reductions may initially induce substantial new subscribership. In communities with high cable penetration, regulated price reductions will not likely lead to a substantial percentage increase in the number of subscribers. Because of these obvious differences between telephone and cable economics, as well as the legal questions arising from replicating a Title II regulatory regime for cable, incorporation of a productivity offset derived from the telephone regulatory regime into the cable price cap regime is particularly inappropriate.

G. The Benchmark Tables and Going-Forward Procedures Already Account for Productivity Increases.

By expanding channel capacity, cable operators have been reducing the costs per channel of providing cable service and thereby have been improving efficiency. Those efficiency or productivity gains are already reflected in the benchmark rate structure that effectively reduces allowed basic revenue per subscriber channel with increasing numbers of channels.[39] On a going-forward basis, cable operators also face an implicit productivity offset inasmuch as when they add additional channels they can only increase regulated rates by decreasing amounts.[40] Accordingly, the benchmark rate structure in the cable rate regulation regime already captures purported efficiency gains. To incorporate an additional "productivity offset" would be, at a minimum, redundant.

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[39] See Second Order on Reconsideration, Fourth Report and Order, and Fifth Notice of Proposed Rulemaking in MM Docket No. 92-266, FCC 94-38, released March 30, 1994, Appendix C, at 15-16.

[40] Id. at 25-28.

H. Conclusion

For the reasons stated above, the Commission should expeditiously -- before it completes consideration of other issues in this docket -- adopt an order terminating its consideration of the proposal to incorporate a productivity offset into the cable price cap regime. Only by doing so promptly will the Commission remove the cloud of uncertainty that still lingers over the industry and the investment community arising out of that proposal.

III. THE COMMISSION'S INTERIM COST-OF-SERVICE RULES MUST BE SUBSTANTIALLY REVISED BEFORE BEING MADE PERMANENT

In the Report and Order the Commission recognized that the benchmark/price cap approach to cable rate regulation "might not produce fully compensatory rates in all cases."[41] As a result, the Commission adopted a "cost-of-service" alternative, pursuant to which cable operators could establish rates based on their costs. As the Commission explained:

> The cost-of-service approach was to serve as a backup to the benchmark/price cap mechanism which a cable operator could invoke if it believed that the maximum rate under the benchmark/price cap formula would not enable the operator to recover costs that it reasonably incurred in the provision of regulated cable services.[42]

The Commission was well-advised to adopt a cost-of-service alternative to the benchmark/price cap approach to cable rate regulation, for without such a "backup" methodology, the Commission's benchmark/price cap regime would have been even more vulnerable to constitutional challenge than it is

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[41] Report and Order at ¶ 3.

[42] Id.

now. See e.g., Federal Power Com'n. v. Hope Natural Gas Co., 320 U.S. 591 (1944) ("FPC v. Hope"). Unfortunately, the interim cost-of-service rules adopted in the Report and Order are so inadequate that they too will not meet the constitutional test that the rate established allow the regulated company to "operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed...." FPC v. Hope, 320 U.S. at 605.

The flaws in the Commission's interim cost-of-service rules are many, and the Further Notice provides the Commission an opportunity to address the problems -- constitutional, statutory and practical -- in those rules as it considers the adoption of a permanent cost-of-service regime.[43] In these Comments NCTA will focus on a number of critical areas which require revision: (1) selection of an "original cost" valuation methodology and the exclusion from the rate base of any cable system acquisition costs in excess of original costs ; (2) exclusion from the rate base of all accumulated start-up losses except for those equal to the lesser of the first two years of operating costs or accumulated losses incurred until the system reaches the end of its prematurity stage as defined by FASB 51; (3) the presumptive exclusion from the rate base of a number of intangibles; and (4) adoption of an 11.25% rate of return.

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[43] The interim cost-of-service rules are also the subject of several cable industry petitions for reconsideration seeking changes in the interim rules. See note 3, supra. NCTA agrees that in the arguments raised in those petitions warrant immediate Commission attention and to the extent the Commission is inclined to revise its interim rules as a result of its consideration of those petitions prior to the conclusion of this proceeding, NCTA urges the Commission to do so expeditiously.

