183. We thus adopt the application of the DCF methodology to the S&P 400 in our development of a reasonable interim rate of return for regulated cable service activities. We perform our analysis in Section IV.F., infra, to set an overall rate of return based on our estimate that the cost of equity lies within this 12% to 15% range.

D. Debt

i. Notice

184. In the Notice we solicited comment on how we should measure the cost of debt for regulated cable service. We tentatively concluded that we should rely on the cost of debt of the surrogate we used to determine the cost of equity, but asked for comment on the weight to accord cable debt.[363]

ii. Comments

185. AUS (Comcast and COA) finds an average 1992 embedded cost of debt of 8.5% for five cable companies. AUS notes that more recent debt information would decrease its overall cost of capital recommendation by 0.25% to 0.50%. AUS also calculated the 1992 embedded cost of debt for the companies in its asserted comparable groups: 9.5% (industrial), 10.0% (broadcast), 8.1%(telephone), and 8.9% (recreation).[364]

186. Bell Atlantic's Vander Weide examines financial data for six cable companies, which provide cable service to approximately 30% of all cable subscribers. He divides interest expense by the book value of debt to arrive at an average embedded cost of debt of 7.8%.[365]

187. Small Cities states that its experience has been that senior bank debt costs small companies at least 1.24% and as much as 4% or more above the prime rate.[366] Avenue states that, as a privately held company, it does not have access to international debt rates such as the London Interbank Offering Rate (LIBOR), and that the average debt cost for similarly situated companies

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[363] Notice at ¶ 53.

[364] Comcast Comments, AUS Consultants at 12, 19, 25, & Exhibit 1, p. 2.

[365] Bell Atlantic, Vander Weide Affidavit at 6.

[366] Small Cities Comments at 32.

is 10%-12%.[367]

iii. Discussion

188. The record on the cost of debt includes compilations of debt costs for specific cable operators. The information on is both industry-specific and concrete, and does not appear to share the biases we found in the cable company-specific information the parties used to estimate the cost of equity.[368] We believe it appropriate to rely on this information, instead of S&P 400 data, as a surrogate for the cost of debt for regulated cable service, because it is industry-specific and provides a sufficient basis for estimating that cost of debt.

189. The cost of debt found by Vander Weide for six cable companies was 7.8%. AUS found an 8.5% cost of debt based on 1992 data and notes it would be lower with more recent data. Several parties suggest higher debt costs, but provide no supporting documentation. Adelphia's SEC Form 10K for 1993 states that its floating note interest rates ranged from LIBOR plus 1.0% to LIBOR plus 1.5%. Its March 31, 1993 average debt rate was 8.65%.[369] TCI's SEC Form 10K for 1991 states 55% of its debt was fixed rate, with an average cost of 9.9% and 45% percent was variable rate, floating at the prime rate.[370] We note that currently the prime rate is 6% and LIBOR is 3.56% (90 day) and 3.75% (180 day).[371]

190. The range for the average cost of fixed rate debt established by this information for the most recently available period (1992-93) is 7.8% to 8.65%. The prevalence of floating rate debt financing in the cable industry persuades us to be cautious in selecting a percentage within this range. We believe that 8.5% represents a reasonable estimate of the cost of debt for cable. In addition to reflecting historical debt costs, this rate allows for an increase in the cost of floating rate debt above current rates.

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[367] Avenue Comments at 5-6.

[368] See Attachment D.

[369] Adelphia SEC Form 10K at 34 (1993).

[370] TCI SEC Form 10K at II-4 (1991).

[371] The New York Times, Feb. 18, 1994, at D 12.

E. Capital Structure

i. Notice

191. In the Notice we asked parties to compare the capital structures within the cable industry to those within traditional regulated industries. We noted the difficulty in evaluating current cable industry practices given that much financing is provided by private or closely held companies for which SEC scrutinized statements of position are not available. We noted that at least some cable operators are very highly leveraged (that is, debt contributes all but a small portion of their total capital.) We sought comment on the impact of requirements adopted in this proceeding on the current overall financial structure of the cable industry. In particular, we asked for comment on the impact on the cable industry if we relied on a traditional regulated industry capital structure, such as one composed of 50% debt and 50% equity.[372]

ii. Comments

192. Comcast's consultant, AUS, found the equity/total capital ratios of 12 cable companies to range from nearly 50% to nearly -100%.[373] AUS recommends a hypothetical capital structure having 50% debt and 50% equity if the prescribed overall return is based on an after-tax cost of equity. AUS would eliminate the capital structure issue with a pre-tax overall return.[374]

193. Bell Atlantic's Vander Weide would use what he considers to be the actual capital structures of six large cable operators. He examined the balance sheets of these companies and found debt exceeding their total book assets or, in other words, that these companies had negative shareholder equity.[375] The average debt/debt + equity ratio was 113.77%. Excluding losses, the ratio was 86.01%. Vander Weide adopts the 86% debt figure, arguing that it is impossible to calculate an average cost of capital when debt exceeds 100% of total investor-supplied

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[372] Notice at ¶¶ 48-49 and n.51.

[373] This ratio is negative when the company has used debt to finance accumulated losses that exceed the capital contributed by the equity holders.

[374] Comcast Comments, AUS Consultants at 8-10.

