



# Journal of Local Government Law

Published by the Local Government Section of the Virginia State Bar

Vol. XVI, No. 2, Fall 2005

## 2005: A Good Year for Yardsticks and Birch Rods

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In the decade since the enactment of the Telecommunications Act of 1996, hundreds of localities, dissatisfied with the offerings of private cable and telephone companies, have deployed advanced telecommunications systems of their own. As interest in such systems has spread across the America, incumbent cable and telecommunications providers have increasingly sought state and federal legislation to stop or delay them.

In 1932, in a speech about the right of localities to form their own utilities, Franklin Delano Roosevelt observed,

It is perfectly clear to me, and to every thinking citizen, that no community which is sure it is

now being served well, and at reasonable rates, by a private utility company, will seek to build and operate its own plant. But on the other hand, the very fact that a community can, by vote of the electorate, create a yardstick of its own, will, in most cases, guarantee good service and low rates to its population. I might call the right of the people to own and operate their own utility a “birch rod in the cupboard, to be taken out and used only when the child gets beyond the point where more scolding does any good.”<sup>1</sup>

In 2005, as America’s global standing in global broadband deployment continued to plummet,<sup>2</sup> and as the cable and telecommunications industries continued to hover at or near the bottom of consumer satisfaction surveys,<sup>3</sup> interest in public telecommunications systems surged across the United States. Alarmed, the incumbents responded by promoting barriers to public broadband initiatives in fourteen states and before Congress. It was, however, a good year for yardsticks and birch rods. Not only did nearly all of these proposed barriers failed to pass, but support grew in Congress for legislation that would preempt state barriers to public entry, once and for all.

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## CHAIRMAN'S MESSAGE

The Virginia State Bar's Local Government Law Section is pleased to present the Fall issue of the *Journal of Local Government Law*. As we all know, local government law spans almost every area of the law, from traditional local land use, sovereign immunity, and taxation issues to the currently evolving body of telecommunications law. The articles in this issue describe some of the recent developments in telecommunications law affecting local governments.

Our thanks to authors Jim Baller of the Washington, D.C. Baller Herbst Law Group, Eric Page with the Richmond law firm of LeClair Ryan, and Roger Wiley with the Richmond law firm of Hefty & Wiley for the time and effort they took to research and write their articles. Jim Baller's article, *2005: A Good Year for Yardsticks and Birch Rods*, discusses barriers to a local government's entry into Internet services. Eric Page's article, *Virginia Municipal Broadband Opportunities*, looks at service gap authority for providing Internet services in rural and other underserved communities in Virginia. The last article, *Restructuring Local Taxes On Communications Services: A Quest for a Level Playing Field and a 21st Century Revenue Base*, by Roger Wiley, describes how shifting technologies in communications services (e.g., landline phones to cellular phone and cable to satellite television services) effect local revenues and proposed legislative solutions.

One of my personal goals as chair of the Local Government Law Section this year is to garner more input from section members for both article topics and names of folks who would be interested in serving on the section's Board of Governors. Article topics for the Winter and Spring issues of the *Journal* were set at the September Board of Governor's meeting. The Board will discuss articles for the Summer and Fall 2006 issues as well as breaking new developments or other changes to be made to the Spring issue at its next meeting in January, 2006. The board meets 3 to 4 times a year in Richmond and beside general administrative matters (e.g., budget), this *Journal* is the Board's major responsibility. Another important function of the Board is planning a CLE for the general member meeting at the VSB's annual meeting in June of each year. I invite you to call me (804-285-0287) or any other member of the section's Board of Governors with input for future articles and names for consideration to serve on the Board.

Finally, note that the Local Government Section is working on a proposal for an exciting joint CLE for this year's June VSB meeting with the Environmental Law and Real Property Sections. So mark your calendars now for the June 15-17, 2006 VSB meeting in Virginia Beach and plan to attend the June 16<sup>th</sup> Local Government Law section meeting. More news on this proposed CLE will be forthcoming in the Winter *Journal*.

*Barbara M. Rose*

### **Background<sup>4</sup>**

A century ago, when electricity was the must-have new technology of the day, private power companies, driven by the short-term profit-maximizing demands of their investors, focused initially on electrifying the most lucrative population centers and left most of America literally in the dark. In response, thousands of unserved communities stepped forward and formed their own electric utili-

ties. These communities recognized that electricity was critical to their economic development, educational opportunity, and quality of life, and they refused to allow the private sector to control their destiny. Communities that took matters into their own hands generally survived and thrived. Many that waited for private power companies to get around to them shriveled up and became "ghost towns."

By the 1920s, more than 3,200 community-owned electric utilities had come into being. Over the next decade, about a quarter of these communities sold their systems to investor-owned electric utilities. Having met their goal of ensuring that they would not be left behind in obtaining the benefits of electrification, they had no further desire to be service providers themselves. Currently, about 2,000 community-owned electric utilities re-

main, providing their communities reliable power at significantly lower rates than their private-sector counterparts.

In the late 1980s and early 1990s, seeing the patterns of the early decades of the electric power industry repeating themselves in the communications industry, a handful of public power communities formed their own communications networks. When Congress began to consider enacting a major overhaul of the federal communications laws in the mid-1990s, the national associations representing public power utilities and their allies pushed for a measure that would protect entities of all kinds, including public entities, from state barriers to entry. As a result, Congress included in the Telecommunications Act of 1996 a provision that read: “No State or Local statute or regulation, or other State or Local legal requirement, may prohibit of have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service.” 47 U.S.C. § 253(a).

Despite the existence of Section 253(a), incumbent cable and telephone companies pushed barriers to public communications services through fourteen state legislatures by the end of 2004. While these fourteen state laws covered different services and worked in different ways, they all had a single purpose – to stop or delay localities from entering the communications field, either alone or in strategic partnerships with members of the private sector. Summaries of the state laws in effect before 2005 are available at

[www.baller.com/comm\\_broadband.html](http://www.baller.com/comm_broadband.html).

Between 1996 and 2004, several federal and state courts split over whether Section 253(a) preempted state barriers to public entry. In March 2004, the Supreme Court of the United States resolved the matter in the negative in *Nixon v. Missouri Municipal League*, 541 U.S. 125 (2004).

Finding that it could not be absolutely sure that the term “any entity” applied to public entities, the Court ruled that Congress had failed to make Section 253(a) clear enough to meet the elevated standard of clarity that the Court applies in determining whether a federal statute preempts a traditional state power. Significantly, however, the Court also stated that its decision should not be interpreted as an adverse ruling on the merits of public entry.

To the contrary, the Court said that municipalities had “at the very least, a respectable position” that denying them entry “flouts the public interest.” The Court also emphasized that the Federal Communications Commission, while ruling against the Missouri municipalities on statutory construction, had “denounced” the policies underlying the Missouri law at issue and that three of the five commissioners had filed separate statements in which they “minced no words” in stressing that the Missouri law was contrary to the pro-competitive purposes of the Telecom Act.

## Pennsylvania – The Tipping Point

In November 2004, Verizon pushed through the Pennsylvania legislature a bill (HB 30) that gave incumbent telephone companies a right of first refusal over local broadband initiatives. The bill required a locality that wanted to build a broadband network, alone or with private-sector partners, to go first to the incumbent telephone company and specify the data speed that the locality wanted. The incumbent then had two months to agree to provide that data speed, and if it did agree, it had a total of fourteen months to follow through. If the incumbent met these requirements, the municipal project could not go forward.

