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JUL - 1 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, D.C. 20554**

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| In the Matter of | ) | |
| | ) | |
| Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation | ) | MM Docket No. 93-215 |
| | ) | |
| and | ) | |
| | ) | |
| Adoption of a Uniform Accounting System for Provision of Regulated Cable Service | ) | CS Docket No. 94-28 |

**COMMENTS OF**
**<u>THE NATIONAL CABLE TELEVISION ASSOCIATION, INC.</u>**

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July 1, 1994

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**COMMENTS OF**
**THE NATIONAL CABLE TELEVISION ASSOCIATION, INC.**

The National Cable Television Association, Inc. ("NCTA"), by its attorneys, hereby submits its comments in response to the Commission's Further Notice of Proposed Rulemaking in the above-captioned proceeding.[1] NCTA is the principal trade association of the cable television industry in the United States. Its members include owners and operators of cable television systems serving over 80 percent of the nation's approximately 59 million cable television households, as well as cable television program networks, cable equipment suppliers, and others interested in or affiliated with the cable television industry.

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1 Report and Order and Further Notice of Proposed Rulemaking in MM Docket No. 93-215 and CS Docket No. 94-28, FCC 94-39, released March 30, 1994 ("Further Notice").

## I. INTRODUCTION AND SUMMARY

In the Report and Order in the above-captioned proceeding, the Commission took a number of significant actions as part of its implementation of the rate regulation provisions of the Cable Television Consumer Protection and Competition Act of 1992 (the "Cable Act"). In particular, it adopted (1) "interim" cost-of-service rules which cable operators could use to justify their rates as an alternative to the benchmark and price cap methodology; (2) accounting and cost allocation requirements (including affiliate transactions rules) to govern cost-of-service showings; and (3) an experimental "Upgrade Incentive Plan."[2] A number of these decisions are currently the subject of Petitions for Reconsideration.[3] The Commission's decisions are also the subject of Petitions for Review in the United States Court of Appeals for the District of Columbia Circuit.[4]

The Further Notice in this proceeding sought comment on a number of proposals. First, and perhaps most significantly, the Commission sought comment on a proposed "productivity offset" to be incorporated into the cable

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[2] Report and Order and Further Notice of Proposed Rulemaking in MM Docket No. 93-215 and CS Docket No. 94-28, FCC 94-39, released March 30, 1994 ("Report and Order").

[3] See Petitions for Reconsideration filed May 16, 1994 by (1) Comcast Cable Communications, Inc. ("Comcast Petition"), (2) Cablevision Industries, Inc. ("CVI Petition"), (3) Bend Cable Communications, Inc. et al. ("Bend Petition"); and (4) Media General Cable of Fairfax County, Inc. ("Media General Request"). See also Response of Continental Cablevision, Inc., Benchmark Communications, L.P. and CableSouth, Inc. to Petitions for Reconsideration of Comcast Cable Communications, Inc., et al., filed June 16, 1994 ("Continental Response").

[4] See e.g. Continental Cablevision Inc. v. FCC, Case No. 94-1443, filed June 14, 1994, Armstrong Holdings, Inc. v. FCC, Case No. 94-1383, filed May 13, 1994, and Viacom International, Inc. v. FCC, Case No. 94-1447, filed June 14, 1994.

price cap calculations -- a proposal which has created an undeniable cloud over the cable industry and the cable investment community. The Commission proposed the offset despite its earlier decision not to adopt one because of "the paucity of information in the record that would provide a basis for determining productivity in the cable industry." Further Notice at ¶ 315. The Further Notice proposed a two percent productivity offset for non-programming costs. Id. at ¶¶ 314-323.

