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Perspective

Paying for the Use of the Public Right of Way

An Examination of Telecommunications Franchise Fees

by Bill Peacock, director of the Center for Economic Freedom

Introduction

Municipal franchise fees are levied on telecommunications services by cities for the use of the public right of way. These fees, which average in the neighborhood of 6 percent of a typical telephone, cable, or video bill, make up a significant portion of the high telecommunication taxes levied on Texans.

Texans pays a total of 29.29 percent in transaction taxes on a typical phone bill, compared to a national rate of 18.17 percent.[1] This means Texans face the third highest tax burden in the country. Only Virginia and Maryland levy higher telecom taxes than Texas.[i]

The breakdown of taxes are: federal taxes, 4 percent; state taxes, 14.17 percent; and local taxes, 11.12 percent. In other words, more than half of the municipal revenue stream from telecommunications taxes is generated by franchise fees.

Franchise fees have traditionally been levied on a variety of services that depend on the public right of way, including telephone, cable, gas, electricity, and water. The rationale for these fees varies.

The 5th Circuit Court of Appeals has held that a franchise fee is "essentially a form of rent: the price paid to rent use of public right of ways."[2] In some cases other than telecommunications services, franchise fees also include payments to cities for relocation and other maintenance costs. However, in the case of traditional phone companies, franchise fees are simply a tax on companies occupying easements in which they have a property right.[3]

Municipal Franchise Fee Reform Key Principles

- Use of franchise fees to provide general revenue for cities is inefficient, anticompetitive and costly—they should be reduced.
- Consumers bear the cost of these excess fees in terms of higher prices and reduced services.
- Franchise fees should be based on the physical occupation of the public right of way and the associated costs, not on the provision of individual services.
- As long as franchise fees remain service based, new, emerging technologies, such as VoIP, should be exempt from franchise fees.
- Local governments have the necessary "budget bandwidth" to accommodate reduced fees.

[i] Virginia has recently reformed its telecom tax structure. When implemented, Texas will move up to second on the list.

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Whatever the legal status of franchise fees, it is clear that they have become divorced from paying for the cost of managing the right of way and have instead become just another revenue source for cities. In 2005, 182 certified telecommunications providers paid approximately $222 million in telephone franchise fees to 1,128 cities.[4] This does not include any payments or costs incurred to relocate, remove or alter facilities in the right of way. One provider estimated that over the last year it spent an additional $20 to $25 million to relocate its facilities for road straitening and widening projects.[5]

Telecommunications Franchise Fees

There are three different forms of franchise fees relating to telecommunications: 1) franchise or licensing fees for telephone service, 2) cable franchise fees, and 3) the new statewide video franchise fee.

For the most part, telephone franchise fees are regulated by HB 1777 (1999), which set a statewide standard by which the fee is assessed on a per access line basis. However, there are some companies in some markets that still operate under franchise agreements outside of this structure.

HB 1777 set up three different categories of the telephone municipal franchise fee: residential, single business line and multiple business/private line. The charge is levied on each access line, and varies by city. For instance, Huntsville charges $0.95, $2.00 and $2.00, respectively, for each access line, while Houston charges $1.58, $5.37 and $15.28, respectively. The average impact of this fee is 6.35 percent of local telephone service.[6]

Municipal Telephone Franchises Fees in Selected Cities

City	Residential Line	Single Business Line	Private Line
Houston	$1.61	$5.47	$15.56
Dallas	$1.45	$6.46	$12.89
Austin	$1.22	$4.77	$11.90
Huntsville	$0.97	$2.04	$2.04
Abilene	$0.87	$2.24	$2.28
McAllen	$0.83	$2.17	$2.17

Source: Public Utility Commission

Until recently, only telephone service provided by a company certificated by the PUC was subject to this fee. But SB 5 (2005)[7] imposed this fee on any company that "provides voice service" using "facilities located at least in part in the public right of way." Cellular service is specifically excluded as a voice service, but this provision appears intended to capture all facilities-based providers of telephone service who use Voice Over Internet Protocol (VoIP) technology.