Notably, data speed was the only relevant criterion under the statute. No other factor mattered – not price to consumers, quality of service, mobility, upload and download symmetry, efficiency, interactivity with public safety or homeland security systems, relationship to economic development or digital equity programs, or anything else.

The bill was originally intended to preclude Pennsylvania communities from following the Borough of Kutztown’s lead in developing their own fiber-to-the-home systems. Late in the legislative process, however, the City of Philadelphia realized that the bill would also thwart the City’s city-wide wireless project. With Edward Rendell, a former mayor of Philadelphia, now the governor of Pennsylvania, a veto suddenly became a serious possibility.

Just before the deadline for Governor Rendell to sign or veto the bill, Verizon promised Philadelphia in writing that it would not exercise its right of first refusal to block the City's wireless initiative. Governor Rendell then signed the bill, leaving all other localities in Pennsylvania at the mercy of the incumbents.

Almost immediately after Governor Rendell signed the bill into law – Act No. 183 – fear and revulsion spread across America, like a wave circulating around a stadium. Before long, the cry “No more Pennsylvanias” was echoing from every corner of America.

Before Pennsylvania, only three major national associations consistently battled state barriers to public entry – the American Public Power Association, the Fiber to the Home Council, and the National Association of Telecommunications Officers and Advisors. Now, many more national associations raised public broadband a high-priority, must-win issue.

Similarly, the major consumer groups stepped forward, including the coalition of groups that had forced Congress to overrule the FCC's media ownership rules two years ago. These organizations now saw public broadband as just as important for freedom of choice and localism as the battle over media ownership.

High-technology giants such as Intel and Dell, and several important high-tech business groups also publicly announced their opposition to state barriers to entry. In their public state-

ments, these companies and groups asserted that localities are important strategic asset for America, that localities have a critical role to play in helping our country to recover its competitive edge, and that state barriers to public broadband initiatives are not only bad for the communities involved, but also for the private sector and America as a whole.

### **State Battles in 2005<sup>5</sup>**

In 2005, incumbents promoted new barriers to public broadband in fourteen states – Colorado, Florida, Illinois, Indiana, Iowa, Louisiana, Michigan, Nebraska, Ohio, Oregon, Nebraska, Tennessee, Texas, Virginia, and West Virginia.<sup>6</sup> Spurred on by memories of Pennsylvania, however, opponents of these bills mounted far more intensive and effective responses than anyone could have imagined before Pennsylvania.

The opponents tracked developments across the United States in near real time on the Baller Herbst website and daily email list. The coalition organized thousands of phone calls, emails, faxes and visits to key legislators. It developed numerous handouts, white papers, economic studies, testimony, news articles, and point-by-point rebuttals to industry attacks on public broadband initiatives. The coalition also traced the funding that the incumbents surreptitiously provided to supposedly independent organizations and “experts.”

Two other factors turned out to be particularly significant. First,

the United States continued to sink in global broadband standing. According to data maintained by the International Telecommunications Union, the United States dropped to sixteenth worldwide in per capita broadband penetration (down from fourth place in 2001) and also fell farther and farther behind the leading nations in Asia, Europe and Canada in availability of high-bandwidth capacity, cost per unit of bandwidth, and growth of broadband usage.<sup>7</sup> These developments gave Americans across a broad range of political views and ideologies a common sense of embarrassment and concern for America's future.

Second, the mainstream media provided extensive, and generally positive, coverage of state battles over barriers to public entry. Beginning in January 2005 with USA TODAY's extensive report and favorable editorial on the Lafayette fiber project in Louisiana, localities repeatedly received sympathetic reviews in such mainstream media as the *Wall Street Journal*, the *Washington Post*, the *Christian Science Monitor*, *Foreign Affairs*, and many others.

In the end, of the thirteen states that have completed their consideration of barriers to entry for 2005, only Nebraska enacted a substantial new barrier to public entry, and it already had a significant barrier on its books.

### **Developments at the Federal Level**

In late May 2005, a few days after the Texas legislature rejected the new barriers to public broadband that San Antonio-

based SBC Communications had sought; Representative Pete Sessions (R-TX) introduced a bill in the U.S. House of Representatives, H.R. 2726, that would severely restrict all forms of public involvement in the communications field.

The press quickly learned, however, that Sessions had worked for SBC for sixteen years, that his wife is currently an executive of SBC, and that the Sessions family has substantial stock options in SBC. As a result, the Sessions bill quickly became associated with SBC, and no other member of Congress has embraced it.

More recently, in the influential House Commerce Committee, senior staffers for Representatives Joe Barton (R-TX), John Dingell (D-MI), Fred Upton (R-MI), Ed Markey (D-MA), and Chip Pickering (R-FL) have recently circulated a draft telecom reform bill that contains a favorable public broadband provision, Section 409.

In the meanwhile, in the Senate, Senators Frank Lautenberg (D-NJ) and John McCain (R-AZ) introduced a bill in the Senate, S.1294, that would protect public entities from state barriers to entry, while at the same time providing safeguards to protect the private sector from discrimination.

Senator John Ensign (R-NV) has included an anti-municipal measure as part of a wide-ranging telecom deregulation bill, S.1504. Upon becoming a co-sponsor, Senator McCain announced that he supports the overall deregulatory purposes of the Ensign bill but will work vigorously to replace Senator Ensign's anti-municipal measure with the language of the Lautenberg-McCain bill.

In the months ahead, Senator Ted Stevens (R-AK), head of the Senate Commerce Committee, is likely to introduce a comprehensive telecom reform bill. That bill is likely to be the main Senate telecom reform measure. The proponents of public broadband are working to ensure that the Stevens bill incorporates the Lautenberg-McCain bill or similar favorable language.

### Looking Ahead

Given the complexity of telecom reform, the House and Senate are likely to take at least a year or two to work through all of the issues and arrive at a broad consensus. It is unlikely that Congress will deal with municipal broadband as a stand-alone issue.

With federal legislation unlikely for some time, the fight over public broadband is likely to shift back to the states again, beginning in January 2006. We

hope that 2006 will be another good year for yardsticks and birch rods.

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<sup>1</sup> <http://newdeal.feri.org/speeches/1932a.htm>

<sup>2</sup> <http://www.itu.int/osg/spu/newslog/ITUs+New+Broadband+Statistics+For+1+January+2005.aspx>

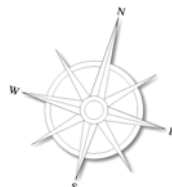
<sup>3</sup> [http://www.theacsi.org/scores\\_commentaries/commentaries/Q1\\_05\\_comm.htm](http://www.theacsi.org/scores_commentaries/commentaries/Q1_05_comm.htm).

<sup>4</sup> For a more extensive comparison of the history of the electric power industry and this period in the communications industry, see Jim Baller, *The Essential Role of Consumer-Owned Electric Utilities in Developing the National Information Infrastructure: A Historical Perspective*, <http://www.baller.com/library-art-history.html>, and the authorities cited in that document.

