



## **Audit of Franchise Fee Collections**

Franchise fees are payments made by a utility for using the City of Denton's rights-of-way to operate. Additional guidance on calculating City-owned franchise fee transfers and verifying investor-owned franchise fee payments would further ensure payments are processed consistently and made accurately. There may be opportunities to increase franchise fee revenues, particularly from State-authorized video, cable, and telecommunications providers.

Historically, the responsibility for managing franchise agreements has not been clear, leading to agreements expiring and a lack of readily available information.

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## Audit at a Glance

### What we Found:

This audit generally evaluates the City's franchise fee collections including the effectiveness of fee collection monitoring and franchise agreement management. Audit findings are summarized below:

**Fee Collection Monitoring.** Over 80 percent of the City's franchise fee revenues are collected from City-owned utilities. Guidance on how to calculate these amounts is outdated and inadequately detailed, resulting in potential inaccuracies and increased risk of lost revenue.

Guidance on verifying investor-owned utility franchise fee payment accuracy is lacking. Agreement-authorized utilities' payments are generally timely, accurate, and reasonable and there do not appear to be significant gaps in service areas. Some potentially significant state-authorized providers do not appear to be submitting payments.

**Franchise Agreement Management.** While all franchise agreements appear to comply with the City's charter, responsibility for managing franchise agreements has historically been unclear resulting in agreements expiring and a lack of readily available information. Opportunities exist to align City-owned and investor-owned franchise fee calculation methodologies.

### Why we did this Audit:

During Fiscal Years 2022 and 2023, the City received almost \$43.5 million in franchise fee revenue from utilities operating in its rights-of-way. Managing and monitoring franchise fee collections appropriately is critical to ensuring that the City continues to receive all revenues it is owed. This audit was included in the City's Fiscal Year 2023-24 Annual Audit Plan as approved by the City Council.

### What we Recommend:

#### Recommendations 1 & 2

Clarify responsibilities, procedures, and methodologies for calculating City-owned franchise fee transfers.

#### Recommendations 3, 4, & 5

Develop written guidance for verifying the accuracy of investor-owned franchise fee payments.

#### Recommendations 6, 8, & 9

Explore opportunities to increase franchise fee revenue collections.

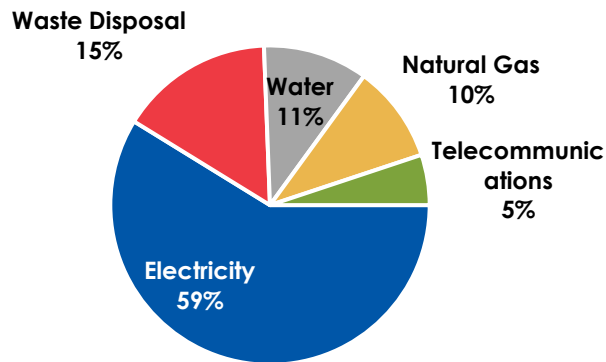
#### Recommendations 7 & 10

Clarify responsibilities for managing franchise agreements and investor-owned franchise relationships.

## Detailed Findings & Analysis

Under Texas State law, municipalities such as the City of Denton have the authority to grant utility companies the right to use its rights-of-way – typically the area around a roadway – for purposes in the public interest. These utilities are then required to pay the municipality a franchise fee for this use, like rent. Utilities whose purposes affect the public interest generally include those supplying electricity, water, and natural gas, those providing video, cable, and other telecommunication services, and those disposing of solid and liquid waste. During Fiscal Years 2022 and 2023, the City collected almost \$43.5 million from utilities in franchise fees as shown in Figure 1.

**Figure 1:** FY22 & FY23 Franchise Fee Revenues by Utility Type



In Denton, there are generally three different ways a utility can be authorized to operate in the City's rights-of-way: 1) the City owns the utility, 2) the City has executed a franchise agreement with the utility, or 3) the utility has been authorized by the State of Texas. Table 1 summarizes the type of utility provided under each category of authorization.

