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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

In the Matter of )

Implementation of Sections of )  
the Cable Television Consumer )  
Protection and Competition Act )  
of 1992 )

Rate Regulation )

MM Docket No. 92-266

REPLY COMMENTS OF  
THE NATIONAL CABLE TELEVISION ASSOCIATION, INC.

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The National Cable Television Association, Inc. ("NCTA")  
hereby submits its reply comments in the above-captioned  
proceeding.

INTRODUCTION AND SUMMARY

Section 623 of the Cable Television Consumer Protection and  
Competition Act of 1992 (the "Act") establishes and directs the  
Commission to implement two distinct frameworks for regulating  
cable rates in the absence of "effective competition." Rates for  
basic cable service are to be regulated, primarily, by local  
franchising authorities, pursuant to Commission standards and  
formulas. The object of those standards and formulas is to  
ensure that a system's rates for basic service do not exceed what  
would be charged if the system were subject to effective  
competition.

Rates for non-basic tiers of "cable programming service" are not to be regulated at all by franchising authorities. But the Commission is authorized to consider, on a case-by-case basis, complaints regarding such rates from franchising authorities and subscribers and to order that non-basic rates be reduced and, in some cases, refunded if it finds them to be "unreasonable." The Act does not define "unreasonable", but makes clear that the Commission is to consider rates charged by all comparably situated systems -- not just those of systems subject to effective competition -- and is to deem unreasonable only those rates that far exceed the norm.

As we proposed in our initial comments, the Commission should adopt different standards to implement the different regulatory tasks and objectives of Section 623(b) and 623(c). In each case, the Commission should adopt a "benchmark" approach and should reject any form of cost-of-service regulation. With respect to regulation of basic service rates, the Commission should adopt benchmarks based on the observed rates of systems that actually are subject to effective competition. With respect to rates for non-basic "cable programming service," we propose a benchmark approach based on the rates charged by all comparably situated systems for all regulated tiers of service.

#### Basic Rates

Many parties, including the major organizations representing cities, counties and other franchising authorities, agree that a benchmark approach based on observed rates of systems subject to

effective competition is both the simplest and the most accurate way to ensure that basic rates are "reasonable," as defined by the Act. These parties endorse, as does NCTA, a "matrix" approach that would provide different benchmarks for different systems, based on certain readily observable variable characteristics.

Other parties, however, urge the Commission to adopt some form of cost-based regulation. In the long-term, they recommend full-fledged utility-type ratemaking -- an approach that would be unduly complex, time-consuming and unpredictable, even if it were not beyond the resources and expertise of most franchising authorities. In the short-term, rate-of-return regulation, as even these parties concede, is impossible, because there is no uniform system of accounting in the cable industry and no readily available ratemaking methodology.

In the short-term, these parties recommend interim cost-based approaches that are based on estimates of average industry costs. These cost-based approaches, as we show, are likely to yield poor and unreliable indicators of what a system would charge if it were subject to effective competition. There is no readily available methodology for identifying average costs. Moreover, systems whose costs exceed the average would, under these approaches, be forced to charge rates that are non-remunerative -- or to cut back on their expenditures on programming and customer service.

A far better method, if it is workable, is to develop basic rate benchmarks based on rates actually charged by "competitive"

systems. And, as we have shown, such a method is workable and simple to apply.

### Equipment

Section 623(b) requires that rates for installation, additional outlets and certain equipment used to receive basic service be based on "actual cost." In our initial comments, we emphasized two principal points with respect to equipment rate regulation:

First, we showed that only equipment provided to "basic-only" subscribers -- or to subscribers who buy only the basic tier and premium or pay-per-view channels -- must be provided at rates based on actual cost. Some parties urge an opposite construction -- that equipment provided to all subscribers must be sold or rented at actual cost, except for equipment used solely to receive non-basic programming. But, as we showed, the purpose of Section 623(b) is simply to ensure that rates for basic service subscribers are, in fact, reasonable. Equipment must be provided to such subscribers on an "actual cost" basis, because it would do little good to regulate basic service rates at "competitive" levels if the rates for equipment used by basic subscribers were not also restricted to a competitive level.

