their rate base by repeatedly purchasing facilities from each other at greater than market value prices. This problem does not arise, however, where acquisitions are not entered into between commonly owned or otherwise affiliated entities and instead reflect an arm's length, free market transaction.[19] As the Supreme Court explained in AT&T v. United States:

> "There is widespread belief that transfers between affiliates or subsidiaries complicate the task of rate-making for regulatory commissions and impede the search for truth. Buyer and seller in such circumstances may not be dealing at arm's-length, and the price agreed upon between them may be a poor criterion of value.

299 U.S. 232, 239 (1936). In such circumstances, the concern exists that purchasers and sellers of telephone plants might arrive at an acquisition price not based on "market or intrinsic value for the uses of the business." Id.[20]

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[19] Likewise, the traditional fear that ratepayers would otherwise have to pay for the same asset twice -- once the first utility and then again to its successor -- is inapposite where the first entity predated rate regulation.

[20] See, also, Montana Power Co. v. FERC, 599 F.2d 295, 300 (9th Cir. 1979) (citing United Gas Pipe Line Co., 25 FPC 26, 64 (1961)). See also California Oregon Power Co. v. FPC, 150 F.2d 25, 28 (9th Cir. 1945) (disallowing a portion of acquisition costs to protect "the public against artificially inflated investment costs on the basis of which utility companies assert the right to a return.") (emphasis added) cert. denied, 326 U.S.781 (1946); American Television Relay, 65 F.C.C.2d 385, 393 (1977) ("[w]ithout this rule, repeated sales of the same property could, and most likely would, result in even larger ratebases, thus requiring higher rates for service to achieve the same rate of return."); Accounting for Public Utilities, at § 4.04[2] (explaining that separate accounting for acquisition adjustments was necessitated by

Other regulatory authorities have recognized that where the purchase price of property acquired by a regulated entity is the result of arm's length bargaining with an unaffiliated seller, the entire acquisition cost is properly allowed rate base treatment. The view of the Louisiana Public Utility Commission is typical:

> Money is prudently invested, even though it is in excess of the original cost of the property purchased, if the excess of purchase price over original cost was paid as the result of arm's-length bargaining between nonassociated buyer and seller . . . .[21]

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abuses in the utility industry mergers of the 1920s and 1930s, which enabled "commonly owned utilities . . . to inflate their rate bases through transactions that lacked economic substance.") See, e.g., Re California Water & Tel. Co., Decision No. 70418, Application No. 48170 (Mar. 8, 1966).

[21] Louisiana Power & Light, 65 P.U.R. (NS) 23 (LA 1946). See also Arlington County v. Virginia Electric Power Co., 87 S.E.2d 139 (Va. 1955) allowing rate base treatment for amount paid in excess of original cost when first devoted to public use because the acquisition was result of arm's-length bargaining); Southwestern Bell Telephone Co. v. Kansas State Corp. Comm'n, 386 P.2d 515 (1963) (where the reasonableness of price paid by utility for telephone exchange property is not questioned, the entire purchase price should be included in rate base); Acme Brick Co. v. Arkansas Pub. Servi. Comm'n, 299 S.W.2d 208 (1957) (amount in excess of original cost, paid by gas company in acquiring plant was properly included in the rate base where the purchase was found to have been made at arm's length); Washington Power Co., 59 P.U.R.3d 86 (1965) (acquisition adjustment amount allowed in rate base where electric company purchased, in an arm's-length transaction, a portion of power project); Alabama Gas Corp., 105 P.U.R. 4th 423 (1989) (utility granted rate base allowance equal to the full fair-market value of acquired utility assets, even though fair market value exceeded the book value of the acquired assets because, among other things, the purchase was the result of

Apparently recognizing that the arm's length acquisition of cable systems prior to rate regulation undermines the traditional rationale for disallowing "excess" acquisition costs, the Commission invokes as its own rationale in this proceeding the "presumption" that acquisition costs above net historical cost "reflect an expectation of monopoly earnings." See Cost-of-Service NPRM at ¶36. The NPRM cites some legislative history raising this concern, but no legal authority for relying on this presumption as the basis for disallowing "excess" acquisition costs. As demonstrated below, it is both analytically and empirically unsupportable to presume that monopoly rents exclusively, or even largely, explain the premiums paid above net historical cost (or even above replacement costs) for plant in a dynamic, rapidly growing industry. Furthermore, as explained below, disallowance based on this gross assumption would so systematically deny cable operators their reasonable, investment-backed expectations as to amount to an unconstitutional confiscation.

