Original

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

In the Matter of	)	
	)	
Implementation of Sections of	)	MM Docket No. 92-266
the Cable Television Consumer	)	
Protection and Competition Act	)	
of 1992: Rate Regulation	)	

REPLY COMMENTS OF
THE NATIONAL CABLE TELEVISION ASSOCIATION, INC.

The National Cable Television Association, Inc. ("NCTA"), by its attorneys, hereby submits its reply comments in the Fifth Notice of Proposed Rulemaking in the above-captioned proceeding.

DISCUSSION

A. The Commission Should Modify Its Going Forward Rules

Our initial comments, and the comments filed by the many cable programmers and operators participating in this proceeding, demonstrate widespread agreement that the rules governing rate adjustments when programming is added to regulated tiers must be modified. The 7.5% mark-up and benchmark adjustment factor currently contained in the "going forward" rules provide virtually no incentive for operators to add programming to their existing tiers of service.

There are several reasons why the current approach is flawed. The pennies yielded by the "going forward" formula do not allow operators in many instances to recover the costs of adding channels, marketing these newly-added services, and notifying customers. The benchmark adjustment factor not only fails to reflect these costs, but also is based on a formula that has no relationship to actual price increases when channels were added in the past. And the 7.5% mark-up on programming costs for newly-added networks fails to provide a reasonable return , does not reward operators for the risks incurred in adding new program services, and discriminates against the addition of low cost services.

Several commenters have suggested modifications to the going forward formula in order to provide appropriate incentives to add channels to regulated tiers of service, while at the same time protecting subscribers against unreasonable rates. As one example, the comments of Tele-Communications, Inc. ("TCI") propose that the Commission establish a "competitive markup" -- that is, a markup that reflects what would be charged by non-competitive systems if they were to face effective competition and were not subject to regulation.[1] The "competitive markup" is derived from examining the historical cable industry markup when a program service is added and then adjusting that markup downward by the Commission's competitive differential. TCI's analysis demonstrates that the estimated competitive markup ranges from 21 cents to 34 cents per subscriber (net of programming costs) for each additional satellite channel added, as opposed to 2 to 3 cents obtained under the FCC's approach. TCI therefore proposes that the Commission adopt a 25 cent flat fee markup (in addition to programming costs) for each new program service added to regulated tiers.

Economists Incorporated ("EI") has conducted an additional analysis for NCTA to determine an appropriate markup that reflects competitive conditions. EI's attached study reveals that a markup well in excess of the pennies currently

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[1] See Comments of TCI at 23 and Attachment, "A Competitive Markup Approach to Establishing Rates When Adding Cable Program Services," Besen and Woodbury, Charles River Associates (June 26, 1994).

allowed is both reasonable and necessary to provide appropriate incentives for utilizing unused capacity for regulated services.

EI first examined the historical experience of the competitive overbuild systems -- those same systems that form the basis of the Commission's rules establishing reasonable rates for existing channels of service.[2] Rates for those competitive systems increased on average 77.3 cents (in 1992 dollars) per channel added per subscriber per month.[3] The median value for these franchises is 30.3 cents in excess of programming costs. Based on their analysis, EI finds a reasonable range for the markup associated with added channels would be between 30 to 77 cents per channel over and above programming costs.[4] A markup at least ten times higher than the pennies currently allowed would be reasonable and would reflect competitive conditions.

The current formula fails to provide operators an incentive to use unused capacity for regulated services for another reason: it fails to account for possible unregulated uses of that capacity. As EI describes, "if a cable operator chooses to add a previously unused channel on a regulated tier, the operator gives up the return that would have been received if that channel had been used on an unregulated tier. The return that is given up is an 'opportunity cost.' An operator will add a channel to a regulated tier only if the return from doing so covers all relevant costs, including the opportunity cost."[5]

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2 EI included in its analysis the 17 overbuild and municipal systems that provided the Commission in its rate survey complete data for both 1986 and 1992 and that changed the number of channels offered on regulated tiers in that time frame.

3 Programming costs were excluded from these calculations.

4 Attachment at 4.

5 Attachment at 5.

EI's examination of the approximate returns for each of the several potential types of unregulated uses shows that an operator adding a channel on an unregulated basis would receive from 18 cents to $1.19 per subscriber per month in excess of the programming cost. On average, an operator would gain a return of 59 cents for unregulated uses. To provide an incentive for operators to use channels to provide regulated service, this study shows that 30 cents per subscriber per month over the license fee would be a conservative value for the opportunity cost.

In short, in order to create incentives to add channels to regulated tiers of service, the evidence supports a markup far in excess of that currently provided under the Commission's formula. As the comments in this proceeding make clear, failure to modify the current approach will continue to damage the programming industry, as programmers' ability to gain access to wider audiences will be constrained by regulations heavily skewed in favor of unregulated uses. This result is not in the public interest, nor, we submit, is this what Congress intended in adopting the Act.[6]

B. The Commission Should Establish Safe Harbors For A La Carte Packages

As we described in our initial filing, the Commission should not resolve issues regarding adding channels to regulated tiers in isolation from other going forward concerns. Rather, this issue should be considered in tandem with resolution of outstanding questions regarding how channels may be added in a la carte packages.