[375] Negative stockholder equity arises when companies finance accumulated losses with debt instead of with stockholder equity.

capital, and that 86% approximates industry's long-run target capital structure.[376] Vander Weide contends that hypothetical capital structures, such as a structure composed of 40% debt and 60% equity, or the 50% equity and 50% debt structure proposed in the Notice, would produce an overall cost of capital exceeding that required to attract capital to cable. He asserts that the S&P 400's average overall cost of capital of 11.88% would translate into an equity return of 36.93% for cable operators with 86% debt and 14% equity.[377]

194. Viacom rejects Vander Weide's use of average cable company debt, and argues that Vander Weide should more properly have used the average yield on cable bonds. Viacom asserts Vander Weide's calculated cable equity return would be only 23.4% if he had used an average cable bond yield of 10% instead of the average cable company debt cost of 7.8%. Viacom contends the cable equity return would fall to 17% had Vander Weide assumed the 73% debt/27% equity of cable companies studied by Brattle.[378]

195. Comcast's consultant, Schink, sees a 40% debt/60% equity capital structure as more appropriate for the assertedly high risks of cable.[379] He proposes that companies above 50% equity use their actual capital structures. Schink maintains that Vander Weide's 15.11% cost of equity for the third quartile of the S&P 400 would be 28.88% if adjusted from S&P 400 average capital structure of 44% debt/56% equity to 86% debt/14% equity.[380] Schink contends that this capital structure would

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[376] Bell Atlantic, Vander Weide Affidavit at 6-10.

[377] Id. at 8.

[378] Viacom Reply at 6.

[379] Comcast Reply, Schink Affidavit at 4, 18-24.

[380] Schink states his calculation is based upon Eugene F. Brigham, Louis, C. Gapenski, and Dana A. Aberwald, Capital Structure, Cost of Capital, and Revenue Requirements (Public Utility Fortnightly, Jan. 8, 1967) (Brigham/Gapenski/Aberwald). Comcast Reply, Schink Affidavit, Appendix 12. Brigham/Gapenski/Aberwald reported that a reduction in the percentage of common equity from 50% to 40% in the capital structure increased the cost of equity by 1.2%. Schink's calculation starts with a 0.07% increase in equity cost for a one percent decline, and doubles the increase for every 10% decline in the equity portion of total capital. Thus, he increases the cost of equity by 0.42% as equity declines from 56% to 50%, and by 5.4% as equity declines from 20% to 14%.

increase the embedded cost of debt from the 7.8% to 11% (the yield on a low-rated 10-year bond), and would increase cable's overall cost of capital to 13.5%.[381]

196. Time Warner's consultant, NERA, contends that ratios based on book equity and debt vary widely within cable and that many cable companies have nearly zero or negative book equity. NERA argues that market value of cable equity and debt is more consistent with finance theory and provides market value debt/equity ratios for 24 cable companies. Calculating the average for NERA's group of companies with significant cable operations yields a capital structure composed of 60% debt and 40% market equity.[382]

197. Brattle (Cablevision Industries) would base capital structure on the market value, rather than book value, of equity and debt.[383] Brattle (Viacom) argues that only a small portion of market value of cable equity reflects monopoly profit expectations.[384] Pitsch assumes a 50% debt/50% equity capital structure.[385]

iii. Discussion

198. We have generally relied on embedded capital structures of the regulated entities' owners on the assumption that they represent the steady-state, long-term basis for financing regulated activity. However, the current capital structures in the cable industry are based on the use of debt, rather than a combination of debt and equity, to finance accumulated losses. We agree with the cable operators that suggest that these structures are not sustainable in the long-term. Although Vander Weide adjusts the capital structures by eliminating accumulated losses, we find his method arbitrary and

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[381] Brigham/Gapenski/Aberwald, however, find that the overall rate of return is not affected significantly by capital structure changes.

[382] Time Warner Comments, Attachment, NERA, A Proposal for Backstop Regulation for Cable Television Prices, (NERA Proposal) at 14-15, Attachments D-H.

[383] Cablevision Industries Comments, Brattle Return at 12.

[384] Viacom Comments, A. Lawrence Kolbe and Susan E. Vitka, Rate Base Issues in Cable Television Cost-of-Service Regulation, (Brattle Ratebase) at 8-10, 18-26.

[385] CATA Comments, Pitsch Report at 21.

unlikely to provide a reasonable basis for setting prospective rates. Therefore, we reject the capital structure of 86% debt and 14% equity he proposes.

199. We also reject recommendations that we adopt capital structures based on the market value of equity. We believe that market value may reflect substantial expectations of non-competitive profits and of growth in nonregulated activities. In addition, the long-term average capital structure of the industry is not clear at this time. Therefore, we believe that we should consider a capital structure range, rather than a single capital structure, for use in our determination of the overall cost of capital for regulated cable operations. Based on the record, we believe that a wide range of capital structures, extending from 40% debt to 70% debt, is justified, and is consistent with the range for cost of equity estimates and the cost of debt adopted above.

F. Overall Cost of Capital

i. Notice

200. In the Notice we tentatively concluded that an overall cost of capital in the range of 10% to 14% would reflect a reasonable balancing of subscriber and cable operator interests, and that we should select a return from within this range to achieve our balancing of goals for cost-based rates for cable service. We sought comment on choosing the maximum allowable rate of return for regulated cable service from within this range.[386]

ii. Comments

201. AUS (Comcast and COA) states its overall recommendation in terms of a pre-tax cost of capital. Schink calculates a 12.9% after-tax cost of capital based on the AUS recommendation.[387] Bell Atlantic's Vander Weide recommends an overall rate of return of 8.83%. This rate combines the 15.11% average DCF cost of equity for the third quartile of the S&P 400 and a 7.80% cost of debt with the 86% debt/14% equity capital structure he calculated by excluding accumulated losses from the capital structures of six large cable companies. Vander Weide would use the 11.80% first quartile S&P 400 average cost of

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[386] Notice at ¶ 52.

