9

The Tennessee Advisory Commission on Intergovernmental Relations

226 Anne Dallas Dudley Blvd., Suite 508
Nashville, Tennessee 37243-0760
Phone: (615) 741-3012
Fax: (615) 532-2443
www.tn.gov/tacir

MEMORANDUM

TO: Commission Members

FROM: Cliff Lippard
Executive Director

DATE: 30 May 2019

SUBJECT: Cord Cutting and Local Revenue—Draft Report for Review and Comment

The attached Commission report is submitted for your review and comment. It was prepared in response to a request at the January 26, 2018, commission meeting from then-Chairman Mark Norris, who asked the Commission to study the effects of cord cutting on cable television, satellite television, streaming video services, and local government revenue in Tennessee. The draft report examines factors affecting the market for video services; whether changes in this market are affecting local government revenues; and whether changes to the state's tax and fee structure and its cable television franchising laws are warranted.

Subscriber counts for both cable and satellite have been decreasing nationally since 2012. In contrast, those for streaming video services have increased. The ongoing shift away from cable and satellite has garnered much comment both from the media and industry analysts; so much so that the term "cord cutting" is now a common descriptor for the practice of forgoing cable or satellite service in favor of subscribing to their streaming competitors. Many streaming services—including well-known services like Netflix, Hulu, and Amazon Prime Video—allow subscribers to select from a variety of movies, television shows, and other programming, similar to video-on-demand services offered by traditional providers. Some—including PlayStation Vue and Sling TV, among others—now offer internet-delivered packages of the same television channels that have long been provided by cable and satellite. The primary difference for consumers is that access is provided over the internet—though if provided over wired internet connections, the videos are delivered over the same wires that would otherwise deliver traditional cable service.

The trend toward cord cutting will likely continue. Streaming's popularity has grown particularly among younger age groups, with many consumers citing the cost of traditional cable and satellite packages as a primary factor motivating their decision to drop these services. But predictions of cable and satellite's immediate demise may be premature. There were still more than 85 million cable or satellite subscribers nationwide at the end of 2018, and industry analysts expect that the shift away from these services will be gradual.

Although cable, satellite, and streaming each offer video entertainment for personal consumption, there are several variations in the taxes and fees that apply to them in Tennessee. Some of these variations result from exemptions in federal or state law. Others result from providers' business practices. Based on a review of other states and interviews both with representatives of providers and with representatives of local governments, particular attention is given in this study to state and local sales taxes in Tennessee and the compensation that local governments receive through cable television franchise agreements.

Tennessee is one of 17 states that apply sales tax to all three of these video services. Although cable and satellite receive partial sales tax exemptions in Tennessee, both are subject to higher state sales tax rates than streaming services for at least a portion of each customer's monthly bill, which partially offsets the effect of these exemptions. Streaming services are subject to the general state sales tax rate of 7%, but they are subject to a uniform local sales tax rate of 2.5%, instead of the individual local option rates adopted by each jurisdiction (see table).

Sales Tax Rates Applied to Cable Television, Satellite Television, and Streaming Services in Tennessee

		Sales Tax Rate	
		State	Local
Cable TV	portion of monthly bill no greater than $15.00	Exempt	Exempt
	. . . greater than $15.00 but no greater than $27.50	8.25%	Exempt
	. . . greater than $27.50	7.00%	Up to 2.75%
Satellite TV		8.25%	Exempt
Streaming Video		7.00%	2.50%

This results in streaming services being taxed at an effective state and local rate of 9.5%, satellite being taxed at a single state rate of 8.25%, and cable being taxed at an effective state and local rate of approximately 8%—based on its exemptions, the current 2.5%

statewide average of local option rates, and the national average for monthly cable bills in 2018. Total sales tax revenue from these services was approximately $188 million—$157 million in state sales tax and $31 million in local sales tax—in fiscal year 2017-18.

Although cable providers interviewed acknowledged that the sales tax rates and exemptions applied to cable, satellite, and streaming vary, they said any reforms, such as equalizing sales tax rates, should also include changes to the compensation local governments receive through cable franchise agreements. Providers of cable service—but not satellite or streaming—are required to obtain cable franchise agreements for the areas in which they provide service, under federal and state law. As described by the Mackinac Center for Public Policy, a nonprofit organization that advances the principles of free markets and limited government, this

> regulatory treatment is due to cable's need for rights-of-way for their network of wires. Local governments control these rights-of-way and often own the utility poles and other infrastructure used for cable television delivery. Thus, cable operators must negotiate franchise arrangements . . . for access to rights-of-way.

