

necessarily bear any relation to the cost of providing cable service. The local cost of living might correlate with local wage rates, but some cable operations may not be located within the actual franchise territory. Furthermore, payroll and benefits account for less than a fourth of cable operating expenses.⁵⁷⁵ And our analysis of our survey data did not address geographic variables. We could not, therefore, define and calculate an LSPI index based upon those data within the statutory deadlines by which we have had to craft the framework for basic tier rate regulation. Accordingly, we will adopt an annual adjustment index based on a national index.

237. An annual adjustment index will permit changes in each system's cap for the basic service tier based on general changes in the cost of doing business. Establishment of such an index will help achieve the statutory goal of reducing administrative burdens on cable systems, consumers, and regulators by permitting rate increases when cable operators experience increases in the cost of doing business shared by all sectors of the economy, without requiring cable operators to make, and regulators to consider, cost-of-service showings. Adjusting the cap to reflect commonly shared increases (or decreases) in the cost of doing business will help assure that cable operators can earn a reasonable profit despite general price increases without having to initiate a cost-of-service proceeding. We observe that there is broad recognition in the comments of the need for an annual adjustment index to reflect general increases in the cost of doing business.

238. We conclude that we should adopt an annual adjustment index that measures changes in overall inflation rather than selecting an index for an industry for which costs are likely to be similar to the cable industry. A telephone service or other public utility price index might logically serve as a surrogate measure of changes in the cost of providing cable television service. The telephone industry is similar to the cable industry in several respects. Both industries are capital intensive with depreciation accounting for between 20 percent and 25 percent of annual operating expenses. Both industries have significant investments in the local physical plants. Unlike most other public utilities, telephone companies and cable operators are not especially sensitive to changes in energy costs. The most significant difference in the two industries is that a significant proportion of the cost of providing cable service is attributable to programming costs. Nonetheless, we

⁵⁷⁵ The U.S. Department of Commerce Annual Survey of Communication Services: 1990 shows total operating expenses of \$21,892 million, Annual Payroll of \$3,832 million, and social security and fringe benefits of \$1,484 million. U.S. Bureau of the Census, Annual Survey of Communication Services: 1990 (1991).

reject the use of telephone indexes because these indexes reflect the fact that productivity increases in the telephone industry have traditionally outstripped productivity increases in the overall economy.⁵⁷⁶ The record does not provide a basis to expect the same productivity gains in the cable industry.⁵⁷⁷ Moreover, to the extent that some productivity gains in the cable industry arise from increased system capacity, the use of per channel rates, which decline with the number of channels, our benchmark formula already reflect this source of productivity gain. Accordingly, we will use a measure of overall inflation as the annual adjustment index for cable service rates. However, we will seek comment on other approaches in the Second Further Notice.

239. We conclude that we should adopt the GNP fixed weight price index (GNP-PI) as the annual adjustment index for the cap for the basic service tier rates.⁵⁷⁸ This index measures the effects of price changes in the whole economy and provides a broader measure of overall inflation than does the Consumer Price Index for all items (CPI), or the Producer Price Index for finished goods (PPI), two other commonly used measures of inflation. The CPI reflects the prices paid by households for the services used in everyday living and does not represent changes in prices paid by businesses. The PPI covers goods sold to both households and businesses, but covers relatively few services. The GNP-PI incorporates both types of indexes as well as other measures of inflation in the economy.

⁵⁷⁶ This fact is reflected in our price cap annual productivity adjustments. The adjustment is 3 percentage points for AT&T and 3.3 percentage points for the Local Exchange Carriers.

⁵⁷⁷ We observe, however, that one commenter states that productivity increases in the cable industry have exceeded productivity increases in the telephone industry. Continental Comments at Appendix C. However, the record does not provide sufficient information for incorporation of a productivity offset into our price cap mechanism at this time. We will examine whether to adopt a productivity offset in the Second Further Notice.

⁵⁷⁸ The Bureau of Economic Analysis (BEA) produces two fixed weight indexes that measure inflation in the overall economy. The GNP-PI measures inflation in the gross national product. The Gross Domestic Product fixed weight price index (GDP-PI), which BEA began producing recently, measures inflation in the domestic national product. The GNP-PI is an appropriate measure of inflation that the Commission currently allows telephone companies to use for inflation adjustment in annual price cap filings. U.S. Department of Commerce, Bureau of Economic Analysis, Survey of Current Business: August 1991.

240. Under our rules, regulated cable operators may adjust the capped base per channel rate for the basic service tier annually by the GNP-PI. This adjustment will permit cable operators to recover the past year's inflation in the rates for the succeeding year. We believe that this approach represents the best balance between the administrative burdens imposed by more frequent rate adjustments and the need to permit prompt adjustments for inflation. We do not believe that this will cause a hardship to cable operators because they will be able to adjust within one year for inflation occurring in the first quarter of the preceding year, and for subsequent quarters more promptly. We require that the adjustment be based on the final GNP-PI index rather than interim indexes.⁵⁷⁹ We will permit adjustments for inflation for the part of the year between the initial date of regulation and the beginning of the next year. The manner of calculating the adjustments will be prescribed in FCC forms.

(g) External Costs

241. In this section we identify the categories of costs that cable operators may "pass through" to subscribers without a cost-of-service showing even if resulting rates exceed the applicable price cap. For cost reductions in these categories, however, cable operators must make rate reductions to reflect such savings. We explain below why this regulatory treatment for these categories of costs is reasonable.

(g)(1) Retransmission Consent Fees

i. Background

242. In the Notice, we sought comment on how we should take into account retransmission consent compensation in establishing regulations governing rates for the basic service tier, while also satisfying our obligation to ensure that such rates are reasonable. We tentatively concluded that we could fully discharge our obligation under the Cable Act to consider the impact of retransmission consent by successfully balancing the enumerated statutory factors, including the direct costs of carrying broadcast signals.⁵⁸⁰

ii. Comments

⁵⁷⁹ The BEA issues an interim index for the previous quarter 75 days after the quarter ends followed by the final index 90 days after the previous quarter.

⁵⁸⁰ See Notice, 8 FCC Rcd at 518, n.60.