As the Commission has apparently come to recognize, such a telephone company-derived offset is inappropriate for the cable industry which is not a utility. Moreover, there was -- and is -- no evidence supporting imposition of a two percent productivity offset. One reason for the paucity of information is that "productivity" is difficult to measure in the context of the cable industry. Indeed, as shown herein, to the extent "productivity" in the cable industry can be measured at all, the data provide no evidence to support a two percent -- or any other -- positive productivity offset. Accordingly, the available data indicate that there is no basis for applying the proposed productivity offset to the cable price cap calculation. For these reasons, the Commission should promptly sever this issue from this proceeding and terminate consideration of a productivity offset for the cable industry.

Second, the Commission requested comment on whether its interim cost-of-service rules should be made permanent. While it specifically sought comment on its establishment of 11.25% as an interim overall rate of return for use in cable cost-of-service proceedings, the entire interim cost-of-service regime was to be the subject of comment. Id. at ¶ 305. As discussed below and in the Petitions for Reconsideration filed by cable industry parties, the Commission must revisit and revise the fundamental bases of its cost-of-service decisions. In particular, it must reconsider its decisions (1) to value all rate base assets at original cost and to presumptively exclude from the rate base all acquisition costs in excess of the original cost of the assets; (2) to presumptively exclude from the rate base start-up losses beyond the first two years of operation as well as other intangible assets; and (3) to use a uniform 11.25% rate-of-return for the entire cable industry.

The Commission also must eliminate the "presumptions" against inclusion of certain intangibles in the rate base particularly its requirement that, to rebut those presumptions, operators must show that the resulting rates will not exceed levels in purportedly "competitive" markets. As we note herein, the Commission's determination of what are "competitive" levels is fundamentally flawed, which renders the "presumptions" based on those purportedly "competitive" rate levels meritless.

Third, the Commission set forth in Appendix C to the Further Notice a draft uniform accounting system for cable operators on which it sought comment, while indicating that it expected to conduct meetings with interested parties and eventually issue a Second Further Notice on a revised proposal. The Commission noted that the proposed uniform system was adopted from the USOA for Class B telephone companies contained in Part 32 of the Commission's Rules, and from NARUC model cable accounting rules. The Further Notice also sought comment on, inter alia, whether small systems that elect cost-of-service regulation should be required to maintain their books in accordance with the accounting system adopted for cable and on the appropriate "accounting requirements" for cable operators seeking rate adjustments due to changes in their external costs under the benchmark/price cap approach. Id. at ¶¶ 306-309.

NCTA looks forward to working with the Commission on these issues but urges the Commission to revisit its determination to impose a complex, uniform, telco-derived USOA on the quite different and diverse cable industry, which already maintains its financial records according to GAAP. In this regard the Commission must offer the cable industry the maximum flexibility in organizing its accounts. At a minimum, small systems and systems not electing cost-of-service should not be required to adopt a cable USOA.

Fourth, the Further Notice sought comment on a permanent Upgrade Incentive Plan and related issues (e.g., enrollment, local-federal coordination). Id. at ¶¶ 324-329. Because the Commission's experimental Upgrade Incentive Plan has just been adopted and there is no track record on which to base permanent rules, NCTA urges the Commission to refrain from adopting rigid rules for a permanent plan until it has gained meaningful experience under its experimental plan. Moreover, any rules adopted must not restrict in any manner the ability of cable operators to recover the full costs of network upgrades or inhibit the upgrading of their networks. Flexibility -- combined with the certainty that investments will not be eventually made worthless -- should be the touchstone of the Commission's Upgrade Incentive Plan.

Fifth, the Commission indicated its intention to initiate a number of cost studies, one purpose being the creation of industry-wide average cost schedules for use in setting rates for regulated equipment and cable service. The Further Notice requested comment on whether average cost schedules should be available to all operators or only small systems. Id. at ¶¶ 330-334. As discussed below, the Commission should permit -- but not require -- all systems to take advantage of average cost schedules once they are developed. In developing those schedules, and in conducting cost studies, the Commission should do so in a manner that is least intrusive into the daily affairs of the subject cable systems, by, for example, limiting the cost studies to selected companies or types of companies, rather than imposing them on the entire industry.