Cities are allowed to change their rates once a year, but these changes do not increase their overall revenue. The PUC annually adjusts the rate by half of the change in the Consumer Price Index. This year, the increase was 1.8 percent.[8]

The cable municipal franchise fee is very similar to its telephone counterpart. It is capped at 5 percent of gross revenues under federal law, which is usually the amount that cable companies have to pay under agreements negotiated with the cities. Additionally, cities generally require in-kind services as part of the franchise agreement. This cost is also passed on to consumers, usually in the form of a fee on a cable bill. It usually runs between 1 to 2 percent.

> Municipal franchise fees today have little correlation to the costs of managing the right of way.

The statewide video franchise fee is imposed on video and cable providers that offer services under new statewide video franchise provisions. As local cable franchise agreements expire, state law requires that cable and video service be provided under the state franchise—already, cable providers are making the switch.

The fee is 5 percent of gross revenues, and is sent to cities where the franchisees do business. Eventually, cities may elect to collect an additional 1 percent in lieu of per subscription payments made under expired franchise agreements. Cable franchises have claimed the 1 percent add-on fee violates the federal 5 percent cap on cable franchise fees.

Municipal franchise fees today have little correlation to the costs of managing the right of way. Services that are provided over copper, co-axial, and fiber lines are now taxed, rather than the lines themselves. For instance, telephone companies that offer both voice and video over the same copper line now have to pay two franchise fees, one for each service. The same is true for cable companies that offer cable and voice service over one coaxial cable. Companies and consumers have to pay the additional tax even though these additional services add no additional costs to cities in managing the rights of way.

Local Right of Way Management

Even though in Texas the state owns the public rights of way along streets and highways, cities have traditionally managed the access to them for several reasons. The 2005 Congress of Cities stated that cities have this responsibility because they have the local knowledge and expertise to identify community needs, can protect the public's interest and can manage conflicts between rights of way users.[9]

However, local management of rights of way have become increasingly problematic over the years. In 2002, Michael Powell, then-chairman of the Federal Communications Commission, explained his concern about local right of way management:

> We've begun to get very focused on … the area of rights of way. This too is a complicated balancing act between the legitimate rights of localities and the management of their rights of way, and the competitive imperatives of federal policy…. We articulated quite clearly our growing concern about rights of way as a barrier to effective deployment of new services.[10]

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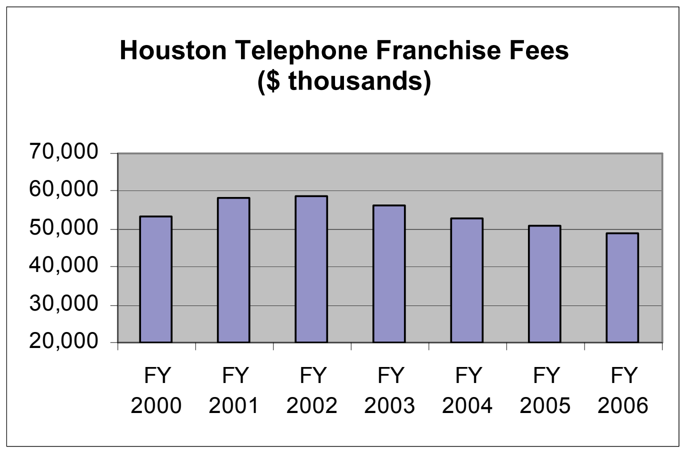
>
> *Michael Powell, former chairman, Federal Communications Commission*

According to Assistant Secretary of Commerce Nancy Victory, telecommunications providers have described four problems with local right of way management: 1) delay, 2) unreasonable fees, 3) a third tier of regulation, and 4) discriminatory treatment.[11]

These concerns have led both federal and state authorities to intervene in local right of way management on several occasions, including the U.S. 1984 Cable Act; the U.S. Telecommunications Act of 1996; Texas HB 1777 in 1999; and Texas SB 5 in 2005.

