among regulated utilities such as telephone companies,[64] those rules establish some peculiar and unjustified treatment for partnerships and subchapter S corporations in the area of calculating the tax allowance. Specifically, the ***Cost-of-Service Order*** directs that entities operating in these corporate forms deduct distributions to investors from the equity earnings subject to a tax allowance.[65]

There is no logical basis for this rule. In general, the issue should be moot because, for the reasons stated above, operators should generally be permitted to calculate the portion of their earnings attributable to equity and to interest based on the hypothetical capital structure upon which the Commission relies in establishing the overall reasonable rate of return. In any particular case in which the operator's actual capital structure is relevant, however, the rule is wrong because, as described below, it confuses an issue that properly relates to overall capital structure with issues relating to the entity's results in specific years.

The confusion is most easily explained by reference to the accounting applicable to a traditional subchapter C corporation. At any given point in time, such an entity will have a certain level of debt outstanding, and a certain amount of paid-in capital and retained earnings. In a traditional utility context, determining the "capital structure" of the entity amounts to adding up these two figures — debt and equity capital invested in the enterprise — and determining what proportion each bears to the total. This capital structure is then

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[64] ***Cost-of-Service Order*** at ¶¶ 138-39.

[65] ***Id.*** at ¶ 140.

used in calculating the overall allowed return, and, once a reasonable return on equity is established, determines the level of allowed equity earnings subject to an allowance for income taxes.

The payment of dividends affects this situation only indirectly. In any given year, the managers of a subchapter C corporation may choose to pay a dividend to investors. Although generally speaking dividends are paid on the basis of current earnings, there is actually no requirement that current earnings exist for dividends to be paid. In fact, it is not uncommon for subchapter C corporations to pay dividends even in years when earnings are non-existent or negative.[66] All that is required is that the entity have cash on hand that is not already committed to other uses, such as interest coverage requirements for debt or reinvestment in the business.

Moreover, the accounting effect of paying a cash dividend is not to reduce current-period earnings. Instead, the payment of a cash dividend has the effect of lowering the

[66] For example, recent accounting requirements relating to the provision for employees' post-employment medical benefits have led to large losses reported on many corporation's books in recent years, but this has not led to a cessation of dividend payments by those entities.

entity's retained earnings balance, as compared to what that balance would have been had the dividend not been paid:

ITEM	DIVIDEND	NO DIVIDEND
TAXABLE EARNINGS FOR YEAR	1,000	1,000
DIVIDEND PAYMENT	500	0
DEBT OUTSTANDING	10,000	10,000
RETAINED EARNINGS (B.O.Y.)	8,000	8,000
RETAINED EARNINGS (E.O.Y.)	8,500	9,000
DEBT RATIO (E.O.Y.)	54.1%	52.6%

The payment of dividends, in other words, has no impact on current taxable earnings or current tax liability. What it affects is capital structure. As a result, in the case of a subchapter C corporation that is subject to cost-of-service regulation, whether dividends are paid or not has no impact on the appropriate allowance for taxes in current rates.

The same result should apply in the case of partnerships and subchapter S corporations. If these entities choose to make distributions to their investors, that will affect the appropriate calculation of that entity's actual capital structure, if in a particular case the actual capital structure is relevant. But, except as explained below, the decision to make distributions to investors has no necessary relationship to the current tax liabilities generated by the activities of the partnership/subchapter S corporation, and, therefore, should have no impact on the calculation of a reasonable allowance for current taxes in

rates. In light of this analysis, the interim cost-of-service rules should be revised to remove the penalty imposed on partnerships and subchapter S corporations that make distributions.

In fact, considerations peculiar to partnerships and subchapter S corporations strongly militate against such a result. In this regard, the Commission appears to have been led astray by the common description of partnerships and subchapter S corporations as entities that are not themselves subject to tax. While this may be true as a technical matter of tax law, the fact of the matter is that every dollar of equity earnings generated by a partnership or subchapter S corporation is a dollar that is subject to tax. The difference between these entities and a subchapter C corporation is that the tax liability is directly assigned to the partners/shareholders.