A. The Commission's Adoption of Original Cost Valuation Methodology Must Be Revisited

In our initial Comments on this proceeding, we urged the Commission to reject the proposal to value assets in the rate base at original cost. We demonstrated -- based on the Commission's own data -- that there exist numerous reasons why the market value of a system may exceed its original cost wholly apart from the notion that such "excess" costs reflect the expectation of monopoly profits. As we observed:

> Market value may differ from book value for reasons having nothing to do with monopoly earnings. These include inflation, divergence between real and accounting rates of depreciation, and various intangible assets, such as goodwill, customer lists, and superior skills and abilities that lead to expectations of higher earnings.[44]

Rejecting the views of NCTA and others, the Commission adopted original cost as the valuation standard on an interim basis. The Commission gave short shrift to the alternative methodology suggested by NCTA: Competitive Market Value (i.e., the market value of the assets that would obtain if the system were facing competition).[45]

The Commission's decision to use original cost as a valuation methodology was based on several conclusions none of which support the Commission's decision. First, the Commission concluded that "[o]riginal cost is the normal traditional method used for public utility valuation, and is the

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[44] NCTA Comments at 8.

[45] See NCTA Reply Comments at 8-13 and Attachment thereto ("The Use of Competitive Market Value For Cable System Rate Base Valuation") attached hereto as Attachment D.

method this Commission has long used for telephone companies."[46] But that conclusion falls of its own weight since it flies in the face of (1) the Communications Act command that cable systems not be regulated as common carriers (see 47 U.S.C. §621(b)), (2) Congress' explicit instruction that the FCC was not to replicate Title II regulation in its cable regulatory regime,[47] and (3) the recognition by Chairman Hundt, Commissioner Quello and others[48] that cable is not a public utility nor should it be regulated as one.

For these reasons, the Commission's conclusions that use of original cost is "consistent with the objectives of the Cable Act" (Report and Order at ¶ 59) and will set "the groundwork for a level playing field for the telephone companies and cable companies, because our telephone company valuation are also based on original costs" (id. at ¶ 66) are also misplaced.

The Commission next cited the purported "practical benefits of original cost valuation," i.e., "it is less administratively burdensome on all involved, and well understood."[49] Even assuming the Commission's conclusions regarding the relative burden of using original cost methodology versus other suggested valuation proposals were correct, that does not outweigh the Commission's public interest -- indeed, constitutional -- responsibility to assure that its regulatees may have an opportunity to recover, and earn a return on, their legitimate investments. FPC v. Hope, supra. Requiring

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46 Report and Order at ¶ 55.

47 See H.R. Rep. No. 102-128, 102d Cong. 2d Sess. 83 (1992).

48 See Hundt Speech at 7; Quello Statement at 2.

49 Report and Order at ¶ 55.

cable operators to value their assets at original cost when their legitimate pre-regulation investments were well above cost denies cable operators this constitutionally-protected opportunity.

In any event, the Commission is simply wrong in asserting that the original cost methodology is significantly less burdensome than the method proposed by NCTA -- valuation at competitive market value. Nor was the Commission correct in concluding that market-based valuation methods "present the problem of circularity."[50] By overestimating the practical problems which a competitive market value standard would create, the Commission gave inadequate consideration to that alternative. The Commission's main concerns appeared to be that the NCTA proposal was impractical and that "[a]pproaches based on market value at the time of acquisition are likely to include expectations of supra-competitive profits...."[51]

That simply need not be the case. As demonstrated in the attached study by EI,[52] determining competitive market value of a cable system is quite simple, using the Commission's own determination of the "competitive differential." Moreover, as the study observes, "[b]y using the Commission's own determination of the level of 'monopoly mark-up' in the industry [] it must therefore be seen by the Commission as completely purging any and all monopoly rents."[53]

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[50] Id. at ¶ 56.

[51] Id. at ¶ 60.

[52] See Economists Incorporated, "Revisiting the Issue of Rate Base and Rate of Return in Cable Regulation," Attachment E hereto.

[53] Id. at 2.

In brief, the competitive market value approach takes into account the fact that "[t]he Commission has found that, due to the market power of 'non-competitive' systems, revenue per subscriber in service categories now to be regulated is 17 percent too high. The Commission could easily compute a competitive cash flow based on that 17 percent adjustment. The only other step in arriving at competitive market value is to take that competitive cash flow and apply it to the historical cash-flow-to-market-value multiple in the cable industry."[54] This approach is neither impractical nor burdensome and the Commission's conclusion to the contrary is simply unfounded.

In sum, competitive market value is a practical, non-burdensome methodology for valuing assets recently brought under regulation. If applied properly, it also can eliminate the Commission's concern regarding the recognition of the expectation of "monopoly profits" in valuing cable assets.[55] Therefore, the Commission should adopt competitive market value as the appropriate valuation methodology for cable assets.[56]

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[54] Id. While we believe that the Commission erred in adopting the 17% "competitive differential," we use it here -- as did EI -- for purposes of illustrating how competitive market value can be determined once the accurate "competitive differential" -- if any -- is itself determined.

