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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
Federal Communications Commission
Washington, D.C. 20554

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
	)	DOCKET FILE COPY ORIGINAL
Adoption of a Uniform Accounting System for Provision of Regulated Cable Service	)	CS Docket No. 94-28

PETITION FOR RECONSIDERATION

The Commission's final cost-of-service rules represent a significant improvement over the interim rules initially adopted in early 1994.[1] The undersigned cable operators appreciate the effort the Commission has undertaken to refine its understanding of the cable television business and to reflect that understanding in the final rules. In some respects, however, the Commission's final rules still call for certain modifications. As a result, the undersigned operators respectfully petition, pursuant to Section 1.429 of the Commission's rules, that the Commission reconsider its final cost-of-service rules in the areas indicated below.

1. Allocation of Plant-Related Costs to Service Tiers.

The allocation of the costs of commonly used plant (such as head-end facilities, trunk and distribution cable, drops, etc.) among different service tiers has been a source of significant controversy in individual cost-of-service cases. Cable operators have

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[1] In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, and Adoption of a Uniform System of Accounts for Provision of Regulated Cable Service, MM Docket No. 93-215, CS Docket No. 94-28, ***Second Report and Order, First Order on Reconsideration, and Further Notice of Proposed Rulemaking*** (released January 26, 1996) ("***Final Cost-of-Service Order***"). This order was published in the ***Federal Register*** on March 8, 1996. This petition, therefore, is timely filed in accordance with Sections 1.429(d) and 1.4(b) of the Commission's rules, 47 C.F.R. §§ 1.429(d), 1.4(b).

generally been concerned that the cost allocation methodology used accurately reflect three related facts. First, as a matter of cable system design and engineering, it does not cost nearly as much to ***add*** a channel of capacity to a given system design as it does, on average, to build a system capable of providing a normal array of basic and cable programming service tier channels. Second, once a cable system is built, while in most cases a substantial majority of customers subscribe to both the basic service tier (BST) and the cable programming services tier (CPST), typically only a fraction of total subscribers choose to receive so-called "premium" channels. Third, irrespective of the specifics of subscribership, subscribers overall spend a majority of their viewing time watching a small fraction of total channels always offered on the basic tier — the networks.

All of these facts point to the conclusion that all channels are not created equal, whether in terms of system design or system use. Premium channels in particular do not impose the same per-channel costs as the initial channel capacity of the cable system, and are viewed a significantly smaller portion of the time. Any fair and reasonable system for allocating the costs of those portions of the cable system that are used in common to provide programming to subscribers should reflect these facts. Different channels on different tiers simply have different cost characteristics, whether viewed from the perspective of system design or of usage of the system by subscribers.

Unfortunately, the "straight channel" allocator, seemingly preferred by the Commission,[2] makes this impossible. The Commission, therefore, should reconsider the portions of the order that establish a preference for a straight channel allocator for commonly used plant (and related costs) and, instead, state that it will expect such costs to be allocated among service tiers in a way that reflects both the cost characteristics of deploying the capacity to offer each tier of service, and the ways in which those tiers of service are actually used by subscribers.

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[2] ***Final Cost-of-Service Order*** at ¶¶ 106-124.

Recognizing the fact that adding channels to a system design costs less per channel — that is, that economies of scale exist — and the fact that subscribers use different channels to different degrees will generally result in more costs being allocated to the channels that are necessarily built into the system, and that are used more heavily, than would be the case under the "straight channel" allocator. There is nothing unfair or inappropriate about this result, however. To the contrary, it is the straight channel allocator — which steadfastly ignores the realities of cable system construction and cable system usage — that results in unfair cost allocations. For these reasons, this aspect of the order should be reconsidered.

