293. To address this possibility, the Commission will consider the need for special rate relief for operators in individual cases. To demonstrate eligibility for such extraordinary relief, the operator should establish that the rates permitted by the benchmark/price cap and cost-of-service mechanisms undermine the financial health of the operator so that it is unable to attract capital and maintain credit necessary to operate, despite prudent and efficient management. The operator should also establish that the resulting rates, though higher than those justified by the operator's costs, will nevertheless not be unreasonable or exploitative of customers. For example, the operator should demonstrate that the rates are not excessive in comparison with similarly situated systems, particularly systems subject to competition. Given the carefully balanced approach in our cost-of-service rules, it is extremely difficult for us to conceive of such a situation arising. Nevertheless, we believe cable operators should have the opportunity to attempt to make such a showing if they deem it warranted.

294. This hardship showing must be made for the MSO level, or in any event at the highest level of the operator's cable system organization. The operator should provide all information and legal authority on which it seeks to rely, and all factors it believes the Commission should consider, to demonstrate that the end result of the other ratesetting options available to it would place the operator in financial difficulty warranting rate relief, and that on balance this relief would not result in unreasonable rates for customers. If the operator makes an adequate initial showing of facts which, if proved, might warrant rate relief, we will subsequently provide the operator with an opportunity to prove the facts alleged and demonstrate that, balancing the relevant interests of investors and ratepayers, rate relief is warranted.

XI. Upgrade Incentive Plan

295. In the Cable Act of 1992, Congress set as one of its policy goals ensuring that cable operators continue to expand the capacity and programs offered over their systems, where economically viable.[561] In the Notice, we sought to develop methods to encourage cable operators to provide additional services and improve the quality of service, while reducing regulatory burdens. The specific method we suggested was to permit an abbreviated cost-of-service showing for rate increases associated with significant prospective capital expenditures. We have also established requirements for the showing for Network Upgrades, supra part IX.B. Upon further analysis and

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[561] Cable Act, Section 3(b)(3).

consideration of the comments, however, we believe that the goal of promoting economically justified system upgrades, as well the goals of the Cable Act and of this proceeding, may also be furthered by development of an incentive regulation approach to upgrading cable services, similar to the incentive plans we have implemented for telephone carriers.

296. The basic outline of this approach would be to permit an operator to enter into a social contract with its customers under which the operator would be given substantial flexibility in setting rates for new regulated services it introduces, such as new service tiers offering additional program channels. In exchange, customers would be guaranteed that rates for current services would be kept stable and reasonable, no higher than rates before the contract takes effect or the benchmark/price cap rate (which might include adjustments for inflation and external cost changes), and that this rate would purchase at least the same program channels, or channels of equivalent value to customers. The operator would also commit to otherwise maintaining or improving its service quality. The contract would be effective for a term of years and would be overseen by this Commission, and reviewed before the end of the term.

297. A plan such as this, which protects the rates and quality of current cable service tiers, while providing profit incentives for operators to introduce new and improved regulated services, may help carry out the purposes of the Cable Act while also being fair to customers of current services, less burdensome on cable operators and those responsible for their regulation, and more likely to encourage worthwhile investments to upgrade cable service. Because this plan would also be more consistent with the incentive plans that this Commission applies to telephone companies, it may also help position us for the future, when it is quite possible that telephone and cable companies may be providing similar and competing services.[562]

298. This approach should generate a strong incentive for

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[562] The intended effect is similar to that created in price cap plans by assigning groups of services with common characteristics to a basket, subject to a price cap index that is not generally affected by changes in the carrier's costs or by the costs and returns of other services. The price cap carrier is deterred from shifting costs from one basket to another basket of regulated servcies, or from unregulated services to price cap services, because it cannot increase rates in the basket. The carrier is encouraged, however, to seek the most efficient method of providing services within each basket, and to introduce new services provided they will be economically viable.

the operator to undertake only upgrades that are economically justified and that best meet customer needs, and to make such upgrades in the most efficient manner possible. In order to profit from the planned upgrade, an operator must provide customers with additional or upgraded services they want to buy. Marketplace forces, not this Commission, will determine which services succeed. This is so because the level of profits the operator can hope to achieve depends on the extent to which it can keep its costs below what customers are willing to pay. The greater the value for customers, and the lower the costs for the operator, the higher the profits the operator will be able to achieve.

299. We also anticipate that a properly designed incentive plan for system upgrades should help achieve other goals. It should, for example, help encourage operators to provide additional tiers of services. An incentive regulation plan should also reduce regulatory burdens, even below those likely under the add-on rate proposal. Under the Upgrade Incentive Plan, we would ordinarily expect to review only whether the operator is continuing to offer existing services at rates no higher and quality no lower than the operator contracted to provide. We would not expect to investigate complaints regarding rates for additional regulated services unless they were clearly outside a wide range of reasonable rates, as evidenced, for example, by similar systems.

300. We believe that offering substantial rate flexibility may also be appropriate to encourage operators to take the entrepreneurial risk of investing in the upgrades needed to offer such services, while replicating competitive marketplace forces. In competitive markets, entrepreneurs offering new and improved services can hope to reap above-market profits for some period, at least until competitors catch up, but also take the risk that the services will not succeed in the marketplace. Permitting cable operators to take the risks and to keep the rewards of introducing new and improved services, at least for a reasonable period, should have similar benefits when applied to cable operators.

301. In addition, we expect that the additional services will be indirectly regulated by the price cap on current regulated services. The added services and capabilities must effectively compete with the other regulated services, whose rates are limited by regulation. Customers are likely to subscribe to and pay for the added services and capabilities only if they offer additional value at a reasonable price, in comparison to those offered by current tiers.

