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Office of the City Auditor

Audit Report

**AUDIT OF COMCAST and TIME WARNER CABLE
FRANCHISE FEES**
(Report No. A08-003)

November 16, 2007

City Auditor

Craig D. Kinton

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Executive Summary

Time Warner Cable (TWC) did not comply with annual audit provisions of Dallas City Ordinance Number 24361 (Ordinance). As a result, the City Auditor's Office cannot determine whether the \$5,555,452 the City received for cable franchise fees for calendar year 2006 is accurate. TWC has also not provided supporting revenue information for its monthly franchise fee payments.

The City Council authorized the transfer of the Cable Franchise control from Comcast Cable to TWC in December 2005. The transfer occurred in August 2006.

Background Summary

City Ordinance Number 24361

Requires the cable company to:

1. File an audited annual report with the City by April 30th of each calendar year that includes a:
 - Detailed breakdown of Cable Gross Revenues; and,
 - Computation of the payment amount.
2. Make available the independent auditors work papers, upon request.

Summary of Recommendations

We recommend the Director of the Office of Financial Services (OFS):

- Consult with the City Attorney to determine how to resolve TWC's noncompliance with the Ordinance; and,
- Request TWC to provide supporting documents, including revenue breakdown by categories, with its monthly franchise fee remittance.

Summary of Management's Response

The Director of OFS agrees with both recommendations and intends to take corrective actions to address the issues identified in this report. The complete response is included as Appendix III to this report.

Summary of Objectives, Scope and Methodology

The objective of the audit was to determine whether the franchise fee payments made to the City for calendar year 2006 were accurate and comply with the provisions of the Ordinance.

We developed an understanding of relevant internal controls, policies and procedures, and the franchise ordinance. In addition, we consulted with Assistant City Attorneys, reviewed the calendar year 2006 franchise fee payments made by Comcast and TWC, reviewed Comcast's supporting franchise fee payment documents for the first seven months of the year, and reviewed the independent audit report.

Audit Results

I. Time Warner Cable did not comply with annual audit provisions of Dallas City Ordinance Number 24361.

Time Warner Cable (TWC) submitted an audited annual report that did not meet the requirements of Ordinance Number 24361 (Ordinance). As a result, the City Auditor's Office (Office) cannot determine whether the \$5,555,452 the City received for cable franchise fees for calendar year 2006 is accurate.

TWC filed a Report of Independent Auditors (Report) certifying that the gross cable revenue was \$103,806,064 for the year ended December 31, 2006. The Report was submitted to the City on June 1, 2007, 31 days after the required filing date. The Report also did not include a detailed breakdown of cable gross revenues and the computation of the payment amount as required by the Ordinance.

Section 9d of the Ordinance states "The Company shall file with the City by April 30th of each calendar year an annual report, prepared and audited by an independent certified public accounting firm acceptable to the City, whose work papers will be made available to the City on request, showing the total Cable Gross Revenues of the preceding calendar year. Such annual report shall include a detailed breakdown of Cable Gross Revenues and the computation of the payment amount."

On September 19, 2007, the Office requested access to the certified public accounting firm's work papers. TWC denied the Office's request stating the independent audit "firm is not a party to the franchise agreement" and, therefore, TWC cannot compel the firm to respond to the Office's request.

Recommendation I:

We recommend the Director of the OFS consult with the City Attorney to determine how to resolve TWC's noncompliance with the Ordinance.

Management's Response

Concur. OFS will consult with the City Attorney's Office regarding TWC's noncompliance with the Ordinance. Further, OFS will explore such remedies that may be available to compel TWC to comply with all provisions of their franchise. It should be noted, however, that due to changes in State law, the City's ability to enforce some provisions of the franchise have been limited.

Nick Fehrenbach with OFS will be responsible for exploring such remedies; however, OFS refrains from setting any deadline to accomplish this task due to the City's inability to force TWC to implement any remedies.

II. Time Warner Cable's monthly franchise fee payments lack supporting documentation.

TWC has not provided supporting revenue information for its monthly franchise fee payments since assuming cable franchise control in August, 2006. TWC sends the City a cover memo that includes the payment month and a check for the franchise fee amount. From January to July 2006, Comcast submitted a list of revenue sources to support its monthly franchise payments. Without more detailed information to understand the basis for the payment, the City cannot adequately monitor franchise fee payments.

Monthly revenues subject to the franchise fees are generated from three primary sources:

1. Customer subscriptions to television and music services;
2. Advertising sales and production services; and,
3. Commissions for Home Shopping Network for airing network programming and other miscellaneous revenues.

Section 15.d of franchise Ordinance Number 24361 gives the City the right to require "the Company report to the City such reasonably requested information relating to the Company and/or the Affiliates necessary for the administration of this Ordinance. Within reason, the City shall have the right to establish forms for all reports, determine the time for reports and the frequency with which any reports are to be made, and require that any reports be made under oath."

Recommendation II:

We recommend the Director of the OFS require TWC to provide supporting documents, including revenue breakdowns by categories, with its monthly franchise fee payments.