[387] Comcast Comments, AUS Consultants at 18-21, 25. Comcast Reply, Schink Affidavit at 5, n.2.

equity if a 50% debt/50% equity capital structure is adopted.[388]

202. Small Cities proposes an overall rate of return of 15% to 20% for rural areas.[389] Avenue proposes an overall rate of return of 15% to 20% based on an equity return of 12% to 15%, debt costs of 10% to 12%, and a desired debt-to-equity ratio of 10%.[390] Medium Operators recommends an 18% to 20% rate of return.[391] Municipals would prescribe a rate of return no higher than interstate rate of return currently in effect for LECs. Municipals contends that the current 11.25% prescription for LECs is too high because the cost of capital has dropped precipitously since this return was adopted in September 1990.[392] Austin sees regulated cable service as not particularly risky and more akin to regulated telephone service. Austin argues that the telephone return of 11.25% is too high for cable because cable is financed with far less equity than assumed by the telephone prescription.[393]

203. Cablevision Industries recommends 16% as the overall average cost of capital for cable, based upon a 2% premium added to the top of the 10% to 14% return range proposed in the Notice.[394] Cablevision Industries also proposes that operators with rates targeting the prescribed rate of return be allowed 1% more if it can be achieved through increased efficiency.

iii. Discussion

204. The Cable Act of 1992 requires that our rate regulations provide cable operators the opportunity to earn "a reasonable profit" while "protecting subscribers ... from rates ... that exceed what would be charged ... if such cable system were subject to effective competition."[395] Companies regulated

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[388] Bell Atlantic, Vander Weide Affidavit, p.13-14.

[389] Small Cities Comments at 31.

[390] Avenue Comments at 6.

[391] Medium Operators Reply at 10.

[392] Municipals Comments at 27.

[393] Austin Comments at 13.

[394] Cablevision Industries Comments at 38-43; accord, Viacom Comments at 43, 46.

[395] 46 U.S.C. § 623(b)(2)(C)(vii) and (b)(1), respectively.

under this standard must be allowed the opportunity to earn a return sufficiently high to maintain the company's financial integrity and ability to attract new capital. At the same time, the prescribed return must not produce rates that are unreasonable. The courts have recognized that there is a zone of reasonableness within which reasonable rates may fall, and that we must use our judgment to select a return within that zone.

205. In the previous sections we have considered the evidence presented by the parties, and have identified a reasonable range for the cost of equity for regulated cable service. We have also identified a cost of debt and a reasonable range for the capital structure. The following table combines all these elements and presents the overall cost of capital implied by these ranges.

Calculation of Overall Rate of Return[396]

	Debt Portion of Capital Structure			
Equity Estimate	40%	50%	60%	70%
12%	10.6%	10.3%	9.9%	9.6%
13%	11.2%	10.8%	10.3%	9.9%
14%	11.8%	11.3%	10.7%	10.2%
15%	12.4%	11.8%	11.1%	10.5%
Average	**11.5%**	**11.0%**	**10.5%**	**10.0%**

Debt Cost: 8.50%

206. We do not believe that any one cell in this table should be given definitive weight. We therefore concentrate on the averages shown on the last row. Based on these averages, we find that the overall cost of capital for regulated cable service lies within a "zone of reasonableness" of 10.0% to 11.5%.

207. We believe that it is appropriate to be cautious when selecting a number within this zone, since the record is less than perfect. In addition, we cannot know with certainty the risks of regulated cable operations, since those risks are

[396] For example, the upper left square's result is calculated: 12% x .60 + 8.5% x .40 = 10.6%.

dependent in part on the cost-of-service rules and principles adopted in this Order and on our revised benchmark methodology. Our caution in prescribing is reinforced by our desire to encourage infrastructure development. We believe that prescribing a return toward the upper end of the zone of reasonableness will enable cable operators to attract the capital needed to provide regulated cable service and to expand their regulated offerings. Based on these considerations, we are prescribing an overall cost of capital of 11.25%, a figure that lies between the two estimates at the upper end of the range.[397]

208. As further evidence of our caution, we note that our prescription is an interim one. In the Further Notice, we seek information on the relative risks of cable operations given our recent actions, and we seek further analysis of S&P 400 companies' costs of capital.

V. Accounting Requirements

i. Background

209. Under existing rules, regulated cable operators are required to maintain their accounts in accordance with GAAP.[398] They also are required to maintain their accounts in a manner that will enable identification of appropriate costs and application of cost assignment and cost allocation procedures to cost categories necessary for rate adjustments due to changes in external costs and for cost-of-service showings.[399] In addition, for accounting purposes, cable operators are generally required to aggregate expenses and revenues at either the franchise, system, regional or company level in a manner consistent with the practices of the operator as of April 3, 1993.[400] Costs associated with franchise fees, franchise requirements, local taxes, and local programming must be identified at the franchise level.[401]

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[397] In implementing this rate of return in individual cases, we will include a tax allowance as specified in part III.B.3., supra.

[398] 47 C.F.R. §76.924(b).

[399] 47 C.F.R. §76.924(c).

[400] 47 C.F.R. §76.924(d). Our rules erroneously identified this date as April 3, 1992. The rules that we are adopting with this Report and Order will correct this error.

[401] Id.

ii. Notice

210. In the Notice, we sought comment on supplemental financial and accounting requirements that were contained in Appendix A.[402] We proposed that all cable operators would be required to maintain their accounts in a manner that would permit them to report in accordance with these requirements if they elect cost-of-service regulation.[403] We also sought comment on whether we should establish a uniform accounting system for cable operators electing cost-of-service regulation similar to the Uniform System of Accounts (USOA) for telephone companies in Part 32 of the Commission's rules.[404] Finally we asked for comment on the organizational level at which we should require that costs be identified.[405]

iii. Comments

211. Several cable operators argue that we should not adopt additional accounting requirements until all of the rules for determining just and reasonable rates have been adopted.[406] Comcast claims that most operators comply with GAAP and that GAAP standards are sufficient for monitoring the cable industry.[407] NCTA states that the Commission can consider adopting an accounting system for the cable industry if the Commission

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[402] Notice at para. 58. Appendix A proposed an income statement that provided accounts for revenues, operating expenses, depreciation and amortization. Id. at Appendix A. It also proposed balance sheet information with a list of accounts for current assets, fixed assets, current liabilities, long term liabilities and owner's equity. Id.