[55] The Commission's other concern -- about pre-acquisition expectations regarding the profitability of unregulated services -- can be met by proper allocation of the rate base between regulated and unregulated services when it comes time to place values on particular assets in the rate base.

[56] While use of competitive market value can reduce -- if not eliminate -- the inequity of valuing cable system assets at no more than original cost regardless of the actual acquisition costs which were arrived at based on an arm's length transaction, as we show below, inclusion of all legitimate pre-regulation acquisition costs in the ratebase is consistent with the Commission's constitutional and statutory obligations.

B. The Commission Should Not Limit the Amount of Acquisition Costs Allowable in the Ratebase

The Commission excluded from a cable operator's ratebase any acquisition costs in excess of original cost. This fundamental error must be rectified before the Commission adopts permanent cost-of-service rules. Exclusion of so-called "excess acquisition costs" is inappropriate as well as unfair to the cable industry. At a minimum, all pre-regulation acquisition costs should be included in the rate base.

The Commission recognized that the question of what acquisition-related costs should be included in the ratebase was distinct from, although related to, the adoption of a plant valuation methodology. Nevertheless, it appears that its purported rationale for adopting an original cost valuation methodology (e.g., concerns about recognition of the expectation of supra-competitive profits) also drove its decision to limit the acquisition costs operators could include in the ratebase.[57]

The Commission recognized that "[t]he issue is one of some importance and controversy, for both operators and customers, because many cable systems changed hands during the years when cable service was essentially unregulated, and in many cases the prices paid exceeded the original cost or the book value of the purchased cable system's tangible assets."[58] Nevertheless it concluded:

> We continue to believe that the prices paid for cable systems, especially during the period when those systems possessed market power, are not a reliable or reasonable basis for ratemaking, and that their use is not required or supported by public utility practice, the

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57 Compare Report and Order at ¶¶ 53, 60 with id. at ¶¶ 91-95.

58 Id. at 90.

> purposes of the Cable Act of 1992, or the Constitution. It appears certain that those prices often include some expectation of supra-competitive profits that the market power of cable systems operating in a less than fully competitive environment could expect to generate. The magnitude of this expectation probably varied over time, increased by the growing list of cable channels that could be obtained only by subscribing to cable service, and discounted by the investors' assessment of the risks of competitive entry and re-regulation. But buyers and sellers negotiating acquisition prices clearly took into account the competitive status of cable systems and their consequent market power. Individual investors purchasing shares in cable companies no doubt also included this factor.[59]

The Commission, therefore, presumptively excluded all acquisition costs above original cost, which the Commission views as "goodwill" or "the portion of plant purchase price that cannot be assigned specifically to identifiable property acquired and that is not recorded on the operator's books of account as accumulated losses, subscriber lists, franchise rights, patent rights or organizational costs."[60] The exclusion of so-called "excess acquisition costs" proceeds from several erroneous assumptions.

First, any premium paid for a cable system pre-regulation did not necessarily reflect the expectation of monopoly profits but rather could have been the result of a variety of factors, as we demonstrated in our earlier comments.[61] Indeed, in the original Notice of Proposed Rulemaking in this proceeding the Commission acknowledged that "while a comparatively high

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59 Id. at ¶ 91.

60 Id. at ¶ 99. The Commission presumptively included in the ratebase a number of intangibles including organizational costs, franchise costs, and customer lists. Id. at ¶¶ 85-88.

61 NCTA Comments at 8-17 and Appendix A; NCTA Reply Comments at 8-13. For the Commission's convenience we attach hereto as Attachment F the EI paper entitled "Prices Above Book Value Do Not Imply Market Power" previously submitted as Appendix A to the NCTA Comments.

acquisition cost may reflect the expectation of monopoly profits, it may also be consistent with the estimation of market value (measured by multiples of cash flow) of similar businesses (e.g. broadcast stations) subject to transactions during the same period." NPRM at ¶ 36, n. 40. In this regard, it must be recognized that there was -- and is -- no substantial evidence in the record supporting the view that the "excess" acquisition costs constitute a reflection of expected monopoly rents.[62]

Second, the Commission bases its decision to exclude certain acquisition-related assets on its view of "traditional" public utility concepts, but those concepts are simply not appropriate for an industry just made subject to regulation. In fact, the traditional public utility concepts cited by the Commission were addressed primarily to fears of rate-of-return regulated utilities padding their rate bases,[63] a concern not applicable to acquisitions made by cable operators prior to their becoming subject to regulation. Moreover, to the extent the Commission is following "traditional" public utility concepts, as we have previously observed, "the cost of plant acquired by a regulated entity but originally constructed by others is generally calculated as the value of the plant when it is first 'placed into service' for regulatory purposes."[64] Under that traditional approach, cable plant must be valued not at original pre-regulation cost, but when it first became regulated.

