 2005.

[309] Hughes Network Systems, LLC, *Hughes Network Systems Achieves 26 percent Growth in Consumer and Small Business Subscribers for DIRECWAY Service* (press release), July 12, 2005. According to Hughes, this represents a 26 percent increase from June 2004.

[310] Hughes Network Systems, LLC, *Hughes Network Systems Boosts Speed and Performance of DIRECWAY Satellite Broadband* (press release), Sept. 12, 2005. DIRECWAY offers two residential pricing plans. The Home Plan costs $599.00 for equipment and installation and $59.99 per month with a 15-month commitment. The Home Plan provides download speeds up to 700 Kbps and upload speeds up to 128 Kbps. The Professional Plan is $599.00 for equipment and installation and $69.99 per month with a 15-month service contract. It provides download speeds up to 1.0 Mbps and upload speeds up to 200 Kbps. Alternatively, subscribers can choose to pay $99.99 upfront for equipment and installation and $99.99 per month for the Home Plan or $109.99 per month for the Professional Plan, including a 15-month term service contract. After the 15-month contract period, the monthly subscription rate converts to the standard subscription rates described above. DIRECWAY also provides two service plans for businesses, both of which cost $999.99 for equipment and installation. The Small Office plan costs (continued....)

service, but DIRECWAY satellite dishes can be upgraded to receive DIRECTV DBS service. EchoStar does not offer a satellite-based broadband Internet service at this time.[311]

84. EchoStar and DIRECTV continue to maintain co-marketing relationships with local exchange carriers to offer DSL broadband services. DIRECTV has relationships with Verizon, BellSouth, Qwest and Internet service provider Earthlink. EchoStar has existing relationships with SBC, Sprint, CenturyTel, and Earthlink.[312] In October 2005, EchoStar and ALLTEL signed a co-marketing agreement under which ALLTEL will offer EchoStar's DISH service in 15 states of its 36-state service territory.[313] EchoStar entered into a similar agreement with Frontier Communications, a subsidiary of Citizens Communications Company.[314] With respect to SBC, EchoStar renegotiated its co-marketing relationship with SBC.[315] In areas where SBC will not be immediately deploying its Project Lightspeed, EchoStar and SBC plan to introduce a single receiver manufactured by 2Wire, Inc. to integrate both satellite and DSL in one set-top box.[316]

85. ***Other Advanced Services***. DBS providers continue to offer HD service but remain constrained in what they can offer by the capacity limitations of their satellite fleets. EchoStar's primary HD programming package remains essentially unchanged from last year and includes ESPNHD, Discovery HD, TNT in HD, HDNet and HDNet Movies. Earlier this year, it expanded its HD programming by offering VOOM HD Networks, which includes ten genre-based channels, such as Monsters HD (horror and science fiction programming) and Rush HD (extreme action sports programming). It also offers HBO HDTV, Showtime HDTV, CBS HDTV, and DISH Network Pay-Per-View in HD.[317] EchoStar offers two HD receivers,[318] and has packaged flat panel LCD televisions with

(Continued from previous page)
$99.99 per month and provides download speeds up to 1.5 Mbps and upload speeds up to 300 Kbps. The Business Internet Plan is $199.00 per month and provides download speeds up to 2 Mbps and upload speeds up to 500 Kbps. Both plans require a 2-year service contract. *See* Hughes Network Systems, LLC, Service Offerings, at http://www.direcway.com.

[311] *See 2004 Report*, 20 FCC Rcd at 2799 ¶ 66.

[312] *Id.* at ¶ 67.

[313] *ALLTEL Offering Dish Network*, MULTICHANNEL NEWS, Oct. 19, 2005, at http://www.multichannel.com/article/CA6275774.html. *See* EchoStar Communications Corp., *ALLTEL Signs Agreement to Offer DISH Network TV Service* (press release), Mar. 8, 2005.

[314] EchoStar Communications Corp., *Frontier Communications Announces Strategic Alliance with EchoStar* (press release), Apr. 6, 2005.

[315] Christy Rickard, *EchoStar Inks New Deal with SBC*, The DBS Report (Kagan Research LLC), Sept. 30, 2005, at 3. Under the terms of the agreement, EchoStar will bear installation and equipment costs, while SBC will provide customer service and billing. SBC will receive a commission and a share of revenue from the subscribers it signs up. The agreement covers the 31.4 million households within SBC's local exchange telephone network service area.

[316] *Id.* at 4.

[317] DISH Network HD Pak costs $9.99 per month. VOOM Original HD Pak retails for $5.00 per month, and is only available with a subscription to DISH Network HD Pak. Premium channel HD programming is included free of charge with a subscription to the premium programming. Subscribers must have a DISH Network HD receiver, HD television and a dish antenna pointing at the appropriate orbital location. Some subscribers may require a second dish antenna to receive certain HD programming. EchoStar Communications Corp., at http://www.dishnetwork.com/content/programming/hdtv/index.shtml.

[318] EchoStar's DISH 811 retails for $399.00 and its DISH Player-DVR 942 retails for $699.00, which offers HD and DVR functionality with a 250 GB hard drive. The DISH Player-DVR 942 can record up to 180 hours of standard-definition programming, or up to 25 hours of HD programming.

its HD set-top boxes to offer an all-in-one equipment and service package.[319] In February 2006, EchoStar began delivering HD local broadcast stations in the New York and Los Angeles markets.[320] DIRECTV's HD Package includes ESPN HD, ESPN2 HD, Discovery HD Theater, HDNet, HDNet Movies and Universal HD for $10.99 per month.[321] DIRECTV delivers the national HD broadcast feed of ABC, CBS, Fox, NBC, and WB in select markets.[322] DIRECTV is planning to use its Spaceway - F1 satellite to deliver HD local broadcast stations in select markets.[323] Beginning in October 2005, DIRECTV launched HD local broadcast stations in several markets.[324]

86. EchoStar and DIRECTV also continue to develop their DVR services. Presently, neither EchoStar nor DIRECTV offers real-time on-demand programming because they lack the capacity on their satellites to store programming and provide feeds to individual subscribers. DIRECTV states that it has experienced higher subscription rates for its DVR-enabled equipment and services following more attractive pricing for the service.[325] DIRECTV has been packaging TiVo's DVR platform into some of its receivers, but has announced that it will transition to its own DIRECTV Plus DVR, which is

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[319] Craig Moffett, Tom Wolzien, *View from the Back Office*, Bernstein Research, Jan. 7, 2005. DIRECTV sells a 30-inch LCD TV for $1,600 and 40-inch TV for $4,000, including delivery, installation, satellite dish, and the DISH 811 HD set-top box.

[320] EchoStar Communications Corp., *Dish Network Launches Local TV Stations in High Definition in Los Angeles via Satellite* (press release), Feb. 2, 2006; EchoStar Communications Corp., *Dish Network Launches Local TV Stations in High Definition in New York City via Satellite* (press release), Feb. 2, 2006.

[321] *See* The DIRECTV Group, Inc., HD Programming, at http://www.directv.com/ DTVAPP/imagine/ HDTV_programming.jsp.

[322] For example, DIRECTV subscribers have two ways to receive satellite-delivered Fox HD programming. First, customers who have an HD receiver and a Total Choice programming package can receive Fox HD programming from either WNYW (located in New York) or KTTV (located in Los Angeles), depending upon their geographic location. The select markets where eligible customers may receive the feeds are: New York; Los Angeles; Chicago; Philadelphia; Boston; Dallas; Washington D.C.; Minneapolis; Detroit; Atlanta; Houston; Tampa Bay and Orlando; Cleveland; Phoenix; Denver; St. Louis; Milwaukee; Kansas City; Salt Lake City; Birmingham; Memphis; Austin' and Greensboro, North Carolina. The second option, available only to unserved households, is to receive Fox HD programming as part of their Distant Network Service. Subscribers must have an HD capable TV set, a DIRECTV HD receiver, and a satellite dish capable of receiving signals from three separate DIRECTV satellites. *See* The DIRECTV Group, Inc., Local Channels in HD, at http://www.directv.com/DTVAPP/imagine HDTV_localchannels.jsp.

[323] Initially, DIRECTV plans to deliver local HD broadcast channels to the following television markets: New York, Los Angeles, Chicago, Philadelphia, Boston, San Francisco, Dallas, Washington, D.C., Atlanta, Detroit, Houston and Tampa. The DIRECTV Group, Inc., *DIRECTV Announces First 12 Markets to Receive Local Channels in High-Definition This Year* (press release), Jan. 6, 2005. DIRECTV states that it will carry each of the primary broadcast networks that offer an HD feed in the market and its customers who subscribe to a local channel package will receive both the standard-definition and HD signal. According to DIRECTV, HD local programming can be received via a new model of dish and customers will require new HD set-top boxes compatible with the new MPEG-4 compression standard.

[324] DIRECTV is providing high definition local channels in Boston, Massachusetts, Dallas and Houston, Texas, Tampa, Florida, Washington, D.C., Detroit, Michigan, New York, New York, and Los Angeles. *See e.g.*, *DIRECTV Lights Up HD Locals in Detroit*, Satellite Business News FAXUPDATE, Oct. 21, 2005; The DIRECTV Group, *DIRECTV Delivers High-Definition Local Channels to Boston, Dallas, Houston, Tampa, and Washington, D.C.* (press release), Dec. 9, 2005; The DIRECTV Group, *DIRECTV Transmits High-Definition Local Channels in New MPEG-4 Transmission Standard to Los Angeles* (press release), Dec. 28, 2005; The DIRECTV Group, *DIRECTV Brings High-Definition Local Channels to New York Today* (press release), Dec. 28, 2005. DIRECTV is carrying the HD local broadcast feed of the ABC, NBC, CBS, and Fox affiliates.

[325] DIRECTV Comments at 18.

manufactured by News Corp. subsidiary NDS.[326] In addition to providing DVR functionality, the new set-top box is designed to support DIRECTV's new interactive features, VOD functionality, and pay-per-view movies with VOD functionality.[327] DIRECTV charges $5.99 per month for its DVR service.[328] EchoStar introduced "DISH on demand" which is based on the model 625 set-top box that offers a hard drive that can record up to 100 hours of programming and reserves enough space for EchoStar to download movies and other content via satellite for the subscriber to view "on demand."[329] DIRECTV reported that it had two million subscribers with DVRs as of June 2005.[330] EchoStar has not reported its DVR subscribership since it reported that it reached one million DVR subscribers in September 2003.[331]

C. Broadband Service Providers

87. For purposes of this report, we define broadband service providers (BSPs) as newer firms that are building state-of-the-art, facilities-based networks to provide video, voice and data services over a single network.[332] Most BSPs are overbuilders.[333] As we have noted previously, BSPs continue to face considerable challenges as discussed below, and competition to cable from BSPs is limited to very few markets. As discussed in the Local Exchange Carrier section, below, a renewed interest from large LECs in entering the video distribution market may change this fact over the next few years.

88. ***OVS.*** In 1996, Congress established the open video system (OVS) framework, one of four statutorily recognized options for the provision of video programming services by LECs.[334] BSPs

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[326] DIRECTV is expected to introduce its new DVR in late 2005. Ian Olgeirson, *DIRECTV Hit By DVR Delays, But Forecast Looks Bright*, The DBS Report (Kagan Research LLC), Aug. 29, 2005; Steve Donohue, *DIRECTV DVR Retail Debut Delayed*, MULTICHANNEL NEWS, Oct. 21, 2005.

[327] DIRECTV Comments at 18. The DIRECTV Plus receiver has a 160-hour recording capacity, but DIRECTV is reported to be making only 100 hours available for consumers to use for their own recording. The remaining 60 hours will be used by DIRECTV to deliver programming, which subscribers can purchase for an additional fee. For example, DIRECTV will deliver select NBC Universal programming from the NBC broadcast network and NBC Universal cable networks, such as USA, Sci Fi and Bravo, to its subscribers' DIRECTV Plus DVRs, which can be accessed on a commercial-free basis for $0.99 per episode. *See* Brook Barnes and Peter Grant, *CBS, NBC Deals Accelerate Shift in TV Landscape*, WALL STREET JOURNAL, Nov. 8, 2005; The DIRECTV Group. Inc., *NBC Universal and DIRECTV Announce First Ever On Demand Deal for Primetime Network Programming; Top NBC Universal Content On Demand for $0.99* (press release), Nov. 7, 2005.

[328] DIRECTV does not charge subscribers for DVR service if they are subscribers to its Total Choice Premier programming package, which costs $93.99 per month. Existing customers seeking to upgrade their service must purchase a DVR equipped set-top box and agree to a new programming contract.

[329] Craig Moffett, Tom Wolzien, *View from the Back Office*, Bernstein Research, Jan. 7, 2005.

[330] Ian Olgeirson, *DIRECTV Hit By DVR Delays, But Forecast Looks Bright*, The DBS Report (Kagan Research LLC), Aug. 29, 2005, at 1. As of March 31, 2005, DIRECTV was reported to have 1.68 million DVR subscribers. Craig Moffett, Amelia Wong, and Lauren M. Pastrich, *DIRECTV (DTV): A Much Brighter Outlook for SSCF*, Bernstein Research Call, May 3, 2005, at 3.

[331] *2004 Report*, 20 FCC Rcd at 2800 ¶ 68. Kagan forecasts that DIRECTV and EchoStar will reach approximately 5.3 million DVR customers by the end of 2005, or approximately one-fifth of total DBS subscribers. *See* Kagan Research, LLC, *DIRECTV Hit By DVR Delays, But Forecast Looks Bright*, The DBS Report, Aug. 29, 2005, at 1.

[332] The term BSP is not intended to imply anything with respect to Commission's policy or proceedings that might involve broadband services. Usually, the services of a BSP can be purchased separately as well as in a bundle. *See 2001 Report*, 17 FCC Rcd at 1296-97 ¶ 3. *See also 2002 Report*, 17 FCC Rcd at 26948-52 ¶¶ 102-11.

[333] *2004 Report*, 20 FCC Rcd at 2801 ¶ 70. An overbuilder is an MVPD that "overbuilds" a second cable network where one already exists.

[334] Most, if not all, OVS providers are also overbuilders. We treat them in a separate section to highlight the separate regulatory classification that Congress created. 47 U.S.C. §571(a)(3)-(4); *1996 Report*, 12 FCC Rcd at (continued....)

are the only significant holders of OVS certifications or local OVS franchises.[335] BSPA reports that new OVS activity has been limited, but that some of its members have converted cable franchises into OVS franchises, which has enabled some BSPs to eliminate build-out requirements.[336] BSPA maintains that build out requirements limit wireline video competition by increasing the costs of entry.[337] BSPA argues that most incumbent cable operators have had decades to build out to current service boundaries with limited or no competition, and did not have to rely on capital markets for funding as current entrants do.[338]

89. ***BSP Overbuilders***. RCN Corporation is the nation's largest overbuilder, supplying voice, video, and high-speed Internet access services to residential subscribers over its own network in the Boston, New York, Chicago, San Francisco, Los Angeles, Washington, D.C, Philadelphia, and Lehigh Valley, Pennsylvania, metropolitan markets.[339] As of June 2005, RCN was the 14th largest MVPD with 371,000 subscribers.[340] WideOpenWest (WOW) is the second largest overbuilder. WOW was the 16th largest MVPD and, as of June 2005, served 292,500 subscribers.[341] The third largest overbuilder is Knoxville, Tennessee-based Knology, which operates mainly in the Southeast. As of June 2005, Knology was the 23rd largest MVPD, and had 179,800 video subscribers.[342] Grande, which operates systems in several cities in Texas, reported that video connections increased from 78,000 to 85,440, and high-speed data increased from 47,000 to 63,241, between June 2004 and June 2005.[343]

90. Last year we reported that many overbuilders were continuing to experience financial difficulties. Since then, RCN emerged from Chapter 11 bankruptcy. RCN reports that it enjoys "a new management team, a new Board of Directors, and [an] improved balance sheet."[344] BSPA reports that

(Continued from previous page) ———————————
4395-98 ¶¶ 68-71. The OVS framework was designed to streamline the process of entering local MVPD markets and it subjects OVS certified providers to regulation under Title VI somewhat different than that applied to cable operators. Among other things, an open video system's carriage rates are entitled to a presumption that they are just and reasonable where one or more unaffiliated video programming providers occupy channel capacity on the system at least equal to that of the open video system operator and its affiliates. We are not aware of any OVS operator carrying programming offered by an unaffiliated program packager. Open video systems are subject to, among others, the Commission's rules governing must carry, retransmission consent, program access, sports exclusivity, network nonduplication, syndicated exclusivity, and public, educational and governmental (PEG) access channels. *Id.* When it authorized the OVS framework, Congress abolished the Commission's video dialtone (VDT) framework under which LECs previously had offered video services.

[335] For a complete list of OVS certifications, *see* Current Filings For Certification of Open Video Systems, at http://www.fcc.gov/mb/ovs/csovscer.html (visited Oct. 10, 2005).

[336] BSPA Comments at 6-7. OPASTCO reports that less than 8 percent of its members provide service under OVS certification. OPASTCO Reply Comments at 3.

[337] BSPA Comments at 19.

[338] *Id.*

[339] RCN Comments at 1-2.

[340] Kagan Research, LLC, *Top Cable System Operators as of 6/05*, Cable TV Investor, Aug. 25, 2005, at 11.

[341] *Id.*

[342] *Id.*

[343] *See* Grande Communications Holdings, Inc., *Grande Communications Holdings, Inc. Announces Results for the Second Quarter Ending June 30, 2005* (press release), Aug. 15, 2005.

[344] RCN Comments at 2 n.2.

BSPs are consolidating ownership of their system holdings, which may help BSPs gain economies of scale and become more financially stable.[345]

91. ***Nature of MVPD Competition***. BSPA highlights a 2005 U.S. Government Accountability Office (GAO) study that examined overbuild video systems.[346] The report states that DBS penetration varies depending on the type of community (*i.e.*, urban, rural, or suburban) and the technical sophistication of the cable competitor and/or the presence of an overbuilder. BSPA maintains that DBS is not as direct a substitute for cable as are BSPs, and that the variation of DBS penetration across communities argues that the Commission should not accede to cable industry arguments that cable is no longer dominant in the MVPD market.[347] We note that the *2004 GAO Report* studied six market pairs for which one market of each pair was served by a BSP overbuilder, and the other was not. GAO found that communities with overbuild competition experienced lower rates (an average of 23 percent lower for basic cable) and higher-quality service. GAO also found that BSPs were facing difficulties competing, such as access to programming and Multiple Dwelling Units (MDUs), and franchise requirements imposed by localities.[348] BSPA calls upon the Commission to monitor and analyze DBS competition as GAO did in the *GAO 2005 Report*, and to reject the notion that markets are not competitive until such time as competitors achieve a market share of 25-30 percent.[349] Comcast strongly disputes the allegation that DBS competition is not meaningful, referring to the "dramatic effects" that DBS competition has had on the multichannel video marketplace.[350]

D. Broadcast Television Service

1. General Performance

92. Broadcast networks and local stations supply video programming directly over the air to consumers. Consumers who do not subscribe to an MVPD service rely solely on over-the-air transmission of local broadcast television signals. Other households receive broadcast television programming over the air on those television receivers that they have chosen not to connect to an MVPD service. In addition, many consumers receive broadcast signals via their cable, DBS, or other MVPD service.

93. As we reported last year, broadcast television stations' audience shares have continued to fall as cable and DBS penetration, the number of cable channels, and the number of nonbroadcast networks continue to grow. For the 2004-2005 television season, broadcast television stations accounted for a combined average 47 share of prime time viewing among all television households, compared to a

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[345] BSPA Comments at 6.

[346] GAO, *Direct Broadcast Satellite Subscribership Has Grown Rapidly, but Varies Across Different Types of Markets*, GAO-05-257, Apr. 2005 (*GAO 2005 Report*). The *GAO 2005 Report* studies how DBS penetration varies across different types of markets (rural, suburban, and urban) and against different types of cable systems (not upgraded, partially upgraded, and fully upgraded). The report finds that DBS penetration is highest in rural areas and lowest in urban, and highest in areas served by a cable system that has not been upgraded and lowest in areas served by a cable system that has been fully upgraded.

[347] BSPA Comments at 7-12.

[348] GAO, *Telecommunications: Wire-Based Competition Benefited Consumers in Selected Markets*, GAO-04-241, Feb. 2004.

[349] BSPA Comments at 10.

[350] Comcast Reply Comments at 37-41. *See also* Time Warner Reply Comments at 1-4.

48 share in the previous season.[351] Broadcast stations achieved a 41 share of all-day (24-hour) viewing during the 2004-2005 season, down from a 44 share the previous season. In contrast, nonbroadcast channels' collective audience share continues to grow. In the 2004-2005 television season, nonbroadcast channels[352] accounted for a combined average 53 share of prime time viewing among all television households, up from the 52 share in the previous season.[353] Nonbroadcast channels accounted for a 59 share of all-day viewing, up from a 56 share in the previous season.[354]

94. Since the 2004 Report, the number of commercial and noncommercial television stations has remained unchanged at 1,747 from June 30, 2004 to June 30, 2005.[355] Total television broadcast advertising revenues grew 11 percent from $42.5 billion in 2003, to $47.2 billion in 2004.[356] Advertising revenue for the seven most widely distributed broadcast networks (ABC, CBS, Fox, NBC, PAX, UPN, and WB) was estimated at $24.9 billion in 2004, a 9.5 percent increase over the $22.7 billion earned in 2003.[357] Cable programming networks fared somewhat better, experiencing a 17.7 percent increase in advertising revenue in 2004; they earned $16.4 billion in advertising revenue compared to $14 billion in 2002.[358]

2. Digital Television

95. DTV allows broadcasters to use a single 6 MHz channel to transmit a high-definition television (HDTV) signal, several standard-definition television (SDTV) signals (multicasting), or ancillary services in addition to video programming.[359] As of October 2005, more than 1,537 stations nationwide are on the air with DTV operations, including all 119 stations affiliated with the top-four network affiliates in the top thirty television markets.[360]

a. Over-the-Air Households

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[351] Nielsen Media Research, *Broadcast Calendar (TV Season) Share of Audience Report, Prime Time and Total Day,* Sept., 2005. Nielsen reports audience shares that exceed 100 percent when totaled due to simultaneous multiple set viewing. We have normalized audience shares to equal 100 percent.

[352] Includes basic (BST and CPST) networks, as well as premium and PPV networks, distributed by MVPDs.

[353] We note that individual broadcast networks generally attract higher audience shares than individual nonbroadcast networks. For example, during the 2004-2005 television season, six of the seven broadcast networks attained average prime time audience shares ratings greater than the average prime time audience rating of the highest rated nonbroadcast networks. Nielsen Media Research.

[354] Nielsen Media Research, *Broadcast Calendar (TV Season) Share of Audience Report, Prime Time and Total Day,* Sept., 2005.

[355] *Compare* Federal Communications Commission, *Broadcast Station Totals as of June 30, 2004* (FCC News Release), Aug. 20, 2004, *with* Federal Communications Commission, *Broadcast Station Totals as of June 30, 2005* (FCC News Release), Aug. 29, 2005.

[356] Television Bureau of Advertising, *2004 TV Ad Revenue Figures,* at http://www.tvb.org/rcentral/adrevenuetrack // revenue/2004/ad_figures (visited Sept. 21, 2005).

[357] *Id.*

[358] Robert J. Coen, *U.S. Advertising Volume 2000-2005*, Universal McCann, Sept. 22, 2005.

[359] *Review of the Commission's Rules and Policies Affecting the Conversion to Digital Television*, 17 FCC Rcd 15978, 15995-96 ¶¶ 39-40 (2002).

[360] *Summary of DTV Applications Filed and DTV Build Out Status,* at http://www.fcc.gov/mb/video/files/ dtvonairsum.html (visited Oct. 2005).

96. On March 1, 2005, the Media Bureau released a staff report concerning over-the-air broadcast viewers (*OTA Report*).[361] The report presented information submitted in response to a *Public Notice* (*OTA Public Notice*) that posed several questions about U.S. TV households that receive broadcast television only in analog format and over the air via an indoor or outdoor antenna.[362] The *OTA Public Notice* asked how many analog over-the-air households there are, where they are located, what their demographic characteristics are, and why they do not subscribe to an MVPD service. The *OTA Public Notice* also requested comment on how best to provide for analog over-the-air households when analog broadcast television service is terminated at the end of the DTV transition. The *OTA Report* notes that the Commission's estimate of over-the-air only households is derived from figures reported in the *2004 Report*. At the time the *OTA Report* was released, the Commission estimated that about 14.86 percent of television households rely on over-the-air television broadcasts to receive video programming.[363] In this report, the *2005 Report*, we find that there are 15.36 million U.S. TV households that do not subscribe to an MVPD service and thus rely on over-the-air broadcast television for their video programming, representing 14 percent of all U.S. TV households.[364] In addition, we note that many households that subscribe to an MVPD also rely on over-the-air signals to receive broadcast programming on some of their television sets.[365] The *OTA Report* also notes that commenters in that proceeding estimate that the percentage of TV households that receive video programming over-the-air only ranges from 13 percent to 19 percent.[366]

97. Nielsen estimates that, as of July 2005, 15.43 million households, or 14 percent of the 109.6 total U.S. television households, rely exclusively on over-the-air television for video programming.[367] Commenters in this proceeding provide estimates of the number of television households relying solely on over-the-air television reception within the range of 12 percent to 18 percent of U.S. television households. NAB, for example, estimates that there are as many as 20.5 million households containing 45 million television sets that do not subscribe to an MVPD and that there are an additional 18.3 million MVPD households with 28 million television sets that are not connected to

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[361] *Media Bureau Staff Report Concerning Over-the-Air Broadcast Television Viewers*, MB Docket 04-210, Feb. 28, 2005. (*OTA Report*).

[362] *Media Bureau Seeks Comment on Over-the-Air Broadcast Television Viewers*, Public Notice, 19 FCC Rcd 9468 (2004).

[363] *See Media Bureau Staff Report Concerning Over-the-Air Broadcast Television Viewers*, MB Docket 04-210, Feb. 28, 2005 (*OTA Report*). *See also 2004 Report*, 20 FCC Rcd at 2869-70. Our estimates of households that do not subscribe to an MVPD service may include a number of households that are using MVPD service without paying for it, and thus overstate the number of OTA households. On the other hand, estimates of MVPD households may be overstated considering that as many as three percent of television households may subscribe to both cable and DBS services. The net effect of these inaccuracies is unknown. In addition, these figures are based on a nationwide average. It appears that the percent of OTA households varies substantially from one market to another. For example, in ten DMAs, over 80 percent of TV households subscribe to cable service. When DBS subscribers to local-into-local service are added, the total MVPD subscribership in most of these markets exceeds 85 percent. In contrast, in 13 DMAs, fewer than 50 percent subscribe to cable. *Id.* at 2872.

[364] *See* Appendix B, Table B-1. According to Table B-1, there are 109,590,170 TV Households, of which 94,226,357 subscribe to an MVPD. This means that at least 15.36 million TV households do not subscribe to an MVPD. *Id.* In the past it has been estimated that approximately 3 percent of all cable households may subscribe to more than one MVPD (3 percent of current cable subscribership is 1.9 million households), but with DBS carriage of local-into-local service, this figure is declining. *See id.* at note (i).

[365] *OTA Report.*

[366] *Id.*

[367] Nielsen Media Research, *U.S. Television Household Estimates*, Sept. 2004, at 1. Nielsen's estimate of 15.43 million households is similar to our own estimate of 15.36 million households.

MVPD service.[368] CEA estimates that approximately 12 percent of all television households receive their broadcast television signals over-the-air.[369] NCTA notes that approximately 15 percent of television households do not subscribe to an MVPD, and that a significant percentage of MVPD households include televisions that are not connected to an MVPD service.[370]

b. Programming

98. ***Programming Available Over the Air.*** NAB indicates that currently the major broadcast networks (ABC, CBS, Fox, and NBC) now provide their most popular programming in high-definition.[371] Special events, such as the Academy Awards and numerous major sporting events, also were broadcast in HD format over the past year.[372] In addition, 1,537 local stations are broadcasting digital signals, including digital multicast, with some broadcasting their local news in HD format.[373] The Association of Public Television Stations (APTS) states that, in 2005, PBS member stations will be distributing 125 hours of high-definition content and also will be distributing 290 hours of widescreen-formatted digital programming.[374] In addition, American Public Television (APT) will be supplying 91 hours of HD programming each month to public television stations. Public television stations also are broadcasting multiple program streams to bring new services to the public that could not be made available using a single analog stream.[375]

99. ***Programming Available Through MVPDs.*** NCTA reports that, as of January 2005, local cable systems were carrying the digital signals of 504 unique broadcast stations, and cable operators offer as many as 23 nonbroadcast networks that transmit much of their programming in HD format.[376] In April 2005, public television and cable operators serving over 80 percent of cable subscribers in markets comprising over 80 percent of U.S. TV households entered into an agreement providing for the carriage of public television stations' digital programming (including multicast channels) by cable operators.[377]

100. ***Multicasting.*** Multicasting is the process by which multiple streams of digital television programming are transmitted at the same time over a single broadcast channel. In the *Notice*, we requested information on the content provided using broadcasters' DTV spectrum, including the use of

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[368] NAB Comments at 2; NAB Reply Comments at 8-10. NAB argues that those households relying solely on over-the-air broadcasting are predominantly lower income and include relatively greater numbers of racial and ethnic minorities. NAB Comments at 3.

[369] CEA Comments at 7. CEA argues that the decision not to subscribe to an MVPD generally is not driven by economic reasons and that those who do not subscribe watch, on average, 30 percent less television per week than MVPD subscribers. CEA Comments at 7-8. CEA also notes that three-quarters of antenna-only households are willing to take some sort of voluntary action to ensure that they continue to receive television programming when analog broadcasts end. CEA Comments at 9.

[370] NCTA Comments at 15.

[371] NAB Comments at 7.

[372] *Id.*

[373] *Summary of DTV Applications Filed and DTV Build Out Status,* at http://www.fcc.gov/mb/video/files/dtvonairsum.html (visited Oct. 2005). *See also* NAB Comments at 7.

[374] APTS Comments at 4-5.

[375] *Id.*

[376] NCTA Comments at 26, 27. NCTA estimates that 92 million television households were passed by at least one cable system offering HDTV service in January 2005. *Id.*

[377] NCTA Comments at 28. *See* para. 53 *supra.*

multicasting, and whether cable operators and other MVPDs are carrying multicast DTV programming.[378] As Comcast notes, the broadcast industry, like the cable industry, recently has undergone a technological evolution, and broadcasters that transmit in digital now are able to distribute multiple channels to any consumers who have also converted their home equipment to digital.[379] Comcast notes that broadcasters are now able to transmit multiple standard-definition over-the-air signals. This multicasting capability will allow stations to offer consumers more services and content, thereby increasing broadcasters' competitive impact in the multichannel video marketplace.[380]

101. NAB indicates that, in addition to providing HD format programming, hundreds of local stations, even local stations in medium and small markets, are using their digital channels for multicast services.[381] According to a study by Decisionmark Corp., the 11 largest broadcast networks and their affiliates broadcast more than 937,000 hours of multicast programming during the month of October 2005.[382] This multicast programming includes news, weather, sports, religious material, music videos and coverage of local musicians and concerts, as well as foreign language programming (especially, but not limited to, Spanish programming).[383] According to a July 2005 survey of full-power commercial television stations conducted by NAB, 50 percent of the responding stations are currently multicasting, and of the remaining 50 percent, 79 percent are considering multicasting in the future. Of those stations currently planning to multicast, 79 percent expect such programming to be locally produced or locally focused.[384] NAB also found that 79 percent of respondents said if multicast is not carried by cable operators, they will not provide these services.[385]

102. APTS states that more than 95 percent of all public television stations have committed to broadcast at least one multicast channel dedicated to formal educational programming.[386] In addition, public television stations plan to multicast public affairs and local issue coverage such as coverage of state legislatures, local town meetings and debates, and instructional television, as well as foreign language programming, children's programming and programming dedicated to the senior community.[387] PBS stations are also using digital transmission capability to offer educational data services discussed in the next section.

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[378] *Notice*, 20 FCC Rcd 14142 ¶ 69-71.

[379] Comcast Comments at 31.

[380] Comcast Comments at 31-32.

[381] NAB Comments at 1, 7, 8.

[382] The 937,000 hours represented multicast programming broadcast by the 13 largest commercial and non-commercial national broadcast networks (ABC, CBS, Fox, NBC, Paxson, PBS, TBS, TBN, Telemundo, Univision, UPN, WB, and Paxson), their affiliates, or independent television stations. This includes digital simulcast and unique programming multicast stations. Decisionmark Corp., *Multicast Analysis*, Nov. 2005. PBS and its affiliates accounted for 47.5 percent of this programming. ABC, NBC, and Paxson each accounted for more than 10 percent of the total multicast programming available (10.25 percent, 10.35 percent and 10.45 percent, respectively). *Id.*

[383] NAB Comments at 7-8. *See also* APTS Comments at 4-7. Approximately 10 percent of all multicast programming during October 2005 was news programming, about 8.8 percent was children's or educational programming, 7.3 percent was documentary or nature programming, 7.2 percent was comedy or drama programming, 6.4 percent was weather, and 2.8 percent was sports. Decisionmark Corp., *Multicast Analysis*, Nov. 2005.

[384] NAB Comments at Attachment.

[385] *Id.*

[386] APTS Comments at 5-6

[387] *Id.* at 5-8.

103. NCTA states that, as of May 2005, cable operators were carrying commercial broadcasters' multicast programming in over 50 markets (including at least seven of the top ten markets).[388] Comcast, for example, offers PBS multicast channel PBS Kids Sprout and has entered into agreements with over 200 commercial broadcasters in 72 markets to carry their local multicast digital signals.[389] Several cable operators agreed to carry CBS stations' extra coverage of the NCAA men's college basketball tournament on multicast channels.[390] In addition, Verizon's video service FiOS and the Tribune Company, owner of 26 broadcast television stations nationwide, have tentatively entered into an agreement in which FiOS will carry any multicast programming Tribune decides to offer.[391]

104. APTS requests that the Commission require DBS providers to carry all free, over-the-air digital signals where local television stations are being carried pursuant to the Satellite Home Viewer Improvement Act of 1999 (SHVIA),[392] and argues that such carriage should include both high-definition programming and all multicast digital programming.[393] APTS argues that digital carriage on satellite will speed the digital transition, given that satellite subscribers account for over 20 percent of all TV households on average.[394] APTS also argues that the Commission should impose multicast carriage requirements on new LEC video providers, arguing that new entrants' broadband networks have more than enough capacity to accommodate such programming.[395]

105. ***Datacasting and Subscriptions Services.*** DTV also allows broadcasters to use part of their digital bandwidth for subscription multichannel video programming services and datacasting.[396]

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[388] NCTA Comments at 28.

[389] Comcast Comments at 44-45. *See also* NCTA Comments at 28.

[390] NCTA Comments at 28.

[391] John Eggerton, *Tribune FiOS Deal Includes Multicasting*, BROADCASTING & CABLE, Oct. 28, 2005, at http://www.broadcastingcable.com/article/CA6279281.html?display=Breaking+News (visited Nov. 30, 2005).

[392] Pub. L. No. 106-113, 113 Stat. 1501, 1501A-526 to 1501A-545 (1999).

[393] APTS Comments at 14. In its *Second Report and Order* on digital television broadcast signal carriage, the Commission affirmed its decision in the *First Report and Order* to interpret the statutory term "primary video" to mean a single programming stream. If a digital broadcaster elects to divide its digital spectrum into several separate programming streams, only one of these streams is entitled to mandatory carriage. *Carriage of Digital Television Broadcast Signals: Amendment to Part 76 of the Commission's Rules,* Second Report and Order and First Order on Reconsideration, 20 FCC Rcd 4516, 4518 ¶ 3 (2005); *see also Carriage of Digital Television Broadcast Signals: Amendment to Part 76 of the Commission's Rules,* First Report and Order and FNPRM, 16 FCC Rcd 2598 (2001). On April 21, 2005, the Commission received five petitions for reconsideration, filed by the following: ABC Television Affiliates Association, CBS Television Affiliates Association, NBC Television Affiliates, ABC Owned Television Stations, and NBC and Telemundo Stations; DIC Entertainment Corporation; Minority Media and Telecommunications Council; National Association of Broadcasters and the Association for Maximum Service Television, Inc.; and Paxson Communications Corp. In its reply comments in this proceeding, Paxson reiterates that, in the absence of full digital multicast must carry, the Commission should not encourage broadcasters to offer ancillary and supplementary services in lieu of free over-the-air programming on their DTV stations. Paxson Reply Comments at 5-7.

[394] APTS Comments at 17.

[395] *Id.* at 36. Verizon replies that the Commission should not impose new regulation that discriminates against, and adds new burdens on, new entrants in the video market. Verizon Reply Comments at 13-14.

[396] Commercial and noncommercial educational DTV broadcast station licensees report annually, using Form 317, whether they have provided ancillary or supplementary services at any time during the 12 month period preceding September 30. Licensees that earn revenues from such services are required to pay fees to the Commission. *FCC Annual DTV Ancillary/ Supplementary Services Report*, 18 FCC Rcd 23972 (2003). *See also* 47 U.S.C. § 336 (a), (e). To date, the provision of ancillary and supplementary services has been modest. In the most recent year, the (continued....)

These services can be provided simultaneously with HD or SD DTV programs, and can provide delivery of virtually any type of data, audio or video, including text, graphics, software, web pages, video-on-demand,[397] and niche programming.[398]

106. Last year, we reported on the activities of U.S. Digital Television, Inc. (USDTV), which combined broadcast spectrum licensed to a number of broadcasters to create subscription video distribution via DTV streams.[399] USDTV continues to offer a multichannel video programming service including broadcast and nonbroadcast programming using local over-the-air DTV spectrum.[400] USDTV provides service in Salt Lake City, Las Vegas, Albuquerque, and Dallas, and has announced plans to begin service in the Norfolk/Hampton Roads area in Spring 2006.[401] Its service costs $20 per month for 30 channels of programming, including 12 nonbroadcast networks, and it serves between 4,500 and 5,000 subscribers.[402] In September 2005, News Corp's station group, Hearst-Argyle Television Inc., McGraw-Hill Broadcasting, LIN TV Corp., Morgan-Murphy Stations and Telcom DTV LLC jointly invested $25.8 million in USDTV in return for an interest in the company. This additional funding is expected to allow USDTV to expand its service to other markets and to add technological upgrades to provide on-demand content and DVR services.[403]

107. APTS indicates that some public television stations are employing datacasting for supplemental programming and public safety purposes.[404] For example, New Jersey Network's 21st

(Continued from previous page)

ancillary and supplementary services provided most often were pay television service and broadband Internet access. Reports on activity during 2005 were due on December 1, 2005. *See also Media Bureau Reminds Digital Television to File Report on Ancillary or Supplementary DTV Services on or before Dec. 1, 2005*, 20 FCC Rcd 19078 (2005).

