CONNECTICUT CABLE TAXES AND DEREGULATION: MOVING BEYOND THE FAUSTIAN BARGAIN

07-253 and Deregulation of Cable Video Services

On October 1, 2007, Public Act 07-253 (07-253), An Act Concerning Certified Competitive Video Service, changed the landscape of Connecticut cable regulation that had been in place since the first cable franchises were granted in 1967. To protect the local telephone company, the Southern New England Telephone Company (SNET), cable companies had been regulated and taxed like the phone company. This meant that Connecticut, in contrast to other states, treated cable as akin to a utility. By 2007, however, SNET, then owned by the telecommunications behemoth AT&T (SNET/AT&T), needed legislative relief to clear the cloud over its legal ability to continue to offer video service that it had branded as u-Verse.

SNET/AT&T's legal issues in Connecticut derived from a successful cable industry challenge in federal court asserting that the u-Verse video product legally would be considered a cable service and, accordingly, could not be offered without first obtaining a franchise (referred to under Connecticut law as a "certificate of public convenience and necessity"), which would subject its video operations to the same rules that cable operators had been meeting for decades.

To remove the cloud over its legal rights, SNET/AT&T sought cable industry support for a legislative deal that would allow all video providers to transition into a deregulatory scheme that granted cable franchises in perpetuity, thus eliminating the need for franchise renewal proceedings. With cable industry opposition eliminated, SNET/AT&T was able to obtain overwhelming legislative support for 07-253, thereby creating new certified competitive video provider categories, with the rights granted to SNET/AT&T and cable providers to offer video service in Connecticut under far less than traditional cable regulation. In short, all certified wireline video providers in Connecticut were effectively freed from the legacy of regulation that had begun over 40 years earlier.

This article is not intended to address the mechanics or the benefits of cable deregulation or of AT&T's legal issues but, rather, concerns instead the tax consequences of 07-253, particularly on the non-AT&T cable operators in Connecticut. Those consequences are significant, as is explained below.

The Faustian Bargain: 07-253 and the Connecticut "Franchise Fee"

After years of litigation at the Federal Communications Commission and in the courts,[1] it is now accepted that the gross earnings tax imposed by the State on Connecticut cable providers is a franchise fee,

If you have any questions about the issues addressed here, please feel free to contact Burt Cohen at 203.772.7714 or bcohen@murthalaw.com.

Mr. Cohen's practice is focused on representing the cable and telecommunications industry in regulatory and litigation matters involving the Public Utilities Regulatory Authority (formerly the Department of Public Utilities Control), the Connecticut Siting Council and the Connecticut Department of Revenue Services (DRS) and has furthered the legal interests of his clients for over 30 years. With an active state tax litigation practice, his client base includes not only those cable and telephone interests, but also entertainment, financial and transportation clients and other significant taxpayers. Mr. Cohen is a long-standing and active member of the Broadband Tax Professionals Institute (BTI). He is active in the Connecticut Bar Association and has served for many years as the Legislative Liaison to the CBA's Energy, Public Utilities and Communications Law Section. Mr. Cohen is also a board member of the Lawyers Collaborative for Diversity and Friends of New Haven Legal Assistance.

[1]See, e.g., Yakima Valley Cablevision, Inc. v. FCC, 794 F.2d 737 (D.C. Cir. 1986); In re: Connecticut Cable Television Association, Inc., 4 FCC Rcd 476(1988), petition for reconsideration granted in part and denied in part (1990).

Copyright © 2014 Murtha Cullina LLP. This alert is one of a series of publications by Murtha Cullina LLP and should not be construed as legal advice or legal opinion on any specific facts or circumstances.
The contents are intended for general information purposes only, and you are urged to consult your own lawyer concerning your own situation and any specific legal questions you may have.

as that term is defined by the Federal Communications Act.[2]

In recognition, Connecticut lowered its gross earnings tax rate from 9% to 5% in 1990 in Public Act 89-251 to conform to the 5% cap on cable provider franchise fees in 47 U.S.C. § 542. Correspondingly, cable service became subject to the then 7.5% sales tax, which was estimated to net, with the decrease in the gross earnings tax, approximately $10 million in additional annual revenue to the State. Because the Federal Communications Act allowed cable companies to designate on each customer's bill the portion of attributable to the franchise fee or gross earnings tax,[3] consumers increasingly became aware that they were burdened with the obligation to pay taxes imposed on cable services.[4]

Beginning in the mid-1990s, each Connecticut cable company then entered into settlement agreements with the Department of Revenue Services. This resolved nearly two decades of tax uncertainty created by claims of the cable industry that the 9% gross earnings tax represented an excessive and unlawful franchise fee. Although specific terms were confidential, the settlements resolved longstanding disputed issues, subject to a provision enabling the companies or DRS to be released from the agreements in the event of a "change in law". The change-in-law provision acted as a deterrent to legislative tinkering seeking to increase again gross earning tax rates. That deterrent was removed with the enactment of 07-253.