302. To generate an incentive plan that is effective in

encouraging operators to invest in worthwhile upgrades, but also fair to customers, we would expect that the rate limits on existing services and the rate flexibility for new services would apply for a substantial period, but would be subject to eventual review. In the case of telephone companies, we set an initial review during the fourth year of the price cap incentive plan. In view of the initial start-up issues for any incentive plan for cable operators, a longer period is probably desirable, both to permit operators to understand and respond to the plan and to assure strong efficiency incentives. We thus propose to review the plan in the fifth year of operation.

303. We believe the need to introduce a plan to encourage cable upgrades and otherwise carry out the policies of the Cable Act of 1992, coupled with the experience we have already acquired in implementing incentive regulation for telephone companies and the record developed in this proceeding warrant adopting the Upgrade Incentive Plan on an experimental basis. Cable systems that commit to meet the basic obligations of freezing rates for current services that have been adjusted to benchmark/price cap or cost of service levels, or conforming their rates to the price cap, and maintaining programming and service quality that is at least as valued by customers as that offered currently, will be permitted substantial rate flexibility in the rates they might wish to introduce for additional regulated services and capabilities for a term of years, up to five years, from the acceptance of the plan. These experimental plans will then be monitored and reviewed no later than the fifth year to evaluate their performance.

304. To gain experience with this approach, we will consider proposals from cable operators that will implement the Upgrade Incentive Plan on an experimental case-by-case basis, for a limited term of years. Cable operators wishing to participate should submit a proposal to the Commission's Cable Services Bureau outlining a proposal and explaining how it would implement the objectives we have outlined here. The proposal should also be accompanied by a written statement by any certified franchising authority with jurisdiction over cable systems affected by the plan of its views concerning the proposed agreement.

Further Notice of Proposed Rulemaking

XII. Cost-Based Cable Rate Regulation

A. Cost-of-Service Requirements

305. In the Report and Order, we establish a comprehensive interim regulatory framework for setting cost-based rates for regulated cable service. We tentatively conclude that the rules adopted here reflect goals and policies that will continue to apply, and that those rules may therefore appropriately be adopted on a final basis. We request comment on whether we should adopt these requirements as our final cost rules in this proceeding. In the Report and Order, for example, we establish an interim overall rate of return of 11.25% for use in cable cost-of-service proceedings. We invite comment on whether we should establish a different permanent rate of return for regulated cable service, including the equipment basket. In this regard, we request interested persons to submit data and expert analyses regarding the risks of regulated cable service, and on how those risks are affected by our cost-of service and our benchmark/price cap rules for cable. We also invite commenters to submit data and expert analyses regarding equity and debt costs for regulated cable service, and the capital structure we should use in determining any permanent rate of return for that service. We also invite comment on whether we should adopt fixed cost of debt and capital structure methodologies for possible use in changing the rate of return for cable in the future and, if so, what those methodologies should be.

B. Cable Accounting System

306. As explained in the Report and Order, we have decided to establish a uniform accounting system for cable operators electing cost-of-service regulation. Attachment C sets forth a draft system that we intend to serve as a starting point for development of a uniform accounting system for cable operations.[563] We seek comment on this proposal. The Cable Services Bureau will obtain suggestions on how to improve this proposal through informal meetings with representatives from the

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[563] In order to facilitate administration of establisment of a uniform accounting system for cable services, we are removing this issue from MM Docket 92-666 and designating it as CS Docket No. 94-28.

cable industry and other interested parties.[564] Following these meetings and the completion of the initial comment cycle, we may seek comment on a revised proposal for a uniform system of accounts for provision of regulated cable service.

307. The system of accounts that we are proposing is adapted from the USOA for Class B telephone companies contained in Part 32 of the Commission's rules,[565] and from NARUC model cable accounting rules.[566] This proposed system of accounts is highly aggregated and is, therefore, far less burdensome than the USOA for Class A telephone companies.[567] We have relied on Part 32 in developing an accounting system for cable because it was designed as a functional accounting system that would be adaptable to changes in communications technology.[568] We tentatively conclude that we can accommodate the cable technology of signal transport by adding certain cable-specific accounts and by modifying account definitions to include cable-specific equipment and activities within existing functions.[569]

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[564] Such cooperative efforts will, of course, be subject to relevant ex parte rules. See 47 C.F.R. §1.1206.

[565] Part 32 of the Commission's rules provide that telephone companies with annual revenues of less than $100,000,000 may adopt Class B level accounts. The Class B accounting system is highly aggregated and requires fewer accounts than does the Class A level. See 47 C.F.R. §32.11.

[566] Uniform System of Accounts for Class A Community Antenna (CATV) Utilities, (National Association of Regulatory Utility Commissioners 1977).

[567] Class A companies have annual revenues from regulated telecommunications operations of $100,000,000 or more. We seek comment, however, on whether we should adopt an accounting system for cable that is disaggregated to a greater extent than that proposed in Attachment C.

[568] See 47 C.F.R. §32.2(d), (e).

[569] We note that in the relatively recent rewrite of Part 32, we substantially conformed the USOA for telephone companies with GAAP. See Revision of the Uniform System of Accounts for Telephone Companies to Accommodate Generally Accepted Accounting Principles, 50 Fed. Reg. 48408 (Nov. 25, 1985); Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies, 2 FCC Rcd 1086 (1987). We expect that most cable operators are already in conformance with GAAP, and we conclude that this should minimize

308. In the Report and Order, we adopt an abbreviated cost of service form for use by small systems.[570] We also seek comment on whether smaller cable systems that elect cost-of-service regulation should be required to maintain their books in accordance with the accounting system we adopt for cable or with some alternative system of accounts. In addition, we seek comment on accounting requirements for cable operators seeking rate adjustments due to changes in their external costs under the benchmark/price cap approach. Although we conclude in the Order that operators regulated under that approach should not be subject to the USOA we adopt for cable,[571] we believe accounting requirements may be necessary to ensure that external cost adjustments are correct. Finally, we propose an exemption from these requirements for companies that are currently required to maintain their accounts in accordance with Part 32 of our rules. We tentatively conclude that it would be unduly burdensome to require such companies to follow separate accounting procedures for their telephone and cable operations.

