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

In the Matter of:	)
	)
WARNER CABLE COMMUNICATIONS	)
	)
Appeal of Local Rate Order	)
of City of Akron, Ohio	)

MEMORANDUM OPINION AND ORDER

Adopted: August 2, 1996 **Released: August 13, 1996**

By the Chief, Cable Services Bureau:

INTRODUCTION

1. On April 28, 1995, Warner Cable Communications ("Warner"), operator of a cable system in the City of Akron, Ohio ("the City"), filed an appeal of a local rate order approved by the mayor of the City on March 3, 1995.[1] The City's rate order reduces Warner's rate for the basic service tier and for certain equipment and installation charges in effect from September 1, 1993 to July 14, 1994 and mandates refunds to subscribers of all charges in excess of the reduced rates for the entire period.[2] Warner alleges that the City erred in determining its basic service rate by treating a three-channel a la carte package as a regulated tier, and in reducing the rate for a new converter. The City filed a response to the appeal on May 11, 1995, and Warner filed a reply on May 22, 1995.

2. Under our rules, rate orders made by local franchising authorities may be appealed to the Commission.[3] In ruling on appeals of local rate orders, the Commission will not conduct a *de novo* review, but instead will sustain the franchising authority's decision as long as there is

[1]By Order, DA 95-817, released April 14, 1995, a Joint Motion for Extension of Time filed by Warner and the City was granted, extending the date for filing an appeal until April 28, 1995.

[2]Under the Cable Television Consumer Protection and Competition Act of 1992 ("1992 Cable Act") and the Commission's implementing regulations, local franchising authorities may regulate rates for basic cable service and associated equipment and installations. *See* Cable Television Consumer Protection and Competition Act, Pub. L. No. 102-385, 106 Stat. 1460 (1992); Communications Act, § 623(b), 47 U.S.C. § 543(b)

[3]*See* 47 C.F.R. § 76.944.

a reasonable basis for that decision.[4] The Commission will reverse a franchising authority's decision only if it determines that the franchising authority acted unreasonably in applying the Commission's rules in rendering its local rate order.[5] If the Commission reverses a franchising authority's decision, it will not substitute its own decision but instead will remand the issue to the franchising authority with instructions to resolve the case consistent with the Commission's decision on appeal.[6] With respect to a determination made by a franchising authority on the regulatory status of an a la carte package as part of its final decision setting rates for the basic service tier, the Commission has stated that "the Commission will defer to the local authority's findings of fact if there is a reasonable basis for the local findings," and the Commission "will then apply FCC rules and precedent to those facts to determine the appropriate regulatory status of the [a la carte package] in question."[7]

DISCUSSION

A. A La Carte Package

3. Warner introduced an a la carte package consisting of three channels in July of 1993, which could be purchased individually for $1.15 each or as a discounted package for $2.31. The a la carte package was created by removing the three channels from the system's cable programming service tier. Warner asserts that the City improperly treated the collective offering of the three channels as a regulated tier. Warner argues that this a la carte package complies with the provisions of the 1992 Cable Act, which it contends encourages cable operators to unbundle programming services from regulated tiers and offer them on a per-channel basis.[8] Warner further argues that the a la carte package fully complies with Commission rules for unregulated treatment existing at the time the package was created.[9] In its opposition the City states that it reached the decision on the a la carte issue after carefully and reasonably applying the Commission's rules for the treatment of a la carte packages.

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[4] *See* Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, MM Docket No. 92-266, Report and Order and Further Notice of Proposed Rulemaking, 8 FCC Rcd 5631, 5731 (1993) ("*Rate Order*"); Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, MM Docket No. 92-266, and Buy-Through Prohibition, MM Docket No. 92-262, Third Order on Reconsideration, 9 FCC Rcd 4316, 4346 (1994) (*"Third Recon. Order"*).

[5] *Id.*

[6] *Id.*

[7] *Second Recon. Order*, 9 FCC Rcd at 4217.

[8] Appeal at 4-5.

[9] *Id at 8. See Rate Order,* 8 FCC Rcd at 5836-5838; Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, First Order on Reconsideration, MM Docket 92-266, 9 FCC Rcd 1164, 1184-85 (1993).

4. The facts presented in this appeal resemble the facts presented in several of our letter of inquiry decisions in which a la carte packages were deemed to be a "new product tier" that should not be treated as a rate regulated tier for purposes of calculating a cable system's basic rates.[10] For example, the a la carte package at issue in the *Comcast of Mt. Clemens* order consisted of a four channel package, made up of channels formerly available on its basic tier and on its two cable programming service tiers, and which was offered as part of a restructuring of the operator's channel line up. In that case, after considering the restructuring put into effect there under the various tests set forth in the Commission's *Rate Order*, in the *Second Reconsideration Order*, and in *Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, Sixth Order on Reconsideration and Fifth Report and Order*,[11] we still were unable to find that the a la carte package at issue clearly was not a permissible non-rate regulated offering under our rules. We further concluded that, in light of prior confusion over what constituted a permissible non-rate-regulated a la carte offering, it would be inequitable to subject the operator to refund liability or to require the operator to restructure its tiers and return the channels offered in the a la carte package to regulated tiers. Instead, we found that the a la carte package at issue there could be treated as a new product tier under the *Going Forward Order*.