2. Treatment of Unactivated Channels

An issue related to the allocation of costs among tiers of service is the treatment of costs associated with so-called unactivated channels. The order states that, in establishing the costs of a cable system that are allocated to regulated services, the operator should not include all of the costs the operator actually incurred in building the system. Instead, the operator should identify the theoretical channel capacity of the system and determine how many channels will be in service by one year from the time the particular cost-of-service review is undertaken. Unless the total capacity of the system will be in use by that time, then a portion of the total system costs that is proportionate to the "unused capacity" of the system must be deducted from the total before determining regulated rates.[3]

This approach is profoundly misguided. While it is hard to imagine that this was the Commission's intent, the Commission's approach creates a strong ***dis***incentive for cable operators to prudently deploy technologies that allow for the addition of channels in the future.

The problem can be illustrated with an example. Suppose a cable operator can build a system capable of providing sixty channels of service to a community for, say,

[3] ***See Final Cost-of-Service Order*** at ¶¶ 31-39.

$12,000,000, and that this sixty-channel system would be adequate for the community's present programming needs (as the operator understands them). Suppose further that with relatively minor refinements to the design (somewhat more optical fiber, for example, or the use of more powerful amplifiers), the cable operator could build a system capable of providing eighty channels of service to the same community for $14,000,000. As described below, if the cable operator chooses to build the system with larger theoretical capacity (even though only sixty channels have been identified as needed in the short run), the operator could easily end up, under the Commission's approach, with a lower regulated rate base than if the higher-capacity system had not been deployed.

Assume that the operator wants to offer fifty channels of BST and CPST service, with ten channels set aside for premium and pay-per-view use. If the operator builds the 60-channel system for $12,000,000, then (using the Commission's "straight channel" allocator) $10,000,000 of that cost would be allocated to regulated channels. If, however, the same operator chose to spend $14,000,000 to build the 80-channel capable system, the Commission would deduct $3,500,000 off the top as a penalty for the unused capacity, leaving $10,500,000 to be allocated among all tiers of service. Still using the straight channel allocator, only $8,750,000 would be allocated to the fifty regulated channels. This is a rate base penalty of $1,250,000, as compared to the costs allocated to regulated services if the smaller and less efficient system were to be deployed.

The only situation in which such an unwarranted regulatory penalty would ***not*** exist is if for some technical reason there were no economies of scale, and it cost the cable operator exactly the same amount, per channel, to add channels to a system. Using the figures above, the sixty-channel system cost $12,000,000, or an average of $200,000 per channel. If there were no economies of scale, the 80-channel system would cost $16,000,000. In that case, disallowing the costs of the 20 channels of initially unused theoretical capacity would amount to a $4,000,000 disallowance. This would leave $12,000,000 to be allocated among the sixty activated channels — the same amount as the sixty-channel system cost.

The only problem with this situation is that it never occurs in the real world. Instead, as discussed in Section 1, over a wide range of capacities, adding channels costs ***less*** per channel than the average cost of the channels already deployed. This is particularly true as new digital compression technologies become available. These technologies squeeze proportionately more "theoretical" channel capacity out of a given 6 MHz analog channel.

But even if there ***were*** no economies of scale, and the average cost of adding channels to the "base case" design was the same as the "base case" average per-channel cost, the Commission's approach is still misguided, because it ignores the inevitable inefficiencies of building the same outside plant twice. The labor costs associated with working on outside plant are such that it will almost always be much more expensive to first build a system to one level of capacity, then at some point in the future send people out to add optical fiber, replace lower-capacity amplifiers with higher, and so on. In other words, if it costs $12 million to build a 60-channel system today and $16 million to build an 80-channel system today (i.e., ignoring actual economies of scale), it will cost more than $16 million — and possibly ***much*** more — to build a 60-channel system today and then go back two or three years from now and convert the 60-channel system to an 80-channel system.

Yet this inefficient course of conduct is exactly what the Commission's treatment of unactivated channels encourages, because under that approach, the $4,000,000 cost of prudently adding channel capacity today would be disallowed. The fact that there are actually ***savings*** on a per-channel basis if the 80-channel system is deployed at the outset, as described above, only makes the situation that much worse. By creating an artificial regulatory penalty for operators who prudently avoid such duplicative deployment costs, the Commission's new rule creates an unfortunate regulatory incentive to incur costs in this economically unreasonable way.