What this means is that, when the activities of a partnership or subchapter S corporation generate taxable earnings, unless the entity makes a distribution to the investors sufficient to cover the tax liability, the investment in the entity will have generated ***negative*** earnings for the investors on a current basis, in that the entity will have increased the investors' tax bills with no offsetting currently realized gains. Unless such distributions were routinely made — and they are, when taxable earnings are generated — investors would have few incentives indeed to invest in such entities. In these circumstances, distributions by a partnership or subchapter S corporation that are equal to or less than the tax liabilities generated by the entity's activities are the equivalent of payments by a

subchapter C corporation to the IRS, and there is no basis for treating such distributions as anything other than tax payments for ratemaking purposes.[67]

In sum, for the reasons discussed above, the calculation of cable operators' allowance for income taxes should generally be made on the basis of the hypothetical capital structure relied upon by the Commission to establish the overall allowed rate of return, and this rule should apply regardless of the organizational form of the entity involved. If the actual capital structure of a particular operator becomes relevant in a given proceeding, then any dividend payments or distributions will automatically be taken into account in calculating that capital structure, because retained earnings will be lower than they otherwise would be if dividends are paid or distributions made. But it is simply not theoretically correct, nor equitable, to use dividend payments or distributions, which reduce the retained earnings balance, as an offset to current period taxable earnings in determining the appropriate level of allowance for income taxes in rates.

C. The Commission Should Permit Cable Operators To State Their Initial Accumulated Deferred Tax Balances As Zero.

The Form 1220 calls for the identification of "accumulated deferred taxes," and for that amount to be deducted from rate base. In order to minimize needless disputes in individual cases, the Commission should clarify in its permanent rules that the initial balance for this amount will often be zero.

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[67] ***See*** Bend Cable Communications, Inc., ***et al.***, Petition for Reconsideration, MM Docket No. 93-215 (filed May 16, 1994) at 3-12.

Traditionally, a utility's rates are determined with an allowance for income taxes included. The allowance for taxes is calculated based on the expenses and earnings recognized, for regulatory purposes, in developing the approved rate, then calculating the tax allowance based on the effective statutory tax rate. This is the fully normalized approach that the FCC has adopted as well.[68]

For the key expense category of depreciation, there are generally significant differences between the deduction accepted for regulatory purposes and the deduction for tax purposes. Specifically, while the cost of providing regulated services is properly determined using depreciation lives that reflect the lives of various classes of plant, tax depreciation allows for much shorter lives, and, therefore, much higher depreciation expense. This means that, theoretically, in the early years of the lives of a group of assets, the actual taxes that the regulated entity would pay would incur will be lower than the pro forma tax calculation would suggest. In later years, the situation would reverse: tax depreciation would be lower, with taxes paid, than shown in the pro forma calculations.

The difference between the pro forma tax expense based on "book" depreciation and tax expense based on "tax" depreciation is accumulated deferred taxes.[69] During the early years of the assets' lives, when "book" depreciation is lower than "tax" depreciation, this

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[68] ***See Cost-of-Service Order*** at ¶¶ 138-39. ***See also*** FCC Form 1220, Instructions at 5 (lines 3a through 3h).

[69] Other sources of differences between "book" and "tax" depreciation rates or other expenses, such as job development investment tax credits, also contribute to a regulated utility's accumulated deferred tax balance.

accumulated balance is a liability. Over the remaining years of the assets' lives, when assets are fully depreciated for tax purposes but not for "book" purposes, each year the balance of the accumulated deferred tax liability decreases, ultimately to zero.

For the typical regulated utility, therefore, in the earlier years of this process, rates set at levels high enough to cover pro forma taxes will contain amounts from ratepayers that are designed to pay taxes that will not be paid currently. In recognition of this situation, accumulated deferred taxes are treated, appropriately, as a source of cost-free capital to the regulated firm. For regulatory purposes, therefore, the accumulated deferred tax balance is either deducted from rate base or included in the calculation of the utility's overall weighted cost of capital as a zero-cost item. Each of these approaches serves the purpose of giving ratepayers credit for money they have been required to pay, in regulated rates, to cover tax expenses that are not currently due.

None of this applies to regulated cable rates today. Cable operators have not, before this proceeding, had rates set on a cost-of-service basis at all, much less one that includes an allowance for pro forma taxes. To the extent that operators have sought to recover tax expenses in their rates, actual, not pro forma tax expense is what they have flowed through.

