# IMPLEMENTATION AND ANALYSIS OF COST OF SERVICE REGULATION FOR THE CABLE SERVICE INDUSTRY

by

Peter K. Pitsch

Pitsch Communications
2300 N Street, NW
Suite 600
Washington, D.C. 20037
(202) 663-9039

August 25, 1993

## Introduction and Summary

On behalf of CATA, Pitsch Communications examined the FCC's cost of service proposals contained in its Notice of Proposed Rulemaking in MM Docket No. 93-215 released July 16, 1993.[1] This report comments on the FCC's tentative recommendations regarding the implementation of cost of service regulation and proposes a possible streamlined alternative. It concludes:

- The FCC should give, at least, small cable systems the option of complying with a system of penetration benchmarks.
- Penetration benchmarks would serve the public interest, because they would create an incentive structure superior to price benchmarks and pose fewer administrative difficulties than cost of service regulation.
- A straightforward system of penetration benchmarks can be devised using the FCC's existing cable survey database and its findings regarding competition's effect on prices.
- In creating cost of service guidelines, the FCC should, at a minimum, adopt an industrywide rate of return of 14.5%.
- This number is based on findings that the debt to equity ratio for the median cable company (from among those cable companies on which public information is available) is roughly 50/50, the typical cost of debt for cable companies with public debt is nearly 11% and the cost of equity for companies with publicly traded stock ranges up to 18%.
- The 14.5% cost of capital figure is probably conservative, because the numerous cable companies who do not have publicly-traded debt or equity will likely have significantly higher capital costs.

---

[1] Biographical information on Peter K. Pitsch is contained in Attachment A.

- Individual cable companies should be given the option of demonstrating that their cost of capital is higher, given the likely wide range in debt and capital costs.

- Well established legal precedent and public policy considerations require that the FCC permit cable operators to place their plant in service in the rate base at its current market value.

- Using current market valuation for the cable rate base obviates any problem presented by so called excess acquisition costs. That is, cable companies should be able to place costs in the rate base up to their current market value. Future capital expenditures should also be valued at their market value. This approach would foster the efficient investment in cable service systems.

- In any event, Q ratio evidence does not warrant the FCC's sweeping conclusions and proposals that acquisition costs are attributable to cable market power. As the FCC as stated in its own Cable Report, Q ratios in excess of unity can be explained by the presence of scarcity rents and other considerations.

- Cable companies should be free to depreciate their assets in response to normal business incentives. By prescribing depreciation rates the FCC would unnecessarily run the risk of discouraging cable investment and innovation. At this point the FCC should only monitor cable company depreciation practices.

**A Streamlined Alternative**

The FCC has recently implemented a benchmark system of rate regulation for the cable service industry. Given the numerous drawbacks of cost of service regulation, the FCC wisely placed primary reliance on a form of incentive regulation. Consistent with the Cable Act of 1992, it now seeks to create a cost of service system of rate regulation as a fallback.

Under either the benchmark or cost of service approach, the goal is to achieve competitive performance. Among other things, this

means: prices should reflect costs including the costs of capital; cable operators should have the proper incentives to operate efficiently, invest in new plant and innovate; and administrative expenses should be minimized. While price benchmarks should be superior to cost of service regulation in achieving these goals, cost of service regulation may be needed in certain circumstances. For example, it may be necessary to protect cable operators from possible confiscatory rate situations that might arise under price benchmarks or to give cable operators the opportunity to recover expenses incurred in upgrading their systems that might not be adequately provided for under the price benchmark system. The expense of cost of service regulation, however, may make it an impractical fallback for all but the largest cable operators.

The Commission seeks comment on how it can more practically address the "upgrade" and small system problems in alternative ways.[2] It considers two approaches: (1) it could establish alternative standards in addition to the price benchmarks or (2) it could establish simplified cost of service showings.[3] An example of the former is to develop a price cap formula using 1986 rates.[4] An example of the latter approach is to allow a cable operator to exceed the price benchmark where it makes a simplified cost of service showing regarding "future capital expenditures

---

[2] See Notice, pp. 37-42.

[3] Notice, p. 38.