YEAR	NUMBER OF DTV LICENSEES THAT REPORTED FEEABLE SERVICES	GROSS REVENUES FROM FEEABLE SERVICES	FEES COLLECTED FROM FEEABLE SERVICES
1999	0	$0	$0
2000	4	$570,000	$28,500
2001	2	$390,000	$19,500
2002	6	$148,280	$7,414
2003	3	$45,000	$2,250
2004	10	$78,625	$3,931

[397] Video-on-Demand via over-the-air broadcast signals may be provided several ways. It may use a model similar to that contemplated by DBS where VOD programming is broadcast and then stored in a local DVR. With the addition of an internet connection, it is also possible to provide true VOD by using broadcast for the downstream transmission of video and an internet connection for the comparatively low bandwidth control signals.

[398] *See 2004 Report*, 20 FCC Rcd at 2807 ¶ 84.

[399] *Id.*

[400] U.S. Digital Television, Inc., at http://www.usdtv.com/company_info.php (visited Oct.19, 2005).

[401] U.S. Digital Television, Inc., at http://www.usdtv.com/GET-USDTV.html (visited Nov. 28, 2005). *See also* U.S. Digital Television, Inc., *USDTV Selects the Norfolk Virginia Market as First East Coast Launch of its All-Digital Low-Cost Cable Alterative* (press release), Jan. 5, 2006.

[402] Linda Moss, *USDTV Gets Cash Infusion*, MULTICHANNEL NEWS, Sept. 26, 2005, at http://multichannel.com/article/CA6260559.html?

[403] U.S. Digital Television, Inc., *USDTV Signs Agreement With Major Broadcasters to Expand "Over-the-Air" Digital Subscription TV* (press release), Sept. 26, 2005.

[404] APTS Comments at 10.

Century Digital Classroom program and WHYY, Philadelphia, Pennsylvania, are using datacasting to deliver media-rich video content over the air to students, teachers, and adults in classrooms and libraries. Such content includes video, text, audio, graphs and maps.[405] The New Jersey Network also datacasts workforce training programs to several sites around the state. Some public television stations are using datacasting to allow public safety and emergency management agencies to transmit securely critical, time-sensitive information to personal computers equipped with DTV tuner cards and a small antenna.[406] Public television stations using this service include Kentucky Educational Television, WNET in New York, New Jersey Network, Nashville Public Television, and New Hampshire Public Television.[407] APTS believes public television stations will play an important role in supporting a national and local digital broadcast emergency alert system through the digital interconnection infrastructure public broadcasting is developing.[408]

108. In addition, digital spectrum can be used for services provided on various types of electronic devices. As reported last year, iBlast and dotcast use the digital broadcast spectrum of local TV stations to distribute digital media content directly to home computers, set-top boxes, DVRs, vehicle entertainment systems, game consoles, PDAs and MP3 players.[409]

c. DTV Equipment

109. The sale of DTV consumer electronics continues to accelerate.[410] Kagan Media Research estimates that between 1998, when digital television sets were first offered for retail sale, and year-end 2004, approximately 15.8 million HD-ready and enhanced-definition (ED)-ready monitors had been shipped to retailers, with 13.65 million of those being HD-ready monitors.[411] Of those shipped, Kagan estimates that a total of 14.7 million have been purchased by consumers, of which 12.4 million were HD-ready.[412] For 2005, Kagan also estimates that 9.9 million HD-ready and ED-ready monitors will be shipped to retailers, with 8.2 million of those HD-ready. Of those shipped, Kagan estimates that more than 8.9 million monitors will be purchased by consumers, with 7.8 million of those being HD-ready.[413] CEA research indicates that 85 percent of DTV displays sold in 2004 were capable of displaying a picture

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[405] *Id.* at 9-14.

[406] *Id.* at 10-14.

[407] *Id.*

[408] *Id.* at 13-14. The Commission recently examined issues pertaining to EAS in digital services in the *Review of the Emergency Alert System*, 20 FCC Rcd 18625 (2005).

[409] *See* iBlast Inc., *What is iBlast?*, at http://www.iblast.com (visited Oct. 18, 2005); *see also* Dotcast, Inc., at http://www.dotcast.com/(visited Oct. 18, 2005). *See also 2004 Report*, 20 FCC Rcd at 2808 ¶ 86.

[410] CEA notes that digital television has been adopted twice as quickly as color television. While it took color television 10 years to achieve 5 percent penetration from introduction, digital television products are already in 16 million American homes. CEA Comments at 2.

[411] Kagan Research, LLC, *Digital TV Set Projection Model*, The State of High Definition Television 2005, at 269; Kagan Research, LLC, *Digital TV Set Projection Model*, Media Trends 2005, at 112. "Enhanced-definition" (ED) refers to digital television signals with a resolution somewhere between standard-definition (current analog signals) and high-definition (HD). Enhanced-definition is approximately DVD-quality. "HD-ready" and "ED-ready" mean that a television is capable of displaying an HD signal or an ED signal, but does not include a digital tuner for over-the-air reception of digital broadcast signals.

[412] Kagan Research, LLC, *Digital TV Set Projection Model*, The State of High Definition Television 2005, at 269; Kagan Research, LLC, *Digital TV Set Projection Model*, Media Trends 2005, at 112.

[413] *Id.*

in HDTV resolution, while the remaining 15 percent were capable of EDTV resolution.[414] HD-ready and ED-ready monitors do not necessarily contain DTV tuners. The remaining households must purchase a DTV tuner to receive digital television over the air or must subscribe to an MVPD that retransmits digital signals. CEA forecasts that 15.3 million integrated DTVs will be sold in 2005, 24.3 million in 2006, 32.1 million in 2007 and 36.3 million in 2008.[415]

110. CEA estimates that, since 1998, more than 17 million DTV sets in total have been sold to consumers, and Americans have spent over $30 billion to purchase DTV sets.[416] CEA reports that during the first six months of 2005, DTV products sold at a faster rate than during any previous comparable period of time, with 3.8 million DTV products sold, accounting for $4.6 billion in sales, a 40 percent increase in unit sales from the same time period in 2004.[417] CEA estimates that, by 2009, Americans will purchase more than 152.3 million DTV tuners and over-the-air tuners will be found in 86 percent of American homes.[418]

111. CEA comments that DTV set prices are 75 percent lower than they were five years ago and are still declining by approximately 15 to 20 percent each year.[419] In 2005, the average retail price of a DTV set is expected to drop to $1,189 from $1,489 in 2004, down from the average price of $3,147 in 1998.[420] CEA states that currently several DTV models are available for under $700, and it expects that soon there will be DTV sets that sell for as low as $400.[421] CEA adds that over the next two years manufacturers plan to introduce one or more $60 digital-to-analog converters that will allow digital TV broadcasts to be converted to analog for viewing on analog TV sets.[422]

112. On June 15, 2005, NAB and the Association for Maximum Service Television, Inc., announced a project in which they would pursue the development of a high-quality, low-cost digital-to-analog converter box for terrestrial DTV reception.[423] CEA, however, states that the digital-to-analog converter box for which NAB and MSTV requested proposals includes features that consumers do not want or need.[424] CEA maintains that these features will add significant costs to the low-cost box originally envisioned, undermining Congress's ultimate goal that an affordable option be made available to consumers.[425] In October 2005, NAB chose LG Electronics, Inc., and Thomson, SA, to each develop a

[414] CEA Comments at 2-3, 5.

[415] *Id.* at 5.

[416] *Id.*

[417] *Id.*

[418] *Id.* at 6.

[419] *Id.* at 5.

[420] *Id.* at 3.

[421] *Id.* at 5.

[422] *Id.*

[423] NAB Comments at 5. Twelve consumer electronics firms submitted proposals in the process. *Id.* at 5-6.

[424] CEA Reply Comments at 2. *See also* Association for Maximum Service Television, Inc., *Thomson and LG Electronics Partner with Broadcasters to Develop Terrestrial Digital-to-Analog Converter Boxes*, Oct. 5, 2005.

[425] *Id.* at 2-3.

prototype high quality, low cost terrestrial digital converter box to receive digital signals on conventional analog televisions.[426]

[426] National Association of Broadcasters, *Thomson and LG Electronics Partner with Broadcasters to Develop Terrestrial Digital-to-Analog Converter Boxes* (press release), Oct. 5, 2005. Neither NAB nor its partners have indicated when working prototypes would be available.

d. DTV Transition

113. In our *2004 Report*, we described several rulemaking decisions that the Commission adopted during 2004 intended to accelerate or promote the transition to DTV.[427] This year, we report on the Commission's continuing efforts to foster the DTV transition.[428]

114. ***DTV Signal Carriage Proceeding.*** In February 2005, the Commission considered petitions for reconsideration of the *Digital Must Carry First Report and Order* and the various comments submitted in response to the *Digital Must Carry FNPRM.*[429] The Commission affirmed its tentative conclusion not to require cable operators to carry both a broadcaster's analog and digital signals (*i.e.*, dual carriage) during the transition. In addition, as noted above, the Commission also denied petitions for reconsideration of its statutory interpretation of "primary video." In the interest of providing certainty on these significant issues, the Commission deferred the resolution of certain other issues to a future order. These include petitions requesting reconsideration or clarification with respect to the Commission's decisions on Program System and Information Protocol (PSIP) carriage and channel numbering, carriage of program-related material, material degradation, and down-conversion of digital-only stations.[430]

115. ***Low-Power Television and Television Translators.*** Last year, we reported that the Commission established rules in September 2004 to allow for the digital conversion of low-power television and television translator stations (*LPTV Report and Order*).[431] In the *LPTV Report and Order* the Commission found that LPTV and translator stations could either file for an on-channel digital conversion of their existing stations or file for a digital "companion channel" to operate in analog and digital simultaneously.[432] On October 4, 2005, a *Public Notice* was issued announcing that the Commission has commenced accepting applications for digital on-channel conversions.[433] The Commission has not yet commenced accepting applications for digital companion channels for LPTV and translator stations.

116. ***Channel Election and Designation.*** In the *Second Periodic Review*, the Commission adopted a multi-step channel election process through which commercial and noncommercial broadcast licensees and permittees (licensees) will select their ultimate "in-core" (*i.e.*, channels 2-51) DTV

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[427] *2004 Report*, 20 FCC Rcd at 2809-2811 ¶¶ 89-96.

[428] *See* Deficit Reduction Act of 2005, PL 109-171 (2006). Among other things, Title III, entitled the Digital Television Transition and Public Safety Act of 2005, establishes a hard deadline of February 17, 2009 for the end of analog transmissions and the transition to digital television. It allocates approximately $990 million of the estimated $10 billion in proceeds from the auction of the broadcast spectrum for a digital-to-analog converter box program.

[429] *See Carriage of Digital Television Broadcast Signals: Amendment to Part 76 of the Commission's Rules,* Second Report and Order and First Order on Reconsideration, 20 FCC Rcd 4516 (2005) (*Digital Must Carry Second Report and Order* and *Digital Must Carry First Reconsideration*) (released in a single proceeding). *See also* 47 C.F.R. § 1.429 (setting forth basis for granting petitions for reconsideration).

[430] *See Second Periodic Review of the Commission's Rules and Policies Affecting the Conversion to Digital Television*, 19 FCC Rcd 18279 (2003) (*Second DTV Periodic Review*).

[431] *Amendment of Parts 73 and 74 of the Commission's Rules to Establish Rules for Digital Low Power Television, Television Translator, and Television Booster Stations and to Amend Rules for Digital Class A Television Stations*, 19 FCC Rcd 19331 (2004) (*LPTV Report and Order*). *See also 2004 Report*, 20 FCC Rcd at 2811 ¶ 95.

[432] *See LPTV Report and Order*, 20 FCC Rcd at 19374-19381 ¶¶ 127-148.

[433] *FCC Commences Accepting Applications For On-Channel Digital Conversion of Low Power TV and TV Translator Stations and Announces Availability of Revised Application Forms 346 and 301-CA* (Public Notice), Oct. 4, 2005 (announcing, among other things, that all of the rules and forms outlined in the *LPTV Report and Order* received the approval of the Office of Management and Budget (OMB)).

channel.[434] In the first round of the election process, licensees currently holding in-core channels filed election forms by February 10, 2005. In June 2005, the Media Bureau approved a number of negotiated channel arrangements among licensees[435] and announced the tentative DTV channel designations for 1,554 licensees participating in the first round.[436] In addition, the Media Bureau notified approximately 160 licensees that had elected to keep their allotted NTSC (*i.e.*, analog) channel as their post-transition DTV channel that their proposed operations would result in impermissible interference to one or more stations, and gave these licensees 60 days to re-file indicating how they would resolve the interference conflict. After analyzing these submissions, the Media Bureau announced a total of 1,713 tentative DTV channel designations based upon the first round of channel elections.[437] The remaining licensees, which could not or did not elect in the first-round, filed second-round channel election forms by October 31, 2005.[438]

117. In early 2006, the Media Bureau expects to announce tentative DTV channel designations and interference conflicts for licensees participating in the second-round. The conflicted licensees will have 60 days from notification to re-file, indicating how they will resolve the conflict. The Media Bureau expects a third-round of elections, to cover any stations that were not tentatively assigned a channel in the prior two rounds.[439]

e. Educational Efforts

118. In the *2004 Report,* we provided information on efforts to educate consumers about the DTV transition. We reported on the Commission's web portal, http://www.dtv.gov, that was intended to serve as a one-stop source of information regarding the transition, and efforts by CEA, the Consumer Electronics Retail Coalition (CERC) and its member companies, NAB, NCTA, and individual MVPD operators.[440]

119. These educational efforts continue. For example, several organizations continue to operate websites, host conventions, and produce videos and publications designed to provide consumers with information about the transition. A consumer and retailer website, http://www.checkhd.com, operated by Decisionmark, continues to provide information about the availability of local digital and HD channels, information on how to purchase a digital set, and answers to basic DTV questions.[441] CEA operates several websites designed for both retail sales associates and consumers,[442] and continues to host

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[434] At the end of the DTV transition, 108 MHz of spectrum in the 700 MHz band currently used by broadcast channels 52-69 will be made available for wireless services – 24 MHz for urgent public safety needs and the remainder for advanced commercial wireless services.

[435] *Negotiated Channel Election Arrangements*, 20 FCC Rcd 10141 (MB 2005).

[436] *DTV Tentative Channels Designations for 1,554 Stations Participating in the First Round of DTV Channel Elections*, 20 FCC Rcd 10983 (MB 2005).

[437] *Tentative Digital Channel Designations for Stations Participating in the First Round of DTV Channel Elections and Second Round Election Filing Deadline*, 20 FCC Rcd 15785 (MB 2005).

[438] *See Deadline for Filing FCC Form 384, Digital Channel Election Form, Second Round Election, Extended Until October 31, 2005*, 20 FCC Rcd 16581 (MB 2005).

[439] *FCC Advances DTV Channel Election Process* (FCC News Release), June 8, 2005.

[440] *2004 Report*, 20 FCC Rcd 2811-13 ¶¶ 97-103.

[441] CheckHD includes information about local channels and programming, antenna selection by zip code, and DTV equipment. CEA provides educational materials and information for the site, including the consumer brochure and the HDTV Guide. NAB Comments at 6; CEA Comments at 16.

[442] Antennaweb.com determines the free over-the-air DTV signals that can be received in a given geographic area or television market and what type of antenna is needed to receive those signals over the air. CEknowhow.com (continued....)

conventions aimed at providing HDTV information updates to local retailers, broadcasters, manufacturer representatives, and cable and satellite providers.[443] CEA also produces "HDTV Update E-News," which is a video that is updated several times per year and sent to retailers, manufacturers, and the press. In addition, NAB has developed an educational video series that it makes available to its television station members and that is designed to educate consumers on basic DTV concepts.[444]

120. In addition, CERC has issued a retail consumer guide that focuses on the choices that consumers will have when analog broadcasting ends.[445] CEA continues to distribute a consumer and retailer tip sheet, "*Buying a Digital Television,*" that it produced in partnership with the Commission and CERC.

E. Other Wireline Video Services

1. Local Exchange Carriers

121. The 1996 Act amended Section 651 of the Communications Act to permit common carriers to provide video services in their telephone service areas. The statute permitted common carriers to: (1) provide video programming to subscribers through radio communications under Title III of the Communications Act;[446] (2) provide transmission of video programming on a common carrier basis under Title II of the Communications Act;[447] (3) provide video programming as a cable system under Title VI of the Communications Act;[448] or (4) provide video programming by means of an open video system (OVS).[449]

122. As we reported last year, there are new signs of LEC interest in providing video services. We previously reported on joint marketing agreements between BellSouth, Qwest, SBC, and Verizon and DBS service providers,[450] and noted that several LECs have reported plans to provide video service via asymmetric digital subscriber line (ADSL), very high-speed digital subscriber line (VDSL), or fiber to the home (FTTH) using IP technology.[451] The Fiber-to-the-Home Council reports that there are 652 communities in 46 states served at least in part by FTTH networks, with 322,700 "connected homes."[452]

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provides training products for retail sales associates. *The Connections Guide*, www.ce.org/connectionsguide/, is designed to help consumers better understand how to connect their DTV products. CEA Comments at 14-15. *See also* CEA, at http://www.ce.org/hdtv.

[443] CEA has hosted 25 "HDTV Updates" conventions nationwide. CEA Comments at 15.

[444] "DTV Lessons" describes DTV concepts in language accessible to the average viewer. NAB Comments at 6.

[445] CEA Comments at 16-17.

[446] 47 U.S.C. § 571(a)(1).

[447] 47 U.S.C. § 571(a)(2).

[448] 47 U.S.C. § 571(a)(3).

[449] 47 U.S.C. § 571(a)(3)-(4). *See also* para. 88 *supra.*

[450] *2004 Report*, 20 FCC Rcd at 2823 ¶ 125. BellSouth, for example, reports that 400,000 BellSouth telephone customers added DIRECTV service. BellSouth Comments at 2. *See also* Comcast Comments at 15-16.

[451] *See Availability of Advanced Telecommunications Capability in the United States, Fourth Report to Congress*, 19 FCC Rcd 20540, 20555-57. Some commenters use the term fiber to the premises (FTTP) instead of the term fiber to the home; the terms are equivalent. Additionally, some LECs are not deploying full FTTH, but instead are deploying fiber-to-the node (FTTN), which provides fiber facilities to the neighborhood node, and copper facilities from the neighborhood node to the residence. *See also* para. 15, n.11 *supra.*

[452] Fiber-to-the-Home Council, *Number of U.S. Fiber-to-the-Home Communities Tops 650* (press release), Oct. 4, 2005.

Over the past year, the larger LECs have continued and accelerated their plans to roll out video services, with Verizon actually signing cable franchises and beginning service in one community.[453]

123. As has been true for the past several years, BellSouth holds 20 cable franchises with the potential to pass 1.4 million homes and provides cable service to approximately 40,000 customers in 14 of its franchise areas.[454] BellSouth reports that it is studying the use of Internet Protocol Video, or IPTV, for further distribution of multichannel video services, and that a full-service market trial could begin next year.[455] Qwest provides video services via traditional Hybrid Fiber-Coaxial (HFC) architecture in the western suburbs of Omaha, Nebraska, and is deploying an FTTH network in Lone Tree, Colorado.[456] SBC is deploying an IP-enabled broadband network called "Project Lightspeed," using both Fiber to the Node (FTTN) and FTTH to deliver video and other services to residential customers.[457] SBC reports that the network will be available to 18 million homes nationwide.[458] SBC separately reports that they will begin commercial service to limited subscribers in neighborhoods in San Antonio, Texas in late 2005 or early 2006, scale to full service in San Antonio in mid-2006, and reach the full 18 million households by the first half of 2008.[459]

124. The efforts of Verizon are noteworthy this year because it has begun commercial service in several communities and committed to beginning service in many additional communities in the near future. Verizon is deploying an FTTH network under the brand name "FiOS" that will allow delivery of multichannel video services in addition to telephony and high-speed Internet access service at speeds above those of ADSL technology. Verizon has received franchises from local communities in California, Florida, Virginia, Texas,[460] Maryland, and Massachusetts.[461] Verizon began offering multichannel video service in Keller, Texas, a city 30 miles from Dallas, on September 21, 2005, and now offers service to more than a dozen Texas communities;[462] in Herndon, Virginia, a suburb of Washington, D.C., on

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[453] Comcast Comments at 12-22; NCTA Comments at 16-18. In addition, the NRTC intends to offer its members IP technology and content by early 2006, and cable operator Time Warner is currently testing IP-based computer access of up to 75 cable channels of programming to certain subscribers in its San Diego system. NRTC Comments at 3, 4-6; Comcast Comments at 24.

[454] BellSouth Comments at 1-2.

[455] BellSouth Comments at 2-3. Microsoft is providing software to BellSouth to assist in its delivery of video service. *See* Jim Hi, *Bell South Begins Microsoft IPTV Trials*, NEWS.COM, Jan. 6, 2005. For general comments on IPTV, *see also* Network Domain Comments, *generally*; Alcatel Comments at 7-8.

[456] Qwest Comments at 1 n.3.

[457] SBC Comments at 7-8. Alcatel and Microsoft are working to assist SBC in its deployment of video service. SBC Comments at 2-3, 8-9; Alcatel Comments at 1-3. In February 2005, Alcatel entered into an agreement with Microsoft to develop an integrated IP delivery technology. Alcatel Comments at 1-3; Colin, C. Haley, *Alcatel, Microsoft to Hand Over Your IPTV*, INTERNET NEWS.COM, Feb. 22, 2005; *Alcatel, Microsoft Unveil IPTV Partnership*, COMM. DAILY, Feb. 23, 2005, at 4.

[458] SBC Comments at 8.

[459] SBC Communications, Inc., *SBC CIO Confirms Project Lightspeed Timing, Milestones at Analyst Conference* (press release), Nov. 3, 2005.

[460] Verizon Comments at 5.

[461] Verizon Communications, Inc., *City of Woburn Awards Video Franchise to Verizon, Providing More Choice and Benefits to Consumers* (press release), Sept. 30, 2005. *See also* Verizon Communications, Inc., *Howard County Council Grants Verizon Authority to Offer FiOS TV to More Than 265,000 Potential Viewers* (press release), Jan. 4, 2006.

[462] Verizon Reply Comments at 1-4. *See also* Verizon Communications, Inc., *Verizon FiOS TV Is Here! New Video Service Harnesses the Speed and Capacity of Broadband With the Power of Broadcast to Offer Consumer Choice in* (continued....)

November 21, 2005;[463] and in Temple Terrace, Florida, a city northeast of Tampa, on December 6, 2005.[464] Verizon commented that it would pass over three million homes and businesses by the end of 2005, and planned to pass an additional three million homes and businesses by the end of 2006.[465]

125. Qwest and a number of smaller incumbent LECs are offering, or preparing to offer, MVPD service over existing telephone lines using VDSL or ADSL technologies.[466] Qwest offers video, high-speed Internet access, and telephone service over existing copper telephone lines using VDSL in the Phoenix, Arizona, metropolitan area and in Denver and Boulder, Colorado.[467] Cincinnati Bell reports that it is upgrading its existing DSL architecture to provide IPTV services through an FTTN configuration similar to that being deployed by SBC.[468] CenturyTel is operating a trial IPTV service over DSL in La Crosse, Wisconsin, and planned commercial launch of the service in the fourth quarter of 2005.[469] Cincinnati Bell and CenturyTel both intend to store all available channels at the network node and deliver only the content requested by the subscriber, either by channel selection or program selection, rather than delivering all channels to all homes all the time.[470]

2. Electric and Gas Utilities

126. Electric and gas utilities possess certain assets that have positioned them well for entry into the MVPD market, including access to public rights-of-way, ownership and operation of various infrastructures amenable to the provision of network services, and well-established relationships with customers.[471] Some utilities continue to move forward with ventures involving multichannel video programming distribution, though such services are still not widespread.

127. As previously reported, some municipal, county, and public utilities provide voice, video, and high-speed Internet access services in competition with incumbent cable systems, generally using fiber optic networks.[472] Some utilities have built systems on their own, but many utilities involved in the video distribution market are engaged in joint ventures with other companies.[473] It is reported that utility systems are being deployed in urban and rural areas and serve both low-income and affluent

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TV (press release), Sept. 22, 2005; *More Verizon Customers in North Texas Get Competitive Choice, Greater Value for TV Service as Verizon Launches FiOS TV in 7 More Communities* (press release), Jan. 5, 2006.

[463] Verizon Communications, Inc., *Verizon to Launch FiOS TV in Herndon; First Rollout in East, New Video Service Harnesses Speed and Capacity of Fiber-Based Broadband With Power of Broadcast to Offer Consumer Choice in TV* (press release), Nov. 21, 2005.

[464] Verizon Communications, Inc., *Verizon to Launch FiOS TV in Temple Terrace; First Rollout in Florida, New Service Offers Customers Better Television Technology, True Competitive Choice and Greater Value* (press release), Dec. 6, 2005.

[465] *See* Letter from Leora Hochstein, Executive Director, Federal Regulatory Affairs, Verizon Communications, to Marlene H. Dortch, Secretary, FCC (Nov. 22, 2005).

[466] NRTC Comments at 4-5; NTCA Comments at 1-3.

[467] Qwest Comments at 1 n.3.

[468] Cincinnati Bell Comments at 1-5.

[469] CenturyTel Comments at 1.

[470] Cincinnati Bell Comments at 1-4; Century Tel Comments at 9. *See also* APTS Comments at 25-32; Comcast Reply Comments at 4-6.

[471] *See 2004 Report*, 20 FCC Rcd at 2826 ¶ 131.

[472] *Id.* at 2826 ¶ 132.

[473] *Id.*

communities.[474] To some extent these systems are bringing video, voice, and high-speed Internet access to previously unserved communities.

128. The American Public Power Association (APPA), created by and for the nation's more than 2,000 not-for-profit, community and state-owned electric utilities, surveyed its members at the end of 2004, and found that 616 public power entities offer some kind of broadband services, serving about 14 percent of total households in the United States.[475] Of those, 102 offered video service, 128 offered high-speed Internet access, 52 offered local telephone service, and 42 offered long distance telephone service. Of the 102 offering video services, 10 are offering video on demand (VOD).[476]

F. Other Wireless Video Services

1. Private Cable Systems

129. Private cable operator (PCO) systems, also known as satellite master antenna (SMATV) systems, are video distribution facilities that use closed transmission paths without using any public rights-of-way.[477] PCOs acquire video programming and distribute it via terrestrial wiring in urban and suburban multiple dwelling units (MDUs), such as apartments and condominiums, as well as commercial multiple tenant units (MTUs), including hotels and office buildings. Traditionally, PCOs receive nonbroadcast programming from resellers called aggregators using satellite master antenna systems atop the buildings they serve. PCOs usually combine this nonbroadcast video programming with local broadcast television signals that they receive using master antennas. Thus, the packages PCOs provide their subscribers are comparable to those of cable systems, and they directly compete with franchised cable operators.

130. PCOs continue to serve a small number of MVPD subscribers, either through their own facilities or through partnership arrangements with DBS operators, DIRECTV and EchoStar.[478] PCO subscribership has declined to one million subscribers this year, a decrease of 9.1 percent from last year's 1.1 million.[479] The Independent Multi-Family Communications Council (IMCC), the trade association

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[474] Steven S. Ross, *Fiber Communities,* BROADBAND PROPERTIES, June 2005, at 10-22. An example of a partnership arrangement is Jackson, Tennessee, through its Jackson Energy Authority, which is building a fiber-optic network in partnership with Aeneas Internet & Telephone, to offer high-speed Internet, VoIP and video service. *Id.; Jackson Energy Authority and Aeneas Internet & Telephone Deliver VoIP over FTTP,* at http://lw.Pennnet.com/Article_Display.cfm?Section=OnlineArticles&SubSection=Display&PU (visited Nov. 9, 2005). Douglas Electric Cooperative, Douglas County, Oregon, provides FTTH, which will include Internet, telephone and video services. BROADBAND PROPERTIES, June 2005 at 10-22.; http://www.ftthciybcuk.org, *U.S. Optical Fiber Communities 2005* (visited Oct. 4, 2005). Examples of municipal utilities which provide video, voice, and Internet access services to their residents include Sylacauga, Alabama, Dalton, Georgia, Kutztown, Pennsylvania, Provo, Utah, and Bristol, Virginia. In Washington State, systems are being built by public utility districts. These include the counties of Bainbridge Island, Chelan County, Clallam County, and Grant County, which are offering Internet, voice, and video services. *Id; see also Community Broadband: Separating Fact From Fiction,* American Public Power Association, Jan. 2004, at 31. In addition, Palo Alto, California, and Taunton, Massachusetts, are conducting trials for the provision of Internet, voice and video. BROADBAND PROPERTIES, June 2005, at 10-22.

[475] George S. Ford, *Does Municipal Supply of Communications Crowd-Out Private Communications Investment? An Empirical Study,* Applied Economic Studies, Feb. 2005, at 1.

[476] American Public Power Association, *2005-06 Annual Directory and Statistical Report,* at 230.

[477] 1996 Act, sec. 301(a)(2), 47 U.S.C. § 522(7). In addition, private cable and SMATV operators: (a) do not pay franchise and Federal Communications Commission subscriber fees; (b) are not obligated to pass every resident in a given area; (c) are not subject to rate regulation; and (d) are not subject to must carry and local government access obligations. *1997 Report,* 13 FCC Rcd at 1085 n.296.

[478] *See 2004 Report,* 20 FCC Rcd at 2759 ¶10.

[479] Kagan Research, LLC, *Basic Cable Network Economics, 2004-2014,* Media Trends 2005, at 69.

that represents PCOs and the MDUs they serve, indicates that it currently has more than 150 members that are PCOs.[480] PCOs have received millions of dollars for the purpose of starting new PCOs in the last two years, and there has been some industry consolidation, creating larger and more stable PCOs. PCOs range in size from large operators serving customers throughout the entire United States, to small operators that serve MDUs in as few as three communities.[481]

2. Wireless Cable Systems

131. Wireless cable systems use Broadband Radio Service (BRS) and Educational Broadband Service (EBS) in the 2 GHz band to transmit video programming and provide broadband services to residential subscribers.[482] These services were originally designed for the delivery of multichannel video programming, similar to that of traditional cable systems, but over the past several years licensees have focused their operations instead on providing two-way high-speed Internet access services.[483] The number of wireless cable subscribers has declined steadily from a peak of 1.2 million in 1996 to approximately 100,000 as of March 2005, down from an estimated 200,000 subscribers in April 2004.[484] Thus, wireless cable systems provide video competition to incumbent cable operators only on a limited basis.

132. Last year we reported that BellSouth provides video programming in the areas where it holds MMDS/BRS and ITFS/EBS licenses.[485] BellSouth continues to provide video programming to limited areas in the Atlanta, New Orleans, and Louisville television markets and in parts of Florida.[486] W.A.T.C.H. TV, an operator of one of the few digital wireless cable systems in the U.S., claims that a wireless cable system can compete successfully against other cable systems and DBS if it digitizes its facilities, which allows it to offer hundreds of channels of programming to its subscribers.[487] W.A.T.C.H. TV reports that it has transformed its 11-channel analog video-only service to a state-of-the-art network, offering its 12,000 subscribers in the Lima, Ohio, market 200 channels of digital video and audio programming and offering high-speed Internet access to 4,800 subscribers, at a lower price than that charged by competing cable and DBS operators.[488] It further states that it is the only operator in its market to provide competition to incumbent cable operators because DBS does not offer either local-into-local broadcast service or a broadband service for consumers.[489]

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[480] In 2004, we reported that IMCC had 135 members operating throughout the United States. *See 2004 Report*, 20 FCC Rcd at 1666 ¶ 110. For a list of members, *see* Independent Multi-Family Communications Council, at http://www.imcc-online.org/membership (visited Sept. 2, 2005).

[481] Telephone conversation with William Burhop, Executive Director, IMCC, Oct. 12, 2005.

[482] This delivery technology was previously known as multipoint distribution service (MDS) and instructional television fixed service (ITFS) until the Commission renamed them in *Amendment of Parts 1, 21, 73, and 74 of the Commission's Rules to Facilitate the Provision of Fixed and Mobile Broadband Access, Educational and Other Advanced Services in the 2150-2162 and 2500-2690 MHz Bands*, 19 FCC Rcd 14165 (2004).

[483] *2004 Report*, 20 FCC Rcd at 2814 ¶¶ 104-106.

[484] NCTA, *Analysis of MVPDs: March 2005*, Cable Developments 2005, at 15; *see also 2004 Report*, 20 FCC Rcd at 2814 ¶ 104.

[485] *2004 Report*, 20 FCC Rcd at 2814 ¶ 106.

[486] Telephone conversation with Bennett Ross, General Counsel-D.C., BellSouth, Oct. 25, 2005.

[487] W.A.T.C.H. TV Comments at 1.

[488] *Id.* at 2-3.

[489] *Id.* at 3. W.A.T.C.H. TV also contends that the Commission's ongoing rewrite of the BRS and EBS rules in WT Docket No. 03-66 has created regulatory uncertainty that threatens its viability, and it seeks action on its pending petition for reconsideration and waiver request. *Id.* at 1-2, 4-7.

3. Commercial Mobile Radio Service

133. In our *2004 Report*, we noted that several cellular telephone companies were beginning to offer video services on their mobile telephones.[490] Wireless companies are now spending billions of dollars to build third-generation, or 3G, networks which enable the transmission of live video to cellphones, and cellphone makers are selling video-ready telephones for as little as $99 when bought with a subscription to a video service.[491] For services currently available, unlimited viewing costs $15 to $20 a month.[492] Mobile telephone providers are increasingly offering video that includes content from traditional cable networks, as well as pre-recorded content from a host of other producers. Examples include live and recorded programming from the Discovery Channel, ESPN, Weather Channel, Fox News and Nickelodeon.[493]

134. Several major cellular telephone companies are offering video services. Verizon Wireless rolled out V-Cast, a service that offers video programming to cellular telephone users, in February 2005. V-Cast provides news updates, sports highlights, celebrity news, stock market quotes, and information, weather and games for $15 a month. Its television-like video, at high bit rates, allows customers to download music videos and other high-quality content.[494] Sprint Corporation began broadcasting live video over its wireless telephones in August 2004. Sprint PCS customers can now view news, video clips and other content in real time over their cellular telephones.[495] MobiTV, a video service available from Sprint PCS, Cingular, and several regional carriers, also sends video programming to cellphones and currently has 300,000 subscribers.[496] Qualcomm recently introduced its TV-to-cellphone technology, called MediaFLO.[497] HBO and Cingular Wireless are reportedly considering a wireless content distribution arrangement.[498]

G. Other Entrants

1. Internet Video

135. .The amount of web-based video provided over the Internet continues to increase significantly each year. As we have reported in the past, many traditional broadcast and nonbroadcast programmers are currently providing streaming and downloadable video content on their Internet web pages, as do many independent content producers. Several companies are also using the Internet, coupled with a television set-top box that allows an on-screen guide, to provide video directly to a television set. In addition, several companies are using Internet Protocol technology to provide facilities-based IP video, as are many independent content producers.

136. ***Streaming Video***. Video streamed over the Internet through the web (sent from the content provider to the subscriber in real-time) is still most viable when delivered over broadband

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[490] *See 2004 Report*, 20 FCC Rcd at 2815 ¶ 107.

[491] *See* Li Yuan, *Now, the Very Small Screen*, WALL STREET JOURNAL, Sept. 22, 2005, at B1.

[492] *Id.* at B9.

[493] Comcast Comments at 39.

[494] NCTA Comments at 11.

[495] *See* Li Yuan, *Now, the Very Small Screen*, WALL STREET JOURNAL, Sept. 22, 2005, at B9. Sprint Nextel has signed a five-year agreement with the National Football League.

[496] Comcast Comments at 39. MobiTV has partnered with Major League Baseball to offer mobile phone customers baseball highlights and "top plays" and is working toward offering live video of baseball games.

[497] NCTA Comments at 11.

[498] *Id.*

networks. Even with the most advanced compression technology available, broadcast quality video is not possible over a 56 kbps dialup connection.[499] Broadcast quality video is possible, however, at 768 kbps with advanced compression/decompression technology (codecs[500]) and at 1.5 Mbps or higher broadcast quality standard-definition MPEG-2 is possible.[501] Some industry observers continue to believe, however, that widespread adoption of streaming video will only be possible if connection speeds significantly increase over those currently achieved over cable and DSL broadband.[502] As we reported last year, the Internet2 network continues to facilitate high-quality streaming video using its highly reliable 10 Gbps backbone.[503] The Internet2 network, however, continues to primarily serve the research and academic communities.

137. Regardless of the fact that there is relatively minimal availability of high-quality video from such high-speed networks as the Internet2, many households continue to access streaming video using dial-up and residential high-speed Internet access connections. The overall number of homes with access to the Internet continues to grow, as does the number of Americans who access the Internet via a high-speed broadband connection. According to one report, as of June 2005, there were approximately 33.7 million residential high-speed Internet access subscribers, representing approximately 48 percent of the 70.3 million residential Internet subscription households.[504] As of January 2005, an average of 14 percent of all Americans had watched some form of streaming video in the past month, and approximately eight percent of Americans had accessed streaming video content in the past week.[505]

138. Many traditional programmers continue to offer streaming video on their websites to increase access to and supplement their regular television programming content. For example, CBS News, CNN, Comedy Central, and Nickelodeon offer 24-hour web access to some regularly featured television programming; ESPN.com has partnered with Major League Baseball to provide access to baseball games and baseball highlights; College Sports TV provides access to live video feeds of some college football games; MTV offers access to regularly featured programming and supplemental content; and In2TV, a partnership between AOL and Warner Bros., allows consumers to stream full-length episodes of popular television series from a library of thousands of television programs.[506] In addition,

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[499] Envivio, Inc., at http://www.envivio.com/images/products/4CasterB3Datasheet050902.pdf (visited Nov. 30, 2005).

