State of California

Board of Equalization
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Memorandum

To: Honorable Judy Chu, Ph.D., Chair
Honorable Betty T. Yee, Vice Chairwoman
Honorable Bill Leonard
Honorable Michelle Steel
Honorable John Chiang

Date: March 7, 2008

From: Kristine Cazadd *Kristine Cazadd*
Chief Counsel

Subject: **Status Report on Cable Television PropertyAssessment Issues**
March 19, 2008, Board Meeting – Chief Counsel Matters – Item L

Under the recently enacted Digital Infrastructure and Video Competition Act of 2006 (DIVCA), local cable television operators are required to obtain a state franchise when an existing franchise expires, and have the option of obtaining a state franchise prior to the expiration of an existing local franchise under certain circumstances. Obtaining a state franchise terminates any existing cable television taxable possessory interests and creates a new cable television taxable possessory interest. This will result in change in ownership under Proposition 13 and a consequent revaluation or reappraisal by the county assessors of such newly created taxable possessory interests in rights-of-way on government-owned land at fair market value.

At the February 1, 2008 Board meeting, the Board discussed an alleged lack of uniformity in the valuation of local-assessed cable television taxable possessory interests and requests from cable television industry representatives for guidance. The Board also directed staff to prepare an introductory overview of federal and state legal principles applicable to the assessment of cable television possessory interests (See attached memorandum dated March 7, 2008, entitled *Cable Television Taxable Possessory Interest Assessment Issues: Introductory Overview of Applicable Federal and State Legal Principles* (hereafter, Memorandum).)

The specific questions asked by the Board and a summary of the conclusions reached by Board staff are as follows:

1. What is the scope of the cable television franchise fee arising from the *Brand X*[1] case and other law in this area? Specifically, are broadband revenues prohibited from being included when calculating a franchise fee? If this issue is not well-settled, explain.

[1] *Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Svcs.* (2005) 545 U.S. 967 (hereafter *Brand X*).

Conclusion: While the issue is not definitively settled and is currently being disputed in courts in other states, it appears from federal regulatory agency rulings that the base upon which a cable television franchise fee is measured cannot legally include revenues from broadband Internet service. California law, under the Digital Infrastructure and Video Competition Act of 2006 (DIVCA), appears to be consistent with respect to the calculation of a cable franchise fee being limited to "cable service" revenues. Therefore, in the future, it is likely that all cable franchise fee rentals paid to California governmental franchisors will be equal to 5 percent or less of cable video service gross revenues. (See Memorandum, at p. 7.)

2. If broadband revenues cannot be included in a franchise fee, what are the implications for applying the preferred valuation method for taxable possessory interests set forth in subdivision (b)(1) of section 107.7[2] of the Revenue and Taxation Code?

   Conclusion: Given that franchise fees will be limited to 5 percent of cable video revenues, if an assessor chooses to apply the preferred method under Revenue and Taxation Code section 107.7, then the contract rentals to be capitalized under the income approach to valuing the cable TV taxable possessory interest generally also will be limited to 5 percent of cable video revenues, and broadband Internet revenues will be excluded. The implication for an assessor that elects nonetheless to consider broadband revenues in his or her valuation of the property is the loss of the presumption of correctness. (See Memorandum, at p. 14.)

3. If broadband revenues cannot be included in the franchise fee, what are the implications for the calculation of economic rent under section 107.7, subdivision (b)(2)?

   Conclusion: If the revenue base upon which a franchise fee is calculated cannot legally include revenues from broadband services, then the issue arises as to whether or not the contract rent for the government rights-of-way that convey both cable video and broadband signals – yet are limited to exclude consideration of the broadband revenues – properly may be found to approximate economic rent for property taxation purposes. (See Memorandum, at p. 18.)

As indicated above, representatives of the cable television industry have alleged a lack of uniformity in the assessment of cable television possessory interests. To address uniformity concerns, staff has identified three approaches described below, and is proceeding with the second approach:

1. Provide no guidance at this time, pending resolution of the legal dispute by the cable industry, county assessors, assessment appeals boards in the courts.

[2] Unspecified references to various codes (e.g. Revenue and Taxation Code and Public Utilities Code) are to California law. Unspecified section references are to the Revenue and Taxation Code unless the context otherwise requires.

2. Publish a Letter to Assessors (LTA) providing specific guidance. Board staff is currently drafting an LTA providing such guidance, which will be available for the Board's review and comment at the April 8-10, 2008 Board Meeting.

3. Initiate a rulemaking process to amend Property Tax Rule 21 to specifically address the valuation of cable television taxable possessory interests.

If you have any questions regarding this matter, please contact Robert Lambert, Acting Assistant Chief Counsel at (916) 324-6593 or Carole Ruwart, Tax Counsel III (Specialist) at (916) 322-3682.

Approved:
Ramon J. Hirsig
Executive Director

KC/CR/ef
ChiefCounsel/Finals/CableTelevision Status Report
Prop/Prec/CABLETEL/CableTelevision Status Report

Attachment

cc: (w/attachment)

Mr. Ramon J. Hirsig	MIC:73
Mr. David Gau	MIC:63
Mr. Dean Kinnee	MIC:64
Mr. Todd Gilman	MIC:70
Mr. Robert Lambert	MIC:82
Ms. Carole Ruwart	MIC:82

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To: Honorable Judy Chu, Ph.D., Chair
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Honorable Bill Leonard
Honorable Michelle Steel
Honorable John Chiang

Date: March 7, 2008

From: Robert Lambert
Acting Assistant Chief Counsel
Tax & Fee Programs Division

Robert Lambert

Subject: **Cable Television Taxable Possessory Interest Assessment Issues: Introductory Overview of Applicable Federal and State Legal Principles**

At the February 1, 2008 Board meeting, the Board requested that the Legal Department provide background information and an introductory overview of the following cable television-related local property assessment legal issues:

1. What is the scope of the cable television franchise fee arising from the *Brand X*[1] case and other law in this area? Specifically, are broadband revenues prohibited from being included when calculating a franchise fee? If this issue is not well-settled, explain. (See p. 7.)

2. If broadband revenues cannot be included in a franchise fee, what are the implications for applying the preferred valuation method for taxable possessory interests set forth in subdivision (b)(1) of section 107.7[2] of the Revenue and Taxation Code? (See p. 14.)

3. If broadband revenues cannot be included in the franchise fee, what are the implications for the calculation of economic rent under section 107.7, subdivision (b)(2)? (See p. 18.)

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[1] *Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Svcs.* (2005) 545 U.S. 967 (hereafter *Brand X*).
[2] Unspecified references to various codes (e.g. Revenue and Taxation Code and Public Utilities Code) are to California law. Unspecified section references are to the Revenue and Taxation Code unless the context otherwise requires.