In light of these concerns, on reconsideration, the Commission should state that the costs of the system as actually incurred should be allocated among the actual uses to which the system will be put (perhaps using the one-year projection reflected in the order). The exception would be a case in which it could be shown that the decision to deploy a particular increment of capacity was imprudent under traditional regulatory standards. Without this type of regulatory regime, almost by definition the Commission will be penalizing those operators who prudently planned for future growth in channel offerings and rewarding those who did not.

3. Calculation of Adjustments To Depreciation.

The order establishes presumptively reasonable depreciation lives for major classes of cable operator assets, and indicates that regulatory adjustments to depreciation-related costs can be made if a cable operator's actual depreciation lives are longer or shorter than the boundaries of the presumptively reasonable range.[4] On reconsideration, the Commission should clarify that, in the case of adjustments to an operator's depreciation lives, accounting changes should be made not only to test year depreciation expense, but also to accumulated depreciation.

This clarification is necessary because a substantial mismatch between expenses and associated assets (rate base) can occur if depreciation expense is adjusted in isolation. Suppose, for example, that a cable operator was depreciating an asset over ten years that, under the new rules, should be depreciated over fifteen years. In that case, two adjustments must be made. First, the annual depreciation expense becomes smaller to reflect the longer asset life. Second, the accumulated depreciation balance also becomes smaller, to reflect the fact that each previous year's depreciation expense was based on the shorter life and, therefore, under the assumption driving the entire adjustment, was too high as well.[5]

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[4] ***See Final Cost-of-Service Order*** at ¶¶ 92, 96.

[5] Even if actual asset-specific records are not available, it is mathematically straightforward to estimate the adjustment required to accumulated depreciation.

These two adjustments will tend to offset each other. A reduction in depreciation expense lowers the revenue requirement, while the corresponding reduction in accumulated depreciation increases net rate base and, therefore, increases the revenue requirement. The reverse holds true if a cable operator has been depreciating an asset over a longer period than the Commission would view as reasonable: Depreciation expense would increase to reflect a shorter life for the asset, but accumulated depreciation would also increase, lowering rate base and revenue requirement, to reflect the shorter asset life.

The order as written is not inconsistent with the correct approach just summarized. Unfortunately, however, the order does not specify that ***both*** depreciation-related adjustments are required. This could lead to confusion, particularly on the part of some local franchising authorities, in cases where a depreciation-related adjustment is called for under the terms of the order. For this reason, the Commission should clarify the order on this point.

4. Treatment of Distributions by Non-Subchapter C Corporation Entities.

The interim cost-of-service rules stated that non-subchapter C corporation entities (generally partnerships and subchapter S corporations) should treat distributions to equity holders in prior years (and anticipated in future years) as affecting the proper calculation of the permitted tax allowance on earnings in the year under review.[6] Comments on the interim rules explained that this approach confused several questions.

At the outset, the amount of money a regulated entity chooses to distribute to its equity holders is not directly related to that entity's earnings. For example, it is common for regulated firms, and particularly for regulated cable operators, to choose to leave some or all earnings in the business for reinvestment, as opposed to distributing them

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[6] ***See*** In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, ***Report and Order and Further Notice of Proposed Rulemaking,*** MM Docket 93-215, FCC 94-39 (released March 30, 1994) ("***Interim Cost-of-Service Order***") at ¶¶ 138-39.

to the system's owners. The lack of relationship between earnings and distributions is particularly acute in the case of partnerships and subchapter S corporations in the context of tax liabilities. These entities are not themselves formally subject to tax. Instead, all of the tax liabilities associated with these entities' operations are attributed directly to the owners. As a result, from time to time such entities make distributions to equity holders in order to flow through funds needed to meet tax liabilities generated by the entities' operations. These "distributions" are functionally equivalent to tax expense for a Subchapter C corporation, and should be treated the same way from a regulatory perspective.