As seen above, the emphasis on generating revenue has paid off for Texas cities, which received about $222 million from franchise fees in 2005. However, in the last three to four years, this revenue has been declining for many cities.



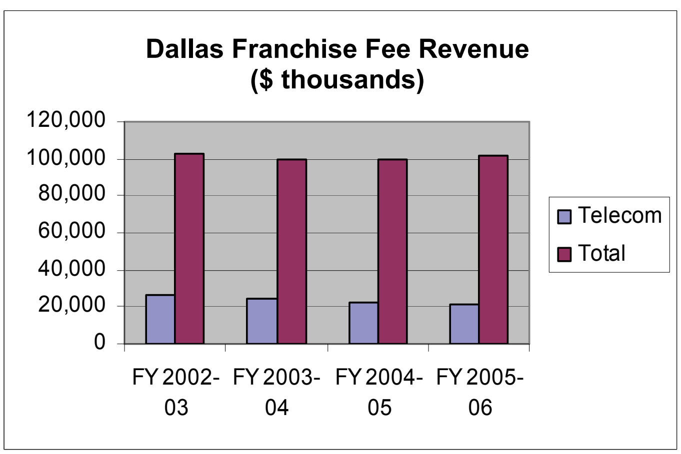
Source: City of Houston 2006 Budget

Telephone franchise fee revenue is based on the number of access lines in a jurisdiction. Since the number of access lines has declined recently as people have switched to cellular providers, revenues have correspondingly decreased for municipalities. For instance, telephone franchise fee revenue for the City of Houston is expected to drop below $50 million in 2006, after having peaked at $58.6 million in 2002.[12] Similar declines have been experienced in Dallas and Austin.

Marvin Kirsner, an attorney who specializes in industry-specific tax issues, provided a national perspective on the issue, which spreads beyond just franchise fees:

> State and local governments are scrambling to maintain revenues they feel are being threatened by new technologies. The explosive growth in e-commerce, for example, is threatening sales tax revenues, because an e-commerce vendor without a physical presence in a state is not obliged to collect sales tax.
>
> The potential loss of tax revenue from VoIP service also terrorizes tax collectors. Likewise, state and local governments feel the popularity of satellite TV and radio service could result in decreased tax revenues and are fighting back by imposing tax structures on satellite TV that do not apply to cable.
>
> State and local governments are concerned about losing revenue from income taxes, property taxes, and franchise fees.[13]

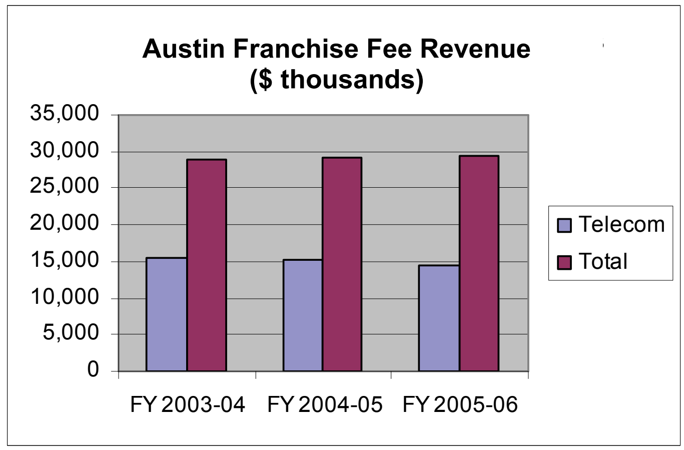
This decline in revenue has been an important factor in recent tax policy decisions at both the Texas Legislature and the Public Utility Commission. Cities have lobbied both entities to expand the types of services subject to the telecommunications franchise fees to make up for the lost revenue. As already mentioned, SB 5 expanded the franchise fee to cover facilities-based VoIP providers. And the Coalition of Cities and the City of Houston have said that PUC rules implementing this provision of SB 5 should subject all VoIP providers to the franchise fee,[14] even though the House sponsor of the bill has said this was not the legislative intent.[15]