[403] Notice at ¶ 58.

[404] Id.

[405] Id. at ¶¶ 59,64.

[406] See, e.g., Cablevision Systems Comments at 37 (Commission should establish an industry working group to determine the accounting requirements necessary for cost-of-service showings and assess the burden associated with such requirements); Comcast Comments at 45; Comcast Reply at 5-6 (achieving accounting uniformity in the cable industry will require a significant effort; consideration of accounting requirements should be deferred); NCTA Comments at 28-29.

[407] Comcast Comments at 45. Accord, NCTA Comments at 39.

ultimately finds that GAAP is inadequate.[408]

212. A number of commenters point out that cable companies have not maintained their accounting systems in a uniform manner nor at a high level of detail, and that to require them to do so now would be burdensome and costly.[409] Cable operators observe that an accounting system will not be necessary for the vast majority of companies whose rates will be regulated under the benchmark/price cap approach.[410] In addition, Aerie asserts that this Commission need not adopt an accounting system for the cable industry because state commissions have authority to require supplemental filings from cable operators.[411] Medium Operators also urge deferral of the accounting issues in this proceeding, and request that the Commission not limit itself by adopting detailed and rigid criteria in these early stages of regulation.[412]

213. Several telephone companies argue that cable operators should be made subject to the equivalent of the USOA that is

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[408] NCTA Comments at 39.

[409] Adelphia Reply at 11-12; Cablevision Systems Comments at 5-51; Georgia Cable Comments at 32-33; Viacom Comments at 51. These commenters maintain that general reliance on GAAP in conjunction with uniform standards for specified critical areas may be adequate for case-by-case determinations of the adequacy of cost showings. See also TMC Comments at 16 (adoption of an accounting system for cost-of-service showings would place a costly burden on small cable operators, and the cost of this additional burden would be passed on to subscribers).

[410] Comcast Comments at 45; Continental Comments at 77-81; Georgia Cable Comments at 32-33; NCTA Reply at 8, 17-18; TCI Comments at 51; TCI Reply at 11; Time Warner Comments at 36-39. They contend that "only a minority" of cable operators will make cost-of-service showings and that it would be unfair and illogical to burden the entire industry with a system similar to the USOA for telephone companies.

[411] Aerie Comments at 15 (recommending that the Commission defer to any reasonable state commission determinations regarding accounting rules).

[412] Medium Operators Comments at 25-28.

imposed upon telephone companies.[413] BellSouth submits that, if cost-of-service filings are to be addressed efficiently, the Commission must adopt uniform accounting requirements to ensure that reported financial results are stable and consistent, and facilitate auditing.[414] BellSouth also suggests that, if the Commission determines that an accounting system would be too burdensome for small cable operators, the Commission can allow them to maintain accounts at a summary level.[415] Bell Atlantic states that an accounting system for cable operators is necessary for federal-state coordination.[416]

214. Other commenters support a simplified accounting system for cable, and suggest that the accounts listed in Appendix A to the Notice provide a satisfactory level to achieve the goals of uniformity and simplicity.[417] New Jersey urges the

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[413] See, e.g., BellSouth Comments at 23-24; Bell Atlantic Comments at 14-15; GTE Reply at 22-23 (reliance on GAAP alone will not give the Commission sufficient information to meet statutory and constitutional mandates; without a uniform accounting system, operators will have the freedom to allocate costs as they choose, and the Commission will not be able to make meaningful comparisons to determine the reasonableness of such allocations). See also Bell Atlantic Reply at 8 (Commission should implement uniform cost accounting rules without delay, since existing cost accounting rules for telephone companies provide a ready model); accord, GTE Reply at 22-23.

[414] BellSouth Comments at 23 (expressing concern that the requirements proposed in Appendix A to the Notice are extremely basic and represent highly aggregated, organizational accounts, rather than functional accounts). Accord, Bell Atlantic Comments at 14-15 (symmetrical rules would preserve regulatory neutrality and economic efficiency, and would ensure that cable operators do not use revenues from regulated services to subsidize competitive business operations, including those that compete with the telephone industry. Bell Atlantic adds that a uniform accounting system, in conjunction with audit requirements, will allow regulators to enforce cost allocation and affiliate transaction rules).

[415] Id. at 23-24.

[416] Id. at 15. See also GTE Reply at 23 (GAAP does not provide sufficiently standardized rules to permit uniform allocations among business operations or between jurisdictions).

[417] Duncan Comments at 27-28; Seaford Comments at 13.

Commission to adopt an accounting system for all cable companies.[418] Arthur Andersen urges adoption of a simplified accounting system for cable operators that elect cost-of-service regulation.[419] Arthur Andersen states that this accounting system should be based on GAAP, and where GAAP is not specific, the accounting system should provide guidelines.[420] Acknowledging that cable operators almost universally oppose an accounting system as burdensome and prefer GAAP as the standard, Arthur Andersen suggests that the Commission could prescribe an account structure and accounting practices for reporting purposes only. Arthur Andersen states that this would allow cable operators to maintain books and records in a manner which both meets their own needs and provides the desired consistency of accounting and reporting for cost-of-service regulation.[421]

215. Cable operators discourage the Commission from either specifying averaging at the multiple system operator (MSO) level, or requiring the maintenance of costing detail at the franchise level. They generally request flexibility to average at the level most appropriate considering operator accounting and

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[418] New Jersey Comments at 9-10 (suggesting that the accounts should provide for the identification of local operating expenses of MSOs and of allocations between regulated and non-regulated services). New Jersey suggests that this Commission may commence the process of establishing a uniform accounting system for cable operators by adopting a standardized reporting form similar to the one in Appendix B of the Notice. (Appendix B of the Notice contains FCC Form 326. This is the Annual Report of Cable Television Systems, which previously required all cable operators to report revenues and expenses, balance sheet information, and supplemental accounting information.)