243. MPAA, NAB and NYSCCT concur with the Commission's tentative conclusion that the costs of retransmission consent should be included in the basic service tier rate.⁵⁸¹ NAB asserts that if the Commission selects a benchmark regulatory structure, costs of retransmission consent should not result in an increase in basic tier rates since cable rates already reflect the value of broadcast signals.⁵⁸² NAB adds that the Commission should first remove from the permitted rate level the value of retransmitted signals, before increasing a rate-based benchmark based on retransmission consent fees, so that cable operators are not unjustly enriched.⁵⁸³ Oxnard contends that the Commission, in balancing the statutory factors used to promulgate reasonable rates, should assign less weight to the retransmission consent issue than to the other factors.⁵⁸⁴

244. Cable operators stress that they should be permitted to directly pass through retransmission consent fees.⁵⁸⁵ NCTA argues that an automatic pass-through of retransmission consent fees would be consistent with the Cable Act since this is a readily identifiable new expense that Congress has ruled to be legitimate.⁵⁸⁶ Media General also asserts that an automatic pass-through would be equitable to cable operators since it would allow the operator to cover its costs and would encourage the cable operator to add program services to the basic service tier.⁵⁸⁷

iii. Discussion.

245. Treating retransmission consent fees as costs external to the cap would permit cable operators to pass such costs on directly to consumers without a cost-of-service showing. If not treated as costs external to the cap, cable systems could increase rates to recover these fees only if higher rates were justified based on an overall cost-of-service showing. Not treating retransmission consent fees as external costs may

⁵⁸¹ MPAA Comments at 2; NAB Comments at 5; NYSCCT Comments at 12-13.

⁵⁸² NAB Comments at 5-7.

⁵⁸³ Id.

⁵⁸⁴ Oxnard Comments at 3.

⁵⁸⁵ See, e.g., Media General Comments at 9; NCTA Comments at 44.

⁵⁸⁶ Id.

⁵⁸⁷ Media General Comments at 9.

provide a greater incentive for cable operators to negotiate aggressively for the lowest fee to which a broadcaster would agree. At the same time, however, such an approach may increase the risk that a broadcast signal may not be available on the basic tier if the broadcaster and the cable operator are not able to reach an agreement on a fee for retransmission consent. Treating retransmission consent fees as costs external to the cap, on the other hand, could encourage broadcasters to elect retransmission consent and provide greater assurance that the signals of such broadcasters will be on the basic tier because cable operators will be able to increase rates to recover these specific costs.

246. We conclude that, after the initial transition to retransmission consent is completed, treating retransmission consent fees as external costs strikes the best balance between these conflicting considerations. While cable operators may have less incentive to drive a hard bargain, they will still have strong incentives to assure that, overall, the rates for the basic service tier are reasonable and thus negotiate reasonable retransmission consent fees. This approach will also provide greater assurance that signals of broadcasters electing retransmission consent will be available on the basic service tier.

247. At the same time, however, we are persuaded that current cable rates reflect the value of broadcast signals to cable operators. Moreover, we are concerned that external treatment during the initial period in which cable operators and broadcasters enter their first retransmission consent agreements may not encourage fair bargaining for reasonable retransmission consent fees. This is particularly true during the first round of negotiations because retransmission consent is a new regulatory and statutory mechanism with which we and the affected industry have no experience. We also believe that a delay in the onset of external treatment for retransmission consent fees will protect subscribers from any precipitous increase in rates after October 6, 1993, the date on which new retransmission consent agreements go into effect. Accordingly, external treatment for retransmission consent costs will commence only after October 6, 1994 and the permitted pass-throughs will be limited to the new or additional fees beyond those already in effect on October 6, 1994.⁵⁸⁸ We will closely monitor initial retransmission consent

⁵⁸⁸ Under our retransmission consent requirements, the initial period for retransmission consent agreements will run from October 6, 1993 until October 6, 1996. See Implementation of the Cable Television Consumer Protection and Competition Act of 1992 - Broadcast Signal Carriage Issues, Report and Order, 58 FR 17350, Released April 2, 1993. Thus, the limitation on external treatment until October 6, 1994 will apply to fees that cable operators will

agreements for their potential impact on subscriber rates.⁵⁸⁹ If it appears that additional measures are needed to assure that pass-through of retransmission consent fees does not have an unwarranted impact on basic tier rates, we will reexamine this treatment of such fees.

248. The Cable Act of 1992 requires that we take into account the costs of retransmission consent in fashioning regulations to assure reasonable rates for the basic service tier. We conclude that we should take such costs into account by treating them, to the extent indicated above, as costs external to the benchmark.

BB. Other External Costs

i. Background

249. In the Notice, we also asked whether, depending on the ratemaking methodology adopted, certain price changes caused by factors outside of the cable operator's control should not be deemed price "increases" subject to the notice requirement, and should be permitted to be automatically passed-through without prior regulatory review.⁵⁹⁰ We specifically asked commenters who advocate such an approach to fully discuss its relationship to the ratemaking methodology recommended.

ii Comments

250. NCTA, CCTA, and CIC argue that any financial obligation imposed upon a cable operator by a governmental entity should not be factored into the benchmark rate, but should be passed on directly to cable subscribers.⁵⁹¹ CIC asserts that since the Cable Act allows these costs to be itemized individually on cable subscriber's bills, this evidences Congress' intent that these are separate and distinct charges

pay to broadcasters during the first year of their retransmission consent agreements.

⁵⁸⁹ See Senate Report at 35-36.

⁵⁹⁰ Notice, 8 FCC Rcd at 529, para. 83.