C. Affiliate Transactions

309. In the Report and Order, we adopt affiliate transaction requirements that will govern the costs incurred that can be recovered in rates for regulated cable service.[572] These

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the number of changes in accounting practices that will be required in implementing a system of accounts based on the Part 32 model.

[570] See part IX.A., supra.

[571] See part VII., supra.

[572] See Part VIII. supra. We adopted affiliate transaction rules for cable operators electing cost of service regulation or seeking to adjust the Benchmark rate to reflect programming costs from affiliated programmers. These new affiliate transaction rules are similar to those that telephone companies are now required to follow. See 47 C.F.R. §32.27. These rules provide that when a cable operator sells assets to an affiliate or buys assets from an affiliate, the assets shall be valued at the asset provider's prevailing company price, if the provider has sold the same kind of asset to a substantial number of third parties at a generally available price. Absent a prevailing company price, the cable operator shall value the asset at the higher of net book cost and estimated fair market value when the regulated cable system is the seller, and at the lower of net book cost and estimated fair market value when the regulated cable system is the buyer.

requirements are substantially similar to our proposals in the Notice in this proceeding.[573] Subsequent to the release of that Notice, however, we conducted a detailed analysis of each of these transaction methods for telephone companies:[574] In the Telco Notice, we proposed to sharply curtail prevailing company pricing for transactions between telephone companies and their nonregulated affiliates.[575] We also proposed to require telephone companies to value affiliate transactions for which we do not permit prevailing company pricing at the higher of cost and estimated fair market value when the telephone company is the seller, and at the lower of cost and estimated fair market value when the telephone company is the buyer.[576]

310. We tentatively conclude that the general changes we have proposed for telephone companies should be applied to cable operators as well. Therefore, we propose to limit the application of the prevailing company price as a measure of a reasonable price for an affiliate transaction. We tentatively conclude that we should not permit prevailing company pricing as a valuation method for transactions between cable operators and their affiliates when a primary purpose of the non-cable affiliate in transactions is to serve the cable operator and its affiliates. We tentatively conclude that prevailing company pricing for affiliate transactions should only be utilized where the predominant purpose of the non-cable affiliate in the transaction is to serve nonaffiliates. We believe that we can identify when the non-cable affiliates's predominant purpose is to serve nonaffiliates by measuring the percentage of each non-cable affiliate's total output that is sold to nonaffiliates.

In addition, when a cable operator sells services to an affiliate or buys services from an affiliate, the services shall be valued at the provider's prevailing company price, if the provider has sold the same kind of service to a substantial number of third parties at a generally available price. When the provider has established no prevailing company price, the cable operator must value the service at the service provider's cost.

[573] Notice at ¶¶ 67-69.

[574] See Amendment of Pars 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates, Notice of Proposed Rulemaking, 8 FCC Rcd 8071 (1993) (Telco Notice).

[575] Id. at 8100.

[576] Id. at 8080.

311. Accordingly, we propose that any non-cable affiliate that sells less than 75 percent of its output to non-affiliates has too large a volume of affiliate transactions to be deemed to have a predominant purpose of serving non-affiliates. Therefore, we propose to continue to allow prevailing company pricing only for affiliate transactions in which the non-cable affiliate sells at least 75 percent of its output to non-affiliates. We invite the commenters to discuss this proposal as well as alternative percentages we might use. We also invite comment on whether we should abandon prevailing company pricing as a valuation method for all affiliate transactions if we find no workable test for determining when prevailing company prices provide reliable measures of how affiliate transactions should be valued.

312. For those transactions that do not meet the prevailing company price test, we propose to require cable operators to value all affiliate transactions at the higher of cost and estimated fair market value when the cable operator is the seller, and at the lower of cost and estimated fair market value when the cable operator is the purchaser. Since this proposal applies to the sale of both assets and services, it would, in effect, retain the existing standard that applies to affiliate transactions that involve the sale of assets and it would expand the application of this rule to affiliate transactions that involve the sale of services. Hence, our proposal would change the requirement under the rules we have adopted with this Report and Order, which provides that affiliate transactions that do not meet the prevailing company price test and involve the sale of services shall be recorded at cost. We invite comment on this proposal.

313. We propose to retain the definition of affiliate that we adopt in the Report and Order.[577] We also propose that our final affiliate transactions rules for cable, like the interim rules, apply to cable operators who either elect cost-of-service regulation or seek to adjust benchmark/price cap rates for affiliated programming costs. We propose, in addition, to require cable operators to apply the costing methods and rate of return we adopt for cable in determining the costs of affiliate transactions. We propose to include our final affiliate

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[577] Under that definition, an entity is affiliated with a cable system operator when it has a five percent or greater ownership interest in the cable system operator. That definition also specifies that a cable system operator is affiliated with another entity when it has a five percent or greater interest in that entity and that two companies that do not own each other are affiliates when a single entity has a five percent or greater interest in each of the two companies. See part VII, supra.

transactions rules in the USOA we adopt for cable. We invite comment on these proposals. Consistent with our approach with regard to the USOA, we also invite comment on whether we should adopt alternative affiliate transactions rules for small cable companies.