Executive Summary

Set forth below is a summary of some of the key points set forth in the body of this memorandum:

Cable Television Franchise Fees

While the issue is not definitively settled and is currently being disputed in courts in other states, it appears from federal regulatory agency rulings that the base upon which a cable television franchise fee is measured cannot legally include revenues from broadband Internet service. These federal agency rulings are determinative unless state law specifies to the contrary. California law, under the Digital Infrastructure and Video Competition Act of 2006 (DIVCA), appears to be consistent with respect to the calculation of a cable franchise fee being limited to "cable service" revenues. Therefore, in the future, it is likely that all cable franchise fee rentals paid to California governmental franchisors (i.e., contract rentals) will be equal to 5 percent or less of cable video service gross revenues. Federal law provides that a franchise fee does not include "any tax, fee, or assessment of general applicability (including any such tax, fee, or assessment imposed on both utilities and cable operators or their services but not including a tax, fee, or assessment which is unduly discriminatory against cable operators or cable subscribers)."

Taxable Possessory Interest Property Tax Assessments of Cable Television Rights-of-Way Over Government-Owned Land

- When local cable TV franchisees obtain state franchises, this will terminate their prior taxable possessory interests and create new taxable possessory interests. This will result in change in ownership under Proposition 13 and a consequent revaluation or reappraisal by the county assessors of such newly created taxable possessory interests in rights-of-way on government-owned land at fair market value.

- The California Constitution requires that all real property be assessed at fair market value (or factored base year value, if lower, under Proposition 13.) The Board's regulations and California case law provide that, in appraising real property value, the assessor must use the most accurate and applicable appraisal methodology – or combination of methodologies – in order to approximate fair market value as closely as possible. The type of methodology or methodologies employed by the appraiser is within his or her best professional judgment and discretion after taking into consideration all the facts and circumstances, including the economic and regulatory market, the characteristics of the property in question, and the available data. Therefore, to mandate the use of only one valuation approach regardless of the facts or circumstances as they exist on the lien date is to risk violating the Constitutional mandate of fair market valuation.

- When an assessor applies the income approach using property rentals, the actual contract rentals paid to the landlord generally may only be utilized to the extent that they approximate economic or market rent for the property. If the contract rentals are found to be materially above or below market rents, then the assessor may instead use market data to determine the appropriate economic rent for the property and use that in calculating the income approach value indicator. ("Economic rent" as defined by California law and the Board's regulations generally must approximate the "market value" rent that theoretically would be agreed upon in an arms-length negotiation between two knowledgeable parties, neither of whom is acting under duress.)

- Given that franchise fees will be limited to 5 percent of cable video revenues, if an assessor chooses to apply the so-called preferred method under Revenue and Taxation Code section 107.7, then the contract rentals to be capitalized under the income approach to valuing the cable TV taxable possessory interest generally also will be limited to 5 percent of cable video revenues. In that circumstance, broadband Internet revenues will be excluded.

- If the revenue base upon which a franchise fee is calculated cannot legally include revenues from broadband services, then the implication for the assessor that elects nonetheless to consider broadband revenues in his or her valuation of the property is the loss of the presumption of correctness. (This means that the assessor must come forward and present evidence of the validity of the assessment.)

- If the revenue base upon which a franchise fee is calculated cannot legally include revenues from broadband services, then the issue arises as to whether the contract rent for the government rights-of-way intended to convey both cable video and broadband signals – yet limited to exclude consideration of the broadband revenues – properly may be found to approximate economic rent for property taxation purposes. This issue is being litigated in at least one California court and is an issue in pending assessment appeals in several counties. We note that Board staff has previously opined that, with respect to cable television possessory interests subject to the franchise fee cap, the franchise fee does not necessarily approximate the economic rent that is appropriate for capitalization under an income approach to value.

Background Information

Converging Markets: Voice, Video, and Internet

Advances in technology have resulted in a convergence of services offered by cable operators and telephone companies. Cable operators have begun offering broadband Internet access and voice service over their cable networks and telephone companies either are now providing – or will soon be ready to provide – Internet and video[3] services over their networks.

[3] For simplicity, this memorandum will sometimes refer to video services comparable to broadcast television as "video," whether provided by cable operators or telephone companies. However, the relevant statutory, regulatory and judicial authorities use varying terms, including "cable television," "cable service," and "video programming," depending on the provider of the service and the regulatory scheme involved.

Given these advances, the expected future trend is for both cable and telephone companies to deliver a "triple play" of voice, video, and broadband Internet access over physical networks consisting of lines, conduits, and equipment installed in public rights-of-way. (Federal Comm. Com., 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, *Report and Order* (72 Fed. Reg. 13189 (March 21, 2007) ¶ 2) (hereafter *First Franchising Report and Order*).)

The Federal Communications Commission (FCC), which is responsible for federal regulation of both telephone companies and cable operators, recently summarized its view with respect to the current and expected future market environment:

> Market conditions today are far different from when incumbent cable operators obtained their franchises. Incumbent cable providers were frequently awarded community-wide monopolies. (*First Franchising Report and Order* at ¶ 87.) . . . .[N]ew cable entrants must compete with entrenched cable operators and other video service providers. A competing cable provider that seeks to offer service in a particular community cannot reasonably expect to capture more than a fraction of the total market." (*First Franchising Report and Order* at ¶ 88.)
>
> New entrants' video offerings thus directly affect their roll-out of new broadband services. Revenues from cable services are, in fact, a driver for broadband deployment. (*First Franchising Report and Order* at ¶ 13.). . . .We also conclude that broadband deployment and video entry are 'inextricably linked' [fn. omitted.] and that. . . .the record demonstrates that broadband deployment is not profitable [for traditional telephone companies] without the ability to compete with the bundled services that cable companies provide. (*First Franchising Report and Order* at ¶ 51.)

Federal Law

For purposes of federal law, Congress has defined three categories of service that roughly correspond to the "triple play" components: cable service, telecommunications service, and information service.

One, "cable service" is defined as "(A) the *one-way transmission* to subscribers of (i) *video programming*, or (ii) other programming service, and (B) subscriber interaction, if any, which is required for the selection or use of such video programming or other programming service." (47 U.S.C.A. § 522(6).) (Emphasis added.) California law imports this definition into DIVCA. (Pub. Util. Code, § 5830, subd. (c).) Video programming is defined under federal law as "programming provided by, or generally considered comparable to programming provided by, a television broadcast station." (47 U.S.C.A. § 522(20).)

Two, "telecommunications" is defined as "the transmission, between or among points specified by the user, of information of the user's choosing, *without change in the form or content of the information as sent and received*." (47 U.S.C.A. § 153(43).) (Emphasis added.) "Telecommunications service" is defined as "the offering of telecommunications for a fee directly to the public, or to such classes of users as to be effectively available directly to the public, regardless of the facilities used." (47 U.S.C.A. § 153(46).)

Three, an "information service" is defined as "the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information via telecommunications, and includes electronic publishing, but does not include any use of any such capability for the management, control, or operation of a telecommunications system or the management of a telecommunications service." (47 U.S.C. § 153(20).)[4]

We note that none of the definitions specifically mentions Internet broadband services.