[500] Codec is short for "compression/decompression." Compression refers to the process by which redundant information is removed from a digital stream to reduce the bandwidth required to transmit it. Decompression is the reverse process of recovering the removed information to restore the original digital stream. Advanced video codecs are capable of removing more redundant information as compared to legacy codecs, with little impact on the video quality. Harry Newton, NEWTON'S TELECOM DICTIONARY (CMP Books, 17th ed., 2001), at 157.

[501] On2Technologies, Inc., at http://www.on2.com (visited Nov. 30, 2005). *See also* Network Domain Comments at 6.

[502] *2004 Report*, 20 FCC Rcd at 2817-8 ¶114.

[503] Led by more than 200 U.S. universities, working with industry and government, Internet2 is being developed and deployed for advanced network applications and technologies for research and higher education. The Internet2 cross-country backbone offers 10 gigabits per second, with the goal of offering 100 megabits per second of connectivity between every connected desktop. Internet2, at http://www.Internet2.edu (visited Nov. 30, 2005).

[504] *See* Morgan Stanley, *Cable/Satellite*, July 20, 2005, at 28. *See also* Federal Communications Commission, *High-Speed Services for Internet Access*, July 7, 2005, at Table 3 (reporting that, as of December 31, 2004, cable, DSL, wireline, and wireless technologies provided high-speed Internet access to 35.3 million residential and small business subscribers).

[505] Arbitron, Inc., *Internet and Multimedia 2005: The On-Demand Media Consumer*, Sept. 3, 2005, at 5.

[506] Comcast Comments at 24; CSTV Networks, Inc., *CSTV All Access: Thousands of Live Games Streamed Right to Your Computer,* at http://allaccess.cstv.com/subscriptions/index_xxl.jsp?partnerId=cstv_aamg (visited Dec. 27, (continued....)

some traditional content producers are also offering new and unique content over the Internet via the web. For example, Scripps Networks has announced that it will launch ten web-based video channels by the end of 2006; AOL continues to offer such exclusive and specialized video content as the Live8 concert and music videos; and Yahoo and Google are both exploring original content for distribution via the web.[507] Clear Channel Communications plans to add original streaming video programming to some 200 local radio stations' web sites.[508] Maxim Magazine plans to offer free streaming video programming on-demand to Internet users via MSN's video streaming service.[509] MTV plans to launch a free hybrid linear video and video-on-demand channel called MTV Overdrive.[510] "The Knot TV" is a 24-hour streaming video channel featuring wedding-related shows.[511]

139. ***Downloadable Video***. As we reported last year, we expect that a large amount of video available through the web will be downloadable video. Downloadable video is available on the websites of both traditional programmers and independent producers of video content. There are numerous online services that allow users to download content to a computer hard drive for viewing on a personal computer, television, or mobile video device. In October 2005, Disney's ABC and Apple's iTunes entered into a deal to offer current and past season episodes of ABC and Disney Channel television shows for download from Apple's iTunes Music Store for viewing on a PC or iPod video player.[512] More established efforts to provide downloadable video include offerings from Movielink, Starz! Ticket on Real Movies, ClickStar and CinemaNow. For example, Movielink, a joint venture of Metro-Goldwyn-Mayer Studios, Paramount Pictures, Sony Pictures Entertainment, Universal Studios, and Warner Bros. Studios, offers movies, television shows, and other popular videos for download on a rental or purchase basis.[513] Some companies are offering or are planning to offer content distribution via the web for independent content producers. DaveTV, Brightcove, and Wi-FiTV provide an Internet-based distribution interface for content producers of all sizes.[514] Some content producers are offering their services directly to Internet users via websites such as Strandvenice.com, which is an online reality channel that offers a 50-minute series pilot episode for free and charges 99 cents for future 30-minute episodes.[515] Akimbo has partnered with producers and distributors of movies and videos to deliver video programming directly to a subscriber's television using the consumer's existing broadband connection.[516]

(Continued from previous page)

2005); America Online, Inc. and Warner Bros., *AOL and Warner Bros. Announce 'In2TV,' New Broadband Network on AOL.com, Delivering The Largest Offering Of Long-Form Television Programming Online* (press release), Nov. 14, 2005.

[507] Comcast Comments at 24; AP, *Scripps Takes Latest Channel Direct to Web*, NEW YORK TIMES, Mar. 21, 2005; David Kaplan, *Home & Garden Hangs Hat Online*, MEDIAPOST, Jan. 14, 2005; Jefferson Graham, *Search Engine Google Sets Sights on Video*, USA TODAY, Jan. 25, 2005, at B1; Saul Hansell, *Google and Yahoo Are Extending Search Ability to TV Programs*, NEW YORK TIMES, Jan. 25, 2005, at C7.

[508] *Clear Channel Overhauls Its Net Strategy*, REUTERS, Mar. 24, 2005.

[509] Gavin O'Malley, *Ladies-On-Demand: Maxim Goes Video Via Deal With MSN*, MEDIA POST, Mar. 31, 2005.

[510] Steve Donohue, *MTV Goes Into Overdrive*, MULTICHANNEL NEWS, Apr. 6, 2005, at 11.

[511] Bob Tedeschi, *Web Sites' Sideline: TV-Type Shows*, NEW YORK TIMES, March 14, 2005, at C5.

[512] Walt Disney Company, *Disney, ABC & Apple Announce Deal to Sell TV Shows Online Hits to Include "Desperate Housewives," "Lost" and "That's So Raven,"* (press release), Oct. 12, 2005.

[513] *See* Movielink, LLC, *Downloadable Movies are Here*, at http://www.movielink.com/store/web/help/eLanding.jsp (visited Dec. 27, 2005).

[514] Comcast Comments at 27-28.

[515] Saul Hansell, *Smaller Video Producers Seek Audiences on Net*, NEW YORK TIMES, Oct. 6, 2005, at C1.

[516] Comcast Comments at 28; *see* Akimbo Systems, at http://www.akimbo.com (visited Nov. 30, 2005). *See also* Comcast Reply Comments at 8-9.

Akimbo provides the subscriber a set-top box that generates an on-screen guide that enables the subscriber to choose programming from a library of video selections. Akimbo then uses IP technology to deliver the video from a central office, over the Internet, to the subscriber's television.[517]

2. Home Video Sales and Rentals

140. The sale and rental of home video, including videocassettes and DVDs, are considered part of the video marketplace because they provide services similar to the premium and pay-per-view offerings of MVPDs.[518] As such, they offer some level of competition to broadcast television, cable television and DBS for the consumer's time and money. Video-on-demand services provided by cable, DBS, and Internet providers have emerged as competitive alternatives to home video.[519]

141. Nine out of ten TV households have at least one VCR.[520] DVDs also have made a significant impact on the home video market. An estimated 80 million households have DVD capability, representing nearly three-quarters of all U.S. households. Consumers purchased 37 million DVD players in 2004, an eight percent increase over 2003, and in the first six months of 2005 nearly 14 million DVD players were sold. Household penetration is expected to reach 80 percent by year-end 2005.[521] There are approximately 47,000 DVD titles available for purchase or rental today compared to 30,000 a year ago.[522] Consumers spent $24.5 billion renting or purchasing DVDs or VHS videocassettes last year, compared to $9.4 billion in U.S. movie ticket revenues.[523] Overall, consumers spent $15.5 billion on DVD sales alone in 2004, a 33 percent increase over 2003, while DVD rentals increased 26 percent over 2003, as consumers spent more than $5.7 billion.[524]

142. Sales and rentals of DVDs have accounted for 60 percent of entertainment companies' profits over the past eight years.[525] Consumers can purchase DVDs and videocassettes from video chains, such as Blockbuster or Hollywood Video; from mass merchandise stores, such as Target and Wal-Mart; or from online companies, such as Amazon. Consumers rented more than one billion DVDs during the first half of 2005,[526] either at retail outlets or via online services, such as Netflix.[527] Netflix currently has about 3.2 million subscribers. It is projected that Netflix will have four million subscribers by the end of 2005, and five million by the end of 2006.[528] Earlier this year, Wal-Mart and Netflix entered a partnership whereby Netflix will promote Wal-Mart DVD sales and Wal-Mart will offer its online customers the opportunity to sign up with Netflix at Wal-Mart's current online movie rental service price for the year.[529] Netflix also has announced that it plans to offer downloadable movies by the end of

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[517] Comcast Comments at 28.

[518] *See 2003 Report,* 19 FCC Rcd at 1675 ¶ 108.

[519] *See, e.g.*, paras. 56-7 *supra.*

[520] Nielsen Media Research, *Television Audience 2004*, Feb. 2005, at 4.

[521] *Id. See also* NCTA Comments at 15-16.

[522] NCTA Comments at 15.

[523] *Id.*

[524] *Id.* at 16.

[525] Comcast Comments at 35.

[526] *Id.* at 37.

[527] *See 2004 Report*, 20 FCC Rcd at 2822 n.560.

[528] Comcast Comments at 36.

[529] *Id.*

2005.[530] In addition to its video stores, Blockbuster offers an online DVD rental service and is reported to have a million subscribers, a number that is expected to double by the first quarter of 2006.[531]

III. MARKET STRUCTURE AND CONDITIONS AFFECTING COMPETITION

A. Market Structure and Ownership Issues

143. The video programming market is comprised of a retail market for the distribution of multichannel video programming to households, and a program supply market for the purchase of video programming by MVPDs. In this section, we first review changes in the market for the distribution of video programming, including changes in the level of competition in that market between June 2004 and June 2005. We then review the market for the purchase of video programming by MVPDs, examining the effects that changes in concentration among MVPDs at the national and regional levels have had on this market in the last year.

1. Competitive Issues in the Retail Market for the Distribution of Video Programming to Consumers

144. In the past year, incumbent cable operators' share of all MVPD subscribers continued to decline. As of June 30, 2005, cable operators served 69.4 percent of the 94.2 million MVPD subscribers, compared to 71.6 percent of the 92.3 million MVPD subscribers a year earlier.[532] DBS, the major wireless MVPD technology that is available to subscribers nationwide, saw its share of MVPD subscribers increase between June 2004 and June 2005, from 25.1 percent of the market to 27.7 percent. Relatively few consumers, however, have a second wireline alternative, such as an overbuild cable system, as indicated by the small number of subscribers to BSPs and the limited entry by LEC thus far.[533] Several other MVPD technologies, such as private cable systems and wireless cable systems, offer consumers alternatives to incumbent cable services, but only in limited areas, and their overall share of the MVPD market has declined from 3.29 percent to 2.88 percent over the last year.

145. The Commission recently opened a proceeding to investigate whether the current local franchising process inhibits competitive entry in the retail market for the distribution of video programming.[534] The *Franchising NPRM* seeks comment on issues relating to the implementation of Section 621(a)(1) of the Communications Act. Specifically, the Commission asks how it can ensure that local franchising authorities (LFAs) do not unreasonably refuse to award cable franchises to competitive entrants. The *Franchising NPRM* tentatively concludes that the mandate of Section 621(a)(1) should be interpreted to prohibit not just the ultimate refusal to award a franchise, but also a broader range of behaviors, including the establishment of procedures and other requirements that unreasonably interfere with the ability of would-be new entrants to introduce their competitive offerings quickly.

146. In the *Notice*, we asked about the impact of the local franchising process on new entrants into local markets.[535] In their comments in response to the *Notice of Inquiry* in this docket, a number of

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[530] *Id.* at 29.

[531] *Id.*

[532] *See* Appendix B, Table B-1. The number of MVPD subscribers is the total number of subscribers to all MVPDs listed in the table. The share of MVPD subscribers served by cable systems is the result of adding together the number of subscribers to all MVPD services and calculating the percentage of this total represented by cable subscribers.

[533] *See* paras. 87-8, 121-5 *supra*. *See also* Appendix B, Table B-1.

[534] *See 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*, Notice of Proposed Rulemaking, 20 FCC Rcd 18581 (2005) (*Franchising NPRM*).

[535] *See Notice*, 20 FCC Rcd at 14121 ¶ 10.

parties addressed this issue. LECs described the local franchising process as an impediment to entry into the market.[536] SBC maintains that cable franchise requirements are unnecessary given existing local authority to manage telephone company rights of way.[537] Verizon and others note that franchise negotiation gives notice of entry to the incumbent, delays entry, and allows LFAs to demand unrelated concessions from the entrant.[538] Verizon alleges that a "level playing field" approach to regulation is harmful to competition, and urges congressional action and Commission action pursuant to Section 621(a) of the Communications Act to alleviate these concerns.[539] Broadband service provider RCN reports that local franchise requirements have not prevented competitors like RCN from entering the market, but argues that RCN should receive equivalent relief if other competitors are relieved from franchise obligations.[540]

147. BSPA indicates that franchise build-out requirements are anachronistic and a barrier to entry and it supports a national policy to eliminate them.[541] BSPA argues that most incumbent cable operators have had decades to build out to current service boundaries with limited or no competition, and did not have to rely on capital markets for funding as current entrants do.[542] Verizon also objects to build-out requirements.[543] NCTA argues that existing franchise regulations and build-out requirements are

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[536] One academic study showed that policies that hinder a new entrant's ability to sell video programming, such as requirements that entrants obtain a local cable franchise agreement, will strongly diminish that entrant's incentive to deploy fiber to low-income households. *See* George S. Ford, Thomas M. Koutsky, and Lawrence J. Spiwak, *The Impact of Video Service Regulation on the Construction of Broadband Networks to Low-Income Households,* Phoenix Center Policy Paper No. 23, Sept. 2005. The authors use data from the U.S. Census Bureau and create simulations of network deployment to show that a new entrant will pass substantially more households, particularly low-income households, if that entrant can readily offer video with voice and broadband Internet access services than it will if its ability to sell video services is sharply curtailed or delayed.

[537] SBC Comments at 15-19. *See also* Cincinnati Bell Comments at 5-9; CenturyTel Comments at 4-6 and 7-10; OPASTCO Reply Comments at 3-4; Qwest Reply Comments at 1-10. BellSouth provides several examples of problems it has had in negotiating local franchises. BellSouth Comments at 3-12; SBC Reply Comments at 2-5.

[538] *See* Verizon Comments at 6-29; Verizon Reply Comments at 4-11; CenturyTel Comments at 6-7; USTA Comments at 8-14. *See also* Qwest Comments at 9-18; SBC Comments at 10-15; NRTC Comments at 7; Consumers for Cable Choice Comments at 2-3; Alcatel Comments at 8-10; USTA Comments at 14-16; USTA Reply Comments at 9-13; BellSouth Reply Comments at 1-9.

[539] In describing "level playing field" regulations, and franchise buildout requirements, Verizon states the following: "[I]ncumbent cable providers pressure LFAs (under threat of litigation) to require the new entrant to build-out and serve an entire franchise area on an expedited basis or to match all of the concessions previously provided by the incumbent in order for it to gain its original monopoly position in the local area, despite the vastly different competitive situation facing the new entrant." Verizon Comments at 9.

[540] RCN Comments at 18. We note that Texas has passed a state-wide video franchising regime, and both Verizon and SBC have received state-wide franchises. Tex. Util. Code §§ 66.001 - 66.017. Lynn Stanton, *Texas PUC Grants SBC Video Franchise*, TR DAILY, Nov. 1, 2005. *See also* Verizon Communications, Inc., *Verizon to Accelerate Availability of FiOS TV Service in Texas* (press release), Sept. 30, 2005; Anne Veigle, *SBC Files for Tex. Franchise for Video Service*, COMMUNICATIONS DAILY, Oct. 12, 2005, at 1-3. Verizon reports that passage of this law in Texas will allow it to offer video services in 21 additional communities in Texas by the end of 2006. Verizon Reply Comments at 3.

[541] BSPA Comments at 18-20.

[542] *Id.*

[543] Verizon Reply Comments at 8-11.

appropriate for all providers in the multichannel video industry, and that they should not pose a "significant barrier" to competitive entry.[544]

148. In addition to franchising requirements, commenters assert that there are other factors that also may inhibit entry and competition. For example, Verizon raises the issue of open and competitively neutral technical standards.[545] BSPA states that discrimination in access to, and pricing of, video programming and other digital content constitutes a threat to BSP entry and competition.[546] SBC also stresses the importance of access to programming, particularly programming affiliated with incumbent cable operators and terrestrially delivered regional sports networks.[547]

149. BSPA also identifies exclusive long-term MDU access contracts as a barrier to entry and notes that difficulties remain for BSPs and other wireline MVPDs gaining access to utility poles at reasonable rates.[548] Verizon also raises the issues of access to residents of MDUs.[549]

150. NTCA and BSPA allege that incumbent cable operators faced with competitive entry have engaged in "targeted" or "predatory" pricing practices.[550] BSPA recommends that the Commission require cable operators to disclose all rates and promotions offered to any customer in a local franchise area, and to consider whether, even in areas in which a finding of effective competition has been granted, the Commission may continue to require uniform pricing; BSPA adds that, if necessary, the Commission should recommend that Congress amend the Communications Act to allow the Commission to require uniform pricing under the circumstances BSPA describes.[551] Comcast disagrees, stating that cable pricing practices are lawful and are indicative of a competitive marketplace.[552]

2. Competitive Issues in the Program Supply Market

151. Buyers in the market for the purchase of video programming are MVPDs, including cable operators and other video programming providers. The sellers are primarily nonbroadcast programming networks. This market tends to be regional or national because programmers seek to reach a much broader audience than could be provided by a local franchise area. For example, some programming

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[544] NCTA Comments at 18-24. *See also* RCN Comments at 18; NCTA Reply Comments at 2-22; Comcast Reply Comments at 15-22.

[545] *Id.* at 40-42. *See also* CEA Comments at 17-19.

[546] BSPA Comments at 12-15; RCN Comments at 9-14.

[547] SBC Comments at 19-27; Verizon Comments at 29-35; Qwest Comments at 19-24; NRTC Comments at 4-6; Cincinnati Bell Comments at 9-11; CenturyTel Comments at 10-12; NTCA Comments at 9-10; USTA Comments at 16-17; Qwest Reply Comments at 10-11; USTA Reply Comments at 13; Verizon Reply Comments at 11-13; SBC Reply Comments at 5-7. BellSouth argues that consolidation and clustering in the cable industry increases the ability of cable operators to gain exclusive contracts with unaffiliated cable networks. BellSouth Comments at 12-16. Smaller video providers stress the difficulties they face in negotiations with and receiving "reasonable rates" from large video programmers. NTCA Comments at 3-7. OPASTCO also raises the issue of the lack of access to affordable programming and states that expensive programming makes it difficult to create a workable business model for rural telecommunications providers offering video service. OPASTCO Reply Comments at 4-6. Comcast counters that no commenter denied access to programming can point to a violation of Commission rules. Comcast Reply Comments at 23-30. *See also* NCTA Reply Comments at 22-30.

[548] BSPA Comments at 20-23.

[549] Verizon Comments at 35-39.

[550] NTCA Comments at 7-9; BSPA Comments at 15-18. *See also* RCN Comments at 14-16.

[551] BSPA Comments at 15-18.

[552] Comcast Reply Comments at 41-43.

services are intended for nationwide audiences (*e.g.*, CNN, USA), while others seek a regional audience (*e.g.*, New England Sports Network).

152. Cable and DBS operators are the primary purchasers of multichannel video programming targeted to a national audience.[553] As shown in Table 9, in 2005, the four MVPDs with the largest subscribership served 63 percent of all MVPD subscribers,[554] while in 2004, the top four served 58 percent of all subscribers.[555] The share of subscribers served by the top ten MVPDs also increased from approximately 85 percent in 2004 to 88 percent in 2005.[556]

TABLE 9: MVPD Competition and Concentration

Percentage of MVPD Subscribers Served by Technology		
	2004	**2005**
Cable	71.6	69.4
DBS	25.1	27.7
Other	3.3	2.9
Percentage of MVPD Subscribers Served by Largest Providers		
	2004	**2005**
Top 4	58	63
Top 10	85	88
Top 25	90	94

153. To compare market concentration for the purchase of programming over a period of time, we have traditionally used the Herfindahl-Hirschman Index (HHI) to measure horizontal concentration.[557] We recognize that the HHI is not an indicator of "competition" in the market for the purchase of video programming, and that it is not being used in the same way that it would be for purposes of antitrust analysis. For purposes of this report, however, the HHI is a useful tool to follow trends in the

[553] Congress adopted Section 613(f) of the Communications Act as part of the 1992 Cable Act to address the consequences of horizontal concentration and vertical integration in the cable television industry. Section 613(f) was adopted as Section 11(c) of the Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460, codified at 47 U.S.C. § 533(f). In *Time Warner Entertainment Co. v. FCC* (240 F.3d 1126 (D.C. Cir. 2001)), the United States Court of Appeals for the D.C. Circuit reversed and remanded the Commission's rules implementing Section 613(f). The Commission has an ongoing proceeding to respond to the ruling of the court. *See Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992*, 16 FCC Rcd 17312 (2001); *The Commission's Cable Horizontal and Vertical Ownership Limits, Second Further Notice of Proposed Rulemaking*, 20 FCC Rcd 9374, 9412-3 ¶¶ 67-70 (2005).

[554] *See* Appendix B, Table B-4. In this section, reported statistics for 2004 are based on March data since June data comparable to that used in previous years were unavailable. This year, June data were available, so we reverted to June data for 2005.

[555] *Id.*

[556] *Id. See also* Appendix B, Table B-3; *2004 Report*, 20 FCC Rcd at 2872, Appendix B, Table B-3.

[557] *1998 Report*, 13 FCC Rcd at 24363 n.562. The HHI is a measure of concentration that is calculated by summing the squared market shares of the participants in the market. It is a measure of concentration that takes account of the distribution of the size of firms in the market. The HHI varies with the number of firms in the market and degree of inequality among firm size. Generally, the HHI increases when there are fewer and unequal sized firms in the market. HHI is usually employed to examine concentration in markets in which products are sold directly to consumers, not intermediate markets like the market for cable programming networks, but a comparison of HHIs from previous years shows a general trend in ownership concentration. The HHI calculation is based on the MVPD shares of cable companies serving over 91 percent of all subscribers and the two largest DBS operators. The addition of the shares of other cable operators and smaller MVPDs would change the HHI only by a small fraction.

concentration of MVPD size from year to year. We use the reported MVPD subscriber shares to calculate HHI figures. In June 2005, the HHI for the national market for the purchase of programming was 1201. This represents a marked increase from the March 2004 MVPD HHI of 1097.[558] This increasing HHI reflects the fact that the DBS providers grew very quickly, while virtually every cable operator, most especially smaller ones, shrank, thereby increasing the share of the industry served by the largest providers.

154. ***Consolidation Among Cable Operators.*** Cable operators continue to pursue a regional strategy of "clustering" their systems. The effect of clustering has drawn significant comment in the license transfer proceeding relating to the sale of Adelphia's systems to Comcast and Time Warner, in which the transfer of systems will enlarge or consolidate various clusters owned by Comcast and Time Warner. The applicants assert that these transactions will enable Comcast and Time Warner to compete on more equal terms with DBS providers and ILECs.[559] BellSouth argues that consolidation and clustering in the cable industry increases the ability of cable operators to gain exclusive contracts with unaffiliated cable networks.[560]

155. Between July 2004 and June 2005, a total of 22 transactions were announced. Together these transactions were valued at approximately $48.7 billion and affected 12,719,387 subscribers.[561] At the end of 2004, there were 118 clusters with approximately 51.5 million subscribers compared to 108 clusters and approximately 53.6 million subscribers at the end of 2003 (although due to a change in methodology, these figures are not directly comparable).[562] In the largest cluster size category (over 500,000 subscribers), the number of clusters remained constant at 29 between 2003 and 2004.[563]

B. Vertical Integration and Other Programming Issues

1. Status of Vertical Integration

156. In 1992, Congress enacted various provisions related to vertical integration between cable operators and programming networks (*e.g.*, program access, channel occupancy limit) to foster competition and diversity.[564] Our examination of vertical integration in the MVPD industry, therefore,

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[558] In the *2003 Report*, we reported a 2003 HHI of 1031. *See 2003 Report*, 19 FCC Rcd at 1689-90, 1721 ¶ 140, Appendix B, Table B-3. We have revised the 2003 HHI for this *Report* due to a revision of previous years' cable industry and MVPD subscribers to allow for use of a consistent data source in the tables in Appendix B.

[559] *Applications for Consent to the Assignment and/or Transfer of Control of Licenses, Adelphia Communications Corporation, Assignors, to Time Warner Cable Inc., Assignees; Adelphia Communications Corporation, Assignors and Transferors, to Comcast Corporation, Assignees and Transferees; Comcast Corporation, Transferor, to Time Warner Inc., Transferee; Time Warner Inc., Transferor, to Comcast Corporation, Transferee, Applications and Public Interest Statement*, MB Docket No. 05-192, at 49-60. Numerous parties filing comments in this transaction dispute this characterization of the increased clustering that will result from the sale.

[560] BellSouth Comments at 12-16.

[561] Kagan Research, LLC, *Cable System Sales Summary*, CABLE TV INVESTOR, Aug. 25, 2005, at 14; Jan. 31, 2005, at 9; and July 29, 2004, at 13. These figures include announced transactions, most notably the proposed Adelphia transaction that is still pending before the Commission.

[562] *See* Appendix B, Table B-2. The way the clusters were counted by Kagan Research, LLC has changed between this year and last, leading to difficulties in directly comparing the two. In previous years, all of Comcast's subscribers in the Northeast and Mid-Atlantic were counted as part of one "supercluster." Beginning this year, those subscribers were broken out into separate clusters. This is probably a more accurate approach, but it causes direct year-to-year comparisons to be uninformative.

[563] *See id.* This figure has remained constant since 2002.

[564] *See* 47 U.S.C §§ 533, 548.

focuses on ownership affiliations between video programming distributors and video programming suppliers. Vertical relationships may have beneficial effects,[565] or they may deter competitive entry in the video marketplace and/or limit the diversity of programming.[566]

157. ***Nationally Distributed Programming Networks.*** In 2005, we identified 531 satellite-delivered national programming networks, an increase of 143 networks over the 2004 total of 388 networks.[567] Of the 531, 116 networks (21.8 percent) were vertically integrated with at least one cable operator in 2005.[568] Last year we identified 388 satellite-delivered national networks, 89 of which (22.9 percent) were vertically integrated with a cable operator.[569] In addition, 22 national nonbroadcast networks, not also owned by a cable MSO, are vertically integrated with a DBS provider.

158. This year we report a significant increase in the number of satellite-delivered national networks. We attribute this increase to several factors. First, we have updated our prior estimates based on additional data sources.[570] Also, we have investigated comments that noted errors or omissions regarding last year's data.[571] Finally, we have identified many new networks since the last report, most

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[565] Beneficial effects can include efficiencies in the production, distribution, and marketing of video programming, and providing incentives to expand channel capacity and create new programming by lowering the risks associated with program production ventures. *See, e.g.,* H.R. Rep. No. 862, 102nd Cong., 2d Sess. 56 at 41-43 (1992).

[566] Possible detrimental effects can include unfair methods of competition, discriminatory conduct, and exclusive contracts that are the result of coercive activity. *See 1995 Report*, 11 FCC Rcd at 2135 ¶ 157; *Implementation of Section 11(c) of the Cable Television Consumer Protection and Competition Act of 1992 Vertical Ownership Limits,* 10 FCC Rcd 7364, 7365 ¶ 4 (1995).

[567] Appendix C, Table C-1.

[568] *See* Appendix C, Table C-1. *See* Tables C-1 and C-2. We count each unique programming service of a multiplexed package separately. This includes the Spanish language simulcast of a particular network, such as Discovery en Español. We do not, however, count services that are not unique, as in a multiplexed programming service that is merely time shifted. *See 1998 Report*, 13 FCC Rcd at 24376, n.661. *See also 2000 Report*, 16 FCC Rcd at 6079, n.579. *See also* Appendix C, Table C-1. This year we also do not count the "on-demand" multiplexes because these versions of on-demand networks are often aggregated into a single "on-demand" channel operated by the MVPD for selection and playback. In addition, we note that last year our nonbroadcast network total included 35 multiplexed iN DEMAND channels and two iN DEMAND HD channels. Based on information obtained this year, we have identified 60 multiplexed iN DEMAND channels and two iN DEMAND HD channels. *See e.g.*, MLSnet.com, *Order the MLS Direct Kick Package: Available on DIRECTV, Dish Network, Digital Cable via iN DEMAND*, Oct. 21, 2005, at http://mlsnet.com/MLS/schedule/tv.jsp (visited Oct. 26, 2005). Last year, we also identified six Starz! networks, one Starz! HD network, and a 13 channel "Starz! Super Pack." Based on information obtained this year, we have determined that the "Starz Super Pack" is a collection of networks already counted in our network totals, including six separately counted Starz! networks and seven separately counted Encore networks. *See* DIRECTV, Inc., *Starz Super Pack – The Best Movie Value from DIRECTV*, at http://www.directv.com/DTVAPP/learn/ Packages_TotalChoice_Starz.jsp.

[569] *2004 Report,* 20 FCC Rcd at 2832 ¶ 145. Although for purposes of this report we make every effort to identify ownership interests establishing vertical integration, we have not attempted to ascertain definitively whether certain vertical relationships would be cognizable under the Commission's attribution rules, nor would we wish to do so without reference to a particular rule or proceeding in which we could explore thoroughly all pertinent information. Hence, we do not intend here to render determinations regarding the application of the Commission's attribution rules.

[570] This year we have included more information from programmers directly, and information from channel lineups of MVPDs currently offering programming. *See* Appendix C, Tables C-1 and C-2 *Sources.*

[571] TAC Comments at 8-9, 15-17. TAC argues that the *2004 Report* did not adequately examine the ownership structure of the programming networks in existence, and thus did not thoroughly assess the health of competition in the video programming market or its impact on consumers' access to programming. TAC Comments at 3, 5, 9-10.

notably new, non-English and multicultural programming services.[572] Despite the substantial revisions to our list, the proportion of national nonbroadcast networks that are vertically integrated with a cable operator has remained relatively stable over the last year.

159. Five of the top seven cable operators (*i.e.*, Comcast, Time Warner, Cox, Cablevision, and Advance/Newhouse) hold ownership interests in satellite-delivered national programming networks. If we count iN DEMAND as one network, 57 satellite-delivered national programming networks are vertically integrated with one or more of these cable operators.[573] Time Warner has an ownership interest in 31 national networks; Cox has an ownership interest in 17 national networks; Advance/Newhouse, owner of cable operator Bright House Networks, has interests in 14 national networks; Comcast has an ownership interest in 11 national programming networks; and Cablevision, through its programming affiliate Rainbow Media, has an ownership interest in four national networks.[574]

160. In the *Notice*, we sought information regarding the ownership of national satellite-delivered programming networks by MVPDs other than cable operators and by "other" media entities, such as broadcast television networks and broadcast television station owners.[575] We have identified 141 programming networks that are owned by one or more of these media entities and that are not owned in any part by a cable operator.[576] These 141 networks represent 26.6 percent of the 531 total networks identified, and 34 percent of the 415 networks that are not affiliated with a cable operator. Thus, of the 531 national nonbroadcast networks we have identified, 116 networks are affiliated with a cable operator, 141 of the remaining networks not affiliated with a cable operator are affiliated with a media entity, and the remaining 274 networks, or 51.6 percent, are not affiliated with any cable operator or other media entity.[577]

161. As shown in Table 10 below, there are 107 national, satellite-delivered nonbroadcast networks that are owned by a DBS operator (DIRECTV, EchoStar, and Dominion), or one or more national broadcast television networks (*i.e.*, ABC, CBS, Fox, NBC-Universal, and Univision) and that are not also owned by a cable operator.[578] These 107 networks represent 20.2 percent of the 531 national nonbroadcast networks we have identified, and 25.8 percent of the 415 networks that are unaffiliated with a cable operator. For example, News Corporation, which holds a 34 percent interest in both DBS operator

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[572] This year, we focused our research efforts more closely than in the past on international networks. MVPDs may have carried some of those networks prior to the release of last year's report.

[573] *See* Appendix C, Table C-1. Traditionally, the Commission has counted each channel of several multiplexed networks separately (*e.g.*, 60 channels for iN DEMAND) for the total number of networks and for these calculations. *See 2004 Report*, 20 FCC Rcd at 2875 Appendix C, Table C-1. Time Warner, Comcast, and Cox each have an interest in iN DEMAND, which we treat as a single network for purposes of determining the number of networks in which each MSO has an ownership interest. *See* iN DEMAND Networks, at http://indemand.com/about/faqDetailsIndemand.jsp?faqCat=1#6 (visited *See also* DIRECTV v. In DEMAND, LLC, File No CSR-6901-C (filed June 29, 2005); EchoStar Satellite, LLC v. In DEMAND, LLC, File No. CSR-6913P (filed July 5, 2005).

[574] *See* Appendix C, Table C-1.

[575] *Notice*, 20 FCC Rcd at 14121 ¶¶ 12-13.

[576] *See* Appendix C, Table C-2.

[577] *See* Appendix C, Tables C-1, C-2.

[578] *Id.* The WB network, through its parent company Time Warner, has ownership interests in 34 national nonbroadcast networks. *See* Appendix C, Table C-1. UPN (United Paramount Network) through its parent Viacom, also the parent of CBS, has ownership interests in 40 national nonbroadcast programming networks. *See* Viacom, at http://www.viacom.com/broadcast.jhtml (visited Nov. 8, 2005). In addition, EchoStar jointly owns G4videogameTV with Comcast, and PBS Kids Sprout is a joint venture between Comcast and PBS. *Id.*

DIRECTV and an 82 percent interest in broadcast network Fox, has ownership interests in 19 national nonbroadcast networks not also owned by a cable MSO.[579] Dominion Video Satellite, provider of DBS service Sky Angel, has interests in three networks. Viacom, the parent company of the CBS and UPN broadcast networks, has ownership interests in 40 national nonbroadcast networks not also owned by a cable MSO, including one network jointly owned with NBC-Universal. Broadcast network ABC, through its parent company Disney, has ownership interests in 22 national networks not also owned by a cable MSO.[580] NBC-Universal, through its parent company General Electric, has ownership interests in 21 nonbroadcast networks not also owned by a cable MSO, including six networks owned jointly with Disney and Hearst, one with Paxson Communications, and one with Viacom. Univision, a Spanish language network and station licensee, has ownership interests in nine networks not also owned by a cable MSO. In addition, Liberty Media, which has an ownership interest in News Corp. (and indirectly has ownership interests in networks owned by News Corp.), has direct ownership interests in 34 national programming networks, including 15 networks it owns jointly with one or more cable operators (*i.e.*, the Discovery-branded networks, which it co-owns with Cox and Advance/Newhouse, and Court TV, which it co-owns with Time Warner).[581]

162. We also have identified programming networks affiliated with broadcast television station licensees not also owned by a cable operator, also shown on Table 10. Hearst, in joint ventures with Disney and NBC-Universal, has ownership interests in a total of 17 national nonbroadcast programming networks not also owned by a cable MSO. Of these, 11 are owned jointly with Disney, and six are owned jointly with Disney and NBC-Universal. E.W. Scripps holds ownership interests in six national programming networks. The Trinity Broadcasting Network owns four programming networks. Landmark Communications owns two networks. The New York Times has ownership interest in one network not also owned by a cable MSO. Tribune and Daystar Television Network each have ownership interests in one programming network not also owned by a cable MSO, and Paxson Communications has an interest in one network with NBC-Universal.[582]

[579] News Corp., *Company Information*, at http://www.directv.com. News Corp also owns one national network jointly with Comcast. *See* Appendix C, Table C-1.

[580] Disney also owns two national networks jointly with Comcast. *See* Appendix C, Table C-1.

[581] *See* Appendix C, Tables C-1 and C-2.

[582] *See* Table 10 and Appendix C, Table C-2.

