



ASHPAUGH & SCULCO, CPAs, PLC
Certified Public Accountants and Consultants

March 16, 2007

VIA EMAIL

Ann Strine
Director of Information Technology
City of Tucson
481 W. Paseo Redondo
Tucson, AZ 85726-7210

Subject: Response to Cox's Analysis of the License Fee Audit

Dear Ms. Strine:

Ashpaugh & Sculco, CPAs, PLC ("A&S") was asked to review the formal proposal submitted to the City of Tucson (the "City") by Cox Communications Tucson ("Cox"), and to provide the City information on two broad topics. You also asked us to review the formal proposal to determine whether, from a financial standpoint, it was "reasonable to meet the future, cable-related needs and interests," of Tucson "taking into account the cost of meeting such needs and interests." We will address those criticisms in a separate letter. You asked us to review the Cox criticism of the license and PEG fee audit that we performed, and to respond to those criticisms. That is the topic of this letter.

I. ADVERTISING REVENUES

A. Cox asserts that it has paid the license fees on "all revenue it received from Cox Media" and that "the City's claim is foreclosed by the plain language of Section 7A-2(11) of the Tucson Code."

We disagree. Contrary to Cox's assertions, Cox Media is performing the normal functions and responsibilities of a cable operator, and therefore Cox Media's revenues must be included in calculating license fee payments to the City. In Cox's Proposal for Cable License Renewal, Cox stated that Cox Media is an affiliate of Cox Communications. The Tucson Code states that "their affiliates...that are not cable operators but that are performing the normal functions and responsibilities of a cable operator" should have their revenues included in the gross revenues included in the license fees paid to the City. Cox Media is clearly performing the normal functions of a cable operator. In fact, Cox agrees that advertising is part of its principal business. Cox stated on Page 3 of Exhibit C of the Proposal for Cable License Renewal "License Fee Audit Analysis" that:

... the (gross revenues) definition was designed to capture revenues from a wide range of services, including revenues from video services, *advertising*,

and other services associated with the delivery of cable services, *which constitute part of Cox's ongoing principal operations.*"

Obviously, the placement of advertising on the cable system is an integral part of any cable company's ongoing principal operations, and is clearly a normal function and responsibility of the cable operator. It has been our experience that it is the normal function of every cable operator to sell advertising on its cable system (whether directly or through or intermediaries or both). Cox elected to organize the advertising services of its cable operations into a separate company, but that does not change the fact that advertising sales is part of the normal course of business for cable operators. In fact, it is a significant portion of the non-subscriber revenues generated by Cox. The commissions paid to Cox Media are no different than salaries and expenses Cox incurs for its own in-house operations and should not be deducted from gross advertising revenues.

B. Cox asserts that "attributing Cox Media's gross revenues to Cox would result in the pass-through of additional license fees to Cox's customers."

This is not necessarily the case. The FCC's rules say that the operator may pass-through the fees associated with advertising. Conversely, Cox may also collect the fees from the advertisers. Before Cox could pass through any additional fees, it would have to show that its current pass-through needs to increase. Cox does not support any such increase.

C. Cox is evading license fees by reporting Cox Media revenues to the City net of all expenses.

Cox stated that it has already paid license fees on all of the Advertising Revenues received from Cox Media. A&S agrees that Cox did pay license fees to the City on some advertising revenues. However, the license fees were paid on the *net* advertising revenues received from Cox Media not the *gross* advertising revenues Cox and its affiliate received. Cox deducted fees, commissions, and operating expenses from the gross advertising revenues generated by Cox Media and reported only the net advertising revenues to the City. As noted above, Cox elected to organize the advertising services of its cable operations into a separate affiliated company. If Cox did not choose segregate this business function, the gross advertising revenues would be included without question. For example, if the advertising sales were performed in-house, and not as an affiliated company, gross advertising sales would be included in the gross revenues reported to the City. All salaries and commissions would be recorded on Cox's books as expenses, and not as an offset to revenues. It is our opinion that the *gross* advertising revenues recorded on the Cox Media financial statements should be reported to the City without any deductions whatsoever.