<sup>5</sup> Copies of papers, news reports and other materials referred to in this section are available at [www.baller.com/comm\\_broadband.html](http://www.baller.com/comm_broadband.html).

<sup>6</sup> Summaries of the nature and histories of these bills are available at [www.baller.com/comm\\_broadband.html](http://www.baller.com/comm_broadband.html).

<sup>7</sup> [http://www.baller.com/pdfs/FP-CU-CFA\\_Broadband\\_Reality\\_Check.pdf](http://www.baller.com/pdfs/FP-CU-CFA_Broadband_Reality_Check.pdf).



## Virginia Municipal Broadband Opportunities

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In a comment made in October 1999, former Federal Communications (“FCC”) Chairman William E. Kennard remarked on the importance of rural broadband deployment in his statement accompanying the adoption of the FCC’s *Report on the Deployment of Advanced Telecommunications Capability to All Americans*:

Those cut off from these high-speed networks today will find themselves cut off from the economic opportunities of tomorrow. And more importantly, they will be cut off from the most important network that there is – the network of our national community. ... I am particularly concerned about deployment in rural areas and in inner cities. Given the early stage of deployment of advanced telecommunications generally, it may seem difficult to discern the extent of the disparity between rural and urban areas. But today’s Report [to Congress] suggests that in the very short term, demand for high bandwidth will really start to take off. My concern is that a geometric increase in

demand may be mirrored by a geometric increase in the urban-rural disparity.

FCC Commissioner Michael Copps made the following similar observation in August 2003:

Broadband networks will be as critical to this new century as roads, canals and transcontinental railroads were to the Nineteenth Century and the Interstate Highway System and basic telecommunications networks were to the Twentieth.

President Bush has noted that the national policy of this nation is “to make sure broadband technology is available in every corner of America by 2007.” Indeed, the availability and affordability of broadband services is just as important to the future of Virginia municipalities as roads, schools, water systems, airports and convention centers have been in the past. Importantly, broadband, or high-speed Internet access, offers the promise of economic development to Virginia communities. Localities with universal and affordable access to broadband services will see economic growth, new and better jobs, improved schools, improved health care services, and a better standard of life than communities without broadband. Given the potential consequences to localities that are “left behind,” it is not surprising that underserved Virginia localities are vitally interested in exploring the options open to them.

The Virginia General Assembly has afforded localities a number of alternatives to provide their citizens access to broadband. However, in an attempt to supposedly “balance” the interests of the private telecommunications and cable television industries with the interests of local governments in providing these vital services to their citizens, the legislature has imposed a number of barriers to municipal entry into the broadband market. The purpose of this article is to outline the ways that Virginia local governments can hurdle those barriers and provide affordable and universal broadband access to citizens and businesses located in or near those localities.

### Telecommunications Act of 1996

It is important to understand the broadband opportunities for Virginia municipalities in the context of the Telecommunications Act of 1996, 47 U.S.C. § 151 *et seq.* (the “Telecom Act”), signed into law by President Clinton on February 8, 1996. In a seemingly sweeping and bipartisan display of federal authority to wipe away decades of monopoly provisioning of telecommunications services, the Telecom Act sought to herald a new era of competition in the telecommunications marketplace, which, in theory, would encourage carriers to develop innovative and affordable technologies and bring new services to all Americans. In return for allowing competitive carriers access to the telecommunications facilities of incumbent telephone companies, especially the infrastructure that brings telephone service to the homes

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and businesses of millions of Americans, the Telecom Act promised entrenched carriers such as Verizon removal of the barriers that prevented that carrier's entry into the Virginia long distance telephone and the newly emerging high-speed Internet markets.

While the Telecom Act has probably not fulfilled its promise for competition in the local telephone market in Virginia and elsewhere, as was envisioned by its proponents, there is no doubt that the Telecom Act has helped to foster innovative technological advances that have swept through Virginia and have led to the relatively widespread deployment of high speed Internet access.

### Dillon's Rule

Reacting to the promise of seemingly unfettered competition in the telecommunications market, Virginia local governments in the late 1990s began to explore ways to bring services to their citizens and the businesses located in those communities. The City of Bristol, in particular, concluded that the City itself would begin providing telecommunications services to its citizens, as an alternative to the incumbent carrier that had, up until the Telecom Act, relied on its monopoly status to provide these services.

Opponents of Bristol's entry into the telecommunications market cited Dillon's Rule as the basis for their challenge, arguing that the Virginia General Assembly had not specifically authorized municipal entry. In 1998, at the urging of Sprint, the incumbent local tele-

phone company, and Charter Communications, the franchised cable television company, both located in the service territory envisioned by Bristol, the General Assembly passed H.B. 335, legislation amending Virginia Code § 15.2-1500, specifically disallowing municipal entry into the telecommunications market in Virginia:

Notwithstanding any other provisions of law, general or special, no locality shall establish any department ... or entity which has authority to offer telecommunications equipment, infrastructure ... or services....

1998 Acts of Assembly Ch. 906. This legislation was successfully challenged by Bristol in the federal court, and the U. S. District Court for the Western District of Virginia declared that the legislature had violated the Telecom Act. *City of Bristol, VA, v. Earley*, 145 F. Supp. 2d 741 (W.D. Va. 2001). The Court determined that Virginia Code § 15.2-1500 violated the Telecom Act's admonition that a state action may not "prohibit or have the effect of prohibiting the ability of *any entity* to provide any interstate or intrastate telecommunications service." (Emphasis added). 47 U.S.C. 253 (a).

### The 2002 Virginia General Assembly

While an appeal of U.S. District Court's decision in *Bristol* was pending in the Fourth Circuit Court of Appeals, the Virginia General Assembly considered and passed legislation that specifically sets forth the conditions under which Virginia municipalities are allowed to

enter the telecommunications market. The resulting legislation, SB245/HB1021, 2002 Acts of Assembly Ch. 479, amended portions of Titles 15.2 and 56 to provide the specific authority for localities that is required by Dillon's Rule.

However, the resulting law bears little resemblance to Senator William Wampler's (R-Bristol) original notion of allowing local governments unfettered access to the telecommunications and broadband markets. The legislation sets up two "classes" of local governments. The first group of localities, those operating electric distribution facilities as of March 1, 2002, are allowed by Virginia Code § 15.2-2160 to "provide telecommunications services, including local exchange telephone service" within localities in which it operated an electric distribution system on March 1, 2002. Virginia Code § 15.2-2160 (A). All other localities, including "[a] county, city, town, electric commission or board, industrial development authority, or economic development authority," on the other hand, may provide "qualifying communications services" in a "specified geographic area" upon approval by the State Corporation Commission ("Commission"). Virginia Code § 15.2-484.7:1 *et seq.* Subsequent General Assemblies have made revisions to the original legislation, and those changes are noteworthy and are discussed later.

### Municipal Local Exchange Carriers

It is important to keep in mind that the original 2002 legislation

was primarily designed to allow the City of Bristol to continue to provide local telephone and broadband Internet access services to retail customers, given that locality's significant investment in facilities, infrastructure and related assets. Hence, there are only fifteen (15) Virginia localities that can use Virginia Code § 15.2-2160 to provide telecommunications services: The Cities of Bedford, Bristol, Danville, Franklin, Harrisonburg, Manassas, Martinsville, Radford and Salem; and the Towns of Blackstone, Culpeper, Elkton, Front Royal, Richlands and Wakefield.