**Table 1:** Summary of Franchise Utility and Authorization Types

City-Owned	Agreement-Authorized	State-Authorized
<ul style="list-style-type: none"> <li>Electricity</li> <li>Water</li> <li>Liquid Waste</li> <li>Solid Waste</li> </ul>	<ul style="list-style-type: none"> <li>Electricity</li> <li>Natural Gas</li> </ul>	<ul style="list-style-type: none"> <li>Video and Cable</li> <li>Telecommunications</li> </ul>

## Additional Payment Reconciliation Guidance Needed; Opportunities to Increase Telecommunications Franchise Revenue Exist

In general, franchise fee payments are equal to a certain percentage of a utility's gross revenue earned within the municipality for a certain period – usually each quarter – as described in Equation 1.

### Equation 1: General Franchise Fee Calculation Methodology

$$\text{Franchise Fee Payment} = \text{Gross Revenue} * \text{Franchise Percentage}$$

To accurately calculate franchise fee payments two parameters must be clear: 1) which revenue sources are related to the utility's customers and 2) which customers are within the City's limits.

Table 2 summarizes franchise fee revenues by each utility and provider for the Fiscal Year 2022 and Fiscal Year 2023. Most of the City's franchise fee revenue comes from City-owned utilities while other sources appear to be generally decreasing.

**Table 2:** Franchise Utility Revenues by Reporting Period

Franchise Utility	FY 2022	FY 2023
<b>City-Owned</b>	<b>\$17,485,912.88</b>	<b>\$18,402,733.03</b>
Denton Municipal Electric	\$11,883,796.50	\$12,590,725.87
Denton Water	\$2,231,669.71	\$2,390,490.14
Denton Solid Waste	\$2,019,881.99	\$1,965,748.58
Denton Wastewater	\$1,350,564.68	\$1,455,768.44
<b>Agreement-Authorized</b>	<b>\$2,774,066.04</b>	<b>\$2,667,293.39</b>
Atmos Gas	\$1,784,437.64	\$1,780,611.00
CoServ Electric	\$552,815.16	\$469,727.13
CoServ Gas	\$374,692.73	\$355,664.93
Oncor Electric	\$62,120.51	\$61,290.33
<b>State-Authorized</b>	<b>\$1,173,706.99</b>	<b>\$1,046,172.37</b>
Charter Communications (i.e., Spectrum)	\$620,361.24	\$560,296.58
Frontier Communications	\$346,273.50	\$292,526.76
Certified Telecommunication Providers	\$119,094.25	\$108,812.92
Grande Communications Networks	\$87,978.00	\$84,536.11
<b>Total Revenues:</b>	<b>\$21,433,685.91</b>	<b>\$22,116,198.79</b>

### What We Found

- Clearer guidance would help ensure City-owned franchise fee transfers are accurate and decrease the risk of lost revenue.
  - The Finance Department has developed written guidance on how to calculate City-owned utility franchise fee transfers; however, this

guidance is outdated and does not provide adequate detail on how to calculate franchise fees – especially for Denton Municipal Electric.

- In addition, during Fiscal Years 2022 and 2023, the franchise fee calculation methodology used was not consistent, generally due to additional revenue accounts being included in the calculation, seemingly resulting in some franchise fee transfers being inaccurate. In addition, some revenue codes may have been inappropriately excluded from the gross revenue definition of City-owned utilities – most notably the resale of raw water. These issues are summarized in Table 3.

**Table 3:** City-Owned Utility Franchise Fee Transfer Accuracy Comparisons

Utility	Actual Transfers	Per Available Guidance Amount	Guidance Difference	Internal Audit Estimate Amount	Estimate Difference
Denton Municipal Electric <sup>1</sup>	\$19,558,309.97	\$19,560,680.48	\$2,370.51	\$19,767,281.27	\$17,074.01
Denton Water	\$4,622,159.85	\$4,646,243.56	\$24,083.84	\$4,924,788.76	\$302,629.04
Denton Solid Waste	\$3,985,630.57	NA	NA	\$3,984,698.38	-\$932.19
Denton Wastewater	\$2,806,333.12	\$2,728,300.75	\$78,032.37	\$2,817,969.79	\$11,636.64

