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Report on Time Warner Cable's Federal Communications Commission Forms 1240 and 1205 Filed with the City of Austin August 31, 2004

Executive Summary

The City of Austin is certified by the FCC to regulate Time Warner Cable's (TWC) rates for basic tier, equipment, and installation services in accordance with 47 CFR 76.910 (b)(1). TWC filed two Form 1205s for 2004 and Form 1240s for the years 2000, 2001, 2002, 2003, and 2004 on October 1, 2003. TWC requested a maximum permitted rate for basic service of \$22.08 and implemented an operator selected rate increase from \$8.58 to \$10.50 on January 1, 2004. TWC increased addressable equipment rental from \$6.95 to \$7.99 and new installation from \$45.86 to \$47.21. All of the rate increases are shown on Attachment 1 of this report. The City of Austin engaged Fox, Smolen & Associates, Inc. (FSA) to review the filings.

The following recommendations are a result of FSA's review:

1. Consider the filings for 2000, 2001, 2002, and 2003 as true-up periods for the purposes of the Form 1240 and only allow interest on the true-up period from January 1, 1999 through December 31, 1999.
2. Use actual costs for the true-up periods in accordance with the FCC rules and regulations.
3. Use the correct number of subscribers in each of the Form 1240 filings for 2000, 2001 and 2002.
4. Adopt a fair market value for News 8 of \$.37 per subscriber or disallow any recovery of News 8 costs.
5. Adopt the rates requested by TWC for its equipment rental and installation charges.

The resulting basic tier rates from adopting the above recommendations are:

<u>2003</u>	<u>2004</u>	
\$8.58	\$ 10.50	With News 8, valued at \$.37
	\$ 8.20	Without News 8

The recommended rates for equipment rental and installation are shown on Attachment 1.

The FCC's Rules require the City of Austin to adopt a rate ordinance prior to October 1, 2004 if it accepts the recommendation to change TWC's requested rates and set the maximum permitted rate at a rate other than \$22.08. If the City does not act prior to October 1, the rates requested by TWC are deemed effective. In the alternative, the City may enter into a settlement agreement with TWC.

TWC has the following options to respond to the City's rate ordinance:

- 1) Agree to a settlement that limits the rate to \$10.50 until January 1, 2006 and use \$10.50 as its maximum permitted rate in its next filing.
- 2) TWC can appeal the City's rate ordinance, if applicable, to the FCC.
- 3) TWC can file a FCC Form 1220 to support a requested rate that exceeds the maximum

permitted rates using the Form 1240.

- 3) TWC can move News 8 to its programming service tier which is not regulated.

**Report on Time Warner Cable's
Federal Communications Commission Forms 1240 and 1205
Filed with the City of Austin
August 31, 2004**

Fox, Smolen & Associates, Inc. (FSA) was engaged by the City of Austin to review the Federal Communications Commission (FCC) Forms 1240 and 1205 filed by Time Warner Cable (TWC). The City of Austin is certified by the FCC to regulate TWC's rates for basic tier, equipment, and installation services. The City of Austin certified to the FCC, in accordance with 47 CFR 76.910 (b) (1) that it would "adopt and administer regulations with respect to the rates for the basic service tier that are consistent with the regulations prescribed by the Commission for the regulation of basic service tier. . ." TWC filed a Form 1205 for 2004 and Form 1240's for the years 2000, 2001, 2002, 2003, and 2004 on October 1, 2003. This engagement was to review Time Warner's proposed rates effective January 1, 2004, to determine if the proposed rates were calculated in compliance with the FCC's forms and rules, and provide the City with recommendations concerning the disposition of the proposed rates. TWC requested a maximum permitted rate for basic service of \$22.08 and implemented a basic rate increase on January 1, 2004 from \$8.58 to \$10.50 monthly. TWC increased addressable equipment rental from \$6.95 to \$7.99 and new installation from \$45.86 to \$47.21. All of the service increases are shown on Attachment I.