During the State's fiscal year ending June 30, 2007, the Connecticut gross earnings tax raised $52 million, up over $10 million compared to the June 30, 2005 figure. As the story goes, while AT&T and cable were working on the details of deregulation for 07-253, some legislators exacted a pound of flesh by engrafting an additional tax of one-half of one percent increase of the gross earnings from cable service primarily to benefit public access interests. After two years, the rate would be lowered to one-quarter of one percent.[5] This money from this additional tax would be "deposited" in a newly created account "to be known as the 'public, educational and governmental programming and education technology investment account' (PEGPETIA). . ."[6] to be divvied up by State utility regulators at what was then known as the Department of Public Utility Control and is now known as the Public Utilities Regulatory Authority (the PURA) as follows: 50% to advisory councils and public access programmers and studio operators "to subsidize capital and equipment costs related to producing and procuring such programming;" and 50 % "to boards of education and other education entities for education technology initiatives."[7]

With this "change in law," the PEGPETIA fund broke through the 5% franchise fee cap that had been honored by the State of Connecticut since 1990. This increase in State taxes, all under the auspices of funding PEG capital costs and educational technology, served as the legislative quid pro quo for applying deregulatory provisions to cable as well as SNET/AT&T in 07-253.[8] The Faustian bargain had been struck – freedom from Connecticut-only utility-type regulation for cable companies only at the cost of being subject to payment of public access subsidies well above federal law limits.

Moving Beyond the Faustian Bargain – The Risks to the State, Connecticut Cable Operators and Consumers

Subsequent to 2007, the PEGPETIA funds began to roll into the State coffers. The PEGPETIA account soon served as an easy target for the State's deficit reduction initiatives. Some of the PEGPETIA money did, in fact, get used as it was intended. Through 2013, the PURA and its predecessor reviewed 208 PEGPETIA grant applications, and awarded funding totaling an estimated $8.4 million dollars. The program was put on hold in the middle of 2014 as the PEGPETIA funds were diverted to mitigate estimated budget shortfalls. This was not the first such diversion as $2 million dollars was transferred from the PEGPETIA funds for fiscal years ending June 30, 2010 and June 30, 2011 to the General Fund.[9] With the transfers in fiscal year 2014 of $3.4 million and fiscal year 2015 of $3.5 million, a total of $10.9 million dollars in PEGPETIA funds were allocated from the statutorily enacted "bargain" of 07-253 to general revenue purposes.

---

[2]See In re: Connecticut Cable Television Association, Inc., supra) in which the FCC concluded that the Connecticut gross earnings tax as applied to cable television systems appears to be a franchise fee, but punted the ultimate issue of what part of the tax would be subject to refund claims over to state court appeals then pending in Docket Nos. CV 83-028512 through 0285627, 83-0298038 and 83-0298041 (Conn. Super. Ct., Jud. District of Hartford-New Britain).

[3]See 47 U.S.C. § 542(c).

[4]Before it was recognized as a franchise fee, the gross earnings tax had been embedded in the price of cable service.

[5]Conn. Gen. Stat. § 16-331cc(c)(1).

[6]Conn. Gen. Stat. § 16-331cc(a).

[7]Conn. Gen. Stat. § 16-331cc(b).

[8]Federal law excludes from the 5% franchise fee cap "capital costs which are required by the franchise to be incurred by the cable operator for public, educational, or governmental access facilities." 47 U.S.C. § 542(g)(2)(C). The State has not allowed the funds assessed under Conn. Gen. Stat. § 16-331cc to be solely limited to such capital costs, however.

[9]Public Act 9-7 (Sept. Special Session).

By way of comparison, revenues collected by the State under the gross earning tax and PEGPETIA funds for the past 3 fiscal years are as follows:[10]

Tax	2012	2013	2014
Gross Earnings Tax	$52,656,640	$56,439,345	$63,574,938
PEGPETIA	$ 3,584,642	$ 3,452,386	$ 4,168,579
Total Cable Taxes (excluding sales tax)	$56,241,282	$59,891,731	$67,743,517

With the ongoing financial issues facing the State of Connecticut, it is certainly understandable and foreseeable that the PEGPETIA funds will continue to be viewed by the State as a readily available source of money to use for budget shortfall mitigation purposes. In doing so, however, Connecticut is effectively evading the 5% franchise fee cap under the Federal Communications Act[11] and the State is also risking upending the long-settled tax issues that were resolved in the historical tax agreements.[12]

There is great risk to the cable industry as well. With the 5% gross earnings tax cap compromised to achieve the 2007 independence from franchise renewal proceedings, the prospect has increased for further legislative interest in not only diverting PEGPETIA funding currently assessed, but also increasing that PEGPETIA rate for use in "a rainy day" situation as a back-door way of trying to circumvent the federal franchise fee cap. And if the PEGPETIA tax can be legislatively increased to help plug budget shortfalls, the gross earnings tax rate remaining set at 5% could also be at risk. With all of these issues in play, only time will tell if the 2007 legislative deal becomes the Faustian bargain that was accepted for deregulatory relief in the State of Connecticut.[13]

Because, in the final analysis, the gross earnings tax/franchise fee and the PEGPETIA fund simply are an indirect tax on Connecticut consumers of what is already a very heavily taxed service that based on current trends will be taking nearly $70 million out of the Connecticut economy, in addition to the sales tax remitted to the State on cable service. The bargain ensures that Connecticut wireline video providers will continue to act as significant surrogate tax collectors for the State, as cable service continues to be one of the most heavily taxed services in Connecticut. More taxes and fees on cable service will undoubtedly serve as a deterrent to consumer purchases of additional services, and cable services are expected to become more price sensitive, particularly as over-the-top content becomes more popular. The elimination of the PEGPETIA tax, whether legislatively or by judicial decision, will restore some level of equilibrium and protection to Connecticut wireline video providers and their customers.

The views reflected herein are solely those of Attorney Burt Cohen and do not reflect the views of the clients of Murtha Cullina LLP.

[10]All data from DRS reports available at http://www.ct.gov/drs.

[11]47 U.S.C. § 542(b) provides, in pertinent part, that "[f]or any twelve-month period, 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.

[12]Refund claims for charging an excessive franchise fee could also represent a significant contingent liability for the State of Connecticut.