EXHIBIT

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LICENSE FEE AUDIT ANALYSIS

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A. The City's License Fee Audit Erroneously Concluded that Cox Underpaid License Fees and Failed to Account for Overpayments.

1. The City has Acknowledged that Cox Already has Paid License Fees on all Advertising Revenues Cox has Received.

The City's License Fee Audit (the "Audit") claims that Cox underpaid the City $851,715 during the five-year period October 1, 2000 through September 30, 2005 (the "Audit Period") based on advertising revenues received not by Cox, but by Cox Media ("CM").[1] CM is an affiliate of Cox's corporate parent, Cox Communications, Inc., and provides advertising services to a variety of businesses in addition to Cox. Contrary to the Audit's conclusion, the City's claim is foreclosed by the plain language of Section 7A-2(11) of the Tucson Code because Cox already has paid license fees on all the revenue it received from CM, which the Audit acknowledged. Moreover, improperly attributing CM's gross revenues to Cox would result in the pass-through of additional license fees to Cox's customers.

Cox receives advertising revenues from CM, and both the City and Cox agree that Cox has paid the City license fees based on all the revenue Cox received from CM. As the Audit observed, CM "provides advertising planning and buying services, research analysis, professional commercial production and exclusive promotions to advertising agencies and business owners."[2] The Audit also confirmed that CM allocates all its gross revenues less expenses to Cox, and that Cox reported and paid license fees to the City based on all the revenue Cox received from CM. In other words, Cox "included [those receipts] in the revenues reported to the City for purposes of calculating [license] fees."[3] The Audit nevertheless concluded that "all of the gross revenues recorded on [CM's] financial statements should be reported to the City" based on the erroneous assumption that "all gross revenues from affiliated companies should be included in the gross revenues reported to the City."[4]

The Audit's underpayment claim is based on a fundamental misreading of Section 7A-2(11) of the Tucson Code regarding the treatment of affiliate revenue. Section 7A-2(11) defines "gross revenues" as:

> 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; any cable operator of the cable system; *or only to the extent necessary to prevent evasion, their affiliates*, subsidiaries, parent and any person in which the licensee has a financial interest, *that are not cable operators but that are performing the normal functions and responsibilities of a cable operator.*[5]

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1 License Fee Audit at 1, 7-8.

2 *Id.* at 7.

3 *Id.*

4 *Id.* at 8.

5 Tucson Code, § 7A-2(11) (emphasis added).

The Tucson Code further specifies "advertising revenues" as an example of the "gross revenues" subject to the City's license fee.[6]

Contrary to the Audit's conclusion that "all gross revenues from affiliated companies should be included in the gross revenues reported to the City[,]"[7] the Tucson Code plainly states that only affiliates "that are performing the normal functions and responsibilities of a cable operator" may have their revenues included in the scope of gross revenues subject to the City's license fee, and even then "only to the extent necessary to prevent evasion."[8] Because, as the Audit admits, CM "provides advertising planning and buying services, research analysis, professional commercial production and exclusive promotions to advertising agencies and business owners[,]"[9] it obviously is not performing the normal functions and responsibilities of a cable operator. CM's revenues, therefore, are not gross revenues subject to the City's license fee under the plain language of the Tucson Code.

In addition, no basis exists to find that CM's revenues should be deemed Cox revenues "to prevent evasion." As the Audit concedes, Cox paid license fees on the total amount of revenue it received from CM, and CM remitted revenue to Cox based on a calculation that simply subtracted CM's operating expenses from its gross revenues. In other words, CM retained only enough revenues to cover its expenses. All remaining revenues were allocated to Cox and included in Cox's gross revenues for purposes of calculating its license fee payments to the City. Thus, Cox fully paid the City license fees based on advertising revenues Cox received.

As the foregoing demonstrates, the Audit's inclusion of CM's gross revenues in the calculation of Cox's license fee is based on a plain misapplication of the Tucson Code. The City, therefore, must at least account for this $851,715 error, along with associated interest and charges, in its Audit.