Finally, the Commission sought comment on a revision of its just-adopted rules governing affiliate transactions in the cable industry, which were based on similar rules for the telephone industry. The Further Notice observes that revised affiliate transaction rules have been proposed for telephone companies and suggests that similar rules should be applied to cable operators as well. The proposed rules would limit the application of the prevailing company price as a measure of a reasonable price for an affiliate transaction where the "predominate purpose" of the non-cable affiliate in the transaction is to serve non-affiliates. Id. at ¶¶ 309-313. As shown below, there is no reason to impose on the cable industry (which has not even had an opportunity to operate under the just-adopted affiliate transaction rules) rules proposed to be applicable to the quite different telephone industry (with its history of affiliate transaction abuses). The proposed rule should be rejected.

## II. THE COMMISSION SHOULD PROMPTLY ADOPT AN ORDER STATING THAT ITS PRODUCTIVITY OFFSET PROPOSAL IS NO LONGER BEING CONSIDERED

### A. Introduction

The productivity offset proposal in the Further Notice has generated a great deal of concern throughout the cable industry and the investment community. Despite the absence of evidence in the record to support the conclusion that any productivity offset is appropriate for the cable industry, the Further Notice proposed a two percent offset based on one isolated and unsupported statement in one commenter's filing.[5]

Since the release of the Further Notice, it apparently has become clear to the Commission that any productivity offset is inappropriate for the cable industry, just as NCTA argued in its initial comments in this proceeding.[6] Indeed, as Chairman Hundt recently stated: "[L]et me point out that we didn't adopt any such offset in our February decision. I don't know of any reason to adopt it now. This sort of offset is generally found in the regulations of a utility, but cable is not a utility."[7] Commissioner Quello echoed that comment: "I have serious concerns about imposing a productivity offset on an already beleaguered cable industry. The burden of proof from my perspective in this proceeding will be on those commentators

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5 See Further Notice at ¶ 317 and n. 584, citing Comments of the Staff of the New Jersey Board of Regulatory Commissioners in MM Docket No. 93-215, filed August 25, 1993 at 11 ("The GNP-PI should be reduced by a static productivity offset, such as 2%. The productivity offset, such as 2%, is meant to reflect the known benefits of technology improvement occurring in the cable industry.") ("NJ Staff Comments"). See also Comments of the Board of Regulatory Commissioners, State of New Jersey in MM Docket No. 92-266, filed January 27, 1993, at 16 ("New Jersey Comments") ("Further, we would reduce the [GNP-PI] by a static productivity offset, such as 2%. This Board has recently adopted such an approach in the context of a [sic] economic regulation for a local exchange carrier and we believe the Commission should give this type of methodology serious consideration.").

6 See Comments of the National Cable Television Association, Inc. in MM Docket No. 93-215, filed August 25, 1993, at 31-33 ("NCTA Comments"); Reply Comments of the National Cable Television Association, Inc. in MM Docket No. 93-215, filed September 14, 1993, at 18-20 ("NCTA Reply Comments"). Because of the relevance of the previously-filed NCTA Comments and Reply Comments to many of the issues in this proceeding, we incorporate by reference those pleadings into these Comments.

7 Chairman Reed E. Hundt, Speech Before the 43rd Annual Convention and Exposition of the National Cable Television Association, New Orleans, Louisiana, May 24, 1994 at 7 (emphasis added) ("Hundt Speech").

who seek to impose a utility regulatory concept on an industry that simply is not a utility."[8]

What follows is an analysis of the Commission's two percent productivity offset proposal prepared with the assistance of Economists Incorporated ("EI"), consultants to NCTA, and Christensen Associates, experts on business productivity generally and productivity offsets in the utility and common carrier fields specifically. We demonstrate herein that the application of a productivity offset to the cable industry is inappropriate and that there is no evidence in the record for a two percent -- or any other positive -- productivity offset. Even though "productivity" in the cable industry is difficult to measure, all direct or indirect evidence shows that a productivity offset is not warranted for the cable industry. In support of our conclusions we resubmit (as Attachment A hereto) the EI study entitled "Why the Commission Should Not Adopt a Productivity Offset," filed with our earlier comments.[9] We also submit the results of additional research done by EI and Christensen Associates.

