different possible regulatory responses to this problem, each of which is far superior to that embodied in the interim rules.

1. The Commission Should Allow 100% Of Purchase Price Into The Rate Base.

The simplest and most reasonable approach would be to allow the entire purchase price paid by the current owner of the cable system into the rate base, subject to a specific disallowance of amounts shown to be properly excludable. The standard to be applied in these cases would be the familiar one of whether the current owner's investment in the cable system was prudent at the time the decision to invest was made.

Allowing the entire purchase price is reasonable (absent a showing of imprudence) because the purchase price will include the cumulative earnings shortfall that the prior owners incurred, along with the value of tangible assets. Consider the sale of a cable system from the perspective of the seller. The seller will demand compensation not only for the physical, tangible assets of the system, but also for the reasonable return that has not yet been earned. In arms-length transactions, where the buyer has no interest in anything other than the lowest possible purchase price, that purchase price will reflect the value of the ***actual*** investment by the prior owner in the system, including an allowance of a reasonable, if implicit, market-based return on that investment. An arms-length purchase

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[19](...continued)
a franchise is revoked for cause, cable television systems should be valued at "fair market value, determined on the basis of the cable system valued as a going concern ...". 47 U.S.C. § 547(a)(1). This section was not amended or changed by the 1992 Cable Act.

price, in other words, will give an accurate, market-based snapshot of the actual, total investment the prior owner had made in the cable system. This amount, therefore, should be included as the gross investment in the cable system for the acquiring operator's asset base.[20]

The US Savings Bond analogy discussed above illustrates the point. If a ten-year savings bond has been held for five years, and has five more years to maturity, the owner will not sell the bond for the amount of money originally paid. The owner of the bond has already accrued some value by forgoing the interest while that money was being used by the government. If the owner were to sell the bond to the bank, the bank would pay a premium above the owner's purchase price, depending on how long it has been held. At maturity, the bank will be paid the face amount, reflecting the full ten years' worth of interest. The bank's return, however, will have been partially offset by the amount of accumulated interest it paid the owner when it bought the bond in the middle of its life.[21]

The seller of a cable system has similar expectations. The seller has incurred losses and forgone returns during the development of the system. The seller will not divest the

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[20] In the FCC's rulemaking proceeding regarding cost-of-service issues, Continental Cablevision submitted an analysis comparing its actual investment — including forgone earnings — in a system it had built and operated from inception, and the price it paid for an otherwise generally similar system it acquired much later in the system's life-cycle. ***Comments of Continental Cablevision***, MM Docket No. 93-215 (August 25, 1993) at 14-25. The amount of intangibles at issue in each case, determined using the two different approaches, was very similar, thus demonstrating that a market-based purchase price will approximate the actual investment of the original owner. A copy of this section of Continental's earlier comments is attached to these Comments as Exhibit E.

[21] ***See*** Letter from P. Glist to P. Donovan, ***ex parte,*** MM Docket No. 93-215 (February 14, 1994).

system for merely the cost of the hardware; it must earn a return for the investment in operating the system, and the return forgone during earlier years. This will almost always be a sizeable amount above the hard assets.[22]

The general rule applicable to utilities, under which acquisition-related intangibles are excluded from the rate base, is inapplicable here. The traditional basis for disallowing recovery of intangibles is that when a ***regulated*** utility buys ***regulated*** assets from another regulated firm, customers of the selling firm have already paid rates that include both a return on, and a return of, those assets.[23] This occurs because a regulated utility earns a current return throughout the life of the investment, not only in the later years. Here, the relevant acquisitions took place between ***nonregulated*** entities, and customers have not yet paid a return on or of these assets. The concerns about customers of regulated entities "paying twice" for the same assets, therefore, simply do not arise in the context of cable acquisitions made during the period of deregulation.[24]

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[22] In this regard, the Commission should consider the unrebutted evidence in the record of the rulemaking proceeding that shows it is commonplace for virtually ***any*** firm to be sold, as a going concern, for a price that far exceeds the book value of the firm's hard assets. ***See Comments of Continental Cablevision***, MM Docket No. 93-215 (August 25, 1993) at 36-39. This specifically includes firms with no monopoly power, and, indeed, even firms that are subject to rate regulation that precludes the exercise of any market power they might have. ***See id.***

[23] ***See, e.g., Re Indianapolis Water Co., etc.,*** 75 PUR 4th 643, 658-59 (Ind. Pub. Serv. Comm'n 1986).

