



Testimony

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TELECOMMUNICATIONS

Data Gathering Weaknesses In FCC's Survey Of Information on Factors Underlying Cable Rate Changes

Statement of William B. Shear, Acting Director
Physical Infrastructure



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Highlights of [GAO-03-742T](#), testimony before the Committee on Commerce, Science, and Transportation, U.S. Senate.

Why GAO Did This Study

Over 65 percent of American households currently subscribe to cable television service. There has been increasing concern that cable television rates have been rising faster than the rate of inflation for the last few years.

As required, on a yearly basis, FCC prepares a report on cable rates in areas that face and those that do not face effective competition—a term defined by statute. For information used in this report, FCC maintains information on the competitive status of cable franchises and annually surveys a sample of cable franchises.

At the request of this committee, GAO examined (1) the reliability of information that cable companies provided to FCC in its annual survey regarding cost factors underlying cable rate increases and (2) FCC's process for updating and revising cable franchise classifications as to whether they face effective competition.

What GAO Recommends

GAO is continuing to evaluate these and other issues and may include recommendations in a final report to be issued in October 2003.

www.gao.gov/cgi-bin/getrpt?GAO-03-742T.

To view the full report, including the scope and methodology, click on the link above. For more information, contact William B. Shear at (202) 512-4325 or shearw@gao.gov.

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Data Gathering Weaknesses In FCC's Survey Of Information on Factors Underlying Cable Rate Changes

What GAO Found

Based on interviews with 100 randomly sampled cable franchises that completed FCC's 2002 survey, GAO's preliminary analysis indicates that FCC's survey may not be a reliable source of information on the cost factors underlying cable rate increases. Because of the following problems, GAO found that there are inconsistencies in how companies completed the survey.

- FCC provided minimal instructions or examples on how the portion of the survey covering the cost factors underlying rate increases should be completed. It appears that cable companies made varying assumptions on how to complete the survey.
- FCC's survey required that cable companies fully allocate their reported annual rate increase to various cost and non-cost factors. Our preliminary findings indicate that there was inadequate guidance on how to achieve this requisite balance, and cable companies approached the question in varying ways.

Based on preliminary work, GAO found that FCC's classification of cable franchises as to whether they face effective competition might not accurately reflect current conditions. GAO found instances where information in the survey responses of some franchises would suggest that the criteria for an effective competition finding that was made in the past might no longer be present. However, a finding of effective competition is only changed if a formal process is instituted. GAO found only two instances where a petition was filed that resulted in a reversal of an effective competition finding.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to provide preliminary observations from our ongoing work on cable television rates. Over 65 percent of American households are currently cable television subscribers. As you have noted, Mr. Chairman, cable television rates have been rising faster than the rate of general inflation for many years. At the request of this Committee, we are providing preliminary observations today on two issues: (1) the reliability of the information that cable companies have provided to the Federal Communications Commission (FCC) in 2002 regarding the costs factors underlying their recent cable rate increases, and (2) FCC's process for updating and revising the classification of cable franchises as to whether they are facing *effective competition*—a statutorily-defined term. We plan to issue a report with our final analysis of these and other issues in October 2003.

To address the reliability of information that FCC collected, we randomly sampled 100 of approximately 700 cable franchises that responded to FCC's 2002 cable rate survey.¹ We selected a random sample of 100 cable franchises so that we could make estimates about the entire population of about 700 cable franchises that responded to the FCC. We asked these franchises a series of questions about how they completed a portion of FCC's survey that asks about the cost factors underlying annual cable rate changes. To examine FCC's process for classifying cable franchises as to whether they face effective competition, we reviewed how various franchises were classified according to FCC's information and whether these classifications continue to accurately reflect current circumstances.