Table 10: National Networks Affiliated with a DBS Operator, National Broadcast Television Network, or Broadcast Television Licensee

Network Owner	Networks Wholly Owned or Owned in Part
Dominion Video Satellite	Angel One, Angel Two, KTV- Kids and Teens Television
News Corp.	Fox Movie Channel, Fox News Channel, Fox Reality, Fox Sports Net, Fox Soccer Channel, FX, Fuel, National Geographic Channel, Speed Channel, TV Games Network, TV Guide Channel, TV Guide Interactive, Fox Sports en Español, Phoenix Info News, Phoenix North American Chinese Channel, Star Plus, Star One, Star News, Vijay
Viacom	BET, BET Gospel , BET Hip Hop, BET on Jazz, Country Music Television (CMT), Comedy Central, College Sports Television, Flix, Logo, MTV, MTV Hits, MTV Jams, MTV2, Nickelodeon/Nick at Nite, Nick 2 , Nick GAS, Nicktoons, TV Land, Noggin, Showtime, Showtime HD, Showtime Beyond, Showtime PPV, Showtime Extreme, Showtime Family, Showtime Next, Showtime Showcase, Showtime Too, Showtime Women, Spike TV, The Movie Channel (TMC), TMC HD, TMC XTRA, VH1, VH1 Classic, VH1 Soul, VH1 Country, MTV Español, VH Uno
Viacom, NBC-Universal	Sundance Channel
NBC-Universal, Paxson	i- Independent Television (formerly PaxTV)
NBC-Universal	Bravo, CNBC, CNBC World, MSNBC, Sci-Fi Channel, Shop NBC, TR!O, Universal HD, USA Network, Weather Plus, Telemundo, Telemundo Puerto Rico, Mun2
NBC-Universal, Disney, Hearst	A&E, Biography Channel, History Channel, History International, Military History Channel, History Channel en Español
Disney	ABC Family, Disney Channel, SoapNet, Toon Disney, Toon Disney en Español.
Disney, Hearst	ESPN, ESPN Classic, ESPN2, ESPN HD, ESPNews, ESPN2 HD, ESPNU, ESPN Deportes, Lifetime Television, Lifetime Real Women, Lifetime Movie Network
Univision	Bandamax, De Pelicula, De Pelicula Clasico, Ritmoson Latino, Telefe Internacional, Telefutura, Telehit, Galavision, Univision
Liberty Media	Encore, Encore HD, Encore Action, Encore Drama, Encore Love, Encore Mystery, Encore WAM!, Encore Westerns, Game Show Network, Hallmark Channel, Movieplex, QVC, Starz!, Starz! Cinema, Starz!Kids & Family, Starz!HD, Starz! Comedy, Starz! Edge, Starz! InBlack
EW Scripps	DIY (Do-it-Yourself Network), Fine Living, Food Network, Great American Country, HGTV, Shop-at-Home
Trinity Broadcasting	Church Channel, JCTV, Trinity Broadcasting, TBN Enlace USA
Daystar	Daystar Television Network
Landmark Communications	Weather Channel, Weatherscan Local
Tribune Company	WGN Superstation

New York Times	Ovation: The Arts Network

163. ***Top 20 National Programming Networks (by subscribership).*** Currently, six of the top 20 nonbroadcast video programming networks (ranked by subscribership) are vertically integrated with a cable operator.[583] Of the remaining 14 networks, one is C-SPAN, which is funded, but not directly owned or controlled, by MVPDs, 12 are affiliated with noncable media entities, and one is unaffiliated. This figure represents a slight decrease from 2004, when seven of the top 20 networks were vertically integrated.[584] Additionally, it appears that there is some diverse ownership of the most popular networks. Eleven different entities own all or part of one or more of the top 20 programming networks in terms of subscribership.[585]

164. ***National Nonbroadcast Programming Networks by Viewership.*** Of the 15 top-rated prime time nonbroadcast programming networks, three are vertically integrated with a cable operator (Time Warner owns 100 percent of TNT and TBS, and Cox and Advance/Newhouse each own 25 percent of The Discovery Channel).[586] The remaining 12 networks are owned by other media entities. News Corp. has ownership interests in Fox News Channel, and Disney has ownership interests in The Disney Channel, Lifetime, Toon Disney, History Channel, and ESPN. Hearst has ownership interests in Lifetime, The History Channel, and ESPN. NBC has ownership interests in USA Network, The History Channel, and the Sci Fi Channel. Viacom has ownership interests in Nickelodeon, Nick at Nite, SpikeTV, and MTV.

165. During the 2004-2005 television season, the combined audience share[587] of all nonbroadcast networks[588] was higher than the combined audience share of all broadcast television stations[589] for both all day viewing and prime time viewing.[590] For all day viewing, the combined audience share of all nonbroadcast networks was 59, and the combined audience share of all broadcast television stations was 41. For prime time viewing, the combined audience share of all nonbroadcast networks was 53, and the combined audience share of all broadcast television stations was 47. More than half of all prime time viewers watched ad-supported cable networks during the past TV season, the second consecutive year that nonbroadcast networks have topped all national broadcast networks combined for an entire TV season.[591]

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[583] *See* Appendix C, Table C-5.

[584] *See 2004 Report,* 20 FCC Rcd at 2901, Appendix C, Table C-6.

[585] They include: Time Warner, Cox, Disney, General Electric (NBC-Universal), Hearst, Liberty Media, Advance Newhouse, Viacom, Landmark Communications, E.W. Scripps, and C-SPAN (National Cable Satellite Corporation).

[586] *See* Appendix C, Table C-6.

[587] A share is the percent of all households using television during the time period that are viewing the specified station(s) or network(s). Due to simultaneous multiple set viewing, Nielsen reports audience shares that exceed 100 percent when totaled. We have normalized audience shares to equal 100 percent.

[588] Nonbroadcast network shares include basic (BST and CPST) networks, premium networks, and PPV networks distributed by MVPDs.

[589] Broadcast shares include network affiliates, independent, and public television stations.

[590] Prime time viewing is Monday through Saturday, 8 p.m.-11 p.m., and Sunday, 7 p.m.-11 p.m. Nielsen Media Research, *Broadcast Calendar (TV Season) Share of Audience Report, Prime Time and Total Day,* Sept. 2005. The most popular nonbroadcast networks continue to receive a lower audience share for all day and prime time viewing than any of the major broadcast television networks.

[591] NCTA Comments at 41.

166. ***Regional Programming Networks***. In 2005, we identified 96 regional networks, the same number of networks as last year, despite the exit and entry of several networks.[592] Many, but not all, regional networks are satellite-delivered. These networks provide programming of local or regional interest and are distributed to subscribers of one or more MVPDs in an area. A significant number of regional networks offer local news or sports programming, but some provide more general programming, such as religious or ethnic programming. Of the 96 regional networks we identified, 44 networks, or 45.8 percent, were vertically integrated with at least one MSO. Comcast has ownership interests in 14, or 14.6 percent, of all regional networks. Cablevision has ownership interests in 13, or 13.6 percent, of the regional networks. Time Warner has ownership interests in 10, or 10.4 percent, of the regional networks. Cox has ownership interests in six, or 6.2 percent, of the 96 regional networks, and Charter has an ownership interest in one regional network. Although not a cable MSO, News Corp., which holds an interest in DBS operator DIRECTV has ownership interests in 16, or 16.7 percent, of the 96 regional networks.[593]

167. ***Planned Services***. This year, we identified 79 programming services that have been planned but are not yet operational.[594] The planned-services count includes some overlap from previous years because it can often take several years from the announcement of a new programming network to its initiation of service.[595]

2. Other Programming Issues

168. In this section, we discuss comments we received about the effectiveness of our program access, program carriage, and channel occupancy rules and issues relating to the carriage of local broadcast stations pursuant to must carry and retransmission consent. We also address other matters related to programming channels including sports programming; news programming; public, educational and governmental (PEG) channels; DBS public interest programming; non-English programming; locally originated and community-oriented programming; children's programming; access to programming by persons with disabilities; and packaging of programming services.

a. Regulatory Issues

169. ***Program Access and Program Carriage Rules***. The Commission's rules concerning competitive access to cable programming were initially adopted to implement the 1992 Cable Act. These rules seek to promote competition and diversity in the multichannel video programming market by preventing vertically integrated programming suppliers from favoring affiliated video distributors over unaffiliated MVPDs in the sale of satellite-delivered programming and making it more difficult for competing MVPDs to attract subscribers.[596] Also, these rules are intended to allow program suppliers that are unaffiliated with cable operators to secure carriage on cable systems that are affiliated with programmers. The program access rules apply to cable operators and to programming vendors that are affiliated with cable operators and deliver video programming via satellite to MVPDs. The rules prohibit any cable operator that has an attributable interest in a satellite cable programming vendor from improperly influencing the decisions of the vendor with respect to the sale or delivery, including prices, terms, and conditions of sale or delivery, of satellite-delivered programming to any competing MVPD. The rules also prohibit vertically integrated satellite programming distributors from discriminating in the

[592] *2004 Report,* 20 FCC Rcd at 2895-2897, Appendix C, Table C-3.

[593] *See* n.579 *supra.*

[594] *See* Appendix C, Table C-4. *See also 2004 Report,* 20 FCC Rcd at 2885, Appendix C, Table C-5.

[595] *See 1995 Report,* 11 FCC Rcd at Appendix H, Tables 3 and 4; *1996 Report,* 12 FCC Rcd at Appendix G, Tables 3 and 4; *2004 Report* 20 FCC Rcd at 2835 ¶ 152.

[596] 47 U.S.C. § 548. *See also* U.S.C. § 521(a)(5)-(6) nt.

prices or terms and conditions of sale of satellite-delivered programming to cable operators and competing MVPDs. In addition, cable operators generally are prohibited from entering into exclusive distribution arrangements with vertically integrated programming vendors. The Commission has concluded that the language of Section 628(c) expressly applies to "satellite cable programming and satellite broadcast programming," and that terrestrially delivered programming is "outside the direct coverage of Section 628(c)."[597]

170. As in previous years, a number of commenters address the statutory exemption for terrestrially delivered programming in the existing program access rules. Several commenters, citing past problems accessing terrestrially delivered, Comcast-affiliated programming in Philadelphia and Boston, repeat their concerns regarding incumbent cable operators' ability to restrict competing MVPDs' access to terrestrially delivered programming.[598] RCN and USTA express concern that terrestrial distribution of video signals will become increasingly common as a result of cable operators' regional clustering of systems.[599] SBC, USTA, EchoStar, BellSouth, CenturyTel, BSPA, Verizon, RCN, and other commenters urge the Commission to ensure that all competitors have access to so-called "must have" programming and that the Commission eliminate the terrestrial exemption or recommend that Congress do so.[600] Comcast counters that these concerns are unfounded, stating that commenters provide no examples of programming networks that were migrated to terrestrial delivery other than Comcast SportsNet Philadelphia, and that terrestrial delivery of that network was premised on legitimate business considerations.[601] Comcast adds that its newest sports networks are delivered by satellite.[602] We are not aware of any comprehensive source for determining the delivery mode for each of the national and regional networks. We will seek such information for our next report on the status of competition in the market for delivery of video programming.

171. Commenters raise various other concerns relating to access to programming. EchoStar and Qwest ask the Commission to recommend that Congress eliminate the sunset of the exclusivity provisions in the program access rules.[603] Verizon suggests that the Commission ensure that cable companies are not able to foreclose access to programming by new MVPD entrants through arrangements that give an incumbent an exclusive right to carry particular programming.[604] CenturyTel proposes that new entrants be granted the right to opt into the terms of the programming agreements entered into by the incumbent cable operator in the market.[605] NCTA urges the Commission to reject these proposals stating

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[597] *See Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition and Diversity in Video Programming Distribution: Section 628 (c)(5) of the Communications Act, Sunset of Exclusive Contract Prohibition,* 17 FCC Rcd 12124, 12158 ¶ 73 (2002).

[598] *See, e.g.*, RCN Comments at 12-14; USTA Comments at 16-17; DIRECTV Comments at 4; EchoStar Comments at 4-5; Verizon Comments at 30-33; BSPA Comments at 13; SBC Comments at 21-23.

[599] RCN Comments at 13; USTA Comments at 17.

[600] SBC Comments at 22-25; USTA Comments at 17; EchoStar Comments at 11; BellSouth Comments at 16; CenturyTel Comments at 14; BSPA Comments at 15; Verizon Comments at 32; RCN Comments at 16.

[601] Comcast Reply Comments at 25-26.

[602] *Id.*

[603] EchoStar Comments at 13; Qwest Comments at 20. Pursuant to 47 U.S.C. § 325(b)(3)(C)(ii)), MVPDs are prohibited from retransmitting the signal of any commercial broadcasting station without the express authority of the originating station. Exclusive retransmission consent agreements are prohibited. Initially, the exclusivity provisions were to sunset on Dec. 31, 2005, but the sunset of the exclusivity provisions was extended to Jan. 1, 2010, in SHVERA.

[604] Verizon Comments at 35.

[605] CenturyTel Comments at 12.

that today's video marketplace is competitive and that most of the popular and widely viewed nonbroadcast programming networks are available from cable's MVPD competitors.[606] Comcast states that differentiation of program offerings is a normal and expected behavior in a competitive marketplace.[607]

172. Various commenters discuss programming cost differentials. BSPA is concerned about discounts cable incumbents receive when purchasing programming, which it asserts are discriminatory.[608] EchoStar asserts that vertically integrated programmers offer lower prices to incumbent cable operators and discriminate against EchoStar in other terms and conditions as well.[609] ACA estimates that the dominant media conglomerates charge smaller MVPDs programming rates that are between 30 percent and 55 percent higher than rates paid by larger MVPDs.[610] ACA states that when a smaller MVPD acquires a cable system from a major MSO, programming costs increase solely due to price discrimination against smaller providers. RCN states that vertically integrated programmers should be subject to affiliate transaction restrictions that would require sales between affiliated companies to be recorded at arm's-length market prices (*i.e.*, that prices be disclosed) and that the price of cable services reflect the market price.[611] Cincinnati Bell and OPASTCO state that the cost of such programming may serve as a barrier to entry into the video market by small and rural IPTV providers. OPASTCO states that it is virtually impossible for rural video providers to know the true market rates for programming because of nondisclosure agreements between programming providers and large cable companies.[612] Comcast claims that these commenters want the Commission to mandate terms of carriage on their behalf so that they need not negotiate with programmers in the marketplace. Comcast adds that government interference in the video marketplace would be inconsistent with Congressional intent to leave negotiations between MVPDs and program suppliers to the marketplace.[613]

173. Commenters also discuss programmers' ability to secure distribution. DIRECTV contends that clustering has enabled MSOs to concentrate their subscribers and achieve market share levels throughout many of the largest DMAs that they previously enjoyed only in their individual franchise areas, thus becoming indispensable to local and regional programmers seeking distribution.[614] The America Channel argues that carriage by both Comcast and Time Warner is essential for survival of advertiser-supported networks and that denial of carriage by either of these MSOs impacts a network's ability to procure funding and the minimal carriage necessary for market entry. The America Channel also states that new networks that are affiliated with cable operators or broadcasters are more likely to be carried than independent programming networks.[615] It maintains that programming networks developed

[606] NCTA Reply Comments at 22.

[607] Comcast Reply Comments at 42.

[608] BSPA Comments at 16.

[609] EchoStar Comments at 13.

[610] ACA Comments at 6. ACA does not identify the media conglomerates.

[611] RCN Comments at 17.

[612] Cincinnati Bell Comments at 10; OPASTCO Comments at 5.

[613] Comcast Reply Comments at 29-30.

[614] DIRECTV Comments at 15.

[615] TAC Comments at 13-14. We note earlier that 257 of the 531 and all of the top 15 non-broadcast programming networks are affiliated with a cable operator and/or another media entity. We will seek further information and comment on program carriage issues and their impact on various types of independent programming networks, including minority programming networks, for our next report on the status of competition in the market for delivery of video programming.

by cable operators and other media companies are launched as linear networks (*i.e.*, basic nonbroadcast networks), while unaffiliated programming networks are able to gain carriage only through VOD distribution. The America Channel also claims that networks affiliated with MVPDs charge higher rates than those of independent networks.[616] The America Channel submits that unfair discrimination, not bandwidth constraints, underlie independent networks' inability to gain carriage. The America Channel requests that the Commission require MVPDs to disclose sufficient information regarding capacity and constraints so it can determine: (1) the digital bandwidth capabilities of the largest MVPDs on a per-system basis; (2) how many digital channels each can carry today; and (3) MVPDs' plans with respect to digital capacity in the future and how they will affect access for independent networks.[617]

174. Comcast states that cable operators and other MVPDs choose programming networks that they believe consumers will demand. It states that MVPDs consider many factors in making carriage decisions, including the content of the network, the necessity or desirability of its presentation as a linear network, the financing of the network, the experience and proven capability of the network's management team, the distribution arrangement the network has already secured, and the fees and terms of carriage. Comcast denies that carriage by Comcast or Time Warner is necessary for a programming network to be carried by other MVPDs. Comcast and Time Warner note that The Sportsman Channel launched successfully without any carriage agreements, secured its first carriage agreement with NCTC, and then signed agreements with 18 other cable operators before signing with Comcast.[618] Time Warner states that The America Channel's claim that affiliated networks charge higher license fees than independent networks is directly contradicted by a GAO report to Congress that found that ownership affiliations with broadcasters or cable operators had no influence on cable networks' license fees.[619]

175. ***Must Carry and Retransmission Consent.*** In 1992, Congress enacted statutory provisions concerning the carriage of local broadcast television stations by cable operators and subsequently extended similar provisions to DBS providers in 1999. Among the reasons for enacting broadcast signal provisions, Congress found that broadcasters and consumers benefit from the carriage of local television stations and that cable operators derive benefits from offering this popular programming. It also concluded that cable carriage of broadcast television signals without consent or copyright liability resulted in broadcasters subsidizing cable operators, creating a competitive imbalance between these two industries that compete for audience, advertising, and programming.[620]

176. Under Sections 614 and 615 of the Communications Act, cable operators must set aside up to one third of their channel capacity for the carriage of commercial television stations and additional channels for noncommercial stations depending on the system's channel capacity.[621] Pursuant to the SHVIA, DBS operators may provide local-into-local broadcast television service.[622] Unlike cable operators, which are required to carry local television stations in every market they serve, a DBS operator must carry all stations in any market where it chooses to carry any local television station ("carry one,

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[616] TAC Comments at 21-24. It submits a license fee analysis based on information provided in Kagan Research's *Economics of Basic Cable Networks 2006, 12th Annual Edition,* to illustrate this difference. *Id.* at Exhibit A.

[617] TAC Comments at 16-19.

[618] Comcast Reply Comments at 32-35; Time Warner Reply Comments at 6-7.

[619] Time Warner Reply Comments at 5-6. *See also,* GAO, *Tele-communications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry,* GAO-04-08, Oct. 2003, at 29.

[620] 47 U.S. C. § 521(a)(19) note; Pub. L. No. 102-385, 106 Stat. 1460, Oct. 5, 1992.

[621] 47 U.S.C. §§ 534(b), 535(b). *See also* 47 C.F.R. § 76.56.

[622] Pub. L. No. 106-113, 113 Stat. 1501, 1501A-526 to 1501A-545 (Nov. 29, 1999).

carry all").[623] In both the cable and DBS contexts, commercial broadcasters may elect to be carried pursuant to must carry status or retransmission consent.[624] Where a station elects must carry, it is generally guaranteed carriage, but it is prohibited from receiving compensation for this carriage.[625] Under retransmission consent, the broadcaster and cable or DBS operator negotiate an agreement that may involve compensation in return for permission to retransmit the broadcast signal. The current rules apply to the carriage of analog television stations only.

177. As we observed in last year's report, through the retransmission consent process, broadcasters can receive cash or consideration comparable to cash in exchange for granting MVPDs the right to retransmit their signals.[626] In this year's *Notice*, we asked for information on the extent to which cable television and DBS retransmission consent negotiations are providing broadcasters with an additional revenue source, either through direct compensation or through indirect benefits such as, for example, contracts for the carriage of affiliated programming. We asked what forms of compensation broadcasters are receiving for retransmission consent, and how they account for indirect compensation.[627]

178. Joint Cable Commenters state that retransmission consent has been a key driver of cable rate increases because it has been used to launch and broaden the carriage of broadcaster-owned nonbroadcast networks.[628] ACA and OPASTCO claim that when dealing with small- and medium-size cable companies, networks and major affiliate groups are demanding monthly fees of $0.50 to $1.00 per subscriber or more for each network-affiliated station, adding $2.50-$5.00 or more per month to basic cable rates in smaller markets.[629] ACA contends that this could cost smaller cable companies and their customers an additional $1 billion over the next three years.[630] BSPA also expresses concern about the ability of broadcasters to leverage retransmission consent to demand exorbitant compensation for programming and asks the Commission to monitor this situation and be prepared to take corrective action.[631] Qwest states that Section 548 of the Communications Act – which prohibits unfair practices, undue influence and price discrimination – does not go far enough to protect new MVPDs from television stations that may adopt a "pay cash or else" stance in the upcoming retransmission consent negotiations. It adds that the Commission should address this problem or, if necessary, make specific recommendations to Congress to correct the problem.[632] NRTC members are concerned about their ability to secure retransmission rights to local off-air signals on fair and reasonable terms, and urge the Commission to continue to monitor retransmission consent issues and to view those issues from the perspective of the small telco IPTV operator.[633]

179. NAB states that cable companies rarely pay cash for retransmission consent and that even if broadcasters could obtain cash payments in return for carriage of their signals, the $1 billion figure

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[623] 47 C.F.R. § 76.66.

[624] 47 C.F.R. § 76.64.

[625] 47 C.F.R. § 76.60.

[626] *See 2004 Report*, 20 FCC Rcd at 2805 ¶ 79.

[627] *See Notice*, 20 FCC Rcd at 14140 ¶ 64.

[628] Joint Cable Commenters Reply Comments at 17.

[629] ACA Comments at 7-8; OPASTCO Reply Comments at 5.

[630] *Id.*

[631] BSPA Comments at 24.

[632] Qwest Comments at 22-23.

[633] NRTC Comments at 8.

cited by ACA is "fanciful at best."[634] According to the Affiliates Associations, some broadcasters negotiated for and received consideration of other kinds, such as agreements by cable operators to purchase advertising on the stations; agreements by cable operators to allow a broadcast station to sell local advertising time in cable programming; and/or agreements by cable operators to carry local news programs or other programming owned by the broadcast company.[635] Some broadcasters do, however, receive cash payments that can be substantial. For example, Hearst Argyle Television Inc. reported a $2.3 million increase in retransmission revenues for the period ending September 30, 2005.[636]

180. Disney states that there is no justification for any changes in the retransmission consent statute or regulations. It states that broadcasters, just like any other business, should be compensated for their product if it is distributed and resold by another entity. Disney adds that broadcasters invest billions of dollars annually to create valuable programming and are entitled to compensation.[637] Network Affiliates contend that the current retransmission consent process furthers the interest of competition in the programming marketplace. It asserts that past retransmission consent election cycles, as well as individual negotiations, show no evidence of a break-down in the process or in the marketplace, and it states that additional government intrusion into these private contractual negotiations is not needed.[638] NAB concurs with Disney and the Affiliates Associations regarding compensation for cable operators' carriage of broadcast signals, especially given cable operators' increasing competition with broadcasters for local advertising revenue. NAB adds that ACA's comments regarding retransmission consent do not accurately depict competitive realities in medium and small television markets, and that television broadcasters in these markets are facing severe financial pressures.[639]

181. Several commenters address the issue of retransmission consent agreements that require MVPDs to carry certain nonbroadcast networks in return for the right to carry local broadcast signals. EchoStar states that the use of such terms is widespread, and it claims that the broadcast networks leverage their ability to withhold must have broadcast programming to obtain carriage of affiliated programming. EchoStar maintains that such practices often violate antitrust law, although violations are difficult to prove because the Commission generally does not allow discovery in retransmission consent proceedings. It urges the Commission to provide for discovery in such proceedings.[640] OPASTCO states that the tying of retransmission consent for carriage of local broadcast networks to carriage of unwanted cable networks prevents rural carriers from crafting tiers that reflect the demands of their local markets.[641] Joint Cable Commenters believe that broadcasters' use of retransmission consent to launch and broaden the carriage of nonbroadcast programming networks has been a major factor in shaping the price and composition of the expanded basic package.[642]

182. Disney states that it negotiates retransmission consent only for its 10 owned-and-operated ABC affiliates. It indicates that it offers cable and satellite operators a stand-alone cash retransmission consent deal with no requirement to carry affiliated networks, but that it also offers alternatives that

[634] NAB Reply Comments at 2-3.

[635] Affiliates Associations Reply Comments at 8.

[636] Hearst Argyle Television Inc., *SEC 10-Q Filing for Period Ending September 30, 2005*, at 16.

[637] Disney Comments at 37-38.

[638] Affiliates Associations Reply Comments at 6-9.

[639] NAB Reply Comments at 3-5.

[640] EchoStar Comments at 8-9.

[641] OPASTCO Reply Comments at 6.

[642] Joint Cable Commenters Reply Comments at 17.

involve the carriage of nonbroadcast programming networks. According to Disney, it works with the MVPD to meet each operator's needs.[643] We will continue to monitor the issues raised by commenters and will seek further information and comment on them for our next report on the status of competition in the market for delivery of video programming.

a. Sports Programming

183. We continue to monitor the availability of sports programming which many MVPDs consider must have programming in order to compete effectively in the video market.[644] There are 37 regional networks devoted to sports programming, a decrease from the 38 we identified last year.[645] Regional sports networks now represent approximately 38.5 percent of the 96 regional networks.[646] Of the 37 regional sports networks, 17, or 45.9 percent are vertically integrated with a cable MSO. Fox continues to be the leader in the distribution of regional sports networks, owning or holding an ownership interest in 16, or 43.2 percent, of all regional sports networks.[647]

184. While we report no new regional sports networks this year, in March 2005, ESPN launched an additional national sports channel, ESPNU, which carries regular season collegiate athletic events and the NCAA championships.[648] News Corp. and Cablevision restructured their ownership of several jointly owned regional sports channels. News Corp. owns 100 percent of Fox Sports Net and FSN Ohio, FSN Florida, and National Advertising Partners. Cablevision controls 100 percent of MSG and its properties, the New York Knicks, Rangers, and Liberty. Cablevision and News Corp. continue to own 20 percent and 40 percent, respectively, of FSN Bay Area, with Cablevision managing the network.[649] On March 7, 2005, the Empire Sports Network, which was owned by Adelphia and featured Buffalo Sabres NHL games, terminated its service.[650] C-SET, a regional sports network that carried sports programming in the Carolinas, terminated its service on June 30, 2005.[651] In addition, in 2005, the Baltimore Orioles and Major League Baseball formed a new network, the Mid Atlantic Sports Network (MASN). The network initially was formed to carry the Washington Nationals baseball games during the 2005 season, with plans to become a full-time network in 2006, and to carry the Baltimore Orioles baseball games once the Orioles' current agreement with Comcast Sports Net expires following the 2006 baseball season.[652]

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[643] Disney Comments at 39.

[644] *2004 Report*, 20 FCC Rcd at 28462841 ¶ 166. *See, e.g.*, SBC Comments at 22-25; USTA Comments at 17; EchoStar Comments at 11; BellSouth Comments at 16; CenturyTel Comments at14; BSPA Comments at 15; Verizon Comments at 32; RCN Comments at 16.

[645] *See* Appendix C, Table C-3.

[646] *Id.*

[647] The Commission remains cognizant that Fox's ownership of numerous regional sports programming networks may pose a public harm when combined with DIRECTV's nationwide distribution platform. The Commission imposed conditions on News Corp. requiring it to enter into arbitration where negotiations fail to produce a mutually acceptable set of prices, terms and conditions. In addition, News Corp. cannot offer any existing or future regional programming services on an exclusive basis to any MVPD and shall make such services available to all MVPDs on a non-exclusive basis. *See News Corp Order*, 19 FCC Rcd at 531-2, 543, 552-555, 626, ¶¶ 127, 147-48,172-79, 366.

[648] NCTA, *Directory of Programming Services,* Cable Developments 2005, at 84-85.

[649] News Corp., *Cablevision Swap Sports Nets,* SATELLITE BUSINESS NEWS FAXUPDATE, Feb. 23, 2005, at 2.

[650] R. Thomas Umstead, *The End of an Empire,* MULTICHANNEL NEWS, Jan. 21, 2005, at http://www.multichannel.com/article/CA498108.html (visited Jan. 26, 2005).

[651] National Basketball Association, at http://www.nba.com/bobcats/news/c-set_050628.html (visited Oct. 27, 2005).

[652] CABLEFAX Daily, Oct. 28, 2005, at 1.

Due to a dispute between Comcast and MASN, which is being addressed in a separate proceeding,[653] MASN has been available only to RCN and DIRECTV subscribers in the Washington, D.C., area.[654]

b. News Programming

185. We requested comment on the extent to which MVPDs provide local news and community affairs programming because such programming allows MVPDs to provide a unique service that meets the interests and needs of their communities.[655] This year, of the 96 regional programming networks identified, 45, or 46.9 percent, are regional news networks.[656] A news channel may concentrate on a single metropolitan area, as do NY1, the News 12 networks, Bay News 9, and News 8 Austin. They may originate their own content, or repurpose news content from co-owned broadcast channels. NewsChannel 5+ in Nashville, NewsWatch 15 in New Orleans, NewsChannel5 in San Diego, and News on One in Omaha are examples of this model. In several markets, cable operators offer local news through VOD services. In Los Angeles, Time Warner is offering VOD newscasts from KNBC; Buckeye Cable offers its Toledo subscribers VOD news from NBC affiliate WNWO; Comcast Cable provides VOD news to its subscribers in Philadelphia, Baltimore, Minneapolis, Boston, San Francisco, Denver and Salt Lake City.[657] Cablevision launched two new News 12 networks, News 12 Brooklyn and News 12 Hudson Valley, this year.[658]

c. Other Programming

186. In the Notice we requested comment on a variety of other types of programming, including PEG programming, DBS public interest programming, non-English programming, locally originated and community-oriented programming, children's programming, and access to programming

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[653] On June 14, 2005, TCR Sports Broadcasting Holding, L.L.P. (TCR) d/b/a Mid-Atlantic Sports Network, Inc. (MASN) filed a Carriage Agreement Complaint and an Emergency Petition for Injunctive Relief requesting that the Commission direct Comcast to comply with 47 C.F.R. § 76.1301 by ceasing its discriminatory activities against TCR and mandate carriage of TCR's programming of Washington Nationals games on MASN on Comcast's systems in the Washington region. Prior to TCR's filings with the Commission, Comcast filed a related lawsuit against TCR in Montgomery County, Maryland, Circuit Court on April 21, 2005, claiming that TCR had violated its agreement with Comcast for the production and exhibition of Baltimore Orioles games. In October, 2005, the Maryland Circuit Court dismissed Comcast's lawsuit, and in November, 2005, Comcast appealed the judgment. *See Comcast SportsNet Mid-Atlantic, L.P., Plaintiff v. Baltimore Orioles L. P., TCR Sports Broadcasting Holding, L.L.P., Major League Baseball, Mid-Atlantic Sports Network,* Complaint, Civ. Action No. 260751-V (Md. Circ. Ct), filed April 21, 2005. *See also Comcast SportsNet Mid-Atlantic, L.P., Plaintiff v. Baltimore Orioles L. P., TCR Sports Broadcasting Holding, L.L.P., Major League Baseball, Mid-Atlantic Sports Network, Defendants*, Court's Order and Notice of Judgment, Civ. Action No. 260751-V (Md. Circ. Ct), entered October 6, 2005; *see also Comcast SportsNet Mid-Atlantic, L.P., Plaintiff v. Baltimore Orioles L. P., TCR Sports Broadcasting Holding, L.L.P., Major League Baseball, Mid-Atlantic Sports Network, Defendants*, Notice of Appeal, Civ. Action No. 260751-V (Md. Circ. Ct), dated November 2, 2005.

[654] RCN Comments at 12; DIRECTV Comments at Appendix B2. In October 2005, Charter announced an agreement to carry MASN. CABLEFAXDAILY, Oct. 28, 2005,]at 1. In a meeting with Media Bureau Staff, Comcast noted that it disputes the complaint and that the Commission is actively addressing the resolution of this issue in another proceeding. Comcast meeting with Media Bureau Staff, Nov. 21, 2005.

[655] *See Notice,* 20 FCC Rcd at 14122 ¶ 14.

[656] *See* Appendix C, Table C-3.

[657] Allison Romano, *Local News Taps Into Cable VOD,* BROADCASTING & CABLE, May 2, 2005, at 10.

[658] CABLEFAXDAILY, June 2, 2005, at 3.

by persons with disabilities. MVPDs use these types of programming to compete more effectively and to serve specific groups in their local communities.[659]

187. ***PEG Programming.*** Many cable operators set aside one or more channels on a cable system for public, educational, and governmental programming. Generally, these channels provide programming produced by community groups and individuals.[660] Local franchising authorities may request, as part of the franchising process, that operators devote a certain amount of channel capacity and equipment for this purpose.[661] According to the Consumer's Union, these channels are heavily used in some communities, but other communities have not sought PEG channels.[662] In Vermont, which regulates cable television at the state level, each cable system is required to set aside channels for PEG programming.[663]

188. ***DBS Public Interest Programming***: DBS operators are required to reserve 4 percent of their channel capacity for "noncommercial programming of an educational or informational nature."[664] To qualify for carriage on this reserved capacity, programmers must be organized for a noncommercial, nonprofit purpose; they must be a national educational programming supplier; and they must be responsible for 50 percent of the direct costs incurred by the DBS operator in making the programming available. Furthermore, the programming offered by such programmers must contain no advertisements, must be of an educational or informative nature, and must be available on a regular schedule.[665] EchoStar reports that it provides 13 channels of public interest programming.[666] DIRECTV provides 12 channels of public interest programming.[667]

189. ***Non-English Programming.*** Cable and DBS operators continue to add non-English language programming either as part of their general packages or as themed tiers. EchoStar states that it is offering the Hispanic Information & Telecommunications Network as a Spanish educational,

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[659] *See Notice,* 20 FCC Rcd at 14122 ¶ 14.

[660] Mike Rhodes, *Media Democracy and the Struggle for Cable Access*, San Francisco Bay Area Independent Media Center, Aug. 9, 2004, at http://www.fresnoalliance.com/home/pegca leaccess.htm (visited Oct. 20, 2005).

[661] 47 U.S.C. § 531. Local franchise authorities are allowed to establish procedures under which the cable operator may utilize unused PEG channel capacity for other services. 47 U.S.C. § 531(d)(1).

[662] *What's at Stake: Community Access*, at http://www.hearusnow.org/tvradiocable/whatsatstake/communityaccess (visited Oct. 20, 2005).

[663] The Vermont Public Service Board has established PEG obligations based on cable system channel capacity. Cable systems with a channel capacity of less than 21 channels must provide at least one full-time activated PEG channel and higher capacity systems are required to have up to three channels for such use, with one channel designated for each type of programming (*i.e.*, public, educational, and governmental programming). *See* Vermont Department of Public Service, at http://publicservice.vermont.gov/cable/cable-pegaccess.html (visited Oct. 25, 2005).

[664] *See Implementation of Section 25 of the Cable Television Consumer Protection and Competition Act of 1992, Direct Broadcast Satellite Public Interest Obligation*, 19 FCC Rcd 5647 (2004).

[665] *See* 47 U.S.C. § 25.701.

[666] EchoStar currently carries the following public interest channels: Brigham Young University, Classic Arts Showcase, Colours TV, Free Speech TV, Good Samaritan Network, Hispanic Information & Telecommunications Network, Worldlink TV, Northern Arizona University, Panhandle Area Education, PBS YOU, Research Channel, RFDTV, University of California, and University of Washington. EchoStar Comments at 13.

[667] DIRECTV currently carries the following public interest channels: HITN-TV, C-SPAN 1, Daystar, EWTN, Link TV, NASA TV, PBS YOU, TBN, The WORD Network, ONCE Mexico, BYU TV, and RFD-TV. *HITN-TV To Join DIRECTV Programming Lineup*, DIRECTV In The News, at http://www.directv.com?DTVAPP/aboutus/headline.jsp?newsId=06_13_2004A (visited Oct. 24, 2005).

instructional, and cultural programming channel in its public interest line-up. It also states that it offers the broadcast signals of Univision, Telefutura, Telemundo, and TV Azteca affiliates, as well as the signals of 88 local independent broadcast stations, which include ethnic, religious, Spanish, and shopping programming. In addition, it also offers three Latino packages consisting of 30, 120, or 160 nonbroadcast channels, as well as international programming packages in various languages, including African, Arabic, Armenian, Chinese, Farsi, French, German, Greek, Hebrew, Italian, Japanese, Korean, Polish, Portuguese, Russian, South Asian, Tagalog, and Urdu.[668] DIRECTV offers Univision, Galavision, ONCE Mexico, CCTV-9 (Chinese), and DIRECTV Para Todos, a 99-channel package of Spanish language programming.[669] Comcast reports that it offers a broad selection of Hispanic programming networks, including Discovery en Español, CNN en Español, and Toon Disney Español. It also states that in the past year it has launched several services catering to multicultural audiences and that, in total, Comcast carries over 50 multicultural channels and plans to add several more in English or other languages.[670]

190. ***Locally Originated and Community-Oriented Programming:*** APTS states that the nation's 356 local public television stations provide programming of interest to their communities. According to APTS, these stations are owned and operated by local community foundations, colleges, universities and school districts, as well as locally responsive state commissions. While these stations are 15 percent funded by the Federal government, the remaining 85 percent is donated by local residents, businesses, state and local governments, local colleges and universities, and foundations.[671] Comcast states that its CN8, which provides news and sports programming with local appeal to subscribers in the Mid-Atlantic states and New England, has expanded its service area to include Pittsburgh.[672] Comcast's VOD service provides local content, including local public affairs programming and newscasts from local broadcast stations that it makes available for as many as three days after the broadcast has occurred.[673] NAB states that broadcast stations remain the leading source of vital public safety information and are a significant source of local, diverse programming. It also states that the broadcast stations carried on cable systems continue to provide a guaranteed minimum of local and diverse voices for subscribers.[674]

191. ***Children's Programming.*** Nonbroadcast networks continue to attract a growing audience among children and families. Total day viewing of expanded basic networks by children (ages 2-11) increased from a 28.3 share in 1993/1994 to a 56.4 share during the 2004/2005 television season.[675] PBS Kids Sprout, a joint venture of Comcast, Sesame Workshop, HITS Entertainment, and PBS Kids, launched on VOD in early 2005.[676] Comcast began distributing the network in September 2005 as a full-

[668] EchoStar Comments at 13-16.

[669] DIRECTV Comments at Exhibit D.

[670] Comcast Comments at 46.

[671] APTS Comments at 3-4.

[672] Radio-Television News Directors Foundation, *A Look At Regional News Channels and State Public Affairs Networks,* May 2004, at 12; Comcast Comments at 44.

[673] *See* Letter from Martha E. Heller, Wiley, Rein & Fielding, to Marlene Dortch, Secretary, FCC, MB Docket No. 05-192 (Nov. 15, 2005) at Attachment; Comcast meeting with Media Bureau Staff, Nov. 21, 2005. *See also* Comcast Corp., *Comcast and CBS Announce Deal to Offer Hit Shows through Video on Demand* (press release), Nov. 7, 2005. *See also* Comcast Comments at 49-50. Comcast's local VOD service also includes programming on community service initiatives addressing issues such as literacy and substance abuse. *Id.*

[674] NAB Comments at 4.

[675] NCTA Comments at 42-43.