In these circumstances, there is no basis for concluding that customers have been providing operators with "cost-free" capital at any time in the past. To the contrary, the history of losses and low earnings described above makes clear that, in general, cable systems in their early years of operations are net recipients of capital from the owner, not

from customers. In effect, cable operator's rates in the past have been set on a "flow through," not a "normalized" basis. It would, therefore, be unreasonable and contrary to the purpose of treating accumulated deferred taxes as an offset to rate base to deduct deferred taxes from rate base in an initial cost-of-service proceeding.[70]

IV. THE 11.25% OVERALL RETURN MUST BE INCREASED SIGNIFICANTLY.

In the ***Cost-of-Service Order,*** the Commission established an interim overall return of 11.25% for use in cable company cost-of-service showings.[71] The Commission emphasized the interim nature of the figure, however, and sought additional information regarding what reasonable overall return figure to use in its permanent cost-of-service rules for cable.[72] Undersigned cable operators and associations retained Dr. A. Lawrence Kolbe of The Brattle Group to respond to the Commission's request for additional information on this topic.[73]

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[70] Of course, cost-of-service regulation is now in effect, and, in general, cost-of-service regulation should produce maximum rates that ***would*** be high enough to generate current earnings and cover pro forma taxes on a current basis. As a result, once a cable operator begins actually charging rates high enough to cover pro forma taxes, a cable operator should ***begin*** accumulating deferred taxes as a rate base offset on a going-forward basis. But the only appropriate accumulated deferred tax offset to a cable operator's rate base in an initial cost-of-service case is zero.

[71] ***Cost-of-Service Order*** at ¶¶ 147 ***et seq.***

[72] ***Cost-of-Service Order*** at ¶¶ 208, 305.

[73] Dr. Kolbe holds a Ph.D. in Economics from the Massachusetts Institute of Technology and a B.S. in International Affairs (Economics) from the United States Air Force Academy. He is the author or co-author of numerous professional publications relating to the cost of capital of firms subject to cost-of-service regulation, and is co-author of a book, ***The Cost of Capital,*** that deals directly with this question.

Dr. Kolbe's report is attached to these comments, and its key conclusions are set out below. In brief, the overall rate of return for regulated cable services should be increased from the current 11.25% interim figure to at least 13%.[74]

A. The Difficulties Facing the Commission In Assessing The Cable Industry's Cost of Equity.

The Commission's effort in the ***Cost-of-Service Order*** to estimate an industry-wide cost of capital for the cable industry was complicated by three facts. First, there are relatively few publicly traded companies that are primarily in the business of providing cable television services. Also, this group represents a much smaller fraction of the industry as a whole than the fraction of the telephone industry represented by large, publicly traded telephone companies.[75] Second, only two of the publicly traded cable companies pays regular dividends. Finally, many cable companies — including some of those that are publicly traded and hundreds of those that are not — are very highly leveraged on a "book" basis, and a significant number even have ***negative*** "book" equity. In these circumstances — and unlike the situation with telephone companies — it is

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[74] The discussion in this section of these comments summarizes and draws upon the attached Brattle Group Report. ***See*** Brattle Group Report, Section I, Introduction and Summary.

[75] The fact that the firms for which meaningful data are available represents a relatively small proportion of the industry as a whole also suggests that the Commission should be more willing than in the telephone context to allow individualized showings regarding a reasonable allowed rate of return. For example, the Commission could identify certain "risk factors" based on existing statutory criteria that would justify an incremental increase in the overall allowed return. These would include low penetration (particularly penetration close to the 30% threshold below which regulation does not apply); the existence of an overbuilder or other competitor (since a competitor with sufficient coverage and penetration is defined as "effective competition); and a relatively short remaining franchise term (since franchise renewal negotiations often result in costly new requirements, or, in some cases, no renewal at all).

essentially impossible to apply the Commission's preferred method for estimating the cost of equity, the Discounted Cash Flow ("DCF") method, to the cable industry.