2. **Launch and Marketing Expense Reimbursements are not Revenues Subject to License Fees.**

The City's Audit also asserts that payments Cox received from program suppliers for expenses incurred in marketing and launching new program services should have been included in the gross revenues Cox used to calculate its license fees. Based upon that determination, the Audit erroneously concluded that Cox underpaid license fees by $213,159 during the Audit Period.[10]

Contrary to the City's claims, these payments are not subject to license fees because they are not revenues. Instead, they are reimbursements for Cox's expenditure of monies on behalf of program suppliers to market and launch new program services. The treatment of these payments on Cox's books as "contra-marketing expenses," rather than as revenue, is consistent with industry practice and Generally Accepted Accounting Principles ("GAAP"). When Cox was a publicly traded company, its auditors approved this treatment on Cox's financial statements. The Federal Communications Commission ("FCC") also has recognized such payments as costs,

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[6] Tucson Code § 7A-2(11)(g). Cox observes that A.R.S. § 9-505(6) specifically excludes advertising revenues from the scope of gross revenues for any cable license renewed or extended after June 30, 2007.

[7] License Fee Audit at 8.

[8] Tucson Code, § 7A-2(11).

[9] License Fee Audit at 7.

[10] *Id.* at 1, 8.

rather than as revenue. Moreover, improperly including these expenses as gross revenues, rather than as contra-marketing expenses, would result in the pass-through of additional license fees to Cox's customers.[11]

Cox did not pay license fees on the launch or marketing reimbursements received from various programmers during the Audit Period because these launch fees are not "revenue" in any relevant sense of the word. In the almost nine years since Cox has been operating the Tucson cable system, the City never before claimed otherwise. In fact, unlike revenues received from customers in connection with the sale of video and other services, or revenues received from advertising sales, launch and marketing support reimbursements are not revenues derived from the operation of the cable system. Rather, such fees represent a cost of doing business in the form of reimbursements for Cox's out-of-pocket expenses on behalf of programmers and are treated as such on Cox's financial statements.

In general, program suppliers pay launch support (also referred to as "marketing support" in some of Cox's programming agreements) to offset the costs associated with launching a new channel on an existing cable system. Cox's launch costs typically exceed the reimbursements it receives in launch support from program suppliers. These launch costs can include: updating channel cards and guides; producing and distributing marketing support materials (such as customer brochures, mailers and bill inserts); producing on-air advertisements and print advertisements; training employees regarding the new programming; and other marketing efforts to promote the new channel. Because launch support received from program suppliers represents reimbursement for costs incurred by Cox on the programmers' behalf to market and launch their services, Cox does not account for the receipt of such fees as revenues. Instead, these payments are booked as "contra-marketing expenses"; in other words, as an offset to the actual costs of launching new channels.

Cox's treatment of these monies as contra-marketing expenses is consistent with GAAP and with Cox's audited financial statements. The relevant guidance under GAAP is set forth in Statement No. 6, which defines revenues generally as inflows and enhancements from activities such as rendering services, or cash flows resulting from an entity's ongoing major operations. The promotional support reimbursements that Cox receives from program suppliers, however, are not the result of activities Cox pursues to produce revenues. Instead, they are the result of activities the programmers undertake to produce revenues. Cox, therefore, has always treated these reimbursements as contra-marketing expenses on its financial statements, and its auditors always have approved that treatment.

Moreover, nothing in the License Agreement or Tucson Code indicates that the definition of "gross revenue" was ever intended to capture reimbursements of this kind. Instead, the definition was designed to capture revenue from a wide range of services, including revenue from video services, advertising, and other services associated with the delivery of cable services, which constitute part of Cox's ongoing and principal operations. Because Cox incurred

[11] Consistent with the State of Arizona's determination that advertising revenue must be excluded from gross revenues for purposes of determining license fees, A.R.S. § 9-506(6), the FCC similarly has concluded that the demand of certain specified costs, fees, and other compensation is unreasonable and must be counted toward the federal five percent (5%) limitation on franchise fees. *See* FCC News, *FCC Adopts Rules to Ensure Reasonable Franchising Process for New Video Entrants* (Dec. 20, 2006) (regarding *Report and Order and Further Notice of Proposed Rulemaking* (FCC 06-180) in MB Docket No. 05-311 (to be released)).

costs to market and launch new services and then received reimbursement for these costs from its program suppliers, it would be unreasonable to claim that monies reimbursed to Cox constituted gross revenues, and they certainly would not qualify as revenue under GAAP Statement No. 6.[12]