Our work has focused on examining whether FCC's annual report on cable rates is providing reliable information on the causes of rate increases and the competitive status in video markets. In summary, our preliminary analysis suggests that some of FCC's information on cable companies is inconsistent and potentially misleading. In particular:

- Our preliminary analysis of the responses provided by 100 cable franchises indicates that FCC's 2002 survey does not provide a reliable source of information on the cost factors underlying cable rate increases. We found two key causes of variation in how companies completed the survey. First,

¹FCC samples between 700 and 800 of the universe of roughly 10,000 cable systems using a stratified sampling approach based on the status of effective competition and the size of the cable operator.

FCC provided minimal instructions or examples on how the portion of the survey covering the cost factors underlying rate increases should be completed. As a result, we found that cable companies made varying assumptions about how to complete the survey. Second, the FCC survey form requires that the reported dollar amounts reported for factors that might underlie rate changes—5 cost factors and a non-cost factor are included on the form—sum to the reported rate increase for the year. In the absence of guidance on how to achieve this requisite balance, cable companies approached the question in varying ways. In particular, most of the companies told us that they adjusted one of the 5 cost factors for the purpose of the required balancing, thereby misreporting actual cost changes that had occurred.

- Our preliminary findings show possible inaccuracies in FCC's current classification of cable franchises regarding their *effective competition* status. We found indications that there are cases in which a finding of effective competition in a particular franchise area that might have existed in the past no longer seemed accurate. Nevertheless, the determination of effective competition remained in effect because the franchising authority had not filed a petition that would challenge that finding. In fact, we found that such petitions are rare.

Background

Cable television emerged in the late 1940s to fill a need for television service in areas with poor over-the-air reception, such as in mountainous or remote areas. By the late 1970s, cable began to compete more directly with free over-the-air television by providing new networks—available only on cable systems—such as HBO (introduced in 1972), Showtime (introduced in 1976), and ESPN (introduced in 1979). According to FCC, cable's penetration rate—as a percent of television households—increased from 14 percent in 1975 to 24 percent in 1980 and to 65 percent by 2002. Cable television is by far the largest segment of the subscription video market, a market that includes cable television, satellite service (direct broadcast satellite (DBS) providers such as DirecTV), and other technologies that deliver video services to customers' homes.

Cable companies deliver video programming to customers through cable systems. These systems consist of *headends*—facilities where programming from broadcast and cable networks is aggregated—and *distribution facilities*—the wires that carry the programming from the headend to customers' homes. Depending on the size of the community, a single headend can serve multiple communities or several headends may be required to serve a single large community. At the community level,

cable companies obtain a franchise license under agreed-upon terms and conditions from a franchising authority, such as a township or county. In some cases, state public service commissions are also involved in cable regulation.

During cable's early years, franchising authorities regulated many aspects of cable television service, including franchise terms and conditions and subscriber rates. In 1984, the Congress passed The Cable Communications Policy Act, which imposed some limitations on franchising authorities' regulation of rates.² However, 8 years later, in response to increasing rates, the Congress passed The Cable Television Consumer Protection and Competition Act of 1992. The 1992 act required FCC to establish regulations ensuring reasonable rates for *basic service*—the lowest level of cable service that includes the broadcast networks—unless a cable system has been found to be subject to effective competition, which the act defined. The act also gave FCC authority to regulate any unreasonable rates for upper tiers (often referred to as *expanded-basic service*), which includes cable programming provided over and above that provided on the basic tier.³ Expanded-basic service typically includes such popular cable networks as USA Network, ESPN, CNN, and so forth. In anticipation of growing competition from satellite and wire-based providers, the Telecommunications Act of 1996 phased out all regulation of expanded-basic service rates by March 31, 1999. However, franchising authorities retain the right to regulate basic cable rates in cases where no effective competition has been found to exist.