[676] *2004 Report,* 20 FCC Rcd at 2846 ¶ 175.

time network on some of its systems.[677] According to RCN, PBS Kids Sprout is a must have network for the children's demographic. Before Comcast acquired an interest in the network, RCN received PBS Kids Sprout through programming supplier TVN as part of its children's VOD package, Kids Unlimited. RCN claims that since Comcast acquired an interest in the network, RCN has experienced difficulties obtaining access to the programming. In spring 2005, RCN lost access to it, resulting in an 83 percent drop in its customers' usage of its Kids Unlimited VOD service.[678]

192. ***Access to Programming by Persons with Disabilities.*** We invited comment and information regarding the accessibility of closed captioning and video description to persons with disabilities.[679] In particular we sought comment regarding the quality, accuracy, placement, technology, and instances of delayed or missing captioning. Currently, video programming distributors are required to provide at least 1,350 hours of captioned "new" nonexempt programming on each channel during each calendar quarter.[680] As of January 1, 2006, the transition period for new programming ends and video programming distributors then will be required to provide captioning for 100 percent of all new nonexempt programming.[681] In addition, a video programming distributor must include captioning in 30 percent of its "pre-rule" nonexempt programming on each channel during each calendar quarter.[682] The rules exempt several specific classes of programming from the closed captioning requirements.[683] Video programming providers may also petition the Commission for an exemption from the closed captioning rules if the requirements would impose an undue burden.[684] The closed captioning rules are enforced through a complaint process, with the complaint initially directed to the video programming distributor responsible for compliance with the rules.[685]

193. Only one commenter provided information on closed captioning. DIRECTV states that it passes along all NTSC closed captioning information in line 21, fields 1 and 2 of the Vertical Blanking Interval (VBI). It adds that programmers are able to use the Secondary Audio Programming (SAP) channels for video description if they do not currently use them for other purposes. DIRECTV currently carries a SAP channel on 39 nonbroadcast channels and over 200 broadcast channels, but it leaves the decision on how to use the SAP channel to programmers. DIRECTV does not monitor the SAP channels on a regular basis. It is unaware of any current HD programming that is being authored with native CEA-

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[677] Comcast Comments at 44.

[678] RCN Comments at 10-11.

[679] *Notice*, 20 FCC Rcd at 14124 ¶ 20. In 1997, the Commission adopted phase-in schedules to increase the amount of closed captioned video programming over time. *See Closed Captioning and Video Description of Video Programming, Implementation of Section 305 of the Telecommunications Act of 1996, Video Programming Accessibility,* Report and Order, 13 FCC Rcd 3272 (1998); Order on Reconsideration, 13 FCC Rcd 19973 (1998).

[680] 47 C.F.R. § 79.1(b)(1) (phase-in schedule for "new" programming which is defined as programming first published or exhibited on or after January 1, 1998). Video programming first published or exhibited for display on television receivers equipped for display of digital transmissions or formatted for such transmission is defined as "new" as of July 1, 2002. 47 C.F.R. § 79.1(a)(6)(ii). *See Closed Captioning Requirements for Digital Television Receivers,* 15 FCC Rcd 16788, 16808-09 ¶ 60 (2000) (*Digital Captioning Order*). A separate phase-in schedule applies for Spanish programming. 47 C.F.R. § 79.1(b)(3)-(4).

[681] 47 C.F.R. § 79.1(b)(iv).

[682] 47 C.F.R. § 79.1(b)(2) (phase-in schedule for "pre-rule" programming). *See also* 47 C.F.R. § 79.1(a)(6) (definition of pre-rule programming).

[683] 47 C.F.R § 79.1(d).

[684] 47 C.F.R § 79.1(f).

[685] 47 C.F.R § 79.1(g).

708B closed captioning, but it has tested its own receivers, which all functioned properly during testing.[686]

194. On July 21, 2005, the Commission released a *Notice of Proposed Rulemaking* seeking comment about: (1) the current status of the Commission's closed captioning rules in ensuring that video programming is accessible to deaf and hard of hearing Americans and whether any revisions should be made to enhance the effectiveness of those rules; and (2) several compliance and quality issues relating to closed captioning that were raised in a *Petition for Rulemaking* filed by Telecommunications for the Deaf, Inc., the National Association of the Deaf, Self Help for Hard of Hearing People, Inc., the Association for Late Deafened Adults, and the Deaf and Hard of Hearing Consumer Advocacy Network.[687] This proceeding is pending.

d. Packaging of Programming Services

195. In the *Notice*, we sought information on how video programming distributors package and market their programming. We also sought comment concerning the extent that MVPDs offer or plan to offer consumers more choice in channel selection rather than traditional tiering of programming services.[688] The commenters indicate that MVPDs generally continue to offer packages or tiers of service that include a large number of programming networks, including a variety of family-friendly services. Generally, however, parents cannot subscribe to those channels alone.[689] Instead, they must buy the channels they do not want their families to view in order to receive the family-friendly channels they desire. Commenters note that by offering programming on a theme tier or smaller package basis, MVPDs can address consumers' concerns regarding their inability to prevent objectionable content from coming into their homes, can differentiate their service offerings, and can allow subscribers to pay only for those programming services they regularly watch.[690]

196. Recently, a number of cable operators have announced plans to offer family-friendly programming tiers.[691] For example, on December 15, 2005. Time Warner announced that it would launch a family tier in the first quarter of 2006.[692] Consisting of 15 channels, the tier will be priced at an additional $12.99 a month above the monthly cost of the basic service tier, which averages about $12 across Time Warner's systems, and generally will require a digital set-top box for every television in the

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[686] DIRECTV Comments at 16.

[687] *See also 2004 Report*, 20 FCC Rcd at 2848 at ¶ 178. *See Closed Captioning of Video Programming, Telecommunications for the Deaf, Inc., Petition for Rulemaking*, 20 FCC Rcd 13211 (2005).

[688] *Notice*, 20 FCC Rcd at 14122 ¶ 16.

[689] The one exception is Sky Angel's DBS service, which offers a family-friendly, faith-based programming service. *See* para. 73 *supra*.

[690] ACA Comments at 12; BSPA Comments at 15; *see, e.g.*, Consumers Union and Consumer Federation of America Comments and Reply Comments, MB Docket No. 04-207, July 15, 2004. *See* Oral Statement of Kevin J. Martin, Chairman, FCC, Before the Committee on Commerce, Science and Transportation, U.S. Senate, *Open Forum on Decency*, Nov. 29, 2005; *Chairman Kevin J. Martin's Statement on the Announcement that Cable Companies May Voluntarily Offer Family Tier* (FCC News Release) Dec. 12, 2005.

[691] According to NCTA, six of the largest MSOs plan to introduce family tiers, although they may have different approaches to launching these tiers, which are in various stages of development. These cable operators are Time Warner, Comcast, Advance/Newhouse Communications (Bright House Networks), Insight Communications, Bresnan Communications, and Midcontinent Communications. *See* Glen Dickson, *Family Tiering Gets Technical*, BROADCASTING & CABLE, Dec. 19, 2005, at 24.

[692] *See* Time Warner, *Time Warner Cable Launches Family Choice Tier* (press release), Dec. 15, 2005.

home that will receive the family tier.[693] On December 22, 2005, Comcast announced that it will launch a family tier with an average of 35-40 channels beginning in early 2006.[694] In addition to the 20-25 channels that customers receive on their basic service tier, Comcast's family tier will include 16 family-friendly networks of primarily G-rated content.[695] According to Comcast, the Family Tier package will cost an average of $31.20 per month, which will reflect its national average for basic service of $12, the 16-channel Family Tier for $14.95, and a digital cable set-top box at a national average price of $4.25 per month. In January 10, 2006, Cox announced it would launch a Family Tier in early 2006, which will consist of an average of 40 channels of programming, including local broadcast stations and broad-based general entertainment, news, and sports programming.[696] Cox's Family Tier will be offered at a national average price of $32 per month for the programming package, set-top box with electronic/interactive program guild capability and parental controls for specific programs and channels. On January 17, 2006, Insight announced that it would offer a Family Tier as a digital package that will include 15 channels of programming for $13 per month. This new tier will be available as an add-on to the 21-channel basic service tier.[697] Other cable operators, such as Midcontinent and Charter, have stated they are committed to developing family-friendly offerings, but have not yet announced specific plans.[698] In addition, DIRECTV plans to offer a Family Tier with more than 40 channels that will include local broadcast stations and nonbroadcast networks at a price of $34.99 per month.[699] On February 1, 2006, EchoStar

[693] The 15 channels are: Broomerang, C-SPAN 2, C-SPAN 3, CNN Headline News, The Science Channel, Discovery Kids, Disney Channel, DIY Network, FIT-TV, Food Network, HGTV, La Familia, Nick Games & Sports, The Weather Channel, and Toon Disney. *Id.*

[694] *See* Comcast Corp., *Comcast Announces Family Tier* (press release), Dec. 22, 2005.

[695] The 16 networks include: Disney Channel, Toon Disney, PBS KIDS Sprout, Discovery Kids, Science Channel (Discovery), Nickelodeon/Nick Too, Nickelodeon GAS (Games and Sports), TBN (Trinity Broadcasting), HGTV, Food Network, DIY, CNN Headline News, The Weather Channel, National Geographic, C-SPAN, and C-SPAN 2. *Id.*

[696] Cox Communications, Inc., *Cox communications Announces Family Friendly Package* (press release), Jan. 10, 2006. The 40 channels include: local affiliates of ABC, CBS, NBC, PBS, Fox, WB, UPN, and Univision, and C-SPAN, WGN, home shopping channels, TV Guide Channel, local public, education, and government access channels, and the Disney Channel, Discovery Kids, Headline News, National Geographic Channel, Home & Garden TV, DIY (Do It Yourself), Nickelodeon, Fit TV, Sprout, Discovery Science, Boomerang, and GSN. Local systems will be able to tailor the package with The Weather Channel or Weatherscan Local, C-SPAN 2 or 3, and additional religious and Spanish-language programming.

[697] Insight Communications Company, *Insight Communication Announces Plans for Family-Friendly Tier of Programming* (press release), Jan. 17, 2006. The new tier of programming will include: Home &Garden Television, Food Network, DIY Network, C-SPAN 2, CNBS, CNN Headline News, The History Channel, The Weather Channel, Discovery Kids, Discovery Science, Nick Games & Sports, The Disney Channel, Toon Disney, PBS KIDS Sprout, and Trinity Broadcasting Network (TBN).

[698] *See* Midcontinent, *Midcontinent Communications to Develop Family Friendly Choice* (press release), Dec. 12, 2005; Jean Spenner, *Cable TV Planning "Family Friendly" Tier*, THE SAGINAW NEWS, Dec. 16, 2005, at http://www.mlive.com/business/sinews/index.ssf?/base/business-1/1134746428242260.xr.. (visited Dec. 29, 2005).

[699] DIRECTV, Inc., *DIRECTV to Offer Family Programming Package* (press release), Jan. 18, 2006. DIRECTV's package of programming will include: Bloomberg, Boomerang, BYU TV, CNN Headline News, C-SPAN 1, C-SPAN-2, Daystar, Discovery Kids, Disney East, Disney West, DIY Network, EWTN, Food Network, Hallmark Channel, HGTV, HITN, HSN, Link TV, NASA TV, National Geographic Channel, Nickelodeon/Nick at Night East, Nickelodeon/Nick at Night West, Nicktoons, Noggin/The N, NRB Network, Once TV, PBS Kids Sprout, QVC, RFD TV, Shop at Home, Shop NBC, TCT Network, The Science Channel, The Weather Channel, Toon Disney, Trinity Broadcasting Network, Word Network, World Harvest Network, XM Disney Radio, and XM Kids.

began offering a family tier with approximately 40 channels at a price of $19.99 per month for nonbroadcast channels, and $24.99 per month with local channels.[700]

197. Alternatively, a number of groups have raised issue with the voluntary industry proposals to offer family tiers. For example, the Parents Television Council contends that "family tiers are not the same as providing consumers with cable choice, the ability to take and pay for only what they want."[701] In a joint letter to Congress, Consumers Union, the Consumer Federation of America, and Free Press state that the recently announced family tiers are a good first step and demonstrate that cable operators can offer smaller, specialized bundles of service.[702] It, however, is concerned that cable operators, along with broadcasters, have decided which channels will be included and the tiers offer consumers very little choice. In addition, The Concerned Women for America (CWA) assert that parents, rather than the cable industry, should be the ones to decide what is appropriate for their children to watch and that control is taken out of parents' hands when the cable operators determine which channel to include in their family tiers.[703] Because the announcement and availability of family tiers is a recent development, we are unable to evaluate the effectiveness of these programming packages in this Report.

198. In response to the request for comment on the packaging of programming in the *Notice*, ACA states that many small- and medium-sized cable operators would like to offer themed tiers at a lower cost, and a more family-friendly expanded basic tier, but that major programming providers prevent it by imposing various types of distribution restrictions and requirements. ACA reports that if its members were permitted to move sports services to a separate tier, they would do so because their subscribers would prefer a lower cost expanded basic package and less sports programming. ACA also states that some of its members would like to be able to respond to customers who find the content on certain entertainment networks that carry mature programming to be objectionable and would like to move these networks to a "Contemporary Adult" tier. It adds that these networks carry partial nudity, sexually explicit content, and profanity. According to ACA, this would reduce wholesale costs for the expanded basic tier, ease retail rate pressure, and address subscribers' concerns.[704]

199. BSPA recognizes that the issue of tiering flexibility, and a la carte service raise many questions which need to be addressed in the marketplace, rather than on paper at the Commission before any decision can be made regarding the final costs and benefits of such offerings (whether to consumers, programmers, or distributors). Accordingly, BSPA proposes that several of its members, with those program suppliers and other cable providers who agree to participate, initiate focused, multi-year market tests in selected local markets, involving a la carte-type offerings. BSPA asserts that its proposed market tests would shed light on a number of questions, including (1) how many subscribers would choose the current structure over a voluntary a la carte option; (2) what level of a la carte would balance the needs of consumers, distributors, and content producers; (3) how many new customers would subscribe to MVPD

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[700] EchoStar Communications Corporation, *DISH Network Introduces "DishFAMILY" Programming Tier* (press release), Jan. 19, 2006. EchoStar's programming package includes: Animal Planet, The Biography Channel, Bloomberg TV, Boomerang, BYUTV, C-SPAN, C-SPAN 2, CSTV, Discovery Kids, Discovery Times, Do It Yourself Network, EWTN, Food Network, Fox News Channel, Great American Country, CNN Headline News, HSN, NASA, Nickelodeon East, Nickelodeon West, Nick Games & Sports, Nick Toons, Outdoor Channel, RFDTV, Shop at Home, ShopNBC, The Science Channel, The Weather Channel, TBN, TV Land, and QVC.

[701] *See* Parents Television Council, *PTC Calls "Family Tiers" a "Red Herring"* (press release), Dec. 12, 2005.

[702] *See* Letter from Jeannine Kenney, Consumers Union, Mark Cooper, Consumer Federation of America, and Ben Scott, Free Press, to Senators Ted Stevens and Daniel Inouye, Co-Chairmen, Committee on Commerce, Science and Transportation, U.S. Senate (Jan. 18, 2006).

[703] *See* Concerned Women for America, *CWA: Family-Friendly Tiers are Not the Answer* (press release), Dec. 12, 2005.

[704] ACA Comments at 12-13.

service if they had a greater choice of offerings; (4) how advertising rates and structures are affected; (5) which networks or types of content would fail to garner significant numbers of subscribers; and (6) the potential financial impact on content producers and distributors. BSPA adds that a market test would improve the Commission's understanding of the key issues and would better inform the legislative debate in Congress regarding consumer choice, pricing, and indecency issues. BSPA asks the Commission to endorse and support the industry's pursuit of limited market tests of a la carte offerings.[705]

200. OPASTCO states that practices that require rural carriers to carry channels that most of their customers do not demand, or that compel them to place less popular channels in certain tiers, prevent these carriers from creating tiers that match the demands of their individual markets.[706] Cincinnati Bell states that although it would like to offer differentiated programming packages, pricing options, and bundled services that compete with packages offered by incumbent cable or satellite providers, it will not be able to do so unless it can obtain reasonably priced programming, as well as carriage and tiering flexibility.[707]

201. Consumers for Cable Choice complain that cable's spectrum limitations keep valuable programming from special interest and minority markets. It claims that only those willing to pay a substantial premium can access additional channels and services of interest, if they are available at all. It adds that broadband-based networks offer the promise of substantially more programming options for these important markets. Consumers for Cable Choice point to the Latino market as an example, stating that many cable providers make available only one or two Spanish-speaking networks, and often no English-speaking Latino networks. It claims that IPTV technology could expand the amount of programming available to minority groups and special interests.[708]

202. Disney claims that MVPD subscribers enjoy many program packaging options that typically include retransmission of local broadcast signals, PEG channels, and selected other programming services.[709] DIRECTV provides examples of its programming packages, which include various packages targeted to specific audiences. Its Total Choice package includes sports, movies, family entertainment, music and local channels. It also offers premium channel packages, such as HBO, Starz, Showtime, and Cinemax, as well as several sports and international packages.[710] Dominion Video Satellite, Inc., through its Sky Angel DBS service, provides faith-based programming, as well as news and family-oriented entertainment networks. It states that it serves the needs of an audience that desires a multichannel service that offers a wide variety of both faith-based and family-friendly channels without being required to receive and subsidize programming that is overtly in conflict with their values.[711]

C. Other Competitive Issues

1. Competitive Developments in Small and Rural Markets

[705] BSPA Comments at 26-27.

[706] OPASTCO Reply Comments at 6.

[707] Cincinnati Bell Comments at 10.

[708] Consumers for Cable Choice Comments at 3-4.

[709] Disney Comments at 4-6. Disney attached its comments in response to the Commission's *Public Notice* in the *A La Carte* proceeding, MB Docket No. 04-207, filed July 15, 2004, to its comments in this proceeding. In those comments, Disney stated that any form of a la carte or tiering would result in consumers paying more for less.

[710] DIRECTV Comments at Exhibits B, C, and D.

[711] E-mail from Nancy Christopher, Vice President, Public Relations, Dominion Sky Angel DBS Television and Radio System, Nov. 15, 2005.

203. In the *Notice*, we requested information and comment regarding issues specific to video programming distribution in rural and smaller markets.[712] Small cable operators and telephone companies have video subscribership ranging from 50 subscribers up to 100,000 subscribers. These relatively small numbers belie the fact that in the aggregate small cable operators and telephone companies serve a significant percentage of the MVPD market. The American Cable Association reports that its 1,100 members serve approximately eight million subscribers, or 12 percent of total U.S. cable subscribers.[713] Their principal competitors are DBS operators DIRECTV and EchoStar, which have higher penetration rates in rural markets than in urban or suburban markets.[714] Many small and rural MVPDs are rolling out advanced services, including Internet access, VoIP, DVR and VOD.[715] OPASTCO states that its members experience increased subscription rates when they bundle broadband services with video services.[716]

204. Generally, small and rural cable operators and telephone companies serve very small numbers of subscribers in communities that experience little or no population growth. These demographics can limit their ability to raise capital for plant and equipment upgrades that will allow these small operators to compete with MVPDs having larger regional or national distribution platforms, such as cable MSOs and DBS, respectively. Thus, small and rural cable operators and telephone companies argue that a major factor limiting their ability to compete is the lack of a cost-effective means to receive and distribute video services.[717] NRTC, which represents approximately 1,200 rural utilities and affiliates in 47 states, states that many of its members distribute DIRECTV's service, but many also are pursuing a multi-platform approach, including satellite, wireless technologies, fiber platforms, and broadband-over-power line technologies, in order to compete for video subscribers.[718] OPASTCO reports that its rural

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[712] *Notice*, 20 FCC Rcd at 14125-6 ¶ 23. Pursuant to Section 208 of SHVERA, the Commission conducted an inquiry and submitted a Report to Congress on the impact on competition in the MVPD market of the retransmission consent, network nonduplication, syndicated exclusivity, and sports blackout rules, including the impact of those rules on the ability of rural cable operators to compete with the direct broadcast satellite industry in the provision of digital broadcast television signals to consumers. *See Retransmission Consent and Exclusivity Rules: Report to Congress Pursuant to Section 208 of the Satellite Home Viewer Extension and Reauthorization Act of 2004*, Sept. 8, 2005.

[713] ACA Comments at 2. According to one analyst, small cable operators serve approximately 22 percent of total U.S. cable subscribers. *See* Michael Hopkins, *Thriving (Albeit Small) Empires*, THE BRIDGE, Sept. 30, 2005, at 1.

[714] *See 2005 GAO Report* at 9-15; Michael Hopkins, *Thriving (Albeit Small) Empires*, THE BRIDGE, Sept. 30, 2005. For example, in Vermont, The Bridge reports DTH penetration to be 35 percent compared to almost 47 percent for cable; in Utah, DTH and cable penetration are tied at approximately 33 percent; in Montana, DTH penetration is 32 percent and cable penetration 48 percent; in Idaho, DTH penetration is 32 percent and cable penetration is 45 percent; in Missouri, DTH penetration is 30 percent and cable penetration is 44 percent. DTH's national average penetration rate is 20 percent and cable's is 54 percent. *Id.* at 8.

[715] *See, e.g.*, Michael Hopkins, *Thriving (Albeit Small) Empires*, THE BRIDGE, Sept. 30, 2005, at 8; Gerry Blackwell, *Rural Cooperative Does IPTV*, ISP Technology, Aug. 22, 2005; Stewart Schley, *Declaration of Innovation; Indie Ops Fight Rivals by Blazing New Trails*, MULTICHANNEL NEWS, Aug. 1, 2005; Matt Stump, *Co-op Brings IPTV to OK*, MULTICHANNEL NEWS, May 2, 2005; Linda Moss, *Telecom: Key to Rural Happiness*, MULTICHANNEL NEWS, Mar. 28, 2005.

[716] OPASTCO Comments at 7.

[717] *See, e.g.*, OPASTCO Comments at 4; NTCA Comments at 12.

[718] NRTC Comments at 2. NRTC reports that, in March 2005, it and the National Rural Electric Cooperative Association's Cooperative Research Network entered into a partnership to conduct two pilot projects to study the performance of broadband-over-powerline in rural communities. NRTC Comments at 4.

LEC members are becoming MVPDs by exploiting newer technologies.[719] NRTC states that it is focused on providing its members with cost-effective access to television programming by using a low-cost, end-to-end IPTV delivery system, with commercial deployment expected in early 2006.[720] NRTC reports that it has entered into an agreement with satellite operator SES-AMERICOM to support and market to its members a service called "IP-Prime," a centralized, satellite-delivered IPTV/MPEG-4 video distribution platform, which will enable small and rural operators to use standard headends to receive signals that can be bundled with standard-definition and HD programming, high-speed Internet, and telephony services.[721] NRTC reports that a commercial rollout of the IP Prime system is expected in the second quarter of 2006.[722]

205. Access to must have programming, including major national cable networks and regional sports networks, on a timely basis and at competitive rates is a key competitive issue for all MVPDs. Small and rural cable operators and LECs planning to offer video programming complain that securing access to programming is cumbersome and expensive.[723] NTCA, a trade association representing more than 560 rural telecommunications providers, reports that small providers lack leverage in their negotiations with video content providers. It states that its members who provide video service spend approximately 50 percent of their operating expenses for programming, adding that it expects that percentage to increase in the future. NTCA adds that rural subscribers are penalized because its member companies serve fewer subscribers than medium- and large-sized MSOs.[724] In addition, NTCA states that some of its members that have analog cable systems are being required to upgrade their facilities to digital in order to gain rights to carry certain programming.[725] NRTC believes that programming providers are hesitant to enter into programming agreements with small and rural LECs that plan to use an IPTV platform due to concerns about digital content copyright infringement.[726] ACA, which represents small

[719] OPASTCO reports that based on a survey of its membership, approximately 50 percent use coaxial cable/hybrid fiber coax; 20 percent use IPTV over DSL; 14 percent use radio frequency based fiber to the home; 13 percent use asynchronous transfer mode; 8 percent use IP-based fiber to the home; and one percent use IP-based VDSL. Some members use more than one technology. OPASTCO Comments at 3, n.7.

[720] NRTC Comments at 4. NRTC states that a majority of rural telephone companies are exploring video distribution systems using IPTV over digital subscriber lines (DSL). NRTC asserts that video platform costs are a limiting factor for small and rural LECs seeking to provide video services in their territories. According to NRTC, a head-end supporting the MPEG-2 video compression standard costs $1 million, and a system using the newer MPEG-4 compression standard can cost $3 million, but due to the limited number of households served by the average rural cable operator or LEC, such an investment is not feasible. NRTC Comments at 5-6. According to NRTC, its members believe they must choose IPTV-over-DSL platforms that support the more costly MPEG-4 standard because it will allow them to deliver multiple channels simultaneously and enable delivery of HD programming, which is not possible using MPEG-2 compression over DSL. *Id.* at 5 n.5.

[721] NRTC Comments at 6. NRTC states that the initial capital cost for a fully deployed IPTV/MPEG-4 system capable of delivering up to 200 channels of video programming will be $100,000.

[722] NRTC Comments at 6.

[723] Michael Hopkins, *Thriving (Albeit Small) Empires*, THE BRIDGE, Sept. 30, 2005. According to one small cable operator executive, most cable operators face a rise in programming costs of 10 percent to 20 percent annually. *Id.* at 6.

[724] NTCA Comments at 3-6.

[725] *Id.* at 12. NTCA reports that one of its members, which provides analog cable television service to only 50 subscribers, would be required to incur an expenditure of $180,000-$250,000 to upgrade its network to a digital platform, but the cost of the upgrade would require a substantial increase in rates that would put it at a disadvantage relative to DBS operators. *Id.*

[726] NRTC Comments at 5.

cable operators, states that more than half of its members serve fewer than 1,000 subscribers. ACA states that many of its members lack leverage in dealing with large programmers, and that retransmission consent fees will add approximately $1 billion to the cost of basic cable service in the small cable sector.[727] ACA asserts that "lighter regulatory burdens and costs" of DBS have ensured its success in competing against cable operators in small and rural markets.[728]

206. Many small cable operators purchase video programming through buying cooperatives, such as the National Cable Television Cooperative (NCTC), which represents approximately 1,000 independent cable operators serving approximately 14 million subscribers nationwide.[729] NCTC negotiates master agreements with cable programming networks, cable hardware and equipment manufacturers, and other service providers on behalf of its membership. Through NCTC, small cable operators earn volume discounts to which they would not be entitled on their own. Disney states that it provides volume discounts to NCTC on behalf of rural cable operators for each of its national programming services, and adds that 99 percent of NCTC's members opted into ESPN's most recent carriage agreement negotiated with NCTC.[730]

2. Competitive Developments in the MDU Market

207. Multiple dwelling units (MDUs) comprise a separate segment of the MVPD market because alternative video providers may have difficulty offering service in MDUs in competition with an incumbent provider.[731] To some extent, competitive choices for MDU residents have been limited, especially from DBS, since many MDU residents do not have the line-of-sight necessary to receive DBS service.[732] DIRECTV reports, however, that it has simplified the delivery of its satellite TV to customers living in apartment buildings.[733] It announced a "single wire" distribution system that makes it possible for DIRECTV to combine all signals from its satellites on a single wire running to multiple set-top boxes in a building.

208. Exclusive contracts are those that specify that video service in an MDU will be provided only by a particular MVPD. Perpetual contracts are those which grant an MVPD the right to provide service for an indefinite or very long period of time, or which have automatic renewal provisions (sometimes referred to as "evergreen" clauses). Competitive entrants into the MVPD market have raised concerns with these kinds of contracts for the past several years. As it did the last two years, BSPA identifies exclusive, long-term MDU access contracts as a barrier to entry.[734] Verizon also raises this issue.[735]

IV. TECHNICAL ISSUES

[727] ACA Comments at 15.

[728] *Id.* at 3-4.

[729] NCTC, at http://www.cabletvcoop.org/welcome.asp?t=/index.asp.

[730] Disney Comments at 5.

[731] The incumbent provider is not necessarily the incumbent cable operator. Private cable operators are the incumbent video provider for many MDUs. We note that a Commission proceeding regarding certain issues of inside and home run wiring is still pending. *See Telecommunications Services Inside Wiring, Customer Premises Equipment,* 19 FCC Rcd 1498 (2004).

[732] DIRECTV estimates that as many as half of MDU residents cannot receive DIRECTV service. DIRECTV Comments at 9.

[733] *DirecTV Says Single Wire Simplifies MDU Delivery,* COMMUNICATIONS DAILY, Aug. 19, 2005, at 3.

[734] BSPA Comments at 20-23.

[735] Verizon Comments at 35-39.

209. Technology changes have important consequences for the state of video competition. Accordingly, we report on a number of developments in this area that affect the manner and state of competition. We examine both regulatory developments and market developments that may affect competition in the video market in the coming years.

A. Navigation and Reception Devices

210. ***Tuner Mandate.*** The DTV reception requirement initially was implemented in phases based on classes of screen size, mandating a date by which 50 percent of manufactured sets of a certain size must include the capability to receive digital television signals and a later date by which 100 percent of sets of a certain size must contain the necessary circuitry. For television sets 36" and larger, July 1, 2005 was the effective date on which all televisions with an analog tuner were required to include a DTV tuner.[736] On June 9, 2005, the Commission modified the schedule by which new televisions and other receiving devices, such as VCRs and digital video recorders, are required to include the capability to receive over-the-air digital broadcast signals.[737] Specifically, the Commission advanced the date on which 100 percent of TV receivers with screen sizes 25"-36" must include DTV tuners to March 1, 2006.[738] On November 8, 2005, the Commission amended its rules to advance to March 1, 2007 the date on which new television receivers with screen sizes 13"-24" and certain other receiving devices, such as VCRs and digital video recorders, must include the capability to receive digital television signals.[739] The Commission also amended its rules to apply the DTV reception requirement to new receivers with screen sizes smaller than 13" on the same schedule.[740] The Commission made these changes to ensure greater commercial availability and better match the consumer electronics manufacturers' normal product introduction cycle.

211. ***CableCARDs and Navigation Devices.*** The development and deployment of CableCARDs continued in 2005. As of November 30, 2005, there were 375 certified or verified models of CableCARD products from 22 manufacturers,[741] up from 60 models from 11 manufacturers the previous year.[742] CableCARDs permit the reception of secured digital cable services without the addition of a set-top box. CableCARDs have been deployed to more than 90,000 subscribers by the 10 largest MSOs.[743] While consumers currently need a set-top box to receive two-way services (*e.g.* VOD, PPV),[744]

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[736] *See Review of the Commission's Rules and Policies Affecting the Conversion to Digital Television*, 17 FCC Rcd 15978 (2002).

[737] *See Requirements for Digital Television Receiving Capability*, 20 FCC Rcd 11196 (2005).

[738] *See id.* ¶ 1. Previously, the deadline for 100 percent compliance was July 1, 2006. The date for 50 percent compliance for TV receivers with screen sizes 25"-36" remained July 1, 2005.

[739] *See Requirements for Digital Television Receiving Capability*, 20 FCC Rcd 18607 (2005). Previously, the deadline for small sets (13"-24") and for other TV receiving devices was July 1, 2007.

[740] *See id.* ¶ 1.

[741] NCTA Comments, CS Docket No. 97-80, filed Dec. 29, 2005; *see also* NCTA Comments, CS Docket No. 97-80, filed Oct. 3, 2005.

[742] *See 2004 Report*, 20 FCC Rcd at 2852 ¶ 187.

[743] NCTA Comments, CS Docket No. 97-80, filed Dec. 29, 2005.

[744] *Implementation of Section 304 of the Telecommunications Act of 1996: Commercial Availability of Navigation Devices; Compatibility Between Cable Systems and Consumer Electronics Equipment*, 18 FCC 20885 (2003). Video-on-demand and pay-per-view each require two way communications to function properly, VOD for ordering and program control and PPV for ordering. With unidirectional CableCARDs, VOD will not function and PPV requires a separate ordering method. Some interactive electronic program guides (EPGs) also require two-way communication.

efforts to develop multi-stream and two-way CableCARDs have continued. Multi-stream unidirectional CableCARDs will permit the development of multi-tuner DVRs without requiring the use of multiple CableCARDs to access each stream. Two-way digital television finally will permit full-featured interactivity without a set-top box. In August 2005, Samsung became the first manufacturer to gain CableLabs certification for a two-way digital television.[745] Additional manufacturers, including Panasonic, LG, Diego, Video Without Boundaries, and Thomson, signed the two-way Cable Host Interface License Agreement (CHILA) in late 2005, enabling them to develop two-way products.[746]

212. In March 2005, the Commission issued a *Second Report and Order* maintaining the ban on cable operator deployment of integrated set-top boxes, but deferring the effective date of the ban by 12 months from July 2006 to July 2007.[747] In doing so, the Commission allowed time for the development of software-based downloadable conditional access and established a December 1, 2005, deadline for the cable industry to report to the Commission on the feasibility of deploying such a conditional access solution.[748] Downloadable conditional access relies upon development of a common hardware platform capable of securely downloading software from any cable operator that will then mimic the cable operator's existing hardware-based conditional access. If a subscriber removes the set-top box and uses it with a different cable operator, the new cable operator downloads a new security system compatible with its conditional access system and erases the previous software-based conditional access code. In July 2005, Comcast, in conjunction with Motorola, Scientific-Atlanta, and Nagravision, demonstrated early development units capable of downloadable conditional access.[749] In November 2005, Comcast hosted a second demonstration in which Motorola, Scientific-Atlanta, and Samsung demonstrated new prototypes capable of more advanced downloadable conditional access functions.[750] On November 30, 2005, NCTA submitted to the Commission the required downloadable security report, which contained a detailed timeline for the development and deployment of downloadable conditional access.[751] NCTA stated that it expected cable operators nationwide to deploy downloadable conditional access by July 1, 2008.[752]

213. Verizon urges the Commission to adopt technology-neutral standards to ensure that FTTP and other modes of video delivery can emerge and compete with traditional cable technology. Verizon contends that CableLabs serves the needs of the cable industry, and it cannot be relied upon to make

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[745] CableLabs, *Samsung Electronics Gains CableLabs Certification on 2-Way Digital Television* (press release), Aug. 23, 2005.

[746] *See* Alan Breznick, *NCTA Unveils Downloadable Conditional Access Plan*, CABLE DIGITAL NEWS, Jan. 1, 2006.

[747] *Implementation of Section 304 of the Telecommunications Act of 1996: Commercial Availability of Navigation Devices*, 20 FCC Rcd 6794 (2005) (*Second Report and Order*). "Integrated" set-top boxes are those that have not separated conditional access and security functions from the tuning, navigation, and other features of the box. To ensure cable compliance with the third-party compatibility requirements of separated security, the Commission has determined a date on which cable operators must rely on separated security. Currently, the Commission plans to ban the "integration" of set-top box functionality and security after July 1, 2007.

[748] *Id.* Conditional access is the means by which cable operators restrict access to their programming. It is generally considered to consist of an encryption technology, which makes digital content inaccessible, and an access provisioning system by which access is granted.

[749] Letter from James L. Casserly, Counsel for Comcast, to Marlene H. Dortch, Secretary, FCC, CS Docket 97-80 (July 18, 2005).

[750] Letter from James L. Casserly, Counsel for Comcast, to Marlene H. Dortch, Secretary, FCC, CS Docket 97-80, (Nov. 30, 2005).

[751] Letter from Daniel L. Brenner, Senior Vice President for NCTA, to Marlene H. Dortch, Secretary, FCC, CS Docket 97-80 (Nov. 30, 2005).

[752] *Id.*

impartial determinations on technologies that affect competitors to traditional cable operators. Verizon indicates that the International Electrical and Electronic Engineers (IEEE), the Alliance for Telecommunications Industry Solutions (ATIS), the Multimedia over Coax Alliance (MOCA), and other neutral, standards-setting bodies are developing open, competitively neutral standards to govern a variety of other technical issues, such as the transport of digital content over home networks and IPTV.

214. Specifically, Verizon states that the Commission should consider technology-neutral standards in proceedings such as the so-called Plug and Play docket.[753] It argues that the Commission should not adopt DOCSIS 2.0 or any other standard centered on technology only used by traditional cable operators when it considers standards for two-way digital television receivers. Verizon observes that the DOCSIS 2.0 specifications do not address the needs of competing technologies, such as FTTP and digital broadcast satellite.[754] Verizon contends that acceptance of CableLabs' standards, such as DOCSIS 2.0, would lead to the development of equipment (*e.g.*, connectors, set-top boxes, and interfaces built into the television sets) that would impose additional costs on competitors that need to connect to FTTP or digital broadcast satellite infrastructures. Verizon recommends that the Commission adopt the IEEE 802.3i framework, or an alternative that will work with all competing technologies, as the two-way standard.

215. ***OCAP and Interactive Television.*** The development and deployment of CableLabs' Open Cable Application Platform (OCAP) middleware solution continued in 2005,[755] with 28 firms demonstrating hardware platforms, middleware implementations, interactive TV applications, and network equipment that is OCAP compatible in August 2005.[756] Once a manufacturer adapts OCAP to a specific device, no further customization is required of the application developers. Operators have access to a simplified development, testing, and support environment by limiting the number of versions of each piece of software deployed to customers. Further, manufacturers can develop products that will support all services (including bi-directional services) delivered by cable operators as well as future Interactive Television (ITV) applications and services.

216. As reported earlier, ITV is a service that supports subscriber-initiated choices or actions that are related to one or more video programming streams (*e.g.*, t-commerce, data enhancements, and interactive gaming).[757] Cable operators, DBS operators, application developers, and consumer electronics manufacturers continue to explore a variety of ITV services in order to increase revenue and subscribership. ITV services may also reduce subscriber churn (*i.e.*, subscriber loss). The development and deployment of ITV services will advance as OCAP is implemented and developers create programs capable of running on OCAP platforms and reaching different types of audiences. In their October 14,

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[753] "Plug and Play" refers to *Implementation of Section 304 of the Telecommunications Act of 1996, Commercial Availability of Navigation Devices, Compatibility Between Cable Systems and Consumer Electronics Equipment*, 18 FCC Rcd 20885 (2003) (*Plug and Play Rules*), recon. pending.

[754] Specifically, that DOCSIS 2.0 specifies an upstream path that is not consistent with the IP over Ethernet (IEEE 802.3i) alternative for upstream transmission.