Moreover, Cox underpaid license fees even if we assume that not all revenues received by Cox Media should be subject to the license fee – if we assume, for example, that Cox should be able to reduce revenues by the amount it would have been expected to pay a third party for commissions. One problem in any transaction involving affiliates is that the affiliates potentially can organize the flow of revenue in a way that evades legal obligations. Suppose, for example, that an electric utility can pass through fuel costs but

only at cost: the utility has an incentive to buy fuel from affiliates at inflated rates. Hence, affiliate transactions are often examined more closely than other market transactions. In this case, Cox reduced advertising revenues by as much as 60% during the review period through its deductions of Cox Media fees, commissions, and operating expenses. Based on our experience, commissions typically are much lower, ranging between from 15% to 30%.

II. LAUNCH FEES AND MARKETING EXPENSES

A. Cox asserts that Launch Fees and Marketing Expense Reimbursements are not revenues defined by the License Agreement and Tucson Code and that its treatment is consistent with GAAP.

We disagree. Cox indicated that these payments are recorded on its books as “contra-expense” in accordance with Generally Accepted Accounting Principles (“GAAP”). GAAP, however, simply provides a method for companies to maintaining accounting records in a consistent manner according to a uniform set of guidelines. The definition of gross revenues is governed by the Tucson Code not GAAP. The license agreement does not refer to GAAP. If Cox wanted to define gross revenues utilizing GAAP, as some other franchise agreements have done, then accounting treatment under GAAP would be referenced in the license agreement. In other words, we are not concerned with how Cox chooses to classify particular charges under GAAP, or whether it has done so correctly. We are looking at whether the amounts received appear to be cash or other consideration received in return for services rendered or products provided within the scope of the license. The launch fees and marketing expense reimbursements fall within that category.

The definition of gross revenues states that “gross revenues” means all cash, credits, property of any kind or nature, or other consideration derived from the operation of the cable system to provide cable services by the licensee. This definition is “intended to be read to reach as broadly as possible to encompass all revenues, subject only to the limitations imposed by federal law.” Placing new programs and channels on its cable system is clearly part of Cox’s ongoing and principal operations, whether or not it receives payment for the launch of these channels. Therefore, any cash payments received by Cox for this purpose must be considered gross revenues pursuant to the license agreement.

Cox argues that imposing the license fee is somehow unfair, noting that launch fees may simply be reimbursement for an expense that it is contractually required to incur. That is just another way of saying Cox wants to pay a fee on net, and not gross revenues. Cox is required to incur expenses when it delivers programming to subscribers. It charges subscribers a fee for those services. It pays a license fee on the total amount received, not the amount less expenses. The same is true when the revenue is received from a programmer. Cox’s filing actually reveals that in many cases, it is receiving revenues from the programmer in return for work performed (like production of video programming). That would be a classic revenue. Cox has not supported any claim that any of the amounts it received from programmers should be excluded from gross revenues.

From an accounting standpoint, the *Disney* decision cited by Cox hurts Cox’s argument.

Speaking broadly, the FCC allowed operators to pass through increases in programming costs. In some cases, operators would agree to pay a certain price for programming, and the programmer agreed to pay some amount back to the operator. The FCC recognized that if the programmer's payment back to the operator was actually designed to reduce the price of the programming, the operator had to reduce the amount it paid by the amount it received. However, *Disney* recognizes that programmers often pay operators to perform services for them, which could include promoting the new programming, or placing advertising on its cable system. All *Disney* says is that these payments are not part of the program costs. The decision actually suggests that the payments are independent revenues paid for services rendered.

It is our opinion that the cash payments received for launch fees and marketing expense reimbursements should be included in the gross revenues reported to the City.

If you have any questions, please do not hesitate to call us at (407) 645-2020.

Sincerely,

ASHPAUGH & SCULCO, CPAs, PLC

Garth T. Ashpaugh, CPA
President & Member

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