As required by the 1992 act, FCC annually reports on cable rates for systems found to have effective competition compared to systems without effective competition. To fulfill this mandate, FCC annually surveys cable franchises regarding their cable rates. In 2002, the survey included questions about a range of cable issues including the percentage of subscribers purchasing non-video services and the specifics of the

²The 1984 Act restricted regulation to only basic services for cable systems not subject to effective competition. In its rulemaking, FCC initially said that effective competition existed if three or more over-the-air broadcast signals existed in a given market. Under this narrow definition, over 90 percent of all cable systems would be subject to effective competition and therefore not subject to rate regulation.

³Basic and expanded-basic are the most commonly subscribed to service *tiers*—bundles of networks grouped into a package—offered by cable companies. In addition, customers in some areas can purchase digital tiers and also premium pay channels, such as HBO and Showtime.

programming channels offered on each tier to better understand the cable industry.

Until recently, cable companies usually encountered limited competition in their franchise areas. Some franchise agreements were initially established on an exclusive basis, thereby preventing wire-based competition to the incumbent cable provider. In 1992, the Congress prohibited the awarding of exclusive franchises, and in 1996, the Congress took steps to allow telephone companies and electric companies to enter the video market. Still, only limited wire-based competition has emerged, in part because it takes large capital expenditures to construct a cable system. However, competition from DBS has grown rapidly in recent years. Initially unveiled in 1994, DBS served over 18 million American households by June 2002. Today, two of the five largest subscription video service providers are DirecTV and EchoStar, the two primary DBS companies.

In a recently released report, we found that competition in the subscription video market can have a significant impact on cable rates.⁴ Using an econometric model, we found that franchise areas with a second wire-based video provider had rates approximately 17 percent lower than similar franchise areas without such a competitor.⁵ We did not, however, find that competition from DBS providers is associated with lower cable prices, although we did find that where DBS companies provide local broadcast networks to their customers, cable companies provide more channels than in areas where DBS companies do not provide local broadcast channels. Moreover, we also found that DBS providers obtain a substantially higher level of subscribers in areas where they are providing local broadcast channels.

⁴See, U.S. General Accounting Office, *Telecommunications: Issues in Providing Cable and Satellite Services*, [GAO-03-130](#) (Washington, D.C.: Oct. 15, 2002).

⁵In a similar analysis, FCC found that cable rates in franchise areas with a wireline competitor were nearly 7 percent lower than in franchise areas without such a competitor. See, Federal Communications Commission, *Report on Cable Industry Prices*, [FCC 02-107](#) (Washington, D.C.: April 4, 2002).

FCC's Cable Rate Survey Does Not Appear to Provide a Reliable Source of Information on the Cost Factors Underlying Cable Rate Increases

FCC's annual cable rate survey seeks information on cable franchises' cost changes that may underlie changes in cable rates during the preceding year. To evaluate the reliability of these statistics, we asked 100 of the approximately 700 franchises that FCC surveyed in 2002 to describe how cost change information that they provided to FCC was calculated. Figure 1 shows the actual portion of the FCC survey which franchises completed to provide their cost change information.

Figure 1: Section of FCC's 2002 Rate Survey Covering Rate and Cost Changes

E. Programming Service Charges in Community

In the following, the "basic cable service tier" or **BST** is the service tier that includes the retransmission of over-the-air broadcast signals and may include a few satellite or regional channels. A "cable programming service tier" or **CPST** is any other tier containing programming other than that on the BST, pay-per-channel, or pay-per-view. **CPST1** refers to the major CPST and typically meets two criteria: It has the most channels and most subscribers among the CPST tiers (if more than one CPST is offered). Sometimes a "mini-tier" with considerably fewer channels has the most subscribers among the CPSTs. This mini-tier is considered **CPST2**, whether or not it has the most subscribers.

Monthly Charges for Programming Services

- 48 Monthly charge for **BST**
- 49 Monthly charge for **CPST1**
- 50 Monthly charge for **BST plus CPST1** (rows 48 + 49)
- 51 Year-to-date change in monthly charge on row 50

July 1, 2000	July 1, 2001	July 1, 2002

For July 1, 2001 and July 1, 2002, allocate the change shown on row 51 by estimating the dollars and cents that each factor, below, contributed. The total of these factors (row 58) should equal the change on row 51.