D. Productivity Offset

314. In the Rate Order, we incorporated an annual inflation adjustment into our price cap mechanism governing rates for cable television service. Specifically, we adopted the Gross National Product Price Index (GNP-PI)[578] as the annual adjustment index for the cap for basic service tier rates.[579] As a result, regulated cable operators are permitted to adjust the capped based per channel rate for the basic service tier annually by the GNP-PI. In addition, there are certain categories of costs that cable operators are permitted to "pass through" to subscribers without a cost-of-service showing, even if the resulting rates exceed the applicable price cap.[580]

315. In the Rate Order, we declined to adopt a productivity offset to the GNP-PI for the non-programming costs incurred by cable companies given the paucity of information in the record that would provide a basis for determining productivity in the cable industry. We made it clear, however, that we would seek such information in the Notice.[581]

316. In the Notice, we solicited comment on whether there is a valid economic basis for assuming that cable television service has been, and will be, experiencing efficiency gains. We observed that there had been insufficient information in the

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[578] The GNP-PI measures inflation in the gross national product and is produced by the Bureau of Economic Analysis (BEA). Rate Order at 5782, n.578.

[579] Id. at ¶¶ 233-35.

[580] These costs include: (1) retransmission consent fees; (2) programming costs; and (3) taxes, franchise fees, and the costs of other franchise requirements. We imposed an express limitation, however, on the pass-through costs for programming services affiliated with cable MSOs. Pass-through of increases in programming costs attributable to program services affiliated with such systems are capped at the lesser of the annual incremental increase in such costs or the GNP-PI. Rate Order at 5788.

[581] Rate Order at 5781-5782.

record to adopt a productivity offset in the price cap mechanism for cable operators.[582] In considering a regulatory framework to govern cost-of-service ratemaking for cable service, we invited the submission of industry studies or other expert economic analysis to examine four possible options: (1) no productivity offset; (2) a consumer productivity dividend of 0.5 percentage points; (3) a "telecommunications" industry adjustment of between 3.0 (for AT&T) and 3.3 (for the local exchange carriers) percentage points; and (4) a different productivity offset for cable operators.

317. The comments received in response to the Notice provided three general perspectives on the use of a productivity offset in cost-of-service ratemaking. The first perspective, which incorporates the views of cable operators and programmers,[583] generally supports the first option -- that is, no productivity offset under the cost-of-service rules. The second perspective, articulated by New Jersey, supports the use of a productivity offset of 2% as reflecting the known benefits of technology improvement in the cable industry[584]. The third perspective, which includes CFA, municipal franchising authorities,[585] local exchange carriers,[586] and ETS, generally supports the adoption of a 3.3% productivity offset, the standard imposed on the local exchange carriers, to be the standard for the cable television companies that choose cost-of-service ratemaking.

318. In this Further Notice, we affirm our tentative decision to incorporate an annual inflation adjustment into our price cap mechanism governing rates for cable television service. We believe that the use of the GNP-PI index in the benchmark will help achieve the statutory goal of reducing administrative burdens on cable systems, consumers and regulators by permitting

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[582] Notice at ¶ 85.

[583] See, e.g., COA Comments at 91; Cablevision Industries Comments at 60-62; Cablevision Systems Comments at 41; Georgia Cable Comments at 40; Discovery Comments at 5-8; Medium Operators Commits at 12-14; TCI Comments at 67-70; Time Warner Comments at 41-47; Viacom Comments at 61-62.

[584] New Jersey Comments at 11.

[585] See, e.g., Austin Comments at 15-16; Municipals Comments at 30-31.

[586] See, e.g., Bell Atlantic Comments at 10-13; BellSouth Comments at 34-35.

rate increases when cable operators experience increases in the cost of doing business shared by all sectors of the economy, without requiring cable operators to make, and regulators to consider, cost-of-service showings.

319. We also tentatively conclude that cable operators should reasonably be expected to achieve productivity gains in the future analogous to those historically realized by other communications firms. Cable television networks are similar in many ways to telephone networks, and both have benefited from advances in telecommunications technology in the past; both are likely to see benefits in the future, especially as cable and telephone networks converge. Both are likely to have opportunities to improve their productivity in other aspects of their operations, including customer service and maintenance. In the near term, however, the productivity growth that cable operators may reasonably be expected to achieve may differ from that of telephone companies, because of the current differences in their networks, operations, services, and histories. For example, local telephone companies have benefited from advances in computerized local switches, which are not in general use by cable systems. Moreover, the productivity offsets selected for telephone companies reflect adjustments to conform them with Commission policy goals. While we recognize the merits of moving toward regulatory parity for cable and telephone regulation, we do not believe the current record provides adequate support for the automatic adoption of the same productivity factor for cable systems as for local telephone companies subject to price caps.

320. The only evidence of record for productivity growth by cable systems appears to be that submitted by New Jersey, supporting a 2 percent productivity offset. We take note, however, of comments from cable operators that there is not sufficient evidence to adopt a productivity offset, without providing them the opportunity to develop such data. We will accordingly allow them another opportunity to provide this data. Based on the current record, we tentatively propose to adopt a 2 percent productivity offset as part of the benchmark for regulated cable rates. Any interested party seeking to justify a different productivity offset will of course be expected to provide reliable, detailed, and credible evidence that some other figure represents the productivity gains, after inflation, that cable systems can reasonably be expected to achieve. In particular, cable systems should not expect that their failure to provide any evidence of cable system productivity gains, information they are best able to provide, should justify the conclusion that cable systems cannot reasonably be expected to achieve productivity improvements.