5. We find that the City's determination that Warner's a la carte package is a regulated tier is inconsistent with the action taken in our a la carte letter of inquiry orders, and in particular in our order in *Comcast of Mt. Clemens*. We further find that Warner's a la carte package should not be treated as a standard rate-regulated tier of service and that the channels comprising it should be treated as non-rate regulated for purposes of rate justification. Accordingly, we are remanding this issue to the City for the entry of an order consistent with these findings.

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[10] *See, for example*, Comcast Cablevision, Mt. Clemens, Michigan, 10 FCC Rcd 103 (1994) (*"Comcast of Mt. Clemens"*). *See also* Paragon Cable (Irving, TX), 9 FCC Rcd 7333 (1994) (*"Paragon, Irving, TX"*)," and Century Cable TV (Huntington, WV), 9 FCC Rcd 7337 (1994).

[11] *See* MM Docket Nos. 92-266 and 93-215, 10 FCC Rcd 1226 (1994) ("*Going Forward Order*"). New product tiers are cable programming services that, subject to certain conditions, are not rate regulated. *Going Forward Order*, 10 FCC Rcd at 1233-39. In the *Going Forward Order*, the Commission reconsidered its regulatory treatment of collective offerings of a la carte channels. Specifically, the Commission determined that such packages are cable programming service tiers within the meaning of Section 3(1)(2) of the 1992 Cable Act and therefore will be subject to our general rate regulation rules. *Id* at 1243. However, the Commission also stated that with respect to packages created between April 1, 1993, and September 30, 1994, where it is not clear that a particular package was not a permissible offering under the a la carte rules in effect at the time it was created, the package may be treated as a new product tier. *Id.*

B. The Rate for the New Converter

6. With respect to the reduced rate for the new converter,[12] Warner alleges that the City erred by reducing Warner's allowance for a "safety stock" inventory,[13] by disallowing Warner's figure for lost converters, and by making an inadequate allowance for Warner's equipment storage costs. Warner asserts that the cumulative impact of these errors is $0.78 and that the permitted rate for the new converter should be at least $4.10, not $3.32 as determined by the City.

1. Allowance for "Safety Stock" Inventory

7. Warner provided cost information in addition to that submitted with its Form 393 at the request of the City's rate consultant by means of an October 21, 1994 letter. In support of its rate for the new converter, Warner included in this showing a "safety stock" inventory based on ten percent (10%) of converters in service. The City reduced this inventory allowance to only five percent (5%) instead of the ten percent (10%) that Warner claimed. The City defends its reduction of the allowance for "safety stock" inventory essentially on the grounds that Warner's need for the new converters was declining. The City bases its finding of a declining need for the new converter on Exhibit I attached to Warner's October 21 letter, which shows a downward trend during the first nine months of 1994 in the number of Tier 2 subscribers who require the new converter for viewing programming. Based on that information, the City concludes that a smaller "safety stock" inventory was required than that claimed by Warner. The City also points to Warner's decision in 1994 not to proceed with a requirement that all CPS tier subscribers utilize converters.

8. Warner contends in response that demand for the new converter is in fact on the increase, because the new converter is required to view the a la carte package introduced in 1993 and to view a new product tier introduced in 1994. Warner presented data to the City showing that the number of the new converters in service increased significantly each month during the months of February through October 1994.[14] Warner contends further that, although its Exhibit D showed a "safety stock" inventory in excess of 10%, a "safety stock" inventory based on 10% of units in service was reasonable and that the allowance of 5% of units in service set by the City is too low.

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[12]The rate in question here is for a Pioneer Model BA-9510 converter introduced by Warner after it had filed its Form 393, cost data for which was subsequently submitted at the City's request. No other equipment rate adjustments made by the City are challenged by Warner.

[13]The parties are using the phrase "safety stock" inventory to denote a supply of converter in inventory adequate to accommodate additions and deletions of converters in service as they occur.

[14]*See* Appeal p. 4-5 and Exhibit D.

9. We believe Warner has demonstrated that the "safety stock" allowance of 5% of units in service set by the City is not consistent with demonstrated demand trends and therefore may be so unreasonably low as not to allow full recovery of relevant costs. Although the City's Exhibit I shows a decline in the number of Tier 2 subscribers during the first nine months of 1994, the City provides no nexus between the number of subscribers and the actual demand for the new converters. It also appears that the City did not take into account information presented by Warner in its Exhibit D, which shows substantially increased numbers of these converters in service for each of these same months in which the City's Exhibit I showed declining Tier 2 subscriber numbers.[15] The City cites nothing which contradicts Warner's explanation that the increased demand for converters is driven by the introduction of a new product tier as well as the a la carte tier. Clearly, in the face of an evident monthly increase in the numbers of new converters in service, it is apparent that the declining numbers of Tier 2 subscribers in and of itself is an unreliable indicator of actual demand for the new converters. For this reason, we will set aside the "safety stock" allowance of 5% inventory set by the City and remand this matter to the City with directions to determine an allowance for a "safety stock" inventory that considers numbers of converters in service along with other relevant data and information.