In establishing the 11.25% interim cost of capital, the Commission did not so much resolve this conundrum as temporarily set it aside. Specifically, the Commission determined that a reasonable cost of long-term debt for cable companies was 8.5%; tentatively accepted a range of 40% to 70% as plausible debt ratios; tentatively concluded that the cost of equity for cable companies would fall into the 12% to 15% range; calculated the resulting mix of possible weighted costs of capital; averaged those figures for each hypothetical debt ratio; and then selected a figure from within the range of averages.[76] While determining an industry's cost of capital is never an exact science, this process is clearly much less precise than would be preferable, and, indeed, much less precise than the process the Commission itself uses when setting an allowed reasonable return for telephone companies.[77]

B. Reliance On Risk Positioning Methodologies, As Opposed To The DCF, Is Appropriate For The Cable Industry.

In the ***Cost-of-Service Order,*** the Commission chose to rely generally on the DCF methodology, with which it is most familiar. Nonetheless, the circumstances of the cable

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[76] ***See Cost-of-Service Order*** at ¶¶ 204-08.

[77] ***See Represcribing the Authorized Return for Interstate Services of Local Exchange Carriers,*** 5 FCC Rcd 7507, 7523-24, ¶¶ 133-39 (1990).

industry, summarized above, make reliance on the DCF methodology peculiarly problematic in this industry.

The most significant problem with applying the DCF methodology is that the vast majority of cable companies, including those that are publicly traded, pay no dividends. At a minimum, the lack of a regular dividend stream, and a lack of reliable estimates of projected growth, represents a significant technical obstacle to applying the DCF approach. Moreover, this situation is very different from the one the Commission faces in the telephone industry. There, while the operating entities themselves frequently have no publicly traded stock, and, therefore, no analysts' forecasts of dividend growth, those entities are owned by firms whose primary business is telecommunications and who do pay dividends. In those circumstances, unlike the situation here, it is a relatively small stretch to rely on cost of equity estimates for the parent companies in setting an overall allowed return for the operating entities.

The problem here, however, is much more fundamental than a technical glitch in the DCF model. Companies that do not pay dividends, and that, therefore, rely on growth in stock value alone to reward their investors, are fundamentally different kinds of companies than companies with a history of paying, and an expectation of ongoing and increasing dividends in the future, a current and regularly increasing quarterly dividend. ***A priori,*** one would expect such companies to be riskier than dividend-paying companies, because the payment of a regular dividend, other things being equal, significantly mitigates investors' risk by providing ***some*** consistent current return. In addition, firms that have the stability

and available cash to pay dividends on a regular basis will generally be less risky than firms that do not.

At the very outset, therefore, the Commission must confront and accept the fact that typical DCF models cannot reasonably be used to estimate the cost of equity of an ***industry*** that does not pay dividends. Indeed, not only can the DCF method not be applied to cable firms directly, it cannot be applied to ***any*** firm that is "like" cable firms in the crucial respect of basing its long-term business success, and its access to capital, ***entirely*** on its ability to increase its asset value over the long term.

In these circumstances, the only sensible alternative is to find a method for estimating the cost of equity that applies easily to firms that do not pay dividends. Fortunately, the Capital Asset Pricing Model ("CAPM") is such a method. Without debating the theoretical advantages or disadvantages of CAPM versus DCF in the abstract, a large body of research shows that the CAPM is a theoretically sound, empirically reasonable method for estimating the cost of equity. And it does not, ***a priori,*** exclude the cable firms at issue in this proceeding, and all firms that are "like" them in the crucial respect of dividend payment.

C. The Evidence Shows That The Cost of Equity For Regulated Cable Operations Is At Least 13%

Dr. Kolbe's analysis proceeded along the following lines. First, to provide assurance to the Commission that there are no systemic biases in applying the CAPM, he calculated

the median DCF cost of equity for the portion of the Standard & Poors 400 ("S&P 400") to which that method can be applied — that is, those firms in the S&P 400 that pay dividends. He then calculated the median CAPM cost of equity for those same firms. While there was a certain degree of variation, which is to be expected, the two approaches produced very similar estimates of the cost of equity of this broad sample of the market.[78] This evidence gives the Commission substantial assurance that the CAPM does not produce results that are out of line with its preferred DCF approach.

Second, he examined whether, in fact, firms that do not pay dividends are, generally, riskier than firms that do. He performed this test directly by determining the CAPM cost of equity for the firms in the S&P 400 that do not pay dividends and comparing the results to the CAPM cost of equity for the firms in the S&P 400 that do pay dividends. The evidence shows that the dividend paying group had a median cost of equity of two to three percentage points ***lower*** than the non-dividend paying group. In terms of the DCF methodology, it appears that the cost of equity of non-dividend paying firms falls into the range of DCF equity costs for the upper two quartiles of the S&P 400.