[419] Arthur Andersen Comments at 34 (cable operators that elect the benchmark should be required to maintain their books in accordance with GAAP). Accord, NCTA Comments at 39.

[420] Id. For the purpose of establishing general principles governing the accounting system for cable operators, Arthur Andersen suggests that the guidelines included in Appendix A of the Notice could be adopted by the Commission. Arthur Andersen recommends that cable operators be directed to submit collectively a proposed accounting system that reflects the principles contained in Appendix A.

[421] Arthur Andersen Reply at 12.

operating practices.[422] Among smaller operators, Avenue TV and TMC express concern that the Commission will require detailed accounting at too low a level.[423] TMC suggests that cost-of-service showings should be at the company level rather than at the system or franchise level.[424] GTE suggests that costs be allocated at the highest level possible, to allow for simplification to the extent possible.[425] State regulator commenters suggest that the system level is the appropriate level for cost averaging.[426]

216. Arthur Andersen, however, states that it would be in the best interest of cable operators to determine cost of service at a level no higher than the franchise level, to avoid the inevitable response of competitors to rates which reflect unrelated costs.[427] Aerie cautions against allowing large companies to use simplified cost-of-service showings based on standardized costs, because such practices may provide substantial windfalls and duplicative recovery of costs.[428]

iv. Discussion

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[422] See Cablevision Industries Comments at 54-56; Continental Comments at 73; Continental Reply at 8-9; TCI Comments at 56-58; Time Warner Comments at 39; Viacom Comments at 52-53. See also Georgia Cable Comments at 35 (it would be desirable to favor company-wide averaging because of its simplicity, but such an approach does not reflect reality, and operators should be allowed the flexibility to allocate costs in a manner that most accurately reflects reality); NCTA Comments at 38-39 (forced averaging applied in the wrong circumstances can result in overcharges to some subscribers and subsidies to others); COA Comments at 93.

[423] Avenue TV Comments at 5; TMC Comments at 19.

[424] TMC Comments at 19.

[425] GTE Comments at 25.

[426] NYS Comments at 9; New Jersey Comments at 1-2. NYS Commission and New Jersey state that the current practice is for system-wide averaging and recommend that this practice be adopted by the Commission. See also MCATC Comments at 8.

[427] Arthur Andersen Comments at 36 (referring to the competitive distortions resulting from averaging in the telecommunications industry).

[428] Aerie Comments at 11.

217. Cable Accounting System. We will adopt a uniform accounting system for cable operators that elect cost-of-service regulation in order to ensure that they accurately record their revenues, operating expenses, depreciation expenses, and capital investments. In the Further Notice, we seek comment on the precise form the accounting system should take. We also explain the process we intend to follow to develop and adopt an accounting system for cable operators.[429] The system of accounts we are proposing is contained within Attachment C.

218. Cable operators that are regulated under the benchmark/price cap approach will not, however, be required to maintain their accounts in accordance with a uniform system. We find that it is unnecessary to require uniform accounting under the benchmark/price cap approach because, while a uniform accounting system is designed to help measure a regulated company's cost of providing service, the benchmark/price cap approach is concerned with the prices a regulated company charges for providing service.[430]

219. A uniform accounting system is an important component of cost-of-service regulation, because accounting records will serve as the principle source of information for determining the reasonableness of rates charged by cable operators that elect cost-of-service regulation. We conclude that neither GAAP nor the interim summary level accounts that we are requiring with the adoption of this Order will adequately provide, in the long run, for uniform accounting practices among cable operators. A uniform accounting system is important, for example, to help ensure that cable operators that elect cost-of-service regulation properly distinguish between expenditures that should be charged to capital and those that should be charged to operating expenses.[431]

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[429] See Further Notice, part XII.C., infra.

[430] It should be noted that in the Further Notice, we seek comment on whether we should require a uniform accounting system for cable operators who seek adjustments under the benchmark/price cap approach to reflect changes in their external costs. See Further Notice, Part XII.C., infra.

[431] If this distinction is not made properly, operators could manipulate their cost of service by charging operating expenses to capital or by charging capital expenditures to operating expenses. For example, some cable operators might categorize all replacements as operating expenses, even if the replacements constitute improved equipment, and other cable operators might categorize such replacements as capital

220. In addition, we believe a uniform accounting system will help minimize variations in accounting practices, thus simplifying cost-of-service proceedings. Since the accounting practices of cable operators may vary widely,[432] cost-of-service regulation could be less than ideally effective unless all operators that elect such regulation are required to follow a uniform accounting system. Uniform accounting has long been recognized as an important component of cost-of-service regulation.[433] In fact, all state and federal agencies that engage in cost-of-service regulation, including this Commission, recognize the importance of uniform accounting.[434]

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expenditures. Further, without a uniform accounting system, the task of valuing property would be more complicated. Uniform accounting will help to ensure that cable operators electing cost-of-service regulation distinguish regulated investments, expenses, and revenues from nonregulated investments, expenses, and revenues. That will help ensure an accurate determination of the revenue requirement for regulated services, and will help prevent improper cross-subsidization of nonregulated services.

[432] See BellSouth Comments at 23.

[433] In upholding the Interstate Commerce Commission's uniform accounting regulations, the Supreme Court stated that

> Congress, in authorizing the Commission to prescribe a uniform system of accounts, recognized that accounting systems were not then uniform; and in reiterating this authorization in 1906, and adding a prohibition against the keeping of other accounts than those prescribed, manifested a purpose to standardize and render uniform accounts of different carriers with respect to matters that entered into property and improvements thereof, on the one hand, and the current operations of the company, on the other. . . . Plainly, the law-making body recognized the essential distinctions between property accounts and operating accounts, between capital and earnings; it recognized that the practice of different carriers varied in respect to those matters; and that no system of supervision and regulation would be complete without requiring the accounts of all carriers to speak a common language.