⁵⁹¹ CCTA Reply Comments at 2; CIC Reply Comments at 15; NCTA Comments at 43-44. Municipal contends that although it generally opposes automatic pass-throughs, governmentally imposed costs should be separated from the benchmark so that no cable operator either is penalized or profits from the treatment of such costs by different jurisdictions. Municipal Reply Comments at 23.

from the costs that should be factored into the benchmark.⁵⁹² NCTA avers that cable system operators should add to their applicable benchmark any government mandated franchise fees, taxes, fees or assessments, as well as PEG and similar costs, on a prorated per-channel basis.⁵⁹³ Discovery maintains that cable operators should also be allowed to pass-through their increased costs for programming and system improvements such as channel expansion or technology upgrades.⁵⁹⁴ In addition, Minn. states that cable operators should be permitted to pass through all obvious and readily identifiable price increases since they would also have to reduce rates as a result of price decreases.⁵⁹⁵

iii. Discussion

251. Programming Costs other than Retransmission Consent Fees. In the Notice we sought comment on how rate regulation would affect the ability of cable programmers to provide programming services to the public. Cable operators generally contend that rate regulation could significantly limit their ability to incur additional costs of obtaining programming.⁵⁹⁶ The record shows that programming costs have increased at a rate far exceeding the rate of inflation.⁵⁹⁷ While operators could justify increased rates under a cost-of-service showing, we are concerned that regulation of basic service tier rates, at least during the early stages of rate regulation, might inadvertently harm the continued ability of programmers to develop and produce programming.⁵⁹⁸ Capping rate increases at GNP-PI also would ignore the faster rate of increase in programming costs. Treatment of programming cost increases as external costs would assure programmers' continued ability to develop, and cable operators' ability to purchase, programming. The risk with this approach is that cable operators may incur excessive programming costs and then pass them on to subscribers. We believe, however, that cable operators also have incentives to

⁵⁹² CIC Comments at 15.

⁵⁹³ NCTA Comments at 41-44.

⁵⁹⁴ Discovery Reply Comments at 4-6.

⁵⁹⁵ Minn. Comments at 23.

⁵⁹⁶ See CIC Comments at 1-11; NCTA Comments at 1.

⁵⁹⁷ TCI Reply Comments at 26-27; Lifetime Comments at 12.

⁵⁹⁸ House Report at 86 (in discussing regulation of unreasonable rates, the Committee recognized that "since cable rates were deregulated in 1986 there has been an increase in the quality and diversity of cable programming.")

assure that service rates are not excessive since excessive programming costs, if passed on to subscribers, may cause them to lose subscribers. On balance, we attach greater importance at this initial stage of rate regulation to assuring the continued growth of programming. Accordingly, on a going-forward basis, we will allow cable operators to pass through to subscribers increases in programming costs.⁵⁹⁹ We will monitor the impact of external treatment of programming cost increases. If it appears that this treatment is resulting in precipitous rate increases or is being harmful, we will take steps to limit these pass-throughs, including subjecting costs to the cap.

252. We make one important exception to the pass-through of programming costs: an express limitation on the pass-throughs permitted for programming services affiliated with cable MSOs. Given the record that Congress established in examining the programming, sales and business practices of such affiliated cable services,⁶⁰⁰ we are concerned about abuses that might occur if we permit vertically integrated cable operators to engage in unlimited pass-throughs of programming costs to their subscribers. Accordingly, pass-throughs of increases in programming costs attributable to the program services affiliated with such systems will be capped at the lesser of the annual incremental percentage increase in such costs or the GNP-PI.⁶⁰¹

⁵⁹⁹ We will only permit the pass through of programming and other external costs that exceed inflation in order to prevent double recovery of costs. See para. 257, *infra*.

⁶⁰⁰ See Implementation of Sections 12 and 19 of the Cable Television Consumer Protection and Competition and Diversity Act of 1992 - Development of Competition and Diversity in Video Programming Distribution and Carriage, Report and Order, FCC 93-178, released April 30, 1993

⁶⁰¹ We will apply our rules adopted in the program access proceeding to define affiliated programmers. See Implementation of Sections 12 and 19 of the Cable Television Consumer Protection and Competition and Diversity Act of 1992 - Development of Competition and Diversity in Video Programming Distribution and Carriage, Report and Order, FCC 93-178, released April 30, 1993; 47 C.F.R. Section 76.1000(b). Under those rules, an affiliated programmer is a programmer with an ownership interest of 5 percent or more including general partnership interests, direct ownership interests, and stock interests in a corporation where such stockholders are officers or directors or who directly or indirectly own 5 percent or more of the outstanding stock, whether voting or nonvoting. Such interests include limited partnership interests of 5 percent or greater.

253. We believe that treating programming costs as external costs outside the cap fulfills the statutory requirement that regulations governing the basic service tier take into account the direct costs (and changes in such costs) of obtaining, transmitting, and providing signals carried on the basic tier including additional video programming signals or services beyond the "must carry" local broadcast television signals.⁶⁰² Our accounting and cost allocation requirements will determine the share of programming costs to be allocated to basic service.⁶⁰³ In general, to the extent they are not directly incurred at the franchise level, programming costs must be allocated from the system or company level to the franchise level on a per subscriber basis and then to the tier on which the programming is provided. The precise methodology for calculating external program costs and allocating them to the appropriate tiers will be set forth in FCC forms.⁶⁰⁴

254. Taxes, Franchise Fees, Costs of other Franchise Requirements. The Cable Act of 1992 requires that in setting basic service rates, we take into account the reasonably and properly allocable portion of: (1) taxes and fees imposed by any state or local authority on transactions between cable operators and subscribers; (2) assessments of general applicability imposed by a governmental entity applied against cable operators or cable

⁶⁰² The Cable Act of 1992 requires that regulations governing rates for the basic service tier take into account cable operator revenues from advertising on the basic service tier or other consideration obtained in connection with the basic tier. Communications Act, § 623(b)(2)(C), 47 U.S.C. § 543(b)(2). We require that any revenues received from a programmer, or shared by the programmer and the operator, for carriage of signals be netted against costs for purposes of calculating whether there has been an increase or decrease in programming costs for the programmer. We believe that this most equitably balances the interests of cable operators in being compensated for increases in programming costs and of subscribers in paying fair rates. Thus, cable operators may recover increased costs of programming from subscribers but not to the extent they receive revenues from a programmer on account of carriage of programming. Our price cap requirements do not provide for adjustments to rates for the basic service tier on account of advertising revenues. However, system advertising revenues would be considered in any overall cost-of-service showing that a cable operator makes in order to justify rates above capped levels.

⁶⁰³ See paras. 556-559, infra.