The 2002 legislation required that in order to provide telecommunications services, these localities must obtain certificates of public convenience and necessity from the Commission pursuant to Virginia Code § 56-265.4:4, a statute that was originally amended in 1995 to anticipate the Telecom Act's encouragement of competition in the local exchange telecommunications market. This statute, supplemented by rules promulgated by the Commission's for certification, have resulted in the issuance of almost three hundred local exchange certificates for competitive carriers in Virginia since 1996. The Commission's rules for certification of local exchange carriers, originally issued in December 1995, created minimal entrance requirements, so as not to run afoul of the Telecom Act's admonition that states not create barriers to entry into the telecommunications market. The Commission has designated localities that obtain telecommunications cer-

tificates as Municipal Local Exchange Carriers ("MLECs").

The 2002 legislation also required the Commission to promulgate standards to ensure that localities that wish to provide telecommunications services do not cross-subsidize those services with revenues from other local government sources. There are two exceptions for the "no cross-subsidy" rule: First, if there are no for-profit providers of those services that exist in the locality [Virginia Code § 56-265.4:4 (B) (3)]; or second, if the Commission finds that a subsidy is "in the public interest and provided that such subsidy does not result in a price for the service lower than the price for the same service charged by the incumbent provider in the area." Virginia Code § 56-265.4:4 (B) (4).

In addition, the 2002 General Assembly required that the Commission regulate MLECs in the same manner in which it regulates other competitive local exchange carriers and interexchange (long distance) carriers, and that in its regulation of the prices charged by localities, the Commission "impute" the expenses incurred by for-profit entities, including taxes, pole rentals, rights of way, licenses and "similar costs." *Id.*

Interestingly, the 2002 General Assembly's SB245/HB1021 forbade MLECs from acquiring by eminent domain "the facilities or other property of any telecommunications service provider to offer cable, telephone, data transmission or other information or online programming services."

Finally, the 2002 legislation prohibited any telecommunications service provider, including local governments, from engaging in "anti-competitive acts" such as "price discrimination, predatory pricing or tying arrangements," as those terms are understood under antitrust laws. Virginia Code § 56-479.2.

It is significant to keep in mind what the General Assembly *didn't* do in its 2002 legislation – nowhere is there a specific mention of the regulation of local governments with electric distribution facilities that provide broadband Internet access, as opposed to local exchange or interexchange telecommunications services. This is a noteworthy omission, as the legislature specifically allows localities without electric distribution facilities to provide "qualifying communications services," which do include Internet access. Initially, there was general agreement that localities with electric distribution systems may provide broadband Internet access to citizens and businesses only after those localities obtain a certificate of public convenience to provide local exchange or interexchange telecommunications services pursuant to Virginia Code § 56-265.4:4. The 2004 General Assembly, however, specifically provided in S.B. 875 (2003 Acts of Assembly Ch. 711) that certificated MLECs may "construct, own, maintain, and operate fiber optic or communications infrastructure to provide consumers with Internet services, data transmission services, and any other communications service that its infrastructure is capable

of delivering....” Virginia Code § 56-265.4:4 (B) (5).

In 2002-03, the Commission had the opportunity to promulgate rules to implement the statutes that allowed for certification of MLECs. In its Order of April 9, 2003 in Case No. PUC-2002-00115, the Commission set forth the requirements for MLEC applications in order to comply with the General Assembly’s directives. The resulting rules, set forth in 20 VAC-5-417-10 through 20 VAC-5-417-80, impose minimal burdens on local government applicants, and, in fact, mirror the rules for certification required of competitive local exchange carriers. And, it is important to recognize that while the Commission has promulgated very specific rules to allow for the certification of MLECs, there is no Commission regulation of the broadband services that MLECs can provide once they are certificated.

Since the original legislation became effect in July 2002, the following localities have applied for and received certification as an MLEC: Cities of Bedford, Bristol, Danville, Franklin, Manassas, Martinsville, Radford and Salem; and the Towns of Front Royal and Richlands. Despite opposition by incumbent local exchange carriers and cable television companies, the Commission has not denied such an application. A number of these localities are, in one form or another, making broadband services available to citizens and businesses, thus delivering on the promises of the Telecom Act.

### **Qualifying Communications Services Providers**

In its 2002 legislation, the General Assembly describes the mechanism for any city, town and county to provide “qualifying communications services,” defined by Virginia Code § 56-484.7:1 to include, but “not be limited to, high-speed data service and internet access service, of general application.”

On its face, Article 5.1 to Title 56 of the Virginia Code sets forth a seemingly simple procedure for the Commission to approve petitions from localities for providing qualifying communications services. Virginia Code § 56-484.7:2 sets out a presumption that the Commission will find that it is in the public interest to approve a petition. The opponent of a locality’s petition has the burden to prove that the qualifying communications services for which approval is requested in the petition are “readily and generally available from three or more nonaffiliated companies in a manner that is functionally and economically equivalent for consumers.” In the alternative, the opponent must show that the petition fails to comply with the statutory guidelines or that “the offering of the proposed qualifying communications services will not benefit consumers.” In H.B. 2397, the 2003 General Assembly removed the requirement that the opponent show that existing service from three for-profit providers is *economically* equivalent, presumably eliminating the locality’s ability to claim that the challenge to its petition must fail since its pro-

posed services are priced far below the incumbent’s prices.

Another important aspect of the statute allowing for approval of qualifying communications service provider petitions is the short time frame for Commission action. Virginia Code § 56-484.7:1 provides that such a petition will be approved unless the Commission acts within sixty (60) days of the filing, unless the Commission extends that time for up to another sixty (60) days.

The 2002 General Assembly enacted Virginia Code § 56-484.7:4, which allows the Commission to revoke approval of a qualifying communications petition after five years if the original factors for allowing approval are no longer true or if “the petitioner has not made satisfactory progress toward making generally available the qualifying communications services specified in the petition.” Upon revoking such approval, the Commission must allow the locality sufficient time to sell the facilities used to provide qualifying communications services “at fair market value.” So, local governments have some risk that they may have to abandon providing Internet services if, after five years from the date of obtaining approval from the Commission to provide qualifying communications services, it can be shown that three or more for-profit providers can supply “functionally equivalent” services to customers. While this Code section allows these localities time to “offer” those facilities for sale, there is no requirement that localities actually receive the fair market

value of those facilities before they must relinquish permission. The Code also specifically provides that the locality can continue to provide qualifying communications services for “intragovernmental purposes” even after revocation of its authority by the Commission. And, presumably, localities can provide Internet-related services to themselves without any regulatory approval.

The 2003 General Assembly further amended Chapter 15.1 to Title 56 of the Virginia Code by passing H.B. 2397. This legislation eliminated the requirement in Virginia Code § 56-484.7:2 that a locality requesting permission to provide qualified communications services show that its proposed services are not “economically equivalent” to services provided by three existing carriers. In addition, the legislation requires localities that offer qualified communications services to provide to for-profit providers non-discriminatory access to poles and other facilities. Also, localities may not charge prices for services that are “lower than the prices charged by any incumbent provider for a functionally equivalent service that is as generally available from such incumbent as it is from such governmental entity.” Virginia Code § 56-484.7:1 (C). The General Assembly also determined that these localities may not acquire the facilities of other communications service providers by eminent domain. Virginia Code § 56-484.7:1 (D).