Source: City of Dallas 2005-06 Budget

However, as cities seek to replace lost revenue, it is important to note that they have other resources from which to raise significant funds. In fact, cities have utilized these other sources to more than replace any revenue lost from the telecommunications franchise fees.

One example is the City of Houston, which renegotiated its electric franchise agreement for 2006, resulting in an increase of $10.35 million, or 13.3 percent.[16] Another example is the City of Austin, which operates its own electric utility and is therefore able to generate revenues far greater than it would receive through electric franchise fees from a private operator.



Source: City of Austin 2005-06 Budget

As a result, while telecom franchise fees have declined, overall franchise fee revenue has recently increased for Houston, Dallas, and Austin. The same is true for all general fund revenue for each of these cities—all showed healthy increases for the most recent fiscal year: Houston, $67.3 million, or 4.7 percent in FY 2006; Dallas, $35.2 million, or 4 percent, in FY 2005-06; and Austin, $27.9 million, or 6.15 percent in FY 2005-06.

Additionally, sales tax revenue to cities is not dependant on land lines—cellular service is also subject to the sales tax. With the overall growth of telecommunications services, the sales tax on these services should be a source of increased revenue for cities.

Policymakers looking into the issue of franchise fees should determine whether or not franchise fees and other telecom taxes are too high and thus hinder competition and deployment of technology. If the answer is yes—and the Foundation believes this to be the case—then these fees must be lowered over time.

As has already been demonstrated, the recent decline in telecommunications franchise fees has not negatively affected the cities' budgets or, most importantly, their ability to manage the public rights of way. A properly managed reduction of these fees in the future would likewise allow cities to adjust to changes in their revenue streams without a negative impact on right of way management.

Municipal Franchise Fee Reform

One of the key principles that has recently shaped the telecommunications debate in Texas is fairness in regulatory and tax policy. Though one result of this principle could be broad support for a "level playing field" shaped by lower taxes and reduced regulations, this has not always been the case. As economists Thomas W. Hazlett and George S. Ford explain, "State cable franchising laws reveal a neglected aspect of the symmetry paradigm: rules that ostensibly mandate fairness can create barriers to entry."[17]

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>
> *Thomas W. Hazlett & George S. Ford*

In other words, a level playing field can be one that subjects every market participant to the same high taxes or heavy regulation. One example of this is the debate last session over the statewide video franchise.

Over the last three decades, cable companies have had to go city by city to secure cable franchises, an expensive and time-consuming process. Local governments used their monopoly status to extract significant concessions from the cable companies, who had little choice but to pay the cities' asking price if they wanted to do business.

Cable companies, understandably, wanted new entrants to face the same hurdle, in order to provide a level playing field. However, this would not have been the result because of recent changes in market conditions and competition.

Though the local franchise agreements were expensive, cable companies originally agreed to them because they were in essence granted monopoly status and able to recoup the cost of franchise requirements such as providing service throughout an entire city and building networks and cable access facilities for the use of cities.

Today, with increased competition, new providers would not receive monopoly protection, and would be at a competitive disadvantage with existing incumbents. Thus the solution to the problem of the local franchise was not to subject new entrants to the same onerous regulations that cable companies faced in the past, but to provide a less onerous system that facilitated entry and lowered regulatory costs for all. SB 5 took this approach, and significantly reduced the regulation of Texas firms offering cable and video service.

Similarly, the recent calls to extend the franchise tax to VoIP providers has ignored the impact of high taxes on new market entrants and consumers, and instead focused on maintaining revenue streams for municipalities by calling for a level—though higher taxed—playing field.