321. We envision this benchmark, including the inflation

adjustment and productivity offset, as a basic part of the two alternatives open to cable operators for setting rates. Under the first, the benchmark would apply to all regulated rates. Under the second, an operator can elect to use cost-of-service regulation, under the standards discussed in this Order. Once the operator's rates are set based upon actual costs of service, however, we would ordinarily expect that the operator could achieve the same future productivity gains as other operators. We therefore propose that future rate changes should at least meet the productivity offset, absent a credible demonstration in the cost-of-service showing that this will not be the case.

322. We do not, however, wish indirectly to restrict the ability of cable programmers to obtain fair value for their products.[587] As a result, we tentatively conclude that programming costs should not be included within the productivity offset for cable system technological and operational improvement.

323. We invite comment on these proposals, including the 2 percent productivity offset and exemption of programming costs from the effects of the offset. We emphasize that comments should be supported by relevant evidence, such as detailed industry studies and expert economic analysis.

E. Upgrade Incentive Plan

324. As we discussed above, the Upgrade Incentive Plan that we will implement on an experimental, case-by-case basis is intended to provide greater assurance of reasonable, stable rates to customers for existing services, while also generating profit incentives to operators to upgrade their systems in cost-effective ways that will benefit subscribers. The basic approach of the plan is to establish a type of social contract between customers and operators, under which the rates for current regulated services are frozen or limited to changes permitted by the benchmark/price cap mechanism, while the quality of service is at least maintained at current levels by some reasonable measure. For their part, operators are given substantial rate flexibility for the new services and capabilities they introduce. The operator thus gains the opportunity to earn higher profits as an incentive and reward for successful innovations. The contract would remain in effect for a fixed, minimum term of years.

325. Developing a permanent incentive plan for cable systems is also likely to raise other issues, including issues that might suggest different regulations than in the case of the

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[587] See, e.g., MPAA Comments at 2-3.

incentive programs we have adopted for telephony. One issue involves enrollment. We might, for example, require cable systems to seek enrollment in the incentive plan in advance of any system upgrade if it wishes to claim the rate and profit flexibility accorded to additional regulated services and capabilities. Enrollment would make clear to this Commission and to customers that the operator was committing itself to keeping existing service rates and quality within the bounds set by the plan. We request comment on these issues.

326. Another issue involves coordination with the regulation of basic service tier rates exercised by local franchising authorities. Setting price and quality limits on regulated services above the basic tier may encourage operators to attempt to shift costs to the basic tier. It may be difficult to identify such cost-shifting in a cost-of-service study review. One remedy for this problem, which may also reduce regulatory burdens for operators, franchising authorities, and this Commission, may be to require the operator to commit to maintaining its basic service tier rates and quality within baseline/price cap guidelines set by a certified franchise authority. We request comment on this or approaches to coordinating FCC and local regulation of cable rates within the Plan.

327. An important part of any incentive plan that limits prices is to assure that the value of the service provided to customers under those prices does not suffer. The customer should be assured that the regulated company is not evading the intent of the plan by increasing profits not through improved efficiency or added services, but by adulterating the products or services the customer receives. For cable service, assuring that appropriate standards are maintained includes assuring that programming services valued by customers are not shifted out of current tiers and into the additional tiers for which the operator would seek to claim rate flexibility. We seek comment on appropriate standards to assure that operators subject to the incentive plan provide services equal to or better than that offered under current rates applicable to those services.

328. One possible approach to maintaining the value of current services while permitting flexibility to adjust tiers might be to require operators to seek the approval of its customers to changes in the composition or rates for current regulated services, in effect empowering customers to decide whether the change is worthwhile. If most of the operator's customers affirmatively agreed by ballot to revise regulated services subject to the incentive plan, this Commission could be confident that the change was reasonable. In any case, of course, operators would be free to offer new services, and we

expect this Plan will encourage them to do so. The only issue would be whether the operator had fulfilled its commitment to maintain or improve the quality of the service provided at regulated rates. We request comment on this and other approaches that would permit reasonable revisions to the current services and rates subject to the incentive plan, especially approaches that take into account the views of the customers using those services.

329. We request comment on whether we should adopt rules for our Upgrade Incentive Plan. We request that commenters address how the plan, if adopted permanently, might best be structured to maximize the benefits to consumers and operators and to encourage efficient operation and innovative services, and what procedures should govern implementation of the Upgrade Incentive Plan by operators. We solicit comment on what standard we should adopt to measure quality of service for existing services; we seek comment also on the extent to which we should permit operators to move existing channels to new regulated tiers eligible for pricing flexibility under an upgrade incentive plan.

F. Average Cost Schedules

330. The Cable Act of 1992 instructs us to consider administrative burdens in establishing rate regulation, and to design rate regulation in a manner that reduces "the administrative burdens and cost of compliance of cable systems that have 1,000 or fewer subscribers."[588] We have met this mandate by providing in the Benchmark Order for streamlined rate reductions for small systems;[589] by providing in the Report and Order here for abbreviated Cost of Service filings by small systems;[590] and by other measures adopted in this Rate Order.[591]

331. We sought comment in the Notice regarding the desirability of allowing cable operators to justify rates based on average costs of providing regulated cable service, in an approach similar to the 'average schedule' regulatory scheme for provision of interstate access by some telephone companies.[592] We

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[588] 47 U.S.C. §543(i).

[589] Benchmark Order at Part II.D.1.c.

[590] See part IX.A., supra.

[591] Rate Order at 5917-5924.

[592] Notice at ¶ 74.

believe that average cost schedules could provide administrative relief for cable operators and regulators by permitting setting of rates for regulated equipment and cable service by reference to average costs rather than an evaluation of each individual operator's costs. Accordingly, we tentatively conclude that we should establish average cost schedules for provision of regulated cable service and equipment.

