# Time Warner Franchise Fees Audit

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# Table of Contents

| | Page |
|---|---|
| **INTRODUCTION** | |
| Authorization | 1 |
| Scope and Methodology | 1 |
| Overall Conclusion | 2 |
| Background | 2 |
| Management Accomplishments | 6 |
| **OPPORTUNITIES FOR IMPROVEMENT** | 7 |

## Authorization

We have conducted an audit of the Time Warner Cable and Access Lines Franchise Fees Audit. This audit was conducted under the authority of Article VII, Section 5 of the Garland City Charter and in accordance with the Annual Audit Plan approved by the Garland City Council.

## Scope and Methodology

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Our audit covered October 1, 2005 – March 20, 2009.

While we report to the Mayor and City Council and present the results of our work to the Audit Committee, we are located organizationally outside the staff or line management functions we are auditing. Therefore, this Audit organization may be considered free of organizational impairments to independence to audit internally and report objectively to those charged with governance.

The objectives of our audit were to:

1. A. Determine that fees collected are properly calculated
   B. Ensure compliance with the State Franchise Agreement
   C. Review Customer Bills
2. Determine if all Franchise Fees have been reported from City of Garland customers by reviewing the accuracy of all customer addresses

To adequately address the audit objectives, we:

- Reviewed the State Issue Franchise Agreement (Obj. 1.B)
- Reviewed the franchise fees payments for video and cable sent to the City of Garland for accuracy (Obj. 1.A)
- Reviewed the franchise fee payments for access lines sent to the City of Garland for accuracy (Obj. 1.A)
- Reviewed financial reports (Obj. 1.A)
- Reviewed address listing for video and cable provided by Time Warner and had GIS assist and determine if any City of Garland addresses were missing from Time Warner's list and all customers were accounted (Obj. 2)

- Reviewed customers in border area zip codes for access lines to determine if all access lines are accounted to the City of Garland (Obj. 2)
- Reviewed 25 video and cable customer bills (Obj. 1.C)

## Overall Conclusion

- We determined that franchise fee payments for access line customers were calculated accurately.(Obj.1.A)
- We determined that Time Warner has not been in compliance with the State Franchise Agreement in regards to reporting Franchise Fees. (Obj.1.B)
- We determined that Time Warner has not been reporting their Franchise Fees accurately as part of "gross revenues" for video and cable customers (Obj.1.B)
- We determined that franchise fees were calculated accurately on customer bills (Obj. 1.C)
- We determined that Time Warner is reporting and paying franchise fees on all their video and cable Garland customers (Obj. 2)
- We are still waiting to receive data on access lines to determine the accuracy of all Garland customers and as soon as that information is received, it will be reported to management (Obj. 2)

## Background

### HISTORY

In 1949, entrepreneurs using simple antennas and Army-surplus coaxial cable created the country's first cable television system and revolutionized the way Americans watched TV. More than fifty years later, Time Warner Cable, as the 2nd largest multiple service provider, owns and manages advanced, well-clustered cable systems in the United States. Today, Time Warner Cable offers cutting edge digital technology, a rich range of home entertainment and information choices for the whole family to enjoy, and superior service that demonstrates customer satisfaction is our number one priority.

Time Warner's mission statement is to connect people and businesses with information, entertainment and each other and give customers control in ways that are simple and easy. Headquartered in New York, NY, Time Warner Cable is the second-largest cable operator in the U.S., with technologically advanced, well-clustered systems located mainly in five geographic areas — New York State (including New York City), the Carolinas, Ohio, southern California (including Los Angeles) and Texas. As of September 30, 2008, Time Warner Cable served approximately 14.7 million customers who subscribed to one or more of its video, high-speed data and voice services, representing approximately 34.2 million revenue generating units. Time Warner Cable serves customers in the following 28 states: Alabama, Arizona, California, Colorado, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Maine, Massachusetts, Michigan, Missouri, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Texas, Virginia, Washington, West Virginia and Wisconsin.

The City of Garland receives two types of fees from Time Warner Cable one is Franchise Fees for cable and the other is Municipal Fees for access lines for the Right-of-Way. Time Warner Cable pays the City quarterly on both types of fees. The Franchise Fee is based on 5% of gross revenues and they also pay a 1% In Kind Contribution from the gross revenues. The Municipal Fees is based on an amount that is calculated monthly based on the access line rate by category established by the PUC (Public Utility Commission of Texas).

## FRANCHISE FEES

### Communications Act of 1934

Franchise Fees are governed by Utilities Code Chapter 66 (State-Issued Cable and Video Franchise) of the Local Government Code. Providers have to obtain a State-Issued Certificate of Franchise Authority (SICFA) from the Public Utility Commission of Texas (PUC). The commission shall be designated as the franchising authority for a state-issued franchise for the provision of cable service or video service. Any entity or person seeking to provide cable service or video service shall file an application for a SICFA with the commission. Also, the holder of a SIFCA shall pay each municipality in which it provides cable service or video service a franchise fee of five percent of gross revenues. The holder of a SIFCA shall pay a municipality in which it is offering cable service or video service one percent of the provider's gross revenues, in lieu of in-kind compensation and grants.