<u>California Law</u>

The California Legislature recently passed Assembly Bill 2987 (Stats. 2006, ch. 700), thereby enacting the Digital Infrastructure and Video Competition Act of 2006 (DIVCA).[5]

DIVCA contains several explicit statements of legislative intent that are pertinent to interpreting its provisions. Among other purposes, DIVCA was enacted to:

- Create a fair and level playing field for all market competitors that does not disadvantage or advantage one service provider or technology over another;[6]

- Protect local government revenues and control of public rights-of-way; and

- Complement efforts to increase investment in broadband infrastructure and close the so-called "digital divide."

(Pub. Util. Code, § 5810, subd. (a)(2).)

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[4] California law does not have a comparable definition.

[5] In 2007, the Legislature passed and the Governor signed Assembly Bill 1715 (Stats. 2007, ch. 123), which made "technical, nonsubstantive, clarifying, and conforming changes" (*id.* at § 2), including changes to the numbering of subdivision (a) of section 5830 of the Public Utilities Code. References in this memorandum to DIVCA provisions are to the amended version effective January 1, 2008.

[6] The Legislature further explained that "Providing an incumbent cable operator the option to secure a state-issued franchise through the preemption of an existing cable franchise between a cable operator and any political subdivision of the state, including, but not limited to, a charter city, county, or city and county, is an essential element of the new regulatory framework established by this act as a matter of statewide concern to best ensure equal protection and parity among providers and technologies, as well as to achieve the goals stated by the legislature in enacting this act. (Pub. Util. Code, § 5810, subd (a)(4).)

To achieve these ends, DIVCA does the following with respect to the provision of cable and video services:

- Makes the California Public Utilities Commission (CPUC) the sole franchising authority for cable and video service operators. (Pub. Util. Code, § 5840, subd. (a).)
- Requires the CPUC to begin accepting applications for state-issued franchises no later than April 1, 2007. (Pub. Util. Code, § 5840, subd. (g).)
- Requires any entity that does not have a local license in place by January 1, 2008 to obtain a state-issued franchise in order to provide service. (Pub. Util. Code, § 5840, subd. (c).)
- Allows holders of existing local franchises the option of either: (1) operating under their local franchise until the local franchise expires; or (2) obtaining a new statewide franchise prior to expiration of the existing franchise: (i) if a different company holding a state franchise begins to offer video service in the same geographical area or (ii) by mutual agreement with the franchising authority. (Pub. Util. Code, § 5840, subd. (o).)
- Provides that a state-issued franchise shall be valid for 10 years, at which point the holder must renew the franchise if it elects to continue offering video service. (Pub. Util. Code, § 5850, subd. (a).)
- For the use of locally controlled public rights-of-way, requires the holder of a state franchise to pay as rent to each local governmental entity where it provides video service a <u>franchise fee</u> based on <u>gross revenues derived from cable television or video programming</u>. (Pub. Util. Code, § 5840, subd. (q)(1) and § 5860, subds. (a) & (d).)[7] <u>Notably, gross revenues do not include revenues from "noncable services" under federal law or FCC rule, regulation, standard or order.</u> (Pub. Util. Code, § 5860, subd. (e)(3).) (Emphasis added.)
- For all holders of state franchises, establishes requirements with respect to the amount of public, educational, and government programming (i.e., "PEG"), the funding for the support of "I-net" service,[8] and forbidding discrimination against consumers based on income. (Pub. Util. Code, §§ 5870, 5890.)

Over time, all cable television operators and other video service providers, including regulated telephone companies, are expected to operate under franchises issued not by local government, but instead by the state Public Utilities Commission (CPUC). We understand that many cable companies will be applying for statewide franchises. The first date that a statewide franchise granted to an incumbent cable company can be effective is January 2, 2008. (Pub. Util. Code, § 5930, subd. (b).)

One significant DIVCA property tax implication for locally assessed cable operators obtaining new state franchises is that such new franchises legally will create new taxable

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[7] Further intent regarding the franchise fee is found in subdivision (d) of section 5810, which states that "the definition of gross revenues in this division shall result in local entities maintaining their existing level of revenue from franchise fees."

[8] A data, video, and/or voice network used by the United States Government, schools, and non-profit institutions; hence called an Institutional Network or I-Net.

possessory interests, resulting in widespread changes in ownership under "Proposition 13," and consequent reassessments of the taxable possessory interests created by the new state franchises. (See Rev. & Tax. Code, § 61, subd. (b); see also Property Tax Rule[9] 462.080.) We understand that many of the major cable operators may choose to obtain a statewide franchise before the normal expiration of their local franchises, thereby accelerating the property tax impact of such reassessments.

Introductory Analysis Of Legal Issues

Question 1: What is the scope of the cable television franchise fee arising from the *Brand X* case and other law in this area? Specifically, are broadband revenues prohibited from being included in a franchise fee? If this issue is not well-settled, explain.

In general, under federal and state law, no one may provide cable television service without a franchise issued by the local governmental entity in whose jurisdiction the operator wishes to provide cable television service. (47 U.S.C.A. § 541, subd. (b)(1); Govt. Code, § 53066, subd. (e).)

What is a Cable Television Franchise?

Federal law. Under federal law, a franchise required for provision of cable television service is defined as:

an initial authorization, or renewal thereof (including a renewal of an authorization which has been granted subject to section 546 of this title), issued by a franchising authority, 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.

(47 U.S.C.A. § 522(9).)

State law. Under DIVCA, the definition of a franchise is similar, except that the authorization is not limited to the "construction or operation of a cable system," but is expanded to include any franchise that "authorizes the construction and operation of any network in the right-of-way capable of providing video service to subscribers." (Pub. Util. Code, § 5830, subd. (f).) (Unless otherwise indicated, and for purposes of this memorandum only, all references to DIVCA will include video service providers, not just cable operators.)

[9] All subsequent references to "Rules" are to the Property Tax Rules promulgated under title 18 of the California Code of Regulations.

What is a Franchise Fee?

Jurisdictions granting franchises[10] are allowed to negotiate compensation from franchisees for use of public rights-of-way. Such compensation generally is known as a "franchise fee." Under state and federal law, the maximum amount of the franchise fee that may be negotiated for a cable television franchise is limited to 5 percent of "gross revenues," as defined by statute, regulatory interpretation, and judicial holdings.

Federal law. Under federal law, a 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.

(47 U.S.C.A. § 542(g)(1).)

All such taxes and fees from governmental entities are added together to determine whether the 5 percent maximum has been reached.

Federal law, however, expressly clarifies that a franchise fee does *not* include, among other things:

> any tax, fee, or *assessment of general applicability* (including any such tax, fee, or *assessment imposed on both utilities and cable operators* or their services *but not including a tax*, fee, or assessment *which is unduly discriminatory against cable operators* or cable subscribers).