Second, we argued that the Act permits certain items of equipment and installation to be provided at rates above actual costs and others to be provided at less than cost, so long as overall rates for installation and equipment do not exceed actual costs. Many parties, including franchising authorities and the

Consumer Federation of America, agree that the Act does not prohibit below-cost pricing of equipment, and the Consumer Federation appears also to agree that what matters, under the Act, is only that the overall cost of installation and equipment not exceed actual cost plus a reasonable profit.

#### Rates for "Cable Programming Services"

The Act and its legislative history mandate different standards and approaches for regulating basic rates from those for resolving complaints with respect to non-basic "cable programming services." Some parties blur the distinction and argue that the same standards and formulas should apply in each context. Such an approach would not only conflict with the statute but would also seriously threaten the quality of cable television service available to consumers.

There are good reasons why Congress sought only to rein in the non-basic rates of the "renegades" whose rates far exceeded the norm and why it did not mandate that all non-basic rates be reduced to rates charged by systems subject to effective competition. Unlike basic service, which may consist primarily of broadcast signals and access programming, non-basic tiers are comprised of optional programming services that are purchased by -- and derive much of their revenue from -- cable systems. As many commenters recognize, lowering rates of non-basic service will generally cause operators to lower their costs -- and to reduce their expenditures on programming, facilities and customer service.

A benchmark that required systems serving even five percent of subscribers to lower their rates and expenditures would have a direct impact on the programming industry and would seriously impair the quality of existing and new programming services. Moreover, it would require the Commission to initiate an overwhelming number of complaint proceedings. Even if only five percent of systems were subject to possible rollbacks of rates, that would make 2,760,000 subscribers to 554 separate cable systems eligible to file complaints initiating such proceedings. Congress could not have expected the Commission to deal with complaints from more than a small minority of the nation's 11,000 cable systems. Therefore, the Commission should adopt a benchmark approach for non-basic rates that classifies only a very small percentage of existing rates as "unreasonable".

Moreover, in order to take into account and not discourage any lowering of basic rates, any benchmark of "unreasonableness" should be based on systems' combined rates and revenues for basic service (including equipment) and non-basic "cable programming service." On this fundamental point, NCTA and the Consumer Federation of America appear to be in agreement.

#### Procedures

The Act charges the Commission with establishing procedures that ensure the expeditious resolution of rate disputes, and that are applied consistently in each community by local franchising authorities. In our initial comments we proposed that the Commission require expedited reconsideration by franchising

authorities of proposed basic service rate increases, and a 30 day timeframe for filing of complaints at the Commission regarding cable programming rates so as to avoid prolonged disputes and continuing uncertainty. And we proposed expedited certification procedures that would minimize the threat of regulation by franchising authorities in those circumstances where effective competition exists or where the franchising authority lacks authority or competence to regulate rates.

The proposals of the local franchising authorities on these and other procedural and interpretive issues, however, are wholly at odds with the need for expedition and predictability. At every step of the way, they suggest timeframes and standards for franchising authority and FCC action that will encourage foot-dragging and will needlessly delay resolution of rate disputes. Their proposals would exacerbate the dangers that rate regulation could pose to the ability of cable systems to meet the needs and demands of their customers.

I. STANDARDS FOR REGULATING RATES FOR BASIC SERVICE

The Commission's obligation, with respect to basic rates, is to adopt regulations that are

designed to achieve the goal of protecting subscribers of any cable system that is not subject to effective competition from rates for the basic service tier that exceed the rates that would be

charged for the basic service tier if such cable system were subject to effective competition.<sup>1/</sup>

The puzzle to be solved in this proceeding, therefore, is how best to identify or estimate the rates that a system would charge if it faced effective competition, and the Commission and the commenting parties have proposed several ways to do that. The most direct and accurate way, as most parties acknowledge, would be to examine the basic rates of systems that are subject to effective competition. Some parties allege, however, that there are not enough such systems to provide a reliable standard of comparison. Therefore, they propose alternatives that would determine what a system's "competitive" rate would be, based on estimates of what a system's costs are or should be, or on what a system charged before its rates were deregulated, taking into account inflation and other estimated increased costs.