## MUNICIPAL FEES

### Texas Local Government Code, Chapter 283

Chapter 283 (sometimes called HB 1777) was enacted by the 76th Legislature as a mechanism to increase competition in the telecommunications industry by establishing a uniform method for certified telecommunications providers (CTPs) to compensate municipalities for the use of public rights-of-way. The provisions of this statute went into effect on September 1, 1999. Chapter 26, Subchapter R, contains the Commission's Provisions Relating to Municipal Regulation and Rights-Of-Way Management.

A CTP has to apply for a certificate from the PUC. A CTP is any telecommunications provider that has been granted one of the following certificates by the PUC to provide telecommunications services in Texas:

- COA - Certificate of Operating Authority
- SPCOA - Service Provider Certificate of Authority
- CCN - Certificate of Convenience and Necessity

As of March 1, 2000, all telecommunications franchise fees in Texas are required to be based on a fee-per-access line method. The PUC, in October 1999, established three categories of access lines - residential, non-residential, and point-to point.

The three types of access lines are:

- Category 1 - Residential
- Category 2 - Non-Residential
- Category 3 - Point-to-Point

Category 1 shall include both analog and digital residential switched access lines and any other access line that provides residential voice service. It shall also include point-to-point private lines, whether residential or non-residential, only to the extent such lines provide burglar alarm or other similar security services.

Category 2 shall include all analog and digital non-residential switched access lines and any other access line that provides non-residential voice service.

Category 3 shall include all other point-to-point private lines, whether residential or non-residential, not otherwise included within category 1.

CTPs must submit a quarterly access line update with increases or decreases and must compensate the municipality accordingly.

## BREAKDOWN OF A CUSTOMER'S BILL

Customers sometimes have difficulty interpreting a cable bill and do not understand what all the charges mean. Following is a brief summary of all the charges on a Verizon's customer's bill, some of the charges are a flat rate while others are based on a percentage:

**Federal USF** - A monthly, per-line surcharge paid by the customer to recover local companies' contribution to the Federal Universal Service Fund. This fund supports telecommunications and information services in schools, public

libraries, and rural health-care facilities. The fund also subsidizes local service to high-cost areas and low-income customers. The FCC regulates this charge.
The Federal Universal Service Fund (FUSF) rate is reviewed quarterly. This fee helps to keep local telephone rates affordable for all customers and gives a discount to schools, libraries and low-income families.

**State USF Surcharge –** The surcharge(s) on services to support universal service. The fees on customer bills fund subsidies to high-cost area telephone companies, and programs for schools and libraries, rural health care, and low-income consumers.

**Franchise Fee –** Fee imposed to customers for a holder of a state-issued certificate of franchise authority to pay a municipality in which it provides cable service or video service.

**Regulatory Recovery Fee –** Revenues generated from this tax are used to appropriate funds to the PUC and the Office of Public Utility Counsel (OPUC).

**Equalization Surcharge –** This surcharge generates additional funds for regions that do not collect sufficient funds through the 9-1-1 emergency service fee. The state 9-1-1 advisory commission imposes this surcharge on customers receiving intrastate long-distance service.

**State USF Surcharge** - Longstanding public policy that all Americans should have access to phone service at a reasonable cost. Also, the financial mechanism that compensates companies for providing telecommunications services, especially in rural, insular and high-cost areas.

**Municipal Telecommunications Surcharge** - A fee assessed for the privilege of using the municipal public rights-of-way. This fee provides the municipality the funds needed to recover the cost of administering the access to the right-of-way. Typical costs included are for inspection, permit processing, engineering, traffic, and other such expenditures that the municipality incurs to manage the health and safety of its citizens, as utility companies work in the right-of-way. The fee is generally either an amount per telephone access line or a percentage of revenue.

**Local 911 Fee** - The 911 Emergency Service Fee is a fee to cover the costs of local jurisdictions providing 911 emergency response services to its citizens. The fee is generally either an amount per telephone access line or a percentage of revenue. State law mandates the fee.[1]

[1]www.puc.state.tx.us

## Management Accomplishments

Financial Services has tracking procedures in place to ensure that each franchisee remit fees when they become due. Financial Services maintains a franchisee contact list and communicates with each franchise on a periodic basis.