(*Id.* at § 542(g)(2)(A). (Emphasis added.)

State law. Under DIVCA, a franchise fee is defined as "the fee adopted pursuant to Section 5840." (Pub. Util. Code, § 5830, subd. (g).) Under subdivision (q)(1) of section 5840, DIVCA provides that "[t]here is hereby adopted a state franchise fee payable as rent or a toll for the use of the public rights-of-way by holders of the state franchise issued pursuant to this division." The Legislature explained its intent that:

> [A] video service provider shall pay as rent a franchise fee to the local entity in whose jurisdiction service is being provided for the continued use of streets, public facilities, and other rights-of-way of the local entity in order to provide service. The Legislature recognizes that local entities should be compensated for

[10] Under federal law, a franchising authority is defined as "any governmental entity empowered by Federal, State, or local law to grant a franchise." (47 U.S.C.A. § 522(10).) Under DIVCA, a "local franchising entity" is defined as "the city, county, city and county, or joint powers authority entitled to require franchises and impose fees on cable operators, as set forth in Section 53066 of the Government Code." (Pub. Util. Code, § 5830, subd. (k).) The FCC sometimes refers to such entities as "local franchising authorities" or LFAs.

> the use of the public rights-of-way and that the franchise fee is intended to compensate them in the form of rent or a toll, similar to that which the court found to be appropriate in *Santa Barbara County Taxpayers Association v. Board of Supervisors for the County of Santa Barbara* (1989) 209 Cal.App.3d 940.
>
> (Pub. Util. Code, § 5810, subd. (b).) (Italics added.)
>
> The *Santa Barbara* court explained that:
>
> Franchise fees are paid as compensation for the grant of a right of way, not for a license or tax nor for a regulatory program of supervision or inspection. [cits. om.] . . . . In sum, franchise fees are paid for the governmental grant of a relatively long possessory right to use land, similar to an easement or a leasehold, to provide essential services to the general public. . . . Although franchises may be taxed like other forms of property, fees paid for franchises are not taxes, user fees or regulatory licenses. . . . . Consequently, franchise fees collected for grants of rights of way are not 'proceeds of taxes' under article XIII B, section 8, subdivision (c). These fees are not user fees or charges, nor are they for regulatory licenses.

(*Santa Barbara*, at pp. 949-950).

Calculation of the Franchise Fee

Federal law provides that the amount of the franchise fee payable by any cable operator for any 12-month period may not exceed 5 percent of the cable operator's "*gross revenues* derived in such period from the operation of the cable system *to provide cable services*." (47 U.S.C.A. § 542(b).) (Emphasis added.) Unlike California law under DIVCA, "gross revenues" are not federally defined by statute. Furthermore, generally under federal law, neither the FCC nor any other federal agency may regulate the "amount" of the franchise fee or the "uses of funds" derived from such fees. (47 U.S.C. § 542(i).) However, the FCC has, under its general rulemaking authority, defined the types of revenues that are included in and excluded from the gross revenues from cable services upon which the 5 percent maximum fee is measured.

Gross Revenues Upon Which a Franchise Fee is Measured

Federal law. In several rulemaking documents,[11] the FCC has addressed the scope of the gross revenues that are properly includable in the calculation of a franchise fee. In 2002, the FCC issued an interpretive ruling declaring that broadband Internet access provided by cable companies was an "information service," and not a "cable service" or a "telecommunications

[11] Inquiry Concerning High-Speed Access to the Internet Over Cable and Other Facilities, 17 FCC Rcd 4798 (2002) (hereafter *Cable Modem Service Ruling*); *First Franchising Report and Order*; and Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Consumer Protection Act of 1992, *Second Report and Order* (72 Fed. Reg. 65670 (Nov. 23, 2007).)(hereafter *Second Franchising Report and Order*.)

service" as defined under relevant federal law,[12] and further declared that gross revenues derived from cable modem service (i.e. broadband Internet service provided by cable operators) should not be included when determining the amount of a franchise fee. (*Cable Modem Service Ruling*, ¶¶ 39, 40, 43, 60, & 105.) This ruling was appealed by a number of Internet service providers (ISPs) and other interested parties, including the "Brand X Internet Service," and eventually the portion of the ruling classifying cable modem service as not a "telecommunications service" was considered by the United States Supreme Court.

The Brand X Case and Subsequent Administrative Action and Litigation

Brand X. In 2005, the United States Supreme Court held that the portion of the *Cable Modem Service Ruling* declaring that broadband Internet access provided by cable companies is considered an "information service," and not a "telecommunications service" that would subject cable television companies to common carrier requirements under Title II of the Communications Act of 1934, as amended by the Telecommunications Act of 1986, was a reasonable interpretation of federal law that would not be overturned by the court. (*Brand X* at p. 997.)

This portion of the *Cable Modem Service Ruling* was reviewed under the deferential standard set forth in *Chevron U.S.A. v. Natural Resources Defense Council* (1984) 467 U.S. 837 (hereafter *Chevron*). (*Brand X* at p. 980.) *Chevron* describes a two-step analysis that was applied by the court in *Brand X*:

- If the statute's plain terms directly address the precise question at issue, then the court "must give effect to the unambiguously expressed intent of Congress." (*Chevron* at p. 842-843.)

- If a statute is ambiguous on the point, however, deference to the agency's interpretation is applicable if the agency's interpretation is a "permissible construction" of the statute (*id.* at p. 843), even if the agency's interpretation is not, in the judgment of the court, the "best statutory interpretation." (*Brand X* at p. 980.)

The court found that the relevant portion of the statute was sufficiently ambiguous and the FCC's interpretation was reasonable, so the FCC's regulatory classification was permissible under the *Chevron* standard of review.

Subsequent administrative action and litigation. Shortly after the *Brand X* decision, the FCC declared that broadband Internet services provided by telephone companies ("wireline" broadband service or more commonly referred to as "DSL") was now classified as an "information service" without a separate telecommunications component, and that, therefore, common carrier burdens (such as third-party access to the telephone companies' broadband

[12] As indicated above, Congress defined "cable service" and "information service" without specific reference to broadband Internet access.

facilities) would be removed. (*Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities* (2005) 20 F.C.C.R. 14853, ¶ 14.) (Hereafter, *Wireline Broadband Order*.) A judicial challenge to this change in regulatory classification was recently decided by the Third Circuit Court of Appeals, which followed the *Brand X* analysis and upheld the FCC's declaration as a permissible interpretation of statute and a proper exercise of agency discretion. (*Time Warner Telecom, Inc. v. FCC* (3rd Cir. 2007) 507 F.3d 205, 224.)