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an arm's length transaction and promoted operating efficiencies).

3. Exclusion of "Excess Acquisition Costs" Would Cause Severe Economic Harm to the Cable Industry and Would Constitute An Unconstitutional Confiscation

Denying cable operators any return on their investment in cable systems in excess of historical cost would have a devastating impact not only on the cable industry, but also on the constitutionality of the Commission's entire rate regulation scheme. The Joint Parties recognize that the Commission retains substantial discretion in determining a constitutionally adequate return on investment, including the determination of whether a given investment was prudent and legitimate. To categorically deny all cable operators any return on the intangibles and other market premiums paid for a cable system prior to rate regulation, however, would not comport with any reasonable notion of fundamental fairness or "just and reasonable compensation" as mandated by the Constitution.

Prudent investments may be constitutionally disallowed where regulated entities know of the risks of disallowance and the price of the asset is set accordingly. This is hardly the situation here, however. No cable operator could reasonably have been expected, in acquiring cable systems at prevailing market prices prior to rate regulation, to account for the risk that it would not only become subject to rate regulation, but that its acquisition costs would be

categorically disallowed to the extent they exceeded the (widely variable) level of undepreciated original plant cost at the time. It would go far beyond the language and intent of the 1992 Cable Act to allow, precipitously and retroactively, the subsequent enactment of the Act to render the reasonable, investment-backed expectations underlying prior cable acquisitions "unreasonable" or "imprudent." Indeed, this would be just the sort of arbitrary governmental deprivation of reasonable expectations that creates an unconstitutional taking. See, e.g., Williamson Planning Comm'n v. Hamilton Bank, 473 U.S. 172, 190-91 (1985).

Disallowing these so-called "excess" acquisition costs would so greatly undervalue many cable systems' ratebase that cost-of-service showings would be completely unavailing. As explained below, the legitimate market value which cable operators pay in excess of net historical cost when acquiring a cable system often represents a substantial portion of the acquisition price. Excluding that portion of investment from the cable system's rate base would make it impossible as a practical matter to recover a reasonable return on their investment, even if the Commission were to allow a rate of return far in excess of the 10-14% range it has proposed. Thus, it would be unlikely that cost-of-service showings would permit cable operators to substantiate rates

significantly greater than the noncompensatory rates allowed under the benchmark/pricecap mechanism itself.[22]

As previously noted, the Commission itself has readily acknowledged that denying cable operators the ability to cover their costs and earn a reasonable profit will not benefit consumers. At a minimum, the ability of operators to obtain financing in the future and to generate the revenues necessary to maintain existing investment levels or expand investment in their system's plant and programming offerings would greatly suffer. Cable customers will be denied not only continued improvements in the quality and quantity of service they receive, but many would likely suffer degraded or even disrupted cable service.

Consistent with this approach, the Commission should also allow operators to recover accumulated losses.[23] As the NPRM suggests, cable systems that have accumulated losses generally incurred them in the initial stages of providing service. Thus, they not only share the nature of a capital investment in that the sums were invested with an expectation of a future return, but they also are financed in the same

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[22] The cost-of-service standards are, of course, only necessary where a cable operator finds the applicable benchmark levels do not adequately cover costs.

[23] See NPRM, n.44.

manner, through debt and equity obtained from capitalists who expect to be reimbursed and earn a return.