[4] Notice, p. 38.

used to improve the quality of service or to provide additional services."[5] Given the incentive problems presented by price benchmarks and the impracticality and drawbacks of cost of service regulation, it behooves the FCC to consider these and the other streamlining proposals put forward in the Notice. Moreover, because no one streamlined alternative will meet the needs of every cable system, the Commission should initially provide several options.

A. A Penetration Benchmark Alternative

The Commission should also consider another alternative standard for compliance--one that targets subscribership penetration as a measure of competitive performance. Under this regime the FCC would set "effective competition" benchmarks for subscribership penetration levels. Using its existing database, the FCC could develop estimates of the relationship between price and subscribership penetration levels. That relationship and the FCC's estimate that prices are 10% lower in cable systems that satisfy the statutory definition of effective competition would allow the FCC to generate "effective competition" penetration benchmarks.

For example, if a 10% price reduction leads to a 1% increase in subscribership penetration, then a cable system's effective competition benchmark would be 1.01 times its penetration level in

---

[5] Notice, p. 40.

September 1992. Thus, if that cable system did not satisfy the statutory definition of effective competition and was subject to possible rate regulation, it would have an alternative means of compliance: it could take competitive measures to increase and keep its penetration level above its penetration benchmark. These penetration benchmarks would remain effective as long as their price benchmark counterparts.

Given that penetration benchmarks would constitute a significant change in the price benchmark system which is just getting underway, the penetration benchmark approach might be applied, at least initially, only to relatively small cable systems that the Commission has recognized face disproportionately large administrative burdens and compliance costs.[6]

B. The Benefits of A Penetration Benchmark System

Such an approach would have important public interest advantages. First, it actually is a better form of incentive regulation than price benchmark regulation. Price is obviously only one of several components of value important to cable consumers. As the Commission has recognized in the telephone arena, price cap type regulation could potentially decrease the incentive to maintain or make improvements in the quality of service. In the case of cable service, price benchmarks likely compensate cable operators insufficiently for upgrading facilities, adding programming services,

---

[6] MO&O, MM Docket No. 92-266, August 10, 1993, p. 10.

improving customer service and other activities that add important value for cable customers. In contrast, penetration benchmarks would provide a better measure of good performance. They would also give cable operators greater flexibility to improve service in ways that best suit the circumstances in their particular communities. Second, relative to cost of service regulation, penetration benchmarks would be easy for the FCC to administer and inexpensive for small systems to apply. Third, a penetration benchmark system would not raise service cross subsidy and cost allocation issues that plague multi-service firms regulated under a cost of service regime.

C. An Illustrative Penetration Benchmark

Using the Commission's cable survey database, multiple regression analysis was used to illustrate how a penetration benchmark might be developed. The FCC's price variable and possible substitutes and complements to cable service were considered as independent or explanatory variables. The following equation was estimated:

$$LNPEN = -.1658\ LNEPCHA3 - .1646\ LNCOMLTV - .5249\ ABC$$

$$(-2.945) \qquad (-4.516) \qquad (-13.443)$$

$$+.0408\ LNCMPSAT - .3121.$$
$$(.956) \qquad (-2.500)$$

where

LNPEN is the natural log of subscribers/homes passed,

LNEPCHA3 is the natural log of the FCC's revenue/channel variable,

LNCOMLTV is the natural log of the number of local TV channels,

ABC is the FCC's competitive dummy, and

LNCMPSAT is the natural log of the number of satellite channels.

The adjusted R Square is .3684 and the number in parentheses are t-statistics. The coefficients of all the variables, except LNCMPSAT, are significant. Although these results are preliminary and only intended to be illustrative, they suggest that this approach is workable. (One obvious way to improve the R Square would be to include an income variable.)

Thus a penetration benchmark for a system that prices competitively but does not face competition from an actual multichannel competitor[7] can be estimated using this equation and the FCC's

---

[7] The coefficient of dummy competition variable was not used to produce competitive penetration benchmarks for two reasons. First, the presence of a multichannel competitor quite naturally reduces penetration levels. That is, while overall multichannel penetration may be up in such markets a particular cable system's penetration will be lower. Second, the

Continued on following page

conclusion that effective competition reduces cable prices by roughly 10%. By way of illustration, reducing the price variable in the above equation by 10% produces a 1.7% increase in subscriber penetration.