Given these analyses, which confirm similar information provided in the initial stage of this proceeding, the Commission immediately should sever the productivity offset issue from this rulemaking proceeding and adopt an order removing the issue from further consideration. Such an action would be consistent with Chairman Hundt's remarks on this issue: "I have taken

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[8] Statement of Commissioner James H. Quello, NCTA Convention, New Orleans, La., May 23, 1994 at 1-2. ("Quello Statement").

[9] See NCTA Comments at Appendix C.

steps to speed up completion of the rulemaking. I don't want concern about this issue to cast a cloud over [cable's] investment prospects."[10]

## B. Background

In July 1993, the Commission solicited comments on whether to incorporate a "productivity offset" in the price cap mechanism for cable operators and whether there is a valid economic basis to assume that "cable service has been, and will be, experiencing efficiency gains."[11] NCTA's initial Comments, buttressed by the EI study, demonstrated that there was no economic basis to require a productivity offset in the rate regulation scheme for the cable industry without an even greater adjustment for price increases to reflect quality improvements. Specifically, the EI study found that the Commission should not adopt a productivity offset for several reasons:

- The proposed productivity offsets were drawn from regulation of interstate telephone rates, and both productivity and price regulation for the cable industry are different from those for the telephone industry;

- There are no government-sponsored measures of productivity for the cable television industry;

- Productivity offsets for the cable industry must account for rapid improvements in the quality of programming and service;

- Reduction of annual inflation increases by productivity offsets was unwarranted based on changes in competitive cable rates between 1986 and 1992; and

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10 Hundt Speech at 7. See also Quello Statement at 1-2 ("One of the major FCC actions should be prompt resolution of the productivity offset issue. . . . The productivity offset proposal looms darkly over the cable industry and results in investment uncertainty.").

11 Notice of Proposed Rulemaking in MM Docket No. 93-215, FCC 93-353, released July 16, 1993, at ¶ 85 ("NPRM").

- Future cable television productivity improvements are likely to be reduced by regulation.

Rejecting (or more accurately, ignoring) this evidence, the Further Notice tentatively proposed to adopt a two percent productivity offset for non-programming costs as part of the benchmark price cap regime.[12] The application of the proposed productivity offset for regulated cable services would be similar to the application of a productivity offset for regulated interstate telephone services under the Commission's telco price cap plan.[13] Each year those regulated cable rates that had already been reduced from September 1992 levels by a full 17 percent would be allowed to be adjusted by an inflation index and productivity offset.[14] Changes in programming expenses would be passed directly through to subscribers, and non-programming costs would be adjusted by a factor equal to the gross national product price index (GNP-PI) less the two percent productivity offset.[15]

At the outset it should be recognized that the arguments advanced in our previous filings regarding the absence of an economic foundation for incorporation of any productivity offset into the rate regulation scheme for the cable industry are equally applicable to the specific proposal for a two percent productivity offset put forward by the Commission in the Further Notice. Therefore, we incorporate by reference our Comments and Reply

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[12] Further Notice at ¶ 320.

[13] See generally, Report and Order and Second Further Notice of Proposed Rulemaking in CC Docket No. 87-313, 4 FCC Rcd. 2873, 2969-3030, 3186-3226 (1989); Second Report and Order in CC Docket No. 87-313, 5 FCC Rcd. 6786, 6792-6801 (1990).

[14] Further Notice at ¶ 321.

[15] Id.

Comments in the initial phase of this docket and attach hereto as Attachment A the study prepared by EI submitted with the initial NCTA Comments.

