FCC 621 Order
Impact on Cable Franchising

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On August 2, 2019 the FCC released its Third Report and Order in the Section 621 proceeding ("621 Order"). This new 621 Order will take effect September 26, 2019. This paper will discuss the impact of the 621 Order on local cable franchises and, most importantly, how this 621 Order may impact franchise fee revenue in your city.

Key Takeaways

The 621 Order upends 35 years of settled law regarding the 1984 Cable Act and has the potential to significantly reduce franchise fee and PEG fee revenue received by cities. The 621 Order is "prospective" in its application and cable operators cannot seek to apply the FCC's conclusions retroactively. This means no ability for cable operators to reach back and impact past franchise fee payments to your city based upon the FCC's new interpretations of the Cable Act. While the FCC concluded that the costs associated with the provision of PEG "channel capacity" are to be considered "in-kind" costs that can be offset from franchise fees, the FCC found the record to be insufficient to determine what those costs should be. This appears to be a short term reprieve for cities as the FCC promises to address this issue within the next 12 months.

For cable franchises that have expired and are in need of renewal, the immediate impact of this 621 Order will likely be the potential loss of any complimentary cable service drops to schools, libraries and public buildings. In addition, cable operators will be able to assess a new "maintenance cost" for the transport of PEG programming to

the cable operator's headend. For existing cable franchises it is unclear exactly how, or how quickly, cable operators may attempt to implement the 621 Order. Cable operators are anticipated to implement the order differently and some have expressed concern about reacting too quickly due to legal challenges (already filed) in federal court.

Despite the federal court challenges to the 621 Order, it is possible some cable operators could start to contact cities as soon as October 2019, either seeking cable franchise modifications or providing notice of the cable operator's intended offset from franchise fees. Moreover, since the 621 Order does not mandate that a cable operator actually contact cities (it only "recommends" that course of action), it is possible some cable operators may simply remain silent and seek to unilaterally implement the order via offsets from franchise fees. Finally, those cities with existing I-Nets may face significant challenges as more fully described herein.

In-Kind Contributions

The FCC concludes that "most cable-related, in-kind contributions" must be included within the 5% franchise fee cap. "In-kind contributions" are defined as:

> *any non-monetary contributions related to the provision of cable services provided by cable operators as a condition or requirement of a local franchise agreement, including but not limited to*:
>
> - *Free or discounted cable service to public buildings;*
> - *Non-capital costs in support of PEG access; and*
> - *Costs attributable to the construction of I-Nets.*

Below we outline how each of these so called "in-kind contributions" may be impacted in a cable franchise. Note that this list is not intended to be all inclusive, the FCC notes that *any* non-monetary contribution included in a cable franchise could be an "in-kind" contribution.

1. Free Cable Service to Public Buildings

Many local cable franchises include an obligation for the cable operator to provide complimentary cable service to schools, libraries, the city hall and other public buildings. The FCC now finds that the value attributable to these free or discounted cable services must be included in the 5% franchise fee cap. This may leave cities with a choice, either maintain the complimentary services (services that have likely been provided free of charge for the past three decades) and have the fair market value of such services deducted from franchise fees, or reduce/eliminate certain complimentary service locations so the city can retain the franchise fee revenue.

Under the 621 Order the FCC "encourages" cable operators to negotiate franchise modifications with each city prior to any offset against franchise fees. But it is important to note that the FCC *does not mandate* any communication by the cable operator. If fact, at least one large cable operator has noted that they have no express obligation under the 621 Order to contact any city they serve before implementing an offset against franchise fees. Obviously such a lack of communication may have a significant impact on any city's budget – but only time will tell if cable operators will take the FCC's advice to undertake franchise modification negotiations, or simply undertake unilateral offsets.

Moreover, cable operators that have hundreds, if not thousands, of local franchises to address under this 621 Order may also attempt to implement the 621 Order by simply writing a letter to your city or offering – *e.g. we plan to implement the 621 Order in the following manner and unless we hear from your city in writing, we assume you do not disagree with this approach*. Those cities in renewal proceedings will likely be forced to assess the cost/benefit of continuing the provision of complimentary service drops to every location. Finally, cities face a dilemma in how to address the 621 Order while legal challenges are pending. If cities accept all of the FCC conclusions and execute new franchises agreements or modify existing agreements, then it will not matter if the courts overturn the FCC's action – the cable operators will have already been successful using the 621 Order to obtain the desired relief and cities will not be able to go back and impose the prior obligations.