The franchising authority must follow the FCC rules and regulations to determine if the cable operator requested rates are reasonable and adopt a rate ordinance for basic tier, equipment and installation rates. The rate ordinance must contain specific reasons for its actions in the rate ordinance if it disapproves the requested rate. Under the FCC rules, the cable operator has the burden of proof to show that its requested rates are reasonable. The cable operator has the right to appeal the franchising authority's rate ordinance to the FCC as do other participants to the ratemaking proceeding. In the alternative, the City may enter into a settlement agreement with TWC as long as the agreed upon rates are reasonable.

Background

The 1992 Cable Act established a process whereby cable equipment and "basic" tier cable rates would be subject to regulation by state and municipal governments in those areas where effective competition was absent. For regulatory purposes, basic tier service includes broadcast signals, local public, educational, and government access channels and other services the system operator chooses to include in the same package with these channels. Basic tier service is typically the lowest priced tier of service that all subscribers receive. The FCC established two methods that a cable operator could use to recover its costs to provide cable programming service; Form 1240, the benchmark system, and Form 1220 the Cost of Service showing. The cable operator has the option to determine which method to use. The FCC describes both methods in its FCC Fact Sheet, located at <http://www.fcc.gov/nmb/facts>

"Basically, the FCC has established a benchmark system for use by the local authorities in their determinations of rate reasonableness. Under the benchmark system, a cable operator's rates are compared to a set of rates designed to approximate the rates that a cable operator facing competition would charge. If a cable company believes that its rates must be permitted to exceed the benchmark, it can elect to justify higher rates by making a cost of service showing. This is a more complicated method for determining the reasonableness of a cable company's rates and is based on the company's higher costs of providing service. If the cable company can make the case that its higher costs require higher rates, its rates will be allowed to exceed the benchmark."

Form 1240, the benchmark system, calculates the cable operator's maximum permitted rate for the basic tier, using inflation factors, changes in external and franchising costs, amounts not recovered through prior rates and changes in channel line-up. The Form 1220, the Cost of Service Showing, determines reasonable rates by analyzing all of the cable operators' costs, including a stated rate of return on assets. Form 1205 establishes the maximum permitted rate for equipment and installation services. The Form 1205 is based on nationwide book information for equipment inventories, hourly labor rates and assets used in providing installation and other customer requested services. The 1240 and 1220 are calculated by each franchising authority or area.

The Form 1240 contains financial information for two time periods. The first of these periods is called the Projected Period. There are only two requirements related to defining a Projected Period. First, the Form 1240 must be filed with the local franchising authority a minimum of 90 days prior to the start of the Projected Period for rate adjustments to the basic tier. The time

between the filing date and the beginning of the Projected Period can be more than 90 days. Second, the Projected Period must always be 12 months long.

The second period is called the True-Up Period. There are two requirements for defining a True-Up Period: 1) Cable operators may not perform a true-up on the same period of time twice; 2) The data used in the true-up must have actual data available to verify the rate adjustments claimed for the True-Up Period. This means that with each Form 1240 filing there will be a space of time between the end of the True-Up Period and the beginning of the Projected Period.

Findings

Below is a summary of findings from our review.

1. TWC prepared the Form 1240 filings for 2000, 2001, 2002, 2003, and 2004. However, TWC did not file these forms with the City of Austin until October 2003. The manner in which these forms were filed assumes that in each year a true-up of the prior year was filed and completed. Therefore the TWC's filings calculated interest on the true-up periods in each Form 1240. TWC should have filed for a maximum permitted rate using January 1, 2004 through December 31, 2004 as a projected period and reflected actual cost for 2000, 2001, 2002 and 2003 as true-up periods. The accrual of interest is cut off at the end of the most recent Projected Period. (Instructions for FCC Form 1240, page 5) Interest is calculated on the difference between the true-up maximum permitted rate applicable to the projected period of the prior filing and the rate which was actually charged during the prior filing's projected period. The projected period in TWC's last filing was January 1, 1999 through December 31, 1999. Therefore the only period which is subject to the accrual of interest is the period from January 1, 1999 through December 31, 1999. We have rerun the forms using this approach and eliminated the improper interest accrual.

This issue was recently addressed in FCC Comcast Cablevision of Dallas, Inc. CSB-A-0710 in which the FCC denied Comcast's appeal of rate orders from Cities of Colleyville, Flower Mound and Grapevine. The FCC order stated ".....a cable operator is not entitled to earn interest on rate increases that it chose voluntarily not to take."