Cable systems incurred these losses in an unregulated environment with the expectation that, if they were successful entrepreneurs and their businesses grew, they would have an opportunity to recover them in the future. Disallowing accumulated losses at the onset of rate regulation would deny operators any opportunity to recover them and would be confiscatory. Accordingly, in determining the composition of the ratebase, the Commission should allow those cable operators having accumulated losses to capitalize such losses, including a return and amortization.[24]

The Commission is, of course, well versed in the constitutional constraints on rate regulation. "Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being employed to render service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of [the Constitution]." Bluefield

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[24] The Commission should not concern itself with trying to determine the extent to which cable operators may have received tax benefits as a result of their accumulated losses. Setting nationwide policy in this regard, and attempting to measure such losses would be extremely difficult because of the range of forms of legal ownership in the cable industry. On the other hand, there would be no tax allowance for future periods.

Water Works & Improvement Co. v. Public Serv. Comm'n, 262 U.S. 679, 690 (1923). See also Hope Natural Gas Co., 320 U.S. at 603, (return on equity must be "sufficient to assure confidence in the financial integrity of the enterprise" so that its credit is maintained and capital may continue to be attracted); Permian Basin Area Rate Cases, 390 U.S. 747, 792 (9168) (rate must "maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed").

Rate regulated entities thus must be allowed to "earn enough revenue not only to cover operating expenses, but also to pay for capital costs of doing business, including service on debt and dividends on stock." U.S. v. FCC, 707 F.2d 610, 612 (D.C. Cir. 1983). See also D.C. Transit System v. Washington Metro Area Transportation Comm'n, 350 F.2d 753, 778 (D.C. Cir. 1965) ("rate fixed without particularized reference to [debt service and other] needs does not satisfy any standard of rate making of which we are aware"). In Duquesne Light Co. v. Barasch, 488 U.S. 299, 305 (1989) the Supreme Court reaffirmed the principle that a just and reasonable rate depends "to some extent on what is a fair rate of return given the risks under a particular rate-setting system, and on the amount of capital upon which the investors are entitled to earn that return." Duquesne confirms that adverse regulatory changes implicating a

utility's return on investment would "have no constitutional effect on the utility's property if they are compensated by countervailing factors in another element." Id. at 314 (emphasis added); see also Scalia, J., concurring, id. at 317 (suggesting that the Constitution requires that all prudent investments, even those disallowed, be considered in assessing the ultimate fairness of the permitted return).

The Commission only recently reaffirmed its understanding of the constitutional command that regulated cable rates be just and reasonable. Memorandum Opinion and Order, MM Docket No. 92-266, FCC 93-389 (released August 10, 1993) at ¶¶14-15. The Commission reiterated therein that "[t]o the extent that the Commission's primary method of competitive benchmarks and price caps may be inadequate when applied in individual circumstances, the Commission has given assurance that it will permit cable operators an opportunity to demonstrate the reasonableness of high rates based on costs . . . ." Id. at ¶15. The Commission thus recognizes that its cost-of-service standards -- and indeed its entire cable rate regulation scheme -- are, of course, ultimately constrained by the Fifth Amendment's mandate that rates not be set at confiscatory levels, i.e., that they provide a just and reasonable return on investment.

Thus, in allowing cable operators to substantiate cost-justified rates in excess of benchmark levels, the cost-of-

service approach serves not only as a "backstop" for cable operators. It also serves as the Commission's "backstop" for the constitutionality of its benchmark approach and overall rate regulation scheme as well. A cost-of-service alternative that, as a practical matter, amounts to no real alternative at all for many cable operators thus utterly fails in its role as constitutional "backstop" for the Commission's comprehensive rate regulation scheme.

In sum, the Commission would misapply "original cost" methodology, create severe dislocation in the cable industry, and flaunt its basic constitutional obligation were it to disallow as "excess" acquisition costs the amounts paid above net historical costs for systems acquired prior to the effective date of its rate regulations pursuant to the 1992 Cable Act. If the Commission is committed to original cost methodology, therefore, it is compelled to recognize that the "original cost" of such systems is in fact their undepreciated acquisition cost. The following section, however, presents an alternative approach which would value cable plant based on a competitive market model, rather than anachronistic historical figures.

B. The Commission's Goal of Setting Rates Similar to Those Produced Under Competitive Conditions Is Best Served By Valuing Ratebase At Competitive Market Value

1. The FCC's Proposed Use Of Net Historical Cost Will Not Lead To Rates That Replicate Competitive Rates

The primary goal of any system of rate regulation is to approximate rates produced in a competitive environment. Indeed, the Commission's benchmark/price cap scheme is grounded on this premise and the Cost-of-Service NPRM similarly proposes that a goal of cost-of-service regulations is to produce rates that approximate competitive levels. NPRM at ¶10.