We note, however, that one state's appellate court has held that the *Brand X* court's upholding of the FCC's regulatory classification of cable-provided broadband Internet service is not binding on that state's interpretation of its own law characterizing cable modem service for special or excise tax purposes. (*Community Telecable of Seattle, Inc. v. The City of Seattle* (2006) 136 Wn. App. 169, 149 P.3d 380.) (Hereafter *Community Telecable*.) In *Community Telecable*, the City of Seattle was not required to refund telephone utility taxes paid by a cable company on account of the inclusion of broadband Internet service revenues in the tax base. The court held that state law (unlike the FCC's interpretation of federal law) provides that broadband Internet service includes a distinct component of "data transmission," and therefore falls under the state's definition of "network telephone service" and is subject to a municipal telephone utility tax imposed on data transmission via a cable system. (*Community Telecable*, 136 Wn. App. At 177-179.) The court stated that:

> Comcast argues that under *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. 967,125 S. Ct. 2688, 162 L. Ed. 2d 820 (2005), the data transmission component of its Internet provision cannot be separated from the Internet services it offers. Comcast's reliance on *Brand X* is misplaced because Brand X is not binding on a Washington court interpreting Washington law. In Brand X, the Court considered whether the Federal Communications Commission's classification of broadband cable modem service under the federal Telecommunications Act of 1996, 47 U.S.C. § 609, as an "information service" rather than a "telecommunications service" was reasonable under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 104 S. Ct. 2778, 81 L. Ed. 2d 694 (1984) and the federal Administrative Procedures Act, 5 U.S.C. §§ 551-559. *Brand X*, 545 U.S. at 967. It did not consider whether data transmission was inseparable from Internet service under Washington law. It also did not address whether, under federal law, states and local governments can tax revenue from cable modem service as a network telephone service.

(*Community Telecable*, 136 Wn. App. at 180-181.)

Community Telecable has been appealed. Nevertheless, the significance of this case is that it indicates that it has not been determined with finality that the *Brand X* decision precludes the states from individually enacting their own respective regulatory definitions – and then imposing taxes upon broadband Internet service revenues in accordance with such definitions.

It is significant to note that the *Brand X* decision did *not* address the portion of the *Cable Modem Service Ruling* declaring that revenues derived from broadband Internet access service could not properly be included in measuring local franchise fees. For this reason, the relevance of *Brand X* to this question has become the subject of active litigation in at least one state outside of California.[13] In 2007, in a case that is now on appeal, a state appellate court in Illinois reversed a motion to dismiss the claim of the City of Chicago, which argued that it was entitled under its franchise agreements to receive a franchise fee of 5 percent of gross revenues attributable to broadband Internet service revenues. (*City of Chicago v. Comcast Cable Holdings, LLC* (2007) 375 Ill.App.3d 595.) (Hereafter *City of Chicago v. Comcast.*) The court found *Brand X* irrelevant to the issue of whether or not franchise fees may be charged on broadband revenues:

> Brand X did not resolve the matter of applicability of franchise fees to cable modem service. The United States Supreme Court denied *certiorari* on the issue of the meaning of the [*Cable Modem Service Ruling*]. Thus, no court ruled on the interplay between the [*Cable Modem Service Ruling*] and the Communications Act and entered a definitive order resolving the applicability of franchise fees to cable modem service.

(*City of Chicago v. Comcast*, 375 Ill.App.3d at 609.)

Thus, it appears that the relevance of *Brand X* to the inclusion of broadband revenues in cable television franchise fees is not yet completely settled.

<u>However, the FCC's regulatory classification of cable modem service arguably has greater relevance for California cable operators because, under DIVCA, the revenue base upon which franchise fees are calculated excludes revenues derived from "noncable service" as defined under federal law and FCC interpretation.</u> Under DIVCA, the maximum state franchise fee is 5 percent of gross revenues as defined in subdivision (d) of section 5860 of the Public Utilities Code. (Pub. Util. Code, § 5840, subd. (q)(1). In section 5860 of the Public Utilities Code, subdivision (d), DIVCA defines, in relevant part, the "gross revenues" on which the five percent franchise fee is measured, as:

> All revenue actually received by the holder of the state franchise. . .that is derived from the operation of the holder's network to <u>provide cable or video services</u> within the jurisdiction of the local entity. . . .

(Pub. Util. Code, § 5860, subd. (d).)

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[13] In a memorandum provided by the California Cable & Telecommunications Association (CCTA) dated August 15, 2007, attorneys for the CCTA advise that the issue of whether such revenues can be included in determining franchise fees is the subject of litigation in several other states, all but one of which, the *City of Chicago v. Comcast* case discussed here, pre-date *Brand X*. (Memo, at p. 3, and fn. 12.)

As indicated above, the California Legislature has further specified that gross revenues do not include revenue derived from noncable services, including information services, as defined under federal law or FCC rules, regulations, standards or orders. (Pub. Util. Code, § 5860, subd. (e)(3).)

Given the above-cited provisions of DIVCA, it might be argued that the *Brand X* decision sustaining the portion of the *Cable Modem Service Ruling* holding that cable broadband is an "information service" and not a "telecommunications service" constitutes sufficient authority to exclude cable broadband revenues from the calculation of cable franchise fees. Nevertheless, the issue of whether or not the revenue base upon which cable franchise fees are calculated may include broadband Internet revenues remains in dispute in at least in one other state.

Post-Brand X FCC Rulings Regarding Franchise Fees. In early 2007, the FCC released the first of two Reports and Orders dealing with various aspects of the local franchising process, including calculation of the franchise fee. In the *First Franchising Report and Order*, which applied only to new entrants to a cable television franchise territory, the FCC ordered the exclusion of the consideration of cable broadband revenues in the calculation of a franchise fee, as follows:

> We clarify that a cable operator is not required to pay franchise fees on revenues from non-cable services. Section 622(b) provides that the 'franchise fees paid by a cable operator with respect to any cable system shall not exceed 5 percent of such cable operator's gross revenues derived in such period from the operation of the cable system to provide cable services." The term 'cable service' is explicitly defined in Section 602(6) to mean (i) 'the one-way transmission to subscribers of video programming or other programming service,' and (ii) 'subscriber interaction, if any, which is required for the selection or use of such video programming or other programming service.' The Commission determined in the Cable Modem [Service] Ruling that a franchise authority may not assess franchise fees on non-cable services, such as cable modem service, stating that 'revenue from cable modem service would not be included in the calculation of gross revenues from which the franchise fee ceiling is determined." Although this decision related specifically to Internet access service revenues, the same would be true for other 'non-cable' service revenues. Thus, Internet access services, including broadband data services, and other non-cable services are not subject to 'cable services' fees.

(*First Franchising Report and Order* at ¶ 98.)

In the *Second Franchising Report and Order*, the FCC applied several of its rulings from the *First Franchising Report and Order* to incumbent cable operators, including its restatement of prior rulings that "a cable operator is not required to pay cable franchise fees on revenues from non-cable services." (*Second Franchising Report and Order* at ¶ 11.) Thus, the FCC has twice restated its position, first articulated in the 2002 *Cable Modem Service Ruling*, that the base on which cable television franchise fees are calculated should not include revenues attributable to services provided other than cable service. As indicated above, the franchise fee base under DIVCA incorporates FCC interpretations such as these. We understand that both of these FCC reports and orders are under appeal, and therefore the federal law in this are cannot be considered well-settled. Therefore, it appears that the relevant portions of these rulings must be followed until they are overturned or modified by a court of competent jurisdiction.