⁶⁰⁴ Forms prescribing the precise methodology for calculating and allocating external costs and applying the price cap regime on a going-forward basis will be released shortly.

subscribers; (3) the cost of satisfying franchise requirements to support public, educational, or governmental channels or the use of such channels or any other services required under the franchise; and (4) the costs of any public, educational, and governmental access programming required by the franchising authority. We meet this statutory directive through the GNP-PI adjustment described earlier and by providing that certain costs unique to cable operations may be treated as costs external to the cap. In particular, we conclude that we should exclude from the cap taxes imposed on the provision of cable television service, franchise fees, and the costs of satisfying franchise requirements, including the costs of satisfying franchise requirements for local, public, educational, and governmental access channels. These costs are largely beyond the control of the cable operator, and should be passed on to subscribers without a cost-of-service showing. Our accounting and cost allocation rules adopted herein require that costs associated with PEG channels carried on the basic tier be directly assigned to the basic tier where possible; remaining costs of taxes and costs of satisfying franchise requirements will be allocated between or among tiers in proportion to the number of channels on each tier.⁶⁰⁵ Because franchise fees may be assessed on a tier, subscriber or revenue sensitive basis, we require that franchise fees be allocated between tiers and subscribers in a manner reflective of the way they are assessed. The specific methodology to be used in calculating and allocating external costs will be prescribed in FCC forms.

(g) (3) Starting Date for External Treatment

255. We determine that for all categories of external costs other than franchise fees, the starting date for measuring changes in external costs for which the basic service per channel rate may be adjusted will be the date on which the basic service tier becomes subject to regulation or 180 days after the effective date of our regulations adopted in this Report and Order, whichever occurs first.⁶⁰⁶ Any prior changes in costs will not receive external treatment.⁶⁰⁷ Thus, for those systems

⁶⁰⁵ See paras. 556-559, *infra*.

⁶⁰⁶ If the date on which the system becomes subject to regulation is after October 6, 1994, only increases in retransmission consent fees occurring after the date of regulation will be accorded external treatment.

⁶⁰⁷ The initial date of regulation of the basic service tier is the date of local notice that the system is subject to regulation. The initial date of regulation of a cable programming services tier is the date on which a complaint is filed with the Commission concerning any cable programming services tier provided

for which the reasonable initial base per channel rate is determined by reference to September 30, 1992 rates, the resulting rate will be adjusted forward by inflation since September 30, 1992 (i.e., GNP-PI) until the date of regulation, or, 180 days from the effective date of our regulations, if the initial date of regulation occurs after 180 days from the effective date of regulation. We believe that this represents the best balance between practicality of administration and the operators recovery of external costs. Thus, it may be burdensome for cable operators to identify changes in external costs since September 30, 1992. On the other hand, permitting only inflation adjustments since September 30, 1992 until the effective date of regulation may unnecessarily encourage cost-of-service showings by cable operators who have experienced high levels of external costs in the interim.

256. We note, however, that the competitive benchmark levels derived from our benchmark formula and survey data will not include franchise fees. Thus, we will permit the total amount of franchise fees to be included in determining the lawful regulated per channel rate for the basic service tier as of the initial date of regulation.⁶⁰⁸

by the system within the franchise area. We anticipate that the initial date of regulation will be different for the two tiers resulting in different initial permitted rates because of different adjustments for inflation and external costs. However, as a practical matter, we do not believe that the permitted rates for different tiers prior to going forward adjustments will differ significantly for most systems since we anticipate that the initial date of regulation for both tiers will be close in time. Thus, we do not believe that the potentially different periods for adjustments for inflation and/or external costs for different tiers depending on the initial date of regulation will cause significantly different rates for tiers such that our principle of tier neutrality will be violated. See also n. 501, supra.

⁶⁰⁸ We conclude that at this time we should not give external treatment to costs of system improvements. Such expenditures are likely to be significant and if automatically passed through could lead to substantially increased rates. Additionally, system improvements typically increase channel capacity, which will increase the total revenues per subscriber achievable, even under the benchmark formula, or reduce maintenance or other service expenses. We believe that local authorities should be permitted to carefully weigh the costs and benefits of network improvements. Costs of network improvements could still be recovered through cost-of-service showings to the extent they cannot be recovered through rates regulated under the price cap scheme. We will monitor the effects of treating network improvement costs this way and, if it appears that this treatment is thwarting the development

DD. Limitation on External Treatment for Increases
Less than Inflation

257. We recognize that the survey data on which our benchmark is based are not adjusted to exclude costs other than franchise fees. Thus, our measure of comparison to competitive rates includes most categories of external costs and the resulting permitted rates will also include these costs. This means that, when the inflation adjustment is applied to the permitted per channel rate on a going-forward basis, it will also permit recovery of increases in external costs to the extent they increase no more than inflation. Accordingly, to permit external treatment for the full amount of increases in these costs after the general adjustment for inflation would permit double recovery of such costs that are equal to or less than inflation. We conclude that, for all categories of external costs, we will permit external treatment for increases in such costs only to the extent they exceed inflation as measured by the GNP-PI. This requirement will not apply to franchise fees because the benchmark is based on data that excludes such fees and because our methodology for determining the permitted per channel rate excludes franchise fees. The annual inflation adjustment will also not apply to franchise fees. This will assure that there will not be a double recovery of franchise fees.⁶⁰⁹

(h) Cost-of-Service Showings

AA. The Opportunity to Justify Rates Above the
Cap Based on Costs

i. Background

258. In the Notice, we proposed to establish an opportunity for cable operators to use cost showings to justify rates for the basic service tier above capped levels.

ii. Comments

of new technologies and services, will review our decision as necessary.

⁶⁰⁹ We additionally find that we should not permit increases for external costs up to the full extent of inflation if, in fact, they have not increased by the full amount of inflation. Thus, we also require that permitted per channel rates be adjusted downward from the rate that would result if based on a full inflation adjustment to the extent one or more external costs increase less than inflation. The practical result of this approach is that adjustments for external costs will equal the actual amount of decrease or increase in external costs.