[24] As noted in connection with petitions for reconsideration of the interim rules, interpreting the Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460 ("Cable Act of 1992" or "1992 Cable Act"), to provide for the disallowance of amounts actually invested in cable systems ***prior to the Act's passage*** also raises serious questions regarding violation of the constitutional ban on retroactive legislation and rulemaking. ***See, e.g., Landgraf v. USI Film Products,*** ___ U.S. ___, No. 92-257 (April 26, 1994), slip op. at 20; ***Bowen v. Georgetown University Hospital,*** 488 U.S. 204 (1988). ***See also*** Cablevision Industries, Inc.,

(continued...)

2. The Commission Should Determine The Prior Owners' Accumulated Return Deficiency If Adequate Data Are Available.

If the Commission remains concerned that imprudent investment might remain embedded in acquisition prices, an alternative approach may be available. Specifically, in some cases, the new owner of a cable system may have received and retained the prior owners' financial records. Where adequate documentation exists, the Commission should permit the current owner to calculate the accumulated return deficiency associated with the system just as the prior owner would do. As noted above, by selecting a reasonable rate of return to use in such calculations, the resulting accumulated return deficiency will be devoid of monopoly profits, and should be allowed into the rate base.[25]

Moreover, it may be possible to develop a broad enough base of experience with the life-cycles of typical cable systems to be able to make reasonable estimates of the amount of accumulated return deficiency (on a per-subscriber basis) associated with systems at different stages of their life cycles. Generally speaking, experience in the industry suggests that a system just completing the first year of construction will have a relatively high

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[24](...continued)
Petition for Reconsideration, MM Docket No. 93-215 (May 16, 1994) at 16-18. The Commission should generally avoid interpreting its enabling statutes in ways that raise constitutional questions. ***See Bell Atlantic v. FCC,*** Nos. 92-1619 ***et al.,*** (D.C. Cir. June 10, 1994), slip op. ("Within the bounds of fair interpretation, statutes will be construed to defeat administrative orders that raise substantial constitutional questions").

[25] It is conceivable that in a highly unusual case (say, a distress sale by a bankrupt or marginal prior owner), the accumulated return deficiency will be ***higher*** than the purchase price paid by the current owner. If that were ever to occur, it would be appropriate to limit the amount allowed into current owner's the rate base to the actual purchase price.

"hard" asset base and a sizeable initial year loss; a system five years from construction may well have a very high level of accumulated low earnings and losses; and a system that is a dozen or more years from its initial construction will likely have substantially recouped those low earnings and losses. Indeed, the court in ***Sammons, supra,*** described exactly this situation, based on the evidence presented there. This suggests that the Commission could develop or accept evidence of an "average schedule" of accumulated losses for use in cases where underlying records do not permit a specific calculation.[26]

3. The Commission Should Establish A More Appropriate Presumption Based On The Commission's Own Benchmark Analysis.

If data to calculate the accumulated return deficiency associated with an acquired system are unavailable, and no "average schedule" exists, the economic analysis underlying the Commission's benchmark system,[27] combined with some basic facts regarding cable system operations and financing, supports a simple, streamlined presumption that is very different from the presumption in the interim rules. As described below, the average 17% benchmark rate reduction would support a maximum disallowance of acquisition-related intangible assets equal to approximately 34% of the gross purchase price of the acquisition.

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[26] ***See*** 47 C.F.R. § 69.606. ***See also Cost-of-Service Order*** at ¶¶ 331-33; In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, ***Notice of Proposed Rulemaking,*** MM Docket 93-215, FCC 93-353 (released July 16, 1993) (***"Cost-of-Service Notice"***) at ¶ 74 n.78.

[27] ***See generally*** Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, MM Docket No. 92-266, ***Second Order On Reconsideration, Fourth Report and Order, and Fifth Notice of Proposed Rulemaking,*** FCC 94-38 (***"Benchmark Order"***) (released March 30, 1994).

The remaining 66% — comprising both tangible and intangible assets — should be presumptively included in rate base.