In Tennessee, cable franchise agreements can be issued by

- cities, only for service provided within their municipal boundaries;
- counties, only for service provided within their unincorporated areas; and the
- Tennessee Public Utility Commission (TPUC), for any area.

Local governments commonly receive compensation from cable providers through franchise agreements. Examples of compensation in both locally issued and state-issued franchises include but are not necessarily limited to

- cable franchise fees—which are capped at 5% of providers' gross revenue from cable service under federal and state law;
- both monetary and in-kind support for the production and distribution of public access programming—often referred to as public, educational, and governmental "PEG" programming; and
- other in-kind compensation, such as providing fiber capacity or building dedicated networks for government uses and providing free service to public schools, courts, and other government buildings.

Of the compensation local governments receive through these agreements, franchise fees in particular will be affected by changes in the market for cable services because they are based on a percentage of providers' gross revenue. In Tennessee, cable franchises fees for providers with state-issued franchises are set at 5% of gross revenue from cable service, while those for providers with locally issued franchises are negotiated with local governments but can be no more than the 5% federal cap. These fees are paid directly to the local governments in which providers offer cable service, regardless of whether franchises are state-issued or locally issued. Tennessee is one of 44 states where providers can be required to pay cable franchise fees; the other six states have eliminated them.

In Tennessee, cable franchise fees totaled approximately $53 million in fiscal year 2016-17—based on local government audit data, a TACIR survey of local governments, and TACIR staff calculations—the state does not collect complete information on the amount of franchise fees collected annually. Franchise fees have continued to increase on a statewide basis in recent years, but the rate of increase appears to be slowing, and more cities and counties reported individual decreases in the last two years.

The effect of losing cable franchise fees would vary by local government. All counties and most cities reported franchise fees that accounted for less than 2% of their total revenue in fiscal year 2016-17. But at least eight cities reported fees accounting for more than 5% of their revenue, with one as high as 10%. Even in communities where they make up no more than 1% of revenue, several local officials interviewed said that despite their relatively small contribution to local budgets, franchise fees are "not an insignificant" revenue source, though one noted that decreases could be budgeted for "as long as they were gradual." Most local governments allocate cable franchise fee revenue to their general funds; however, several appear to be using it to fund services, including education, that have maintenance of effort requirements.

Providers disagree about whether increasing competition in the video industry warrants changes in the compensation that can be required in cable franchise agreements. Prior efforts to resolve industry concerns that franchise fees were too high have balanced the interests of providers and those of local governments. Citing similar goals, the US Congress capped cable franchise fees at 5% of gross revenue in 1984. The federal cap has remained unchanged, though the Federal Communications Commission (FCC) is considering a proposed rule that could reduce the overall amount of compensation some local governments receive through their franchise agreements. The proposed rule would clarify that much of the other compensation some local governments currently receive—including in-kind compensation and a portion of the support for PEG programming—must be counted toward the 5% franchise fee cap.

A review of other states' laws identified several alternatives to Tennessee's current tax and franchise fee framework. Some of these alternatives include

- authorizing cable providers to credit at least some of their franchise fees against state taxes;
- adopting new sales taxes with approximately equal rates on cable, satellite, and streaming services in lieu of a other taxes and fees on these services, including cable franchise fees; and
- replacing cable franchise fees with other right-of-way use fees that aren't calculated as a percentage of gross revenue from cable service.

Because each of these alternatives would either impose costs on the state or its local governments or increase taxes on cable's competitors that don't deploy infrastructure in public rights-of-way, because franchise fees originated as a means to compensate local governments for cable providers' use of public rights-of-way, because the FCC's proposed rule changes could reduce compensation for some local governments if they take effect, and because the effective combined state and local sales and use tax rates that currently apply to cable, satellite, and streaming in Tennessee are already similar to each other, **the draft report doesn't recommend any immediate changes to Tennessee's cable franchising laws or its tax and fee structure.**

However, because it is likely that revenue from cable franchise fees will decrease in the future if industry trends continue, **the draft report instead recommends that local governments should consider no longer using this revenue to fund government services that have maintenance of effort requirements.**

Although the draft report recommends no immediate changes to the state's cable franchising laws or its tax and fee structure, numerous concerns raised by commission members, providers, local officials, and others interviewed warrant further study, in part because no state appears to have a comprehensive, ready-made solution to them. Each of the issues identified are described in the draft report, which proposes that the Commission evaluate these issues in the update to its 2017 broadband report required by the Tennessee Broadband Accessibility Act (Public Chapter 228, Acts of 2017), which is due in January 2021.