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62 Id.

63 See e.g., Montana Power Co. v. FERC, 588 F.2d 295, 303-04 (9th Cir. 1979) (Goodwin J., dissenting).

64 NCTA Comments at 12, citing Tennessee Gas Pipeline Co., 15 FERC ¶ 61, 100(1991), Virginia Electric Power Co., 38 FPC 487 (1967), and Black Hills Power & Light Co., 40 FPC 166(1968).

While adoption of a competitive market value valuation methodology and use of such a methodology to determine what acquisition costs should be included in the rate base would ameliorate the severe effects of the Commission's decisions on acquisition-related costs, the exclusion of any pre-regulation acquisition-related costs still would raise troubling questions.

By excluding any acquisition costs even though they were the result of arms-length, bona fide business transactions prior to the advent of cable regulation, the Commission could irreparably harm a number of cable operators who would be unable to recover enough of their legitimate, pre-regulation costs to repay their debt.[65] This result would, at the least, be inequitable. It may well be violative of the basic tenet of law against retroactive rule-making. See Bowen v. Georgetown University Hospital, 488 U.S. 204 (1988).[66] And, of course, as we have pointed out earlier,[67] if operators cannot recover their fixed debt service, they may have to reduce expenditures on variable costs such as programming or network upgrades.

For these reasons, at a minimum, the Commission must adopt some transitional approach to permit inclusion of pre-regulation acquisition-related costs in an operator's ratebase in order to allow those operators to recover their legitimate investments, repay their debt and upgrade their systems. As the CVI Petition notes, such a transitional approach would be

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65 See CVI Petition at 13-16; Comcast Petition at 16-17.

66 In some circumstances, agencies may create rules with retroactive application but only if explicitly authorized to do so by their Congressional mandate. The Cable Act of 1992 provided no such mandate.

67 NCTA Comments at 15-16.

similar to that the U.S. Court of Appeals required the Commission to take when it first imposed rate regulation on Comsat.[68]

The Commission must permit the inclusion in the rate base of pre-regulation acquisition-related costs and other intangibles. With respect to post-regulation acquisitions, the Commission's concerns about expectation of supra-competitive profits no longer would apply so it should permit inclusion of all bona fide acquisition costs arrived at through arms-length business transactions.

C. All Accumulated Start-Up Losses Should Be Included in the Rate Base

The Commission recognized that "some accumulated start-up losses, to the extent that they reflect operating losses in the early years of the system, should be included in the ratebase." Report and Order at ¶ 70. It did so acknowledging that "it is frequently necessary for businesses during a start-up phase to sustain a period of losses prior to profitability. As such, the losses benefit customers because it is necessary for the operator to incur them in order to bring future service to subscribers." Id.

Despite this statement, the Commission limited the start-up losses which operators could include in their ratebase to those "equal to the lesser of the first two years of operating costs or accumulated losses incurred until the system reaches the end of its prematurity stage as defined by FASB 51." Id. at ¶ 71. These losses must be amortized over a period generally no longer than fifteen years. Any other start-up losses will be presumptively excluded from the ratebase.

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[68] CVI Petition at 16, citing Communications Satellite Corp. v. FCC, 611 F.2d 883, 908 (D.C. Cir. 1977).

Other losses presumptively disallowed include continuing operating losses after the system reaches maturity, and accumulated losses associated with amortization of disallowed goodwill or interest expense associated with disallowed goodwill. The Commission said "this treatment is appropriate because these costs presumably benefited past subscribers, or were incurred in the expectation of monopoly profits or profits from nonregulated activities and thus should not be borne by current and future subscribers."[69]

The Commission's rationale for restricting inclusion of certain early start-up losses does not withstand scrutiny. In this regard, we note that Commissioner Quello has recently said that the Commission "should consider allowing systems relying on cost-of-service showings to deduct all accumulated start-up losses, not just [those in] the first two years."[70] Commissioner Quello's point is well taken. It often takes more than two years for a cable system to become financially viable.[71]

More significantly, as has been pointed out to the Commission on reconsideration,[72] the FASB 51 accounting standard -- upon which the two-year limitation on the inclusion of start-up losses is based -- is simply not applicable to the cost-of-service rate regulation regime the Commission must

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69 Report and Order at ¶ 73. While the Commission would allow an operator to rebut the presumption against inclusion of additional start-up losses in the rate base, that showing will be meaningless given the high (and vague) standards the Commission requires for rebuttal. We discuss this presumption in the following section.