Cable system financing is vitally dependent upon cash flow, which is, simply, revenues minus operating expenses, not including depreciation, amortization or financing costs. Cash flow provides the basis for the cable system to repay interest on the debt obtained to purchase the system, and is the primary, if not exclusive, source of funds from which a cable operator may upgrade the system itself. For these reasons, when a cable system is sold, the selling price is typically calculated and negotiated as a multiple of cash flow.[28]

While the circumstances of each individual system will vary somewhat, on average, a cable system's operating revenues generally equal two times its operating expenses. As a matter of arithmetic, this means that cash flow is about one-half of revenues. In these circumstances, an "exogenous" decrease in revenues, not accompanied by a decline in operating costs (***e.g.,*** a rate decrease ordered by a regulator) will result in a dollar-for-dollar

[28] Factors affecting the precise ***multiple*** of cash flow for which a system will sell include the buyer's view of operational efficiencies and improvements that could be added to the system and the buyer's anticipation of significant growth in the subscriber base (whether through population growth, system build-out, or improved marketing and service). ***See*** Millsap Declaration.

decline in cash flow. In percentage terms, therefore, each 1% revenue reduction leads to a 2% reduction in cash flow:[29]

Item	Before	After	% Change
Revenue	$100	$99	-1%
Operating Expenses	$ 50	$50	0%
Cash Flow	$ 50	$49	-2%

It follows that, if the FCC is correct that 17% of cable operator revenue represents monopoly profits, then 34% — but no more than 34% — of cable operator cash flow is similarly "tainted." In the case of a cable company acquisition, therefore, because purchase price is based directly on cash flow, 34% of the purchase price — but no more than 34% — might represent monopoly profits.[30]

In these circumstances, the ***only*** presumption regarding acquisition intangibles that is consistent with the Commission's "benchmark" analysis of monopoly profits in cable operator revenues is a presumption that cable operators should be allowed to include 66%

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[29] It is appropriate to use the generally accepted, average ratio of cash flow to revenue for this purpose, because the critical question in the sale of a system is anticipated future cash flows, which can be expected to reflect reasonable averages, rather than a particular system's actual cash flow in one particular year. ***Id.***

[30] Undersigned cable operators and associations do not believe that the FCC has correctly calculated the level of price reduction required to remove purported monopoly profits from cable operators' prices. To the contrary, we believe that the FCC's ***previous*** 10% rate reduction was excessive. The point here, however, is that whatever number the Commission chooses as its appropriate average benchmark reduction, that number likewise establishes a maximum proportion of acquisition price that could reasonably be viewed as "tainted" as well.

of the price paid for a system in the asset base used for ratemaking purposes.[31] Based on this analysis, cable operators should presumptively be permitted to calculate the amount of intangible assets that should be included in rate base so that the sum of gross tangible and intangible assets for the system, as of the date of acquisition, represents 66% of the purchase price.

4. The Special Case Of Acquired Tangible Assets.

The ***Cost-of-Service Order*** states that, in general, a cable operator's tangible assets should be valued at "original cost" for purposes of determining the operator's rate base.[32] For these purposes, "original cost" means, essentially, net book value, ***i.e.,*** the gross investment in the plant, minus depreciation, plus any capital additions.[33] The Commission recognized, however, that in the case of systems acquired from a prior owner, the cable operator may not be able to reconstruct the original cost of the plant. In those cases, the operator may use the value of the system's tangible assets as recorded on the operator's books in connection with the acquisition as an estimate of original cost, subject to certain conditions.[34] For the reasons described below, the Commission should revise its permanent

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[31] The current presumption in the interim rules, therefore, is plainly unreasonable The courts have not hesitated to reverse the FCC's establishment of a presumption that cut a broader swath through the costs of regulated firms than the policies underlying the presumption would justify. ***See Mountain States Tel. & Tel. Co. v. FCC,*** 939 F.2d 1021 (D.C. Cir. 1991); ***Mountain States Tel. & Tel. Co. v. FCC,*** 939 F.2d 1035 (D.C. Cir. 1991).

[32] ***Cost-of-Service Order*** at ¶¶ 53-67.

[33] ***Id.*** at ¶ 45.

[34] ***Id.*** at ¶ 64.

cost-of-service rules to allow operators to use tangible asset values recorded in connection with an acquisition as the "original cost" of those assets.

Generally Accepted Accounting Principles (GAAP) require that an acquired cable system's tangible assets be recorded on the acquiring operator's books at fair market value. For this and other reasons, an operator acquiring a cable system will generally have the value of the system appraised in connection with the transaction in order to ascertain the fair market value of those assets.[35]

In these circumstances, the amount recorded on an operator's books in connection with acquired tangible assets is, simply, the price the operator actually paid for those assets. In other words, that amount represents ***the current operator's*** "original cost," and should be allowed into the operator's rate base. At least for acquisitions that took place before the effective date of the interim cost-of-service rules, there is little to be gained by trying to go beyond this simple and straightforward approach.[36]

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[35] This process also results in an allocation of the purchase price as between tangible and intangible assets: whatever portion of the purchase price is not identified as relating to tangible assets is perforce allocated to intangible assets, with the intangible assets often categorized in various ways based on a number of factors, such as relevant classifications under then-current state or federal tax laws.