The most significant provision in H.B. 2397 was the mandate that localities eligible to become

MLECs with populations over 30,000 may not obtain approval of the Commission to provide qualifying communications services. Presumably, the legislature determined that such a locality must obtain an MLEC certificate from the Commission if it wishes to provide Internet access and other services. This amendment to Virginia Code § 56-484.7:1 (A) appears to reinforce the notions that (1) localities that own electric distribution facilities and have populations of over 30,000 can provide qualifying communications services if they obtain an MLEC certificate; (2) localities that own electric distribution facilities and have populations of under 30,000 can provide broadband services if they obtain an MLEC certificate; and (3) localities that do not own electric distribution facilities can provide broadband services if they obtain authority from the Commission to provide qualifying communications services.

Despite the seemingly strong presumption in favor of the local government petitioner for authority to provide qualifying communications services, the General Assembly left it to the Commission to determine the meaning of “functionally and economically equivalent.” The ambiguity of this phrase became the problem for the City of Staunton when it filed a petition for approval to provide qualifying communications services in April 2003. The City requested permission to provide “fully scalable data transport service over fiber optic and wireless networks using Internet Protocol standards,” but the petition was dismissed without prejudice

when a group of cable television companies and Verizon intervened and argued that at least three other existing carriers provide “functionally and economically equivalent” services in Staunton. State Corporation Commission Case No. PUC-2003-00065 (Final Order of June 26, 2003). The Commission determined that it did not have sufficient time to decide whether Staunton’s proposed services were indeed unique, in view of the affidavits and other evidence presented by the parties in pleadings. The Commission reasoned that Article 5.1 of Chapter 15.1 to Title 56 of the Virginia Code did not allow the Commission in this case adequate time to investigate and consider the petition by a hearing or other means. The Commission invited the City to refile its petition, along with the affidavit and evidence submitted to rebut the interveners’ contentions. The City of Staunton has never refiled its petition, and this is the only proceeding considered by the Commission to allow a locality to provide qualified communications services.

In 2003, the Commission initiated a proceeding to promulgate rules to implement Article 5.1 of Chapter 15.1 to Title 56 of the Virginia Code, but after hearing comments by numerous parties, including a coalition of Virginia localities, the Commission declined to do so. In its Final Order in Case No. PUC-2004-00118, the Commission agreed with the local government participants that the applicable Virginia Code sections explicitly set forth the criteria for approval of local governments’ petitions for authority to

provide qualified communications services. This ruling certainly acknowledges that Article 5.1 of Chapter 15.1 to Title 56 of the Virginia Code creates a presumption in favor of granting such authority to a local government petitioner, but no locality has come forward since the City of Staunton to test the Commission's understanding of the law.

### **The Virginia Wireless Services Authorities Act**

Another possible avenue for a locality to provide broadband services is to develop a project pursuant to the Virginia Wireless Service Authorities Act ("Wireless Services Act"), codified in Virginia Code §§ 15.2-5431.1 *et seq.* The Wireless Services Act was enacted in 2003 to provide unserved or underserved rural communities an opportunity to obtain broadband services as rapidly as possible. The Wireless Services Act gives localities "full and complete authority" to create an authority that provides wireless broadband services, and the General Assembly provided that the law "shall be liberally construed to effect the purposes of the chapter." Virginia Code § 15.2-5431.1. Most importantly, the Wireless Services Act allows localities to "[c]onvey or

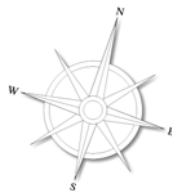
lease to any authority, with or without consideration, any systems or facilities for the provision of qualifying communications services" and to "[c]ontract, jointly or severally, with any authority for the provision of qualifying communications services." Virginia Code §§ 15.2-5431.5.1, 15.2-5431.5.2. The Act also authorizes localities to "lend, advance or give money" to their authorities. Virginia Code § 15.2-5431.8.

Localities that set up authorities under the Wireless Services Act need not obtain any regulatory approval from the Commission. Rather, the law establishes more streamlined procedures for localities to use in perfecting their authority to provide wireless broadband services under the Wireless Services Act than the procedures set forth in Article 5.1 of Chapter 15.1 to Title 56 of the Virginia Code for qualifying communications services generally. Under the procedures set forth in the Wireless Services Act, localities can complete the process in little more than a month, as opposed to the 120 days that it may take for a locality to become a qualified communications services provider. Specifically, the Wireless Services Act requires that localities: (1) prepare a resolution and articles of incorporation to

establish an authority under the law, (2) provide thirty (30) days notice of a public hearing on the resolution and articles, (3) conduct the hearing, (4) determine whether the criteria specified in Article 5.1 of Chapter 15.1 to Title 56 of the Virginia Code are met, and (5) adopt the resolution and articles. Virginia Code §§ 15.2-5431.3 - 15.2-5431.6.

### **Conclusion**

The Virginia General Assembly has provided Virginia localities that wish to provide broadband Internet and services with a number of choices. Local governments with electric local distribution facilities and populations over 30,000 that wish to provide these services must first obtain a certificate of public convenience and necessity from the State Corporation Commission to provide Municipal Local Exchange Carrier services. All other localities may either obtain approval from the Commission to provide qualifying communications services or form Wireless Services Authorities. Local governments that wish to take advantage of these statutes are cautioned to act sooner rather than later, as the fluid nature of the technology, regulatory atmosphere and political environment may create unexpected barriers in the future.



## **Restructuring Local Taxes On Communications Services – A Quest for a Level Playing Field and a 21st Century Revenue Base**

**Roger C. Wiley**  
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Do you have a friend or relative who has given up a landline home phone and now uses a cellular phone exclusively? Have you cancelled your cable television service and installed a satellite dish on your roof? Perhaps your cable company now also provides your telephone service and your Internet access along with your video programming?

If so, you are not alone. These and other rapidly changing, technology-induced customer choices about communications services have major implications for local governments' future revenues from fees and taxes on those services.

### **Effect of Shifting Technologies**

As wireless phone service has improved, more and more customers are choosing it as their only source of voice communication. The switch to high speed services such as DSL has also accelerated landline decline, by eliminating many residential customers' need to pay for separate, dedicated access lines for their computers or fax machines.

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In the twelve months ended September 30, 2004, the number of telephone access lines (i.e., telephone landlines connecting fixed customer locations to end-office switches) in service in Virginia decreased by 20%.<sup>1</sup> The number of access lines in service as of September 30, 2005, is expected to show further decline.

This decline in access lines threatens to deplete local revenues from telecommunications. Local consumer utility taxes (LCUTs) on landline phone service and E-911 fees on those same access lines make up the two largest sources of the nearly \$400 million that Virginia localities currently receive from telephone customers.