70 Quello statement at 2 (emphasis in original).

71 See e.g. Media General's Request for Reconsideration in MM Docket No. 93-215 and CS Docket No. 94-28, filed May 16, 1994, at 2-9 (describing inequity of applying presumptive exclusion of start-up losses beyond two years to Media General's circumstances).

72 Id.

adopt. The FASB 51 standard determines when certain expenses for a cable system under construction may be capitalized rather than expensed; it has no decisive bearing on what should be included in a system's rate base for purposes of a cost-of-service showing.

For these reasons, all "start-up" losses in the early years of a cable system should be included in the operator's rate base for purposes of a cost-of-service showing. The method of calculating those losses is not overly complex.[73] In its permanent cost-of-service rules, the Commission should revisit and revise its conclusion to presumptively exclude significant start-up losses from the rate base.

D. The Commission's Presumption Excluding Certain Assets From the Rate Base Is Untenable and Must Be Revisited

As noted above, the Commission has presumptively excluded from the rate base a number of assets including (1) acquisition costs above original cost (i.e. "goodwill") (2) start-up losses incurred generally beyond the first two years of operation; (3) continued operating losses after the system reaches maturity (as defined by FASB 51); and (4) accumulated losses associated with the amortization of disallowed goodwill or interest expense associated with disallowed goodwill.[74] In such cases, however, the Commission stated that a cable operator could rebut the presumption against inclusion of the particular asset in the ratebase by "demonstrat[ing] that allowance of these costs would result in reasonable rates, that the costs were the result of an

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[73] See Response of Continental Cablevision, Inc., et al. at 8-9.

[74] See Report and Order at ¶¶ 71-72 and n. 131, ¶ 73 and n. 138 and ¶ 99.

arm's-length transaction, and that the goodwill has produced for subscribers concrete benefits that would not have been realized otherwise."[75]

More significantly, the Commission observed:

> In reviewing such showings, the franchising authority or this Commission will scrutinize the extent to which inclusion of these costs will produce rates above competitive levels. To the extent they do, the operator will need to demonstrate why its particular situation justifies the inclusion in the ratebase of these costs.[76]

The Commission must revisit and reverse this presumption against inclusion of these assets in the rate base. As it recognized, given the fact that "disallowance of any excess acquisition costs could have an adverse impact on the cable industry,"[77] an operator's ability to rebut such presumptions in appropriate circumstances is critical to the legitimacy of the cost-of-service scheme. As currently structured, the presumptions fail this test. First, the Commission has the presumption backward. As shown above, since cable is in a transition phase from unregulated service to regulation and compelling reasons exist why pre-regulation acquisition (and other) costs above original costs should be included in the ratebase, the burden should be on the franchising authority (or the Commission if appropriate) to demonstrate that particular assets are to be excluded from the ratebase.

Second, if, in fact, the Commission's rationale for presumptively excluding acquisition-related intangibles from the rate base is that they

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[75] Id. at ¶ 99.

[76] Id.

[77] Id. at n. 178.

represent the expectation of supra-competitive profits, then, at most, that portion of acquisition-related intangibles reflecting purportedly capitalized monopoly profits should be excluded from the ratebase. As has been suggested to the Commission on reconsideration, "the 17% revenue reduction in the FCC's new benchmark system would support a maximum disallowance of acquisition intangibles equal to approximately 34% of the gross purchase price of the system. The remaining 66% of the price, comprising both tangible and intangible assets, should presumptively be included in the ratebase."[78]

Third, the standard the Commission has established for rebutting the presumption against allowing certain intangibles in the ratebase is wholly inappropriate. The Commission recognized the necessity of adopting cost-of-service rules as a safety-valve and fallback for operators to use if the benchmark/price cap framework did not result in compensatory rates. But, in the same breath, the Commission concludes that an operator may not include certain costs in its cost-of-service rate base calculations if doing so results in rates above competitive levels (i.e. rates justified by the benchmark/price cap scheme). This "Catch-22" approach to rate justification is irrational, to say nothing of its being arbitrary and capricious. To require that cable operators who seek to justify rates above purportedly "competitive"

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[78] See Continental Response at 4. NCTA agrees with the parties filing the Continental Response that the FCC's 17% "competitive differential" is not correct and is being used for illustrative purposes only. However, the principle advanced in the Continental Response is worthy of consideration -- "whatever is ultimately settled upon as an appropriate average benchmark reduction, that number is directly linked to the proportion of acquisition price that should be viewed as `tainted' with monopoly profits, in an approximate 1:2 ratio." Id. at n.8. This approach is consistent with the competitive market value methodology for valuing cable assets discussed supra.