# Opportunities for Improvement

During our audit we identified certain areas for improvement. Our audit was not designed or intended to be a detailed study of every relevant system, procedure, and transaction. Accordingly, the Opportunities for Improvement section presented in this report may not be all-inclusive of areas where improvement might be needed.

| Finding # | Condition (The way it is) | Criteria (The way it should be) | Cause (Difference between condition & criteria) | Effect (So what?) | Recommendation | Management Response |
|---|---|---|---|---|---|---|
| 1 (Obj. 1.B) | Time Warner is not submitting a summary explaining the basis for the calculation of franchise fees as it is stipulated in Chapter 66. | Chapter 66. State-Issued Cable and Video Franchise agreement states in Section 66.005. Franchise Fee. (b) "The franchise fee payable under this section is to be paid quarterly, within 45 days after the end of the quarter for the preceding calendar quarter. Each payment shall be accompanied by a summary explaining the basis for the calculation of the fee." | Time Warner only submits their "gross revenues" without any detail as to what makes up the "gross revenues." | Not providing a break down of what makes up the "gross revenues" makes it difficult to verify the numbers from one month to the next. If Time Warner provides a break down like they did for our review, it would allow the City of Garland to determine where the revenues are increasing or decreasing and the reasonableness of what was reported. | The Managing Director of Financial Services should communicate to Time Warner that they need to provide a more detailed summary of what makes up the "gross revenues" that they report to us. | Financial Services will verify that reported gross revenues are in compliance with Utilities Code Chapter 66 Sec.66.002 (B) (i). Financial Services will request detailed gross revenue data from Time Warner for the current fiscal year and for as many prior years the data is available. Financial Services will have Time |

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|---|---|---|---|---|---|---|
| | | | | | | Warner's response by May 31, 2010. |
| 2 (Obj. 1.B) | Time Warner is not complying with Utilities Code Chapter 66 when reporting "gross revenues." Their reporting method is on the accrual basis and not the cash basis. | Utilities Code Chapter 66. State-Issued Franchise Sec. 66.002 (B) states: For purposes of this section, "gross revenues" does not include: (i) any revenue not actually received, even if billed, such as bad debt | Time Warner reports on the Accrual Basis rather than the Cash Basis | • Reporting on the cash basis would be easier to audit since cash received is easier to verify than net income and bad debt expense.<br>• There would be less manipulating gross revenues incorrectly and estimating bad debts since Time Warner would only report on what was received.<br>• There is also non-compliance of Chapter 66 when reporting on the accrual | Management should ensure that Time Warner reports their "gross revenues" on what was actually received as it is stipulated on Utilities Code Chapter 66 Sec. 66.002 (B) (i). | Financial Services will discuss with the City Attorney current reporting practices for gross revenues. Financial Services will then determine appropriate actions in seeking Time Warner's compliance with Utilities Code Chapter 66.Sec. 66.002 (b) (i). Management Financial Services will have Time Warner's |

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| | | | | basis. | | response by September 30, 2010. |
| 3 (Obj. 1.B) | Time Warner is not complying with Utilities Code Chapter 66 Sec. 66.002 (6) (A) when reporting franchise fees as part of their gross revenues. | Utilities Code Chapter 66. Sec. 66.002 (6) (A) discusses "Gross Revenues" as: (ii) any fee imposed on the holder of a state-issued franchise certificate of franchise authority by this chapter that is passed through and paid by subscribers (including without limitation the franchise fee set forth in this chapter).<br><br>See example below that shows explanation as to how Time Warner is reporting vs. how it should be reported per Chapter 66.[1] | Time Warner should be reporting the franchise fees that were billed to the customers as part of their "gross revenues." | The method that Time Warner is using to report their franchise fees is an estimation which they refer to as a "fee on fee" based on their "gross revenues" and not what was actually billed to the customers. Time Warner could be under or over reporting their "gross revenues" when they use this method instead of what was actually billed. | Management should ensure that Time Warner reports their franchise fees as part of their gross revenues based on what was billed to the customers. | Financial Services will determine appropriate actions in seeking Time Warner's compliance with Utilities Code Chapter 66 Sec.66.002 (6) (A). Management Financial Services will have Time Warner's response by September 30, 2010. |

[1]The following is the comparison as to how Time Warner reports their franchise fees and how it should be reported based on Chapter 66. The 2007 Quarter 3 numbers were used for the comparison.

| | Condition (The Way it Is) | Criteria (The Way it Should Be) |
|---|---|---|
| | **Time Warner** | **Chapter 66** |
| Net Ad Sales | $ 621,504.40 | $ 621,504.40 |
| Shopping | $ 30,563.11 | $ 30,563.11 |
| Cable | $4,457,017.01 | $4,794,899.60[2] |
| Total Revenue Basis | $5,109,084.52 | $5,446,967.11 |
| Franchise Fee 5% | $ 255,454.23 | |
| SICFA 1% | $ 51,090.85 | |
| Total Franchise Fee Basis | $5,415,629.59 | |
| Total Gross Revenue | | $5,446,967.11 |
| Total Franchise Fee Due | $ 270,781.48 | $ 272,348.36 |
| Total SICFA Due | $ 54,156.30 | $ 54,469.67 |
| Total Payments Due | $ 324,937.78 | $ 326,818.03 |
| Difference | | $ (1,880.25) |

[2]Includes $259,672.85 in Franchise Fees and $78,209.74 in SICFA (State-Issued Certificate of Franchise Authority) for a total of $337,882.59.