Third, Dr. Kolbe determined the median cost of equity of a group of eight firms that are as close to "pure play" cable companies as could be identified. The result, approximately 17.5% (using a 50/50 capital structure), is a cost of equity that falls squarely within the range determined previously for firms that do not pay dividends. This provides

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[78] In fact, the CAPM estimates of the cost of equity are generally slightly ***lower*** than the DCF estimates.

substantial confirmation that cable companies are significantly riskier than the market as a whole. It also provides a reasonable basis for establishing a cost of equity for use in cable industry cost-of-service cases. Indeed, other factors, such as the fact that most cable companies do not have publicly traded stock and are highly leveraged, suggest that this median figure is a conservative estimate for the cable industry as a whole.

Fourth, Dr. Kolbe recognized that the 11.25% interim overall return the Commission established for cable companies is the same as the overall return the Commission has established for telephone companies. For a number of reasons, one would expect regulated cable services to be significantly riskier than regulated telephone services.[79] As a result, the fact that the Commission's interim figure for the cable industry was the same as its figure for the telephone industry suggested a problem in the analysis. To investigate this issue, Dr. Kolbe calculated the CAPM cost of equity for a sample of seven major telephone firms (the RBOCs) and compared it to the previously-calculated cost of equity of eight cable firms. The average cost of equity of the telephone sample was several hundred basis points below both the cost of equity of the cable sample and the median cost of equity of

[79] These include, for example, the fact that regulated telephone service has been in constant and growing demand for more than 100 years, as opposed to a little more than a decade for cable services beyond simple re-transmission of over-the-air broadcasts; the fact that regulated telephone service is generally viewed as a necessity, and is purchased by well above 90% of potential customers, as opposed to only about 60% of potential customers subscribing to cable; the fact that the firms providing regulated telephone service are generally not only large in absolute terms, but also larger than cable firms, and generally much more geographically concentrated and better capitalized to boot. Finally, putting aside, for these purposes, questions about the ***strict*** comparability of particular substitutes, there is also the key fact that most people have virtually ***no*** alternative to the use of regulated telephone service today, while over-the-air television, rental of taped movies, and attending movies and live performances all represent significant substitutes for the core services offered by cable companies. In addition, MMDS and Direct Broadcast Satellite services have recently begun commercial operation.

the non-dividend paying segment of the S&P 400. This suggests that, while the 11.25% overall return may not be inappropriate for telephone companies, it is far too low for cable companies.[80]

Finally, well-established techniques of financial analysis allow the calculation of the impact on the cost of equity of varying degrees of leverage in the capital structure of a business. This makes it possible to calculate directly the correct cost of equity figure to use in connection with any particular assumed capital structure. Elsewhere in these comments, the undersigned cable operators and associations have suggested that, where the Commission does not permit reliance on an operator's individual capital structure, it should use an assumed, hypothetical capital structure of 50% debt and 50% equity. Retaining the Commission's determination that 8.5% is a reasonable allowance for long-term debt costs, a reasonable overall cost of capital for cable companies would be at least 13%.

V. THE COMMISSION SHOULD NOT ADOPT A PRODUCTIVITY OFFSET FOR CABLE OPERATOR PRICE CAPS.

The ***Cost-of-Service Order*** proposes grafting a 2% "productivity offset" onto the current price cap plan for cable operators. For the reasons described below, the Commission should reject this proposal and, instead, implement a price cap plan with no productivity offset.

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[80] As noted above, in general the DCF methodology appears to produce slightly higher estimates of the cost of equity here than does the CAPM approach. This also supports the view that the 11.25% figure is not too high for telephone companies. But the evidence clearly shows that 11.25% is much too ***low*** for cable companies.

First, there is no evidence in the record upon which the Commission could base a reasonable quantification of cable operator "productivity." As Continental Cablevision pointed out in the proceedings leading to the ***Cost-of-Service Order,*** no meaningful information regarding cable industry productivity exists and, to the extent that rough estimates can be made, there does not appear to be sufficient productivity growth to justify any offset.[81] The only conclusion consistent with this record is a price cap plan with no productivity offset.

Second, imposing a productivity offset on cable firms now would sabotage the goal of an improved video services infrastructure.[82] While the industry has made significant progress in upgrading cable systems in the past decade, millions of subscribers still do not have access to the improved signal quality and additional viewing options that optical fiber and improved electronics can bring to traditional cable offerings. Similarly, many enhanced and innovative services simply are not available over a traditional cable system.