(i.e., benchmark) levels must demonstrate that the resulting rates will not be above those "competitive" levels is an absurdity.

Fourth, as Comcast has shown in its Reconsideration Petition (at 9), the Commission has no information regarding costs incurred or recovered by cable systems operating in a competitive environment. Accordingly, as Comcast correctly observes, "[t]he Commission, cannot, therefore, justify any of its presumptive disallowances on the grounds that systems facing competition would not have incurred the costs in question."[79]

Finally, the Commission's presumption must fall because it is premised on the assumption that the Commission's benchmark determinations reflect true, competitive rates. In fact, as NCTA and others demonstrated on reconsideration in MM Docket No. 92-266, the Commission's original benchmark determinations were fatally flawed.[80]

That fatal flaw continues to infect the most recent round of rate regulation decisions. In a report prepared by Arthur D. Little, Inc., and submitted in response to the Commission's Notice of Inquiry in CS Docket

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[79] Comcast Petition at 9. Comcast also correctly states that the presumptions are in fact quite more than presumptions given the fact that they carry great weight and are unlikely to be rebutted, in large part due to the vague standards announced for rebutting the presumptions. Id. at 13-14. In this regard, we note that even the United States Telephone Association ("USTA") concludes that these presumptions are "ambiguous, complex and probably unworkable in local rate setting proceedings." Response of the United States Telephone Association to Petitions for Reconsideration in MM Docket No. 93-215 and CS Docket No. 94-28, filed June 16, 1994 at 10.

[80] See, e.g., Petition For Reconsideration in MM Docket No. 92-266, filed by the National Cable Television Association, Inc., filed June 21, 1993 at 10-16, and Attachment thereto (Economists Incorporated, "The Effect of 'Competition' on Rates for Large and Small Cable Systems" (1993)), incorporated by reference herein.

No. 94-48,[81] the Commission's conclusions with respect to the rates charged by "competitive systems" are seriously called into question. Among other things, the A.D. Little study finds that "[b]y not appropriately taking into account the size of cable systems in its estimation of the competitive price differential, the FCC vastly inflates the impact of the outcomes for the very small systems."[82] It then concludes: "The competitive price differential disappears when we run the FCC's own regression model, using the FCC's database, but weight the results by size of system."[83]

The A.D. Little study calls into question the Commission's 17% "competitive differential" conclusion, but it also does more. For purposes of this proceeding, it demonstrates that the Commission may not require an operator seeking to rebut a presumption against inclusion of assets in the rate base to show that the resulting rates are not above "competitive" levels -- because the A.D. Little study debunks the Commission's determination of what are indeed "competitive" levels.

For all of the above reasons, the Commission must include in the rate base intangibles such as acquisition costs above original cost, start-up losses beyond the early years and other costs now presumptively excluded. At a minimum, the presumption against their inclusion must not be based on a determination that inclusion of the subject assets would result in rates above

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81 See Comments of the National Cable Television Association, Inc. in CS Docket No. 94-48, filed June 29, 1994 at 15-16 and A.D. Little Report appended thereto, incorporated by reference herein. For the Commission's convenience we are submitting a copy of the two-volume A.D. Little Report with these comments. See Attachment H hereto.

82 A.D. Little Report at 3.

83 Id.

purported "competitive" levels, based on the Commission's benchmark conclusions.[84]

E. A Uniform 11.25% Rate of Return is Not Appropriate for the Cable Industry

1. Introduction

In the Cost-of-Service Report and Order, the Commission prescribed -- on an interim basis -- an overall rate of return (or cost of capital) of 11.25%[85] -- the same rate of return applicable to local exchange carrier interstate services. The Commission was appropriately tentative about this conclusion, observing:

> We believe that it is appropriate to be cautious when selecting a number within this [10.0% to 11.50%] zone, since the record is less than perfect. In addition, we cannot know with certainty the risks of regulated cable operations, since those risks are dependent in part on the cost-of-service rules and principles adopted in this Order and on our revised benchmark methodology. Our caution in prescribing is reinforced by our desire to encourage infrastructure development.[86]

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[84] The Commission took a similar approach in establishing the "hardship" showing an operator must make to show, in individual cases, that rates permitted by either the benchmark/price cap or cost-of-service methodologies would threaten the financial health of its business and continued ability to provide cable service. Even if such a showing is made, the operator must show that the resulting rates "are not excessive in comparison with similarly-situated systems, particularly systems subject to competition." Report and Order at ¶ 293. As with the presumptions discussed above, making a hardship showing dependent on the resulting rates not exceeding "competitive" rate levels is illogical, arbitrary and capricious. As has been pointed out to the Commission, there are other significant problems with its hardship showings. See CVI Petition at 3-11.