Local governments get more taxes from landlines than from wireless phones. Although state law currently caps LCUTs on both types of service at \$3.00 per month, many localities have "grandfathered" rates on landline service that are significantly higher, and some have chosen not to tax wireless at all. The monthly E-911 fee for wireless phone customers is set statewide at only 75 cents per month, compared to a \$3.00 per month cap on local E-911 fees for landline service.<sup>2</sup>

Initially, the decline in access lines has been more noticeable in urban and suburban areas, where more competitive and reliable wireless service has induced younger, more tech-savvy customers to forego their landline service. Recently, however, that trend has begun to affect rural localities as well. A confidential source at Verizon, the

largest certificated local exchange provider in Virginia, indicates that over the last six calendar quarters, access lines in service in the part of Verizon's territory formerly served by GTE, which generally includes smaller and more rural localities, declined by about six percent, suggesting that the technology shift is moving beyond the state's urban/suburban "golden crescent." As wireless service becomes better in rural areas, this trend will accelerate.

### **The VOIP Challenge**

The shift from landline to wireless service may eventually level off, but its impact on the industry (and thus on local government revenues) may eventually prove to be less than that caused by an even more dramatic technology change, the use of "voice-over-Internet-protocol" or "VOIP." Although voice communication over the Internet has been technically possible for quite a while, making such a connection simple and user-friendly has been a recent development.

Within the past couple of years, both software and adapter hardware have been developed that make it easy for residential and small business customers to plug ordinary telephones into their broadband connections and make all of their phone calls over the Internet. The advantage to the customer (and disadvantage to traditional telephone businesses) is obvious: all calls become local, and their duration becomes irrelevant.

A New Jersey firm called Vonage is the current U.S. market leader in selling VOIP ser-

vice to residential users. Over a million subscribers nationally now pay Vonage \$24.95 monthly for the adapter and software necessary to implement this unlimited, world-wide calling service. The precise impact of Vonage on Virginia localities isn't yet measurable, but the company has privately told state officials that Northern Virginia is its second-largest market.

What is clearer is that state law does not currently enable Virginia localities to apply their LCUTs to VOIP service. Under current enabling legislation, "local telecommunications services" subject to the LCUT are defined as "the two-way local transmission of messages through use of switched local telephone services."<sup>3</sup> Since VOIP uses no switched facilities and is not limited to local calling, it simply doesn't fit this definition. In Dillon Rule-bound Virginia, any attempt by a locality to tax VOIP under current law is probably doomed.

### **Competition in Cable Industry**

Even as cable television companies have begun to compete with Verizon for local exchange telephone customers, they have come under increasing competitive pressure from providers of direct-to-consumer satellite television service. Local governments may have traditionally viewed satellite TV as a strictly rural phenomenon, marketed only in areas with no cable service. As the size of satellite dish antennas has shrunk, however, the urban and suburban market for those services has grown.

Because satellite TV service is not now subject to any state or local tax, information on the number of cable subscribers lost to satellite companies is difficult to obtain. Cable industry officials confide privately, however, that they have begun to see satellite making significant inroads in cable-served areas. They have suggested that there could be as many as 100,000 satellite subscribers in Fairfax County alone.

Of course, every subscriber switching from cable to satellite ceases to pay the local franchise fee applicable to cable service, and current law provides no authority for the locality to levy any equivalent tax or fee on the satellite customer. This is particularly galling to cable companies, because the satellite services gleefully point out the absence of any such governmental charges when making price comparisons in their advertising.

### **Tax Restructuring Effort Initiated**

Governmental response to these changes in the industry has been slow to develop. In the 2002 Session of the General Assembly, Virginia became one of the first states to consider restructuring taxes on communications services with the adoption of House Joint Resolution 209. That resolution noted the current unequal taxation of competing technologies, and cited a "private study presented to the Governor's Commission on Government Finance Reform for the 21<sup>st</sup> Century show[ing] that Virginia applies one of the highest local tax rates in the na-

tion to the telecommunications industry and its customers."<sup>4</sup>

Also noted in HJR 209 was the "ad hoc patch work" of taxes and fees on communications services across the Commonwealth. That is a valid observation. There are approximately 250 counties, cities and towns that now levy some combination of LCUTs, cable franchise fees, rights-of-way use fees, E-911 fees or business license taxes on landline and wireless telephone and cable company customers, and each locality has its own peculiar combination of taxes fees and rates. Because cable systems and local telephone exchanges are not confined within the boundaries of political subdivisions, the administrative burden this places on the companies is undeniable.

During its first year the joint subcommittee recognized the complexity of the existing local tax structure, and the lack of reliable data about the mounts and sources of the revenue it generated. Accordingly, in the 2003 Session, the Assembly adopted House Joint Resolution 651<sup>5</sup> to continue the study. At the subcommittee's request, a work group of representatives from the industry, the Virginia Municipal League ("VML") and the Virginia Association of Counties ("VACo") was formed to seek common ground on restructuring these local taxes.

### **Local Government Reluctance**

Despite legislators' and the industry's assurances that any restructuring of communications taxes and fees would be "revenue neutral" to local budgets,

the local government organizations approached the restructuring effort with great skepticism and reluctance. Past experience with state restructuring of local taxes has often been fraught with problems, most notably in the case of the personal property or “car tax” relief program, which has proved difficult for the state to fund and for local tax officials to administer.

Another example of state interference with a local revenue source to localities’ detriment has occurred with wireless E-911 fees. By accumulating those payments, which formerly went directly to localities, into the state Wireless E-911 Fund, the legislature has created a tempting target for state budget writers. In adopting the state budget for the 2005-2006 biennium, the General Assembly appropriated \$3.7 million from the Wireless E-911 Fund in each year to fund state police dispatch operations, and took another \$125,000 each year to fund the Virginia Geographic Information Network.<sup>6</sup> These raids on a fund ostensibly created to reimburse local expenditures, over the objections of localities and of the board created to administer that fund, have increased local officials’ distrust of state government and particularly of the General Assembly.

### **Moving Forward**

Notwithstanding these negative experiences and misgivings, a team of negotiators for VML and VACO<sup>7</sup> began meeting in the work group with industry representatives as requested by the joint subcommittee and the 2002 and 2003 study resolutions. After much discussion,

by the end of 2003, the work group agreed on some basic principles. These included the intention to replace at least four types of current taxes and fees with a uniform statewide tax on all telecommunications services at a rate equal to the general retail sales and use tax (at that time 4.5 percent), to be distributed to counties, cities and towns on a basis that would assure them of as much revenue as they currently received from the eliminated sources. Also proposed as a replacement revenue source would be a uniform statewide E-911 collection from landline customers at a reduced rate of 75 cents per month.

Taxes and fees proposed to be replaced included the LCUT on both landline and wireless services (imposed under Va. Code § 58.1-3812), business license taxes in excess of 0.5 percent on telecommunications companies’ gross receipts (“grandfathered” in some localities under § 58.1-3731), the Virginia Relay Center Assessment (a state fee set by the State Corporation Commission under §56-484.6 and used to fund a call relay center for the deaf and hard of hearing), and E-911 fees or taxes on both landline and wireless service (imposed under §§ 58.1-3813.1 and 56-484-12, respectively). The negotiators further agreed that the Virginia Relay Center and the Wireless E-911 Board also would be assured revenue neutrality in any distribution formula.