[36] The general rule that rate base assets transferred from one regulated utility to another will be allowed into the acquiring utility's rate base at the selling utility's net book cost has no application here, because neither the selling cable operator nor the acquiring cable operator were regulated utilities at the time of the relevant transactions.

Moreover, as a policy matter, the fair market value of the tangible assets as of the date of the acquisition will likely be a more accurate representation of the true "original cost" of the assets than would any amount calculated based on the selling operator's financial records. Cable operators have never had depreciation lives prescribed for their plant. As a result, there is a fair degree of variability, within the constraints imposed by GAAP, in the rates at which different operators depreciate different classes of plant.

Despite this variation, the basic principle underlying depreciation is that the value of an asset declines over time. If depreciation could be calculated perfectly, each year's depreciation charges would exactly reflect the amount by which the asset's value has declined that year, so that at any point in time, the net book value of the asset would exactly equal its true value in the market.

As a result, when an acquired asset is placed on the acquiring operator's books at its fair market value, the operator is recording the value of the asset at its ***true*** "original cost," ***i.e.,*** an amount equal to the original owner's purchase price minus the ***actual*** amount by which the asset's value has declined over time. For regulatory purposes, therefore, the appraised fair market value of acquired tangible assets better implements the policy underlying reliance on an "original cost" rate base than does relying on the books of the operator from whom the assets were acquired.

In these circumstances, the Commission should amend its cost-of-service rules to generally allow operators to include in their rate bases the amounts they paid, at arms-

length, for tangible assets, whether acquired from vendors or from another cable operator, and, in the latter case, whether or not the financial records of the selling operator are available.[37] In addition, where the selling operator's financial records are not available, the Commission should simply allow the recorded value of the tangible assets to be included in the rate base without requiring any special studies, analyses or justifications.[38]

5. In Any Event, The Commission Should Allow Cable Operators To Amortize Any Portion Of Their Actual Investment That Is Disallowed.

In the original Notice of Proposed Rulemaking in this matter, the Commission suggested that if substantial amounts invested by current system owners in acquired cable systems were not allowed into rate base, rates might nevertheless be set to include the cost of amortizing those disallowed investments over a reasonable period of time.[39] The Commission did not include an allowance for such amortization in the interim rules.[40] Undersigned cable operators and associations respectfully request that the Commission establish a permanent rule that cable operators will be permitted to include, in their cost-of-

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[37] Consistent with the usual rule regarding transactions among regulated utilities, the Commission could reasonably limit the application of this approach to assets acquired from other operators prior to the Commission's decision, in the ***Cost-of-Service Order,*** to rely on an original cost rate base for regulated cable services.

[38] ***See Cost-of-Service Order*** at ¶ 64. In this regard, it is hard to see, in practical terms, how an operator in an individual case could provide information of the sort apparently contemplated by the ***Cost-of-Service Order.*** In the case of acquired assets, the best available information regarding their "original cost" will almost certainly be an appraisal of their value as of the date of the acquisition, and this is what the acquiring operator will have recorded.

[39] ***Cost-of-Service Notice*** at ¶ 41.

[40] ***Cost-of-Service Order*** at ¶¶ 96-97.

service calculations, amortization of any acquisition-related intangible assets or accumulated losses/low earnings not allowed into the rate base.

There is long-standing precedent for handling a situation where a regulated utility has made reasonable investments that regulators later conclude is not used and useful. In those cases, regulators often allow the firm to amortize the investment, but not to earn a return on it. For example, this approach is often used to deal with the costs involved in studying, planning, and, in some cases, even constructing power generating capacity that proved not to be needed in light of changes in demand or for other reasons.[41]

Here, there can be no question that cable operators made their business decisions regarding acquisitions in reasonable reliance on the legal and regulatory climate that existed when the acquisitions took place. After the 1984 Cable Act, that legal and regulatory climate was quite unrestricted, and operators enjoyed a great deal of operating flexibility. Public policy at the time encouraged growth of cable systems, and limited the degree to which either federal or local regulatory authorities could regulate the prices charged by those systems. There was nothing unreasonable, unfair, or imprudent in decisions by cable operators to make system acquisitions on the basis of this policy. To the contrary, the market inevitably, and appropriately, reflected this reality. In fact, penetration grew even as rates increased, presumably due to the increased value of cable services.

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[41] ***See, e.g., Duquesne Light Co. v. Barasch,*** 488 U.S. 299, 302-05 (1989) (Pennsylvania PUC allowed amortization of such costs before doing so was expressly barred by statute).