- City-owned utility franchise fee transfers are calculated for each month and are generally posted in the City's general ledger about 20 days after the close of each month; however, twelve of the expected 96 transfers were posted after investor-owned utilities would have been expected to submit payments (i.e., 45 days after the close of the quarter during which the revenue was collected).
- Investor-owned, agreement-authorized franchise fee payments appear to be timely, accurate, and reasonable, except for one utility with an expired agreement.
  - Three of the City's four agreement-authorized utilities submitted required quarterly and annual payments on time. The remaining utility – CoServ Gas – had an expired agreement that required payments to be submitted within ten days of the reporting period closing instead of the 45 days allowed for the other utilities. Only one of this utility's payments would have been late per the standard timeline.
  - Submitted payments appear generally accurate based on the provided supporting detail and agreement requirements, except for CoServ Gas, which appears to be submitting payments based on a higher franchise percentage than what was agreed to – though it should be noted that the most current agreement appears to have

<sup>1</sup> Denton Municipal Electric accuracy verification excludes \$4,916,212.40 in franchise fees from Energy Cost Adjustment revenues.

expired in 2009. Expected to actual franchise fee payments are detailed in Table 4.

**Table 4:** Summary of Agreement-Authorized Franchise Payments

Utility	Expected Amount	Actual Amount
Atmos Gas	\$3,565,038.72	\$3,565,045.64
CoServ Electric	\$864,885.11	\$864,885.11
CoServ Gas	\$390,101.00	\$730,357.66
Oncor Electric	\$129,780.46	\$129,780.47
All:	\$4,949,805.29	\$5,290,068.88

- Gas and electric utilities experience significantly similar revenue trends due to weather. In addition, the gas and electric utility's estimated customer shares are generally proportional to their share of franchise fee revenue, indicating that submitted franchise fee payments are reasonable.
- There do not appear to be significant geographical gaps in the service areas of the City's electric and gas suppliers; however, several agreement-authorized utilities appeared to have address points included in their gross revenue calculation that were outside of the City's limits. While some of these discrepancies appear to be due to the utility, the City does not currently have a formal process for notifying utilities when it annexes or deannexes land.
- Franchise fee payments from State-authorized video and cable providers are generally monitored, though not all supporting documentation is submitted. Some State-authorized providers operating in the City's limits do not appear to be submitting franchise fee payments.
  - Based on information provided by the Public Utilities Commission of Texas, five cable and video providers have a State-Issued Certificate of Franchise Authority – or SICFA – and have filed activity in Denton's city limits; however, two of these – DIRECTV and Bluepeak did not submit franchise fee payments during Fiscal Years 2022 or 2023. It should be noted that Bluepeak has not begun offering video or cable service in Denton, though this is expected in the future.
  - The remaining three video and cable providers submitted all 24 required payments on time.
  - Only one of the video and cable providers submitted adequate supporting documentation with their payments to verify that the five percent franchise fee rate was applied accurately.



- Franchise fee payments from State-authorized certified telecommunications providers have historically not been monitored in detail. One significant certified telecommunications provider does not appear to be submitting the required payments.
  - The City has not created written documentation to guide staff when tracking or verifying the accuracy of franchise fee payments from certified telecommunications providers. While a former Finance Department employee had access to the State's access line report, there was no indication that it had been used to verify access line-related payments. In addition, payments from seven vendors totaling almost \$16,800 appeared to be misclassified as franchise fee revenue.
  - Based on a review of access line reports available from the Public Utility Commission of Texas, eight certified telecommunication providers do not appear to be submitting required franchise fee payments to the City for an estimated net loss of about \$344,000 – almost 92 percent of which was attributable to Time Warner Cable. In addition, 12 certified telecommunication providers submitted inaccurate payments resulting in a total loss of almost \$7,900 as summarized in Table 5. Almost 88 percent of this loss is attributable to a single missing payment from AT&T Communications of Texas.

**Table 5:** Summary of Revenues from CTPs Reporting to the State

	CTPs	Expected Rev.	Actual Revenue
No Payments	8	\$343,537.27	\$0.00
Underpaid	8	\$108,892.30	\$100,868.06
Overpaid	4	\$41,236.18	\$41,312.41
Accurate	13	\$20,938.57	\$20,938.57
Total:	33	\$514,604.32	\$163,119.04

- An additional 44 certified telecommunication providers submitted payments to the City for a total revenue of just over \$195,000 for Fiscal Year 2022 and the first through third quarters of Fiscal Year 2023, but do not appear to be reporting access lines to the State. Of these, 35 appeared to use the correct access line rate based on the available documentation, but this could not be verified for the remaining nine due to a lack of submitted supporting documentation. In addition, it was not possible to verify if these providers had missing payments.