These alternatives should be rejected by the Commission. In our initial comments, we urged the Commission to adopt a benchmark approach that was based on rates charged by systems subject to effective competition. While noting that the number of "competitive" systems might be relatively small, we showed that, even if this were the case, it would still be possible to develop benchmarks that were based on the rates of such

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1/ Act, Sec. 623(b)(1) (emphasis added).

systems.<sup>2/</sup> We also showed that approaches based on estimates of system costs or on past regulated rates would be less reliable and more cumbersome and burdensome than an approach based on competitive systems.

To the extent that such approaches are less reliable, the risks of using them, as NCTA showed, would be severe. If, for example, they resulted in maximum permissible rates significantly lower than what would actually be charged by systems subject to effective competition, they would not only fail to fulfill the Commission's statutory mandate but would require rate reductions and cutbacks in expenditures that would seriously threaten the financial underpinnings of cable systems and cable programmers. In this respect, the estimates of maximum allowable rates that are provided by those parties supporting such alternative approaches are alarming. Those rates appear to be far below the range of current rates for basic service. If they are also far below the rates charged by systems subject to effective competition, forcing basic rates to such levels would have immediate effects on the quality, if not the viability, of cable service.

It would be unfortunate, indeed, if the Act left the Commission no alternative but to take such risks. But there is no justification for adopting benchmarks based on such unreliable

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2/ See, B. Owen, M. Baumann and H. Furchtgott-Roth, Cable Rate Regulation: A Multi-Stage Benchmark Approach (Jan. 27, 1993) (attachment to NCTA Comments).

measures of competitive rates where more accurate measures, based on the actual rates of competitive systems, exist.

A. Cost-Based Regulation Should Be Rejected.

Several parties urge the Commission to adopt some form of cost-based regulation -- ranging from full-fledged cost-of-service ratemaking to benchmarks or formulas that are based in large part on estimates of cable systems' costs. These approaches will not work and should be rejected. Even those parties that favor full utility-type regulation generally agree that for the foreseeable future, adopting a system of cost-based ratemaking would be impossible. For example, the Consumer Federation of America ("CFA") points out that "[a]ccounting practices across the cable industry are not uniform, circumstances vary, and methodologies are lacking in the short term,"<sup>3/</sup> and that "[d]eveloping this cost methodology will be a formidable task."<sup>4/</sup>

Therefore, these parties propose "interim" formulas and approaches that are based not on the actual costs of individual systems but on estimates of average system costs. CFA, for example, proposes a "global formulaic cost approach" that sets rates based on the past regulated rates of systems, with adjustments based on estimates of average system costs since

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3/ Consumer Federation of America ("CFA") Comments at 85.

4/ Id. at 86.

deregulation.<sup>5/</sup> The National Association of Broadcasters ("NAB") and a "coalition" of seven franchising authorities ("Coalition") separately propose a different interim approach. Their approach would use estimated average system costs to construct an "ideal-type" system, and would establish rate ceilings at levels that would permit such a model system to recover only its costs plus a reasonable profit.

In NCTA's initial comments, we showed why efforts to approximate "competitive" rates based on short-cut estimates of system costs would be highly unreliable and undesirable. Attached to these reply comments is a report by Economists Incorporated, which discusses in detail why the specific proposals of CFA, NAB and the Coalition are flawed.<sup>6/</sup> CFA, NAB and the Coalition seem to have few qualms about the reductions in the quality of cable service and the impact on the viability of cable systems that would occur if their short-cut approaches to cost-based regulation missed the mark. And they seem inexplicably reluctant to try an approach that would empirically test their "rough-cut"<sup>7/</sup> estimates of what systems subject to effective competition would charge -- that is, an approach that

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5/ Id.

6/ Economists Incorporated, Economic Comments on Three Proposals for Cable Television Rate Regulation (Feb. 11, 1993).

7/ Haring, Rohlfs & Shooshan, Efficient Regulation of Basic-Tier Cable Rates (Appendix A to NAB Comments) 13 (Jan. 26, 1993).

is based on the rates currently charged by systems that are subject to effective competition.