In focusing on whether acquisition prices paid by current system owners might include "capitalized" monopoly profits, the Commission appears to have lost sight of the fact that the current owner of an acquired system has not earned ***any*** such profits, and will not do so even if the full purchase price paid for a system is allowed into the rate base. To the contrary, the current owners of such systems have put up new capital (whether from lenders or equity investors) for the systems.[42] If "capitalized" monopoly profits have been obtained, therefore, they have been obtained by the ***prior*** owners of the system. The rationale for subjecting current system owners to unreasonably low earnings on their actual investments because the ***prior*** owners might have received a high return — consistent with then-current public policy — is obscure at best.

In these circumstances, to the extent that any portion of acquisition-related intangible assets are excluded from a cable operator's rate base, the Commission should expressly permit the operator to amortize the excluded portion over a reasonable period of time.[43] This approach will reasonably balance the interests of operators and customers, and at the

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[42] ***Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n, supra,*** 262 U.S. 277, 290 (1922); ***Democratic Central Committee v. Washington Metro Area Transit Commission, supra,*** 485 F.2d 786, 801 (D.C. Cir. 1973).

[43] An amortization period of no more than ten to fifteen years from the date of the acquisition would not be unreasonable. The appropriate portion of the unamortized balance of acquisition-related intangibles on an operator's books would be removed from the rate base, but would be amortized to expense for ratemaking purposes over a period ending between ten and fifteen years from the year of the acquisition.

same time reduce the risk that the cost-of-service rules will be found to constitute an uncompensated confiscation of property under the Fifth Amendment.[44]

II. THE COMMISSION SHOULD CLARIFY THE TREATMENT OF CERTAIN COST ALLOCATION ISSUES.

A. The Commission Should Establish Certain Guidelines For The Allocation Of Plant and Related Costs Among Service Baskets.

The Commission stated in the ***Cost-of-Service Order*** that it would take a flexible approach to cost allocation issues, as long as the operator complies with key principles set out in the ***Order***.[45] The Commission should clarify that this flexible approach will continue under the permanent rules.[46] It would also greatly improve the operator's ability to assess the reasonableness of their rates under cost-of-service principles for the Commission to indicate, in advance, that one or more approaches to allocating costs are reasonable.

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[44] ***See, e.g.,*** Comcast Cable Communications, Inc., Petition for Reconsideration, MM Docket No. 93-215 (filed May 16, 1994), ***passim; Bell Atlantic v. FCC, supra.*** In this regard, the Commission's suggestion that exclusion of significant investment amounts from the rate base can be reflected in the allowed reasonable rate of return is illusory. ***See Cost-of-Service Order*** at ¶ 61. If acquisition-related intangibles represent 50%, or even 75%, of purchase price — not unrealistic percentages — then the overall allowed after-tax return would have to be increased to a figure in the range of 25% to 50% to make up the difference. While the Commission has broad discretion regarding establishing a reasonable allowed return, it seems unrealistic to expect that figures of this magnitude would ever be adopted.

[45] ***Cost-of-Service*** Order at ¶ 240.

[46] This is important because the instructions to Form 1220 can be read to impose particular approaches to certain cost allocation issues, especially in connection with the allocation of costs among different corporate levels.

One key issue is how to allocate the costs of cable plant, and related maintenance and depreciation costs, among service baskets. The Commission should specify that one acceptable method of allocation is "weighted channels," with weighting performed on the basis of the number of households subscribing to the service at issue. As described below, this approach — which closely tracks that used in the original Form 393 and, in some cases, the Form 1200 as well — is reasonable and usage-based. It also represents a fair middle ground between a strict "cost causation" analysis and a simplistic capacity-based allocation that takes no account of the usage of the system.

A strict "cost causation" approach, while justified from a business and economic perspective, would lead to the vast majority of a cable operator's plant and related costs being assigned to the basic service category. This is because the key purpose of building cable plant in the first place was to serve basic service customers and to make basic services available to those customers. This business reality is reflected directly in the Cable Act of 1992: cable operators are ***required*** to offer a basic tier of service, and it is the only tier of service that they may require all customers to buy.[47] Moreover, looking at the development of the cable industry as a whole, the provision of the most "basic" of basic tier services — improved signal reception of existing over-the-air channels — has at many points in the history of the industry played a major role in its growth. Applying this principle, the only plant and plant-related costs that would be allocated to the CPS tiers and to other activities would be those costs that are specifically needed to provide those other services.

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[47] Cable Act of 1992, § 3(b)(7).