2. PEG Costs

Capital Costs

In welcome news for cities, the FCC expanded its definition of PEG "capital costs." As anticipated, the FCC finds that in-kind contributions to PEG access facilities, other than "capital costs," must be included in the 5% franchise fee cap. The FCC, however, provides a new definition of "capital costs" to now include costs incurred in acquiring or improving capital assets for PEG facilities. The FCC finds that this definition of "capital costs" includes costs associated with the construction of PEG access facilities, but is not limited to such costs.

Examples of capital costs within the 621 Order include, vans, studios, cameras, "other equipment relating to the use of" PEG channel capacity. Other examples include the purchase of land, buildings, construction and equipment to be used in the production of PEG programming.

Operating Costs

The FCC also finds "that *capital* costs are distinct from *operating* costs (or operating expenses), which are generally defined as expenses 'incurred in running a business and producing output.'" The FCC references "salaries and training are two examples of operating costs." Cable operators requested that the FCC make clear that cable operators have the right to audit a city's use of the PEG contributions and that a city must provide reasonable supporting documentation during an audit that such PEG contributions are, or were, being used for PEG "capital" expenses. The FCC rejected that request and instead concluded that the Cable Act neither provides authority for such an audit of PEG fees nor precludes such an audit. The FCC held that a court may award a cable operator the right to audit if the court finds that relief appropriate. Watch for many cable operators to seek to require such an audit mandate in renewal franchises.

As a result of this expanded FCC definition of capital costs, renewal proceedings will still include an assessment of the future cable-related needs and interests of the city, including capital costs for PEG, and cable operators will continue to review the reasonableness of the costs associated with meeting those needs and interests. Historically cities and cable operators have been able to reach agreement on such PEG

capital support via the informal renewal process under the Cable Act, or in limited cases, via formal renewal proceedings.

One possible complication for renewal that is introduced by the 621 Order is the FCC's attempt to address the Cable Act's use of the word "adequate." The FCC found that cities "may only require 'adequate' PEG access channel capacity, facilities, or financial support." The FCC concludes that "adequate" means "satisfactory or sufficient." The FCC concludes that demands for PEG capacity requirements that are more than "adequate" are subject to judicial challenge under the Cable Act. It is not at all clear how the 621 Order discussion of "adequacy" may impact the long settled Cable Act renewal procedures and standards which are typically related to whether the operator's proposal for renewal is reasonable to meet the future cable-related needs and interests of the city.

3. I-Net Costs

An institutional network, or "I-Net," is a communication network that is constructed or operated by the cable operator and generally available only to subscribers who are not residential customers. The FCC concludes that the "costs associated with the construction, maintenance, and service of an I-Net fall within the 5% cap on franchise fees. Such costs are cable-related, in-kind contributions that meet the definition of franchise fee." Since the FCC also concludes that its franchise fee rulings are "prospective," cable operators can only count ongoing and future in-kind contributions toward the 5% franchise fee cap once the 621 Order is effective. Thus, if an I-Net is already constructed, the cable operator is not permitted to seek to recoup

construction costs retroactively. However, ongoing maintenance and service costs for an I-Net would fall within the 5% cap on franchise fees. The 621 Order permits the cable operator to assess the "fair market value of an I-Net." See below for description of fair market value.

What is the "fair market value" of an I-Net that is already constructed and paid for? The FCC states that "where there is a product in the market" that is the most reasonable valuation for in-kind contributions because it is easy to ascertain.

PEG Channel Capacity and PEG Transport

1. PEG Channel Capacity

In what may be only a temporary victory for cities, the FCC left in place the "status quo" that PEG channel capacity costs should ***not*** be offset against the 5% franchise fee. However, the FCC placed all parties on notice that the FCC has concluded that PEG channel capacity is an in-kind contribution, but the FCC opted to defer the issue for future consideration. The FCC concluded the record is insufficiently developed to determine whether the provision of PEG channel capacity should be excluded from franchise fees as a PEG capital cost.