Question 2. If broadband revenues cannot be included in a franchise fee, what are the implications for applying the preferred valuation method for taxable possessory interests set forth in subdivision (b)(1) of section 107.7 of the Revenue and Taxation Code?

Revenue and Taxation Code section 107.7 addresses the valuation of taxable possessory interests in publicly owned rights-of-way used for the delivery of cable television and video services by local and state franchisees. At the outset, it is important to note that section 107.7 does not mandate the application of any particular assessment methodology.[14] Under section 107.7, in valuing cable television and video service possessory interests, the "preferred method" of valuation is the income approach, capitalizing that portion of the annual contract rent that is determined to be payment for the taxable possessory interest, at an appropriate capitalization rate, and for the appropriate term. (Rev. & Tax. Code, § 107.7, subd. (b).)

The "Fair Market Value" Standard

Fair market value. Section 107.7 provides that cable television and video service possessory interests must be valued consistent with the requirements of section 401 of the Revenue and Taxation Code, which sets forth a general requirement that every county assessor shall assess all taxable property in his or her county at its full value. Subject to the exceptions noted herein, the "fair market value" standard of assessment for both state-assessed and locally assessed property is mandated by section 1 of article XIII of the California Constitution, which states that:

Unless otherwise provided by this Constitution or the laws of the United States.

(a) All property is taxable and shall be assessed at the same percentage of fair market value. When a value standard other than fair market value is prescribed by this Constitution or by statute authorized by this Constitution, the same percentage shall be applied to determine the assessed value. The value to which the percentage is applied, whether it be the fair market value or not, shall be known for property tax purposes as the full value.

(b) All property so assessed shall be taxed in proportion to its full value.

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[14] In fact, for a statute to mandate a particular assessment methodology under all factual, economic, and regulatory circumstances would raise issues of the constitutionality of the statute vis-à-vis the constitutional requirement of fair market value assessment.

As further explained in the Board-approved *State Assessment Manual*:

> Thus, the standard of value, or value concept, by which all state-assessed property is assessed is "fair market value." [Fn. omitted.] With the exception of restricted value property, whose value is statutorily prescribed at a standard other than market value as recognized in the second sentence of subdivision (a) [of section 1 of Article XIII of the California Constitution cited], this is the same value standard applied to locally assessed property. [Fn. omitted.]
>
> Section 110 [of the Revenue and Taxation Code] describes the concept of market value. As provided in subdivision (a): Except as is otherwise provided in Section 110.1, "full cash value" or "fair market value" means the amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other, and both the buyer and the seller have knowledge of all the uses and purposes to which the property is adapted and for which it is capable of being used, and of the enforceable restrictions upon those uses and purposes.

(State Board of Equalization *State Assessment Manual* (March 2003), p. 12.)

Propositions 13 and 8. For locally assessed property such as cable television taxable possessory interests, Proposition 13 provides that the assessed value is the lower of the fair market value or the factored base year value. Thus, for each assessment year, both the fair market value and the factored base year value of each taxable possessory interest must be calculated and compared to determine which value to enroll for assessment purposes.

Appraisal methodologies. To establish the fair market value of property, there are three principle appraisal methods that may be considered: the income approach, the cost approach, and the comparative sales approach. Consideration of the appropriateness of each approach is a matter of assessment judgment pursuant to the guidance provided by Rules 1-22. As the United States Supreme Court recently recognized:

> Valuation is not a matter of mathematics. . . .Rather, the calculation of true market value is an applied science, even a craft. Most appraisers estimate market value by employing not one methodology but a combination. These various methods generate a range of possible market values which the appraiser uses to derive what he considers to be an accurate estimate of market value, based on careful scrutiny of all the data available. [Citations.] Appraisers typically employ a combination of methods because no one approach is entirely accurate, at least in the absence of an established market for the type of property at issue.

(*CSX Transportation, Inc. v. Georgia State Bd. Of Equalization* (S. Ct. 2007) *128 S. Ct. 467, 472.*)

If more than one valuation approach is considered, it is not an uncommon result that "[i]ndependent application of the approaches utilized will lead to separate indicators of value." (Assessors' Handbook Section 501, *Basic Appraisal*, at p. 74.) Therefore:

> The final analytical step in the appraisal process is to reconcile the separate indicators into a final value estimate. In the reconciliation process, each indicator is reviewed and reconsidered. Consideration should be given to factors influencing value that are not reflected or only partially reflected in the indicators. One should not make a simple arithmetic average of the several values. The greatest weight should be given to the approach(es) that most reliably measures the type of benefits sought by buyers in the market for the subject property."

(*Ibid.*)

In *CSX Transportation, supra*, the Supreme Court viewed the choice of a particular appraisal methodology as an important factor in determining whether fair market value has been estimated:

> The individual methods yield sometimes more, sometimes less reliable results depending on the peculiar features of the property evaluated. . . .[¶] Given the extent to which the chosen methods can affect the determination of value, preventing courts from scrutinizing state valuation methodologies would render § 11501 a largely empty command. It would forcee district courts to accept as "true" the market value estimate of the State, one of the parties to the litigation. States, in turn, would be free to employ appraisal techniques that routinely overestimate the market worth of railroad assets. By then levying taxes based on those overestimates, States could implement the very discriminatory taxation Congress sought to eradicate. . . .[C]ourts would be powerless to stop them, and the Act would ultimately guarantee railroads nothing more than mathematically accurate discriminatory taxation.

(*CSX Transportation*, *supra*, at p. 472-473.)

The Board's Rules, as well as the appellate court decisions in *ITT World Comm. v. Santa Clara County* (1980) 101 Cal.App.3d 246, and *Los Angeles SMSA Ltd. Partnership v. State Bd. of Equalization* (1992) 11 Cal.App.4th 768, acknowledge that different appraisal methods are necessary to value properties under different market and regulatory circumstances. The Board's Rule's and California case law provide that, in appraising real property value, the assessor must use the most accurate and applicable appraisal methodology – or combination of methodologies – in order to approximate fair market value as closely as possible. The type of methodology or methodologies employed by the appraiser is within his or her best professional judgment and discretion after taking into consideration all the facts and circumstances, including the economic and regulatory market, the characteristics of the property in question, and the available data. Therefore, to mandate the use of any one valuation approach regardless of the facts or circumstances as they exist on the lien date is to risk violating the Constitutional mandate of fair market valuation.

The Income Approach[15] and its Application to Valuation of Cable Television Possessory Interests

Under section 107.7, the county assessor may use any accepted appraisal method for valuing a cable television operator's or other video service provider's taxable possessory interest. However, as stated above, under section 107.7, subdivision (b), the preferred appraisal methodology for cable television and video service taxable possessory interests is the income approach capitalizing the "annual rent," as defined, using the appropriate capitalization rate.