[755] Middleware is a term of art for software that acts as an interpretation layer between the operating system and specific devices of a piece of hardware and software. OCAP is related to the more familiar Java platform developed by SUN Microsystems. For each operating system (such as Microsoft Windows or Apple Mac OS), a version of the Java Virtual Machine must be adapted. Once this is done, any program written in Java will run properly. Once OCAP has been tested and certified on a platform (or set-top box, television, or other consumer electronics device), application developers, including the MSOs themselves, may write a single version of their application and test it on one OCAP implementation and be assured it will run on all OCAP implementations.

[756] CableLabs, *Twenty-eight Firms Demonstrate Interoperability on OCAP and eTV Platforms at CableLabs Event* (press release), Aug. 17, 2005.

[757] *See 2003 Report*, 19 FCC Rcd at 1712-5 ¶¶ 187-192. *See also Nondiscrimination in the Distribution of Interactive Television Services Over Cable*, 16 FCC Rcd 1321 (2001) *(ITV NOI)*.

2005 update, CEA and NCTA agreed to incorporate support for OCAP in interactive Digital Cable Ready (iDCR) devices, although the two organizations continue to negotiate technical details.[758]

217. In January 2005, Samsung entered into an agreement with three major MSOs, Time Warner, Bright House Cable, and Charter Cable, to implement bi-directional OCAP software in cable set-top boxes.[759] Bi-directional OCAP is a necessary component to allow third parties to produce two-way capable third party set-top boxes. In January 2006, several MSOs announced they would begin trials of OCAP in select markets: Comcast in Philadelphia, Denver, Boston, and Union, New Jersey; Time Warner in New York, Milwaukee, Green Bay, Lincoln and Waco; Advance/Newhouse in Indianapolis. Cox, Cablevision, and Charter made similar announcements, but did not specify the markets where the trials would occur.[760] Samsung also recently achieved certification status and began testing an OCAP-enabled interactive digital television set, thereby becoming the first consumer electronics manufacturer to build a two-way integrated digital television capable of handling interactive digital cable content and services, including VOD.[761] Panasonic and LG also have joined Samsung in entering into agreements with CableLabs, allowing them to implement OCAP middleware on cable-ready digital TVs, set-top boxes, and other products to support two-way, interactive cable services.[762] Panasonic has announced it will become the first major manufacturer to supply OCAP based set-top boxes in an agreement with Comcast.[763]

218. In addition, the Advanced Television Systems Committee (ATSC) recently approved the Advanced Common Application Platform (ACAP), which synchronizes the ATSC DTV Application Software Environment (DASE) Standard with OCAP. The new standard provides consumers with advanced interactive services, while providing content creators, broadcasters, cable operators and consumer electronics manufacturers with the technical details necessary for the development of services and products interoperable with both cable and broadcast.[764] The cost and complexity of design, implementation, and support decrease by having a common application platform on which to develop services.

B. Emerging Technologies

219. ***Fiber Optic Delivery of Video.*** Fiber to the Premises (FTTP) and Fiber to the Node (FTTN) are emerging as competitive methods for the delivery of voice, video, and data. Both Verizon and SBC are deploying Broadband Passive Optical Networks (BPON). In September 2005, Verizon

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[758] Letter from Neal M. Goldberg, General Counsel, NCTA, to Marlene H. Dortch, Secretary, FCC, CS-Docket 97-80, (Oct. 14, 2005).

[759] Rodolfo La Maestra, *2005 HDTV Report, Part 4: Satellite, Cable, Broadcasting,* HDTV MAGAZINE, Oct. 14, 2005, at http://www.hdtvmagazine.com/articles/2005/10/2005_hdtv_repor_2.php?page=1, at 3 (visited Dec. 8, 2005).

[760] CableLabs, *Cable Television Industry Voices Support for OCAP and Two-Way Digital Cable-Ready Product Deployments* (press release), Jan. 11, 2006.

[761] CableLabs, *Samsung Electronics Gains CableLabs Certification on 2-Way Digital Television* (press release), Aug. 23, 2005. Samsung, *Samsung and Time Warner Cable Deploy World's First Interactive OCAP TV* (press release), Jan. 11, 2006.

[762] *Panasonic Signs CableLabs Licenses for Two-Way Digital Cable Products*, SPECS NEWS AND TECHNOLOGY VOL. 17 NO. 2, March/April 2005, at http://www.cablelabs.com/news/newsletter/SPECS/MarApr_2005 (visited Dec. 8, 2005).

[763] Panasonic, *Panasonic and Comcast Announce Industry-First Agreement for Enhanced OCAP HD-DVR Set-Top Boxes and OCAP Software License* (press release), Jan. 4, 2006.

[764] Advanced Television Systems Committee, *ATSC Publishes "ACAP" Standard For Interactive Television* (press release), Sept. 6, 2005.

launched FiOS TV, which was expected to offer video programming to an anticipated three million homes passed by their FTTP plant by the end of 2005.[765] Verizon delivers video programming from two national super-headends to regional video hub offices via its Sonet network. Verizon inserts local broadcast signals and public, educational, and government channels at the hub offices, and then transmits the signals to the central offices (COs) for distribution to customer premises. All VOD content and the interactive program guide are sent using the Internet Protocol (IP).[766] Video entering as an IP stream will be sent to the set-tops using Multimedia over Coax (MoCA) technology.[767] Verizon is expected to use MoCA for set-top upstream capabilities. Currently, Verizon plans deployment of its high-speed data, voice, and video networks in 15 states.[768] SBC projects it will pass nearly 18 million households in 13 states by the end of 2007 with its FTTN Project Lightspeed.[769] Both Verizon FiOS and SBC Project Lightspeed will offer data speeds in excess of current average broadband speeds and will provide video services competitive with existing offerings from the major MSOs.[770]

220. Other FTTP deployments also are occurring. Developers of active FTTP architectures are entering into agreements primarily with smaller telephone companies, municipalities, and utilities. Active networks use active electronic devices (*e.g.*, amplifiers, splitters), and the platform enables sending only the channel the subscriber is watching, providing more efficient use of spectrum and preventing signal theft through compromised or unauthorized set-top boxes. For example, the Utah Telecommunications Open Infrastructure Agency (UTOPIA) and iProvo are using active FTTP architecture. UTOPIA connects 140,000 homes and businesses in Salt Lake City.[771] iProvo is building out a network that reaches 27,000 homes and 4,100 businesses and has recently completed Phase 5 of its deployment.[772]

221. ***Distributed Transmission of Digital Television (DTS/DTx).*** A DTV distributed transmission system employs multiple synchronized transmitters spread around a television station's service area. Each transmitter broadcasts the station's DTV signal on the same channel, relying on the performance of "adaptive equalizer" circuitry in DTV receivers to cancel or combine the multiple signals plus any reflected signals to produce a single signal. Such distributed transmitters are considered to be similar to analog TV booster stations, a secondary, low-power service used to "fill in" gaps in the parent station's coverage area, but DTV technology has the potential to enable this type of operation more efficiently than its analog predecessor.[773]

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[765] Linda Haugsted, *Verizon, FiOS TV Launch is "Seismic,"* MULTICHANNEL NEWS, May 22, 2005, at http://www.multichannel.com/article/CA6259344.html (visited Sept. 22, 2005).

[766] Vince Vittore, *Verizon Uses RF for FiOS TV*, Telephony Online, Sept. 26, 2005, at http://telephonyonline.com/fttp/marketing/telecom_verizon_uses_rf/index.html (visited Sept. 26, 2005).

[767] *Id. See* paras. 224-5 *infra*.

[768] *Id.* at 18.

[769] *Id.* at 21.

[770] Verizon, *Verizon FiOS FAQ*, at http://www22.verizon.com/FiOSforhome/channels/FiOS/root/faq.asp (visited Oct. 19, 2005).

[771] Utah Telecommunications Open Infrastructure, at http://www.utopianet.org/ (visited Oct. 19, 2005).

[772] Provo City Telecom, *IProvo General Information*, at http://www.iprovo.net/modules/xoopsfaq/index.php?cat_id=1 (visited Oct. 19, 2005).

[773] The Commission's Spectrum Policy Task Force has recommended that digital television broadcasters be permitted to operate single frequency low power distributed transmission systems within their present service areas. *See Spectrum Policy Task Force Report*, ET Docket No. 02-135 (Nov. 2002), available at http://www.fcc.gov/sptf/reports.html.

222. In the *Second DTV Periodic Report and Order*, the Commission approved, in principle, the use of distributed transmission system (DTS) technologies but deferred to a separate proceeding the development of rules for DTS operation and the examination of several policy issues related to its use.[774] In November 2005, the Commission issued a *Notice of Proposed Rulemaking* to examine the issues related to the use of DTS and proposed rules for future DTS operation.[775] The proposed rules would permit an existing authorized broadcast station to use DTS after the new, post-transition DTV Table of Allotments is established and the current freeze on the filing of most applications is lifted. This would afford stations the opportunity to apply to maximize their service areas. In addition, the Commission issued a *Clarification Order* with respect to the interim rules established in the *Second DTV Periodic Report and Order*.[776] Those rules continue to be available for stations that wish to apply to use DTS technology during the pendency of the rulemaking proceeding.

223. ***Enhanced-VSB (E-VSB).*** Enhanced-VSB or E-VSB is an amendment to the ATSC A/53C standard for DTV. E-VSB provides an option to broadcasters to trade off data-rate for a lower carrier-to-noise threshold for a portion of their data stream. This portion can be more resistant to interference and low signal strength conditions. One potential application is for a "fallback audio" stream that could be heard even if the video picture is unavailable. Another could be a small video stream for mobile handheld devices or data transfer to mobile devices. The ATSC has published a number of related Candidate Standards that support the E-VSB System. CS/T3-608 and CS/T3-609 provide transport specifications, and CS/T3-606 provides enhancements to the ATSC PSIP Standard (A/65). Enhancements to AC-3 audio (E-AC-3) are contained in documents CS/T3-613 and CS/T3-614.[777]

224. ***Home Networking and Wi-Fi.*** Home networking allows consumers to connect multiple devices in the home (*e.g.*, set-top boxes, television sets, personal computers) with each other. Currently, the most common application for home networking is to connect multiple PCs to cable modems. Within the context of video competition, home networks may also be used to transmit video such as downloaded VOD movies. MoCA, the Multimedia over Coax Alliance, was formed to develop specifications for networking over existing in-home coaxial cables.[778] By allowing devices connected to the same set of coax cables to network at high speeds (over 100 Mbps), programming recorded by one PVR in the house can be accessed by any other set-top device in the house.[779] The Digital Living Network Alliance (DLNA), a consortium including Fujitsu, IBM, Intel, Microsoft, and other consumer electronics manufacturers,[780] also is seeking to standardize the interaction of various networked devices in the home

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[774] *Second Periodic Review of the Commission's Rules and Policies Affecting the Conversion to Digital Television*, 19 FCC Rcd 18279, 18283, 18355-57, ¶¶ 9, 174-78 (2004) (*Second DTV Periodic Report and Order*).

[775] *Digital Television Distributed Transmission System Technologies*, 20 FCC Rcd 17797 (2005).

[776] *Id.*

[777] Advanced Television Systems Committee, *ATSC Approves Enhancements to DTV Standard* (press release), July 20, 2004.

[778] Multimedia over Coax Alliance, at http://www.mocalliance.org/en/index.asp (visited Oct. 20, 2005). *See also Digital Entertainment without Compromise*, CABLENET, at http://www.cablenet.org/participants/demos/MoCA.pdf (visited Oct. 20, 2005).

[779] Multimedia over Coax Alliance, *MoCA Concludes Successful Field Trials for Home Networking of Digital* Entertainment Using Coax (press release), Apr. 4, 2005.

[780] DLNA Promoter Members are: Fujitsu, Hewlett Packard, Huawei, IBM, Intel, Kenwood, Lenovo, Microsoft, Motorola, NEC, Nokia, Panasonic, Philips, Pioneer, Samsung, Sharp, Sony, ST, Texas Instruments, Thomson, and Toshiba. For the complete list of member companies, *see* Digital Living Network Alliance, *DLNA Member Companies,* at http://www.dlna.org/about/roster/ (visited Nov. 7, 2005).

to enable the seamless transfer and management of content among enabled devices.[781] In addition, Comcast, Time Warner, and Cox offer home networking using a wireless system based on CableLabs' CableHome.[782] Another example of home networking is TiVo Corporation's TiVo ToGo service, which permits consumers to view programming recorded on one TiVo device in the home on other TiVo devices, on home computers, and on portable media players.[783]

225. Cable operators also are forming alliances with wireless hotspot[784] providers to offer subscribers high-speed data access via Wi-Fi hotspots.[785] For example, Comcast offers its high-speed Internet subscribers owning Wi-Fi enabled laptops the T-Mobile subscription "HotSpot" service.[786] Cox has joined Qwest, Intel, and Arizona State officials to offer a Wi-Fi hotspot service known as Public Online Wireless Electronic Resource (POWER), which provides free wireless broadband service to members of the public in Arizona. Time Warner is deploying its own wireless network in large, heavily trafficked commercial establishments, and Charter is using a Wi-Fi wholesaler to deliver roaming coverage to its cable modem subscribers.[787] Cable operators believe the hotspot coverage will enable additional services and increase revenue streams.

226. ***WiMAX and Municipal Wi-Fi.*** WiMAX continues to develop as a wireless standard that is expected to become a last mile solution for cable operators, broadband providers, and others.[788] The technology, embodied in IEEE Standard 802.16, has the potential to reach rural customers outside the range of today's infrastructure and also can be used to provide entire metropolitan areas with high-speed data access. With speeds up to 75 Mbps and ranges up to 30 miles, WiMAX technology is a step in the transition to IP communication entirely without wires.[789] Among the potential applications for WiMAX is the delivery of high-quality video to handheld or portable devices. Development of WiMAX has continued, with the creation of a certification program in April 2005[790] and the opening of an official testing laboratory in July 2005.[791] While the primary proponent of WiMAX has been the Intel

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[781] Digital Living Network Alliance, at http://www.dlna.org/home (visited Nov. 7, 2005).

[782] CableLabs CableHome, at http://www.cablelabs.com/projects/cablehome/ (visited Oct. 20, 2005).

[783] TiVo, *TiVoToGo Transfers*, at http://www.tivo.com/4.9.19.asp (visited Oct. 20, 2005).

[784] A hotspot is a place where the public can access Wi-Fi service, either for free or for a fee. Hotspots are available at coffee shops, airport lounges, train stations, convention centers, hotels and many other public meeting areas. Corporations, campuses, and local governments also are implementing hotspots to provide wireless Internet access to their visitors and guests. Wi-Fi Alliance, *Glossary of Terms,* at http://www.wi-fi.com/OpenSection/glossary.asp?TID=2 (visited Jan. 14, 2005).

[785] Wi-Fi is an interoperability certification for wireless local area network (LAN) products based on the Institute of Electrical and Electronics Engineers (IEEE) 802.11 standard.

[786] Alan Breznick, *MSOs Seek Winning Wi-Fi Forumula,* CABLE DIGITAL NEWS, Apr. 1, 2005.

[787] *Id.*

[788] Intel Corporation, *WiMAX – Broadband Wireless Access Technology,* at http://www.intel.com/netcomms/technologies/WiMAX (visited Oct. 20, 2005).

[789] Intel Corp., *Broadband Wireless Access: IEEE 802.16 and WiMAX White Paper,* Aug. 2003, at http://www.intel.com/technology/magazine/standards/st08031.pdf (visited Dec. 8, 2005).

[790] WiMAX Forum, *WiMAX Forum Launches Certification Program, Expects First Equipment in Market by Year-end (*press release), Apr. 18, 2005.

[791] WiMAX Forum, *The WiMAX Forum Showcases Equipment and Breadth of Applications, Opens Test Lab* (press release), July 13, 2005.

Corporation, Nokia also has begun significant investment in the technology.[792] Some analysts do not expect widespread availability of WiMAX before 2010.[793]

227. Closer on the horizon than WiMAX deployment is the provision of wireless broadband by various municipalities, often offered for free.[794] At least six major cities, including Philadelphia, San Francisco, Chicago, Denver, Miami Beach, and Portland, Oregon, have begun developing or announced plans to deploy municipal Wi-Fi networks, either free or at low cost to local residents.[795] In general, municipalities deploy Wi-Fi as a mesh network covering an entire, large area with wireless data access based on IEEE Standard 802.11.[796] Traditional public wireless access has followed the hotspot model already deployed.[797] Some municipalities, including Philadelphia, have partnered with an existing service provider, such as Earthlink, to offer this new network at wholesale rates to competitive ISPs.[798] In some cases incumbent providers and other competitors have sought and continue to seek local and national government prohibitions on publicly funded data networks.[799]

228. ***Next Generation Network Architecture.*** NGNA is an undertaking by Comcast, Cox, and Time Warner to advance cable operators' transition to all-digital networks without expensive rebuilds. While encompassing many aspects of cable service, including advanced video and audio compression technologies (codecs), such as MPEG-4 and Windows Media 9, a primary goal of NGNA has been the development in 2005 of an alternative software-based conditional access system which continues to support cable operators' existing security. Comcast and Motorola have begun development of a solution based on Motorola's MediaCipher technology.[800] The companies demonstrated this technology to the Commission at a Comcast-hosted event in July 2005.[801]

229. ***Advanced Compression.*** The use of advanced codecs in place of MPEG-2 can significantly decrease the amount of bandwidth required to transmit digital video. Although advanced compression technologies require significant investment in new hardware, MVPDs have embraced the reduction in bandwidth that advanced compression allows. Existing video delivery services are able to provide more programming and new entrants face decreased barriers to entry into the competitive video

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[792] Simon Hendery, *WiMAX Not Up To Billing*, NEW ZEALAND HERALD, Oct. 18, 2005, at http://www.nzherald.co.nz/section/ story.cfm?c_id=5&objectid=10350750 (visited Oct. 20, 2005).

[793] Marsha Walton, *Is Wifi on Steroids the Next Big Thing?*, CNN, Oct. 17, 2005, at http://www.cnn.com/2005/TECH/10/17/wireless.WiMAX/index.html (visited Oct. 20, 2005).

[794] Michael Grebb, *Cities Unleash Free Wi-Fi*, WIRED NEWS, Oct. 19, 2005, at http://www.wired.com/news/technology/wireless_special/0,2914,68999,00.html (visited Oct. 20, 2005).

[795] *Id.*

[796] A mesh network is a network that provides a direct connection between each site and every other site. Through the use of intelligent internetworking devices, each transmission might be routed over an alternative path should the primary (direct) path between the two sites be either congested or in a state of failure. *See* Harry Newton, NEWTON'S TELECOM DICTIONARY (CMP Books, 17th ed., 2001), at 434.

[797] Jay Wrolstad, *Cities Take on Wi-Fi Challenge*, CIO TODAY, Oct. 5, 2005, at http://www.cio-today.com/news/Cities-Take-on-Wi-Fi-Challenge/story.xhtml?story_id=011000UKI4MH (visited Oct. 19, 2005).

[798] Leslie Cauley, *Debate Swirls over City Wi-Fi Networks*, USA TODAY, Oct. 4, 2005, at http://www.usatoday.com/tech/products/services/2005-10-04-wifi-networks_x.htm (visited Oct. 19, 2005).

[799] *Id.*

[800] Jeff Baumgartner, *Blowing It Up*, CED MAGAZINE, June 2005, at 38-46.

[801] Letter from Neal M. Goldberg, General Counsel, NCTA, to Marlene H. Dortch, Secretary, FCC, CS Docket 97-80, (Oct. 14, 2005).

marketplace.[802] MVPDs have focused on two codecs – MPEG-4/H.264 (also known as AVC) and Microsoft's VC-1 (formerly Windows Media 9/VC-9). Both AVC and VC-1 are included in the HD-DVD and Blu-ray BD-ROM high-definition disc specifications along with MPEG-2, which provides at least one new pipe into the home for HD programming.[803] The ATSC has several candidate standards under consideration that could include AVC and VC-1 for limited use in terrestrial digital broadcasting.[804] In January 2005, DIRECTV announced that it has begun to transition its operation to AVC, with the intent to provide local HD channels nationwide by 2007.[805]

230. ***Mobile Video.*** Several technologies have emerged to offer broadcast television to mobile telephones. Digital Video Broadcast-Handheld (DVB-H) and QUALCOMM's proprietary MediaFLO technology are the two most prominent mobile video platforms. Tower operator Crown Castle has deployed a single-frequency DVB-H test site in Pittsburgh, Pennsylvania, using spectrum in the 1440-1790 MHz band.[806] The service will provide video at 24-30 frames per second. Crown Castle plans to launch commercially in select major markets, including New York, in 2006 and to deploy nationwide to the top 30 markets throughout 2007.[807] Verizon Wireless plans to use Crown Castle's network to send live television to its phones in the first quarter of 2006.[808] MediaFLO transmissions are expected to use 700 MHz TV channels.[809] On September 27, 2005, QUALCOMM announced the first live, over-the-air demonstration of the FLO (Forward Link Only) Technology delivered to a wireless handset.[810]

231. Mobile phone companies also are beginning to deliver video programming to cellular telephones and other portable devices via 3G data services. Verizon Wireless launched a 3G multimedia service called VCAST in February 2005. Transmitting at a maximum speed of 300 to 500 kbps, VCAST

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[802] DBS providers DIRECTV and EchoStar are turning to MPEG-4 as a way to increase their video offerings within the limited bandwidth available through their existing satellites. New entrants, such as SBC, are using advanced codecs as a way to maximize the benefits of their initial investments by carrying the greatest number of channels in the minimum amount of bandwidth.

[803] At least one affordable HD-DVD player will be available by the end of the year. JVC, *JVC Unveils Affordable, High Definition DVD Player* (press release), June 8, 2005. Playstation 3 will have a Blu-ray player and is due out in early 2006. *See* Tony Smith, *Sony Unveils PS3,* THE REGISTER, May 17, 2005, at http://www.theregister.co.uk/2005/05/17/sony_unveils_ps3/ (visited Oct. 20, 2005).

[804] Currently, the ATSC Technology and Standards Group is considering the possibility of specifying one or two advanced video codecs for the E-VSB mode. CS/TSG-658 and CS/TSG-659, developed by the Specialist Group on Video and Audio Coding (TSG/S6), define the video system characteristics for VC-1 and AVC, respectively.

[805] Robert Heron, *DirecTV's HD Future is MPEG-4,* PC MAGAZINE, Jan. 6, 2005, at http://www.pcmag.com/article2/0,1759,1748991,00.asp (visited Oct. 20, 2005).

[806] Junko Yoshida, *Cell Phone Video Gets Real,* EE TIMES, Sept. 20, 2004.

[807] Texas Instruments, *Texas Instruments Brings Live Digital TV to Your Cell Phone* (press release), Oct. 21, 2004. *See also* Crown Castle, *Crown Castle Mobile Media Becomes Modeo: Showcases Live Mobile TV at International Consumer Electronics Show* (press release), Jan. 4, 2006.

[808] *Verizon Wireless Seen Offering TV via Crown Castle,* EWEEK.COM, Oct. 4, 2005, at http://www.eweek.com (visited Oct. 20, 2005).

[809] Doug Lung, *Broadcasting to Cell Phones,* TV TECHNOLOGY, Sept. 7, 2005, at http://www.tvtechnology.com (visited Sept. 7, 2005).

[810] QUALCOMM, *QUALCOMM Conducts First Live Demonstration of FLO Technology on a Wireless Handset* (press release), Sept. 27, 2005.

offers on-demand content, as well as 3D games to phones compatible with the next-generation network.[811] Sprint began streaming live Fox News on wireless phones in April 2005 through its Sprint TV service.[812] Satellite radio providers are also testing mobile video. In January 2005, On2 Networks announced that XM Satellite Radio will use On2 Networks' VP6.2 codec for streaming video to mobile receivers in vehicles.[813]

232. MobiTV launched live broadcast television service beginning in November 2003, although the initial service deployment frame rate was only one frame per second.[814] The first MobiTV service allowed consumers to access some 13 channels in real time.[815] MobiTV today is providing about 36 channels to 500,000 subscribers.[816] The service is available to customers of Sprint PCS, Cingular, and several regional carriers.[817] Other startups, such as GoTV, PacketVideo, and SmartVideo, are delivering video content to phones. Chip manufacturers continue to improve the speed and quality of mobile video.

233. Consumer electronics manufacturers are beginning to offer portable video players. Computer manufacturer Apple recently unveiled a new version of the iPod capable of carrying 75-150 hours of downloaded video.[818] Disney offers programming through the iTunes store that consumers can view on the iPod, including Pixar short films and hit television shows for $1.99 per download.[819] In March 2005, Sony released the Playstation Portable, a combination portable gaming device and media player that can display full-length movies from a Sony proprietary Universal Media Disc (UMD).[820] CinemaNow offers movie downloads that consumers can view on PCs and on several portable video players from a variety of manufacturers.[821] The Commission will monitor these nascent technologies as their services develop.

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[811] Ed Oswald, *Verizon Wireless VCast Goes Live,* BETANEWS.COM, Feb. 1, 2005, at http://www.betanews.com/article/Verizon_Wireless_VCAST_Goes_Live/1107259065 (visited Dec. 12, 2005). *See also* NCTA Comments at 10-11.

[812] David Hayes, *Sprint Presents Live TV on Phone*, KANSAS CITY STAR, Apr. 19, 2005, at http://www.kansascity.com/mld/kansascity/business/technology/11428413.htm (visited Oct. 20, 2005). Viewers see the broadcast at just under 15 frames per second, the minimum required for humans to perceive continuous motion. *See also* NCTA Comments at 11.

[813] On2 Technologies, Inc., *XM Satellite Radio Selects On2 True Motion VP6* (press release), Jan. 5, 2005.

[814] Jefferson Graham, *With MobiTV, It's Television on the Go*, USA TODAY, Oct. 9, 2005 (*Graham Article*), at http://www.indystar.com/apps/pbcs.dll/article?AID=/20051009/BUSINESS/510090347/1003/BUSINESS (visited Dec 12, 2005).

[815] MobiTV, *Watch Live TV Content On Your Sprint Mobile Phone* (press release), Nov. 13, 2003.

[816] Jefferson Graham, *TV on Cellphones? Funny but Profitable*, USA TODAY, Sept. 27, 2005, at http://www.usatoday.com/tech/products/services/2005-09-27-mobitv_x.htm (visited Dec 12, 2005). *See also* MobiTV, *MobiTV Channel Lineup*, at http://www.mobitv.com/channels/index.html (visited Oct. 20, 2005).

[817] *Graham Article. See also* NCTA Comments at 11.

[818] Apple, *Apple Unveils the iPod; Fifth Generation iPod Now Play Music, Photos & Video* (press release), Oct. 12, 2005.

[819] *Apple's Wide-Ranging Video Visions,* IPMediaMonitor, Oct. 17, 2005, at http://www.ipmediamonitor.com/subscribers/index.htm?article_id=46&sid=1 (visited Oct. 20, 2005).

[820] Sony, *Most Anticipated Consumer Product Launch of 2005, PSP [Playstation Portable] Ushers in a New Era In Portable Entertainment* (press release), Mar. 24, 2005.

[821] MediaNow, *CinemaNow is First to Add Download-To-Own Video Option to Online Service* (press release), Jan. 15, 2004.

234. ***DOCSIS 3.0.*** CableLab's Data Over Cable Service Interface Specification or DOCSIS continues to be the dominant standard used to provide high-speed Internet service for cable operators. As the throughput to operators increases, their ability to deliver additional and more complex services, including video over IP, increases.[822] As noted in our *2004 Report*,[823] CableLabs will not pursue a new DOCSIS 2.x specification[824] and will instead use routine "Engineering Change Requests"[825] to add many of the planned features to the existing DOCSIS 2.0 specification, saving other changes for a future DOCSIS 3.0 specification.[826] DOCSIS 3.0 will enable advanced services, such as Internet video, by supporting delivery of hundreds of Mbps to a single DOCSIS device.[827] CableLabs has selected "packet bonding" over "MPEG bonding"[828] for wideband[829] capabilities in the emerging DOCSIS 3.0 specification.[830] This is partly based on the fact that packet bonding gives operators a faster time to market because the technique can be deployed with existing technologies. Legacy cable modem termination systems (CMTSs), for example, can support packet bonding with a software revision. DOCSIS 3.0 enables channel bonding, a technique that will allow cable operators to offer speeds of 100 Mbps and greater, allowing them to better compete against new fiber-to-the-home (FTTH)

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[822] "Throughput" is the actual amount of useful and non-redundant information which is transmitted or processed. *See* Harry Newton, NEWTON'S TELECOM DICTIONARY (CMP Books, 17th ed., 2001), at 697.

[823] *2004 Report*, 20 FCC Rcd 2859 ¶ 209.

[824] Alan Breznick, *CableLabs Drops DOCSIS 2.x Plans, Eyes DOCSIS 3.0 Spec*, CABLE DATACOM NEWS, Sept. 2004.

[825] An Engineering Change Request (ECR) is the first step in the procedure to change CableLabs specifications. CableLabs posts the proposed change to their website and sends the ECR to a subject area working group mail list for work on the proposed change. CableLabs then posts an Engineering Change Order (ECO) to their website with indication of an ECO Comment Deadline. The final step in the procedure to change specifications is called an Engineering Change Notice (ECN), in which the proposed change is officially considered to be part of the specification that it modifies. CableLabs, *Glossary*, at http://www.cablelabs.com/news/glossary.html#E (visited Sep. 17, 2004).

[826] Alan Breznick, *CableLabs Drops DOCSIS 2.x Plans, Eyes DOCSIS 3.0 Spec*, CABLE DATACOM NEWS, Sept. 1 2004, at http://www.cabledatacomnews.com/sep04/sep04-3.html (visited Oct. 20, 2005).

[827] Douglas Shapiro, *CableLabs Financial Analyst Day*, Banc of America Securities, May 20, 2004, at 3.

[828] Packet bonding virtually welds together the multiple channels by breaking down and spreading the MPEG data packets over two or more QAM channels. The cable modem, which already operates in terms of packets, then recombines the packets. Packet Bonding is easier to implement than MPEG bonding because it is compatible with current Cable Modem Termination Service (CMTS, located in the cable headend) architecture. *See* Alan Breznick and Michael Harris, *Packet Bonding Picked for DOCSIS 3.0*, CABLE DIGITAL NEWS, May 1, 2005, at http://www.cabledatacomnews.com/may05/may05-1.html (visited Nov. 17, 2005). MPEG bonding, another form of channel bonding, virtually fuses together multiple 6 MHz channels, thereby creating one larger bandwidth and higher speed channel. *See* Jeff Baumgartner, *Drilling for Bandwidth: A Pipeline Full of Options Can Help MSOs Keep Pace*, CED MAGAZINE, Mar. 1, 2005, at http://www.bigbandnet.com/news/inTheNews/2005/news_030105b.php (visited Nov. 17, 2005).

[829] The wideband protocol spreads the DOCSIS frames, consisting of the access control and payload increments associated with each IP data flow, "vertically" across the multiple QAMs so that each frame is delivered in a fraction of the time it would take to deliver it in standard DOCSIS single-channel mode. Because DOCSIS frames are transported in the larger framework of 188-byte MPEG transport frames, the actual breaking up of the flow into vertically stacked fragments is done at the MPEG transmission convergence layer, leaving intact the DOCSIS physical and media access control (MAC) layers. *See Cisco Unveils Gig-IP Path Uniquely Suited for Cable*, SCREENPLAYS, Sept. 1, 2005, at http://www.screenplays.bz/sp105k.html, (visited Nov. 17, 2005).

[830] Alan Breznick and Michael Harris, *Packet Bonding Picked for DOCSIS 3.0*, CABLE DIGITAL NEWS, May 1, 2005, at http://www.cabledatacomnews.com/may05/may05-1.html (visited Oct. 28, 2005).

technologies.[831] The next-generation of CMTSs under the emerging DOCSIS 3.0 specification may also set the technical groundwork for more IP video in the future.[832]

235. ***PacketCable.*** PacketCable, another CableLabs project, is the specification standard developed for delivering advanced real-time multimedia services over two-way cable plant.[833] PacketCable uses IP technology to enable a wide range of services, including IP telephony, multimedia conferencing, interactive gaming, and general multimedia applications.[834] As of September 2005, 35 PacketCable-embedded multimedia terminal adapter devices were certified by CableLabs.[835] In addition, 31 DOCSIS certified modems also contain PacketCable capabilities. PacketCable Multimedia is an evolution of PacketCable that expands the realm of applications supported. It provides opportunities for better bandwidth management and the deployment of a variety of IP-based services by enabling dynamic bandwidth requests, managing shared edge network resources and integrating noncable specific applications in the DOCSIS environment. PacketCable Multimedia also provides a general, all-purpose quality-of-service (QoS) framework for multimedia applications.[836] PacketCable Multimedia allows MSOs to use its quality-of-service feature to provide better, more consistent VoIP service, which is a critical part of the triple play (*i.e.*, video, voice, data) business model for cable operators, as competing VoIP services, such as Vonage, gain ground.[837]

V. FOREIGN MARKETS

236. In the *Notice*, the Commission invited comment on the status of competition in foreign markets for the delivery of video programming that would provide insights regarding the nature of competition in the United States and the relative efficiency of market structures and regulations within the United States. In last year's report, we reviewed several countries' experiences with the digital television transition; broadcast, cable and satellite competition; and developments in video over broadband, now more commonly referred to internationally as IPTV.[838] This year we focus on developments in IPTV.

237. The advent of IPTV is a response by both incumbent operators and new entrants to the growth of competition in the provision of broadband services.[839] Although the rates of growth vary

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[831] Jeff Baumgartner, *"Packet Bonding" to be Part of DOCSIS 3.0 and the Modular CMTS*, CED BROADBAND DIRECT, Apr. 18, 2005, at http://www.cedmagazine.com/article/CA6264575.html (visited Dec. 12, 2005).

[832] *See* High-Speed Service Report at Table 3; Alan Breznick and Michael Harris, *Cable Operators, Baby Bells See Big Drop in Data Gains for Q2, (but MSOs Regain Quarterly Market Share Edge as Telcos Fall Faster*, CABLE DIGITAL NEWS, Sept. 1, 2005, at http://www.cabledatacomnews.com/sep05/sep05-1.html (visited Dec. 12, 2005).

[833] CableLabs, *PacketCable Home*, at http://www.packetcable.com (visited Oct. 19, 2005). *See Availability of Advanced Telecommunications Capability in the United States, Fourth Report to Congress*, 19 FCC Rcd at 20554; Letters from Paul Glist, Cole, Raywid & Braverman, Counsel for CableLabs, to Marlene Dortch, Secretary, FCC, July 28, 2004 and July 29, 2004, at 7-8, 25, respectively.

[834] CableLabs, *PacketCable Home*, at http://www.packetcable.com (visited Oct. 19, 2005).

[835] CableLabs, *PacketCable Certified Products*, at http://www.cablemodem.com/downloads/Certified_Products.pdf (visited Oct. 20, 2005). An embedded multimedia terminal adapter (E-MTA) is a device used to enable voice services over a cable modem.

[836] Ellacoya Networks, *Ellacoya Multimedia Service Manager (MSM) PacketCable Multimedia-based Application*, at http://www.ellacoya.com/products/multimediaMgr.shtml (visited Dec 12, 2005).

[837] Kurt Dobbins, *The Advantages of PacketCable Multimedia Technology Beyond Voice*, SCTE CABLE-TEC EXPO 2005 PROCEEDINGS, June 14-17, 2005.

[838] *See 2004 Report*, 20 FCC Rcd at 2860-62 ¶¶ 213-17.

[839] Organization for Economic Co-Operation and Development, *OECD Communications Outlook 2005*, 2005, at 96-97, 124-28.

worldwide, a number of countries have seen stagnant growth in the fixed line market, due in part to saturation, such as in Western Europe, and due in part to the ubiquity and density of mobile telephone service in Asia and Europe generally, which has led to substitution of mobile telephone service for fixed line service.[840] Incumbents have responded by upgrading their facilities to deliver more advanced services, such as broadband Internet. Similarly, competitive providers have taken advantage of regulatory initiatives in some markets that open up incumbent operators' facilities to competition and, in the European Union, allow cross border competition.[841] Overall, this has led to lower prices, more competition, and increased use of broadband infrastructure to deliver a bundle of services that include voice, data, and video.[842]

238. In Europe, recent developments suggest a measured rollout of IPTV over DSL[843] by incumbents and new entrants.[844] In the United Kingdom, the unbundling of local telephone loop connections prompted several companies to introduce IPTV, in conjunction with telecommunications and Internet access services. As we reported last year, Homechoice has been providing service primarily to residential areas of London, and now passes 2.4 million homes.[845] It recently announced that, beginning in 2006, it will expand its network to 10 million homes passed.[846] Within its present footprint, Homechoice, which reports approximately 34,000 subscribers, is adding new pay-TV customers at a faster rate than either cable or satellite operators.[847] Approximately 55 percent of Homechoice's customers subscribe to all three of its services – video, telephony and Internet access service. The leading telecommunications carrier in the United Kingdom, BT, announced that it would enter the IPTV market in late summer 2006.[848] BT's service will be delivered at a minimum connection speed of 1.5 Mb, and will include a set-top box with an integrated digital over-the-air broadcast receiver and wireline broadband receiver, as well as a DVR capable of storing up to 80 hours of programming and capable of

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[840] *See, e.g.*, International Telecommunications Union, *Europe & CIS's Telecommunications/ICT Markets and Trends (ITU European Trends 2005)*, 2005, at 2, at http://www.itu.int/ITU-D/ict/statistics/at_glance/Europe_RPM_2005.pdf.

[841] For example, in Europe, Telecom Italia operates in France, Netherlands and Germany; BT Group has operations in Italy, Spain, Germany and other countries; and Deutsche Telekom has high-speed Internet operations in France, Spain, Austria, and Switzerland. *ITU European Trends 2005*, at 10.

[842] For example, according to the ITU, competition to European incumbent operators is common, with approximately 85 percent of local markets, 73 percent of long distance markets, and 74 percent of international markets open to other operators. *ITU European Trends 2005*, at 1. *See e.g.*, Gerry Blackwell, *IPTV: The Big Picture*, ISP Planet, Apr. 15, 2005; Robert Clark, *Going for the Treble*, Telecom Asia, June 2005; Evan Ramstad, *Triple Play*, WALL STREET JOURNAL, Oct. 24, 2005; *IPTV Builds Momentum in Several Markets*, Point Topic.com, Feb. 22, 2005.