### Why It Matters

To summarize, the City appears to generally be receiving accurate franchise fee revenue payments from City- and investor-owned utilities and providers; however, some potentially significant utilities were identified that seemingly had not submitted required payments. Developing additional guidance on



calculating City-owned franchise fee transfers, verifying that investor-owned payments are accurate, and ensuring investor-owned utilities are updated when there are changes to the City's limits would help to further ensure all revenues are being received accurately and timely.

**Recommendations:**

1. Create a standard operating procedure to guide staff in calculating City-owned utility franchise fee transfers, including revenue code applicability. Ensure revenue codes are reviewed and updated at least annually.

**Finance Department Comments:** *Concur. Staff will develop SOP and review chart of accounts annually.*

2. Clarify when City-owned utility franchise fee transfers should be posted after the period ends. Consider calculating and transferring City-owned utility franchise fee payments in line with the general investor-owned utility payment schedule (i.e., within 45 days of each quarter closing).

**Finance Department Comments:** *Concur. Staff will close month end within a specific time-frame.*

3. Create a standard operating procedure to guide staff in tracking and verifying the accuracy of all investor-owned franchise fee payments, including those with franchise agreements and those authorized by State law. Guidance should include information on significant franchise contracts, expected payment rates, and obtaining the certified telecommunications provider access line report from the Public Utilities Commission of Texas. Consider performing audits of significant investor-owned franchise fees periodically.<sup>2</sup>

**Finance Department Comments:** *Concur. Staff will develop SOP to track and verify payments.*

4. Develop a process to ensure investor-owned utilities are informed when the City annexes and de-annexes land.

**Finance Department Comments:** *Concur. Staff will work with internal departments to develop a process.*

5. Require investor-owned utilities and providers to submit clear documentation that provides sufficient detail to show how each component of its franchise

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<sup>2</sup> Significant investor-owned utilities submit more than \$50,000 in franchise fees annually.

fee payment was calculated and retain this documentation as part of the City's journal entry support.

**Finance Department Comments:** *Concur. Staff will reach out to external parties for supporting documents.*

6. Reach out to State-authorized video and cable providers and certified telecommunications providers reporting to the State but not submitting franchise fee payments to request expected revenue.

**Finance Department Comments:** *Concur. Staff will reach out to the State quarterly for the reports.*

## Lack of Clear Responsibility Hinders Franchise Agreement Management

The City of Denton's charter grants the City Council the authority to grant, renew, and extend franchises of all public utilities operating within the City for no longer than 20 years, and for no less than two percent of the gross revenue received by the franchises for their operations in the City. For investor-owned utilities that are not authorized by State law, a current agreement is required to legally operate their business in the City. For this reason, the City should work to ensure that information on obtaining a franchise agreement is available and that these utilities have current agreements.

### What We Found

- All franchise agreements comply with the City Charter's requirements around minimum fee and agreement length. Responsibility for managing franchise agreements has historically been unclear, leading to agreements expiring and a lack of readily available information.
  - Based on available records, the City has historically executed franchise agreements with five utility companies including Atmos Gas, CoServ Gas, CoServ Electric, Oncor Electric, and Charter Communications.
  - Due to changes in State law, the agreement with Charter Communications was allowed to expire and the utility obtained a State-Issued Certificate of Franchise Authority.
  - For the remaining four utilities, both the CoServ Electric and CoServ Gas agreements appear to be currently expired by about one and 15 years respectively. In addition, the Atmos Gas agreement was recently renewed but expired over eight years before that, and the Oncor Electric agreement was expired for over a year before its renewal in 2024.

- According to City staff, the two recent agreement renewals were assigned as special projects and the responsibility for continually managing franchise agreements has not been clear, thus hindering efforts to locate franchise agreements. Further, information about obtaining a new franchise agreement is not readily available on the City's website.
  - In addition, the City Charter requires the City Secretary's Office to compile and maintain a public record of franchises granted by the City, but this record does not currently exist.
- City- and investor-owned franchise fee revenue calculations could be further aligned.
  - Denton Municipal Electric's gross revenue calculation methodology is based on a franchise percentage factor as shown in Equation 1 on page five. However, investor-owned electric utility's franchise fees are calculated by multiplying a kilowatt hour factor by kilowatt hours sold as shown in Equation 2.