In addition to the arguments we have previously presented on this issue, (1) the proposed two percent productivity offset has no basis in the record; (2) although subject to limitations, the only direct measurement of cable productivity shows that cable's productivity lags behind that of the economy as a whole and is, in fact, negative, demonstrating that a positive productivity offset is not supported by the available evidence; (3) reduction by a two percent productivity offset of annual inflation increases to regulated rates net of programming expenses is unwarranted based on recent experience with changes in competitive cable rates; (4) a productivity offset for cable television would not be comparable to -- nor should it be based upon -- the offset incorporated in the interstate telephone price cap regulatory scheme; and (5) the benchmark tables and going-forward procedures already account for productivity increases.

### C. The Proposed Two Percent Productivity Offset Has No Basis In The Record.

The Commission erroneously states "[t]he only evidence of record for productivity growth by cable systems appears to be that submitted by New Jersey, supporting a 2 percent productivity offset."[16] Not only did the Commission ignore the comments filed by NCTA on the issue, but also the comments referenced by the Commission, which were submitted by the Staff of the New Jersey Board of Regulatory Commissioners, provide no empirical

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[16] Id. at ¶ 320.

basis for a cable industry productivity offset of two percent, or any other measure. The sum total of the New Jersey "comments" on the productivity offset issue in this docket consists of the following:

> [The] Board's Staff repeats the position of the Board that the GNP-PI should be reduced by a static productivity offset, such as 2%. The productivity offset, such as 2% is meant to reflect the known benefits of technology improvement occurring in the cable industry. The economic benefit of such improvements and efficiencies are fairly passed to the cable subscriber through the productivity offset mechanism. Board's Staff believes that the Commission might adjust this offset, if necessary on a yearly basis, but it should be clearly stated that such an index and offset approach could result in rate decreases and that such decreases are intended.[17]

That "evidence" -- essentially one unsupported, conclusory paragraph -- is hardly sufficient to support the Commission's proposal of a two percent productivity offset.

While basing its proposal on non-existent evidence, the Commission overlooked empirical evidence on productivity growth submitted by NCTA based on data collected by the Commission.[18] This failure to recognize the impact of NCTA's submission is particularly disturbing in light of the statement in the Further Notice that "cable systems should not expect that

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[17] NJ Staff Comments at 11. The Board's Comments (filed in MM Docket No. 92-266) referenced in the NJ Staff Comments merely stated that "we would reduce the [GNP-PI] by a static productivity offset, such as 2%. This Board has recently adopted such an approach in the context of a [sic] economic regulation for a local exchange carrier and we believe the Commission should give this type of methodology serious consideration." New Jersey Board Comments at 16.

[18] See NCTA Comments at Appendix C, attached hereto as Attachment A.

their failure to provide any evidence of cable productivity gains, information they are best able to provide, should justify the conclusion that cable systems cannot reasonably be expected to achieve productivity improvement."[19]

In fact, NCTA's analysis showed that, based on the April 1993 benchmark equation, real cable rates per subscriber channel in competitive franchises rose in excess of four percent annually between 1986 and 1992.[20] This price increase was consistent with either a decline in efficiency growth, or, more plausibly, with a efficiency gains that were less than the cost of the growth in the quality of service.[21] In either case, the Commission's own data base clearly did not -- and does not -- support any positive productivity offset, much less a specific productivity offset of two percent. And as indicated above, the New Jersey "comments" -- the only "support" cited for the two percent offset proposal -- simply cannot shoulder that burden. In sum, there was -- and is -- no record support for any productivity offset.

### D. Measurement of the Industry's Productivity Demonstrates That a Positive Productivity Offset is not Warranted.

Productivity is an economic concept associated with improved efficiency of production over time. Productivity improvements can be measured either as increases in output holding inputs constant or as the reduction of unit costs of producing a good or service after adjusting for changes in input factor prices.[22] Productivity improvement can be broken

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19 Further Notice at ¶ 320.