[843] Approximately 90 percent of broadband Internet connections in Europe rely on ADSL infrastructure. *ITU European Trends 2005*, at 10.

[844] By one estimate, one percent of Western European households subscribed to IPTV services in 2004. IDC, Inc., *European Telcos Become Entertainment Providers Through Launch of IPTV Services* (press release), Aug. 24, 2005. IDC projects that, by 2009, approximately six percent of Western European households will subscribe to IPTV services.

[845] *See 2004 Report*, 20 FCC Rcd at 2861 ¶ 216.

[846] *Video Networks to Roll-Out Homechoice Nationally*, IPTV NEWS, Nov. 3, 2005. Homechoice provides end-to-end customer service and installed its own network work equipment in 137 BT central office facilities.

[847] *Video Networks to Roll-Out Homechoice Nationally*, IPTV NEWS, Nov. 3, 2005.

[848] *BT IPTV Launch By Summer 2006*, THE REGISTER (UK), Sept. 28, 2005.

displaying HD content.[849] BT's service also will include VOD services characterized as "catch-up TV," in which programs from the previous seven days' broadcast schedule will be available on demand without the need to record; 30 digital over-the-air TV channels; communications services, including instant messaging, chat, and video telephony on TV; and interactive services.[850]

239. Italy's FastWeb, one of Europe's first IPTV providers, which launched in 2001, reported that it has approximately 644,000 subscribers as of September 2005.[851] FastWeb's network covers 85 cities and population centers in Italy, passing a total of 7.5 million homes.[852] FastWeb plans to extend its network to 30 million homes passed by the end of 2006. FastWeb is the only Italian operator offering a triple play service package of video, voice, and data service. For approximately $30 a month, FastWeb's basic package offers metered broadband service of 300 minutes of voice and Internet access, including Internet access of 10 Mbps download for subscribers with a fiber optic connection and 6 Mbps download for subscribers with a DSL connection; and a package of television programming that includes four national Italian broadcast channels, a collection of thematic and international channels (*e.g.*, CNN, Cartoon Network, Disney Channel); VOD; and a network-based DVR.[853] Beyond the included video programming, FastWeb offers a range of thematic programming tiers, such as Sports and Movies, and also offers programming on an a la carte basis.[854] Approximately 40 percent of FastWeb's subscribers choose to subscribe to a la carte channels and subscription packages.[855] In addition, FastWeb resells on an a la carte basis some of the programming of its principal video programming competitor, Sky Italia. In July 2005, Telecom Italia launched free trials of its IPTV over ADSL service in Rome, Milan, Bologna, and Palermo and was expected to introduce the service in 21 Italian cities by the end of 2005. The service will feature live TV, including exclusive Italian football matches, top Italian basketball, and VOD. Telecom Italia is using Microsoft TV IPTV Edition software.[856]

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[849] *BT Select Philips as Set Top Box Provider for Broadband Services*, IPTV NEWS, Oct. 26, 2005. In the UK, Freeview is the principal over-the-air digital television service, allowing the reception of 30 digital broadcast channels, and accounts for 5.178 million of the UK's 15.7 million total digital television households. *See* Ofcom, *Digital Television Update – 2005 Q2*, Sept. 15, 2005.

[850] *BT Select Philips as Set Top Box Provider for Broadband Services*, IPTV NEWS, Oct. 26, 2005.

[851] FastWeb SpA, *FastWeb Files Q3 Prelims* (press release), Oct. 7, 2005. Last year, we reported that FastWeb had 151,000 customers as of June 2004. *See 2004 Report*, 20 FCC Rcd at 2861 ¶ 214. One factor contributing to the sharp increase in FastWeb subscribers was a promotion in which premium channels showing professional soccer games were given away for free with new subscriptions. Gerry Blackwell, *IPTV Grows in Europe*, ISP Planet, June 30, 2005. FastWeb's network is a combination of fiber optic cable and DSL. FastWeb expanded its network following a 2001 Italian anti-trust decision that required Telecom Italia, the incumbent telephone company, to provide access to cable ducts and rights of way that it had built for a cable television network but subsequently abandoned. In addition, the Italian government has subsidized the purchase of the FastWeb set-top box as part of its effort to foster the development of interactive television in Italy. *Id.*

[852] FastWeb SpA, *FastWeb Files Q3 Prelims* (press release), Oct. 7, 2005.

[853] FastWeb SpA, *FastWeb's TV Options*, at http://www.fastweb.it/principale.php?PAGEST=4_family.php.

[854] For example, FastWeb offers Roma Channel, Milan Channel, and Inter Channel for $9.45 each per month; Disney Channel and Cartoon Network for approximately $4.75 each per month; and CNN and ESPN Classic Sport for approximately $2.40 each per month. FastWeb's VOD service is also available a la carte for approximately $9.45 per month. *See* FastWeb SpA, FastWeb's TV Options, at http://www.fastweb.it/ rincipale.php?PAGEST=4_family.php. In addition, FastWeb charges a one time activation fee of approximately $112.

[855] Gerry Blackwell, *IPTV Grows in Europe*, ISP Planet, June 30, 2005.

[856] *Telecom Italia Readies "Superphone" and IPTV Launch*, CONVERGE NETWORK DIGEST, Oct. 27, 2005.

240. France has three national operators providing IPTV service. France Telecom's MaLigne TV, a DSL-based service, passes approximately 8.5 million homes and has approximately 142,000 subscribers as of September 2005.[857] France Telecom will extend this service to the carriers it owns in the United Kingdom, the Netherlands and Poland by mid-2006.[858] In addition, France Telecom is planning to introduce a set-top box, called "LiveBox," which will be capable of supporting a range of service offerings in addition to home networking.[859] Neuf Telecom launched its IPTV over DSL service in late 2004 and offers a triple play service for approximately $35 per month, featuring 46 channels and more than 150 additional channels that can be purchased a la carte or in bundles.[860] The third provider, Iliad, markets its triple-play service through its "Free" broadband service provider. At a cost of approximately $35 per month, in addition to Internet access and telephone service, Free provides 80 free television channels and offers approximately 170 subscription video channels on an a la carte basis or in thematic packages, such as sports and music.[861] As of June 2005, Free had approximately 1.18 million subscribers to its triple-play package, 130,000 of whom choose to subscribe to a la carte video programming.[862]

241. Elsewhere in Europe, in June 2005, Finland's Alcom, the primary DSL provider for the Aland Islands, launched that country's first commercial IPTV over DSL service and now serves approximately 1,000 subscribers.[863] Alcom offers 26 channels for approximately $11 per month.[864] Broadband and telephone service are separate subscriptions and range in price from approximately $35-$64 per month, depending on the speed of service.[865] In May 2005, Russian company Sistema Multimedia launched its IPTV service Stream TV, which offers Internet access, VOD, and 80 Russian and international television channels, with a basic service package costing approximately $9.95 per month. The service, which is available to approximately 3.3 million Moscow homes, allows subscribers to add new video channels or packages on an a la carte basis.[866]

242. In Asia, a number of countries have seen the introduction of IPTV services by both incumbent operators and new entrants. One analyst argues that Asia is "fertile ground" for IPTV services given incumbent operators' extensive existing wireline networks, high population density of urban areas, leadership of Asian countries in broadband penetration growth, widespread deployment throughout Asia of ADSL networks supporting at least 6 Mbps to residential areas, and government policies encouraging aggressive broadband implementation through a combination of regulatory flexibility and financial

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[857] France Telecom, *Revenues Up By 3.8% in the Third Quarter of 2005* (press release), Oct. 27, 2005.

[858] *France Telecom Outlines NExT – New Experience in Telecom Services*, CONVERGE NETWORK DIGEST, June 30, 2005.

[859] France Telecom, *France Telecom Launches NExT : A Three-Year Transformation Programme to Make France Telecom the Operator of Reference for New Telecom Services in Europe* (press release), June 29, 2005.

[860] *See* Neuf Telecom, at http://www.neuf.com/fr/index.html; Ray Le Maistre, *Neuf: Time is Right for IPTV*, Light Reading, Jan. 31, 2005, available at http://www.lightreading.com/document.asp?doc_id=66872.

[861] *See* Iliad Group, at http://www.iliad.fr/en/activities/internet.html. For example, Free's music pack, consisting of three MTV channels and two VH1 channels, costs approximately $2.30 per month.

[862] Iliad Group, *Leading Voice over IP and TV over ADSL Operator in Europe* (press release), Aug. 2, 2005.

[863] *Alcom Launches First IPTV Over DSL Service in Finland Using Paradyne's Broadband Access Solutions*, Business Wire, June 13, 2005.

[864] Alcom Datakommikation, Aland.tv – Digital TV Over Broadband, at http://www.alcom.aland.fi/index.php?page=produkter/aland_tv.php.

[865] *Id.*

[866] *Stream TV IPTV Service Launches in Russia*, Informitv, May 13, 2005; Sistema Multimedia, *Sistema Multimedia Launches Interactive Television* (press release), May 11, 2005.

incentives.[867] PCCW of Hong Kong launched its IPTV service Now Broadband TV (NOW) in 2003 and had over 441,000 subscribers as of June 2005.[868] The service is offered on a stand-alone basis or in combination with PCCW's Netvigator broadband Internet access service. NOW offers customers 15 free video channels and 57 subscription video channels, 22 of which are exclusive to the provider.[869] NOW allows its customers to subscribe to individual channels on a month-to-month, six-month, or 12-month basis, in addition to annually based subscriptions to packages of programming offered by other providers. At present the service does not support any DVR functionality, nor can any content be recorded by any other means.[870] In China, despite aggressive deployment of broadband infrastructure, the rollout of IPTV has been very slow and is limited to trials at the present time, as China's major telecommunications operators await the issuance of IPTV licenses by the State Administration of Film, Radio, and Television.[871] Four companies in Japan provide IPTV service, and a new service was expected to launch in South Korea before the end of 2005.[872]

VI. ADMINISTRATIVE MATTERS

243. This *2005 Report* is issued pursuant to authority contained in sections 4(i), 4(j), 403, and 628(g) of the Communications Act of 1934, as amended, 47 U.S.C. §§ 154(i), 154(j), 403, and 548(g).

244. It is ORDERED that the Office of Legislative Affairs shall send copies of the *2005 Report* to the appropriate committees and subcommittees of the United States House of Representatives and the United States Senate.

245. *Accessible Formats*. To request materials in accessible formats for people with disabilities (Braille, large print, electronic files, audio format), send an e-mail to fcc504@fcc.gov or call the Consumer & Governmental Affairs Bureau at 202-418-0530 (voice), 202-418-0432 (TTY). *Ex Parte Rules*. There are no *ex parte* or disclosure requirements applicable to this proceeding pursuant to 47 C.F.R. § 1.1204(b)(1).

246. Pursuant to Sections 1.415 and 1.419 of the Commission's rules, 47 C.F.R. §§ 1.415, 1.419, interested parties may file comments on paragraphs 31-36 in MB Docket No. 05-255 on or before April 3, 2006, and reply comments on or before April 18, 2006. Comments may be filed using: (1) the Commission's Electronic Comment Filing System (ECFS), (2) the Federal Government's eRulemaking Portal, or (3) by filing paper copies. *See* Electronic Filing of Documents in Rulemaking Proceedings, 63 FR 24121 (1998).

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[867] *See* Jeffrey Soong, *Why is Asia Leading the Global IPTV Revolution?*, CONVERGE NETWORK DIGEST, June 23, 2005.

[868] PCCW Limited, *PCCW Reports 2005 Interim Results* (press release), Aug. 18, 2005.

[869] Individual channels cost approximately $0.80 per month; movie channels, such as HBO, cost approximately $6 per month. Bundles of channels cost approximately $15 per month. Evan Ramstad, *Triple Play*, WALL STREET JOURNAL, Oct. 24, 2005.

[870] NOW employs three-layered content protection comprising network-based conditional access, digital copyright protection, and analog copyright protection, resulting in no instances of piracy, compared to the 15 percent piracy rate of other pay TV operators in Hong Kong. This triple layer of digital content protection is credited with enabling PCCW to obtain exclusive programming rights from programmers concerned with the piracy of their programming on IP-based video networks. Jeffrey Soong, *Why is Asia Leading the Global IPTV Revolution?*, CONVERGE NETWORK DIGEST, June 23, 2005. PCCW is expected to introduce a network-based DVR functionality. Entone Technologies, *Entone Selected for World's Largest IPTV VOD Deployment* (press release), Oct. 3, 2005.

[871] Ray le Maistre, *China Mulls IPTV Licenses*, Light Reading, Jan. 13, 2005, available at http://www.lightreading.com/document.asp?doc_id=65985.

[872] *See* Evan Ramstad, *Triple Play*, WALL STREET JOURNAL, Oct. 24, 2005; Ginny Parker Woods, *In the Fast Lane*, WASHINGTON POST, Oct. 24, 2005.

- *Electronic Filers*: Comments may be filed electronically using the Internet by accessing the ECFS: http://www.fcc.gov/cgb/ecfs/ or the Federal eRulemaking Portal: http://www.regulations.gov. Filers should follow the instructions provided on the website for submitting comments.

    - For ECFS filers, if multiple docket or rulemaking numbers appear in the caption of this proceeding, filers must transmit one electronic copy of the comments for each docket or rulemaking number referenced in the caption. In completing the transmittal screen, filers should include their full name, U.S. Postal Service mailing address, and the applicable docket or rulemaking number. Parties may also submit an electronic comment by Internet e-mail. To get filing instructions, filers should send an e-mail to ecfs@fcc.gov, and include the following words in the body of the message, "get form." A sample form and directions will be sent in response.

- *Paper Filers*: Parties who choose to file by paper must file an original and four copies of each filing. If more than one docket or rulemaking number appears in the caption of this proceeding, filers must submit two additional copies for each additional docket or rulemaking number.

  Filings can be sent by hand or messenger delivery, by commercial overnight courier, or by first-class or overnight U.S. Postal Service mail (although we continue to experience delays in receiving U.S. Postal Service mail). All filings must be addressed to the Commission's Secretary, Office of the Secretary, Federal Communications Commission.

    - The Commission's contractor will receive hand-delivered or messenger-delivered paper filings for the Commission's Secretary at 236 Massachusetts Avenue, NE., Suite 110, Washington, DC 20002. The filing hours at this location are 8:00 a.m. to 7:00 p.m. All hand deliveries must be held together with rubber bands or fasteners. Any envelopes must be disposed of before entering the building.

    - Commercial overnight mail (other than U.S. Postal Service Express Mail and Priority Mail) must be sent to 9300 East Hampton Drive, Capitol Heights, MD 20743.

    - U.S. Postal Service first-class, Express, and Priority mail should be addressed to 445 12th Street, SW, Washington DC 20554.

- In addition, parties must serve the following with either an electronic copy via e-mail or a paper copy of each pleading: (1) the Commission's duplicating contractor, Best Copy and Printing, Inc., Portals II, 445 12th Street, S.W., Room CY-B402, Washington, D.C. 20554, telephone 1-800-378-3160, or via e-mail at www.bcpiweb.com; (2) Marcia Glauberman, Media Bureau, 445 12th Street, S.W., Room 2-C264, Marcia.Glauberman@fcc.gov; (3) Anne Levine, Media Bureau, 445 12th Street, S.W., Room 2-A864, Anne.Levine@fcc.gov; and (4) Timothy May, Media Bureau, 445 12th Street, S.W., Room 2-C315, Timothy.May@fcc.gov.

247. *People with Disabilities*: Contact the FCC to request materials in accessible formats (Braille, large print, electronic files, audio format, etc.) by e-mail at fcc504@fcc.gov or call the Consumer & Governmental Affairs Bureau at 202-418-0530 (voice), 202-418-0432 (TTY).

248. The Media Bureau contacts for this proceeding are Anne Levine at (202) 418-7027, Anne.Levine@fcc.gov, and Timothy May at (202) 418-1463, or Timothy.May@fcc.gov.

Marlene H. Dortch
Secretary

APPENDIX A

LIST OF COMMENTERS

Initial Comments

Alcatel
American Cable Association (ACA)
The America Channel (TAC)
Association of Public Television Stations (APTS)
BellSouth Corporation and BellSouth Entertainment, LLC (BellSouth)
Broadband Service Providers Association (BSPA)
CenturyTel, Inc.
Cincinnati Bell Inc.
City of Ontario, California
Comcast Corporation (Comcast)
Community Broadcasters Association (CBA)
Consumer Electronics Association (CEA)
Consumers for Cable Choice
DIRECTV, Inc.
EchoStar Satellite L.L.C. (EchoStar)
Media General, Inc.
National Association of Broadcasters (NAB)
National Cable & Telecommunications Association (NCTA)
National Rural Telecommunications Cooperative (NRTC)
National Telecommunications Cooperative Association (NTCA)
Network Domain, LLC
Qwest Communications International Inc. (Qwest)
RCN Telecom Services, Inc. (RCN)
SBC Communications, Inc. (SBC)
Telecommunications Industry Association (TIA)
United States Telecom Association (USTA)
Verizon Communications Inc. (Verizon)
The Walt Disney Company (Disney)
W.A.T.C.H. TV Company (W.A.T.C.H. TV)

Reply Comments

ABC, CBS and NBC Television Affiliate Associations (Affiliates Associations)
BellSouth Corporation and BellSouth Entertainment, LLC (BellSouth)
Comcast Corporation (Comcast)
Consumer Electronics Association (CEA)
DIRECTV, Inc.
EchoStar Satellite L.L.C. (EchoStar)
iN DEMAND L.L.C.
Joint Cable Commenters (Advance/Newhouse Communications, Cox Communications, Inc., and Insight Communications)
National Association of Broadcasters (NAB)

National Cable &Telecommunications Association (NCTA)
Organization for the Promotion and Advancement of Small Telecommunications Companies (OPASCO)
Paxson Communications Corporation (Paxson)
Qwest Communications International Inc. (Qwest)
SBC Communications, Inc. (SBC)
Time Warner Cable Inc. (Time Warner)
The United States Telecom Association (USTA)
Verizon Communications Inc. (Verizon)

APPENDIX B
TABLE B-1
Assessment of Competing Technologies

Technology Used	June 01	June 02	June 03	June 04	June 05
(1) TV Households	102,184,810	105,444,33	106,641,91	108,410,16	109,590,17
Percent Change	1.37%	0	0	0	0
		3.19%	1.14%	1.66%	1.09%
(2) MVPD Households[i]	86,062,074	87,562,641	88,312,191	92,295,766	94,226,357
Percent Change	3.72%	1.74%	0.86%	4.51%	2.09%
Percent of TV Households	84.22%	83.04%	84.18%	85.14%	85.98%
(3) Cable Subscribers	66,732,000	66,472,000	66,050,000	66,100,000	65,400,000
Percent Change	0.73%	-0.39%	-0.63%	0.08%	-1.06%
Percent of MVPD Total	77.54%	75.91%	73.58%	71.62%	69.41%
(4) MMDS Subscribers	700,000	490,000	200,000	200,000	100,000
Percent Change	0.0%	-30.00%	-59.18%	0.00%	-50.00%
Percent of MVPD Total	0.81%	0.56%	0.22%	0.22%	0.11%
(5) PCO Subscribers	1,500,000	1,600,000	1,200,000	1,100,000	1,000,000
Percent Change	0.0%	6.67%	-25.00%	-8.33%	-9.09%
Percent of MVPD Total	1.74%	1.83%	1.34%	1.19%	1.06%
(6) HSD Subscribers	1,000,074	700,641	502,191	335,766	206,358
Percent Change	-32.28%	-29.94%	-28.32%	-33.14%	-38.54%
Percent of MVPD Total	1.16%	0.80%	0.56%	0.36%	0.22%
(7) DBS Subscribers	16,070,000	18,240,000	20,360,000	23,160,000	26,120,000
Percent Change	23.74%	13.50%	11.62%	13.75%	12.78%
Percent of MVPD Total	18.67%	20.83%	22.68%	25.09%	27.72%
(8) OVS Subscribers[ii]	60,000	60,000			
Percent Change	0.00%	0.00%			
Percent of MVPD Total	0.07%	0.07%			
(9) BSP Subscribers[iii]			1,460,000	1,400,000	1,400,000
Percent Change			N/A	-4.11%	0.00%
Percent of MVPD Total			1.63%	1.52%	1.49%

Notes:

(i) The total number of MVPD households given on this table is the sum of the subscribers to each of the MVPD services listed. The actual total number of MVPD households is likely to be somewhat less than the given figure since some households subscribe to the services of more than one MVPD. *See 1994 Report,* 9 FCC Rcd at 7480. However, the number of households subscribing to more than one MVPD is expected to be low. Hence, the total can be seen as a reasonable estimate of the number of MVPD households.

(ii) Beginning in 2003, we combined OVS subscribers with BSP subscribers. We are no longer, therefore, reporting a separate number for OVS subscribers.

(iii) This number includes some, if not all, OVS subscribers, and may double count some cable subscribers from newer cable overbuild systems. We started reporting this number two years ago and thus we do not have subscribers for years prior to 2003.

Sources:

(1) Television households: All years, *Nielsen Media Research.*

(2) Total MVPD households: The sum of the total number of subscribers listed under each of the categories of the various technologies. See note (i) above.

(3) Cable subscribers: All years, Kagan Research, LLC, *Kagan's 10-Pay TV Subscriber History,* Broadband Cable Financial Databook 2005, July 2005, at 11.

(4) MMDS subscribers: 2001 from NCTA Comments for the *2001 Report* at 7; 2002 from NCTA Comments for the *2002 Report* at 12; 2003 from NCTA Comments for the *2003 Report* at 8; 2004 from NCTA Comments at 7, n.12; 2005 from NCTA, *Analysis of MVPDs: March 2005*, Cable Developments 2005 at 15.

(5) PCO (SMATV) subscribers: 2001 subscribers from NCTA Comments for the *2001 Report* at 9; 2002 subscribers from NCTA Comments for the *2002 Report* at 12; 2003 subscribers from NCTA Comments for the *2003 Report* at 8; 2004 subscribers from NCTA Comments at 7, n.12; 2005 from Kagan Media Research, Media Trends 2005, at 69.

(6) HSD subscribers: 2001 from SBCA Comments for the *2001 Report,* Table 1 at 4; 2002 from SkyReport.com at http://www.skyreport.com/dth_us.htm; 2003 from SBCA Comments for the *2003 Report* at 4; 2004 from *2004 Report*, 20 FCC Rcd at 2798 ¶ 64; 2005 from *C-Band Decline Continues*, Satellite Business News FAXUpdate, July 6, 2005.

(7) DBS subscribers: 2001 from SBCA Comments for the *2001 Report,* Table 1 at 4; 2002 from SkyReport.com at http://www.skyreport.com/dth_us.htm; 2003 from SBCA Comments for the *2003 Report* at 4; 2004 from *2004 Report*, 20 FCC Rcd at 2792 ¶ 54; 2005 from The DIRECTV Group, Inc., *SEC Quarterly Report Form 10-Q Pursuant to Section 13 or 15(d) of the Securities Act of 1934 for the Quarterly Period Ended June 30, 2005*, at 40, and EchoStar Communications Corp., *SEC Quarterly Report Form 10-Q Pursuant to Section 13 or 15(d) of the Securities Act of 1934 for the Quarterly Period Ended June 30, 2005*, at 25.

(8) BSP subscribers: 2003 subscribers from NCTA Comments for the *2003 Report* at 8; 2004 subscribers from BSPA Comments at 6 for the *2004 Report* and Commission estimates; 2005 subscribers from Commission estimates.

TABLE B-2

Number and Subscriber Size of Major Cable System Clusters
(Cumulative Figures)

Range of Clustered Subscribers (thousands)	2001		2002		2003		2004	
	Clusters	Subscribers (millions)	Clusters	Subscribers (millions)	Clusters	Subscribers ((millions)	Clusters	Subscribers ((millions)
100-199	30	4.3	31	4.5	34	4.9	46	5.4
200-299	17	4.2	18	4.4	18	4.4	18	6.3
300-399	18	6.1	21	7.1	17	5.7	17	6.6
400-499	10	4.4	10	4.4	10	4.4	8	3.5
>500	32	33.3	29	31.0	29	34.3	29	29.7
Total	107	52.3	109	51.3	108	53.6	118	51.5

Sources:

2001 from Kagan World Media, *Major Cable TV Systems/Clusters*, Broadband Cable Financial Databook 2002 at 38; 2002 from Kagan World Media, *Major Cable TV Systems/Clusters*, Broadband Cable Financial Databook 2003, at 39; 2003 from Kagan Research, LLC, *Major Cable TV Systems/Clusters*, Broadband Cable Financial Databook 2004, at 39-40; and 2004 from Kagan Research, LLC, *Major Cable TV Systems/Clusters*, Broadband Cable Financial Databook 2005, at 39-40. Since last year, Kagan World Media's methodology for counting clusters has changed, leading to difficulties in directly comparing the numbers for 2004 with those for previous years, which causes year-to-year comparisons to be uninformative. In previous years, all of Comcast's subscribers in the Northeast and Mid-Atlantic were counted as part of one "supercluster." Beginning this year, those subscribers were broken out into separate clusters. This is probably a more accurate approach, but causes direct year-to-year comparisons to be uninformative.

TABLE B-3
2005 Concentration in the National Market for Purchase of Video Programming[1]

Rank	Company	Percent of Subscribers[2]
1	Comcast	22.99
2	DirecTV	15.72
3	EchoStar	12.27
4	Time Warner	11.69
Top 4		62.67
5	Cox	6.73
6	Charter	6.37
7	Adelphia	5.50
8	Cablevision	3.22
Top 8		84.50
9	Bright House	2.34
10	Mediacom	1.55
Top 10		88.39
Top 25		94.00
Top 50		95.73
	HHI	1201[3]

Notes:

(1) MSO subscriber totals as of June 2005, and reported in Top Cable System Operators as of March 2004, Kagan World Media, *Cable TV Investor,* July 29, 2004, at 16-17. There is no double counting of subscribers. If a cable operator is partially owned by more than one MSO, its subscribers are assigned to the largest MSO. Subscribers for DIRECTV and EchoStar are based on the company's SEC 10-Q filings.

(2) The total number of MVPD subscribers used to calculate the HHI is 94,226,357 from Table B-1.

(3) The HHI is calculated on the basis of market shares for the top 65 companies. Because all of the remaining MVPDs have very small shares of the market, an HHI calculation that included all cable system operators could only be slightly higher (no more than 2-3 points) than the given HHI.

TABLE B-4
Concentration in the National Market for the Purchase of Video Programming
2002-2005

Market Share	Percent of MVPD Subscribers			
	2002	2003	2004	2005
Top Share	14.75	22.69	23.37	22.99
Top 2	29.04	35.01	35.47	38.71
Top 3	41.03	46.63	47.34	50.99
Top 4	50.48	55.98	57.97	62.67
Top 10	84.44	81.95	84.72	88.39
Top 25	90.26	87.45	90.41	94.00
Top 50	92.05	89.29	92.32	95.73
HHI	884	1031	1097	1201

Sources:

Data for 2002 through 2004 were taken from *Reports, 2002-2004*. Data for 2005 are from Table B-3. Reported statistics for 2004 were based on March data since June data comparable to that used in previous years were unavailable. For 2005, June data were available, and were used.

APPENDIX C

TABLE C-1
National Video Programming Services
Affiliated with One or More Cable MSO

Programming Service	Launch Date	MSO Ownership (%)	Ownership by Other Media Entity (1)
Rainbow Media Group			
American Movie Classics (AMC)	Oct. 84	Cablevision (60)	
Fuse	Jul. 94	Cablevision (60)	
Independent Film Channel	Sep. 94	Cablevision (60)	
WE: Women's Entertainment	Jan. 97	Cablevision (60)	
Turner Broadcasting System Group			
Boomerang	Apr. 00	Time Warner (100)	
Cartoon Network	Oct. 92	Time Warner (100)	
CNN	Jun. 80	Time Warner (100)	
CNN En Español	Mar. 97	Time Warner (100)	
CNN Headline News	Jan. 82	Time Warner (100)	
CNN International	Jan. 95	Time Warner (100)	
TBS (Turner Broadcasting System)	Dec. 76	Time Warner (100)	
Turner Classic Movies (TCM)	Apr. 94	Time Warner (100)	
Turner Network Television (TNT)	Oct. 88	Time Warner (100)	
TNT HD		Time Warner (100)	
Court TV	Jul. 91	Time Warner (50)	Liberty Media
HBO Group			
Home Box Office (HBO)	Nov. 72	Time Warner (100)	
HBO 2	Oct. 98	Time Warner (100)	
HBO Comedy	May 99	Time Warner (100)	
HBO Family	Oct. 98	Time Warner (100)	
HBO Latino	Nov. 00	Time Warner (100)	
HBO Signature	Oct. 98	Time Warner (100)	
HBO Zone	May 99	Time Warner (100)	
HBO HD		Time Warner (100)	

Programming Service	Launch Date	MSO Ownership (%)	Ownership by Other Media Entity
Cinemax	Jun. 98	Time Warner (100)	
Cinemax HD		Time Warner (100)	
Action Max (Cinemax multiplex)	Aug. 80	Time Warner (100)	
@Max (Cinemax multiplex)	May 01	Time Warner (100)	
5StarMax (Cinemax multiplex)	May 02	Time Warner (100)	
MoreMAX (Cinemax multiplex)	Jun. 98	Time Warner (100)	
OuterMax (Cinemax multiplex)	May 01	Time Warner (100)	
Thriller Max (Cinemax multiplex)	Jun. 98	Time Warner (100)	
WMAX (Cinemax multiplex)	May 01	Time Warner (100)	
Comcast Corp. Networks			
E! Entertainment	Jun. 90	Comcast (60.5)	Disney
G4 VideogameTV (formerly G4 tech TV)	Jun. 02	Comcast (83.5)	EchoStar
Golf Channel	Jan. 95	Comcast (99.85)	
Outdoor Life Network (OLN)	Jul. 95	Comcast (100)	
Style	Oct. 98	Comcast (60.5)	Disney
TV One	Jan. 04	Comcast (32.8)	News Corp.
AZN Television	Jul. 90	Comcast (100)	
PBS Kids Sprout	Oct. 05	Comcast (40)	PBS
Discovery Communications, Inc.			
Discovery Channel	Jun. 85	Cox (25), Advance Newhouse (25)	Liberty Media
Discovery En Español	Oct. 98	Cox (25), Advance Newhouse (25)	Liberty Media
Discovery Health	Jul. 98	Cox (25), Advance Newhouse (25)	Liberty Media
Discovery HD Theatre	Jun. 02	Cox (25), Advance Newhouse (25)	Liberty Media
Discovery Home	Oct. 96	Cox (25), Advance Newhouse (25)	Liberty Media
Discovery Kids	Oct. 96	Cox (25), Advance Newhouse (25)	Liberty Media
Discovery Times	Oct. 96	Cox (12.5), Advance Newhouse (12.5)	Liberty Media New York Times
Animal Planet	Oct. 96	Cox (25), Advance Newhouse (25)	Liberty Media
BBC America	Mar. 98	Cox (25), Advance Newhouse (25)	Liberty Media

FiT TV	Jan. 04	Cox (25), Advance Newhouse (25)	Liberty Media
Programming Service	**Launch Date**	**MSO Ownership (%)**	**Ownership by Other Media Entity**
Military Channel	Jul. 98	Cox (25), Advance Newhouse (25)	Liberty Media
The Learning Channel (TLC)	Nov. 80	Cox (25), Advance Newhouse (25)	Liberty Media
Travel Channel	Feb. 87	Cox (25), Advance Newhouse (25)	Liberty Media
Science Channel	Oct. 96	Cox (25), Advance Newhouse (25)	Liberty Media
Joint Ventures and Other Vertically Integrated Networks			
iN DEMAND (60 multiplexed channels)	Nov. 85	Comcast (54.1), Time Warner (30.3), Cox (15.6)	
iN DEMAND HD1 (also called iNHD)	Sep. 03	Comcast (54.1), Time Warner (30.3), Cox (15.6)	
iN DEMAND HD2 (also called iNHD2)	Sep. 03	Comcast (54.1), Time Warner (30.3), Cox (15.6)	

(1) "Other" media entity is defined as a DBS operator, broadcast network, or broadcast television station licensee. Liberty Media's programming interests are listed because of Liberty's ownership interest in News Corp.

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Letter from Arthur H. Harding, counsel for Time Warner Inc., to Marlene H. Dortch, Secretary, FCC, MB Docket No. 05-192 (Oct. 21, 2005), at 1-5.

TABLE C-2

National Video Programming Services
Not Affiliated with a Cable MSO
(By Affiliation)

Programming Service	Launch Date	Ownership by "Other" Media Entity (1)
A&E (Arts & Entertainment)	Feb. 84	Disney, NBC-Universal, Hearst
ABC Family	Apr. 77	Disney
America's Store	Sep. 86	
American Life (formerly Goodlife Television Network)	Feb. 85	
Angel One		Dominion Video Satellite
Angel Two		Dominion Video Satellite
Anime Network	Dec. 02	
Auction Network		
Black Entertainment Television (BET)	Jan. 80	Viacom
BET Gospel	Jul. 02	Viacom
BET Hip Hop	Jul. 02	Viacom
BET on Jazz	Jan. 96	Viacom
Beauty & Fashion		
Biography Channel	Nov. 98	Disney, NBC-Universal, Hearst
Black Family Channel	Nov. 99	
Bloomberg Television	Jan. 95	
B Mania	Nov. 00	
Bravo	Dec. 80	NBC-Universal
Bridges TV	Nov. 04	
Buzztime Entertainment	1994	
BYUTV	Jan. 00	
Catalog TV		
Celtic Vision	1995	
Church Channel	Jan. 02	Trinity Broadcasting Network
Classic Arts Showcase	May 94	
Country Music Television (CMT)	Mar. 83	Viacom
CNBC	Jul. 89	NBC-Universal
CNBC World	Apr. 89	NBC-Universal
Comedy Central	Apr. 91	Viacom
C-SPAN	Mar. 79	(2)

Programming Service	Launch Date	Ownership by "Other" Media Entity
C-SPAN2	Jun. 86	(2)
C-SPAN3	Sep. 97	(2)
CSTV (College Sports Television)	Apr. 03	Viacom
Colours TV	Dec. 01	
Cornerstone Television	Apr. 79	
Current TV	Aug. 05	
Daystar Television Network	Dec. 98	Daystar Television Network
Deep Dish TV	Jan. 86	
Disney Channel	Apr. 83	Disney
DIY (Do-It-Yourself Network)	Dec. 94	EW Scripps
Encore	Apr. 91	Liberty Media
Encore HD	Mar. 04	Liberty Media
Encore Action	Sep. 94	Liberty Media
Encore Drama	1994	Liberty Media
Encore Love	Jul. 94	Liberty Media
Encore Mystery	Jul. 94	Liberty Media
Encore WAM!	Sep. 94	Liberty Media
Encore Westerns	Jul. 94	Liberty Media
Epic Sports	2005	
ESPN	Sep. 79	Disney, Hearst
ESPN Classic	May 95	Disney, Hearst
ESPN2	Oct. 93	Disney, Hearst
ESPN HD	Mar. 03	Disney, Hearst
ESPNews	Nov. 96	Disney, Hearst
ESPN2 HD		Disney, Hearst
ESPNU	Mar. 05	Disney, Hearst
Eternal Word Television Network (EWTN)	Aug. 81	
Faith Television Network	Jul. 02	
Familyland Television Network	Nov. 99	
Family Net	May 00	
Fine Living	Mar. 02	EW Scripps
Flix (a Showtime Network)	Aug. 92	Viacom
Food Network	Nov. 93	EW Scripps
Fox Movie Channel	Nov. 94	News Corp.