Despite this asserted goal, however, the NPRM proposes a method of valuing cable assets -- original or net historical cost -- that is entirely irrelevant to competitive firms and that will not produce rates approximating competitive levels. Net historical cost substantially undervalues the assets of a competitive firm for several reasons.[25] First, the value of competitive assets increases with inflation, while net historical cost does not account for inflation. Second, assets in a competitive market change from year to year

[25] This point is discussed at length in the Comments of Viacom International Inc. which include an economic study by Dr. A. Lawrence Kolbe, Rate Base Issues In Cable Television Cost Of Service Regulation, and which the Joint Parties have reviewed.

according to a number of external factors, such as technological changes and relative productivity. In any event, the value of the assets does not correspond to straight-line depreciation schedules. These economic forces demonstrate that assets in a competitive environment are worth at least net replacement cost.

Moreover, a third factor, unique to growing industries like the cable industry, indicates that competitive assets are worth more than replacement cost. Indeed, companies expand and attract capital precisely because new assets are worth more than they cost to build. Capital is attracted to a growing company until incremental investments are worth no more than their cost. Thus, it is entirely reasonable and thoroughly consistent with sound economic theory that the value of cable system assets will exceed both not historical cost and replacement cost. It is also consistent that this economic fact should affect the "competition" level at rates.

In sum, the Commission's proposed original cost valuation method does not account for the presence of basic economic factors and thus will substantially undervalue the competitive market value of cable assets.[26] Given this erroneous valuation, it is most unlikely that cable rates

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[26] The FCC's tentative conclusion that cable asset acquisition prices paid in excess of net historical cost represent nothing more than monopoly profits also fails to account for these economic factors.

will approximate those produced by companies operating under competition.

2. Setting Cable Rate Base At Competitive Market Value Will Produce Rates That Approximate Competitive Levels

Two standards for determining the value of cable assets are economically rational. First, cable assets could be valued at their actual market value as of the effective date of regulation. While this approach has obvious merit, the NPRM raises the concern that the actual market value of cable assets acquired prior to regulation might reflect capitalized monopoly profits. Cost-of-Service NPRM at ¶36. In view of this concern, therefore, the Companies recommend adoption of a second standard -- competitive market value -- that would value assets according to their actual market value, less any quantifiable capitalized monopoly profits.

As demonstrated in the Kolbe Study of Rate Base Issues, the percentage of a cable company's value that represents monopoly profits can be determined through an "event study," which tracks stock market response to passage of the 1992 Cable Act and the Commission's adoption of the benchmark/price cap scheme.[27] If the actual market value of cable companies is based in part on the expectation of

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[27] The Viacom Comments contain a detailed description of the event study.

capitalized monopoly profits, then these rate regulation events, which signalled the elimination of such profits, would cause portfolios of "pure play" cable companies to fall by the amount of the capitalized monopoly profits.

The Kolbe Study concludes that because regulatory events caused cable company equity values to fall 20 to 25 percent (which corresponds to a fall in asset value of under 10 percent), capitalized monopoly profits, to the extent they exist, likely comprise less than 10 percent of the value of cable assets prior to rate regulation. Indeed, the actual percentage of value attributable to monopoly profits may be much lower than 10 percent, given the stock market's immediate recovery from the "regulatory falls" associated with passage of the 1992 Act and enactment of the benchmark/price cap mechanism.

Thus, while the percentage of actual market value attributable to capitalized monopoly profits may be difficult to determine precisely, the figure must, in any event, be less than 10 percent. The Companies recommend that the FCC adopt a competitive market valuation standard consistent with these sound economic principles and findings.