At the other extreme would be a cost allocation methodology that utterly ignores both the reasons that cable plant was built and the operator's reasonable expectations regarding the usage of the plant, and myopically focuses on notions of theoretical plant capacity. From this perspective, a channel that is activated for pay-per-view events for a few hours a day to be viewed by a small fraction of subscribers is just the same as a channel that is constantly sending programming to every subscriber to the system. Such an approach would grossly over-allocate costs to the channels with lower levels of usage.

Weighting channels by subscribing households strikes a reasonable, usage-based middle ground between the two extreme cost allocation approaches just outlined. It uses the number of subscribing households to the various categories of service as an indirect measure of the usage of the system by subscribers, and the number of channels on each tier as a measure of "raw" capacity which could be, but need not be, used. Each category of service is then allocated its share of plant and related costs based on this measure. By taking account of both the number of channels and the penetration on each type of service, this system of cost allocation represents a reasonable measure of the capacity of a system devoted to a particular type of service. As a result, it represents a reasonable measure of the causal basis on which system costs were incurred.[48]

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[48] In this regard, a weighted channel approach is similar to the usage-based allocators used to separate the costs of local exchange carrier operations as between the state and federal regulatory jurisdictions. ***See*** 47 C.F.R. § 36.1(c) ("The fundamental basis on which separations are made is the use of telecommunications plant in each of the operations.")

B. The Commission Should Clarify The Definition of "Excess" Capacity.

The interim cost-of-service rules call for the exclusion from the rate base of plant that represents excess capacity, except that plant that will be used and useful within a year will be allowed.[49] As described below, there is a situation that is sometimes termed "excess capacity" in the cable industry that cannot reasonably be treated under that rubric for ratemaking purposes.

When a cable operator has undertaken a system upgrade, the distribution system may be technically capable of handling a greater number of channels than have actually been activated. This will often occur because the cost of the head-end electronics required is often very high on a per-channel basis. For example, an upgrade of an older-technology 36-channel system, for example, may make it technically possible for the operator to provide 80 channels of programming, but only 60 may be initially activated. While the theoretical unactivated channels may sometimes be called "excess," it would be arbitrary and unreasonable in this situation to fail to include 100% of the cost of the cable plant in the operator's asset base to be allocated among current actual uses of the plant.

The reason is that, in this situation, 100% of the deployed plant is "used and useful." Those facilities are energized and carrying programming twenty-four hours a day, seven days a week, three hundred and sixty-five days per year. While the cable operator might in the future decide to offer additional programming, this does not change the fact that ***all***

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[49] ***Cost-of-Service Order*** at ¶¶ 116-17.

of the plant is being used to provide service ***all*** of the time today. Based on that usage, an appropriate portion of the plant can be allocated to the various service baskets the Commission has established. This prudently deployed, used and useful plant may not reasonably be disallowed, either in terms or in effect (by, for example, an artificial or arbitrary cost allocation scheme).[50]

Additional support for this conclusion comes from the regulatory treatment of analogous telephone company plant, ***i.e.,*** the local loops that connect customers with telephone company local exchange switches. Most of the time, local loops do nothing at all, because most of the time people are not making or receiving telephone calls. Moreover, with technology now available for installation, telephone companies could more than double the capacity of their local loops by converting them to Basic Rate Access Integrated Services Digital Network links.[51] Yet no regulatory body of which we are aware has ever concluded that the amount of telephone company local loop investment allowed into the rate base should be reduced to reflect either the generally idle state of those loops or the fact that when they operate, they do so at only a fraction of their theoretical capacity based on

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[50] Of course, if additional channels are activated for either regulated or non-regulated services, the usage-based allocation of plant costs would change.

[51] A Basic Rate Access Integrated Services Digital Network link has the capacity to handle two simultaneous voice-grade telephone calls, along with a simultaneous 16-kilobit per second data channel as well. ***See*** In the Matter of Petition to Amend Part 68 of the Commission's Rules to Include Terminal Equipment Connected to Basic Rate Access Service Provided via Integrated Services Digital Network Access Technology, etc., ***Notice of Proposed Rulemaking***, CC Docket No. 93-268, FCC 93-484 (October 22, 1993) at ¶ 2.

available technology.[52] It would also be unreasonable to impose an effective disallowance by presuming that the currently unused theoretical capacity will be used for non-regulated activities.