332. We will obtain necessary cost information through our industry cost studies.[593] In addition, operators and other interested parties may submit other cost information that they believe will be useful. The Cable Service Bureau will additionally work informally with interested organizations to facilitate the compilation, analysis and development of average cost schedules.

333. We solicit comment on whether average cost schedules should be available for all operators, or only small systems.[594] If use of average cost schedules should be limited to small entities, we solicit comment on how we should define small systems for this purpose. Commenters suggesting the restriction of average schedules to small entities, or suggesting a particular threshold or definition for 'small,' should support their recommendations with data, including differences in costs, efficiencies, corporate structures or other factors, that would necessitate the proposed differences in treatment.

XIII. Initiation of Cost Studies

334. In the Notice we stated that we would conduct cost studies of the cable industry to provide information that could be useful to develop requirements to set rates based on costs.[595] We have additionally tentatively concluded in this proceeding to develop average cost schedules for provision of regulated cable service and equipment. In the Benchmark Order, we have determined that we will collect information on costs with respect to small operators and systems with relatively low prices. Actually, we are initiating at this time general cost studies of the cable industry that will be used for these purposes as well

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[593] Part XIII., infra.

[594] We note that the average schedules developed for use by telephone companies in calculating access charges are not restricted to small telephone companies, although that has been their principal use. See 47 C.F.R. §69.606.

[595] Notice at ¶ 80.

as to provide information that will help us determine whether any changes should be made in our interim framework for cost-of-service regulation. We delegate to the Chief, Cable Services Bureau authority to conduct these studies. Since the cost studies will be part of this rulemaking proceeding, the ex parte rules for non-restricted proceedings apply. Requests for confidentiality may be made pursuant to Section 0.459 of the Commission's rules.

XIV. Regulatory Flexibility Analysis

A. Final Regulatory Flexibility Analysis for the Report and Order

335. Pursuant to the Regulatory Flexibility Act of 1980, 5 U.S.C. Sections 601-12, the Commission's final analysis with respect to the Report and Order is as follows:

336. Need and purpose of this action: The Commission, in compliance with Sections 3 and 14 and those portions of Section 9 of the Cable Television Protection and Competition Act of 1992 (the Act) pertaining to rate regulation, adopts rules and procedures intended to ensure cable subscribers of reasonable rates for cable services with minimum regulatory and administrative burdens on cable entities.

337. Summary of issues raised by the public comments in response to the Initial Regulatory Flexibility Analysis (IRFA): The Chief Counsel for Advocacy of the United States Small Business Administration ("Office of Advocacy") offers several remarks in response to the IRFA. The Office Advocacy expresses concern that numerous small cable operators cannot operate profitably, if at all, under the constraints imposed by the benchmark. It agrees with the Commission that some other process must be developed to permit small cable operators to demonstrate the reasonableness of rates. The Office of Advocacy believes the Commission's experience with regulation of common carriers may prove beneficial in developing mechanisms that balance the need for exactitude with administrative simplicity.

338. First, the Office of Advocacy opines that the 1,000 subscriber standard in the 1992 Act does not provide an adequate definition of small operator. It recommends defining small cable operators as those with less than $7.5 million in gross revenues, a standard roughly equivalent to 20-25,000 subscribers. Within this category it recommends separate tiers at 1,000, 3,500, and 10,000 subscribers.

339. Second, the Office of Advocacy commends the Commission for its compliance with the Regulatory Flexibility Act and its

extensive examination of alternative regulatory regimes. It supports the Commission's proposal to streamline cost of service showings for smaller firms, if a relatively simple form can be developed to show what these costs are. It also supports the Commission's proposal of an abbreviated cost showing for significant capital expenditures. The Office of Advocacy also suggests that the Commission consider use of average cost schedules, maintained by an organization of cable operators to provide the same functions for the cable industry that the National Exchange Carrier Association performs for local telephone companies.It opposes use of 1986 rates adjusted for inflation and productivity as an alternative.

340. Third, the Office of Advocacy also supports considering exemptions for small cable operators, provided certain principles are maintained, including a Commission finding that exempt operators' rates are reasonable.

341. Most of the proposals raised by the Office of Advocacy were adopted by the Commission in some form, or are the subject of further comment. For example, the definition of a small cable operator for purposes of cost of service showings was broadened to 15,000 subscribers. We expect that this definition will fairly balance the costs of regulation with the need to ensure reasonable rates.

342. The Commission also is adopting its proposals for streamlined cost of service studies for small companies, based on a simplified form, and abbreviated cost of service showings for significant capital expenditures. We are also seeking the information needed to consider development of average cost schedules. The Upgrade Incentive Plan we are adopting on an experimental basis, and seeking comment on, may also be an attractive alternative form of regulation, with substantially reduced administrative burdens, for small operators.

343. The Commission agrees with the Office of Advocacy that we must ensure that rates for regulated services are reasonable for all cable operators. We are also willing to consider proposals for pooling cable system costs and revenues in a manner similar to that employed for small telephone companies. It is unclear to us, however, that cable operators are sufficiently interested in such an approach to make its adoption worthwhile. Our consideration of average cost schedule approaches in the Further Notice may provide insight on this matter.

344. The Commission has also considered the other comments and proposals regarding small cable operators, as we discuss in more detail in the body of the Report and Order. For example, in response to a proposal in comments from Small Systems, we have

broadened the definition of small systems for purposes of the cost of service mechanisms to include MSOs with 250,000 or fewer subscribers, who do not own any system with more than 10,000 subscribers, and whose average system size is 1,000 subscribers or less.[596] Interested persons will also have the opportunity to submit further comments on these interim rules in the Further Notice so that we may consider appropriate revisions before these rules become final.