At a minimum, it is critical that the Commission establish clear safe harbors that would permit an operator to know at the outset whether its a la carte package

[6] See Comments of the National Cable Television Association on the Fifth Notice of Proposed Rulemaking at 2 (filed June 29, 1994).

is permissible. As our initial comments described, these safe harbors must address, among other things, when migration of services from a regulated tier is "significant" and what is an appropriate level of discount where a la carte channels are presented in packages. And the Commission should include packaging opportunities, as has long been the case with premium, a la carte networks like HBO and Showtime.

Any safe harbor provisions must be readily determinable. Therefore, penetration of individual a la carte networks also offered in a package opportunity cannot be a useful test, since penetration levels can only be determined after a customer has had time to consider the a la carte offering. Moreover, penetration levels of individual networks, especially new offerings, may change as customers become familiar with the offering and may elect to buy each network separately instead of the package.

CONCLUSION

The record in the proceeding amply demonstrates that the Commission must quickly take action to establish new "going forward" rules. In addition, the Commission must resolve questions regarding acceptable a la carte packaging, and do so in tandem with its resolution of the going forward question.

Respectfully submitted,

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July 29, 1994

July 29, 1994

GOING-FORWARD RULE FOR NEW CHANNELS

I. Introduction

The Federal Communications Commission currently permits cable operators that provide new program services on existing regulated tiers to increase their rates by an amount equal to the cost of the programming plus 7.5 percent; in addition, an amount, typically one to three cents, derived from the benchmark formula, is added. It is clear that this formula is likely to provide inadequate incentives for cable operators to add new networks on regulated tiers.[1]

Replacing the present approach with one that more fully allows operators to recover the costs of adding new networks plus a reasonable return, would appropriately create the needed incentive. One method would be to permit an operator that added a new channel to recover the license fee plus a specific markup expressed in cents. Economists Incorporated has been asked to consider what mark-up might be appropriate for this purpose.

Economists Incorporated evaluated evidence based on the behavior of overbuild systems between 1986 and 1992. In addition, we considered estimates of the value that cable operators give up when they add a channel to a regulated tier instead of an unregulated tier.

Based on this analysis, we conclude that there is support for a formula which would permit cable operators that add a channel from an existing regulated tier to increase their rates by an amount equal to

1 For example, the 7.5 percent markup is based on license fees which, in the past, have often been very low or even negative for startup cable networks.

the net change in license fees plus a mark-up of between 30¢ and 77¢ per subscriber per month.

II. Historical Experience of Overbuild Systems

A lower bound of 30 cents for incremental operator revenue per basic subscriber per month for each channel added to regulated tiers is consistent with the historical experience of overbuild and municipal franchises.[2] We reach this conclusion based on an analysis of the data collected by the Commission in its 1992 survey of competitive franchises.[3]

To compare 1986 cable rates and 1992 rates under the 1994 going-forward rules, we must subtract programming expenses from both. The Commission's data base does not include information on programming expenses. Consequently, we estimated programming expenses per cable network per subscriber month in 1986 and 1992.[4] We

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2 For purposes of this calculation, in order to conform with the Commission's current concept of effective competition, we exclude low-penetration franchises and franchises that do not meet the statutory requirement for effective competition.

3 The FCC survey data are described in FCC, *FCC Cable TV Rate Survey Database: Structure and Explanatory Notes*, February 24, 1993; and FCC, *FCC Cable TV Rate Survey Database: Structure and Explanatory Notes*, MM Docket No. 92-266, March 30, 1994.

4 We calculated the average monthly license fee per satellite channel per subscriber based on data from the Kagan Media Index. For 1986 total cable network license fees were $261 million, for 1992 network license fees were $1.503 billion. To obtain average annual license fee payments per subscriber, we divided these fees by the number of basic cable subscribers, 39.7 million in 1986 and 55.2 million in 1992. We then divided this amount by 12 to obtain average monthly subscriber fees. We then divided this amount by the average number of satellite channels, weighted by the number of system subscribers. Based on a GAO study (General Accounting Office, *Follow-Up National*

then estimated the total license fees per subscriber for a cable franchise in 1986 as the estimated 1986 average license fee per satellite channel times the number of satellite networks carried by the cable franchise in 1986. We then subtracted the estimated 1986 satellite license fees from the actual average 1986 monthly subscriber revenues that would be subject to regulation in 1992. We then translated this value from 1986 dollars into 1992 dollars by the GNP-PI.

We similarly estimated the license fee expenditures in 1992 for a franchise based on the number of satellite channels and characteristics that it had in 1992. We subtracted the estimated 1992 license fee expenditures from the 1992 regulated revenues.