20 NCTA Comments at Appendix C at 8-9.

21 Id. at 10.

22 For a review of the measurement of industry productivity, see M.I. Nadiri, "Some Approaches to the Theory and Measurement of Total Factor

Footnote cont'd.

down into several contributing factors such as technological advances, economies of scale, changes in input quality, and changes in product quality.[23]

The measurement of productivity requires detailed and exact information over time on the prices, quantities, and characteristics of both the goods and services generated by a firm or industry and the factor inputs used in production. Most regulated industries -- such as telephony, electricity generation, and much of the transportation sector -- have decades of publicly-available, complete, detailed records of data on prices and quantities for both inputs and outputs. Moreover, because of standardized accounting principles within each of these regulated industries, these historical records are usually comparable across firms and over time. Partly as a result of the wealth of publicly available data, the academic economics literature contains productivity studies for most major American industries and for practically every regulated industry.[24]

This is not the case with the cable industry,[25] which to date has been largely unregulated. Therefore, measuring its productivity is difficult

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Productivity: A Survey," Journal of Economic Literature, Vol. 8, (1970), pp. 1137-1177; and T.G. Cowing and R.E. Stevenson (eds.), Productivity Measurement in Regulated Industries, New York: Academic Press, 1981.

23 For a discussion of the causes of changes in productivity growth in U.S. industries, see E.F. Denison, Accounting for Slower Economic Growth: The United States in the 1970s, Washington: The Brookings Institution, 1979.

24 For a review of productivity studies in several regulated industries, see T.G. Cowing and R.E. Stevenson (eds.), Productivity Measurement in Regulated Industries, New York: Academic Press, 1981.

25 See Christensen Associates, "Productivity Growth in the Cable Television Industry," June, 1994, attached hereto as Attachment B ("Christensen Report") at 2 where Christensen Associates observe that no prior studies

Footnote cont'd.

because of the lack of historical data on prices and quantities for both cable system inputs and outputs. The cable industry has had little time to develop the data needed for comprehensive productivity studies that are comparable in quality to other regulated industries. Indeed, the FCC is only now in the early stages of developing a uniform system of accounts for the cable industry which is a fundamental prerequisite to developing financial data needed for sound productivity studies.[26]

Nevertheless, with these limitations in mind, NCTA asked Christensen Associates to conduct a study of the cable industry's productivity using whatever current, albeit limited, data are available. As the attached report discusses, Christensen Associates collected available financial data from the past ten years from three cable MSO's in order to calculate relevant productivity measures. The three companies from which data was obtained represent six percent of the nation's subscribers and reflect differing corporate structures, histories and growth strategies. Christensen concluded that results based on this sample "provide a reliable indication of the overall trend in productivity growth for the three MSO's studied. . . .[and] a useful indication of the productivity growth trend for the entire cable industry."[27]

Christensen Associates performed a total factor productivity analysis (TFP) for these three companies. TFP is a well-known and well-used

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of total factor productivity in the cable industry have been published in the academic literature.

26 As discussed in Section IV infra, there are numerous reasons why the Commission should not -- and need not -- impose its proposed telco-derived Uniform System of Accounts on the diverse cable industry.

27 Christensen Report at 4.

analytical tool used for measuring productivity. The FCC itself has employed TFP analyses in developing price cap regulation for telephone companies.[28] The TFP for the three companies studied declined at an average annual rate of -1.9%, from 1984 to 1993, showing that not only had the cable industry failed to achieve productivity gains over this time period, but actually experienced annual productivity losses.[29]

As Christensen concludes:

> Conceptually, the productivity offset in a price cap formula is based on the differential between productivity growth achieved by the industry in question and the U.S. economy. . . . The average annual rate of growth for the private business sector between 1984 and 1990 was 0.9 percent. Thus, for the historical evidence to support a productivity offset for the price cap formula, the cable television companies would have had to attain TPF growth in excess of 0.9%. For the historical evidence to support the FCC's proposed productivity offset of 2%, the companies would have had to attain TFP growth of 2.9%.
>
> . . . . [B]ased on the historical evidence, there is no basis for applying a positive productivity factor to the price cap formula for cable television companies. Indeed, adopting a price cap formula with no productivity offset would still provide a significant challenge to the industry, since it would represent expected productivity growth well in excess of the industry's historical performance.[30]