C. Rather Than Relying On Original Cost Methodology, The Commission Should Value Cable Plant Based On Current Market Values

The essential purpose of rate base valuation, as previously discussed, is to arrive at a return on investment replicating that which would exist in competition. Faced with a transition from an unregulated to a regulated environment, however, an approach based on historical costs cannot be relied upon to even reasonably approximate the competitive marketplace. It is illogical and improper to value assets as of the time of their purchase without regard to the seller's or purchaser's regulated status. The Kolbe study provides the Commission with a rational, marketplace based alternative.

Misapplying "original costs" methodology to disallow acquisition costs in excess of net historical costs to the predecessor prior to regulation will systematically undervalue the cable ratebase, even to the extent of constituting an unconstitutional confiscation. At the same time, a proper application of "original cost" methodology that recognizes cable plant as being newly dedicated to regulated use is not without its own potential flaws. The Commission may be unwilling, for example, to risk the inclusion of acquisition costs that it believes incorporate at least some measure of capitalized monopoly rents. Thus, a genuine balancing of cable operator and consumer interests

warrants a departure from original cost methodology altogether and a reliance on an alternative that would better replicate the competitive market as discussed in the foregoing section.

IV. THE COMMISSION SHOULD ADOPT STANDARDS CAPABLE OF PRODUCING A STREAMLINED COST-BASED APPROACH THAT BALANCES THE INTERESTS OF CONSUMERS AND CABLE OPERATORS IN A RATIONAL AND ADMINISTRATIVELY FEASIBLE MANNER

The Commission has invited suggestions as to how the cable rate regulation program may be streamlined in order to fulfill the Cable Act's mandate that, to the extent feasible, it attempt to alleviate the administrative burdens of rate regulation.[28] NPRM at ¶70. These comments present a set of recommendations that, taken together, constitute a comprehensive yet streamlined approach to cost-based cable rate regulation capable of assuring reasonable rates for consumers, recovery of costs for operators, and ease of administration.[29]

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[28] As noted above, a full cost-of-service showing should be--and indeed constitutionally must be--available to those relatively few cable operators denied a reasonable return even by this streamlined cost-of-service regime. See, e.g., Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1943).

[29] As the NPRM states (at n.18), the elements of a cost-of-service showing are traditionally expressed by the formula:

$$R = E + (V-d)r$$

Specifically, any constitutionally valid regulatory scheme requires:

- A proper initial valuation of the ratebase and a determination of how it will be treated on a "going-forward" basis;
- Establishment of a reasonable rate of return;
- Implementation of proper depreciation schedules; and
- Determination of appropriate operating expenses.

These comments offer specific proposals for each of these essential components. Used in conjunction with the proper determination of the ratebase addressed in Section III of these comments, these proposals constitute a coordinated, streamlined, and workable package of cost-of-service regulations for the cable industry.

A. Once A Cable System's Ratebase Is Established, The Commission Should Use "Trended Original Cost" To Replicate A Competitive Market

Establishing the value of a ratebase, as discussed in the preceding section, is only the first step in a cost-of-service analysis. The second, and equally important step is to determine how those assets should be valued on a going-forward basis. The Joint Parties suggest that the proper way to do so in the case of the cable industry is to use trended original cost ("TOC"), as other federal regulators have done in similar circumstances. As demonstrated by the Kolbe

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where R is the revenue requirement, E is expenses (including operating and maintenance expenses, depreciation, and taxes), V is the value of the ratebase (including plant in service and working capital), and r is the rate of return.

Study of Rate Base Issues, TOC provides an economically more rational approach to cable rate regulation than does a historical cost standard.

Under trended original costing, the starting ratebase and future asset additions should be trended for inflation and the allowed rate of return on that ratebase should be reduced correspondingly.[30] As the NPRM acknowledges, one of the principal aims of the 1992 Cable Act is to replicate rates as they would exist in a fully competitive marketplace. However, as the Kolbe study shows, valuing cable ratebases at historical cost fails to produce rates that would be produced in a competitive environment and therefore produces inefficient results. By valuing ratebases in a manner consistent with competition, TOC provides a key link in the process of setting competitive rates in a cost-of-service regime. And, as discussed above, the proper valuation of the ratebase is especially critical during a transition from unregulated to regulated status.