**Equation 2:** Investor-Owned Electric Franchise Fee Calculation Methodology

*Franchise Fee Payment*

$$= (\text{Kilowatt Hours Sold} * \text{Franchise Fee Factor}) + (\text{Additional Revenues} * \text{Franchise Fee Percentage})$$

- All investor-owned utilities, except CoServ Gas, are required to include contributions in aid of construction in their gross revenue, but this is excluded for City-owned utilities.
- Revenues received from reselling each utility's services (i.e., supply of electricity, water, gas, and liquid waste treatment) are not treated consistently. Specifically, revenues for gas resold to other utilities are excluded for Atmos Gas, but not CoServ Gas. In addition, intragovernmental sales and wastewater fees to other cities are included for Denton Municipal Electric and Denton Wastewater respectively and Denton Water includes revenues from reselling treated water but not raw water.
- Finally, the agreement with Oncor Electric includes revenues from certain discretionary charges as defined in 2002 in the calculation of franchise fees; however, Oncor's discretionary charges have been updated since 2002, indicating that there may be relevant revenues that are not being included in its submitted franchise fee payments even though they are complying with the current agreement.

## Why It Matters

Franchise agreements are critical to ensuring that the City is receiving the revenue it is owed for the use of its rights-of-way. For this reason, the responsibility for managing franchise agreements should be clear to City staff as well as existing and potential new franchises. Further, all utilities operating in the City's rights-of-way should have an active franchise agreement with the City to protect both the City and the utility's interests.

In addition, while not required, aligning the City's franchise fee transfer calculation methodology with investor-owned utilities could help to streamline the calculation verification process and potentially increase equity between all utilities, and ultimately Denton's residents.

## Recommendations:

7. Clarify who is responsible for managing the City's franchise agreements to ensure agreements remain up-to-date, information on current agreements is centrally retained, and adequate information for utilities seeking a new franchise agreement is readily available.

**City Auditor's Office Comments:** *Based on discussions with the City Manager's Office, franchise agreements will be managed by the Finance Department going forward.*

8. Work with the City Attorney's Office to execute new franchise agreements with investor-owned utilities operating in the City's rights-of-way without current authorization.

**Finance Department Comments:** *Concur. Staff will reach out to the City Attorney's Office to review investor-owned utility agreements.*

9. Consider more closely aligning City-owned franchise fee transfer calculations to investor-owned utilities gross revenue definitions, including using a kilowatt-hour factor for Denton Municipal Electric and including contributions in aid of construction.

**Finance Department Comments:** *Staff will evaluate aligning to investor-owned revenue definitions, however a per kWh factor may have additional implications, such as billing changes and the need to establish separate tariff rates on our rate ordinance to align with investor-owned utilities. Staff will evaluate the use of a kWh factor, but may not recommend moving forward base on the outcome of the evaluation.*

10. Consider requesting an amendment to Oncor's franchise agreement to include discretionary service charges created since 2002 and any new

discretionary service charges to the extent that the service is paid directly by the customer in the gross revenue definition.

**Finance Department Comments:** *Concur. Staff will work with the City Attorney's Office to review the Oncor franchise fee agreement.*

## Audit Project Background

The City Auditor's Office is responsible for providing: (a) an independent appraisal<sup>3</sup> of City operations to ensure policies and procedures are in place and complied with, inclusive of purchasing and contracting; (b) information that is accurate and reliable; (c) assurance that assets are properly recorded and safeguarded; (d) assurance that risks are identified and minimized; and (e) assurance that resources are used economically and efficiently and that the City's objectives are being achieved.

### Auditing Standards

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

### Management Responsibility

City management is responsible for ensuring that resources are managed properly and used in compliance with laws and regulations; programs are achieving their objectives; and services are being provided efficiently, effectively, and economically.

### Objectives, Scope, and Methodology

The City Auditor's Office has completed a performance audit of the City's franchise fee collections processes. This report is intended to provide assurance that the City is effectively receiving all franchise fee revenue to which it is entitled.