B. Initial Regulatory Flexibility Analysis for the Further Notice

345. Pursuant to Section 603 of the Regulatory Flexibility Act, the Commission has prepared the following initial regulatory flexibility analysis (IRFA) of the expected impact of these proposed policies and rules on small entities. Written public comments are requested on the IRFA. These comments must be filed in accordance with the same filing deadlines as comments on the rest of the Further Notice, but they must have a separate and distinct heading designating them as responses to the regulatory flexibility analysis. The Secretary shall cause a copy of the Further Notice, including the initial regulatory flexibility analysis, to be sent to the Chief Counsel for Advocacy of the Small Business Administration in accordance with Section 603(a) of the Regulatory Flexibility Act, Pub. L. No. 96-354, 94 Stat. 1164, 5 U.S.C. Section 601 et seq. (1981).

346. Reason for action. The Cable Television Consumer Protection and Competition Act of 1992 requires the Commission to prescribe rules and regulations for determining reasonable rates for basic tier cable service and to establish criteria for identifying unreasonable rates for cable programming services. The Commission has adopted rate regulations that require a comparison to the rate of cable systems subject to effective competition, as defined in the Cable Act of 1992, and interim regulations for setting rates for regulated services based on cost. This Further Notice proposes to establish additional and permanent regulations governing the setting of rates for regulated cable service based on costs.

347. Objectives. To propose rules to implement Section 623 of the Cable Television Consumer Protection and Competition Act of 1992. We also desire to adopt rules that will be easily interpreted and readily applicable and, whenever possible, minimize the regulatory burden on affected parties.

348. Legal Basis. Action as proposed for this rulemaking

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[596] Small Systems Comments at 37.

is contained in Sections 4(i), 4(j), 612(c), and 623 of the Communications Act of 1934, as amended.

349. Description, potential impact and number of small entities affected. Until we receive more data, we are unable to estimate the number of small cable systems that would be affected by any of the proposals discussed in the Further Notice. We have, however, attempted to reduce the administrative burdens and cost of compliance for cable systems that have 1,000 or fewer subscribers as required by Section 623(i) of the Cable Act of 1992.

350. Reporting, record keeping and other compliance requirements. The proposals under consideration in this Further Notice include new and revised reporting and record keeping requirements for cable systems. These reporting requirements include the filings by cable operators of financial and/or leased access data annually at the Commission or participating in an annual survey. Additionally, this Further Notice proposes the permanent use of forms to submit data that is to be presented to the regulating entity in a cost-of-service showing by a cable operator. Furthermore, the Further Notice proposes general cost accounting and cost allocation requirements that could be imposed on the cable industry.

351. Federal rules which overlap, duplicate or conflict with this rule. None.

352. Any significant alternatives minimizing impact on small entities and consistent with stated objectives. Wherever possible, the Further Notice proposes general rules, or alternative rules for small systems, to reduce the administrative burdens and cost of compliance for cable systems that have 1,000 or fewer subscribers as required by Section 3(i) of the Cable Act of 1992.

XV. Paperwork Reduction Act

353. The proposal contained herein has been analyzed with respect to the Paperwork Reduction Act of 1980 and found to impose a new or modified information collection requirement on the public. Implementation of any new or modified requirement will be subject to approval by the Office of Management and Budget as prescribed by the Act.

XVI. Procedural Provisions

354. For purposes of this non-restricted informal rulemaking proceeding, members of the public are advised that ex parte contacts are permitted from the time of issuance of a

notice of proposed rulemaking until the time a draft Order proposing a substantive disposition of the proceeding is placed on the Commission's Open Meeting Agenda. In general, an ex parte presentation is any written or oral communication.(other than formal written comments or pleadings and oral arguments) between a person outside this addresses the merits of the proceeding. Any person who submits a written ex parte presentation addressing matters not fully covered in any written summary must be served on this Commission's Secretary for inclusion in the public file, with a copy to the Commission official receiving the oral presentation. Each ex parte presentation discussed above must state on its face that the Secretary has been served, and must also state by docket number the proceeding to which it relates. See generally Section 1.1231 of the Commission's Rules. 47 C.F.R. §1.1231.

355. Pursuant to applicable procedures set forth in Sections 1.415 and 1.419 of the Commission's Rules, 47 C.F.R. Sections 1.415 and 1.419, interested parties may file comments on or before **July 1, 1994** and reply comments on or before **August 1, 1994**. To file formally in this proceeding, you must file an original plus four copies of all comments, reply comments, and supporting comments. If you want each Commissioner to receive a personal copy of your comments and reply comments, you must file an original plus nine copies. You should send comments and reply comments to Office of the Secretary, Federal Communications Commission, 1919 M Street, N.W. Washington, D.C. 20554. Comments and reply comments will be available for public inspection during regular business hours in the FCC Reference Center, Room 239, Federal Communications Commission, 1919 M Street N.W., Washington D.C. 20554.

XVII. Ordering Clauses

356. Accordingly, IT IS ORDERED that, pursuant to Sections 4(i), 4(j), 612, 622(c) and 623 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 154(i), 154(j), 532, 542(c) and 543, the rules, requirements, and policies discussed in the foregoing Report & Order ARE ADOPTED, and that Part 76 of the Commission's rules, 47 C.F.R. Part 76, IS AMENDED as set forth in Attachment B.

357. IT IS FURTHER ORDERED that, the rules, policies, and requirements adopted herein SHALL BE EFFECTIVE May 15, 1994.

358. IT IS FURTHER ORDERED that, pursuant to Sections 4(i), 4(j), 612(c) and 623 of the Communications Act of 1934, 47 U.S.C. §§ 154 (i), 154 (j), 532 (c), 542(c), and 543, NOTICE IS HEREBY GIVEN of proposed amendments to Part 76, in accordance with the proposals, discussions, and statement of issues in this Further

Notice of Proposed Rulemaking, and that COMMENT IS SOUGHT regarding such proposals, discussion, and statement of issues.