259. Many cable operators and municipalities agree that cost-of-service principles should be implemented as a secondary mechanism to supplement the primary rate standard.⁶¹⁰ CATA and EET support the tentative conclusion reached in the Notice that secondary cost-of-service showings be available to cable operators that seek to justify rates above the basic service benchmark.⁶¹¹ Municipalities, however, contend that secondary cost-of-service showings should be accessible either to all interested parties (e.g., cable operators, local franchising authorities, subscribers), or limited only to franchising authorities.⁶¹² Dover and Municipal, for example, argue that if cable operators are allowed to justify rates above the benchmark, then franchising authorities and the Commission should also be permitted to use actual cost data to reduce rates below the benchmark in appropriate cases.⁶¹³

260. Parties supporting the proposed secondary cost-of-service showing maintain that this regulatory approach cannot succeed without various uniform accounting and cost-of-service standards for the cable industry.⁶¹⁴ Municipal states that since cost-of-service regulation generally requires a substantial administrative expertise, effective Commission cost guidelines are necessary to permit local franchising authorities to effectively review rates. BellSouth finds that a reliable cost-of-service methodology is also necessary since: the Act requires the FCC to use a cost-based type approach to determine installation rates for the basic service tier; and the Commission needs to protect against cable operator cross-subsidizing their entry into non-cable markets.⁶¹⁵

⁶¹⁰ See, e.g., Austin Comments at 48-49; CATA Comments at 21-22; Dover Comments at 15-16; EET Comments at 5; Municipal Comments at 15; Rapids Comments at 30-31; TIA Comments at 13.

⁶¹¹ CATA Comments at 21-22; EET Comments at 5.

⁶¹² See, e.g., Austin Comments at 49-49; Dover Comments at 15-16; Municipal Comments at 15; Rapids Comments at 30-31.

⁶¹³ Dover Comments at 15-16; Municipal Comments at 15. Austin states that cable operators should only be allowed to initiate a cost-of-service proceeding where it is constitutionally mandated, or where, at a minimum, the cable system submits actual cost data. Austin Comments at 48-49.

⁶¹⁴ See, e.g., BellSouth Comments at 16-18; Municipal Comments at 15; NewBern Comments 8-11; NYNEX Comments at 4; TIA Comments at 13.

⁶¹⁵ BellSouth Comments at 16-18.

261. NATOA opposes the use by cable operators of a secondary cost-of-service mechanism to justify rates above the primary rate.⁶¹⁶ NATOA argues that this approach would unfairly skew rate regulation in favor of the cable operator at the expense of the consumer.⁶¹⁷ NATOA and MCATC contend that cable operators might use secondary cost-of-service showings to seek higher unreasonable rates, since they are cognizant of the administrative disadvantages that this presents to local franchising authorities.⁶¹⁸ NATOA contends that a cable operator should not be permitted to exceed the benchmark for the basic service tier unless it can show that the benchmark is confiscatory in its individual circumstance.

iii. Discussion.

262. We have determined that our primary method of regulating cable service rates on a going-forward basis shall be a price cap mechanism applied to rates after they are initially set in relation to the competitive benchmark. This regulatory approach will ease administrative burdens because it will effectively regulate rates in most cases without the need for examining an individual system's costs. This choice reflects a reasonable balance of the statutory goals of minimizing administrative burdens and of protecting consumers. However, the starting price cap level is based on industry-wide data and does not necessarily reflect individual systems' costs of providing cable service. Thus, we can not be certain that the initial capped rate defined through benchmark comparisons will permit all cable operators to fully recover the costs of providing basic tier service and to continue to attract capital. We do not believe that Congress intended that cable operators could, or should, be compelled to provide basic service tier service at rates that do not recover such costs. Further, an overly tight cap on rates could hinder cable operators ability to make network improvements that could benefit subscribers. Accordingly, we believe that it is acceptable to permit cable operators to exceed the capped rate if they can make the necessary cost showings in certain circumstances.⁶¹⁹

⁶¹⁶ NATOA Comments at 44.

⁶¹⁷ Id.

⁶¹⁸ MCATC Comments at 9; NATOA Comments at 45-46.

⁶¹⁹ Of course, the fact that an operator has incurred a cost does not establish its right to recover that cost from subscribers. The extent to which costs can be recovered from subscribers will be governed by cost-of-service standards.

263. We reject the alternative of not permitting cable operators to exceed the cap unless that rate as applied to them is confiscatory. As we explain below, we believe that it will be preferable for the Commission to establish cost-of-service standards for the basic service tier. The Commission can then embody in those standards a balancing of the interests of consumers in paying a reasonable rate and of cable operators in earning a reasonable profit. A "confiscatory only" standard would, by contrast, constitute a substantially stricter standard that may ultimately disserve consumers by limiting cable operators' business incentives to provide service.

264. The Cable Act of 1992 requires that the Commission take into account in establishing regulations governing the basic service tier a "reasonable profit", as defined by the Commission, consistent with the Commission's obligations to ensure that rates are reasonable and the goal of protecting subscribers of any cable system not subject to effective competition from paying more for the basic service tier than subscribers would pay if the system were subject to effective competition.⁶²⁰ In order to assure that our framework for regulation of rates of the basic service tier will take this statutory factor into account we establish that in any cost-of-service proceeding rates must be set to allow cable operators to earn a reasonable profit for provision of cable service. While we are not defining a reasonable profit for cable service generally at this time, and will be addressing that issue in the Second Further Notice and reviewing local franchising determinations concerning a reasonable profit on a case-by-case basis in the interim, a reasonable profit will be one that is fair to both cable operators and consumers. Thus, our regulatory framework for regulation of the basic service tier will satisfy the statutory requirement that we consider a reasonable profit consistent with statutory goals.

BB. Cost-of-Service Standards

i. Background.

265. In the Notice, we stated that cost-of-service regulation at any level requires determinations relating to four major cost components: rate base; cost of capital; depreciation; and operating expenses.⁶²¹ We stated that cost-of-service showings also require rules to govern the design of rates once determinations have been made in the four areas listed above. We proposed, in the Notice, to adopt requirements in each of these

⁶²⁰ Communications Act, § 623(b)(2)(C), 47 U.S.C. § 543(b)(2)(C).

⁶²¹ Notice, 8 FCC Rcd at 525, para. 61, Appendix B.

areas to govern cost-of-service showings by cable operators seeking to justify rates above the benchmark. We solicited comment on what requirements we would need to adopt in these areas and on the impact on the cable industry and subscribers of those requirements. We asked for comment on the specific issues raised in Appendix B to the Notice regarding rate base, cost-of-capital, depreciation, and operating expenses that would require resolution for cost-of-service standards to be adopted. The Notice additionally solicited comment on the optimal degree of cost averaging under cost-of-service regulation of cable service.⁶²²

ii. Comments.