Finally, from a regulatory accounting perspective, whatever the motivation for distributing funds or retaining them in the business, such distributions, or lack of them, have no bearing on the level of the entity's regulated ***earnings*** in a given test year. Instead, distributions to equity owners affect the proper calculation of the entity's ***capital structure***. It follows that, in cases where an actual capital structure (as opposed to a hypothetical capital structure) is used to set rates, distributions should be used to help calculate that capital structure, not to adjust earnings or tax allowances on earnings.[7]

The final cost-of-service rules appear to retain the old rule, although it does not appear that the issue received a great deal of scrutiny in the Commission's deliberations.[8] For the reasons described above and discussed in detail in the cited comments, the Commission should reconsider its final order and, consistent with its treatment for entities that are subchapter C corporations, assess the reasonableness of the rates of non-C-corporation entities based on the results of those entities' test year operations, without adjustments (other than to capital structure) for contributions from, and distributions to, equity holders.

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[7] ***See*** Comments of Continental Cablevision, Inc., ***et al.,*** Regarding the Interim Cost-of-Service Rules and the Further Notice of Proposed Rulemaking (filed July 1, 1994) at 37-42.

[8] ***See Final Cost-of-Service Order*** at ¶¶ 104-05.

5. **The Commission Misunderstood The Impact of the First Amendment.**

A number of commenters explained how the First Amendment affected the proper application of cost-of-service regulation to cable operators. The Commission's order, however, misunderstood that argument, and, on the basis of the misunderstanding, rejected it. The Commission should reconsider this aspect of its decision as well.

Recent case law holds that cable rate regulation is subject to "intermediate" scrutiny for First Amendment purposes. This means that the regulatory regime must be "narrowly tailored" to meet an important government interest.[9] In the context of cost-of-service regulation of cable rates, the government interest may be characterized as the avoidance of unreasonably high rates. Indeed, this is how the Commission itself characterized the purpose of the law. ***See, e.g., Final Cost-of-Service Order*** at ¶ 28 (goal of cable rate regulation is "to protect consumers from unreasonable rates"); ¶ 59 (refers to Commission's "statutory mandate to guard against unreasonable rates").

If a cable operator has unreasonably high rates, then under the "intermediate" scrutiny test, the government may establish regulations to ensure that those rates are lowered to a level that is not unreasonably high.[10] But once rates have been lowered to a level that is not unreasonably high, further reductions in rates constitute a burden on the cable operator's speech that — by definition — is not needed to advance the government's interest.[11] The First Amendment cannot countenance such a result, even under the "intermediate" level of scrutiny to be applied here.

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[9] ***See Time Warner Entertainment Co., L.P., v. FCC,*** 56 F.3d 151, 181-82 (D.C. Cir. 1995).

[10] This discussion assumes, without conceding, that this is, indeed, a sufficiently important purpose to justify burdening cable operators with rate regulation in the first place.

[11] There can be no question that regulating the price of speech (here, rates for cable service) constitutes a burden on speech. ***Riley v. National Federation of the Blind of North Carolina,*** 487 U.S. 781, 790 (1988).

What this means in constitutional terms is that the goal of cable rate regulation must be to establish a maximum permitted rate that is the ***highest*** rate that is also "reasonable" under normal ratemaking standards. In practical cost-of-service ratemaking terms, this means that any particular ratemaking approach that could lawfully be accepted under normal ratemaking standards — that is, any ratemaking approach that leads to rates that fall within the "zone of reasonableness" — must be accepted in assessing a cable operator's cost-of-service rate.[12] Otherwise, the application of cost-of-service regulation is certain to burden more speech than necessary to accomplish the government's purpose.

In this respect, the proper approach to all cable cost-of-service ratemaking is similar to that adopted for small cable operators in the ***Small System Order.***[13] There, as long as the small operator's rates are lower than a presumptively reasonable level of $1.24 per channel, any ratemaking approach is acceptable if it is not affirmatively unreasonable. The First Amendment requires that same general principle —accepting all approaches that are not unreasonable and that support an operator's chosen rate — must be applied to all operators, not just small systems.