- 52 License or copyright fees, *existing* programs
- 53 License or copyright fees, *new* programs
- 54 Headend or distribution facility investment
- 55 General inflation, not included elsewhere
- 56 Other cost changes (positive or negative)
- 57 Non-cost-related factors (positive or negative)
- 58 Total of rows 52-57 (must equal row 51)

Source: 2002 FCC Rates Survey

Our discussions with cable franchises indicated considerable variation in how franchises completed this section of the 2002 FCC cable rates survey. Our preliminary observations indicate that there are two causes for the resulting variation: (1) there were insufficient instructions or examples on how the form was supposed to be completed, leading to confusion among cable operators regarding what to include for the different cost factors and how to calculate each of them; and (2) the requirement that the cost and non-cost factors sum to the reported annual rate increase caused many cable operators to adjust one or more of the cost factors, thereby resulting in data that might not provide an accurate assessment of the cost factors underlying cable rate increases.

Lack of adequate instructions. Our interviews with 100 cable franchises indicate that the lack of specific guidance regarding the cost change section of the survey caused considerable confusion about how to fill out the form. Every franchise that we spoke with said it was unclear what FCC expected for at least one of the six factors (5 cost factors as well as a non-cost factor); 73 of the 100 franchises said that the instructions were insufficient. In particular, several cable representatives we interviewed noted that there were no instructions or examples to show how to calculate investment, what types of cost elements should go into the *other costs* category, and what FCC meant by non-cost factors. This lack of guidance created considerable variation in the approaches taken to develop the cost factors. Table 1 provides information on the approaches cable franchises used to complete the portion of the survey pertaining to cost and non-cost factors underlying rate changes.

Table 1: Summary of Approaches Used by Cable Franchises to Calculate Cost and Non-Cost Factors

Type of cost/non-cost factor (line of FCC survey)	Discussion of how franchises approached this factor
License or copyright fees, existing and new programs (lines 52 and 53)	- Most of the cable companies told us they used specific cost data on existing programming costs to develop the cost changes associated with increases in existing programming. - Thirty-nine of the 47 franchises that reported an increase in new programming costs said they used actual information to calculate these cost changes. - Some companies took a standard company-wide approach to estimating programming costs as opposed to estimating the costs for each individual franchise. - Some companies combined cost changes for all programming without separating existing from new programs.
Head-end or distribution facility investment (line 54)	- Eighty-three of the 100 franchises we surveyed entered zero for these infrastructure investments. Of these, 33 told us that there had, in fact, been additional costs for such upgrades that year. The reasons provided to us for leaving it blank included concern that it would be too difficult to determine how much of these costs would be appropriately allocated to a certain video service or franchise. - Some cable companies performed significant calculations to estimate how much should be allocated to the support of video services, while other estimates did not include detailed cost calculations.
General inflation (line 55)	- Fifty-seven of the 100 franchises estimated inflation by using either FCC or Bureau of Labor Statistics' inflation factors. - Other companies left the inflation factor blank because they assumed that most inflation would be captured in the other cost factors.
Other cost changes (line 56)	- Sixty-four of the 100 franchises filled in a zero for the <i>other cost</i> factor. Of these 64 franchises: - Thirty-two told us that there were, in fact, cost changes that would have appropriately been captured in the <i>other</i> category; - Seventeen told us that they did not understand what items should be included in <i>other costs</i>; and - Fifteen told us that by the time they got to this line on the form, they had already accounted for enough costs to offset the reported rate increase and thus, they did not evaluate whether there were any costs that should be included as <i>other costs</i>.
Non-cost-related factors (line 57)	- Eighty-seven of the 100 respondents said they did not understand what non-cost factors would cover, and as a result, 76 of the respondents left the <i>non-cost</i> factor blank. - Those that did enter a number for this factor cited such items as a change in profit margin or the need to establish uniform rates across franchises.