The 621 Order encourages submissions to supplement the record on the channel capacity issue and the FCC intends to address the issue within 12 months. It is not clear if the FCC will issue a further notice of proposed rulemaking or simply allow parties to submit comments absent such a proceeding. Once again cities will be at a significant disadvantage since the industry will have far greater resources to supplement the record regarding the "value" of PEG channels, particularly when many

cities will be engaged in challenges to the FCC on both the 2018 small-cell order and this 621 Order.

2. PEG Transport

The FCC defines "PEG transport" as facilities that cities use to deliver PEG services from locations where the programming is produced to the cable operator's headend. The FCC concludes that installation costs for such facilities are a capital expenditure because it is a long-term asset meant to deliver the programming. As a result the 621 Order finds that such installation costs do ***not*** count toward the 5% franchise fee cap. However, the 621 Order finds that the ongoing costs associated with the "maintenance or operation" of such PEG transport facilities are an "operating cost." As such, the maintenance or operation costs for PEG transport facilities would be included in the 5% franchise fee cap.

The FCC also concludes that costs associated with the use of transport lines for "episodic" or "short-term" PEG programming is an operating cost that is subject to the 5% franchise fee cap. However, the FCC declined to clarify exactly what that means – e.g. how many times a year must a transport line be used before it is no longer considered "episodic."

It is also unclear how a cable operator may assess its "maintenance costs" since the FCC does not provide any guidance on what may be included for such calculations. As outlined below in this summary, the FCC permits cable operators to assess the "fair market value" for certain other in-kind contributions such as free service to public buildings and I-Nets. It does not appear that maintenance costs fall under the same

fair market valuation, but rather would be calculated based on the costs incurred by the cable operator to "maintain" the transport facilities. At least one cable operator has suggested that they intend to now charge cities "transport costs" for PEG distribution. This certainly implies a fair market valuation of PEG transport as opposed to simply "maintenance" costs. The difference between the two may well be substantial and could have the immediate impact of driving some PEG channels out of operation depending upon cost.

Buildout and Customer Service

1. Build-Out Costs

The 621 Order excludes from the 5% franchise fee cap any costs incurred by a cable operator to meet cable franchise terms that impose build-out requirements and presumably line extension obligations. This appears to be the cable industries' desire to continue to allow cities to require competitive over-builders to face mandatory buildout obligations. Most incumbent cable operators routinely seek to avoid any line extension requirements arguing instead that they will extend their system to unserved areas only if they determine there is a business case – not based on any franchise requirement.

2. Customer Service Obligations

Similar to buildout requirements, the 621 Order concludes that "customer service obligations" do not count toward the 5% franchise fee cap. The 621 Order states that "customer service means the direct business relation between a cable operator and a subscriber," and "customer service requirements include requirements related to interruption of service; disconnection; rebates and credits to consumers; deadlines to

respond to consumer requests or complaints the location of the cable operator's consumer service offices; and the provision to customers (or potential customers) of information on billing or services." Presumably this means that even costs incurred by a cable operator to comply with customer service obligations that exceed the FCC's customer service standards would ***not*** be subject to the 5% franchise fee cap. Expect many operators to now seek in franchise renewals to limit any customer service obligations to only what the FCC requires, and only for as long as the FCC may maintain such requirements.

Prospective Application – Not Retroactive

The 621 Order is prospective only; cable operators are not permitted to recoup past franchise fee payments related to the findings in the 621 Order. However, the 621 Order does apply to existing cable franchises after the September 26, 2019 effective date of the 621 Order.

Fair Market Value

Unlike the small cell order in the fall of 2018 where the FCC limited cities to the recovery of the cities' "costs," in the 621 Order the FCC concludes that cable operators can assign the "fair market value" to any cable related in-kind contribution mandated in a cable franchise. The FCC states that "where there is a product in the market, (fair market value) is the most reasonable valuation for in-kind contributions because it is easy to ascertain – cable operators have rate cards to set the rates that they charge customers for the service that they offer." While this may be true for complimentary cable service to public buildings, it will be far more difficult to assess the fair market

value for I-Net services where the rates vary widely and commercial services rates charged by cable operators are often confidential. So far some cable operators have suggested that "commercial" rates, not residential rates, will be applied to all complimentary service outlets. Commercial rates are often the rates a cable operator may assess on a bar or restaurant that may show the cable programing to its patrons – this is often a far higher rate than the cable operator charges to residential subscribers.