266. NCTA urges the Commission not to adopt cost-of-service standards to govern secondary cost-of-service showings by cable operators.⁶²³ It states that these issues can be resolved by local franchise authorities and the cable operator at the local level.⁶²⁴ NATOA also urges the Commission not to adopt cost-of-service standards.⁶²⁵

267. Rate Base. Municipalities, cable operators, and New Jersey addressed the question of what should be included in the determination of the cable operator's rate base. Municipal and New Jersey state that the "used and useful" standard is the appropriate standard to use in measuring a cable operator's rate base.⁶²⁶ Cable operators generally argue that acquisition costs represent bona fide business investments that should be included in the rate base.⁶²⁷ On the other hand, municipalities support disallowance of goodwill since they contend that it is not cost-based and, if allowed, would permit operators to recover their own expectations of monopoly profits from subscribers.⁶²⁸ NAB

⁶²² Notice, 8 FCC Rcd at 524-25, para. 60.

⁶²³ NCTA Comments at 39.

⁶²⁴ NCTA Comments at 40-41.

⁶²⁵ NATOA Comments at 46.

⁶²⁶ Municipal Comments at 16-17; New Jersey Comments at 11-13.

⁶²⁷ See, e.g., ACI Reply Comments at 2; Media General Comments at 15; Prime Comments at 6-9. Prime maintains that goodwill must be included in rate base to avoid the Fifth Amendment's prohibition on confiscatory rates.

⁶²⁸ See, e.g., Municipal Comments at 16; NewBern Comments at 19; New Jersey Comments at 12; Thousand Oaks Comments at 20; Rapids Comments at 31.

submitted a proposed regulatory framework for the basic service tier that would prevent recovery from subscribers of costs in excess of system replacement costs.⁶²⁹ Thousand Oaks claims that since converter boxes are for the benefit of pay-per-view customers, this equipment should be excluded from rate base.⁶³⁰ Rapids and New Jersey recommend that equipment be included in rate base rather than expensed, to be consistent with traditional cost-of-service regulation.⁶³¹

268. Cost of Capital. Media General argues that the cable industry's rate of return should exceed that of the telephone industry. Media General states that competition from DBS, cellular television, broadcast television, and video dialtone demonstrates that the long term risk in the cable industry is higher than for telephone companies.⁶³² Rapids contends that the risk of investing in cable stock is no greater than investing in the Standard & Poors 400 companies, and that the risk might even be lower due to the lack of competition.⁶³³

269. Depreciation, Operating Expenses, Rate Design. Few commenters specifically commented on depreciation, operating expenses, or rate design. McKinney and NewBern want industry-wide uniformity in determining the expected service life of cable plant in order to facilitate judgement of reasonableness of basic tier rates.⁶³⁴ McKinney and NewBern would include retransmission consent fees as operating expenses.⁶³⁵

iii. Discussion.

270. We conclude that cost-of-service standards should be adopted to govern the extent to which cable operators may exceed capped rates for the basic service tier based on costs. Such standards are necessary to define the costs and level of profits that will justify a rate increase and to permit a reasoned decision whether the proposed rate increase should be allowed. Moreover, we believe that it is preferable, at least in

⁶²⁹ NAB Comments at 16-18.

⁶³⁰ Thousand Oaks Comments at 21.

⁶³¹ New Jersey Comments at 12; Rapids Comments at 32.

⁶³² Media General Comments at 61; see also NCTA Reply Comments at 24.

⁶³³ Rapids Comments at 32.

⁶³⁴ McKinney Comments at 19; NewBern Comments at 18.

⁶³⁵ McKinney Comments at 20; NewBern Comments at 19-21.

the initial stages of rate regulation of cable service, for the Commission to establish uniform cost-of-service standards. Uniform standards governing cost-of-service showings by cable operators for basic service provided in different communities, and between basic service and cable programming services, are more likely to promote the statutory goal of reducing administrative burdens than would a multiplicity of cost-of-service standards applicable to an individual operator and to the industry as a whole. Allowing local authorities to determine cost-of-service standards would also foreclose significant opportunities for efficiencies in administration of rate regulation because it could foreclose the possibility of applying cost-of-service standards on a higher operating level than the franchise level. Moreover, because cost-of-service standards embody a fundamental balancing of the interests of consumers in paying a fair rate and of cable operators in recovering their costs and earning a reasonable profit, how this balance is struck could have a far reaching impact on the industry and cable subscribers.⁶⁶ While it may be appropriate in the future for local franchising authorities to assume a larger role in setting cost-of-service standards for the basic tier as rate regulation develops, we believe that these standards should for now be established at the national level. The Cable Act of 1992 also envisions that the Commission, not local authorities, will establish standards and procedures for rate regulation of the basic service tier. Accordingly, we determine that the Commission will establish cost-of-service standards for the basic service tier.

271. In the Notice we proposed to adopt cost-of-service standards and solicited comment on the potential impact on subscribers and operators of the particular standards that we might adopt. The Commission will carefully balance competing interests and fashion standards that are fair to consumers and operators. By not unreasonably restricting a cable operator's ability to earn a reasonable profit, such standards can also assure the continued growth and success of the cable industry and

⁶⁶ See, e.g., *Jersey Central Power & Light v. FERC*, 810 F.2d 1168, 1177 (D.C. Cir. 1987); *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1502 (D.C. Cir. 1984); *Mobil Oil Corp. v. FPC*, 417 U.S. 283, 308-309 (1974); *In Re Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968) (finding that the regulatory authority had a responsibility to consider not only the interests of producers in earning a fair return, but also "the relevant public interests, both existing and foreseeable"); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944) ("It is not theory but the impact of the rate order which counts."); *id.* at 603 ("the fixing of 'just and reasonable' rates involves a balancing of the investor and the consumer interests."); and *Bluefield Waterworks v. PSC*, 262 U.S. 679 (1923).

the continuation of related benefits that it can bring to the public. We find, however, that the record concerning cost-of-service for cable service generally is not sufficient to permit the crafting of detailed cost-of-service standards for cable service required to achieve these objectives.⁶³⁷ For example, we are unable to gauge at this time the extent to which general disallowances of debt incurred to purchase cable systems in excess of replacement cost would affect the industry and consumers. Similarly, we do not have information on the impact of particular depreciation and amortization schedules for different categories of equipment. Nor do we have adequate information on the optimum level of cost averaging. We also do not have significant information on the cost of providing cable service. Accordingly, we will not adopt specific cost-of-service standards at this time. Instead, we will issue a Second Further Notice of Proposed Rulemaking in the near future looking toward adoption of cost-of-service standards.