Since the penetration benchmark might, at least initially, be used exclusively by relatively small cable systems, only one percentage benchmark would be necessary, say 2%. For example, a small cable system could opt out of the price benchmark system, if it increased its subscriber penetration level (as of September 1992) by 2.0%. That is, if 50% of the homes passed by that cable system subscribed in September 1992, then its penetration benchmark would be one percentage point higher or 51%. To assure compliance, the FCC could require systems using the penetration benchmark approach to report penetration levels periodically.

**Cost of Service Regulation**

While the above alternative would reduce the need for a cost of service regulatory fallback, at least for small cable operators, it does not eliminate it. As the FCC's Notice amply demonstrates, cost of service regulation is a complex process. This report considers three key cost of service issues: (1) the proper rate of return, (2) the valuation of plant in service and the treatment of

---

Continued from previous page
statutory definition of effective competition includes systems with penetration levels under 30%. Inclusion of these low penetration systems may have the effect of overstating the "competition" variable's effect on subscriber penetration.

acquisition costs, and (3) the prescription of depreciation rates.

A. The Appropriate Rate of Return

A company's required cost of capital is the weighted average of its cost of debt and equity. For example, if a cable operator's debt/equity ratio is 50/50, its cost of debt is 10% and its cost of equity is 20%, then its cost of capital is 15%.

In its Notice of Proposed Rulemaking the Commission reaches tentative conclusions as to each of these three variables in computing an industrywide rate of return for cable service. First, the Commission uses a cost of debt of 7.5%, based on recent bond yields for "Aa" (public utility) grade bonds.[8] Second, the Commission tentatively concludes that the cost of equity will be in the range of 12%-17%.[9] Third, it uses a debt/capital ratio of 50%, in estimating the required rate of return on capital for regulated cable service to be between 10% to 12.4%, after taxes.[10]

In the end, given changes in debt and equity costs, the Commission tentatively concludes that "a rate of return somewhere in the range of 10% to 14%, after taxes, would reflect a reasonable balancing of subscriber and cable operator interests and that we

---

[8] Notice, p. 29.

[9] Notice, pp. 29-30.

[10] Notice, p. 30.

could select a final rate of return within this range to achieve our balancing of goals for cost-based rates for cable service."[11] The Commission asks what the industrywide maximum rate of return should be. This report concludes that the FCC's implied 50/50 debt/equity ratio is appropriate, but that the proposed cost of debt and equity are too low and must be adjusted upward in setting an appropriate cost of capital for the entire cable service industry.

Debt/Equity Ratios. The FCC seeks comment on the capital structure of the cable service industry. While public information on the relative proportions of debt and equity is available for only a relatively few cable companies, it appears that there is wide variation centering around the FCC's proposed 50/50 debt/equity ratio. In 1992 19 cable operators had debt/equity ratios ranging from 11/1 to .1/1.[12] Five had ratios over 3. Five had ratios between 1 and 2. Five had ratios under 1. The median debt/equity ratio was 1.1/1 or .52/.48. The median is the better indicator of mean value in this case, because the arithmetic mean is unduly skewed by the high-end numbers. (Numbers on the low-end are limited by zero.) Thus, while it is problematic to pick one industrywide number in an industry that is undoubtedly characterized by more variation than is customary in utility

---

11 Notice, p. 30.

12 Paul Kagan's The Cable TV Financial Databook, June 1993, p.67 (hereafter Kagan).

industries, the FCC's proposed 50/50 debt/equity ratio is the appropriate one. As discussed below, many cable companies may not be able to borrow in today's lending environment and therefore individual cable companies should be free to demonstrate that their capital structure justifies basing its cost of capital on a lower debt/equity ratio.