[85] Report and Order at ¶ 207.

[86] Id.

The Commission's well warranted hesitancy in prescribing an 11.25% rate-of-return on an interim basis was also reflected in the Further Notice, with its invitation for further comment specifically addressed to the 11.25% rate-of-return.[87] The Commission must revisit its tentative conclusion to adopt a uniform 11.25% rate of return for the entire cable industry. As shown below, not only does the 11.25% figure fail to reflect the higher risks associated with cable systems, but also imposition of a single industry-wide rate of return on the disparate cable industry makes no sense.

In re-examining the prescribed tentative rate-of-return, the Commission must be mindful of the Supreme Court's admonition that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital."[88]

2. The 11.25% Rate of Return Fails to Reflect Adequately the Risks Associated With Cable Systems.

In NCTA's earlier comments in this proceeding, we demonstrated that the risks associated with cable systems differed significantly from, and in general exceeded, the risks attendant to telephone companies or the S&P 400.[89] In this regard, we submitted a study by EI, which demonstrated that the market risk of cable operators examined therein exceeded the risk in the

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[87] Further Notice at ¶ 305.

[88] FPC v. Hope, 320 U.S. at 602 (emphasis added).

[89] NCTA Comments at 19-25; NCTA Reply Comments at 13-15.

market as a whole by 30 to 50 percent, and that telephone companies face a risk much different from -- and lower than -- cable operators.[90]

Despite this and other evidence submitted to it, the Commission's 11.25% rate of return prescription was based on using the S&P 400 as a surrogate for the cable industry cost of equity[91] and is identical to the rate of return used for telephone industry regulatory showings for local exchange carriers' interstate services. The Commission's decision is fatally flawed in a number of respects.

First, the Commission did not satisfactorily account for the relative risk of the cable industry. As noted above, NCTA and others presented definitive evidence that cable equity is riskier than that for the overall equity market. We attach hereto and incorporate by reference herein the study submitted with our earlier comments which demonstrates this point. That study suggests that the cost of cable equity is about 50 percent higher than for the overall market.[92] If the Commission had merely accounted for that factor, it would have found a substantially higher cost of equity, resulting in a cost of capital of around 13.5 percent.[93]

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[90] See NCTA Comments at Appendix B ("The Equity Cost of Capital for Cable Operators is High and Variable") attached hereto as Attachment G.

[91] Report and Order at ¶ 181.

[92] As we also observed in our Comments (at 13), under the Commission's then-proposal to use the S&P 400 as a surrogate to determine a cable industry cost of equity, the end result was a cost of equity for a median S&P 400 company. Therefore, by definition, half of the S&P 400 themselves would require a higher return. However, the median return would be (and was) used to determine the rate of return for all cable companies.

[93] This assumes the Commission's determination that 8.5 percent for the cost of debt is appropriate although, as shown herein, it is plainly too low.

In light of the Commission's conclusion, EI revisited the issue of an appropriate rate of return for the cable industry, examining the Commission's stated rationale and conclusions.[94] That study concludes that the Commission's procedure for calculating the cost of capital is not the standard, economically sound approach. As a result, "the Commission systematically understates both the cost of debt and the cost of equity to the cable industry."[95]

A primary reason for this result is the Commission's decision to ignore the covariance (the beta) in its approach. Report and Order at ¶ 176 and Attachment D thereto at ¶¶ 2-5. The Commission's rationale for ignoring the conventional risk factor analysis for its cable calculations will not withstand scrutiny. The Commission concluded -- without any support -- that

> the historic pattern of fluctuations in cable stock prices is not purely the outcome of the changing risk-and-return assessments of market investors, but instead reflects in large measure insider decisions regarding cable stocks. Even if cable betas are purely a reflection of the changes in investor evaluations of the risks and return from cable services, we would still have to adjust for the monopoly profit component of investor expectations. We believe that the monopoly profit component was by far the most variable element in investor expectations. We, therefore, give no weight to this source of evidence about the risks of the cable industry.[96]

But, as the EI study observes:

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[94] See Economists Incorporated, "Revisiting the Issue of Rate Base and Rate of Return in Cable Regulation," Attachment E hereto.

[95] Id. at 4.

[96] Report and Order at ¶ 176.