1. There are Serious Flaws in the Proposed Use of Past Regulated Rates for Benchmarks.

When the Commission announced its tentative conclusion that a benchmark approach to regulating basic rates would be far superior to cost-of-service regulation, the immediate reaction from most parties was favorable. Not only did NCTA endorse such an approach, but

[t]he cable association's ideological rival, the Consumer Federation of America, also praised the benchmark idea. The organization's chief lobbyist, Gene Kimmelman, said the approach would result 'in a simple, streamlined system .... At worst, we could see rates remain at status quo. At best, they could be squeezed down significantly.'<sup>8/</sup>

Indeed, one would have expected the Consumer Federation of America to support a benchmark approach based on rates charged by systems subject to effective competition. Throughout the legislative battle over the Act, it had steadfastly maintained "that cable TV rates are at least 30% lower in the 50 or so communities where cable competition exists,"<sup>9/</sup> and it therefore "argued that the bill [could] reduce cable rates by a total of \$6

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8/ "FCC Considers 'Benchmark' Prices as Base for Setting Cable TV Rates," Washington Post, Dec. 11, 1992, p. D-1.

9/ "Cable TV Industry Takes Fight to Courts, FCC," Los Angeles Times, Oct 7, 1992, p. D-1.

billion a year."<sup>10/</sup>

The Consumer Federation has now, however, changed its mind. Instead of praising the Commission's proposed approach, the Consumer Federation contends that "[t]he Notice indicates that the Commission is, at best, confused by, or at worst, hostile to Congress' regulatory directives" and that "[t]he Notice misses the mark ...."<sup>11/</sup> Instead of supporting a "simple, streamlined" benchmark approach, the Consumer Federation now contends that "the Commission should begin to implement a system of cost-based regulation."<sup>12/</sup>

Having previously argued to Congress that rates for systems facing effective competition were 30 percent lower than rates for other systems, the Consumer Federation now maintains that it is impossible to measure the difference between rates for competitive and non-competitive systems -- even though, ideally, that would be the best way to establish rate regulation benchmarks:

[T]he Congress directed the Commission to rely on price comparisons between monopoly cable systems and systems subject to effective competition if it can. Unfortunately, for the foreseeable future the Commission will not be able to do so for lack of a

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10/ "A Mixed Signal for Consumers; Cable TV Bill Provides Only Limited Regulation of Rates," New York Times, Oct. 6, 1992, p. A-18.

11/ Consumer Federation of America Comments at 1.

12/ Id. at 85.

sufficient number of examples.<sup>13/</sup>

Instead of focusing on actual rates charged by competitive systems, the Commission should, according to the Consumer Federation, attempt to estimate the costs charged by cable systems and to develop a method or formula for allowing operators to recover no more than their reasonable costs plus a reasonable profit. Not surprisingly, the "formulaic global cost-based regulation"<sup>14/</sup> that the Consumer Federation proposes would, reduce average basic rates by "approximately 27 percent."<sup>15/</sup>

The "global formulaic cost approach" proposed by CFA is, in essence, a benchmark based on past regulated rates. Each system's maximum allowable rate would be based on its rate prior to deregulation, using "national and industry averages"<sup>16/</sup> of cost and other economic factors to adjust the prior regulated rates.

In our initial comments, we identified several obvious and serious problems with such an approach. As we noted, it is difficult, in the first place, even to identify accurately the rates charged by cable systems in 1984 or 1986. Moreover, the notion that "[r]ates at these dates can be assumed to be reasonable since they were subject to regulation" is simply

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13/ Id. at 84 (emphasis added).

14/ Id. at 86.

15/ Id. at 103.

16/ Id. at 106 (emphasis added).

wrong. As we showed -- and as Congress suggested when it deregulated rates in 1984 -- regulation by city councils and other state and local regulatory authorities had kept rates significantly below levels that would have allowed operators to maximize consumer satisfaction.<sup>17/</sup>

Even if prior regulated rates could be accurately identified and even if such rates reflected what would be charged by "competitive" systems, using average industry costs and economic factors to adjust such rates to current benchmark levels would be highly problematic. First, given the acknowledged lack of uniform accounting in the cable industry, there is no accurate way of measuring average industry costs. Second, there is no reason to assume that systems with costs in excess of industry averages incurred those costs unreasonably and no reason to prevent such systems from charging rates sufficient to recover those costs plus a reasonable profit.

CFA acknowledges -- but seems not to care -- that benchmarks based on past regulated rates are likely to err severely in many cases. Thus, CFA notes that if cable operators and subscribers were allowed to challenge such benchmarks in particular cases, invoking full-fledged cost-of-service analysis, "such a cost analysis may result in rates far below or above the benchmark ...."<sup>18/</sup> But because such ratemaking analysis may also yield a

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17/ See NCTA Comments at 20-22.