Cost of Debt. The cable industry's cost of debt can be conservatively estimated from market yields on bonds and the bond ratings of cable companies with public debt. Company cost of debt can be estimated from bond ratings.[13] S&P's Bond Corporate & Government Guide (p. 3) for June 1993 gives the following 1993 annual yields for corporate bonds:

TABLE 1

| TYPE/RATING | HIGH | LOW | MAY |
|---|---|---|---|
| AAA | 8.12 | 7.56 | 7.63 |
| AA | 8.21 | 7.62 | 8.11 |
| A | 8.60 | 7.92 | 8.20 |
| BBB | 9.03 | 8.65 | 8.84 |
| BB | 9.88 | 9.32 | 9.39 |
| B | 11.19 | 10.55 | 10.59 |

Table 2 lists the bond ratings for cable service companies with public debt. It groups them into two categories: "primarily cable" and "mixed cable" service companies. To put cable service company debt costs in perspective, Table 2 also provides rating and yield information for the Regional Bell Operating Companies.

---

13 Westin and Copeland, Managerial Finance (Dryden, 9th Ed.), p.608 (hereafter Westin and Copeland).

The S&P ratings for "primarily cable" companies vary from BBB- to B. The RBOC's S&P bond ratings vary from AAA to A.

TABLE 2[14]

| COMPANY | S&P RATING | MAY 1993 BOND YIELD |
|---|---|---|
| **Primarily Cable** | | |
| Adelphia Communications | B | 10.59 |
| Cablevision Industries | B+ | 10.59 |
| Cablevision System 'A' | B+ | 10.59 |
| Continental Cable | B+ | 10.59 |
| Jones Intercable | B | 10.59 |
| TCI | BBB- | 8.84 |
| TKR Cable I | BBB- | 8.84 |
| **Mixed Cable** | | |
| Century | B+ | 10.59 |
| Comcast | B | 10.59 |
| Houston Industries | BBB | 8.84 |
| Knight Ridder | AA- | 8.11 |
| Times Mirror | AA- | 8.11 |
| Time Warner | BBB- | 8.84 |
| Viacom 'A' | B | 10.59 |
| **RBOC** | | |
| Ameritech | NA | NA |
| Bell Atlantic | AA- | 8.11 |
| Bell South | AAA | 7.63 |
| NYNEX | A | 8.20 |
| Pactel | AA- | 8.11 |
| Southwestern Bell | A+ | 8.20 |
| US West | AA- | 8.11 |

The cable service industry has debt costs significantly above the debt costs of utility grade companies. Of those companies with public debt and who are primarily in the cable service busi-

---

14 The cable company bond ratings are from Kagan, p. 79. The RBOC ratings are from S&P Corporate & Government Bond Guide, December 1992. The bond yields are from S&P Corporate & Government Bond Guide, June 1993, p. 3. The bond yields do not reflect pluses or minuses in bond ratings.

ness, debt costs range from 8.84% to 10.59%--considerably above the FCC's implied 7.5% cost of debt!

Moreover, these figures provide a conservative estimate of the cable service industry's cost of debt for two reasons. First, the May 1993 figures are probably low, because corporate bond yields have fallen sharply over the last six months. Second, and more importantly, the vast majority of cable operators do not have public debt and will likely have substantially higher debt costs. Indeed, only the large companies with low debt/equity ratios have access to the public bond markets. Other cable operators in search of funds will either have to go to the private capital market (that is, sell part of the company) or try to get lending from banks that are not currently disposed to lend.[15] Therefore, 11.00% would appear to be a conservative industrywide cost of debt estimate for the cable service industry.

Cost of Equity. Estimating a company or industry's cost of equity can be done in several ways. Typically, four methods are used: (1) the Capital Asset Pricing Model (CAPM), (2) Bond Yield Plus Equity Risk Premium, (3) Realized Investor Yield, and (4) Dividend Growth Model.[16] The FCC applies a hybrid of methods (4) and (2) to S&P 400 firms in estimating the industywide cost of equity for cable service to be in the range of 12% to 17%. All of these

---

15 Kagan, p. 4.

16 Westin and Copeland, pp. 610-612.

approaches are problematic. To give but one example, most of them theoretically require prospective estimates of risk, but current or historical measures are generally the best that is available. Judgment is required in using these methods and they are best used in combination with each other.

This report uses the CAPM and equity risk premium methods to estimate the equity costs of the leading cable companies. This analysis should provide a conservative measure of industrywide costs, because those cable companies who do not have public equity or debt will likely have higher equity costs than those firms that do. The report then examines the FCC's hybrid approach and concludes that it fails to reflect adequately the risks of the cable service industry. Based on that analysis, this report concludes that a probably conservative industrywide cost of equity would be 18%.