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28 As the Report notes: "The methodology employed in this study is the same as that which we employed in our 1981 study of the Bell System. The Bell System study was the basis of Dr. Christensen's testimony in the AT&T anti-trust trials and was also used by the FCC in determining the productivity offset for AT&T. This methodology has also been used in our recent study of TFP growth for the Local Exchange Carriers, commissioned by the United State Telephone Association, and numerous TFP studies conducted for individual Local Exchange Carriers." Id. at 3-4 (footnotes omitted).

29 Id. at 11.

30 Id. at 13 (emphasis added).

Therefore, based on the limited available evidence, recognized experts in the field have concluded that there is no sound basis for incorporating any productivity offset into the cable price cap formula.

### E. Reduction by a Two Percent Productivity Offset of Annual Inflation Increases to Regulated Rates Net of Programming Expenses is Unwarranted Based on Recent Experience with Changes in Competitive Cable Rates.

Recent studies by EI are consistent with the results of the Christensen Report. In its study submitted with NCTA's earlier Comments in this proceeding, EI compared the real rates charged by competitive franchises in 1986 with the rates that the same franchises would have been allowed to charge under the 1993 proposed benchmark rules. That study was based on the Commission's 1992 survey. It found that real 1986 rates were substantially below the allowed 1992 benchmark rates under the 1993 benchmark formula and it concluded that the price increases for all forms of competitive franchises were likely the result of improved quality of service.[31]

One of the likely sources of improved quality for cable services between 1986 and 1992 was increased expenditures on cable network programming. However, under the revised 1994 rate regulation rules, changes in license fees are not subject to an inflation factor or the proposed productivity offset. Other costs, however, would be subject to those factors. Therefore, applying those factors to franchises with unchanging characteristics would result in a two percent price reduction after accounting for inflation. If the proposed two percent productivity offset were reasonable,

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[31] NCTA Comments at Appendix C, attached hereto as Attachment A, at 7-10.

then one would expect that rates net of programming expenses for a competitive cable franchise with unchanging characteristics would decline by two percent annually in real terms. For example, one would expect that a calculated rate based on 1986 franchise characteristics and the 1994 benchmark rate formula net of licensing fees would be less than the real actual 1986 rate by two percent compounded annually between 1986 and 1992.

EI performed this exercise to test the hypothesis that a two percent productivity offset is appropriate to simulate a competitive cable market. They examined separately different types of "competitive" franchises (overbuilds, municipal systems, less-than-30-percent penetration) and "non-competitive" franchises.[32] To compare 1986 rates and the benchmark formula rates under the 1994 rate regulation rules, they subtracted programming expenses from both.

The complete methodology employed by EI is described in Attachment C hereto. The results of the study are significant: Based on the benchmark formula, holding all characteristics constant, adjusted real revenues per subscriber have been rising rather than falling, even in competitive franchises. Clearly, these results do not support a positive productivity offset.

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[32] See "A Comparison of Real Rates Charged by Competitive Cable Franchises in 1986 and 1992 Based on the 1994 FCC Cable Rate Rules," Economists Inc., June, 1994, attached hereto as Attachment C. As the EI study explains, franchises were placed in competitiveness categories based on their 1992 attributes; there was insufficient information to place them in 1986 competitiveness categories. They also examined separately franchises that reported that they faced rate regulation in 1986 and those that reported that they did not. Id at 2.