> The Commission's criticisms of the standard approach are for the most part irrelevant. There is no reason to think that the covariance of cable stocks with the overall market would be related to monopoly profits. Insider holdings is also irrelevant in this context. To the extent that the covariance can be measured, it ought to be taken into account. If the Commission wants to dismiss the ability to measure a true beta, it could take the approach that cable industry cost of equity is the historical return to small company stocks. The returns to small company stocks more closely reflect the equity costs of the average cable system than does the return to the S&P 400 relied upon by the Commission. An approach based on small company stocks would generate a cost of equity of 17.6 percent, and a cost of capital of 13.5 percent, both substantially greater than those determined by the Commission.[97]

In a further effort to assist the Commission in arriving at a reasonable cost of capital for the cable industry, EI examined the cost of capital for seven publicly-traded cable companies using the conventional procedure for computing cost of capital. The results suggest that the Commission's 11.25% figure is more than 250 basis points less than a reasonable figure.[98]

As the EI study concluded:

> The approach to measuring the cost of capital presented here is not only economically sound, it is also conservative given the sample of firms and the nature of the regulations being imposed. The seven companies in the sample are generally larger and, because they are publicly traded, are likely to have easier access to capital markets than the average cable system. For those reasons, they probably have capital costs substantially lower than the average cable system.[99]

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97 Attachment E at 6 (emphasis in original).

98 Id. at 4-5.

99 Id. at 7.

This study demonstrates that 11.25% is not an appropriate rate of return for the cable industry. When it is recognized that the same 11.25% rate of return is applicable to the far less risky local exchange carriers, the absurdity of the Commission's conclusion becomes apparent.[100]

The local exchange carrier rate of return is not appropriate for the cable industry because the cable industry faces significantly more business risks than does the local exchange telephone industry. The EI study submitted with NCTA's earlier comments demonstrated that telephone companies face a risk much different from -- and lower than -- cable companies.[101] As NCTA stated when this issue was first raised:

> Cable companies provide a discretionary service; telephone companies an essential service. Cable companies are likely to be more sensitive to fluctuations in the economy than telephone companies. And while it may be true that local telephone companies to a highly limited and incipient extent face competition, cable competes on a much broader scale. The vast majority of cable subscribers can receive at least three broadcast stations. Cable also competes with MMDS, SMATVs, home satellite dishes, and faces very real prospects of potential competition with direct broadcast satellite and, perhaps, even telephone companies. The cable industry

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[100] As Comcast points out in its Petition for Reconsideration, local exchange carriers subject to rate of return regulation may target rates to achieve an 11.25% rate of return and may earn up to 11.50% without risk of an "overearnings" complaint. Comcast Petition at 19, citing Represcribing the Authorized Rate Return for Interstate Services of Local Exchange Carriers, 5 FCC Rcd. 7507 (1990).

[101] See NCTA Comments at Appendix B (attached hereto as Attachment G) at 3-4, showing that telcos' betas range from .85 to .95, as compared to ranges of 1.35 to 1.55 for the cable systems analyzed, based on Value Line estimates.

> as a result certainly faces greater business risks than telephone companies, or most industrial firms.[102]

In addition to the inappropriate use of the S&P 400 as a surrogate for cable's cost of equity and the consequent calculation of a rate of return identical to the less risky telephone industry, the Commission failed to take into account the effect its own newly-adopted cable rate regulations have on the risk of investing in the cable industry. As the EI study concludes: "[T]he Commission ought to realize that the regulations it is enforcing will increase the cost of capital for all systems. That is, the reductions in cash flow and increases in risk of bankruptcy engendered by the new regulations are likely to increase substantially the cost of capital for cable systems."[103]

While the industry appreciates recent remarks by Chairman Hundt, Commissioner Quello and others which demonstrate a sensitivity to the effect the FCC's rules have on the financial community's perception of the cable industry's investment prospects, it goes without saying that the two rounds of cable regulation within the last year and pending rulemaking proposals have cast a cloud over the industry and its investment prospects.[104] The Commission must take this circumstance into account in setting an

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[102] NCTA Reply Comments at 14. As we noted then, investors view bonds of cable companies as much more risky than bonds of telephone companies, whose ratings range from Aaa, "best quality", to A, "upper medium-grade obligations." The lowest rated telephone company is rated above the highest rated cable company -- which range from Baa, "medium grade obligations" to B, lacking "[c]haracteristics of the desirable investment. Assurance of interest and principal payments . . . over any long period of time may be small." Id. citing descriptions from Moody's Investors Service, "Moody's Bond Record, U.S. Corporate Bonds Ratings," August 1993 at 3.

[103] Attachment E at 7.

[104] See, e.g., Quello Statement at 2 ("The productivity offset proposal looms darkly over the cable industry and results in investment uncertainty").