Delegate Preston Bryant (R-Lynchburg), a primary proponent of the restructuring effort and chief patron of the two previous study resolutions, agreed

to introduce a bill in the 2004 Session expressing the intent of the General Assembly to adopt a bill in 2005 based on these agreed-upon principles, and directing the Auditor of Public Accounts (the “APA”) to make a determination of the fiscal year 2004 revenues received from the taxes proposed to be replaced. This 2004 “intent” bill was adopted as an uncodified act.<sup>8</sup>

### **Cable: In or Out?**

Although cable television industry representatives had participated in the work group established by the joint subcommittee under the 2002 and 2003 study resolutions, including cable in the proposal had proven to be difficult. A major point of disagreement had been treatment of existing cable franchises.

Since a majority of existing local franchises set the franchise fee to be collected from cable franchises at the 5 percent maximum allowed by Federal law, replacing that fee with a 4.5 percent tax would automatically create a revenue shortfall. Local governments were also concerned that the General Assembly’s replacement of the franchise fees paid under existing cable franchises with the statewide tax could be considered a violation of the constitutional ban on laws impairing the obligation of existing contracts.<sup>9</sup> They proposed having the cable service providers continue to make their franchise fee payments to the respective localities until the existing franchises expired, and treating those payments as credits against the providers’ statewide uniform

communications sales tax obligation.

Cable providers feared that differing treatment of their obligation for the proposed new statewide tax would give their satellite competitors a basis for claiming discriminatory treatment that would eventually enable the satellite companies to escape the statewide tax. In addition, the cable industry was reluctant to forego, even temporarily, the administrative convenience of a single payment point that their telephone industry competitors would be gaining under the proposal. Because of these differences between local governments and the industry, cable and competing satellite services were not included in the 2004 "intent" legislation.

### **Initial Estimates Fall Short of Goal**

The APA's estimate of fiscal year 2004 state and local revenue from the taxes and fees proposed to be replaced was \$391 million. With the help of the industry and the Department of Taxation, staff of the Division of Legislative Services had also projected the revenue that would be generated by the proposed replacement sources: the 75-cent monthly E-911 charge on landlines, and the statewide 4.5% tax on all telecommunications services, including services such as long distance calling and VOIP, not now being taxed. Estimating tax revenue from sources not currently taxed is always difficult, but the projections made by Legislative Services indicated that a 4.5 percent on all telecommunications services and a 75 cent

monthly landline E-911 charge would generate less than the \$391 million target.

### **Modifications to Achieve Revenue Neutrality**

To close this gap, the industry proposed several changes to the proposal. The most significant of these would be to increase the proposed statewide tax to 5 percent, as the General Assembly had just done with the general sales tax in the 2004 Special Session.<sup>10</sup> Another significant proposal was to include cable and satellite services in the proposal.

In addition, the cable industry agreed to begin collecting and paying the Public Rights of Way Use Fee calculated on the same basis that now applies to certificated local exchange telecommunications providers. The industry group also agreed to other modifications to the definition of services that would be subject to the proposed statewide tax, resulting in some minor additional projected revenue.

Future tax revenues can never be absolutely guaranteed. With these changes in the scope and applicability of the tax restructuring proposal, however, the local government negotiators became convinced that it can generate enough revenue to fully replace the taxes and fees to be eliminated.

### **Distribution of Replacement Revenues**

Once that overall objective had been satisfied, the negotiators had to provide a formula for distribution of the proceeds

from the statewide 5 percent tax and other replacement sources that would protect each individual locality from any revenue loss.

Industry representatives made it clear that they did not want to be involved in determining the distribution of tax proceeds, and VML and VACo staffs traditionally have avoided such issues so as not to risk favoring some of their members over others.

Development of the distribution provisions thus became the task of representatives of individual localities serving on the work group.

After considering various suggestions, those negotiators decided that the best way to proceed would be to have the Auditor of Public Accounts compile audited totals, by locality, of the actual amounts received from the sources being eliminated in the fiscal year before the restructuring takes effect. These would be used to calculate the percentage that each locality's receipts represented of the statewide total receipts from those current sources.

The receipts from the new 5-percent tax, the 75-cent monthly tax on landlines<sup>11</sup> and the rights-of-way use fees from cable customers would be paid by the service providers to the Department of Taxation. After first deducting the amount required to fund the Virginia Relay Center, and a small amount to cover the cost of administering the 5 percent tax, the Department would distribute these funds to the localities in the percentages

the APA has determined. If, as expected, the new revenue sources generate at least as much statewide as the revenue sources being eliminated, use of these percentages will effectively ensure that no locality suffers a revenue loss.

It should be noted that, although the portion of each locality's percentage attributable to its current collection for landline E-911 fees will be included in the distribution from the Department of Taxation, that amount will no longer be earmarked for E-911 purposes. It will instead be general fund revenue to the locality. This will likely be a concern to public safety officials, who will no longer be guaranteed the E-911 fee revenue, but will have to rely on the local governing body to appropriate the correct part of the distribution for E-911 purposes.

### **Bill Drafted and Introduced**

With tentative agreement on the local taxes and fees to be eliminated, the replacement state taxes and fees, and the distribution methodology, the negotiators, with the capable assistance of the Division of Legislative Services, proceeded to drafting of a bill for introduction in the 2005 Session. The product of that effort, House Bill 2880, was introduced just before the bill-filing deadline by Delegate Sam Nixon (R-Chesterfield) with Delegate Bryant as co-patron. Senator Jay O'Brien (R-Fairfax) was patron of identical Senate Bill 1335. Space does not permit a detailed discussion of every provision in these bills,

but several features should be noted.

To address local government concerns about the General Assembly diverting funds from the newly-imposed taxes and fees to other state purposes, the legislation provides that the amounts received by the Department of Taxation would be placed in a segregated trust fund account, and automatically distributed to localities in full each month in the established percentages. The funds would not show up in the state budget, and no balance would accumulate in the trust fund for longer than a month to tempt legislators or budget staff members to divert it for state use. That model has been used successfully for over 15 years to collect and distribute a special sales tax on motor vehicle fuels that supports the Washington Metro Area Transit system. Under that model, the two transportation districts in Northern Virginia that receive these funds have not experienced any attempts to divert revenues for state use.<sup>12</sup>

The negotiators were unable to get the cable industry to agree to continuing payment of franchise fees directly to localities until existing franchise agreements expire. They will, however, be required to include with their payments to the Department of Taxation a statement of how much of each payment is required by the terms of the franchise for every locality with which the provider has an unexpired current franchise. All other franchise terms and benefits are preserved and may be enforced by the franchising locality, including requirements

for in-kind services and for the support of PEG channels. These provisions lessen, but admittedly do not completely eliminate, concerns about unconstitutional impairment of existing contract obligations.

To facilitate enforcement and administration of the new tax (to be called the Virginia Communications Sales and Use Tax) the proposed legislation mirrors the registration, collection and enforcement provisions used for the general Virginia Retail Sales and Use Tax. This should enable the Department of Taxation to begin enforcement promptly, without having to develop too many new regulations or procedures. Because of a computer system upgrade now in progress, the earliest possible date for the Department to implement the legislation would be July 1, 2006

### **Rejection in 2005; Reintroduction in 2006**

Unfortunately because of their late introduction and a number of other factors, neither of the 2005 bills was adopted in substance. Senate Bill 1335 was tabled in the Commerce and Labor Committee, and the sole provision adopted in House Bill 2880 was the requirement for the APA to produce audited figures on localities' revenue received in the fiscal year ended June 30, 2005. Those figures and the resulting distribution percentages will be made available by December 1. These figures should give local governments some reassurance before the bill is reintroduced in the 2006 Session.