Management's Response

Concur. OFS will request TWC to provide supporting documents, including revenue by category, to be provided with its monthly franchise fee payment. OFS will consult with the City Attorney's Office to determine if this information may be required. Although casual reading of the franchise Ordinance would

tend to imply such information may be required, there are currently three cable TV providers operating in the City of Dallas. Two of these entities are operating under State issued franchises. The Federal Cable Act and FCC rules address how and under what conditions cable providers may be given disparate requirements. TWC has previously stated that the requested information is competitively sensitive and refused to disclose the information based on provisions of the Cable Act. Further, the FCC is currently modifying their rules pertaining to competition in the Cable industry. A thorough review of this body of Federal statutes must be completed prior to issuing any demands on TWC that could have the effect of voiding the franchise agreement.

Nick Fehrenbach with OFS will be responsible for requesting that TWC submit all supporting documents, including revenues by category, to be provided with its monthly franchise fee payments. OFS, however, refrains from setting any deadline to accomplish this task due until consulting with the City Attorney's Office to determine if this task can be accomplished.

Appendix I

Background, Objectives, Scope and Methodology

Background

Ordinance Number 24361 (Ordinance) defines the terms and conditions under which a cable franchisee operates within the City of Dallas. Part of this Ordinance, Section 9, defines the fees, payments, and compensation that the cable operator agrees to pay the City. The principal fees and payments of this Ordinance include:

1. A franchise fee of five percent of cable gross revenues;
2. Late fee payments of \$200 per day or partial day or interest at ten percent annual percentage rate of the total amount past due; and,
3. Interest of eight percent for any net undisputed amount due to the City, compounded monthly.

The effective date of the franchise is January 1, 2001 through December 31, 2015, plus any extensions mutually agreed to by the parties.

Ordinance Number 26167, approved by the City Council on December 5, 2005, granted the consent to the transfer of the Cable Franchise control from Comcast to Time Warner Cable (TWC). The transfer occurred in August 2006.

The Office of Financial Services (OFS) provides management oversight of the franchise.

Objectives, Scope and Methodology

The audit was conducted under authority of City Charter, Chapter IX, Section 3 and in accordance with generally accepted government auditing standards. The audit covered franchise fee payments for calendar year 2006.

The objective of the audit was to determine whether the franchise fee payments made to the City were accurate and comply with the provisions of the Ordinance.

To develop an understanding of relevant internal controls, policies and procedures, we:

- Reviewed the franchise ordinances;
- Held several meetings and conference calls with Comcast's, TWC's, and City personnel concerning relevant matters;

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- Reviewed the twelve franchise fee payments received by the City for calendar year 2006;
- Reviewed the documents provided by Comcast that relate to the franchise fee payments for the months of January to July 2006;
- Reviewed TWC's independent external audit report for 2006; and,
- Consulted with Assistant City Attorneys.

Appendix II

Major Contributors to this Report

Carol Smith, CPA, CIA, CFE, Audit Manager
Jing Xiao, CPA, Project Manager
Thandee Kywe, Auditor
Theresa Hampden, CPA, Quality Control Manager

Management's Response

Memorandum

RECEIVED
NOV 13 2007
CITY AUDITOR'S OFFICE



DATE November 13, 2007 (second submittal)
TO Craig Kinton, CPA, Internal Auditor
SUBJECT Audit Response for Time Warner Cable

We have reviewed your audit findings for Time Warner Cable. The results of the review are detailed with our responses below.

Time Warner Cable

Recommendation I

We recommend the Director of the OFS consult with the City Attorney to determine how to resolve TWC's noncompliance with the Ordinance.

Management's Response:

We concur. The OFS will consult with the City Attorney's Office regarding Time Warner's non-compliance with the Ordinance. Further OFS will explore such remedies that may be available to compel Time Warner to comply with all provisions of their franchise. It should be noted; however, that due to changes in State law, the City's ability to enforce some provisions of the franchise have been limited. Nick Fehrenbach will be responsible for exploring such remedies. We however, have refrained from setting any deadline to accomplish this task due the City's inability to force Time Warner Cable to implement any remedies.

Recommendation II

We recommend the Director of the OFS require TWC to provide supporting documents, including revenue breakdowns by categories, with its monthly franchise fee payments.

Management's Response:

We concur. The OFS will request TWC to provide supporting documents including revenue by category to be provided with its monthly franchise fee payment. The OFS will also consult with the City Attorney's Office to determine if this information may be required. Although casual reading of the franchise Ordinance would tend to imply such information may be required, there are currently three cable TV providers operating in the City of Dallas. Two of these entities are operating under State issued franchises. The Federal Cable Act and FCC rules address how and under what conditions cable providers may be given disparate requirements. TWC has

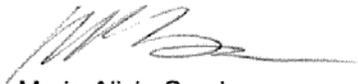
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previously stated that the requested information is competitively sensitive and refused to disclose the information based on provisions of the Cable Act. Further the FCC is currently modifying their rules pertaining to competition in the Cable industry. A through review of this body of Federal statutes must be completed prior to issuing any demands on Time Warner Cable that could have the effect of voiding our franchise agreement.

Nick Fehrenbach will be responsible for requesting that TWC submit all supporting documents including revenues by category to be provided with its monthly fee payments. We however, have refrained from setting any deadline to accomplish this task due until we spend some time with the City Attorney's Office to determine if this task can be accomplished.

If you have any questions, please contact me.



Maria Alicia Garcia
Director
Office of Financial Services

cc: David K. Cook, Chief Financial Officer
Nick Fehrenbach, Utilities Manager