The pricing strategies employed by many members of the cable industry in a deregulated environment represent, as a

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[30] Under TOC, "original cost plant surviving additions are segregated by year of addition. These amounts are then trended using indices that recognize changes in the general price levels or in the costs of constructing plant facilities. The object is to restate the cost of installed facilities at current price levels." Accounting for Public Utilities, § 4.01 at 4.4. For a fuller discussion of TOC, see Kolbe Study, Appendix B.

practical matter, a self-imposed form of trended original cost. A cable operator who makes a very significant capital investment in a substantial system rebuild or upgrade does not attempt to recoup that entire investment over a very short time period. Rather, the operator typically takes reasonable rate increases over a more extended timeframe; this approach benefits subscribers by stabilizing over time the rates associated with legitimate investments in system improvements and by taking into account additional revenues derived from those improvements. The ability to do this, of course, is dependent upon whether the operator's reasonable expectation of averaging out these costs through rate increases over time, either because it is deregulated or because it has negotiated a rebuild and rate increase agreement with the franchise authority, will be realized.

Trended original cost thus provides a regulatory replacement for a legitimate and appropriate industry practice in a deregulated environment. As described below, in their cost-of-service showings cable operators should take their ratebases, as developed in Section III above, and apply TOC to value the ratebase on an on-going basis.[31]

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[31] This point underscores why the Commission must afford operators the opportunity to justify existing rates under cost-of-service standards and why the Commission should permit negotiation and settlement of rate cases as various parties, including several of the Parties to these Joint Comments, have argued in Petitions for Reconsideration of the rate regulation Report and Order.

B. The Commission Should Set A Uniform Rate of Return In the Range of 12 to 16 Percent

The NPRM solicits comment on whether an industry-wide rate-of-return should be set and, if so, at what level. NPRM at ¶46. As demonstrated below and by the attached analysis by members of The Brattle Group,[32] the Commission should prescribe an industry-wide rate of return of two percentage points above that of S&P 400 to account properly for the greater risk that cable companies face. The NPRM stated that a rate of return comparable to that of the S&P 400 ranges between 10 to 14 percent after taxes.[33] Accordingly the rate of return for the cable industry should fall between 12 to 16 percent, and should be at the higher end of this range if the Commission uses a Discounted Cash Flow Model to calculate the return for the S&P 400. This rate of return would be applied to the trended original cost ratebase as previously described.

1. An uniform industry-wide rate of return is in the public interest

The rate of return established by the Commission should be uniform nationally and applicable to all cable systems.

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[32] Dr. A. Lawrence Kolbe and Lynda S. Borucki, The Brattle Group, Rate of Return Issues In Cable Television Cost-of-Service Regulation (August 24, 1993) (attached hereto and hereinafter referred to as "Rate of Return Study").

[33] NPRM at ¶53.

Capital investment in the cable industry is now a nationwide, and indeed international, market. The Commission should not create incentives for investors to favor cable operators in some regions over others, as would be the case with a non-uniform rate of return.[34]

Furthermore, the Commission has already in effect established a single uniform rate of return in the cable industry by setting a reasonable rate of return to be used in developing equipment basket rates. No reason has been offered why a different approach should apply to overall service rates.

2. The rate of return should be at the upper end of a 12 to 16 percent range, with an efficiency incentive of at least 1 percent

It is a fundamental principle of law that the Commission must select a rate of return that carefully balances "the investor and the consumer interests." Hope Natural Gas Co., 320 U.S. at 603. Although regulation need not ensure that a business realize net revenues, the Supreme Court has recognized that a company's investors have a legitimate expectation in:

> a return commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so

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[34] Despite a uniform rate of return, there should be an opportunity for a cable operator in unusual circumstances to present its case for a higher rate of return.

> as to maintain its credit and to attract capital.

Id. See also Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679, 693 (1923) (a regulated firm "is entitled to such rates as will permit it to earn a return on the value of the property which it employs . . . equal to that generally being made . . . on investments in other business undertakings which are attended by corresponding risks and uncertainties."). The capital attraction standard is met if investors truly expect to earn at least their cost of capital. Accordingly, in selecting a rate of return for the cable industry, the Commission must account for the risks inherent in a rapidly growing industry in transition from an unregulated to a regulated environment in order to arrive at a rate of return that enables cable investors to earn their expected cost of capital.