Generally, under an income[16] approach to value, the flow of income[17] expected to be derived from the property held or used by the entity is discounted to a present value to arrive at an estimated value subject to *ad valorem* property taxation. "The income to be capitalized must be attributable to the rights in real property in the subject taxable possessory interest." (Rule 21, subd. (e)(3)(C).) Therefore, under Rule 21, subdivision (e)(3)(C), the income to be capitalized may be based on either:

- The "rents paid" (estimated economic rent); or
- The estimated net operating income received by a typical, prudent operator of the property.

Thus, fair market value may be estimated by capitalizing either the "rents paid" by the holder of the taxable possessory interest, or the "operating income" received from operation of the property. Subdivision (e)(3)(C) of Rule 21 explains that "[r]ental income is preferable to operating income (i.e., income from operating a business) because operating income may be influenced by managerial skills and may derive, in part, from nontaxable property."

Under the preferred method of the income approach, in describing the annual "rents paid" to be capitalized, subdivision (b)(2) of Section 107.7 offers the option of using either:

(1) That portion of the franchise fee received that is determined to be payment for the taxable possessory interest for the actual remaining term or the reasonably anticipated term of the franchise; or

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[15] The Board's general regulatory guidance regarding the income approach is found in Rule 8, while Rule 21 provides detailed guidance on the valuation of taxable possessory interests, including substantial detail on applying the income approach to these interests in real property. (See Rule 21, subd. (e)(3).)

[16] The value resulting from application of an income approach is sometimes referred to as the Capitalized Earning Ability (CEA) indicator, and thus the income approach is sometimes referred to as the "CEA approach."

[17] Referred to as the "net income" or "net return" as defined in Rule 8, subdivision (c).

(2) The appropriate economic rent.[18]

Nevertheless, the section goes on to provide that, if the county assessor does not use a portion of the franchise fee to approximate economic rent, then the resulting assessment does not benefit from the presumption of correctness ordinarily accorded the assessor under subdivision (a) of Rule 321. Furthermore, under subdivision (c) of section 107.7, use of the comparable sales method also results in the loss of the presumption of correctness. Thus, there are two "preferences" implied in section 107.7: the stated preference of applying an income approach using capitalized rents paid and the implied preference (based on availability of the presumption of correctness) for using a "portion of the franchise fee" as a stand-in for economic rent (that is, the amount to be capitalized).

Therefore, if the revenue base upon which a franchise fee is calculated cannot legally include revenues from broadband services, then the implication for the assessor that elects nonetheless to consider broadband revenues in his or her valuation of the property is the same as for the assessor that elects to use the comparable sales method: the loss of the presumption of correctness. When the presumption is lost, the assessor must present evidence of the validity of the assessment.

Question 3. If broadband revenues cannot be included in the franchise fee, what are the implications for the calculation of economic rent under section 107.7, subdivision (b)(2)?

Contract Rent vs. Economic Rent

Under California property tax regulation, economic rent is defined as follows:

> [T]he estimated amount that would be paid by the possessor, on the valuation date in cash or its equivalent, for the rights in real property provided by the taxable possessory interest if (i) the rights to possession were offered in an open and competitive market and (ii) the public owner's interest in the property were not exempt or immune from taxation. Economic rent does not include payments by the possessor to the public owner that are not paid as consideration for rights in real property, such as payments for the rental of personal property, for the provision of security services, and for advertising and promotional services.

(Rule 21, subd. (a)(8).)

The actual rent paid is sometimes referred to as "contract rent;" it is not necessarily the same as economic rent. (See Rule 21, subd. (a)(7).) Some tenants negotiate bargains, other get bad deals. In theory, economic rent should approximate what knowledgeable, reasonable parties, not acting under duress, would agree upon in a free market, arms-length transaction, with neither party taking advantage of the other. Therefore, in determining the value of taxable possessory

[18] "Economic rent" is defined in subdivision (a)(8) of Rule 21 (see below), but is most easily understood as "market rent," which may or may not be the same as the "contract rent" actually paid by the assessee.

interests based on "rents paid," the contract rent must be examined to determine the extent to which it is reflective of or probative as to economic rent. Under Rule 21, subdivision (e)(3)(C)a., the economic rent for the subject taxable possessory interest may be estimated by reference to . . . the contract rent for the subject taxable possessory interest. . . ," but only if those contract rents are entered into under conditions similar to those that would establish a fair market value of real property, i.e., they "shall have been negotiated in an open and competitive market.

Under DIVCA, the franchise fee is the annual contract rent *actually* paid for use of cable television and video service rights-of-way to provide "service." (Pub. Util. Code, § 5810, subd. (b); *Santa Barbara County Taxpayers Assoc. v. Bd. of Supervisors of Santa Barbara County* (1989) 209 Cal.App.3d 940, 949 ("Franchise fees are paid as compensation for the grant of a right of way, not for a license or tax nor for a regulatory program of supervision or inspection."))

The ultimate, settled determination of the appropriate franchise fee to be paid by cable companies obviously will have a significant impact upon the annual rents – the contract rents – paid by cable companies to the franchisor municipalities. Thus, if it is determined that broadband revenues cannot be included in the franchise fee, then the issue arises as to whether or not the contract rent, so limited to exclude consideration of broadband revenues, properly may be found to approximate economic rent. Stated another way, even if it is found that the contract rent must exclude consideration of broadband revenues, must the economic rents used in valuing cable television rights-of-way under the income approach be similarly limited? The settlement of the issue of the proper contract rent to be paid by cable companies, therefore, may not necessarily impact the issue of the proper *economic rents* that would be paid for the cable television rights-of-way in arms'-length transactions, absent any mandatory franchise fee statutes.

Not surprisingly, cable operators and county assessors are in disagreement as to the *appropriate economic rents*, determined consistently with the generally accepted appraisal principles set forth in Rule 21, applicable to cable television rights-of-way. Their primary dispute is as to whether or not the economic rent for cable television rights-of-way properly may be the same or different than the franchise fee/contract rent; and if different, how the appropriate amount of economic rent properly should be determined in any particular case. Board staff is aware of several pending assessment appeals involving this issue, and one completed assessment appeal that has been appealed to Superior Court.

California Assessment Appeals and Litigation

There are several assessment appeals in various stages throughout California, and at least one dispute has lead to a case before the Superior Court. The following is a summary of some of the pending actions:

- Sacramento County has a pending assessment appeal involving a cable television provider. While the hearing has not been scheduled yet, the anticipated issues are whether broadband income can be included in the income and whether the county assessor may use more than the 5 percent franchise fee as economic rent. We understand that the assessment appeals board (AAB) recently ordered the assessee to supply the assessor with information regarding income from broadband operations.