2. Allowance for lost converters

10. In the additional cost showing, Warner also submitted a 4.7% converter loss factor in support of the rate for the new converter. This 4.7% converter loss factor was in addition to the amount Warner claimed for its "safety stock." The City rejected any allowance for lost converters, concluding that its 5% allowance for a "safety stock" inventory was more that adequate for this purpose as well. The City ruled that equipment losses should be included in the depreciation calculation and not as a separate cost presented as an "unusual" loss as Warner had done.[16] The City asserts that an unusual loss should be accounted for in depreciation expenses in such manner as to avoid a rate spike. The City also questioned the sincerity of Warner's claimed allowance for lost converters, on the grounds that Warner did not raise the concept of unusual losses of converters for over six months until a phone conversation with the City's consultant occurred.

11. Warner states that it intends to account for all equipment losses as part of depreciation in accordance with Commission policy. However, it contends that depreciation rates could not be developed for the initial rate showing for the new converters, because this equipment had just been introduced and neither a calendar nor a fiscal year had elapsed. Therefore, it

[15]The number of new converters in service increased from 3,540 in February 1994 to 81,524 in October 1994, for an average increase of over 9,700 monthly over the eight month period.

[16]The City relied on a Commission statement from paragraph 66 of the *First Order on Reconsideration, Second Report and Order, and Notice of Proposed Rulemaking*, MM Docket 92-266, 9 FCC Rcd 1164, 1199 (1993), "Lost converters should not require separate consideration in the calculations of equipment rates inasmuch as the depreciation rates may take into account a normal loss, and requirement of such lost items will adjust the net plant balance."

annualized its first several months of actual loss experience to arrive at the loss rate figure of 4.7% presented to the City.[17] The City erred, Warner contends, in rejecting this figure and subsuming this item within the safety stock allowance discussed above. This action, according to Warner, ignores the difference between the concept of a safety stock inventory which is added to capital costs of equipment in use, and the concept of equipment lost which represents actual cost of equipment lost during an accounting period. Warner contends that a converter in inventory incurs only financing, storage and depreciation charges, while a lost converter means a total loss of the capital investment in that piece of equipment.

12. We hold that the City erred in rejecting Warner's new converter loss rate figure of 4.7% for use in determining the rate for the new converter. In the absence of a full year of experience with this newly introduced item of equipment on which to base depreciation rates, we believe that use of annualized loss experience for the initial partial year, a period of nine months, serves as a reliable proxy for the absent depreciation rates. Grounded as it is in actual experience with losses, it is certainly more reliable than an unsupported assumption by the City that both loss and safety stock inventory could be accommodated by the 5% safety stock allowance. It appears that the major reason for the City's rejection of Warner's 4.7% loss rate stemmed from Warner's characterization of that loss rate as an "unusual" cost item. It is clear from this record, however, that Warner used that characterization only in the sense that this cost element had not been derived from depreciation accounting because of the recent introduction of this equipment into service. The City also expressed concern about an unreasonable rate spike resulting from use of the 4.7% loss rate. The City did not, however, show how an unreasonable rate spike would result in this instance from a loss rate grounded in losses experienced with these converters prior to submission of the cost showings. Moreover, as Warner points out, further experience with this equipment will be factored into future depreciation allowances (and will not be stated as a separate item as was done here), which should preclude any unusual or unreasonable rate spiking. For these reasons, we will set aside the disallowance for lost converters and remand this matter to the City with directions to use a 4.7% loss rate factor in developing a rate for the new converter.

3. Storage Costs

13. Warner in its appeal objects to the manner in which the City determined an allowance for converter storage costs, arguing that the City failed to annualize the nine months of documented warehouse expenses and treated these expenses as capital costs rather than as operating expenses. In its reply, Warner states that it cannot say that the City's approach, which is explained in the City's response, is unreasonable. Accordingly, we will dismiss this matter as moot.

[17] *See* Warner Exhibit E.

ORDERING CLAUSES

14. Accordingly, **IT IS ORDERED** that Warner Cable Communications' appeal of the local order of the City of Akron, Ohio **IS GRANTED**, and the cause **IS REMANDED** to the City for further proceedings consistent with this Order.

15. This action is taken by the Chief, Cable Services Bureau, pursuant to authority delegated by Section 0.321 of the Commission's rules, 47 C.F.R. § 0.321.

FEDERAL COMMUNICATIONS COMMISSION

Meredith J. Jones
Chief, Cable Services Bureau