Finally, it would fly in the face of other goals of the Cable Act of 1992 to fail to allow the full cost of a high-capacity cable system into the current asset base that will be allocated among current uses of the plant. If cable operators are penalized in rates for deploying plant that can be made to carry more signals than are needed to meet today's demand, then operators will delay or avoid deploying such plant. This will deprive customers of new and innovative services, as well as improvements in the quality and scope of existing regulated offerings. This result is clearly contrary to the purposes of the Act, and the Commission should take pains to avoid it.[53]

For these reasons, the undersigned operators and associations respectfully request that the Commission clarify that 100% of energized plant that is actually used to send signals to customers is actually use, or will be used within one year, for purposes of determining an operator's rate base. The Commission should also clarify that all of this

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[52] Also consistent with telephone company practices, the Commission should allow cable operators to include in rate base a reasonable level of spare capacity that can be activated in the event of a malfunction or failure of existing plant, and in reasonable anticipation of demand growth. In this regard, the labor and related costs of actually deploying certain distribution plant so far exceed the cost of the marginal coaxial cable or optical fiber that it would often be ***imprudent*** for a cable operator ***not*** to deploy spare capacity, even if it will not likely be used within a year.

[53] ***See*** Public Interest Petitioners, Petition for Expedited Reconsideration, MM Docket No. 93-215 (filed May 16, 1994) at 6-8.

"used and useful" plant must be allocated among regulated and unregulated service baskets based on a reasonable measure of the current usage of that plant.

C. The Commission Should Clarify The Treatment Of Certain Revenues.

Unlike costs, it is generally a simple matter to directly assign the revenues a cable operator receives to the appropriate service basket. Basic service revenues go to the BBT basket, CPS revenues to the CPS basket, and so on. In at least three situations, however, there might be some question as to the appropriate assignment of revenues: advertising revenues, home shopping commissions, and revenues from the publication and sale of Cable Guides.

The Form 1220 instructions indicate that revenues received from the placement of advertising on a regulated tier should be allocated to that tier and used as an offset to the costs of providing that tier of service.[54] A similar instruction suggests, without stating explicitly, that the same treatment should apply to commissions a cable operator receives from home shopping channels included on a regulated tier.[55] For the reasons described below, these revenues should generally be assigned to the non-regulated "Other Cable Activities" category.

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[54] ***See*** FCC Form 1220 at 14 ("Line 51—Advertising").

[55] ***See id.*** ("Line 52—Other Cable Revenue Offsets").

Cable operators are under no obligation to carry any advertising of their own (as opposed to advertising contained in broadcast signals obtained from others, and from which the cable operator derives no revenue). Cable-specific advertising represents an improved customer service, because advertisers are better able to reflect the likely interests and needs of cable subscribers in cable-specific advertisements. This is true for all advertisements placed on cable systems, and particularly true for advertisements that are unique to an individual cable system.

Cable operators provide this service to consumers and advertisers because it is profitable to do so. If the sole result of providing this service in the cost-of-service context is lower rates on the regulated service tiers on which the advertisements are run, then the only logical course from a business perspective is to discontinue the service. Cable operators, advertisers, and consumers will all be worse off if this occurs. It also provides a video outlet for small businesses that cannot afford broadcast television advertising rates, or whose potential customer base is so local that broader advertising money would be wasted. The local spots are also increasingly used by political candidates for local, state and congressional offices who benefit from cable's narrow-casting feature. Subscribers, in turn, benefit from the additional information that is unavailable from other sources.

The situation is even clearer with regard to the treatment of commissions a cable operator receives from home shopping services. If the effect of using a valuable channel slot for a home shopping service is to reduce the cable operator's regulated rates from the level that would result if some other service were offered, that will create a strong

regulatory disincentive to carrying home shopping services. The public interest would not be served by creating such a disparity among programmers.

Assigning such revenues to the non-regulated "OCA" category is also consistent with the Commission's recent clarification of the treatment of home shopping revenues and advertising in connection with the calculation of external costs.[56] Advertising revenues, for example, are simply disregarded in the Form 1210 calculations. That Form is applicable in both the benchmark and cost-of-service regimes, and consistency suggests that the same methodology used for measuring costs on that Form be used in both regulatory contexts. In this case, that means that both home shopping commissions and advertising revenues should be allocated to a nonregulated category.

The situation regarding Cable Guides will be subject to more variation. The Cable Guide is a magazine-style publication, usually updated monthly, that lists the offerings on a cable system. In some cases, operators give the Guide away at no additional charge to all customers. In other cases, it is provided at no additional charge for premium (unregulated) service customers, but all other customers are charged to receive a copy. In other cases, only those customers who pay for the Guide receive it. In still other cases, cable operators make arrangements with local newspapers to carry complete listings of cable offerings, and do not publish a Guide at all.