(1) CAPM. The CAPM approach compares company risk with general market debt and equity risks to calculate a company's cost of equity. It states that an investor's required rate of return on common stock equals the rate for risk free debt plus the product of a general market risk premium for equity and a measure of the firm's riskiness relative to common stocks as a whole. Where:

- The risk free rate is the Treasury Bill rate. Given the volatility of short term rates some experts suggest using the 10 year Treasury Bond rate as a check.[17]

[17] Westin and Copeland, p. 610.

- The market risk premium is the market rate minus the risk free rate. According to Westin and Copeland, over long periods of time the market risk premium averages between 6% and 8% in the United States. They use 7.5%.[18] In a recent docket the FCC noted that from 1926 to 1988 (63 years) the market risk premium over long term government bonds averages 6.9%.[19]

- The firm's volatility as compared with the stock market as a whole is given by a statistical measure of variation called its beta coefficient.

Table 3 gives beta coefficients for cable companies that both have publicly traded equity and are primarily cable service companies. Using a risk free rate of 5.8%[20] and market risk premiums of 6.9% and 7.50%, it also gives cost of equity estimates for these same companies using the CAPM approach.[21]

---

18 Id.

19 See Exhibit B to the Telco Reform NPRM, CC Docket No. 92-133, Pike & Fischer, Current Service, p. 95:21.

20 This rate is based on the rates of roughly 10 year government bonds. Wall Street Journal, July 29, 1993, p. C15.

21 For example, using a market risk premium of 7.5%, the cost of equity for TCI 'A' is 5.8% plus 1.65 times 7.5% or 18.18%.

TABLE 3[22]

| COMPANY | BETAS | COST OF EQUITY (6.9% MARKET PREMIUM) | COST OF EQUITY (7.5% MARKET PREMIUM) |
|---|---|---|---|
| Primarily Cable | | | |
| Cablevision System 'A' | 1.45 | 15.81 | 16.68 |
| TCI 'A' | 1.65 | 17.19 | 18.18 |
| Mixed Cable | | | |
| Comcast | 1.60 | 16.84 | 17.80 |
| Knight Ridder | .95 | 12.36 | 12.93 |
| Times Mirror | 1.10 | 13.39 | 14.05 |
| Time Warner | 1.30 | 14.77 | 15.55 |
| RBOC | | | |
| Ameritech | .80 | 11.32 | 11.80 |
| Bell Atlantic | .90 | 12.01 | 12.55 |
| Bell South | .80 | 11.32 | 11.80 |
| NYNEX | .85 | 11.67 | 12.18 |
| Pactel | .90 | 12.01 | 12.55 |
| Southwestern Bell | .90 | 12.01 | 12.55 |
| US West | .85 | 11.67 | 12.18 |

The RBOC cost of equity figures provide some context in which to evaluate the cable cost of equity figures. Using a 50/50 debt/equity ratio and the cost of debt figures cited above, the RBOC cost of equity estimates based on a market risk premium of 7.5% translate into cost of capital figures below 10.5%. The current allowed cost of capital figure for local exchange carriers is 11.25%.

The upshot is that the CAPM analysis estimates the cost of equity for publicly traded companies primarily in the cable service

---

22 The beta coefficients are taken from Value Line Investment Survey, Part 1, Summary & Index, July 23, 1993.

industry to be 16% to 18%. Again, these estimates are probably conservative, because smaller firms likely require higher rates of return.[23]

(2) Bond Yield Plus Equity Risk Premium. This method employs a risk premium over the company's own long term debt cost. Calculating this equity risk premium requires comparing the volatility of the company's bond yield vis a vis the stock market overall. The beta coefficient of the company's bond should be lower than the beta coefficient of its stock, because risk on bonds is lower than the risk on common stock. Thus, the equity risk premium should be smaller than the market risk premium. Here 6% is used.