In addition, these reimbursements should not be considered revenues because the program suppliers agreed to incur these costs as an inducement for Cox to carry their services. Although Cox routinely uses launch support to offset marketing expenses, some program suppliers providing launch and marketing support to Cox contractually require that these monies be expended as part of a specific marketing plan. Under these programming agreements, Cox's use of launch support for any purpose other than as a contra-marketing expense would contravene its contractual obligations to program suppliers. Moreover, Cox follows the standard cable industry and accounting practice of using launch and marketing support to offset marketing expenses incurred in launching new services even without such explicit contractual obligations.

The FCC also determined long ago that reimbursements such as "launch support" received by a cable operator for costs incurred on behalf of programmers to advertise and market their offerings – including but not limited to printing and postage costs, advertising agency fees, and sales force commissions – are not revenues attributable to the cable operator.[13] The FCC understood that reimbursements of advertising and marketing expenses "are neither an element of, nor related to, the programming fee charged to the operator; rather, these costs represent ordinary costs of doing business *for the programmer* that should not be deemed refunds or rebates of the programming fees paid by operators to programmers."[14] Therefore, the FCC held that "a programmer's payments to an operator for advertising time to promote the programmer's offerings, or payments to reimburse the operator for reasonable, documented expenses of marketing the program service to consumers, [should not] be offset against increases in programming costs for purposes of calculating charges accorded external treatment."[15] The FCC

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[12] GAAP Statement No. 6, paragraphs 78 and 79, provides:

> 78. Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
>
> 79. Revenues represent actual or expected cash inflows (or equivalent) that have occurred or will eventuate as a result of the entity's ongoing major or central operations. The assets increased by revenues may be of various kinds – for example, cash, claims against customers or clients, other goods or services received, or increased value of a product resulting from production. Similarly, the transactions and events from which revenues arise and the revenues themselves are in many forms and are called by various manes —for example, output, deliveries, sales, fees, interest, dividends, royalties, and rent – depending on the kinds of operations involved and the way revenues are recognized.

[13] *See The Disney Channel c/o Mr. Frederick Kuperberg, Esq.*, 9 FCC Rcd 7762 (Cab. Serv. Bur. 1994).

[14] *Id.* (emphasis added).

[15] *Id.* Because the FCC understood that these reimbursed expenses are not compensation the operator receives from program suppliers, cable operators are not required to net them against the operator's payments to the suppliers for programming under the FCC rate regulations.

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reached this determination precisely because it understood that the reimbursement of marketing expenses incurred by a cable operator on behalf of a programmer is not revenue to the cable operator. Instead, these reimbursed costs represent expenses programmers must incur to market their products, but that cable operators are in a better position to advance for them because the operator may produce and distribute marketing materials to its customers more efficiently than the program supplier. The assessment of license fees against these same reimbursements would amount to the payment of license fees on Cox's expenses rather than its revenues.

The foregoing demonstrates that reimbursements Cox received from programmers for marketing and launch expenses Cox incurred on their behalf cannot rationally be included in Cox's gross revenues consistent with GAAP, standard industry practices, and Cox's programming agreements. The City, therefore, must also account for this $213,159 error, along with associated interest and charges, in its Audit.[16]

3. The City's Collection of License Fees Exceeding Five Percent of Gross Revenues Violates Federal and State Law and Constitutes a Breach of the Cable License and a Violation of the Tucson Code.

a) The Cable License is Subject by its Terms to Federal and State Laws Including the Franchise Fee Limitations of 47 U.S.C. § 542.