359. IT IS FURTHER ORDERED that, the Secretary shall send a copy of this Report and Order, including the certification, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with paragraph 603(a) of the Regulatory Flexibility Act. Pub. L. No. 96-354, 94 Stat. 1164, 5 U.S.C. §§ 601 et seq. (1981).

360. IT IS FURTHER ORDERED that AUTHORITY IS DELEGATED to the Chief, Cable Services Bureau to conduct cost studies in conjunction with this proceeding and to develop forms necessary and appropriate to implement this Order.

361. IT IS FURTHER ORDERED pursuant to Sections 4(i), 4(j), 623(b), and 623(c) of the Communications Act, 47 U.S.C §§ 154(i), 154(j), 543(b) and (c), that the Upgrade Incentive Plan described herein IS ADOPTED ON AN EXPERIMENTAL BASIS. Authority is delegated to the Chief, Cable Services Bureau to implement this plan.

FEDERAL COMMUNICATIONS COMMISSION

William F. Caton

William F. Caton
Acting Secretary

Attachment A

Comments

Aerie	Aerie Group Incorporated
Arlington	Arlington County, Virginia
Arthur Andersen	Arthur Andersen & Co.
Austin	Austin, Texas; King County, Washington; and Montgomery County, Maryland
Avenue TV	Avenue TV Cable Service, Inc.
Bell Atlantic	Bell Atlantic, The NYNEX Telephone Companies, and The Pacific Companies
BellSouth	BellSouth Telecommunications, Inc.
BC	Benchmark Communications
COA	Cable Operators and Associations
Cablevision Industries	Cablevision Industries Corporation, Consolidated Cable Partners, L.P., Crown Media, Inc., Multivision Cable TV Corp., Parcable, Inc., and Providence Journal Company
Cablevision Systems	Cablevision Systems Corporation
California Cable	The California Cable Television Association
CATA	Community Antenna Television Association, Inc.
CFA	Consumer Federation of America
Comcast	Comcast Cable Communications, Inc.
Connecticut	Connecticut Department of Public Utility Control
Continental	Continental Cablevision, Inc.
C-Span	National Cable Satellite Corporation (C-Span and C-Span 2)
Discovery	Discovery Communications, Inc.
Duncan	Duncan Cable TV
E!	E! Entertainment Television, Inc.
Eagle	Eagle Communications, Inc.
ETC	Economic and Technical Consultants, Inc.
Georgia Cable	Cable TV of Georgia Limited Partnership, Falcon Cable TV, Insight Communications, Mid-America CATV Association, Mount Vernon Cablevision, Inc., Nashoba Communications, Pennsylvania Cable Television Association, Prestige Cable TV, Westar Communications, and Whitcom Investment Company
GTE	GTE Service Corporation
MCATC	Massachusetts Community Antenna Television Commission
Media General	Media General Cable of Fairfax County, Inc.
Medium Operators	Medium-Sized Operators Group
Michigan Committee	Michigan Ad Hoc Committee for Fair Cable Rates
MPAA	Motion Picture Association of America, Inc.
Multichannel	Multichannel Communication Sciences, Inc.
Municipals	Counsel to the Municipal Franchising Authorities
Muzak	Muzak Limited Partnership
NATOA	National Association of Telecommunications Officers and Advisors, The National League of Cities, The United States Conference of Mayors, and The National Association of Counties
NCTA	National Cable Television Association
New Jersey	Staff of the New Jersey Board of Regulatory Commissioners
New York	New York State Commission on Cable Television
NTCA	National Telephone Cooperative Association

Comments (continued)

NY Assembly	New York State Assembly, Committee on Oversight, Analysis and Investigations
Omega	Omega Communications Inc.
Pegasus	Pegasus Cable Television
Philips	Philips Broadband Networks Inc.
SBA	United States Small Business Administration
SCBA	Small Cable Business Association
Seaford	City of Seaford, Delaware
Small Cities	Small Cities Cable Television
Small Systems	Prime Cable, Harron Communications Corp., Georgia Cable Partners, Atlanta Cable Partners, L.P., Wometco Cable Corp., and the Coalition of Small System Operators
Summit	Summit Communications, Inc.
TCI	Tele-Communications, Inc.
Time Warner	Time Warner Entertainment Company, L.P.
TMC	Tele-Media Corporation
Utah	Utah League of Cities and Towns
Viacom	Viacom International Inc.

Reply Comments

Aerie	
Arthur Andersen	
Austin	
Bell Atlantic	
Blade	Blade Communications, Inc.
COA	
Cablevision Industries	
Cablevision Systems	
Comcast	
Continental	
Corning	Corning Incorporated and Scientific-Atlanta, Inc.
Georgia Cable	
Grassroots	Grassroots Cable Systems
GTE	
Liberty	Liberty Media Corporation
Media General	
Medium Operators	
Municipals	
NATOA	
NCTA	
NTCA	
Pegasus	
SCBA	
Seaford	
Small Systems	
TCI	
Time Warner	
Viacom	

Ex Partes

Grand Rapids	City of Grand Rapids and other Michigan municipalities
ParCable I	ParCable, Inc., Star Cable Associates, Bend Cable Communications, Inc., Etan Industries, Inc., and River Valley Cable TV
Parcable II	ParCable, Inc.
COA	
Continental	
Comcast	Comcast Corporation
McConnell	Senator Mitch McConnell, Jr.[1]
Sun Country	Sun Country Cable

[1] Just passes on a letter from a constituent re small cable.