Process for Modifying a Cable Franchise

The FCC concludes that to the extent a cable franchise is currently in place that conflicts with the 621 Order, the FCC **encourages** "the parties to negotiate franchise modifications within a reasonable time." The FCC finds that 120 days should be, in most cases, a reasonable time for the adoption of franchise modifications. However, the FCC warns that if a city refuses to modify any provision of a cable franchise that is inconsistent with the 621 Order, such franchise provision "is subject to preemption under section 636(c)" of the Cable Act. Section 636(c) essentially provides that any cable franchise provision that is inconsistent with the Cable Act is preempted and superseded. The FCC has no similar warning for cable operators despite the fact that the FCC permits operators the option to avoid franchise modification negotiations and simply move to unilaterally offset "in-kind" costs against franchise fees. If a cable operator were to avoid franchise modification negotiations, cities would likely not even be aware of a franchise fee offset until the 2019 fourth quarter franchise fees are remitted, perhaps in February of 2020.

The 621 Order states that cities ***may not ask a cable operator to voluntarily waive*** anything under the Cable Act as interpreted by the FCC. The FCC stated, "Complying with the terms of the statute is not optional."

Mixed-Use Rule

The FCC concludes that cities are not permitted to regulate anything other than "cable services" in a cable franchise. This means that cities cannot seek to regulate services such as broadband internet access or other telecommunications services in a cable franchise. Moreover, cities may not lawfully impose fees for the provision of broadband internet access against a franchised cable system or their affiliated companies. Nor may cities require a separate franchise (or other authorization) for the provision of broadband internet access via such cable system.

Specifically the 621 Order seeks to overcome a recent Oregon Supreme Court's decision in *Eugene v. Comcast*, which upheld generally applicable right-of-way fees on the non-cable services provided by cable operators. To overcome this case, the FCC expressly preempts any state or local requirement, whether or not imposed by a city, which would impose obligations on franchised cable operators beyond what the Cable Act allows.

This mixed-use preemption includes:

1. Any fees on a franchised cable operator that exceed the 5% franchise fee whether styled as a 'franchise' fee, 'right-of-access' fee, or a fee on non-cable (*e.g.*, telecommunications or broadband) services, and

2. Any requirement that a cable operator with a cable franchise obtain an additional franchise or authorization to provide non-cable services (*e.g.*, telecommunications or broadband) over the cable system.

The 621 Order states that "installation of Wi-Fi and small cell antennas attached to the cable system" are part of the cable system and thus ***states and local governments cannot impose separate rights of way fees on cable operators' Wi-Fi and small cell attachments***. However, cities may still impose requirements on non-cable facilities and equipment designed to protect public safety, so long as such requirements otherwise are consistent with the provisions of the Cable Act.

Application to State Franchising

This 621 Order, as well as the two previous 621 Orders issued in this FCC docket, apply to local cable franchises issued by cities and also "apply to franchising actions taken at the ***state level*** and state regulations that impose requirements on local franchising."

Recommendations or Action Plan

1. Review your city's cable franchise to determine whether any non-monetary (in-kind) obligations may exist that may allow the cable operator to seek an offset from franchise fees under the 621 Order.

2. Do not execute or agree to any correspondence from the cable operator attempting to implement the 621 Order without careful consideration and consultation with your attorney. Given that the 621 Order is under appeal, it is possible the entire 621 Order could be overturned by a federal court. Some cable operators may seek to

have cities agree to cable franchise modifications so that even if the 621 Order is overturned by a court, the cable operator has already gained the relief it seeks via written agreement with the City.

3. Review the city's future franchise fee payments closely, beginning with the 2019 fourth quarter payments, to determine if there have been any unilateral offsets without your city's authorization.

4. Review the 621 Order and this summary with city staff to determine potential budget changes for 2020 and beyond as well as possible impacts on PEG operations.

5. Consider participating in the federal appeal process brought by cities challenging the 621 Order. Contact Brian Grogan at Moss & Barnett for details.

6. Watch for another FCC rulemaking regarding whether PEG channel capacity should be excluded from franchise fees. This proceeding will have the potential to cause significant pressure on franchise fee revenue received by the city.

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