- San Mateo County has a pending assessment appeal. The hearing is scheduled to start in July 2008. One issue before the assessment appeal board will be the inclusion of broadband revenues in the income stream.

- San Francisco County has an assessment appeal pending. Issues before the appeals board include the inclusion of broadband income, the term of possession, and whether the county assessor may use more than the 5 percent franchise fee.

- Santa Clara, Alameda, Stanislaus, and Napa Counties have assessment appeals pending in various stages on the assessment of the personal property of cable television operators.

- The San Luis Obispo County Assessment Appeals Board used a 10 year, non-declining term of possession and economic rent of 10 percent of the cable services revenue in valuing a cable television possessory interest. The cable television provider sued for a refund of property taxes in Superior Court, where the case is currently pending. A more detailed review of the contentions made on appeal is instructive.

San Luis Obispo lawsuit. The case appealed from San Luis Obispo County to the Superior Court of San Luis Obispo County is *Charter Communications v. County of San Luis Obispo* (filed January 24, 2007), Case No. CV07-0057. In its complaint, Charter Communications (Charter) asserts that nine taxable possessory interests for tax years 2000-2001 through 2005-2006 were overvalued by a total of $594,918. Attached to the complaint is a copy of the AAB's Findings of Fact (hereafter, *Findings of Fact*), which contain the substantive grounds on which the appeal is based. One of the issues before the AAB, and apparently a contention in Charter's complaint, is the amount of economic rent to be capitalized under the income approach used by the assessor to value the taxable possessory interests. The assessor and Charter apparently "agreed that the income to be capitalized would be the projected economic income to be received by the public agency in exchange for the possessory interest, although they disagreed on how that income would be determined." (*Findings of Fact*, p. 5, § V, first Para.) The assessor and Charter further agreed that the income to be capitalized would be the "Economic Rent Percentage, the percentage of revenue paid as economic rent whether in cash or in kind." (*Findings of Fact*, p. 5, § V, second para.) The Economic Rent Percentage would then be multiplied by the relevant annual revenue figure to calculate the "Economic Rent Amount," which is a factor in the calculation of value under the income approach. The dispute of interest to this discussion involves the Economic Rent Percentage.

Charter contended that the Economic Rent Percentage should be 3 to 5 % of revenues and provided its own evidence and arguments. The assessor contended that the Economic Rent Percentage should be 10% of revenues (we assume, gross revenues from cable services as provided in section 107.7).[19] In support, the assessor provided a survey and other evidence of "typical market rents" (*Findings of Fact*, p. 10, § IX, para. (B)); cited Charter's franchise agreements requiring Charter to provide non-cash consideration to the franchising authority (*Findings of Fact*, p. 10, § IX, para. (C)); and disputed Charter's contentions that the value of its cable television system was declining in the face of competition (*Findings of Fact*, p. 10, § IX, paras. (D, E)). The AAB concluded that the appropriate Economic Rent Percentage was 10% of revenues, based in part on the following findings:

- The federal 5% cap on franchise fee payments was not an enforceable restriction on the use of land because the cap does not apply to the use of the lands. (*Findings of Fact*, p. 13, § IX, subd. (C)(1).)[20]

- The federal 5% cap on franchise fee payments "is not an upper limit on economic rent." (*Findings of Fact*, p. 13, § IX, subd. (C)(2).)

- There was no evidence that the 5% franchise fee payment included nontaxable intangibles under section 107.7, subdivision (d), and "the possessory interests at issue could not be put to beneficial or productive use in an operating cable system without assuming the presence of the right to operate the cable television system and that therefore as a matter of law, it is not necessary to make a deduction for these intangible rights." (*Findings of Fact*, p. 13, § IX, subd. (C)(3).)

We note that while this matter was under appeal, the AAB requested a letter opinion from the State Board of Equalization on several of the issues before it. (*Findings of Fact*, pp. 1-2.) On July 13, 2005, Board legal staff issued the letter, which contained the following opinion regarding the relationship between the franchise fee and economic rent:

> Section 107.7 does not require that the assessor use a portion of the franchise fee as the estimated economic rent for a cable system taxable possessory interest. As stated in section 107(b)(2), 'the annual rent shall be that portion of that franchise fee received by the franchising authority that is determined to be payment for the cable television possessory interest. . .or the appropriate economic rent. If the assessor does not use a portion of the franchise fee as the economic rent, the resulting assessment shall not benefit from any presumption of correctness.' In

[19] Regarding the presumption of correctness, the AAB noted that the assessor acknowledged that its assessments did not benefit from the presumption because it did not use the franchise fee as the economic rent. The AAB stated that "the burden of providing evidence becomes the obligation of both parties" under Rule 321, subdivision (a) (*Findings of Fact*, p. 8, § VI, para. 1), and that it would therefore "weigh the evidence of both parties and decide in favor of the party whose evidence had the greater weight." (*Findings of Fact*, p. 8-9, § VI.) The AAB specifically declined to adopt Charter's contention that it "should draw a negative inference from the fact that the Assessor used a method that was different from the method described in. . .section 107.7" (*Findings of Fact*, p. 8, § VI, para. 2.)

[20] In other words, the 5 percent cap is not an enforceable restriction because the statutory franchise fee limitation only limits what the cable company pays in rents, not the revenues it derives from the rights-of-way.

> other words, the consequence of not using a portion of the franchise fee as the economic rent is that the assessment loses the presumption of correctness.
>
> In our view then, other than as provided by section 107.7, there is no legal nexus between the franchise fee and the economic rent for a cable system taxable possessory interest. Thus the federal limit on cable television franchise fees does not establish a limit on the economic rent of a cable system taxable possessory interest. Similarly, neither does the state limit on such fees establish a limit on the economic rent of a cable system taxable possessory interest.

(Board of Equalization letter dated July 13, 2005, from Senior Tax Counsel J. McManigal, Jr. to Mr. James Lindholm, San Luis Obispo County Counsel, annotated as Property Tax Annotation[21] 660.0034 (7/13/05), at p. 5.)

The AAB noted that its conclusions regarding the appropriate economic rent were consistent with this letter. (*Findings of Fact*, at p. 13.)

Thus, while the California courts of appeal have yet to address this issue, the issue of whether a cable television franchise fee approximates the economic rent of the possessory interest for property taxation purposes is being actively litigated in the California courts.

If you have any questions regarding this matter, please contact Robert Lambert, Acting Assistant Chief Counsel at (916) 324-6593, or Carole Ruwart, Tax Counsel III (Specialist) at (916) 322-3682.

RL/CR/ef
Prop/FINALS/CableTelevision Memo
Prop/Prec/CABLETEL/CableTelevision Memo

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	Mr. Robert Lambert	MIC:82
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[21] Annotations are summaries of the conclusions in selected legal rulings of counsel that are intended to provide guidance in the interpretation of statutes and Board regulations. (Cal. Code Regs., tit. 18, § 5700, subd. (a)(1).) Annotations do not have the force and effect of law. (*Ibid.*)