But these benefits are not free. To the contrary, a significant upgrade in even a relatively small system can cost millions of dollars and, nationwide, billions of dollars are needed for the cable industry to make its contribution to assuring that we do not become a nation of information "haves" and "have nots." As noted elsewhere in these comments, however, the cable industry generally financed its expansion in the 1980s and early 1990s

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[81] ***See*** Comments of Continental Cablevision, Inc., MM Docket No. 93-215 (August 25, 1993), attachment. Dr. Roddy's previous submission on this topic remains valid today. A copy is attached hereto as Exhibit F.

[82] ***See Cost-of-Service Order*** at ¶ 1; Cable Act of 1992, §2(b).

through the use of debt, so that the industry as a whole is very highly leveraged. In these circumstances, cable industry revenues must be improved, not eroded, if additional funds to expand and upgrade cable networks are to be made available.

Third, there is no basis in the Cable Act of 1992 or its legislative history for imposing a productivity offset. To the contrary, to the extent that Congress focused on the question of the standard to apply to cable prices, it expressed concern that some cable prices had apparently been increasing more rapidly than the Consumer Price Index.[83] Once the Commission has established reasonable initial rates, either through benchmark or cost-of-service regulation, therefore, Congress's purpose will be fulfilled by limiting general rate increases to the level of inflation. Imposing a productivity offset as well, in light of the nature of Congress's concerns, is simply punitive.

Fourth, the proposal to include a productivity offset ignores the fact that the Cable Act of 1992 and implementing regulations have imposed significant new service quality obligations on cable operators, including a number of obligations that will require operators to increase the number of employees per subscriber.[84] It would be unfair to expect operators to staff up to meet these new demands while refusing to allow even inflation-based rate increases.

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[83] Cable Act of 1992, § 2(a)(1).

[84] ***See, e.g.,*** Cable Act of 1992, § 8(b).

From an economic perspective, if the price of regulated cable services increases only at the rate of inflation, but the quality of those services is improving — as it must, under the new rules — then productivity is improving as well. The new service quality rules themselves, therefore, constitute a "productivity offset," and an additional 2% offset is unwarranted.

Finally, a productivity offset is inconsistent with the Commission's statements that it wants to rely on benchmark regulation, as opposed to cost-based regulation, as the primary means of regulating cable companies. The reason for including a productivity offset in a price cap plan is that costs will generally increase with inflation, but that improvements in productivity will allow the firm to resist those inflationary pressures to some extent.[85] As a result, therefore, the firm's prices will not diverge too greatly from the regulated firm's underlying costs.

Such an approach makes perfect sense in the context of the price cap plan for local exchange carriers, which represented the beginnings of a departure from the pure cost-of-service regulation that has characterized regulation of local telephone companies for the better part of a century. In the cable context, however, Congress did not intend the Commission to regulate cable companies like common carriers,[86] and the Commission has repeatedly made clear that cost-based rate regulation is to be the exception, not the rule,

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[85] Policy and Rules Concerning Rates for Dominant Carriers, ***Second Report and Order,*** 5 FCC Rcd 6786 (1990).

[86] ***Cost-of-Service Notice*** at ¶ 15; House Report 102-628 at 83.

for cable companies. In these circumstances, grafting a productivity offset onto cable price caps is contrary to the entire thrust of the Commission's scheme for regulating cable rates.

VI. THE COMMISSION SHOULD CLARIFY ITS RULES FOR CERTAIN ISSUES RELATING TO SYSTEM EXPANSIONS, UPGRADES AND REBUILDS.

One of the objectives of the 1992 Cable Act is to "ensure that cable operators continue to expand ... their capacity and the programs offered over their cable systems" where such expansion is economically justified.[87] More generally, the Commission has concluded that cable television systems have an important role to play in developing the nation's telecommunications infrastructure.[88]

In these circumstances, the Commission should be extremely careful, in constructing its cost-of-service regulations, to avoid creating barriers and disincentives to system upgrade and expansion that is justifiable in economic terms. To the contrary, the Commission should be especially solicitous of those cable operators who have either already upgraded their systems, or who are willing to commit to do so on economically reasonable terms. As explained below, however, implementing this policy goal — which, as a statutory matter, is no less important than the goal of reasonable rates[89] — may entail

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[87] 1992 Cable Act, § 3(b)(3).