The inference to be drawn from this evidence is not one of productivity decline but rather of quality improvements that are not captured in either the benchmark formula or in programming expenses. Indeed, as the EI study concludes:

> These results do not mean that cable operators have not improved efficiency. Like other industries that must invest in new technology to remain competitive, cable operators are constantly adapting new technology and providing more efficient services. These results, however, clearly indicate that the data collected by the Commission do not provide a basis to isolate the effect of productivity improvements. Any adoption of a productivity improvement offset by the Commission to reduce price increases for the benchmark tables should be coupled with a much larger quality improvement offset. The net effect of productivity and quality has been increasing revenues per subscriber, for all competitive systems.[33]

In sum, instead of reducing real rates annually by two percent, based on the EI study, the Commission should allow quality adjustments to <u>increase</u> real rates annually. In any event, this study is consistent with the Christensen Associates report and is further proof that no productivity offset should be incorporated into the cable price cap formula.

**F. A Productivity Offset for the Cable Industry Would Not Be Comparable to -- Nor Should It Be Based Upon -- the Offset Incorporated in the Interstate Telephone Price Cap Scheme**

The Commission appears to base its proposed cable productivity offset on a direct analogy to the offset incorporated in the price cap regulation of

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33 Attachment C at 5. Significantly, the study also observes that "[h]istorical quality improvement has been paid for by increasing prices. If regulated price increases are limited to inflation alone (GNP-PI), future quality improvements will be slower than quality improvements were between 1986 and 1992. If regulated price increases are limited to a level less than inflation, future quality improvements will be slower still." Id.

the telephone industry. The New Jersey suggestion of a two percent offset was admittedly derived from its regulation of a local exchange carrier.[34] Even if Congress had not instructed the Commission not "to replicate Title II regulation" in its cable regulatory regime,[35] the Commission's proposal for a telco-like productivity offset would be unwarranted.

In our comments last year, we explained why productivity and price regulation concepts applicable to the telephone industry are inapplicable to, and inappropriate for, the cable industry.[36] The newly revised approach to cable price regulation is based on revenue per subscriber rather than revenue per subscriber channel as was the case in the first round of rate rules. Under the current form of cable rate regulation, a productivity offset such as applied to interstate telephone services is even more inappropriate.

The units of regulatory measurement for interstate telephone calls can be either the number of calls completed or the number of minutes of such calls. These units can expand within the overall service capacity of the telephone system even if the subscriber base remains constant. With increasing subscribership, these units can grow more rapidly. Demand for interstate telephone services, whether measured in number of calls or number of minutes, can respond with intensity of usage to price changes. The quantity of regulated interstate calls demanded presumably goes up in most households as the regulated price falls.

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[34] See New Jersey Board Comments at 11.

[35] H.R.Rep. No. 102-628, 102d Cong. 2d Sess. 83 (1992).

[36] NCTA Comments at Appendix C, attached hereto as Attachment A, at 3-4.

A large part of productivity improvement for interstate telephone service as measured by reduced unit costs comes from increased network and capacity utilization.[37] Both interstate carriers and local exchange companies have large fixed costs associated with plant and equipment. As more and longer interstate calls are made, the unit cost to provide each call or call minute declines. Under these circumstances and with increasing demand for calls, it might be appropriate to have a productivity offset on the regulated price of a call or a call minute since the incremental cost of each additional unit is falling even if subscribership remains unchanged.

In contrast, the current unit of measurement for regulated basic cable services is simply the number of basic household subscribers. This unit grows no larger and no faster than the subscribership base. The demand for most basic cable programming services is not measured by intensity of usage but rather by a yes-or-no decision.[38] Productivity improvements as measured by reduced unit costs of regulated cable services -- unlike regulated interstate telephone services -- cannot decline substantially with intensity of usage for a fixed subscriber base.

In households that already subscribe to basic cable programming services, a reduction in the regulated price will not induce those households to purchase more of the same service. Only in those households that are not currently subscribers will reductions in basic prices lead to a switch in demand. In communities with low cable penetration, regulated price

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[37] See generally, Second Report and Order in CC Docket No. 87-313, supra.

[38] Only demand for equipment rentals, additional outlets, and other auxiliary services may respond with intensity of usage.