272. Pending this rulemaking, which we intend to complete on an expedited basis, cable operators may elect either to maintain rates currently in effect and attempt to justify them through a cost showing in their initial rate filings, or to reduce these rates to the level we have discussed above. Cable operators that reduce rates in accordance with our requirements may subsequently seek to raise rates above the cap pursuant to the general procedures we are establishing.⁶³⁸ Pursuant to those procedures, local authorities (or the FCC in situations where we regulate basic rates) will review cost-of-service showings by cable operators seeking to raise rates above capped levels, when

⁶³⁷ As discussed at n. 715, *infra*, we identify a permitted rate of return for installation and provision of equipment by cable operators. The Cable Act of 1992 requires that charges for equipment be based on actual cost. Cable operators must comply with our actual cost requirements as of the initial date of regulation, whereas cost-of-service standards for cable service generally will be the secondary method of regulation of cable service rates and will only be applied if cable operators elect to make cost-of-service standards. In addition, specifying a reasonable profit level for cable service generally may have a greater industry impact than would specifying profit levels only for provision of installation and equipment. Accordingly, we identify a reasonable profit level for equipment at this time while proceeding on a case-by-case basis for cost-of-service showings for cable service generally pending our rulemaking that will address cost-of-service standards.

⁶³⁸ See Section II.A.3.b *supra*.

cable operators choose to make such showings.⁶³⁹ When a cable operator elects to make a cost-of-service showing we will permit local authorities to prescribe any rate that is justified by the cost showing, including a rate lower than the benchmark or the operator's current rate level. Thus, when electing a cost-of-service showing, the cable operator assumes the risk that its rate could be lowered if such action is justified by the cost showing. Cable operators or subscribers may then appeal the local decision to the Commission. We will review such local decisions on a case-by-case basis pending our cost-of-service rule making.⁶⁴⁰

(3) Regulations Governing Rates for Equipment

273. This section establishes regulations to comply with Section 623(b)(3) of the Cable Act of 1992, which directs the Commission to establish standards for setting, on the basis of actual cost, the rates for installation and lease of equipment used by subscribers to receive the basic service tier, and installation and lease of monthly connections for additional television receivers. The Commission concludes that the equipment covered by this section of the Act includes the converter box,⁶⁴¹ remote control unit, connections for additional television receivers and cable home wiring. We further conclude that Congress intended these actual cost regulations to cover all installations and equipment used by subscribers to receive the basic service tier in systems not subject to effective competition, even if the installation or equipment is also used for other cable services. While we decline to establish our own separate test of effective competition for equipment, we conclude that Congress intended our regulations to encourage competition in the provision of equipment and installation services. Therefore, our regulations require an unbundling of the charges for all regulated equipment and installations, as described below.

⁶³⁹ A local authority may not, of course, use our subsequently adopted cost-of-service rules to justify a refund for rates charged prior to the rules' effective date, but would have to rely on the general cost-of-service regulatory principles it chooses to use prior to the effective date of those rules.

⁶⁴⁰ Local authorities may require cable operators to reduce rates based on their cost-of-service determinations. We will consider petitions for stay of the local decision pending any appeal of the local decision by the operator to the Commission.

⁶⁴¹ Converter boxes include those boxes that act as an extended tuner for subscribers who do not have a cable-ready television, those boxes that descramble a signal, and addressable boxes.

274. The Commission has determined that Congress intended that cable operators can recover the costs of leasing equipment and service installation by charging directly for those activities. Because the Act requires the Commission to establish standards for setting rates for lease of equipment and installation, we will require the local franchising authorities to follow the detailed guidelines we now adopt for identifying the costs to be recovered through equipment and installation rates and for calculating those rates. We believe that our guidelines satisfy the statutory requirements, and thus a local franchising authority's proper use of them to determine reasonable rate levels cannot form the basis of a cable operator complaint to the Commission. Under our guidelines, cable operators shall establish an Equipment Basket to which they will assign the direct costs of service installation, additional outlets, leasing and repairing equipment. The basket will include an allocation of all those system joint and common costs that installation, leasing and repairing equipment share with other system activities, excluding general system overhead. The Equipment Basket includes a reasonable profit. The Commission will not prohibit the use of promotional offerings, but operators must exclude the costs of promotions from the Equipment Basket.

(a) Equipment Covered

i. Background

275. The Cable Act of 1992 directs the Commission to establish standards for setting, on the basis of actual cost, the rate for lease of equipment used by subscribers to receive the basic service tier, including converter boxes and remote control units, and lease of monthly connections for additional television receivers.⁶⁴² The Notice tentatively concluded that equipment covered by this section of the Act includes the converter box, remote control unit, connections for additional television receivers, and wiring that includes other inside cabling.⁶⁴³ The Notice, however, sought comment on the extent of this coverage. The Notice expressed a need to clarify the relationship between Section 623(b)(3), which requires regulating, on the basis of actual cost, "equipment used for the basic tier," and Section 623(c), requiring regulations for cable programming services, which include installation or rental of equipment used for the receipt of such programming services. For the latter, the Commission must establish standards for determining whether the rates are unreasonable. Cost is to be only one of several

⁶⁴² Communications Act § 623(b)(3), 47 U.S.C. § 543(b)(3).