Kansas City S. Ry. v. United States, 231 U.S. 423, 442-43 (1913).

[434] All state commissions, for example, have adopted a uniform system of accounts for gas, electric and telephone utilities. National Association of Regulatory Utility Commissioners, Utility Regulatory Policy in the United States and

221. Although numerous cable operators have argued against the imposition of an accounting system because it would be burdensome, we conclude that the burden on those companies that elect cost-of-service regulation is outweighed by the need for the most accurate information possible on the companies' cost of service. Moreover, a uniform accounting system is important to the cost-of-service approach because it will reduce the administrative burdens on the Commission and on local franchising authorities. Without a uniform system, the regulatory body charged with evaluating cost-of-service showings may find it necessary to engage in greater scrutiny of each cost-of-service filing and to require cable operators to supplement and clarify their filings to ensure that cost-of-service principles are followed. Further, we are streamlining and simplifying the accounting system to the extent possible.

222. Interim Summary Level Accounts. We are adopting an interim summary accounting system for use by cable operators that elect cost-of-service regulation, until we have a permanent uniform system of accounts in place. Cable operators that elect

Canada, Compilation 1992-1993 (1993). The Securities and Exchange Commission maintains a uniform system of accounts for utility holding companies. 17 C.F.R. Part 256. The Federal Energy Regulatory Commission utilizes a uniform system of accounts for electric utilities and interstate natural gas companies. 18 C.F.R. Part 101.

In addition, this Commission has recognized the relative importance of a uniform system of accounts for ratebase/rate of return regulation of telephone. One of this Commission's first acts was to adopt a uniform system of accounts for telephone companies by modifying the system the Interstate Commerce Commission had created in 1913. Accounting Rules for Telephone Companies, Order No. 7-B, 1 FCC 43 (1935); Order No. 7-C, 1 FCC 45 (1935); Order No. 7-D, 3 FCC 9 (1937). In commencing the process of substantially modifying the uniform system of accounts in 1978, the Commission stated that the uniform system of accounts must provide "the type of information that is necessary to regulate an increasingly complex telecommunications industry." Uniform System of Accounts and Financial Reporting Requirements for Telephone Companies (Parts 31, 33, 42, and 43 of the Commission's rules), Notice of Proposed Rulemaking, 70 FCC 2d 719 (1978). The Commission noted that "[t]o effectively regulate on a cost of service basis, we need reliable figures on operating revenues, plant investment and operating expenses and sub-categories thereof, broken down both by regulatory jurisdiction (i.e., interstate vs. intrastate) and by individual service categories." Id. at 721-22.

cost of service regulation shall identify costs in 55 summary level accounts contained in FCC Form 1220. This form requires that cost-of-service showings include a balance of broad summary level investment, expense, and revenue categories. These cost categories are similar to the categories that we proposed in the Notice, and we believe that this information will provide regulators with necessary basic information on the cable operators' costs of service. We note that there are no substantive objections to these requirements in the record.

223. We are concerned, however, that even this summary accounting approach may be burdensome for some small systems. We are directed by the Cable Act of 1992 to reduce the administrative burden on regulated cable operators, and particularly on small systems.[435] In order to provide further relief to small system, we are aggregating still further the summary level accounts that small operators will be required to report as a part of their cost-of-service filings.[436] Hence, small cable system operators shall identify their costs in FCC Form 1225, which contains 32 summary level accounts.

224. With regard to the level at which these accounting requirements apply, we will continue to require that cable operators electing cost-of-service regulation identify all amounts associated with each revenue and cost category, as provided for in FCC Forms 1220 and 1225, at the franchise, system, regional and/or company level, depending upon the organizational level at which the operator identified revenues and costs for accounting purposes as of April 3, 1993.[437] We will continue to explore in this proceeding the extent to which operators should be permitted or required to report average costs at levels different than those in effect on April 3, 1993.

225. Further, cable operators shall provide any additional financial data and explanations reasonably requested by franchising authorities and this Commission to substantiate cost-of-service showings or other related proceedings. Where a

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[435] 47 U.S.C. § 623(b)(2)(A) and (i).

[436] We define a small system as an independent small system or a group of small systems owned by a multiple system operator that (1) has 250,000 or fewer subscribers, (2) owns only small systems with less than 10,000 subscribers, and (3) has an average system size of 1,000 or fewer subscribers. This standard of eligibility is the same that we adopt for other forms of small system administrative relief. See Benchmark Order at II.D.1.

[437] See Section 76.924(c).

reasonable response is not forthcoming, franchising authorities are authorized to make such disallowances as are appropriate, pending the presentation of convincing evidence by cable operators. The Commission will follow this procedure as well.

VI. Cost Allocation Requirements

i. Background

226. The purpose of cost allocation is to assign costs (both investment and expenses) accurately to the regulated services offered by an operator, so that the rates charged for such services are just and reasonable. The goal of cost allocation regulation is to provide a fully distributed costing methodology that emphasizes direct assignment and cost causation principles in assigning costs to the various services offered. Just and reasonable rates depend upon the support provided by the cost allocation methodology.[438]

227. In the Rate Order we adopted allocation rules for regulated cable operators.[439] These rules are applicable to cable operators for which the basic service tier is regulated by local franchising authorities or the Commission, or, with respect to a cable programming services tier, for which a complaint has been filed with the Commission. The requirements are applicable for purposes of cost-of-service showings and for rate adjustments for external costs.[440] Under these rules, cable operators that aggregate their expenses and revenues at the system, regional, or company level, are required to allocate these expenses and revenues to the franchise level based on the ratio of the total number of subscribers served at the franchise level to the total number of subscribers served at the higher level.[441] In

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[438] For a disccussion of cost allocation requirements, see Amendment of Part 31, Uniform System of Accounts for Class A and Class B Telephone Companies, CC Docket No. 86-111, Report and Order, 2 FCC Rcd 1298, 1310, para. 94 (1987). This Order provided standards for allocating telephone company costs between regulated and nonregulated activities. See also Amendment of Parts 32 and 74 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates, Notice of Proposed Rulemaking, CC Docket No. 93-251, 8 FCC Rcd 8071 (1993) (Telco Affiliate Transactions Notice).