2. TWC filed the forms prepared in previous years and in some cases did not use actual data as required in the true-up periods. FSA has updated each true-up period using actual costs.
3. The subscriber counts used in the 2000, 2001 and 2002 Form 1240 filings did not agree with TWC's supporting documentation. The subscriber counts were misstated within a range of 25,000 to 35,000 in the filings. We have adjusted subscriber counts to reflect the appropriate number.

4. TWC's largest expense included in the filings to establish the maximum permitted rate for basic tier is the cost for News 8. News 8 is an exclusive service produced by TWC and provided to TWC's subscribers in Central Texas. The service was recently expanded to Bell County through the Waco Division and to Fredericksburg. There were eleven similar news channels provided by TWC through its cable systems in Texas, New York, Florida and North Carolina. News channels in Charlotte, North Carolina, and San Antonio and Houston, Texas, were recently discontinued. The projected costs included in TWC's filings for the channel is \$1.71 per basic subscriber or about 16% of TWC's total requested maximum permitted rate.

TWC describes its business relationship with News 8 in its response to the 1st Request for Information, question # 1:

"TWEAN News Channel of Austin, L.P., which owns News 8 Austin is a limited partnership which is 99% owned by Entertainment Advance/Newhouse Partnership ("TWEAN") and 1% owned by TWEAN Holdings Inc. which itself is a wholly owned subsidiary of TWEAN. Thus News 8 Austin is ultimately wholly owned by TWEAN which is, of course, the owner of the cable system in Austin."

TWC of Austin used News 8's annual operating costs as the programming costs established in Worksheet 7 of each year's Form 1240s. News 8 is not offered to any third parties. In response to question #4 of the 1st Request for Information, TWC acknowledged that "(t)here is no contract with News 8, given the ownership structure." In a follow-up question during our on-site review, TWC personnel stated that no cash was transferred between the entities and that News 8 News was accounted for as a separate cost center in TWC.

The Filing Instructions of the FCC Instructions for Form 1240 state:

The Commission's rules recognize seven categories of external costs: retransmission consent fees, copyright fees, programming costs, certain cable specific taxes, franchise-related costs, franchise fees and Commission regulatory fees. You may adjust your maximum permitted rate for changes in these categories of costs except for franchise fees, which are not included in your permitted rates but rather are simply added to them. (Page 2)

Based on the information provided by TWC, it appears that the programming costs

associated with News 8 are not external.

However, if the News 8 costs are considered to be external and purchased from an affiliate, the FCC Rules at 47 CFR 76.922 (6) provides the standard to allow affiliated programming cost to be passed through to subscribers. It states:

(6) Adjustments to permitted charges to reflect changes in the costs of programming purchased by affiliated programmers, as defined by 76.901 shall be permitted as long as the price charged to the affiliated system reflects either prevailing company prices offered to third parties (where affiliated program supplier has established such prices) or the fair market value of the programming.

The reasonableness of a TWC New York News 1 channel was addressed by the New Jersey Board of Public Utilities on August 18, 2003 in BPU Docket No. CR02100722. The administrative law judge in that docket found that a reasonable rate would be based on the lower of book value or the estimated fair market value of the programming. New York 1 News programming was offered to third party for \$.37 per channel but had requested \$.61 per subscriber through the regulated rate. The Board found that TWC had *not met the burden of proof* by providing that the request was cost based and reasonable. The Board imputed the rate of \$.37 per subscriber as a fair estimation of the fair market value for a local news channel.

The City may adopt a reasonable rate using the best available information. The use of \$.37 is the best available information to establish the fair market value of a local news channel since TWC has not provided any support for the fair market value of News 8.

4. TWC's October 2003 Form 1205 filing and the July 30, 2004 filing were reviewed and additional information was obtained. FSA found the requested equipment and installation rates to be reasonable. The changes in the rates are shown on Attachment 1.

