

**Audit Report**  
**TIME WARNER CABLEVISION**  
**FRANCHISE FEE AUDIT**  
**PART II**

**June 17, 2008**

**Office of the City Auditor**  
**Austin, Texas**

## **BACKGROUND**

The City of Austin granted Austin CableVision a cable television franchise in 1981. The Austin CableVision franchise expired and was renewed in July 1996 with Austin CableVision's successor, Time Warner Cable Television (TWC), operating under the franchise agreement. Under City Ordinance Number 960613-A, this cable franchise agreement runs for fifteen years and will expire in August of 2011. The franchise agreement has provided a significant stream of revenue since 1996.

Part I of this audit was presented to the Audit and Finance Committee on April 22, 2008. We found that TWC did not consistently update their subscriber database to reflect a series of annexations that occurred since the 1996 franchise agreement. As a result, TWC owed the City of Austin \$1,072,148 in fees and interest. TWC agreed with those findings and has paid the outstanding amount.

In Part II, we utilized the services of a consultant, MuniServices LLC, to assist in analysis of TWC advertising revenue, apportionment of bad debt, and other revenue for the years 2003-2007. We also analyzed franchise fees applicable to the public, educational, and governmental (PEG) access fees for the years 1996-2007.

## **OBJECTIVES, SCOPE, AND METHODOLOGY**

### **Objectives**

Determine whether franchise fee and PEG fee payments from the cable company are correct. More specifically, we focused on whether the cable franchise fee and PEG fee was remitted for all customers inside the Austin city limits.

### **Scope**

The scope of work in Part II included cable franchise fees owed to City by TWC with a focus on PEG fees for the years 1996-2007, and advertising revenue, apportionment of bad debt, and other revenue for the years 2003-2007.

### **Methodology**

OCA contracted with a consultant with expertise in cable franchise agreements, MuniServices LLC, to conduct a financial analysis of advertising and other revenue, and bad debt apportionment calculations.

This audit was conducted in accordance with generally accepted government auditing standards.

## AUDIT RESULTS

TWC underpaid franchise fees related to PEG fee revenue for the period 1996 to 2007. In addition, TWC underpaid franchise fees related to some non-subscriber revenues for the period 2003-2007 and overpaid on others. The resulting net liability to the City is \$663,990 (See Exhibit 1).

### EXHIBIT 1 Summary of Time Warner Cable Television Franchise Fee Liability

REVENUE CATEGORY	SCOPE PERIOD	FRANCHISE FEES AND INTEREST OWED
Franchise Fees on PEG Fees	1996-2007	\$524,386
Franchise Fees on Bad Debt	2003-2007	\$248,511
Interest on Prior Period Adjustment	2003-2007	\$71,210
Franchise Fees on Advertising	2003-2007	\$18,586
<b>Overstated Other Revenue (credit)</b>	<b>2003-2007</b>	<b>(\$198,703)</b>
<b>TOTAL</b>		<b>\$663,990</b>

Source: Office of the City Auditor and MuniServices LLC Analysis

**PEG fees were excluded from the calculation of gross revenue subject to the franchise fee by TWC resulting in a liability to the City of \$524,386.** According to the franchise agreement, gross revenue includes all fees charged subscribers for any and all services provided by the cable operator. Federal courts have ruled that PEG fees are considered gross revenue and thus are subject to franchise fees. However, it had been the position of TWC that PEG fees are not subject to franchise fees. Therefore, TWC failed to include PEG fees as gross revenue from 1996 to 2007 and thus understated gross revenue subject to the franchise fee. The understated gross revenue totals \$6,936,711 and underpaid franchise fees plus interest owed to the City totals \$524,386. TWC collects the PEG fees through a \$0.35 per month charge on all residential non-bulk Subscribers.

Public, Educational, and Governmental Access Channels are channels on the cable system which are reserved for non-commercial public, educational and governmental uses, in accordance with applicable law and with the rules and procedures established by the City. TWC is required to make annual payments in support of these channels with funds obtained through the \$0.35 per month charge on all residential non-bulk Subscribers.

**Bad debt expense was improperly apportioned resulting in a liability to the City of \$248,511.** Bad debt expense is used to write off revenue that is not expected to be collected. TWC assigned all of its bad debt expense to revenues that were subject to the franchise fee. However, a portion of the bad debt expense should have been assigned to revenues that are not subject to the franchise fee such as internet access and telephone services. The result of this improper apportionment of bad debt expense is that revenues subject to the franchise fee were understated for the years 2003-2007.

The result of TWC's method was under reported revenue of \$4,498,708 with underpaid franchise fees plus interest owed to the City totaling \$248,511.

**TWC did not pay interest on the franchise fees for a prior period adjustment made related to advertising revenue resulting in a liability to the City of \$71,210.** TWC reported a prior period adjustment of \$5,173,104 in the fourth quarter of 2004 that had been originally recorded at the corporate level only and had not been allocated to the various local franchise areas. The adjustment resulted in franchise fees of \$258,655 paid in the fourth quarter of 2004. However, these additional franchise fees should have been paid during the course of the four years that they were due.

The franchise agreement calls for a penalty of the greater of \$100 or ten percent annual interest on any delinquent payments. TWC owes interest of \$71,210 on this delinquent franchise fee payment.

**Advertising revenue was under reported resulting in a liability to the City of \$18,586.** TWC omitted two franchise tax areas included in the City of Austin jurisdiction in calculating advertising revenues. As a result, \$279,754 of advertising revenue was under allocated with underpaid franchise fees plus interest owed to the City totaling \$18,586.

Advertising revenue is a non-subscriber revenue accumulated on a system-wide basis and allocated among the various municipal jurisdictions based upon the relative number of basic subscribers. These revenues are generated from local, regional and national advertising programs and are included in the revenue base for the computation of the franchise fee.

**Other Revenues were overstated by TWC resulting in an overpayment of \$198,703.** Other Revenues should be accumulated on a system-wide basis and allocated amongst the various municipal jurisdictions based upon the relative number of basic subscribers. However, in 2003, 2004, and 2005, TWC allocated Other Revenues to the City at 100% rather than applying the appropriate percentage. Additionally, in 2006 and 2007, TWC allocated Other Revenues to the City using the same incorrect percentage used to allocate advertising revenue as discussed previously. This resulted in a net over-allocation of Other Revenue to the City of \$3,663,427 and an overpayment of franchise fees and interest totaling \$198,703. We credited the overpayment against TWC's liability (See Exhibit 1).

Other Revenues include home shopping, marketing support credits, cooperative advertising credits and revenue from other sources.

## **RECOMMENDATION**

- 01. The Director of Telecommunications and Regulatory Affairs (TARA) should arrange with Time Warner Cable Television (TWC) for immediate payment of franchise fees and interest owed to the City of Austin.**

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**Management Response:** Management concurs. An immediate request for payment of franchise fees and interest by Time Warner Cable Television will be made.

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