When the legislation is reintroduced, one change in the distribution methodology can be expected. Because towns under 3500 population are not legally required to submit annual audits to the APA, the 2005 bills provided for a schedule of flat-rate distributions to be made to those towns. In the interim, it has become apparent that there are too many variations in the taxes and fees imposed by small towns for that schedule to compensate them all fairly. The negotiators will likely recommend and incorporate in the 2006 bill some way to use actual past receipts to calculate the distribution of revenues from the restructured taxes and fees for these towns, no matter how small, putting them on the same basis as larger jurisdictions.

The industry proponents of the bill and VML and VACo have made efforts since the 2005 Session to educate both their own members and legislators about the terms of the restructuring proposal and the need for it. Strong opposition can be expected once again from satellite providers and their customers, but the unfairness of allowing them to escape taxation while cable users are paying seems obvious. Legislators from rural areas, where existing taxes and fees tend to be lower, may be concerned that their constituents will pay more under the broad-based 5 percent tax, even though the net revenue to their local governments may be unchanged.<sup>13</sup> And some local governments that have not imposed the full range of existing taxes and fees will likely be concerned that the bill removes

their option to use these revenue sources in the future.

Despite these uncertainties and complaints, local governments should support the restructuring legislation. Regardless of its imperfections, it offers a better hope for future revenue from taxing communications services than does preservation of the status quo.

### **A New and Greater Threat**

The pace of technological change, meanwhile, shows no signs of slowing. While Vonage continues to add VOIP subscribers who pay it a monthly fee, an even more problematic business model is offered by Skype, a British firm started by the same two Danish entrepreneurs whose KaZaA file sharing software has previously dropped the music industry to its knees.

Because the company has been privately held, Skype's revenues and its methods for generating them are not fully known. The firm actually gives its software away over the Internet, and probably gets most of its revenues not from the software users at all, but from the sale of pop-up advertising that the users tolerate in exchange for the free service.

*Newsweek* reports that, in its three years of operation Skype has acquired 60 million users in 225 countries, and adds them at the rate of 150,000 per day. Its 6 million U.S. users pay nothing to talk to other VOIP users and only 2 cents per minute to talk to users of traditional land line or wireless phones.<sup>14</sup>

Whatever Skype's method for making money may be, it seems to be working. On September 12, 2005, Internet giant e-Bay agreed to buy Skype for at least \$2.6 billion. Estimating Skype's current annual revenues at only \$60 million, British business journal *The Economist* says that "perhaps e-Bay, rather like some over-excited bidder in one of its own auctions, has paid too much."<sup>15</sup> Nevertheless, *The Economist* concludes that "the rise of Skype and other VOIP services means nothing less than the death of the traditional telephone business, established over a century ago."<sup>16</sup>

That prediction may seem a bit dire and premature, but Skype's business model certainly presents a challenge for both the telecommunications industry and state and local taxing officials. It remains to be seen whether that business model will leave anything to be taxed or any practical way of collecting whatever tax there may be. Regardless of the answers to those questions, traditional telephone and cable businesses won't survive without changing to stay competitive, and local governments won't be able to derive significant revenue from communications providers by clinging to a century-old taxing model.

### **Conclusion**

Despite still being uneasy about some aspects of the restructuring proposal, the local government negotiators are convinced that maintaining the current model is not in localities' best interest. Based on their recommendation VML agreed as an organization to support the pro-

posal when it was introduced in 2005, and will continue to do so when it is reintroduced in the 2006 Session. VACo has maintained a more neutral posture.

Individual local governments, of course, may choose to oppose the legislation based on their individual circumstances. Before deciding to oppose, however, they should consider

carefully a proposal that treats competitors more fairly, is easier to administer, preserves local revenues for now and broadens the tax base to give them a reasonable chance to grow in the future.

<sup>1</sup> Each year by December 1, the Virginia Department of Transportation reports the number of access lines in service as of September 30, based on the information provided by each certificated provider of local exchange telecommunications service to be used by VDOT for calculation of the Public Rights-of-Way Use Fee that will be applied to the monthly billing for each access line in the next ensuing fiscal year. Va. Code Ann. § 56-486.1(F).

<sup>2</sup> Since the adoption in 2000 of the Advanced Public Safety Telephone Services Act, Va. Code Ann. §§ 56-484-12 through 56-484.18, E-911 fees on wireless customers do not come directly to any locality, but are collected by mobile telecommunications service providers (i.e., wireless telephone companies or "CMRS providers") and remitted to the state-level Wireless E-911 Fund, then distributed by the Wireless E-911 Board to both local government public safety access points ("PSAPs") and CMRS providers, to pay for operating and capital costs incurred in providing E-911 service to wireless telephone callers.

<sup>3</sup> Va. Code Ann. § 58.1-3812 (M).

<sup>4</sup> 2002 Va. Acts (Reg. Sess.) 2818.

<sup>5</sup> 2003 Va. Acts (Reg. Sess.) 2469, 2470.

<sup>6</sup> ch.4, 2004 Va. Acts (Sp. Sess.), items 454 B and 466 B.

<sup>7</sup> The local negotiators have included Ellen Davenport from VACo, now succeeded by Sharon O'Hare, Bernard Caton (Alexandria), Mary Ann Curtin (Chesterfield), Anna D'Antonio (Chesapeake), Susan Mittereder (Fairfax County), and Linda Robinson (Henrico). In 2004, the author of this article succeeded Michael Edwards as VML's lead negotiator.

<sup>8</sup> Ch. 634, 2004 Va. Acts (Reg. Sess.).

<sup>9</sup> Va. Const. (1971), Art. I, § 11.

<sup>10</sup> See ch.3, 2004 Va. Acts (Sp. Sess. I), amending Va. Code §§ 58.1-603 and 58.1-604 to increase the general state tax on retail sales and uses to 4 percent effective August 1, 2004. With the addition of the one percent that is returned to localities, the total general sales and use tax became 5 percent as of that date.

<sup>11</sup> Proceeds of the 75-cent monthly E-911 charge on wireless customers would continue to be paid by providers to the Wireless E-911 Board for distribution in the current manner.

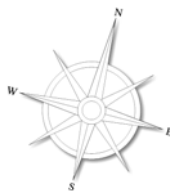
<sup>12</sup> See Va. Code Ann. § 58.1-1724.

<sup>13</sup> Conversely, customers in localities with higher-than-average LCUT and E-911 rates will be likely to pay less, even though their localities revenues are not decreased. As the highest rates tend to be in more populous jurisdictions, one may logically assume that on a state-wide basis, winners will outnumber losers.

<sup>14</sup> R. Foroohar and D. McGinn, "Hyped over Skype", *Newsweek*, Nov. 14, 2005, pp. E10-E16.

<sup>15</sup> "Telecoms and the internet: How the internet will kill the phone business," *The Economist*, Sept. 17, 2005, p. 11;

<sup>16</sup> *Id.*



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