Section 7A-34(5) of the Tucson Code provides that the City's five percent (5%) of gross revenues license fee:

> shall be in addition to and not in lieu of any other tax, fee (including by way of example and not limitation, permit fees), or payment owed the city by the licensee pursuant to any other applicable provisions of this Code or laws of the state, *unless the tax, fee or payment is required to be treated as a franchise fee under 47 U.S.C. §542.*

(emphasis added). Sub-Section 5(b) of the License similarly provides that:

> The license fee is in addition to all other fees, assessments, taxes or payments that Licensee may be required to pay under any federal,

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If the "launch support" Cox receives from programmers were consideration for the carriage of programming, Cox would be required (if it were subject to rate regulation) to offset it against programming costs to calculate whether and how much of such costs could be passed through to subscribers. The FCC's offset requirement is designed to protect subscribers by assuring that programming expenses subject to external cost treatment fully reflect any revenues, rebates, or other compensation received by the cable operator in consideration of carriage. *See* 47 C.F.R. § 76.922(f)(7) (formerly 47 C.F.R. § 922(d)(3)(x); *see also* Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, *Report and Order and Further Notice of Proposed Rulemaking*, 8 FCC Rcd 5631, 5789 at n. 602 (1993) ("We require that any revenues received from a programmer, or shared by the programmer and the operator, for carriage of signals be netted against costs for purposes of calculating whether there has been an increase or decrease in programming costs for the programmer.) (*Rate Order*).

[16] Cox observes that A.R.S. § 9-505.6 specifically excludes launch fees from the scope of gross revenues for any cable license renewed or extended after June 30, 2007.

> state, or local law, *subject to any limitations set forth in 47 U.S.C. § 542.*

(emphasis added). The City, therefore, has expressly acknowledged and agreed that its license fees are subject to and limited by Section 622 of the Act. To the extent Cox has paid the City license fees exceeding the maximum fee permitted to the City under federal law (*i.e.*, five percent (5%) of annual gross revenues), the City consequently must offset such overpayments against all supposed underpayments claimed in its License Fee Audit (even assuming *arguendo* such claims were accurate) and may be required either to refund such overpayments with interest or credit them with interest against future license fee payments.

Section 622(g)(1) of the Act defines a franchise fee as "any tax, fee, or assessment of any kind imposed by a franchising authority or other governmental entity on a cable operator or cable subscriber, or both, solely because of their status as such."[17] Section 622(b) provides that "[f]or any twelve-month period, the franchise fees paid by a cable operator with respect to any cable system shall not exceed 5 percent of such cable operator's gross revenues derived in such period from the operation of the cable system to provide cable services."[18]

Section 622(g)(2), however, exempts certain specific payments from the definition of franchise fees. Relevant here are subsections 622(g)(2)(B) and (C). Subsection 622(g)(2)(C) exempts from the definition of franchise fees "capital costs which are required by the franchise to be incurred by the cable operator for public, educational, or governmental access facilities." Subsection 622(g)(2)(B) by contrast includes in the definition of franchise fees "payments which are required by the franchise to be made by the cable operator during the term of such franchise for, or in support of the use of, public, educational, or governmental access facilities."[19] Therefore, *bona fide* capital costs used for PEG access facilities and equipment are not franchise fees under Section 622(g)(2)(C); on the other hand, payments "for, or in support of the use of" PEG access are franchise fees under Section 622(g)(2)(B). The FCC has observed that "[c]apital costs refer to those costs incurred in or associated with the construction of PEG access facilities. . . . These costs are distinct from payments for, or in support of the use of, PEG access facilities. PEG support payments may include, but are not limited to, equipment costs, salaries, and training."[20] In addition, the legislative history of Section 622 confirms, among other things, that "lump sum grants not related to PEG access for municipal programs such as libraries, recreation departments, detention centers or other payments not related to PEG access would be subject to the 5 percent limitation [of Section 622(b)]."[21]

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[17] 47 U.S.C. § 542(g)(1).

[18] 47 U.S.C. § 542(b).

[19] 47 U.S.C. §§ 542(g)(2)(C), 542(g)(2)(B) (respectively). Other payments that are excluded from the franchise fee definition include copyright fees, requirements incidental to award of the franchise (bonds, security funds, letters of credit, insurance, indemnification, penalties, or liquidated damages), and taxes, fees or assessments of general applicability (unless unduly discriminatory against cable operators or subscribers). *See* 47 U.S.C. § 542(g)(2).

[20] Letter Ruling, 14 FCC Rcd 7674, answer to question 4 (Cab. Serv. Bur. 1999), *clarified*, DA 99-1252, CSB-ILR 99-2.

[21] *See* H.R. REP. NO. 98-934, at 65 (1984), *reprinted in* 1984 U.S.C.C.A.N. 4655, 4702.