Programming Service	Launch Date	Ownership by "Other" Media Entity
Fox News Channel	Oct. 96	News Corp.
Fox Reality	May 05	News Corp.
Fox Sports Net	Nov. 97	News Corp.
Fox Soccer Channel (formerly Fox Sports World)	Nov. 97	News Corp.
FX	Jun. 94	News Corp.
Fuel	Jul. 03	News Corp.
Free Speech TV (FSTV)	Jun. 95	
Game Show Network (GSN)	Dec. 94	Liberty Media
Golden Eagle Broadcasting	Nov. 98	
Great American Country	Dec. 95	EW Scripps
Good Samaritan Network	2000	
Guardian Television Network	1976	
Hallmark Channel	Sep. 98	Liberty Media
Hallmark Movie Channel	Jan. 04	
HDNET	Sep. 01	
HDNET Movies	Jan. 03	
Healthy Living Channel	Jan. 04	
Here! TV	Oct. 04	
History Channel	Jan. 95	Disney, NBC-Universal, Hearst
History International (also called History Channel International)	Nov. 98	Disney, NBC-Universal, Hearst
Home & Garden Television (HGTV)	Dec. 94	EW Scripps
Home Shopping Network (HSN)	Jul. 85	
Home Preview Channel		
Horse Racing TV	Dec. 02	
Hot Net (also called The Hot Network)	Mar. 99	
Hot Net Plus	2001	
Hot Zone	Mar. 99	
Hustler TV	Apr. 04	
i - Independent Television (formerly PaxTV)	Aug. 98	NBC-Universal, Paxson
ImaginAsian TV	Aug. 04	
Inspirational Life Television (I-LIFETV)	Jun. 98	
Inspirational Network (INSP)	Apr. 90	
i Shop TV	Feb. 01	
JCTV	Nov. 02	Trinity Broadcasting Network

Programming Service	Launch Date	Ownership by "Other" Media Entity
Jewelry Television	Oct. 93	
KTV – Kids and Teens Television		Dominion Video Satellite
Liberty Channel	Sep. 01	
Lifetime Movie Network	Jul. 98	Disney, Hearst
Lifetime Real Women	Aug. 01	Disney, Hearst
Lifetime Television	Feb. 84	Disney, Hearst
Link TV	Nov. 96	
Logo	Jun. 05	Viacom
Mav TV - Mav'rick Entertainment Network	Oct. 04	
Mall TV (also called Outlet Mall TV)		
Men's Channel	Jan. 01	
Military History Channel	Apr. 05	Disney, NBC-Universal, Hearst
MoviePlex	Oct. 94	Liberty Media
MSNBC	Jul. 96	NBC-Universal
MTV Hits	May 02	Viacom
MTV Jams	May 02	Viacom
MTV	Aug. 81	Viacom
MTV 2	Dec. 98	Viacom
NASA Television	Jul. 91	
National Geographic Channel	Jan. 01	News Corp.
NBA TV	Nov. 99	
NFL Network	Nov. 03	
Nick 2 (also called Nick Too)	May 98	Viacom
Nickelodeon-Games & Sports (also called GAS)	Mar. 99	Viacom
Nickelodeon/Nick at Nite	Apr. 79	Viacom
Nicktoons	Jan. 99	Viacom
Noggin/The N	Feb. 99	Viacom
Oasis TV	Sep. 97	
Ovation: The Arts Network	Apr. 96	New York Times (6)
Oxygen	Feb. 00	(3)
Outdoor Channel	Apr. 93	
Outdoor Channel 2HD		
Pentagon Channel	May 04	
Playboy TV	Nov. 82	

Programming Service	Launch Date	Ownership by "Other" Media Entity
Playgirl TV	Mar. 05	
Pleasure	Jun. 99	
PIN (Product Information Network)	Apr. 94	
QTN (Q Television Network)	Jul. 04	
QVC	Nov. 86	Liberty Media
Research Channel	2000	
RFD TV		
Safe TV		
Sci-Fi Channel	Sep. 92	NBC-Universal
Shop at Home	Jun. 86	EW Scripps
Shop NBC	Oct. 91	NBC-Universal
Short TV	Jan. 99	
Showtime	Jul. 76	Viacom
Showtime HD		Viacom
Showtime Beyond	Sep. 99	Viacom
Showtime PPV (formerly Showtime Event Television, SET)	1979	Viacom
Showtime Extreme	1998	Viacom
Showtime Family (also called Showtime Family Zone)	Mar. 01	Viacom
Showtime Next	Mar. 01	Viacom
Showtime Showcase	Jul. 01	Viacom
Showtime Too	2001	Viacom
Showtime Women	Mar. 01	Viacom
SOAPNet	Jan. 00	Disney
Speed Channel	Jan. 96	News Corp.
Spice 1	May 89	
Spice 2	1999	
A Taste of Spice		
Spice Platinum (formerly Vivid TV)	2000	
Spice HD	2004	
Spice Live	2003	
Spice Hot	2002	
Spice Ultimate	2004	
Spike TV	Mar. 83	Viacom
SPIRIT Television		

Programming Service	Launch Date	Ownership by "Other" Media Entity
Sportsman Channel	Apr. 03	
Starz!	Mar. 94	Liberty Media
Starz! Cinema	May 99	Liberty Media
Starz! Kids & Family	May 99	Liberty Media
Starz! HD	Dec. 03	Liberty Media
Starz! Comedy	Mar. 94	Liberty Media
Starz! Edge	Mar. 96	Liberty Media
Starz! In Black (formerly Black Starz!)	Feb. 97	Liberty Media
Stuff TV		
Sundance Channel	Feb. 96	Viacom, NBC-Universal
Trinity Broadcasting Network (TBN)	May 73	Trinity Broadcasting Network
TBN Enlace USA	May 02	Trinity Broadcasting Network
Three Angels Broadcasting Network	Nov. 86	
The Erotic Network (TeN)	Sep. 98	
TeN Blox	Jan. 03	
TeN Blue	Jan. 03	
TeN Clips	May 00	
TeN Xtasy	Feb. 98	
The Tennis Channel	May 03	
The Movie Channel (TMC)	Dec. 79	Viacom
TMC HD	Dec. 03	Viacom
TMC XTRA	1997	Viacom
Toon Disney	Apr. 98	Disney
Total Living Network		
TR!O (5)	Sep. 94	NBC-Universal
TVU/TVU Live		
TV Games Network – TVG Interactive Horse Racing	Jul. 94	News Corp.
TV Guide Channel	Jan. 88	News Corp.
TV Guide Interactive	Oct. 96	News Corp.
TV Land	Apr. 96	Viacom
TVN Entertainment PPV (previously 33 PPV networks, now 1 PPV network)	Feb. 98	
Universal HD (formerly Bravo HD+)	Dec. 04	NBC-Universal
USA Network	Apr. 80	NBC-Universal
VH1	Jan. 85	Viacom

Programming Service	Launch Date	Ownership by "Other" Media Entity
VH1 Classic	May 00	Viacom
VH1 Soul	Aug. 98	Viacom
VH1 Country	Aug. 98	Viacom
VTV: Varsity Television	Jan. 03	
Weather Channel	May 82	Landmark Communications
Weatherscan Local	Oct. 99	Landmark Communications
Weather Plus		NBC-Universal
WGN Superstation	Nov. 78	Tribune Company
Wisdom Television	Jul. 97	
The Word Network	Feb. 00	
The Worship Network	1992	
World Harvest Television	Aug. 92	
Xy.tv	Dec. 03	
Spanish Language Spanish/Latin American Cultures		
AYM Sports	Nov. 03	
Bandamax	May 03	Univision
Azteca America	Aug. 04	
Canal 24 Horas	Jun. 99	
Cine Latino	Jun. 94	
Canal 52 MX		
Canal Sur		
Casa Club	Jul. 97	
Caracol TV		
CCTV-E&F		
Centroamerica TV		
CNC Columbia	May 99	
De Pelicula	May 03	Univision
De Pelicula Clasico	May 03	Univision
ESPN Deportes	Jan. 04	Disney, Hearst
Ecuavisa Internacional		
EWTN en Español		
Fox Sports en Español	Nov. 96	News Corp.
HITN	Jul. 87	
Galavision	Oct. 79	Univision

Programming Service	Launch Date	Ownership by "Other" Media Entity
Gol TV	Mar. 03	
Mexicanal		
Grandes Documentales	1996	
MTV Español	Aug. 98	Viacom
Mun2	Oct. 01	NBC-Universal
Once Mexico		
History Channel en Español	May 04	Disney, NBC-Universal, Hearst
Playboy en Español		
Ritmoson Latino	May 03	Univision
Puma TV	1997	
HTV (Hispanic TV)	Aug. 95	
La Familia Network	May 02	
SiTV	Feb. 04	(4)
Sorpressa	Mar. 03	
Sur	Aug. 91	
Telefe Internacional	Apr. 90	Univision
Telefutura	Jan. 02	Univision
Telehit	May 03	Univision
Telemundo	Jan. 87	NBC-Universal
Telemundo Puerto Rico	Mar. 00	NBC-Universal
Toon Disney en Español		Disney
TV Internacional	2003	
Univision	Sep. 96	Univision
Utilisima	Mar. 96	
VH Uno	Nov. 99	Viacom
Mexico 22		
NDTV Color Vision		
Sur Peru		
Television Española Internacional		
TV Chile		
TV Columbia		
TyC Sports		
Video Rola	1998	
WAPA America		

Programming Service	Launch Date	Ownership by "Other" Media Entity
Chinese		
CCTV-4 (China Central Television)	1995	
CTI Zhong Tian Channel	1995	
ATV Home Channel America		
Beijing TV		
CCTV-9		
CCTV		
CCTV Entertainment		
CCTV Opera		
China Movie Channel		
CYRTV		
Dragon TV	Oct. 03	
Fujian Southeast TV		
Guandog Southern TV		
Hunan Satellite TV		
Jiangsu International Channel		
Pacvia TV		
Phoenix Info News		News Corp.
Phoenix North American Chinese Channel		News Corp.
CTS		
CTV		
PTS		
TTV		
Videoland		
The Jade Channel		
Jadeworld Super		
TVBS		
The Chinese Movie Channel		
The Chinese Channel	Dec 04	
Chinese Prime		
Chinese Cinema		
ET China		
ET Drama		
ET Global		

Programming Service	Launch Date	Ownership by "Other" Media Entity
ET News		
JET TV International		
YoYo TV		
Korean		
MBC (Munhwa Broadcasting Corp.)	2002	
tvK 24 (Korean)	Sep. 04	
Arirang TV		
JSTV		
KBS World		
MBN		
Korean Channel		
Media Korea		
Tagalog-Filipino		
Filipino Channel	Feb. 98	
The Mabuahy Channel		
GMA Pinoy		
ABS-CBN News Channel		
Cinema One Global		
Pinoy Central TV		
South Asian		
Saigon Broadcasting Television Network	Feb. 02	
TV Asia	Jul. 91	
AAJTAK		
B4U		
Headlines Today		
Sahara One		
Sahara Samay		
Set Max		
Sony Entertainment Television Asia		
Zee Cinema		
Alpha ETC Punjabi		
Gemini TV		
Channel-I		
Star Plus		News Corp.

Programming Service	Launch Date	Ownership by "Other" Media Entity
Star One		News Corp.
Star News		News Corp.
MTV Desi		
Vijay		News Corp.
Sun TV (International)		
EAASTHA Broadcasting Network		
NTV Bangla		
ETV Gujarati		
ETV Telegu		
Bangladesh Channel		
American Desi		
South Asian World		
Surya TV		
Tara Muzik		
Teja TV		
Zee Gujarati		
Kairali TV		
KTV		
ZEE TV	1999	
Japanese		
TV Japan	Jul. 91	
Urdu		
Ary Digital		
Ary One		
GeoTV		
PTV Prime		
Middle Eastern Language and Culture		
National Iranian Television (NITV)	2003	
ART (Arab Radio & Television America)	1999	
Rang-a-Rang (Iranian)	2003	
ANA Television Network (Iranian)	Dec. 91	
ART Movies		
ART Music		
Al Arabiaya		

Programming Service	Launch Date	Ownership by "Other" Media Entity
Al Jazeera		
Al Zikr		
Dubia Satellite Channel		
ESC-1`		
Future TV		
Kuwait TV		
LBC		
Middle East Broadcasting Company		
NBN		
New TV		
Nile Drama		
Melody Arabia		
IQRAA		
Noursat		
National Iranian Television		
Farsi		
NITV (Farsi)		
Channel One Television		
T2		
Tapesh		
Hebrew		
The Israeli Network		
Polish		
TV Polonia	2003	
Kino Polska		
Polsatz International		
TVN 24		
ITVN		
Armenian		
Armenia TV		
Russian		
Channel One Russia	2003	
Russian TV Network of America (RTN)	Aug. 00	
NTV America		

Programming Service	Launch Date	Ownership by "Other" Media Entity
RTVI		
RTVI Plus		
Italian		
RAI International	1999	
Leonardo World		
Video Italia		
Sky TG24		
French/African		
TV5 (French)	Jan. 98	
3A Telesud		
Trace TV		
RFI		
ABN America		
AIT (African Independent Television)	2003	
German		
Prosiebensal.1 Welt		
German TV	Apr. 02	
Greek		
Antenna Satellite		
ERT-SAT		
Mega Cosmos		
Alter Globe		
Greek Channel & NGTV		
TV Globo Internacional		
Portuguese		
SPT		
Record International		
RPTI		
Multinational		
SCOLA	Aug. 87	

Notes:
(1) Other media entity is defined as a DBS operator, broadcast network, or broadcast television station licensee. Liberty Media programming interests are listed because of Liberty's ownership interest in News Corp.

(2) The National Cable Satellite Corporation (C-SPAN) derives 97 percent of its revenues from affiliate fees (*i.e.*, subscriber fees from MVPDs). The remaining three percent is provided by various investments. Affiliates have no ownership or program control interests in C-SPAN.

(3) Both Charter Communications' parent company Vulcan Ventures and Time Warner, Inc. subsidiary AOL have equity interests in Oxygen Media. Time Warner holds more than a five percent equity share in Oxygen; however, we have no information with regard to the voting status of that investment. For purposes of the channel occupancy rules (47 C.F.R. §76.504), nonvoting stock is not attributable to an MSO. For purposes of the program access rules (47 C.F.R. §§76.1000-1200), nonvoting stock is attributable to an MSO if the company holds more than a five percent equity interest. *See* Vulcan Capital, *Other Portfolio Holdings*, http://capital.vulcan.com/Template.aspx? contentId=7 (visited Nov. 2, 2005); AOL Time Warner, *Oxygen Media And AOL Time Warner Expand Strategic Alliance*, Apr. 3, 2001; Clarity Partners, *Portfolio: Oxygen Media*, at http://www.claritypartners.net/portfolio.html# (visited Oct. 31, 2005).

(4) Time Warner Investments has more than a five percent equity interest in SiTV. However, we have no information with regard to the voting status of that equity investment, thus we list it as nonvertically integrated. *See* note (3); s*ee also* Time Warner Inc., at http://www.timewarner.com/corp/businesses/detail/tw_investments/ index.html (visited Nov. 28, 2005).

(5) NBC-Universal plans to migrate Trio to "online only" format in 2006. Abbey Klaasen, *Trio Cable Operation to Relaunch in Broadband Format*, ADVERTISING AGE, Nov. 21, 2005.

(6) In the *2004 Report*, we reported that Time Warner held a 5.1 percent equity interest in Ovation. Currently, Time Warner holds less than five percent equity in Ovation, and thus is listed as an unaffiliated network this year. *See 2004 Report*, 20 FCC Rcd at 2875 Appendix C, Table C-1.

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TABLE C-3

Regional Video Programming Services By Affiliation

Programming Services	Launch Date	MSO Ownership (%)	Other Media Entity Ownership
Altitude Sports & Entertainment	Sep. 04		
Arabic Channel	Apr. 91		
Arizona News Channel	Nov. 96	Cox (50)	
Bay News 9	Sep. 97	Bright House (Advanced/Newhouse)	
Boston Kids and Family			
Bravesvision (Atlanta)	Jul. 03	Comcast (100)	
California Channel	Feb. 91		
Capital News 9-Albany New York		Time Warner (100)	
Central Florida News 13 (CFN 13)	Oct. 97	Bright House (Advanced/Newhouse)	
ChicagoLand Television News (CLTV)	Jan. 93		
Chicagoland Korean TV	2005		
CN8-The Comcast Network	Oct. 97	Comcast (100)	
Comcast Entertainment TV (Denver)	Jun. 04	Comcast (100)	
Comcast Local (Detroit)	Aug. 04	Comcast (100)	
Comcast SportsNet (Philadelphia)	Oct. 97	Comcast (84.1)	
Comcast SportsNet Chicago	Oct. 04	Comcast (30)	
Comcast SportsNet Mid Atlantic	Apr. 84	Comcast (100)	
Comcast SportsNet West	Nov. 04	Comcast (100)	
Comcast / Charter Sports Southeast (CSS)	Apr. 84	Comcast (70.2), Charter (23)	
County Television Network San Diego	Jul. 96		
Cowboys TV (Dallas)	Sep. 04	Comcast (100)	
Cox Sports Television	Oct. 02	Cox (100)	
Ecumenical Television Channel	1983		
Denver Channel 207			
Falconvision (Atlanta)	Sep. 04	Comcast (100)	
Fox College Sports Atlantic			
Fox College Sports Central			
Fox College Sports Pacific			

Programming Services	Launch Date	MSO Ownership (%)	Other Media Entity Ownership
Fox Sports Net Arizona	Sep. 96		News Corp.
Fox Sports Net Bay Area	Apr. 90	Cablevision (60)	News Corp.
Fox Sports Net Chicago	Jan. 84	Cablevision (100)	
Fox Sports Net Detroit	Sep. 97		News Corp.
Fox Sports Net Florida	1989		News Corp.
Fox Sports Net Midwest	Sep. 97		News Corp.
Fox Sports Net New England	Jan. 88	Cablevision (50) Comcast (50)	News Corp.
Fox Sports Net New York	1989	Cablevision (100)	
Fox Sports Net North	Mar. 89		News Corp.
Fox Sports Net Northwest	Nov. 88		News Corp.
Fox Sports Net Ohio	Feb. 89		News Corp.
Fox Sports Net Pittsburgh	Apr. 86		News Corp.
Fox Sports Net Rocky Mountain	Nov. 88		News Corp.
Fox Sports Net South	Aug. 90		News Corp.
Fox Sports Net Southwest	Jan. 83		News Corp.
Fox Sports Net West	Oct. 85		News Corp.
Fox Sports Net West 2	Jan. 97		News Corp.
Gwinnett News & Entertainment Television	May 97		
International Television Broadcasting (ITV)	Apr. 86		
Kansas 22 Now			
Las Vegas One News	Apr. 98		
Local News on Cable (LNC) – Hampton	Feb. 97		
Madison Square Garden Network (MSG)	Oct. 69	Cablevision (100)	
MetroSports – Kansas City, Mo.	Feb. 04	Time Warner (100)	
Michigan Government Television	Jul. 96		
New England Cable News (NECN)	Mar. 92	Comcast (50)	Hearst
New England Sports Network (NESN)	Mar. 84		
New York 1 News (NY1 News)	Sep. 92	Time Warner (100)	
NY 1 Noticias	Jun. 03	Time Warner (100)	
News 10 Now – Syracuse, N. Y.	Nov. 03	Time Warner (100)	
News 12 Connecticut	Jun. 95	Cablevision (75)	
News 12 Bronx	Jun. 97	Cablevision (75)	

Programming Services	Launch Date	MSO Ownership (%)	Other Media Entity Ownership
News 12 Brooklyn	2005	Cablevision (75)	
News 12 Hudson Valley	2005	Cablevision (75)	
News 12 Long Island	Dec. 86	Cablevision (75)	
News 12 New Jersey	Mar. 96	Cablevision (75)	
News 12 Traffic & Weather (formerly Metro Traffic & Weather)	2005	Cablevision (75)	
News 12 Westchester	Nov. 95	Cablevision (75)	
News 8 Austin	Sep. 99	Time Warner (100)	
News Channel 5+	Sept. 96		
News 14 Carolina (Charlotte)	Mar. 02	Time Warner (100)	
News 14 Carolina (Raleigh)	Mar. 02	Time Warner (100)	
News Channel 3 Anytime			
News Now 53 (Oklahoma City)	Jun. 97	Cox (50)	
News Now 53 (Tulsa)	Jun. 97	Cox (50)	
News on One	Oct. 97	Cox (50)	
News Watch 15 (New Orleans)	Oct. 99		
News Channel 8	Oct. 91		
NGTV (National Greek Television)	Dec. 87		
Nippon Golden Network	Jan. 82		
North West Cable News (NWCN)	Dec. 95		
Ohio News Network (ONN)	May 97		
Pennsylvania Cable Network (PCN)	Sep. 79		
Pittsburgh Cable News Channel (PCNC)	Jan. 94	Comcast (30)	
Regional News Network (RNN)	Dec. 95		
Rhode Island News Channel	Sep. 98	Cox (50)	
R News – Rochester, N. Y.	Jul. 95	Time Warner (100)	
San Diego's News Channel 15	Jan. 97		
Six News Now	Jul. 95		
Soundtrack Channel (STC)	Mar. 02		
SunSports (formerly Sunshine Network)	Mar. 88		News Corp.
10 News 2			
Texas Cable News	Jan. 99		
Turner South (STC)	Oct. 99	Time Warner (100)	

Programming Services	Launch Date	MSO Ownership (%)	Other Media Entity Ownership
TV33	Dec. 95		
24/7 News Channel			
Washington Korean TV (WKTV)	1985		
Yankee Entertainment Sports Network (YES)	Mar. 02		

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TABLE C-4

Planned Programming Services

Programming Service	Planned Launch Date, If Announced
Africast Television Network	Available for carriage
America Channel	Available for carriage
American David	
America National Network	
AMC's American Pop	
Anti-Aging Network	
Asia Channel	
Auto Channel	
BET World Music Beat	
Bingo TV	
Black Belt TV	
Black Education Network	Sept. 2006
Black Entertainment Network	
Blue Highways TV	
Boating Channel	
BOB: Brief Original Broadcasts	
Booknet	
Box TV	
Career Entertainment Television	
Casino & Gaming Television	
Classified Channel TV	
Collectors Channel	
The Crime Channel	
Crime & Investigation	
CSN (Cable Science Network)	
Destiny Channel	
Documentary Channel	
Edge TV	
Election Channel	
Employment Channel	1Q06
Fad TV (Fashion & Design Television)	
Fifth Avenue Channel	

Programming Service	Planned Launch Date, If Announced
Film Festival Channel	
Florida Channel	
Fox Enhanced TV	
Gambling Channel	
GETV Program Network	
Global Village Network	
Government Channel	
Home Improvement Channel	
Honey Vision	
The Horror Channel	
Ice Channel	
Investment TV	
JTV (Jewish TV)	
Las Vegas Channel	
Local News Network	
Local News TV	
Local Sports TV	
Major League Baseball	
Moore TV Network	
Mountain West TV	4Q06
Moviewatch	
Native American Nations Program Network	
New York Channel	
New York Mets	2006
Orb TV	
Premiere Horse Network	
Puppy Channel	
RadioTV Network	

Programming Service	Planned Launch Date, If Announced
Real Estate Channel	
Real Estate Network (TREN)	
Reality 24-7	
Reality Central	
Scream Channel	
SCTV (Stand-Up Comedy Television)	
Senior Citizens Television Network	
Simulation Channel	
Sundance Documentary Channel	
Theater Channel	
Tickets On Demand (The Ticket Channel)	
Tourist Channel	
U.S. Military Television Network	
Vegas Channel	
Voy Network	Available for carriage
Wheels TV	
Wicked TV	
Wine Network TV	
World Cinema	

Sources:

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TABLE C-5

Top 20 Programming Services by Subscribership

Rank	Programming Network	Number of Subscribers	Ownership Interest in Network
1	Discovery Channel	90.1	Cox, Advance/Newhouse, Liberty Media
2	ESPN	90.0	Disney, Hearst
4	CNN	89.6	Time Warner
4	TNT	89.6	Time Warner
6	USA Network	89.4	NBC-Universal
6	C-SPAN	89.4	National Cable Satellite Corporation **
9	TBS	89.3	Time Warner
9	Spike TV	89.3	Viacom
9	Nickelodeon	89.3	Viacom
11	A&E	89.2	Disney, Hearst, NBC-Universal
11	Lifetime Television	89.2	Disney, Hearst
13	The Weather Channel	89.0	Landmark
13	ESPN2	89.0	Disney, Hearst
15	QVC	88.9	
15	TLC	88.9	Cox, Advance/Newhouse, Liberty Media
18	MTV	88.6	Viacom
18	Home & Garden TV	88.6	
18	Headline News	88.6	Time Warner
20	ABC Family Channel	88.5	Disney
20	Home Shopping Network	88.5	

Note:
* - In addition to cable systems, other MVPDs such as DBS (direct broadcast satellite) systems, wireless cable (or MMDS) systems, PCOs (private cable operators or SMATV) services, and HSD (home satellite dish) program providers may distribute these signals. Subscriber figures may include these noncable services.

** - The National Cable Satellite Corporation (C-SPAN) derives 97 percent of its revenues from affiliate fees (*i.e.*, subscriber fees from MVPDs). The remaining three percent is provided by various investments.

Source:
Kagan Research, LLC, *Network Census: July 31*, Cable Program Investor, August 31, 2005, at 14.

TABLE C-6

Top 15 Programming Services by Prime Time Rating

Rank	Programming Service	Ownership Interest in Network
1	Nickelodeon	Viacom
2	TNT	Time Warner
3	Nick at Nite	Viacom
4	USA Network	NBC-Universal
5	Disney	Disney
6	Lifetime	Disney, Hearst
7	Toon Disney	Disney
8	TBS	Time Warner
9	Spike TV	Viacom
10	Fox News Channel	News Corp.
11	History Channel	Disney, Hearst, NBC-Universal
12	ESPN	Disney, Hearst
13	MTV	Viacom
14	Discovery Channel	Cox, Advance/Newhouse, Liberty Media
15	Sci Fi Channel	NBC-Universal

Source:
Kagan Research, LLC., *Prime Time Ratings Averages: April*, CABLE PROGRAM INVESTOR, June 29, 2005, at 16.

STATEMENT OF CHAIRMAN KEVIN J. MARTIN

Re: Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 05-255

In enacting the Cable Television Consumer Protection and Competition Act of 1992, Congress sought to promote video competition. Competition in the market for video programming serves to improve quality and customer service, increase consumer choice, decrease prices, and promote innovation.

As this year's report reflects, we are seeing wired competitors to cable trying to enter the market. The Commission should facilitate this entry, not only because it furthers video competition, but also because it promotes the deployment of the broadband networks over which the video services are provided. The widespread deployment of these networks is critical to the United States' international competitiveness. Further, it will help improve Americans' lives through applications such as distance learning and remote medical diagnostics.

Given all of the benefits that additional competition offers for consumers, we will continue to closely monitor the progress of all new entrants and seek to eliminate any unreasonable barriers to entry and to address other issues that we find impede such progress.

STATEMENT OF COMMISSIONER MICHAEL J. COPPS

Re: *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*

I commend Chairman Martin for holding this Commission meeting outside of Washington. This is something I have long advocated us doing. We can learn so much more from getting outside the Beltway to hear directly from those on the ground who are working to make video competition a reality. Yesterday and this morning, we have had the opportunity to see and learn first-hand about a whole new range of video services that are becoming reality for America's consumers. These visits in Texas will help us make better decisions as we go about our work in Washington. Equally important, hearings like this bring the FCC to the American people, giving them a closer look at issues that inevitably affect them. I look forward to more such meetings in communities across the country that can provide greater perspective and information as we address the complex and difficult issues in front of us. I believe, in fact, that a regulatory commission like ours has an obligation to do regularly what we are doing here this week.

Today's report grows out of our duty to report to Congress annually on the status of competition in the market for the delivery of video programming. Here, as throughout the Communications Act, Congress recognized and emphasized that competition in the delivery of services is the surest road for bringing significant benefits to consumers. When people have more options, they reap big rewards—better services, higher technology, lower prices and more varied content.

Today's report shows an enormous potential for increased competition in the video programming market. We are seeing large investments not only from existing participants in the market, but also from telephone companies and others that are expanding their efforts to deliver video programming. Cable and telephone companies are beginning to compete to offer consumers the much-heralded triple play—bundles of telephone, video and Internet services. The erosion of old industry boundaries can give way to a more consumer-friendly future, but arriving at that future will demand not only creative entrepreneurship and considerable investment, but also FCC policy founded foursquare on advancing the public interest—our primary charge from Congress.

I am happy that this year's report is more rigorous than some of its predecessors. For example, we admit the limitations of the data we have received and we go in search of additional comment. We also build on the discussion in last year's report by, for example, considering what is happening in certain other countries and including a separate section that focuses specifically on video program distribution in rural areas. But we must always look for ways to improve these reports to provide a more solid foundation for Commission and Congressional actions. For our next report, I hope we will undertake more pro-active and comprehensive information gathering efforts in order to obtain independent, verified data. I also believe we need to conduct some audits of the data we receive because we need to be sure of its accuracy.

This is an especially important report this year because it delves into issues relevant to numerous other pending Commission proceedings. These include horizontal and vertical cable ownership rules, an area where Commission action is overdue.

I note with concern that last year—and this seems to be an annual story—cable rates rose again, out-stripping inflation by a significant margin. Different interests cite different reasons for these never-ending consumer cost increases. I know two things. First, consumers are feeling the pain and paying the cost and not liking it. And, secondly, we need to better understand what's going on here. We need to

determine which factors are primarily responsible for these escalating consumer bills, and I would like to see us get a handle on this important issue in time for the next annual report on cable rates.

In another area still requiring work, we need to nail down the percentage of U.S. households which receive their programming from cable. Congress instructed us in the statute to be attentive to this because of our obligation to ensure diversity of information sources. Finally, in the months ahead, I believe we need to understand more clearly how such things as program access, retransmission consent, and vertical and horizontal integration affect the state of video competition. Congress seems to be turning its attention to these interactions and it is important for us to develop the data and analysis Congress needs for its consideration and that the Commission requires for its proceedings.

So this is a major report and we need to ensure that we use it well in the months ahead because it can help us in so many other proceedings. The world of program delivery is going through such wide-ranging, even staggering, changes that the Commission cannot afford to miss a beat as we attempt to exercise our responsibilities.

My thanks to the Bureau for this report and for its many improvements, and I look forward to being able to cite next year's annual report as even better than this year's.

STATEMENT OF COMMISSIONER JONATHAN S. ADELSTEIN

Re: Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming

I want to thank Chairman Martin for taking this meeting outside of Washington, D.C. I have been attending hearings across the country over the past three years and I have learned that nothing tops the experience of getting out into the public and meeting with local officials, company employees, and consumers to hear their thoughts about media and telecommunications. Today, we are getting a better sense of what is happening on the ground with video competition. The effort by some of the Nation's largest telecommunications companies to provide a competitive alternative for video services is one that deserves our attention and encouragement, and we are giving it both through our visit to Texas as a Commission.

I vote to approve this twelfth annual report on the state of competition in the video marketplace because it is a promising improvement over previous years. It attempts, albeit in a limited fashion, to provide at least more of a semblance of analysis that the Commission should provide Congress.

While this *Report* continues to simply recite information submitted by private parties rather than conduct its own in-depth analysis of the state of competition, it is commendable that, in one significant respect, we seek comment on whether the criteria set forth in section 612(g) of the Communications Act (generally referred to as the "70-70 test") has been met and, if so, whether the Commission should promulgate additional rules to achieve the statutory goal of providing diversity of information sources in video programming. I welcome this inquiry and look forward to working on it with my colleagues to fulfill the goals of competition, diversity and localism in U.S. media markets.

As the Report shows, competition in video distribution and programming markets is intensifying. From 2001 to 2005, the number of cable subscribers, as a share of total MVPD subscribers, has decreased from 77 percent to 69 percent. Commensurately, DBS subscribership has increased from 18 percent to 27 percent. Local exchange carriers, electric and gas utilities, and cellular phone companies have all announced plans to upgrade their systems to offer video services and, in some cases, are already offering multimedia programming. Moreover, while 14 percent of U.S. television households continue to rely solely on over-the-air broadcast signals, the sale of digital television sets has skyrocketed, a trend certain to continue as prices are steadily decreasing. The digital television transition is also supported by the fact that more than 1,537 stations nationwide are broadcasting digitally.

Of particular significance is the entry of some of the largest local exchange companies into the video marketplace. LECs are upgrading their facilities to fiber-based platforms in many areas across the country so that these carriers can offer a suite of video, voice and data services. This investment could bring the most substantial new competition into the video marketplace that this country has ever seen. Equally significant is the potential for this new revenue stream to drive broadband deployment, which can benefit consumers and the free flow of information beyond the video marketplace.

Consumers will benefit not only from more choice, better service and lower prices, but also stand to gain from a more robust exchange in the marketplace of ideas. I have long expressed grave concerns about the negative effects of media consolidation in this country, and have focused on the problems raised by growing vertical integration of programming and distribution. Vast new distribution networks promise to limit the ability of any vertically integrated conglomerates from imposing an economic, cultural or

political agenda on a public with few alternative choices. I truly believe the benefits of this new competition extend beyond the normal ones that accrue to consumers, and can actually improve the health of our overall democracy.

Nothwithstanding these healthy competitive indicators, the Report highlights areas of serious concern that will likely require our careful examination and possible action. While the competitive presence of DBS has reduced cable's dominance, concentration remains a concern: the top four MVPDs serve 63 percent of all MVPD subscribers, up five percent from 2004. Vertical integration and program access are also areas of growing concern. Of the 96 regional networks providing local sports and news, almost half are vertically integrated with at least one MSO. Several commenters, particularly small and rural cable operators and LECs, have raised concerns about securing access to programming at competitive, nondiscriminatory terms and rates.

The findings discussed in this Report should serve as the factual foundation to inform future Commission decision as well as providing Congress with information that can inform the national policy debate.

STATEMENT OF COMMISSIONER DEBORAH TAYLOR TATE

Re: Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 05-255

First, I would like to applaud the Chairman for holding this meeting in Keller, Texas. I also wish to thank Mayor Tandy and Mayor Moncrief for not only participating in our open meeting but also their leadership in championing competition and consumer choice. I want to specifically acknowledge Commissioner Barry Smitherman from the Texas Public Utilities Commission, my friend and former colleague, for joining us. I look forward to our continuing relationship with state and local officials on these issues which are crucial not only to our nation, but to communities like Fort Worth and Keller. Finally, thank you for the warmth and hospitality that has been shown to us while we've been here in the Great State of Texas.

As stated by the Chairman, I feel it is important for the Commission to take opportunities such as this to travel outside of Washington, D.C. Sometimes getting out into wide open spaces just helps put the issues into perspective; to talk with real people about the innovative products and services that are transforming the way they work, live, and play. And, also, to see areas which may not have access to exciting new services like those we've seen on this trip. I believe that it is critical that we, as policymakers, do not lose touch with how communications technology, and the decisions we make in this arena, affect the lives of all Americans, impact both the local and global economies, and influence investment decisions in the communications marketplace.

And so I am delighted to be here, not simply to talk about video competition in the abstract, but to actually see first-hand the efforts of new entrants into this market and to hear from consumers, local government representatives, and the entities actually providing such services. For example, yesterday we saw a working demonstration of Broadband over Power Line (BPL) in a neighborhood in Dallas. Current Communications Group, LLC and TXU are using this innovative new technology both to provide broadband and to help the electric grid work smarter and more efficiently. At their model home I was able to talk to my assistant, Teri, using a Voice over Internet Protocol (VoIP) phone while watching high-quality video streamed over the Internet. All the while, the electric company is able to use that same technology to monitor exactly how much electricity is being used and identify immediately when and where the power goes out.

This beautiful, new community center in which we are meeting provides more than just a wonderful setting for our open meeting; it also serves as an excellent example of the concept of "bundling." Here, under one roof, the citizens of Keller can enjoy a variety of sports and exercise options, games, a swimming pool, and childcare – all in a family friendly atmosphere. In a similar vein, we are here today to discuss the fact that an increasing number of entities are providing a bundle of communications services that can include voice, data, video, and even wireless. And just as is the case with this community center, many of us would like to enjoy those bundles – the so-called "triple play" and "grand slam" –in a family friendly atmosphere.

Tennesseans are used to hearing me say this, but since I find myself today in Texas, I will say it again: I am a strong supporter of competition. Efficiently operating competitive markets do a much better job of ensuring that the needs of consumers are met than we could ever hope to accomplish through unnecessary regulatory intervention. Competitive markets force rivals to be more responsive to the needs of consumers; to provide lower prices; to innovate; to offer more choices; and to provide better customer service. To summarize: whatever the concern may be, robust competition is, in virtually every case, the preferred solution to government regulation.

The marketplace for the delivery of video programming provides a perfect example of this point. The significance of video competition cannot be overstated – because it has the ability to play a critical role in a number of high-priority areas:

Cable TV Prices: Competition from Direct Broadcast Satellite (DBS) operators and, as we have witnessed here in Texas, and now traditional phone companies will continue to drive down prices for consumers.

Indecency: In a fully competitive marketplace, there is every reason to be confident that consumers' concerns about the programming that enters their homes would be met. Unfortunately, however, the video programming marketplace – while much more competitive today than when the 1992 Cable Act was passed, as this year's Video Competition Report makes plain – so far has been unable to adequately address this issue. But as the number of competitors increases, we are beginning to see signs of progress in this area. Indeed, the recent announcements by cable operators and DBS providers regarding the offering of family tiers, as well as the public statements by AT&T and EchoStar indicating an interest in providing their customers with programming on an a la carte basis, could well represent the initial steps in that very process. But they are only that – initial first steps.

Competition should be not only about more choices, but about **better** choices for our families. I am hopeful that, as competition continues to expand, parents – and concerned viewers generally – will be able to choose from a range of programming options that they find appropriate. In that regard, I am encouraged by the ability of the video delivery platforms we have seen on this trip to provide video programming in customized packages *based on what customers want.* This new technology will eliminate any technical hurdles that may have been asserted in the past as a reason not to allow customer choice.

Broadband Deployment: Greater video competition also can play an important role in ensuring that the benefits that broadband can offer are made available to **all** Americans. Modern telecommunications networks are capable of providing the so-called "triple play" of voice, data, and video – and, when bundled with wireless offerings, the "grand slam." As a result, the ability to offer video programming services holds the promise of an additional revenue stream from which the substantial capital investment required for broadband deployment can be recovered. In many cases, including in rural and higher cost areas the additional revenue provided by video programming hopefully will provide the extra push needed to justify the decision to deploy broadband facilities.

* * *

So it seems clear that full and vibrant competition in the delivery of video programming can provide a wide range of benefits. This leads logically to two follow-up questions: (1) how competitive is the multichannel video programming distribution market today, not only here in Texas but throughout the United States?, and (2) what can we do to make it even more competitive?

This year's video competition report describes the current state of the MVPD marketplace. I commend Bureau Chief Gregg and Ms. Glauberman and their colleagues in the Media Bureau's Industry Analysis Division for their good work. We must rely upon your expertise along with real-world experience – like we are obtaining here today – in order to make the best possible decisions. And based upon this report, it appears that although incumbent cable operators remain the leading provider of multichannel video programming, their market shares continue gradually to decline. And while I applaud the DBS providers for the competitive inroads they have made, particularly in rural areas not served by cable, I believe that wireline competition should be encouraged as well.

Which leads me to my second question: what can policymakers do to foster greater video competition envisioned by Congress? Here in Texas, legislation passed last year to facilitate the entry of new providers established a streamlined process by which new entrants can obtain state-issued certificates of franchising authority. Other states are considering enacting similar laws, and franchising reform also is being considered at the federal level. Representative Marsha Blackburn from my home state of Tennessee last June introduced the Video Choice Act of 2005, which would have eliminated cable franchise requirements for companies already authorized to access public rights-of-way.

Meanwhile, the FCC initiated an investigation into the local cable franchising process for competitive entrants last November, prior to my arrival. This Section 621 rulemaking seeks to determine whether the franchising process serves as an unreasonable barrier to entry for new providers and, if so, what remedial steps the Commission might take. Comments are due on Monday, February 13th. I look forward to working with my fellow Commissioners on this proceeding in the months ahead. I also look forward to hearing from consumers and others here today, and interested parties everywhere, regarding what we can do to increase investment, innovation, and deployment of multi-use broadband networks throughout the United States.

Thank you.