A level playing field is important for increasing competition in the telecommunications market, but competition is never enhanced, and consumers' interests are never served, by increasing taxes or regulations. Reforms to the management of the public rights of way must be based on the ideal of limited government.

The following are key principles to be considered by policymakers seeking to reduce the harmful impact of today's excessive franchise fees:

- Use of franchise fees to provide general revenue for cities is inefficient, anticompetitive and costly—they should be reduced.

- Consumers bear the cost of these excess fees in terms of higher prices and reduced services.
- Franchise fees should be based on the physical occupation of the public right of way and the associated costs, not on the provision of individual services.
- As long as franchise fees remain service based, new, emerging technologies, such as VoIP, should be exempt from franchise fees.
- Local governments have the necessary "budget bandwidth" to accommodate reduced fees.

The challenge of reforming and reducing telecommunications franchise fees is the same challenge faced anytime government revenues are threatened—there is always a more organized, vocal lobby fighting to protect the revenues than there is fighting for the reduction of taxes.

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"Neutrality" Interferes with Efficiency and Innovation

The ability of municipalities to collect franchise fees based on services cannot be reconciled with any of the traditional reasons for local management of the public right of way. Instead, the rationale for the collection of franchise fees on services today is that this 1) protects the revenue streams of municipalities, and 2) provides for a competitively neutral collection of fees, i.e., all services are equally taxed regardless of the provider.

However, the "competitively neutral" argument ignores the different business decisions that have been made. For instance, executives with a traditional telephone company made a decision to offer telephone service based on a business model of building facilities that occupy the public right of way and paying the attendant costs. On the other hand, VoIP providers made a decision based on a business model that avoided the costs of building new facilities in the right of way—they should not be expected to bear the costs of those that made different decisions. Franchise fees should be levied on the facilities sited in the rights of way, not the services that are provided over those facilities.

While such an approach could theoretically lead to a situation where a telephone company providing Internet service to a consumer loses that customer's telephone business to a VoIP provider that doesn't have to pay a franchise fee, such a result is unlikely. Instead, market-based responses would likely level the playing field. These could include: bundling of services to consumers, even to the point that a telephone company would not provide Internet service to a customer unless telephone service was also purchased; tiered consumer pricing based on bandwidth; and pricing arrangements with content providers for high-priority bandwidth.

Unfortunately, "net neutrality" legislation being considered by Congress would hinder these market-based responses. If Internet service providers are prohibited from managing the bandwidth of their own lines, the efficiency and innovation that results in lower prices and new services will disappear. Government at all levels should reject regulations offered in the name of neutrality.

The previously stated principles for reforming franchise fees are designed to address that problem by allowing franchise fee revenue reductions to occur over time, following the current trend of revenue declines caused by technological shifts.

This phased-in approach, combined with the recognized anticompetitive nature of the existing franchise fees, the high overall telecom tax burden faced by Texas consumers, and the fact that local governments have the "budget-bandwidth" to withstand reduced franchise fees, provides an excellent opportunity for reforming franchise fees.

This should be part of an overall effort to reduce the high level of telecommunications taxes in Texas. Combining this with other measures—such as the elimination of the Telecommunications Infrastructure Fund Fee—would continue the recent reforms that are making Texas into the most competitive, consumer-friendly telecommunications market in the nation.

Bill Peacock is the director of the Center for Economic Freedom at the Texas Public Policy Foundation. Contact Bill Peacock at: bpeacock@texaspolicy.com.

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Endnotes

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[4]Julie Parsley, testimony before the Texas House Regulated Industries Committee (May 11, 2006).

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[8]Public Utility Commission, "Order Setting CPI-Adjusted City-Preferred Access Line Rates For Year 2006" (March 2006) http://interchange.puc.state.tx.us/WebApp/Interchange/Documents/24640_131_511718.pdf.

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