We estimated the average change in real regulated revenue—net of programming expenses—per subscriber month between 1986 and 1992 with the addition or deletion of a channel from one of the regulated tiers of service for both competitive and non-competitive franchises. In the Commission survey are 17 overbuild and municipal franchises that provided complete information on regulated service revenues and channels in both 1986 and 1992 and that changed the number of channels offered on regulated service tiers between those two years. Of these franchises, 12 had increasing net regulated revenues per channel with increasing numbers of channels, and 5 had declining net regulated revenues per channel with increasing numbers of channels. The average value for all 17 franchises was an increase of 77.3 cents (in 1992 dollars) in regulated revenue per subscriber month,

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Survey of Cable Television Rates and Services, Report to the Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, House of Representative, June 1990), we assumed that there were an average of 11.1 satellite networks per subscriber in 1986. We calculated the average number of satellite channels per subscriber in 1992 as 20.6 from the 1992 FCC survey. We subsequently calculated the average license fee per subscriber channel as 5 cents in 1986 and 11 cents in 1992.

net of programming expenses, for each additional channel on a regulated tier.

The changes in regulated monthly revenue per subscriber for each additional channel range from –\$0.81 to \$6.26 among the 17 franchises. Given the number of franchises with complete information, the average value of the distribution of rate changes is quite sensitive to the extreme values. Under these circumstances, the median—the value of the rate change for the average franchise—may be as useful an indicator of the changes for the distribution as the mean. The median value for the 17 franchises is 30.3 cents.

Based on the foregoing analysis, a reasonable range for the mark-up associated with added channels would be between 30 cents and 77 cents per channel.

III. Analysis of Incentives and Opportunity Costs

The Commission's immediate concern in setting its going-forward rules is to provide adequate incentive for cable operators with existing unused channel capacity to add programming services to the regulated tiers. This incentive will exist only if the profits operators receive from adding a programming service to a regulated tier are at least as great as the incremental profits from alternative uses of the unused channel capacity.

In principle, any channel could become an "unused" channel if the programming now shown on that channel were removed. An operator will only continue to carry a channel on a regulated tier as long as the estimated value of that channel is at least as great as its value in an alternative use.

Through its recent rate reduction rulings, the Commission reduced the value of channels on the regulated tiers for most operators. It thereby reduced incentives to use unused channel capacity to add channels to a regulated tier. If such incentives are reduced sufficiently, growth in programming on regulated tiers will cease.

The FCC could attempt to solve this problem by increasing the incentives for cable operators to add programming to the regulated tiers. A cable operator with existing unused channel capacity has the option of adding programming to a regulated tier or to an unregulated tier. In order to provide an adequate incentive for operators to add programming to regulated tiers, the operator must receive at least the same financial return from adding to a regulated tier as would be received from adding to an unregulated tier.

The same principle can be stated in other terms. If a cable operator chooses to add a previously unused channel on a regulated tier, the operator gives up the return that would have been received if the channel had been used on an unregulated tier. The return that is given up is an "opportunity cost." An operator will add a channel to a regulated tier only if the return from doing so covers all relevant costs, including the opportunity cost.

Precise data are not available on the return that a cable operator would receive from adding an unused channel to an unregulated tier. Paul Kagan has estimated some parameters for a "model" system that can be used to approximate this return for each of several types of unregulated service, as shown in the table below.[5] Based on these parameters, a cable operator adding a channel to an unregulated tier would receive from 18¢ to $1.19 per basic subscriber per month in excess of the cost of programming. A simple average of the return in each of these unregulated uses is 59¢.

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5 Values are taken from Paul Kagan Associates, *Cable TV Programming*, February 28, 1994.

This figure may overstate the true return to the operator for two reasons. First, the calculated returns are based on an average channel of each type. Assuming that the operator has already chosen the programming services that offer the highest return from among the available offerings, the return to be received from an additional channel would likely be below the average. Of course, this would not apply to newly created program services. Second, there may presently be an insufficient supply of programming suitable for these unregulated uses. Taking these factors into account, 30¢ per subscriber would be a conservative value for the opportunity cost.[6]

IV. Conclusion

Providing cable operators with a flat amount between 30¢ and 77¢ in excess of programming costs eliminates an undesirable feature of the FCC's previously proposed going-forward procedure. Under the previous proposal, operators' return would have increased if the cost of the programming increased. The operator's incentive over some range of prices would have been to choose high-priced programming and ask to pay a premium. A flat amount would remove any incentive to inflate programming costs.

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6 This approach makes sense for the basic tier of service, to which everyone subscribes. Whatever number is chosen for channels added to tiers to which everyone subscribes, some larger number would be necessary for tiers with lower penetration rates.

Incremental Revenue from Adding Programming to an Unused Channel Based on Kagan		
A-la-carte Tier		
Revenue per channel		$1.27
Programming expense		($0.25)
Penetration	75%	
Total Incremental Revenue per Basic Sub		$0.77
Minipay Service		
Average monthly rate		$3.95
Programming expense		($1.58)
Penetration	50%	
Total Incremental Revenue per Basic Sub		$1.19
Pay-per-View		
Average PPV movie charge		$3.99
Operator split	45%	
Operator revenue		$1.80
Average penetration	10%	
Total Incremental Revenue per Basic Sub		$0.18
Premium Service		
Average monthly rate		$6.95
Programming expense		($2.78)
Average penetration	5%	
Total Incremental Revenue per Basic Sub		$0.21