TABLE 4

| COMPANY | S&P RATING | MAY 1993 BOND YIELD | COST OF EQUITY |
|---|---|---|---|
| Primarily Cable | | | |
| Adelphia Communications | B | 10.59 | 16.59 |
| Cablevision Industries | B+ | 10.59 | 16.59 |
| Cablevision System 'A' | B+ | 10.59 | 16.59 |
| Continental Cable | B+ | 10.59 | 16.59 |
| Jones Intercable | B | 10.59 | 16.59 |
| TCI | BBB- | 8.84 | 14.84 |
| TKR Cable I | BBB- | 8.84 | 14.84 |

23 See for example, Banz, Ralph, "The Relationship Between Return and the Market Value of Common Stocks," Journal of Financial Economics, March 1981, p.3-18. The Commission's own Notice suggests a strong inverse correlation between size and rate of return. The Commission states that if instead of the average S&P 400 stock (which the FCC estimates having a cost of equity no higher than 13%), "regulated cable service was judged to be more comparable to the risks of the highest quartile of S&P 400 companies, the cost of equity would be around 15%" Notice, p. 29.

Mixed Cable

| | | | |
|---|---|---|---|
| Century | B+ | 10.59 | 16.59 |
| Comcast | B | 10.59 | 16.59 |
| Houston Industries | BBB | 8.84 | 14.84 |
| Knight Ridder | AA- | 8.11 | 14.11 |
| Times Mirror | AA- | 8.11 | 14.11 |
| Time Warner | BBB- | 8.84 | 14.84 |
| Viacom 'A' | B | 10.59 | 16.59 |

RBOC

| | | | |
|---|---|---|---|
| Ameritech | NA | NA | NA |
| Bell Atlantic | AA- | 8.11 | 14.11 |
| Bell South | AAA | 7.63 | 13.63 |
| NYNEX | A | 8.20 | 14.20 |
| Pactel | AA- | 8.11 | 14.11 |
| Southwestern Bell | A+ | 8.20 | 14.20 |
| US West | AA- | 8.11 | 14.11 |

To put these calculations in context, the 6% equity risk factor is roughly equal to that implied by the bond yield and the above CAPM analysis for Cablevision System. That is, its 16.68% cost of equity minus its 10.59% cost of debt equals 6.09%. Also, using a 50/50 debt/equity capital structure and the cost of equity estimated using the bond yield method translates into a cost of capital for the RBOCs which is slightly lower than their current 11.25%. Thus, bond yield plus equity risk analysis produces a creditable cost of equity range of 15% to 17%. Even using the 5% equity risk premium employed in the FCC's hybrid approach (see discussion below) produces a equity range of 14% to 16%.

The two other commonly used methods for calculating cost of equity are the realized investor yield and the dividend growth model. The realized investor yield method adds the the average dividend yield to the average capital gain over a prior period, e.g., 10 years. The Dividend Growth Model computes the required return on

equity by adding the ratio of expected dividends to stock price to the expected growth in dividends.[24] Neither approach seems appropriate here. The historic rates reflect great regulatory and growth changes in the cable service industry and provide an uncertain basis for future estimates. Similarly, analysts' predictions about dividend growth, which are essential to the dividend growth model, would seem to be far too speculative at this point.

(3) The FCC's Hybrid Approach. The Commission uses a hybrid approach. Using discounted cash flow analysis of the cost of equity for firms in the S&P 400 index, it estimates an equity risk premium for S&P 400 firms as compared to low risk corporate debt rates.[25] Based on this analysis it concludes that the average S&P 400 company's cost of equity would be no more than 5% above the yield on public utility "Aa" grade bonds. Given recent bond yields of approximately 7.5%, this approach produces a cost of equity of no higher than 13%.

This hybrid approach seriously undervalues the cable service industry's risk as compared to the S&P 400. For example, if the FCC had compared the S&P 400 equity figures to the risk free rate (Treasury Rate) instead of a utility bond rate, it would have estimated a market risk premium rather than a equity risk premium. The resulting market risk premium for the S&P 400 would have been

---

[24] Westin and Copeland, pp. 611-612.

[25] Notice, n. 57.

6.7%.[26] Using the CAPM method, the S&P 400 cost of equity would equal the risk free rate (5.8%) plus the product of the market risk premium (6.7%) and the beta coefficient for the S&P 400 (1) or 12.5%.