⁶⁴³ Notice, 8 FCC Rcd at 525.

factors considered in determining these standards for cable programming services.⁶⁴⁴

276. The Notice pointed out the tension between Section 623(b)(3)(A), which specifically lists an addressable converter box needed to access video programming on a per channel or per program basis, among the equipment subject to the actual cost standard,⁶⁴⁵ and the inclusion of equipment and installation in the definition of cable programming services.⁶⁴⁶ The Commission surmised that Congress intended for some equipment to be regulated on the basis of actual cost and other equipment to be regulated under the standards for cable programming services, but expressed uncertainty over how to treat equipment that is used for the provision of both basic tier service and cable programming services. Therefore, we requested comment on the existence of any equipment not used for basic tier service and the extent to which the actual cost standard of Section 623(b)(3) controls the rates charged for equipment used for more than just basic tier service.⁶⁴⁷

ii. Comments

277. Commenters generally do not disagree with the Notice's tentative conclusion on rate regulation for the types of equipment used to receive cable service.⁶⁴⁸ As an initial matter, a few local franchising authorities request clarification

⁶⁴⁴ Notice, 8 FCC Rcd at 525.

⁶⁴⁵ In addition, the legislative history indicates a change in wording from "equipment necessary for subscribers to receive the basic service tier" in the original House bill, to "equipment used by subscribers to receive the basic tier" in the Act. The Conference Report says that this language is meant to give the Commission greater authority to protect the interests of the consumer. Conference Report at 64.

⁶⁴⁶ In fact, the definition of cable programming service was amended in conference to include installation and lease of equipment. See Conference Report at 66.

⁶⁴⁷ Notice, 8 FCC Rcd at 525-26.

⁶⁴⁸ See Armstrong Comments at 21-22; InterMedia Comments at 22; Rapids Comments at 34. It appears, however, that CIC and Cox did not include cable home wiring as equipment, and would include the drop from the pole to the home as part of customer equipment. CIC Comments at 38; Cox Comments at 33-34; CSC Comments at 12-13.

that they have jurisdiction to regulate equipment rates.⁶⁴⁹ The main area of discussion concerning the types of equipment covered by the Act involves the question of whether certain equipment should not be regulated because of its wide commercial availability.⁶⁵⁰ Many cable operators argue that some equipment, particularly remote control devices, is commercially available and the marketplace should regulate the price of this equipment.⁶⁵¹ Several cable operators urge the Commission to adopt a test of effective competition specifically for equipment.⁶⁵² They would avoid regulation of a piece of equipment by certifying that a particular piece of equipment is available for sale or lease from third party sources and that they have advised subscribers of that fact.⁶⁵³

278. NATOA disagrees with cable operators who suggest that equipment of a regulated system should not be subject to rate regulation if there exist third-party sources for such equipment in a franchise area. NATOA argues that Congress did not intend for cable service to be interpreted narrowly to exclude equipment, installation and additional outlets. According to NATOA, the definition of cable programming service, which includes equipment and installation, demonstrates a broader statutory definition of cable service. If equipment and installation are subsumed in the term cable service, they are covered by the effective competition standard. Thus, equipment

⁶⁴⁹ NJ Comments at 24; Rapids Comments at 33-34; SD Comments at 3.

⁶⁵⁰ In addition, CSC asserts that additional outlets should not be regulated because they are discretionary services and not required to meet the statutory goal of an affordable entry level package of service and equipment. CSC Comments at 6. For a further discussion of regulation of additional outlets, see paras. 306-307, *infra*. Also, NATOA expresses concern that operators would begin charging for equipment that previously did not have a charge, particularly equipment that would be considered network rather than customer premises equipment. NATOA Comments at 50.

⁶⁵¹ CIC Comments at 38; Continental Comments at 40; CSC Comments at 4; see also Encore Comments at 15. Continental argues that non-addressable converters also have wide commercial availability. Continental Comments at 40.

⁶⁵² AdelphiaII Comments at 72; Nashoba Comments at 71; TimeWarner Comments at 56.

⁶⁵³ AdelphiaII Comments at 73; Falcon Comments at 41; Nashoba Comments at 72; TimeWarner Comments at 57; see also CSC Comments at 13-14.

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⁶⁵³ AdelphiaII Comments at 73; Falcon Comments at 41; Nashoba Comments at 72; TimeWarner Comments at 57; see also CSC Comments at 13-14.

control devices, which are not necessary to receive basic tier service.⁶⁶⁰ Others argue this language change was meant to mirror the equipment language in the cable programming services definition and to give the Commission greater authority to protect the interests of the consumer.⁶⁶¹ Several cable operators contend that applying an actual cost standard broadly will inhibit research and development in new equipment technologies.⁶⁶²

281. Operators suggest two tests for whether equipment is used for the basic tier. Some contend that the test should be the service level of the subscriber using the particular equipment. A basic subscriber pays for equipment based on an actual cost standard, and a subscriber to cable programming services is charged for equipment based on an unreasonable standard, even if the equipment is identical.⁶⁶³ Others argue that capacity of equipment is the key.⁶⁶⁴ Thus, if an addressable converter is required to access basic, its price would be regulated under basic. If basic were unscrambled, but a subscriber needs an addressable converter for satellite tier programming, the price of a converter would be regulated as a cable programming service. Rates for converters required only to access premium services would not be regulated under this approach.⁶⁶⁵

iii. Discussion

282. We adopt our tentative conclusion concerning the type of leased equipment covered by the rate provisions of the

⁶⁶⁰ CSC Comments at 10 and n. 17; NCTA Comments at 49.

⁶⁶¹ AdelphiaII Comments at 66-67; Nashoba Comments at 65-66; Newhouse Comments at 19-20; TimeWarner Comments at 50-51.

⁶⁶² Comcast Comments at 47; Continental Comments at 39-40; CSC Comments at 11-12; TCI Comments at 37-38.

⁶⁶³ AdelphiaII Comments at 68-69; Cole Comments at 30-31; Falcon Comments at 38-39; Nashoba Comment at 67-68; Newhouse Comments at 20-21; TCI Comments at 31-32; TimeWarner Comments at 55; see also CSC Comments at 10 (equipment subject to this provision of the Act should be limited to converter and remote made available to a basic customer for use in connection with a primary outlet).

⁶⁶⁴ Armstrong Comments at 21-22 (functionally required); Blade Comments at 10 (operationally necessary); Continental Comments at 39-40; InterMedia Comments at 22; Simmons Comments at 1.

⁶⁶⁵ Continental Comments at 39.