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[56] ***See Letter of Clarification to QVC, Inc.*** (released May 9, 1994); ***Letter of Clarification to Home Shopping Network*** (released May 9, 1994); ***Letter to Disney Channel*** (released May 24, 1994).

There is no single, correct answer to the treatment of Guide costs and revenues that applies to all of these circumstances. As a result, the Commission should allow cable operators to treat those costs and revenues in a cost-of-service presentation in the manner that is most appropriate to the facts of a particular case.

III. THE COMMISSION SHOULD CLARIFY CERTAIN ISSUES RELATING TO THE ALLOWANCE FOR INCOME TAXES.

A. Calculation of the Allowance for Taxes — Hypothetical Capital Structure.

The ***Cost-of-Service Order*** correctly recognizes that cable operators should be allowed to include in their rates an allowance for income taxes on the equity portion of the overall allowed return on rate base.[57] The ***Cost-of-Service Order*** also correctly recognizes that the tax allowance should be calculated on the basis of the combined state and federal corporate tax rate.[58] The ***Order,*** however, is silent as to the appropriate capital structure to use in determining the cable operator's pro forma tax liability.

In order to avoid an illogical mismatch among different aspects of the overall ratemaking equation, the capital structure used to set the regulated firm's rates must be used consistently throughout the analysis. As a result, where regulators set rates on the basis of a hypothetical capital structure, it is necessary, in connection with the calculation of pro forma taxes, to adjust the regulated firm's actual interest expense to a level that corresponds

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[57] ***Cost-of-Service Order*** at ¶ 139.

[58] ***Id.***

with the interest expense the firm ***would*** incur if the hypothetical capital structure represented its actual capitalization. This conclusion is consistent with the treatment of taxes in traditional utility regulation.[59]

Here, the Commission has established an interim overall rate of return of 11.25%, based on an assumed debt cost of 8.5%, and a set of hypothetical capital structures ranging from 40% debt to 70% debt.[60] In its permanent rules, the Commission should select a single, reasonable hypothetical capital structure for use in assessing cable operator's overall cost of capital and for use in calculating the allowance for taxes in rates. Undersigned cable operators and associations suggest that a 50% debt ratio be used for both of these purposes. This suggestion is based on the Commission own suggestion of an appropriate capital structure for cable operators in the Notice of Proposed Rulemaking leading up to the Cost-of-Service Order.[61]

Alternatively, cable operators should be allowed to calculate their pro forma tax allowance based on system-specific data that allow the calculation of a system-specific capital structure. For example, a cable operator should be permitted to construct an estimate of an "actual" debt ratio, based on the actual equity infusions the system has

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[59] ***See, e.g., Citizen's Utilities Co. v. Idaho PUC,*** 739 P.2d 360 (Idaho 1987).

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

[61] ***Cost-of-Service Notice*** at ¶ 49 n. 51. The Commission should, however, continue to allow operators to challenge the presumption in individual cases, including cases where an operator, contrary to typical industry experience, is either not highly leveraged, or not leveraged at all. In those cases, reliance on the operator's actual capital structure, and, if applicable, actual debt cost, with a corresponding revision in the overall allowed return, would be appropriate.

received over the course of its operations, compared to the amount of debt outstanding. This approach to estimating capital structure would reasonably reflect the debt and equity that have actually been used in the system, but avoids the accounting conundrum arising from the fact that a cable operator's books show a ***negative*** retained earnings figure.[62]

The FCC's rules and the ***Cost-of-Service Order*** are silent on this aspect of the proper calculation of the pro forma tax allowance. The instructions for Form 1220, however, suggest that a cable operator should calculate its pro forma tax allowance on the basis of its ***actual*** interest expense, even though a ***hypothetical*** capital structure was used to determine the overall after-tax return.[63] As noted above, this would create a "mismatch" in the ratemaking calculations. The FCC, therefore, should clarify in its permanent rules that cable operators should adjust their actual interest expense to reflect the hypothetical capital structure used to set the overall allowed return.

B. Calculation of the Allowance for Taxes — Special Considerations for Partnerships and Subchapter S Corporations.

The Commission's interim rules regarding calculating the allowance for income taxes by subchapter S corporations, partnerships, and sole proprietorships are also in need of revision. Although the interim rules correctly recognize that operators using these forms of legal organization should be treated like the subchapter C corporations more common

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[62] That figure is negative, of course, because the normal accounting treatment of losses in any particular year is to charge them against retained earnings and start the new year, from an income statement perspective, with a "clean slate."

[63] Form 1220, Instructions at 5 (lines 3a through 3h).