This approach may be appropriate for local telephone companies that have beta coefficients less than 1. However, as discussed above, cable service firms have beta coefficients well in excess of 1. Put differently, incorporating the FCC's numbers into a CAPM analysis with a beta coefficient of 1.5 produces a cost of equity of roughly 16%. Using TCI's beta coefficient produces a cost of equity of roughly 17%.

In sum, the three methods of analysis produce estimates which range as high as 18%, 16% and 17%. Because an industrywide cost of equity must cover many smaller, riskier cable service companies that are unable to raise capital in the public debt or stock markets, the maximum cost of equity should, at a minimum, be set at the high end of the range of estimates, that is, at 18%.

Total Cost of Capital. Using a 50/50 debt to equity capital structure, a 11% cost of debt figure and a 18% cost of equity figure, produces a conservative industywide cost of capital estimate of 14.5%. Again, this estimate may inadequately account for

---

26 That is, the difference between the bond yield rate of 7.5% and the treasury rate of 5.8% added to its equity risk premium of 5% gives a market risk premium of 6.7%.

the higher costs of debt and equity for those cable systems without public debt or equity.

B. The Valuation of Plant In Service & the Treatment of Acquisition Costs

The FCC tentatively proposes to exclude from the rate base what it characterizes as "excess acquisition costs," including the portion of those costs assigned to goodwill, customer lists, franchise rights and other intangible assets.[27] The FCC believes this is appropriate under cost of service regulation, because acquisition costs in excess of original, replacement, or reproduction costs are likely to be attributable to an expectation of earning monopoly profits.[28] In general, the FCC proposes to use original cost as the means of valuing plant in service. The FCC seeks comment on these proposals.

As a legal and policy matter, the FCC should allow cable service operators to place plant in service in the rate base at its current market value. The analogous issue of how to value assets withdrawn from a rate base provides clear guidance here. Under Democratic Central Committee of D.C. v. Washington Metro Area Transit Commission, 485 F.2d 786 (DC Cir. 1973), it is well established that a company under cost of service regulation should be able to capture the gain from investments retired from the

---

[27] Notice, p. 22.

[28] Notice, p. 21.

ratebase where it bore the risk of possible loss.[29] That is, the company and its owners get the benefit of any capital appreciation due to an increase in the retired asset's market value, if the company bore the risk of possible loss.

Valuing assets being placed into a rate base is directly analogous. That is, if the company prior to being subjected to rate of return regulation bore the risk that an asset would fall in value as compared to its original cost, it should get the benefit of any gain in market value. Before the 1992 Cable Act, unregulated companies bore the full risk of their investment. Now their plant in service is subject to rate regulation. Under Democratic Central, cable service companies seeking the protection of cost of service regulation should be able to value their plant in service at its current market value. Thus, cable operators should be able to recover acquisition costs to the extent they are within the company's current market value.

Using current market value for plant transferred to a rate base also makes good policy sense for several reasons. First, under effective competition or regulation, market value should roughly approximate reproductive costs (or replacement costs assuming sufficient technical innovation), but because it encompasses

---

29 The actual paradigm in Democratic Central Committee involves a second rule that is not relevant here. See also, AT&T Information Systems, Inc. v. FCC, 854 F.2d 1442 (DC Cir. 1988).

everything in the going concern it allows for recovery for superior management and other assets important to a firm's value. Second, under a market valuation approach, operators who recently purchased systems can recover their market based expenses and other cable operators would not have an artificial incentive to sell their systems. Third, under this approach operators who have upgraded or do upgrade their systems can recover those costs.[30] Overall, this approach would foster the efficient acquisition, transfer and upgrading of cable service facilities.

Moreover, even if the FCC were to reject current market valuation, the FCC's proposal and rationale for excluding "excess acquisition costs" are too sweeping. First, under its theory that excess acquisition costs are attributable to an expectation of monopoly profits, the FCC should permit inclusion in the rate base of acquisition costs for acquisitions that predate the 1984 Cable Act or postdate the 1992 Cable Act. These acquisitions occurred or will occur in an environment in which regulation or competitive forces address the concern that that expected monopoly profits account for any premium paid for these companies.

Second, within the 1984-1992 period, cable service companies should be able demonstrate that expected monopoly profits do not explain their excess acquisitions costs. Contrary to the FCC's

---

30 See Notice, n. 37.