[88] ***See Cost-of-Service Order*** at ¶ 67.

[89] ***See*** Public Interest Petitioners, Petition for Expedited Reconsideration, MM Docket No. 93-215 (filed May 16, 1994), ***passim.***

a greater degree of flexibility in applying traditional ratemaking concepts than contemplated by the interim cost-of-service rules.

A. The Commission Should Clarify Its Rules For A Streamlined Cost-of-Service Showing In The Case Of A Significant System Upgrade.

In the ***Cost-of-Service Order,*** the Commission indicates that it will allow operators who have recently upgraded their systems to make a "streamlined" cost-of-service showing relating to the costs of the upgrade. The results of that cost-of-service showing would then be used to support an "add-on" to the operator's then-current rate.[90] This provision in the interim rules represents an important step by the Commission in implementing the provisions of the 1992 Cable Act calling for the continued deployment of improved and expanded system capacity where economically justified. The Commission, however, should modify and clarify this process somewhat in its permanent rules, as described below.

To improve the ease of administration of cost-of-service regulation, the Commission should specify that the streamlined cost-of-service showing should be made using the Form 1220 or Form 1225. The capital costs associated with the upgrade should be included on the appropriate lines of Worksheet A. To the extent that expenses are expected to increase or decrease as a result of the upgrade, those changes would also be reflected on the appropriate lines of Worksheet A. The net impact of the upgrade could then be calculated in a manner that is consistent with the Commission's overall cost-of-service rules, and an appropriate "add-on" calculated.

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[90] ***Cost-of-Service Order*** at ¶¶ 285-91.

The Commission should also clarify that the "streamlined" cost-of-service procedure is available not only to "benchmark" systems, but also to systems whose current rates had been set using a cost-of-service methodology. In the initial period of rate regulation following adoption of the 1992 Cable Act, cable operators in thousands of franchises throughout the country have been called upon to justify their current rates. Some fraction of those rate justifications have been based on cost-of-service principles, as opposed to benchmarks. Once reasonable rates have been established under those principles, however, there is no logical basis for depriving those operators of access to the "streamlined" approach to reflect the costs of a subsequent system upgrade.[91] Any operator whose current rates do not include the costs of the upgrade should be allowed to take advantage of the streamlined procedures.

B. The Commission Should Allow Anticipatory Rate Increases To Recover The Cost Of Planned Or Required Upgrades And Should Allow Average Rates For A Region Or An Company.

A typical regulated telephone company that needs to upgrade its plant has a number of options to obtain the funds needed to do so. In many cases, revenues are high enough to cover not only operating expenses and interest charges, but also "non-cash" depreciation expenses as well. These revenues can be used to fund ongoing capital improvements. In addition, regulated telephone companies typically have relatively easy access to the capital

[91] Of course, if the cost-of-service rate established for the operator included the costs of the upgrade, in the form, for example, of a "known and measurable" adjustment to rate base, additional recovery would not be allowed.

markets, so that long-term debt or additional equity infusions can be obtained, if needed, to provide for major capital outlays.

These financing options are often not available to cable companies. In some cases, after paying operating expenses and interest charges, little or no cash is available to reinvest in the business. Access to capital markets will also be quite limited in many cases, due both to the inherent riskiness of the cable business and the extremely high leverage of most cable firms. In many cases, therefore, the only realistic source of funds to pay for a system upgrade is increased revenues, which will either fund the upgrade directly or be committed to repaying new debt obtained for that purpose.

This reality cannot easily be squared with the typical approach to rate regulation. Generally, the regulated firm is not allowed to obtain revenues relating to plant until that plant is actually placed into service.[92] But if the only way the plant can be financed is through additional revenues, a strict adherence to this rule would mean that cable plant expansions and upgrades which are fully justified economically will never get built.

Moreover, some franchising authorities have imposed significant requirements to upgrade existing cable systems, either as part of a franchise renewal process or otherwise.[93] Unless there is realistic assurance that sufficient revenues will be available to cover the

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[92] ***Cost-of-Service Order*** at ¶ 106.