Source: GAO Survey of 100 Cable Franchises

Requirement that factors sum to the reported annual rate change. Our survey of 100 cable franchises that responded to FCC's 2002 cable rates survey indicated that a second source of confusion relates to the requirement that the sum of the underlying cost and non-cost factors (see fig. 1 lines 52-57) equal the change in the franchise's cable rates (see fig. 1 line 51). This portion of FCC's survey was originally designed during the 1990s when both basic and expanded-basic services were regulated. At that time, cable companies were required to justify any rate increases the cable company implemented based on cost increases that it had incurred during the year. An FCC official told us that the rate/cost factor portion of the form was designed to mirror a regulatory form that was used at that time to justify rate changes. When expanded-basic services were deregulated in March 31, 1999, FCC realized that cost factors would no longer necessarily equal the yearly rate change because companies were no longer required to tie rate changes to explicit cost factors for regulatory purposes.⁶ In the 1999 cable rates survey, FCC added the non-cost line in this section of the survey and continued to require that the cost factors and the non-cost factor sum to the reported annual rate change.

FCC officials told us that cable operators could use the non-cost factor element to make up any difference (positive or negative) between their changes in costs and rates. However, based on our findings, it appears that this may not have been clearly communicated to cable franchises. We found that only 10 franchises took this approach and instead, most franchises told us that they chose to change their estimate of one or more of the cost factors. In most cases, cable representatives told us that this meant *reducing* other cost factors because most franchises told us that their actual annual cost increases for the year covered by the 2002 survey exceeded their rate change for expanded-basic service.⁷ In other words, most franchises—84 of the 100 franchises we spoke with—did not provide a complete or accurate accounting of their costs changes for the year. The following are some examples of how the franchises we surveyed chose to equalize the cost factors with the rate change.

⁶In unregulated markets, for example, costs are an important factor in price setting by companies, but several other key factors, such as consumer demand and the competitiveness of the market also influence market price.

⁷Many franchises said that their profit margins for basic and expanded cable services decreased in 2002, but many said that those decreases were offset by increased profits from other services, such as cable Internet and digital cable. The 3 franchises that said that their rate increase exceeded their cost increases made the two balance by entering a positive number in non-cost-related factors.

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- Fifteen franchises said they entered dollar values in the factors until the entire rate increase was justified and did not consider the remaining cost factors;
 - Twenty franchises said they chose to adjust the dollar estimates in existing and/or new programming in order to balance costs and rates;
 - Seven franchises said they chose to adjust the costs included for investment in order to balance costs and rates;
 - Twenty-seven franchises said they chose to adjust the amount of their inflation estimate to ensure that costs and rates were in balance;
 - Twenty-six franchises said they chose to adjust the *other costs* factor to ensure that costs and rate changes were in balance; and
 - Four franchises said they adjusted more than one of the cost factors in order to balance costs and rates. For example, one franchise chose to adjust all of the factors by a uniform percentage in order to retain a constant ratio of cost increases.

FCC's Process for Updating and Revising its Classification of the Competitive Status of Cable Franchises May Lead to Classifications that are No Longer Accurate

The 1992 Cable Act established three conditions for a finding of effective competition, and a fourth was added in the 1996 Act. Specifically, a finding of effective competition in a franchise area requires that FCC has found one of the following conditions to exist:

- Fewer than 30 percent of the households in the franchise area subscribe to cable service (low-penetration test).
- At least two companies unaffiliated with each other offer comparable video programming service (through a wire or wireless—e.g., DBS—service) to 50 percent or more of the households in the franchise area and at least 15 percent of the households take service other than from the largest company (competitive provider test).
- The franchising authority offers video programming service to at least 50 percent of the households in the franchise area (municipal test).
- A local telephone company or its affiliate (or any other company using the facilities of such carrier or its affiliate) offers video programming, by

means other than direct broadcast satellite, that is comparable to that offered by the cable provider in the franchise area (LEC test).⁸