Audit fieldwork was conducted during January, February, and March 2024. The scope of the review varied depending on the procedure being performed. The following list summarizes major procedures performed during this time:

- Reviewed documentation to develop criteria including documented policies and procedures, industry standards, and best practices;
- Developed process narratives to identify current control activities in franchise fee processes including agreement negotiation, fee payment processing, and franchise utility monitoring;

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<sup>3</sup> The City of Denton City Auditor's Office is considered structurally independent as defined by generally accepted government auditing standard 3.56.

- Interviewed Finance, Development Services, and Capital Project Departments staff;
- Recalculated quarterly franchise fee transfers for City-owned utilities and compared to actual transfers;
- Verified that all investor-owned utility franchise fee payments for the Fiscal Years 2022 and 2023 reporting periods were submitted timely and accurately based on the related franchise agreement or State regulation;
- Mapped electric and gas utility service points using geographic information system software to identify any obvious service area gaps or service point misclassifications;
- Reviewed available reports from the Public Utility Commission of Texas on state-authorized video and cable service providers and Certified Telecommunication Providers operating in Denton's city limits to identify missing or inaccurate payments;
- Reviewed existing franchise agreements and verified that agreement terms complied with City Charter requirements; and
- Compared gross revenue definitions between like-type utilities to identify opportunities to further align calculation methodologies.



## Appendix A: Management Response Summary

The following summarizes the recommendations issued throughout this report. The auditors found that staff and the Departments were receptive and willing to make improvements where needed. Management has provided their response to each recommendation.

1	Create a standard operating procedure to guide staff in calculating City-owned utility franchise fee transfers, including revenue code applicability, and ensure revenue codes are reviewed and updated at least annually.	<b>Agree</b>
Responsibility:	<b>AD Finance/CFO</b>	Expected Completion: <b>2024, 4th Quarter</b>
2	Clarify when City-owned utility franchise fee transfers should be posted after the period ends.	<b>Agree</b>
Responsibility:	<b>Controller</b>	Expected Completion: <b>2024, 4th Quarter</b>
3	Create a standard operating procedure to guide staff in tracking and verifying the accuracy of all investor-owned franchise fee payments, including those with franchise agreements and those authorized by State law.	<b>Agree</b>
Responsibility:	<b>Budget Manager</b>	Expected Completion: <b>2024, 4th Quarter</b>
4	Develop a process to ensure investor-owned utilities are informed when the City annexes and de-annexes land.	<b>Agree</b>
Responsibility:	<b>AD Finance/CFO</b>	Expected Completion: <b>2024, 4th Quarter</b>
5	Require investor-owned utilities and providers to submit clear documentation that provides sufficient detail to show how each component of their franchise fee payment was arrived at and retain this documentation as part of the journal entry support.	<b>Agree</b>
Responsibility:	<b>Controller</b>	Expected Completion: <b>2024, 4th Quarter</b>
6	Reach out to State-authorized video and cable providers and State-authorized certified telecommunications providers reporting to the State but not submitting franchise fee payments to request expected revenue.	<b>Agree</b>
Responsibility:	<b>Budget Manager</b>	Expected Completion: <b>2024, 4th Quarter</b>

7	Clarify who is responsible for managing the City's franchise fee agreements to ensure agreements remain up-to-date, information on current agreements is centrally retained, and adequate information for utilities seeking a new franchise agreement is readily available.	<b>Agree</b>
Responsibility:	<b>CFO</b>	Expected Completion: <b>2024, 3rd Quarter</b>
8	Work with the City Attorney's Office to execute new franchise fee agreements with investor-owned utilities operating in the City's rights-of-way without current authorization.	<b>Agree</b>
Responsibility:	<b>AD Finance/CFO</b>	Expected Completion: <b>2024, 4th Quarter</b>
9	Consider more closely aligning City-owned franchise fee transfer calculation methodology to investor-owned utilities gross revenue definitions, including using a kilowatt hour factor for Denton Municipal Electric and including contributions in aid of construction.	<b>Partially Agree,</b>
Responsibility:	<b>AD Finance/CFO</b>	Expected Completion: <b>2024, 4th Quarter</b>
10	Consider requesting an amendment to Oncor's franchise fee agreement to include discretionary service charges created since 2002 and any new discretionary service charges to the extent that the service is paid directly by the customer in the gross revenue definition.	<b>Agree</b>
Responsibility:	<b>AD Finance/CFO</b>	Expected Completion: <b>2024, 4th Quarter</b>