18/ CFA Comments at 107 (emphasis added).

rate that varies from what the operator or the subscriber desires, and "since challenges will involve costly data gathering, we believe neither cable operators nor consumers will have an incentive to challenge the global formulaic benchmark in most instances."<sup>19/</sup>

In other words, benchmarks based on past regulated rates may limit rates, in particular cases, to far less than would be justified to recover costs and a reasonable profit, but the costs and uncertainty of challenging such inaccurate and potentially confiscatory benchmarks in ratemaking proceedings would deter any such challenges! This is hardly, as CFA suggests, a "simple, comprehensive and fair approach to implementing the intent of Congress."<sup>20/</sup>

It is unlikely, in any event, that a cable operator would be deterred from challenging a benchmark that forced it to price below cost -- much less, "far below" cost; it is difficult to stay in business under such conditions. The more likely result is that benchmarks using past regulated rates in the manner suggested by CFA would be so unreliable and inaccurate as to lead, inevitably, to widespread reliance on traditional ratemaking proceedings, with all their attendant costs, delays and uncertainties. This is precisely the opposite of what Congress intended when, rejecting traditional utility-type

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19/ Id.

20/ Id. at 108 (emphasis added).

regulation,<sup>21/</sup> it directed the Commission to create an approach that was not "cumbersome" and that kept basic rates at levels comparable to those that would be charged if systems were subject to effective competition.

2. Cost-of-Service Benchmarks Are Unworkable.

The Coalition and NAB, like CFA, do not dispute the accuracy and simplicity of benchmarks based upon rates of systems that face effective competition. Indeed, the Coalition concedes that "[t]his method would promote Congress' intent that rates be no higher than rates that would be charged if the area were subject to effective competition" and that "the method would not be unduly burdensome to administer."<sup>22/</sup> But, like CFA, the Coalition and NAB contend that there are not enough systems facing effective competition to provide an adequate basis for establishing benchmarks.<sup>23/</sup>

The Coalition and NAB do not, however, agree with CFA that using past regulated rates to establish basic rate benchmarks would be a better alternative. As the Coalition notes, "there are significant problems with this approach."<sup>24/</sup> Instead, the Coalition and NAB each endorse variants of another approach

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21/ See House Report at 3.

22/ Coalition Comments at 41.

23/ Id. at 42; NAB Comments at 20.

24/ Coalition Comments at 43.

identified by the Commission -- a "cost-of-service benchmark" approach.<sup>25/</sup> Under this approach, the Commission would gather information on the costs of cable systems nationwide and seek to "construct the costs of an 'ideal' or 'typical' cable system or systems."<sup>26/</sup> The per-channel benchmark rate would then be established at a level that enabled the "ideal" system to recover its costs and a reasonable profit.

There are, however, at least three serious problems with using such an approach to approximate rates that would be charged by systems facing effective competition, and these problems are only highlighted by the Coalition and NAB proposals. First, simply obtaining the necessary cost data is no simple task. As the Coalition points out, its model "requires the FCC to adopt a uniform system of accounts, such as a simpler version of the one required by telephone companies,"<sup>27/</sup> before any compilation of industry norms and "ideal types" can be begun. Such a system does not currently exist, and it would not exist for some time, even if the Commission embarked today on an effort to create it.<sup>28/</sup>

While the Coalition at least concedes that the cost information necessary to construct its benchmarks is not

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25/ See Notice, para. 48.

26/ Id.

27/ Coalition Comments at 50-51.

28/ See NCTA Comments at 13.

currently available,<sup>29/</sup> NAB is oblivious to the problem. Thus, NAB maintains that an advantage of its cost-of-service benchmark approach is that

the Commission would be confident of obtaining enough information to have a fully comprehensive rate scheme to offer to municipalities. In other proposed schemes, most noticeably the effectively competitive system rate benchmark scheme, the Commission will be unable to obtain an adequate amount of data through its proposed annual report of cable television systems, because there are not enough systems that meet this definition. No such problem exists with NAB's approach. There will be sufficient data for the Commission to generate the equation for the capital cost benchmarks and include the many variables that may affect these costs ....<sup>30/</sup>

In fact, the opposite is true. As NCTA showed in its initial comments, not only is data regarding current rates of "competitive" systems readily available, but valid methodologies exist to construct reliable benchmarks based on such data. The data required to construct NAB's cost-based benchmark, on the other hand, is not now available and will not be for the foreseeable future.