[439] Rate Order at 8 FCC Rcd 5973-5976, ¶¶ 553-59.

[440] 47 C.F.R. § 924(a).

[441] 47 C.F.R. § 76.924(e)(1).

general, costs that are identified at the franchise level or allocated to the franchise level must be allocated among the basic service tier and each tier of cable programming services based on the ratio of channels in each tier to the total number of channels offered in the franchise area.[442]

228. The rules require that costs of programming and retransmission consent fees be directly allocated to the tier on which the programming is offered.[443] Further, costs associated with franchise fees must be allocated among equipment and installations, program service tiers and subscribers in a manner that is consistent with the methodology of assessment of franchise fees by local authorities.[444] Costs associated with public, educational, and governmental access must be directly assigned to the basic tier where possible.[445]

229. In the Rate Order we determined that common costs must be allocated to service cost categories based on direct analysis of the origin of the costs.[446] Where direct analysis is not possible, common costs must be allocated to service cost categories based on an indirect, cost-causative linkage to other costs directly assigned or allocated to the service cost category.[447] When neither direct nor indirect measures can be found, common costs must be allocated to each service cost category based on the ratio of all costs directly assigned and attributed to a service cost category over total costs directly assignable and attributable.[448]

ii. Notice

230. In the Notice, we proposed to require that cable operators allocate their costs among the following service cost categories: basic service tier activities, cable programming

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[442] 47 C.F.R. § 76.924(e)(2).

[443] 47 C.F.R. § 76.924(e)(3).

[444] 47 C.F.R. § 76.924(e)(4).

[445] 47 C.F.R. § 76.924(e)(5).

[446] 47 C.F.R. § 76.924(f)(1). These rules are similar to the direct assignment process used in telephone regulation. See 47 C.F.R. Part 64.

[447] 47 C.F.R. § 76.924(f)(2).

[448] 47 C.F.R. § 76.924(f)(3).

services activities, other cable programming services activities, other cable activities, and non-cable activities.[449] We proposed that, to the extent possible, all costs should be directly assigned to their service cost category.[450]

231. The Notice also sought comment on whether we should adopt different or supplemental cost allocation requirements to govern allocation of costs between regulated cable service and unregulated activities.[451] We stated that we see a continuum between the poles of franchise-specific allocations and MSO-wide cost averaging, and that we would consider requiring cable operators either to identify all costs that are unique to the cost of the franchise, or to determine the average company-wide costs. We sought comment on which approach would come closest to achieving the right balance of accuracy and administrative burden. We also sought comment on how these proposals would affect the ability of cable operators to recover their costs, make improvements in service, and expand channel capacity and program offerings. In addition, the Notice sought comment on how these proposals would impact on the ability of the Commission and local franchising authorities to ensure reasonable rates for regulated services.

232. Within the context of our proposal to require the identification of costs to a franchise on a case-by-case basis, we sought comment on the level at which general industry practice would allow the identification of major categories of joint and common costs to the franchise level, and what costs are joint and common, and should be so allocated.[452] We requested comment, for example, on the impact of a per-subscriber allocator on the allocation of costs to systems with low and high penetration rates, and on how the number of channels in a tier might be

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[449] Notice, Appendix A at 4-6.

[450] Id. at 4. As explained above, common costs are allocated in accordance with the allocation procedures set forth in Section 76.924(f). Under our proposal, costs in each service cost category would include recoverable costs as defined in Appendix A of the Notice; direct material and labor costs plus the indirect costs associated with the particular service cost category; marketing, advertising and general and administrative overhead costs associated with the particular service cost category; and all common costs assignable to the particular service cost category.

[451] Notice at ¶ 59.

[452] Id. at ¶ 64.

factored into the allocator.

iii. Comments

233. Some cable operators state that little or no additional specific allocation requirements are necessary.[453] Others express concerns with the specification of allocators, and especially with the concept of tier-neutral allocations.[454] Continental states that the application of a single basis across all cost elements would present problems, and urges the Commission not to mandate inflexible methods of allocating costs.[455] TCI urges that cable operators be allowed to support allocations on a case-by-case basis.[456]

234. Other cable operator commenters challenge the validity of channels as the basis of allocations between regulated and

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[453] Cablevision Industries Comments at 49-50; Viacom Comments at 50-51 and 53-56; Medium Operators Comments at 5, 25-28 (the rules established in the Rate Order are sufficient for allocations between regulated and nonregulated operations and for determining initial regulated rates. For fiber optic upgrades and rebuilds, however, per channel allocations are not appropriate).

[454] See, e.g., Cablevision Systems Comments at 37-38 (costs are not incurred in proportion to the number of channels on a tier, so tier-neutral allocation could result in subsidy of one tier by another); accord, Continental Comments at 77-81.

[455] Continental Comments at 77-81. Accord NCTA Comments at 27-29. NCTA maintains that cable operator cost allocation practices vary widely and that it is too early in the process of establishing regulation to determine which allocation method is appropriate nationwide. Until a fuller understanding of cost allocation methods is attained, it recommends allowing operators to follow the rules currently in Section 76.924(f).