The Commission appears to have thought that the commenters were arguing that the Commission's cost-of-service rules should be subjected to strict scrutiny, and that the rules failed to pass constitutional muster, if at all, only under a "strict scrutiny" approach.[14] The point here is that in order to survive ***intermediate*** scrutiny, the

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[12] The Commission, of course, recognizes that there is a "zone of reasonableness" within which rates must fall under traditional ratemaking principles grounded on the Fifth Amendment's ban on confiscation. ***See, e.g., Final Cost-of-Service Order*** at ¶ 53. What the order fails to recognize is the relationship of this fact to the First Amendment.

[13] ***Sixth Report and Order and Eleventh Order on Reconsideration,*** MM Docket Nos. 92-266, 93-215, FCC 95-196, 10 FCC Rcd 7393 (1995).

[14] ***Final Cost-of-Service Order*** at ¶¶ 179-180. The Commission indicates that the commenting parties "suggested" that strict scrutiny applied. In fact, while not conceding that strict scrutiny would ***not*** apply, the entire analysis of the commenting parties was on the assumption that intermediate scrutiny applied. ***See*** Comments of Continental Cablevision, Inc., ***et al., supra,*** at 71-72. There is,
(continued...)

Commission's regulatory regime must be crafted so that it intrudes on cable operator discretion as much as necessary, ***but no more than necessary***, to accomplish the goal of rates that are not unreasonably high. This is what "narrow tailoring" means.

The Commission states, correctly, that one formulation of the intermediate scrutiny test is "whether the cost of service rules 'substantially burden more speech than necessary.'"[15] But the that is exactly the result of failing to target the cost-of-service rules to produce the highest rate that is not an unreasonable rate. Suppose that the goal of avoiding unreasonable rates could be met by lowering a rate to the top of the zone of reasonableness — say, from $20 to $18. To lower the rate further — say, to $16 — is a substantially greater burden than is necessary to avoid unreasonably high rates. This is true even if, under some exercise of traditional ratemaking discretion, the $16 rate could also be viewed as reasonable.[16]

The Commission's order does not even address this argument, much less refute it. On reconsideration, therefore, the Commission should revise its cost-of-service rules in light of the actual argument made by the commenters, and summarized above. This would entail implementation of at least the following principles. First, the operator's rates for regulated services would start with a presumption of reasonableness, with the burden placed on those challenging the rates to show that they are unreasonable. Second, in assessing the

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[14](...continued)
therefore, no basis for the Commission's statement that the parties' First Amendment argument was based "on the incorrect premise that our rules are subject to strict scrutiny." While the rules would obviously not survive strict scrutiny, they do not, in their current form, survive intermediate scrutiny either.

[15] ***Final Cost-of-Service Order*** at ¶ 180.

[16] As noted in the original comments, "[a] regulation is not 'narrowly tailored' — even under the more lenient tailoring standards applied in ***Ward*** and ***Renton*** — where, as here, 'a substantial portion of the burden on speech does not serve to advance [the Government's] content-neutral goals.'" ***Simon & Schuster v. New York State Crime Victim's Board,*** 502 U.S. 105, 112 S.Ct. 501, 116 L.Ed. 2d 476, 491 n.* (1991). In the context of rate regulation, a requirement to charge a price below the highest reasonable rate imposes a burden "that does not serve to advance" the content-neutral goal of the regulations, which, as the Commission itself has recognized, is the avoidance of ***un***reasonable rates.

reasonableness of rates in a particular case, any ratemaking approach that supports the operator's chosen rates and that is not ***un***reasonable must be accepted. Third, in any particular case, a variety of specific aspects of the Commission's rules (e.g., allocation of costs among service tiers) would need to be applied carefully in order to avoid establishing a maximum permitted rate that is lower than necessary to meet the statutory goal of rates that are not unreasonably high.

6. Conclusion.

The undersigned operators recognize that the Commission's final cost-of-service reflect a substantial improvement over the interim rules, and appreciate the effort that the Commission made to develop a better understanding of the cable business that is reflected in the final rules. Even so, there are some aspects of the final rules that should be reconsidered, as described above.

Respectfully submitted,

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