A second problem with an "ideal type" cost-of-service benchmark approach is that it establishes reasonable rates indirectly, not by measuring what competitive systems charge but by measuring what the average "ideal" non-competitive system spends. In effect, it identifies reasonable costs, not

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29/ See Coalition Comments at 39.

30/ NAB Comments at 20-21 (emphasis added).

reasonable rates. But cable systems have widely divergent costs, and nothing in the Act or its legislative history suggests that rate regulation was intended to regulate a cable operator's decisions regarding expenditures on programming, facilities, customer service or any other components of its service. To the contrary, the Commission's rules are supposed to ensure that an operator's rates are reasonable and reflect those of "competitive" systems, taking into account the divergent costs of different systems.

Under NAB's "hybrid" approach, only capital costs would be included in the ideal-type cost-based benchmark, and individual systems' maximum allowable rates would be based on their benchmarks for capital costs plus their actual non-capital expenditures. By allowing operators to pass through their costs for programming, retransmission consent fees and customer service, NAB's proposal is intended not to regulate such expenditures and not to give operators incentives to reduce the quality of cable service in order to comply with maximum benchmark rates.

NAB is right in recognizing that if a cable system's costs exceed those of the average, it will have no choice, under an "ideal-type" cost-based benchmark approach, but to cut back expenditures. But NAB's "hybrid" solution only makes matters worse. Under its approach, an operator whose fixed capital costs exceeded those of the average or ideal-type systems would have no viable options at all.

If fixed costs are regulated on an average benchmark basis and variable costs are regulated on a cost-plus basis, there is nothing that a system whose fixed costs exceed the norm can do to come into compliance with the maximum allowable rates. Reducing its variable costs will result in a corresponding reduction of its maximum allowable rate. And reducing its fixed costs will, by definition, be impossible -- because they are, in fact, fixed. But reducing rates to the maximum allowable level simply will not enable such a system to recover its costs plus a reasonable profit.

NAB is rightly concerned that rate regulation of cable systems could reduce the quality of cable service. To the extent possible, the Commission's regulations should seek to minimize the likelihood of such effects. Congress specifically recognized that some form of pass-throughs for increased programming costs might be appropriately incorporated into the Commission's regulatory scheme,<sup>31/</sup> and in NCTA's initial comments, we showed how this might be done.<sup>32/</sup> Pass-throughs of increased programming costs are critical to prevent necessarily imperfect

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31/ See, e.g., House Report at 82 ("This subsection is intended to permit the Commission to develop a system of "pass throughs" or other appropriate regulatory mechanisms (bearing in mind the need to protect consumers' interests) to permit cable programmers to be fairly compensated for the service they provide to cable subscribers and to encourage cable systems to carry such services in the basic tier.")

32/ See NCTA Comments at 30, 33.

benchmarks from adversely affecting the quantity and quality of programming available to cable subscribers. But trying to graft such pass-throughs onto an "ideal-type" cost-of-service benchmark approach only highlights the problems with such an approach.

Cost-of-service benchmarks essentially compel cable operators to bring their costs into compliance with industry averages. The only way to do that is by reducing variable costs -- in other words, by reducing expenditures on programming, new facilities, and customer service. But applying a cost-of-service benchmark approach only to a system's fixed costs makes it impossible for a system whose costs are above average to come into compliance. NAB's "hybrid" solution is, in other words, no solution at all to the fundamental problem of using benchmarks based on what average systems spend.

The third problem with a cost-of-service benchmark approach, as the Coalition casually notes, is that "the FCC would have to establish an appropriate rate of return, which would then be factored into the model."<sup>33/</sup> Neither the Coalition nor NAB devotes any attention to precisely how this would be done, although the rate of return that is selected will obviously have a significant effect on the resulting benchmarks.

In the dynamic video programming marketplace, selecting inappropriate rates of return -- guessing incorrectly as to the appropriate level of risk involved -- will affect the level of

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33/ Coalition Comments at 50.