Recommendations

1. We recommend that prior years' filings be considered as true-up periods for the purposes of the Form 1240 and that interest be allowed on the true up period from January 1, 1999 through December 31, 1999.
2. We recommend that the Form 1240s use actual costs for the true-up periods in accordance with the FCC rules and regulations.
3. We recommend that the City adopt Form 1240 rates calculated by using the correct number of subscriber in each of the Form 1240 filings for 2000, 2001 and 2002.
4. We recommend three alternatives for Council's consideration for the treatment of costs related to News 8.
 - a. The expenses related to News 8 should be eliminated from the current Form 1240 filings because TWC did not meet its burden of proof to substantiate the fair market value of News 8. Using the Forms 1240s, with the adjustments described above and disallowing all News 8 expenses, the resulting maximum permitted rate is \$8.20. TWC requested a maximum permitted rate of \$22.08 and implemented an operated selected rate of \$10.50 in January 2004.
 - b. The City of Austin could adopt the fair market value of the local news channel of \$.37. This rate was adopted in the New Jersey case in 2003. Using \$.37, which is the best available information to establish the fair market value of a local news channel, results in a maximum permitted rate of \$10.50.
 - c. Enter into a settlement with TWC in which TWC agrees to not increase the current rate of \$10.50 until January 1, 2006 and use \$10.50 as the maximum permitted rate in its October 1, 2005 filing to establish its 2006 rates. The settlement is silent concerning the fair market value of News 8 and each party maintains reserves it rights in future filings except for the maximum permitted rate and reflecting zero as the true-up amount.
5. We recommend the City adopt the 1205 rates requested for installation and equipment leasing. The recommended rates are shown on Attachment 1.

Summary

If the City of Austin determines that TWC has not supported its request for a maximum permitted rate of \$22.08, the maximum permitted rate supported by the FCC Form 1240 is \$8.20. TWC should implement a new rate not to exceed \$8.20, beginning with its October 2004 billing. The recalculated maximum permitted rate exceeds the operator selected rate by \$2.30 per month, per subscriber. The City of Austin should order a refund if TWC does not file a Form 1220 to justify its requested rates. As stated in 47 CFR 76.942, the operator's liability for refunds is limited to a one-year period. The refund liability is calculated as follows:

\$2.30 for January through September 2004	\$20.70
\$.38 for October through December 2003	<u>\$ 1.14</u>
Total Refund per Subscriber	<u>\$21.84</u>

If TWC files FCC Form 1220 to recover the cost of News 8, the City can defer ordering refunds pending the outcome of the City's review of the rates requested in that filing. If the City orders refunds, TWC should file a refund plan and schedule with the City of Austin detailing the total amount of the refund, the calculation of interest as prescribed by the FCC rules and regulations.

If the City of Austin determines that the fair market value of News 8 should be based on \$37, the resulting maximum permitted rate is \$10.50. Since TWC implemented \$10.50 rate on January 1, 2004, no refund is required.

TWC has the following options to respond to the City's rate ordinance:

1. TWC can appeal the City's rate ordinance to the FCC.
2. TWC can file a FCC Form 1220 to support a requested rate that exceeds the maximum permitted rates using the Form 1240.
3. TWC can move the News 8 channel to its programming service tier which is not regulated.

In the alternative, the City may enter into an agreement with TWC to establish a reasonable rate. In this case, a rate ordinance is not required.

City of Austin

Time Warner Maximum Permitted Rates for Basic Tier, Equipment and Installations

	<u>2003</u>	<u>2004</u>	
<u>Basic Tier</u>	\$8.58	\$ 10.50	With News 8 valued at \$.37
		\$ 8.20	Without News 8
<u>Equipment</u>			
Addressable	\$ 6.95	\$ 7.99	
Non-Addressable	\$ 0.59	\$ 0.68	
Remote Control	\$ 0.35	\$ 0.34	
Cable Card	\$ -	\$ 2.02	
<u>Installation</u>			
New Installation	\$ 45.86	\$ 47.21	
Reconnect/Additional Outlet	\$ 31.81	\$ 33.05	
With Install	\$ 19.89	\$ 18.65	
Separate Trip	\$ 31.74	\$ 32.92	
VCR Connection			
With Install	\$ 18.89	\$ 18.65	
Separate Trip	\$ 31.74	\$ 32.92	
Change of Service	\$ 31.81	\$ 33.05	
Interior Wall Drop	\$ 31.81	\$ 33.05	
Addressable Change of Service	\$ 5.25	\$ 5.25	