The NPRM proposes to use the S&P 400 index as a surrogate for the cable industry for the purpose of setting a rate of return and proposes a rate of return ranging from 10 to 14 percent which it calculates using a Discount Cash Flow ("DCF") model.[35] As demonstrated in considerable detail by the Rate of Return study, the proposal to use the S&P 400 as a surrogate tacitly illustrates a fundamental reason why the Commission should use a risk premium model rather than a DCF

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[35] NPRM at ¶¶48 & 53.

model, in setting a return for the cable industry. As the study explains, not only does the cable industry have an insufficient dividend experience on which to base a DCF model, but the DCF model is inappropriate for the fast growth, low dividend companies, characteristic of the cable industry. Indeed, the study demonstrates that the cable industry is much too risky to apply a DCF model, which would in any event tend to underestimate the industry's cost of capital. Nevertheless, the S&P 400 surrogate is an acceptable starting point if the Commission, as it should, grants cable companies, at the very least, "an incremental overall risk premium of at least two percentage points above the S&P 400's overall rate of return.[36]

This risk premium is necessary because, as demonstrated by the Rate of Return study, the cable industry is significantly riskier than the S&P 400 and its risk level is increasing. This is shown not only by the fact that a DCF model cannot be used for the cable industry, but also by a comparison of their "betas".[37] In 1993, publicly-traded cable companies had a beta of 1.74, compared to the S&P 400 of near 1.0., indicating a much greater risk. Cable companies are riskier still than local telephone companies,

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[36] Rate of Return study at 24.

[37] Beta measures an equity's "systematic" risk, or the extent to which its returns correlate with returns on other stocks. See Rate of Return study at 15.

another possible surrogate suggested by the NPRM, whose betas average from 0.6 to 0.8, showing that they are even less risky than the overall market.

In order to compensate cable investors for this greater risk, the Commission should adjust upward the rate of return on assets generated by the S&P 400 by a risk premium of at least approximately 2 percent.[38] Using the range of 10 to 14 percent for the S&P 400 identified in the NPRM, this risk premium adjustment should produce a rate of return for the cable industry at the high end of a range from 12 to 16 percent. The rate of return should be at the upper end of this range, because the DCF model (on which the 10-14 percent range is calculated) tends to underestimate the cost of capital for unregulated companies, and thus the S&P 400 "base" to which the risk premium is added is itself deflated. This range would strike an equitable balance of interests by allowing cable operators to recover the cost of the legitimately higher risk of providing cable service while protecting consumers from unreasonable charges.[39] Neither

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[38] As the Rate of Return study shows, the Commission is correct that there is no need to adjust the standard rate of return for debt/equity ratios, because the overall cost of capital remains relatively steady at most ratio levels. Where the debt/equity ratio is severely weighted towards debt, the operator may need to justify a higher rate of return to offset its correspondingly greater rate.

[39] A rate of return in this range should allow adequate recovery of the legitimate costs of providing cable service in the vast majority of cases. However, if cable

non-compensatory nor excessive, this range, when used in conjunction with a trended original cost, will produce reasonable rates for subscribers.

As in the case of other industries regulated by this Commission on a cost-of-service basis, the Commission should also allow cable operators to earn a maximum return above the prescribed rate in order to promote efficiency.[40] As the Rate of Return study explains, there should be symmetry between cable operators' upside and downside risks.[41] The Commission has allowed Comsat without rate changes an additional margin of 1.0 percent in order to encourage operating and internal efficiencies. Due to the relatively greater risk faced by cable operators, no less an increment should be added to determine the maximum earnings for cable systems.

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operators incur unusually high costs as a result of their size, demographics or other characteristics unique to their systems, and can demonstrate a need for a system-specific rate-of-return, they should be allowed to opt out of this streamlined approach and make such a demonstration. Such an alternative showing should be available in order to ensure that no systems are denied the opportunity to recover fully the costs they incur in providing cable service.

[40] See Communications Satellite Corp., 56 F.C.C.2d 1101, 1173 (1975).

[41] The Rate of Return study at 9.