[93] For example, the New York State Cable Television Commission has imposed wide-ranging system upgrade requirements on cable operators subject to its jurisdiction.

costs of these mandated upgrades, cable operators are in danger of being prevented by the operation of the Commission's rules for rate regulation from fulfilling these obligations.

The 1992 Cable Act permits the Commission to allow a different result. Nothing in the Act compels the Commission to literally apply the normal rules applicable to regulated utilities, even within the context of a cost-of-service option.[94] To the contrary, one of the explicit goals of the Act is to encourage the expansion and development of cable systems where such expansion and development is economically justified.[95]

In order to fully effectuate this goal, the Commission's final cost-of-service rules should provide that cable operators may receive rate increases (or avoid rate decreases) in order to fund planned system upgrades and expansions. This opportunity should be available in both full cost-of-service cases and in a streamlined proceeding relating solely to the costs of the upgrade itself.[96]

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[94] "The legislative history of the Cable Act of 1992 indicates a congressional preference that the regulatory framework we adopt for governing cable rates should not closely mirror common carrier regulation. 'It is not the Committee's intention to replicate Title II regulation. ...' House Report 102-628 at 83. ... Our cost-of-service requirements will not replicate Title II regulation." ***Cost-of-Service Notice*** at ¶ 15 n.16.

[95] ***Cost-of-Service Notice*** at ¶ 9 & n.12, ***citing, e.g.,*** 1992 Cable Act, § 2(b)(3).

[96] A cable operator requesting a rate increase in these circumstances should be required to submit a proposed schedule for implementing those increases. We note that it has been common practice in the industry for cable operators in the course of a system upgrade to begin charging a higher rate any one customer at the time that individual customer begins receiving the additional services from the upgraded plant. In some cases, however, operators may need to implement a rate increase sooner in order to obtain funding commitments.

A cable operator seeking a rate increase to fund a planned system upgrade would be required to explain the scope and timing of the planned upgrade, and rate increases would be allowed only for upgrades for which specific near term plans (for example, within the next two years) have been made, or for which regulatory requirements exist. The rate increase could be timed to correspond with the beginning of construction or until the operator obtains a loan to finance the construction. The cable operator would be required to make periodic reports on the progress of its upgrade planning and deployment to ensure that the additional revenues were, indeed, being used for their intended purpose. Finally, the additional revenues would be subject to refund if the operator were to fail to actually implement the required upgrade.

With these safeguards in place, the public interest would be served by allowing a rate increase to be implemented. Current customers might pay somewhat more than they would under a regime of strict, year-by-year cost-based rates, but this would only be true for the relatively short time (perhaps two years) that the plant was not yet in service. This relatively short time frame indicates that the current customers who would pay a bit more, and the future customers who would benefit from the new plant, will, by and large, be the same customers.[97] Moreover, because some upgrades will be delayed or cancelled if funds from rate increases are not available, it would significantly advance one of the purposes of the 1992 Cable Act to allow rate increases to be implemented in these circumstances.

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[97] The Commission has already concluded that the Cable Act does not require an exact fit between the customers who bear a burden in one period and those who receive a benefit in a later period. ***See*** 47 C.F.R. § 76.961(c) (rate refunds need not be made to specific customers who paid rates found to be excessive, but may, instead, be made to the affected ***class*** of customers).

Large utilities, such as telephone companies, avoid this entire problem by averaging their rates over a wide area. Viewed as individual assets, one or more telephone switches may be fully depreciated, with correspondingly low or non-existent capital costs, while other switches, newly placed, have high capital costs. Under the logic applied to cable companies, the telephone company customers served by the fully depreciated switches are paying too much, while the customers served by the new switches are paying too little. Yet, in general, telephone company customers do not pay different rates based on the costs of the particular switch that serves them. To the contrary, state regulators and this Commission generally permit (and often require) telephone companies to set rates for their services that are averaged over large regions, such as an entire state or (for interstate services) the entire geographic area served by all the telephone companies in an affiliated group.

A franchise, which is the basic regulatory unit under the Commission's rules, is often a ***smaller*** area than is served by a single head-end, which, for these purposes, is analogous to a single telephone company switch. The Commission should adopt rules that allow cable operators serving a number of franchises to establish uniform, average rates for an entire region or company based on average costs for the affected area. This would facilitate the process of planning and implementing system upgrades that encompass several franchise areas, and, at the same time, greatly reduce the burden of cost-of-service regulation for operators serving multiple franchises.