[456] TCI Comments at 51-56 (the Commission does not have appropriate experience in regulating cable, and it is impossible for the Commission to develop accurate cost accounting and cost allocation rules in a few months' time). See also Cablevision Systems Comments at 37-38; Continental Comments at 77-81; COA Comments at 87-91; Georgia Cable Comments at 34; Medium Operators Comments at 25-28.

nonregulated operations.[457] Arthur Andersen opposes allocation of costs between tiers on the basis of relative number of channels, and states that the Commission should adopt for cable operators the cost allocation principles used for telecommunications carriers. It argues that this is necessary because the two may eventually compete.[458] Other parties support the use of per-channel allocators.[459]

235. California Cable states that accounting-based allocation rules may not be workable. California Cable is concerned that decisions to expand systems and add unregulated services could be held hostage to inflexible allocation rules

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[457] See Cablevision Industries Comments at 51-54 (allocations between regulated and nonregulated operations on the basis of channels are not appropriate for a digital world where capacity is measured in terms of bit rate rather than bandwidth); Discovery Comments at 8-10 (the concept of a standard channel is becoming anachronistic in the emerging digital environment of cable; the standard channel concept will be replaced by other concepts, such as bit rates received at the television receiver).

[458] Arthur Andersen Comments at 35-36. Summarizing these principles, it says that the Commission requires that costs be directly assigned to the maximum extent possible, causally attributed when they cannot be directly assigned, and finally, generally allocated based on the ratio of expenses directly assigned and attributed. Accord, GTE Reply at 25, 32-33. But see COA Comments at 87-91; COA Reply at 38. COA claims that we should not apply the existing telephone industry cost allocation rules to the cable industry. Unlike the telephone companies, which have not had to be concerned with start-up costs for years and have developed a "massive regulated revenue stream" to cover losses on unregulated services, cable does not have the luxury of wasting money from its core business to subsidize nonregulated operations. Accordingly, COA claims that the need for cost allocation rules to prevent abuse does not apply to cable as it does to telephone companies.

[459] CFA supports tier-neutral allocation on the basis of channels as a starting point, but also suggests that the Commission will have to develop a more complex theory of cost causation, as more complex enhancements, especially non-entertainment offerings, are added to the cable offerings. CFA Comments at 6. Similarly, Michigan Committee and others encourage the Commission to set up strict guidelines to provide better allocations or to prevent cross-subsidization of non-entertainment forms of service. Michigan Committee Comments at 20-22; see also Muzak Comments at 6; ETC Comments at 6.

which might allocate a disproportionate cost to any new expansion.[460] Small Systems recommends development of a model that would provide for different allocators to be applied to the appropriate expense and investment categories.[461]

236. Other parties argue that further allocation rules are necessary. BellSouth recommends that the scope of the cost allocation requirements in Section 76.924(a) of the rules be expanded to include all cable operators.[462] Bell Atlantic, claiming that there must be parity of treatment for telephone companies and cable operators, states that cost allocation rules must be established to allow the Commission to examine the manner in which cable operators allocate common costs among different lines of business and account for transactions between affiliates.[463]

iv. Discussion

237. We find that it is necessary to require allocation of costs to nonregulated service categories to help ensure that the allocation of costs to regulated services is fair and reasonable in relation to the allocation of costs to nonregulated services. Section 76.924(e)(2) of the Commission's rules currently requires that costs be allocated among the basic service tier and each tier of cable programming service. This Report and Order amends the rule to require that, in addition to the basic and cable programming service tiers, cable operators shall allocate costs to nonregulated programming service activities, other cable

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[460] California Cable Comments at 69.

[461] Small Systems Comments at 39-42. Such a model, it suggests, should be developed by the Commission and should be computerized.

[462] BellSouth Comments at 22. Noting that the rule is limited to "cable operators for which the basic service tier is regulated ... or ... for which a complaint has been filed... ," BellSouth urges that it is impossible to predict which operators may file cost-of-service showings and which operators will be subject to complaints. Unless the financial records are maintained in accordance with GAAP and the cost allocation requirements of Section 76.924, it may be impossible to reconstruct the data to resolve cost-of-service showings or complaints, BellSouth asserts.

[463] Bell Atlantic Reply at 6-9 (parity of treatment for telephone companies and cable operators will promote competition between the converging industries).

activities, and non-cable activities.[464]

238. Accordingly, as we proposed in the Notice, we are requiring that, after revenues and costs are identified at the appropriate organizational level(s),[465] cable operators shall allocate costs among the equipment basket[466] and the following service cost categories: basic service,[467] cable programming services,[468] nonregulated cable programming services,[469] other

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[464] See Section 76.924(e).

[465] As stated above, cable operators may aggregate all amounts associated with each revenue and cost category in Attachment B at the franchise, system, regional and/or company level, depending upon the organizational level at which the operator aggregated revenues and costs for accounting purposes as of April 3, 1993. See part V. supra.

[466] 47 C.F.R. § 76.923(d).

[467] 47 C.F.R. § 76.901(a) defines basic service as follows:

> The basic service tier shall, at a minimum, include all signals of domestic television broadcast stations provided to any subscriber (except a signal secondarily transmitted by satellite carrier beyond the local service area of such station, regardless of how such signal is ultimately received by the cable system), any public, educational, and governmental programming required by the franchise to be carried on the basic tier, and any additional video programming signals a service added to the basic tier by the cable operator.

By this Report and Order, we require that the basic service cost category include only allowable costs as defined by Sections 76.922(e) through (g) of our new rules.

[468] 47 C.F.R. § 76.901(b) defines cable programming services as follows:

> [A]ny video programming provided over a cable system, regardless of service tier, including installation or rental of equipment used for the receipt of such video programming, other than:
>
> (1) Video Programming carried on the basic service tier as defined by this section;
>
> (2) Video programming offered on a pay-per- channel or pay-