Franchising authorities have primary authority to regulate basic cable rates. However, these rates may only be regulated if the cable system is not facing effective competition. Under FCC rules, in the absence of a demonstration to the contrary, cable systems are presumed not to face effective competition. The cable operator bears the burden of demonstrating that it is facing effective competition.⁹ Once the presence of effective competition has been established, the franchising authority is no longer authorized to regulate basic cable rates. FCC does not independently update or revise an effective competition finding once it is made. An effective competition finding may be reversed if a franchising authority petitions to be recertified to regulate basic rates by demonstrating that effective competition no longer exists. However, such petitions are rare.

Our preliminary review of the approximately 700 cable franchises that responded to FCC's 2002 cable rates survey suggests that the agency's lack of any updates or reexamination of the status of competition in franchise areas may lead to some classifications of the competitive status of franchises that do not reflect current conditions. For example:

- Forty-eight of the 86 franchises in the sample that FCC had classified as satisfying the low-penetration test for effective competition actually reported current information to FCC on their operations that appeared, based on our preliminary calculations, to indicate that current penetration rates are greater than the 30 percent threshold.¹⁰ Ten cable franchises appeared to have a penetration rate exceeding 70 percent—a full 40 percentage points above the legislated low-penetration threshold.
- Forty of the 262 franchises in the FCC survey that had been classified as having effective competition by FCC also reported that the franchising

⁸For this test to be applicable, the telephone company and the cable provider must be unaffiliated.

⁹In some cases, franchise authorities do not wish to regulate rates and cable companies may choose not to file for a determination of effective competition, even if conditions warrant.

¹⁰We calculated the penetration rate by dividing the number of franchise subscribers by the number of households in the franchise area, as reported by the cable company to FCC.

authority was currently regulating basic service rates. This would not be in accord with the statutory requirement. It is possible that such an inconsistency could occur because cable companies incorrectly completed FCC's survey in some fashion.

- Although the survey form asks the cable franchise whether they face effective competition in the franchise area, those responses are not always consistent with information maintained by FCC regarding whether there has been an official finding of effective competition. When FCC's information conflicts with the survey response, FCC overrides the answer provided by the cable franchise. We found that FCC staff overrode the survey responses on effective competition for 24 percent of all franchises in its 2002 survey.

Also, we have searched for instances in which franchising authorities sought to have a finding of effective competition reversed. We found two instances in which FCC reversed a finding of effective competition. However, in one of these instances involving ten franchises in Delaware, some of the franchises appear to remain classified as having effective competition even though FCC reversed the position in 1999.

In its 2002 *Report on Cable Industry Prices*, FCC acknowledges that the classification of the competitive status of some franchises may not reflect current conditions. Some franchises that face competition may not have filed a petition, and therefore are not classified as facing effective competition. Also, some franchises may have previously met the criteria for a finding of effective competition, but because of changing circumstances may not currently meet the criteria and remain classified as facing effective competition.

Additional GAO Work on Cable Rate and Competition Issues

We are conducting additional work on the issues discussed today and a more complete analysis will be included in our final report, which we plan to issue in October 2003. In addition to the topics discussed today, we will be providing a more comprehensive analysis of the factors underlying recent cable rate increases, the impact of competition on cable rates and service, and cable tiering issues.

Mr. Chairman, this concludes my prepared remarks. We would be pleased to answer any questions you or other members of the Committee may have.

Contact and Acknowledgments

For questions regarding this testimony, please contact William B. Shear on (202) 512-4325 or at shearw@gao.gov. Individuals making key contributions to this testimony included Amy Abramowitz, Mike Clements, Keith Cunningham, Michele Fejfar, Wendy Turenne, Mindi Weisenbloom, and Carrie Wilks.

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