

**Proposed Findings on Cable-Related Needs
and Interests and Past Performance
December 12, 2006**

**I. CABLE-RELATED NEEDS AND INTERESTS/PAST PERFORMANCE
SUMMARY**

The federal Cable Communications Policy Act of 1984 as amended (the “Cable Act”) establishes a process for considering a cable operator’s request for renewal of its license. Part II describes the process in detail. As a first step in the process, a local government must conduct a proceeding to identify the cable-related needs and interests of the community, and to evaluate the operator’s past performance. This document sets out the staff’s proposed findings regarding needs and interests and past performance. Staff recommends that the City release it for public comment. This will ensure that the City Council is in a position to evaluate the accuracy and the completeness of staff’s findings. Based on those comments, staff intends to amend this document as necessary and bring it back to the Council for final adoption in January. Once the City adopts findings on needs and interests and past performance, the first stage proceeding will end.

The staff’s central proposed findings are:

1. There is a significant need and interest in maintaining at least the current level of PEG facilities, equipment and support over a new license term (in real dollars), and providing for PEG improvements that will allow PEG users to take advantage of new technologies; and

2. There is a significant need and interest in providing at least seven PEG channels as part of basic service; and in allowing PEG users to take advantage of cable’s “on-demand” capabilities as those are implemented for commercial purposes. There is a need and interest in maintaining the City’s digital fire channel, at least for a period.

3. There is a significant need and interest in upgrading the existing cable system. It is not necessary to eliminate PEG channels in order for Cox to provide more advanced cable services, or to provide more high definition channels.

4. Cox should be able to satisfy cable-related needs and interests without increasing the rates to subscribers, and should be able to satisfy those needs and interests without significantly impacting its financial or competitive position.

5. By contrast, if access channels are moved from basic service to a digital tier, 10% of subscribers would either lose access to some PEG channels, or be forced to pay \$30.00 per month more than they do now; many other subscribers would be forced to pay at least \$10/month more to receive the PEG channels they now receive (under Cox’ current pricing).

Detailed proposed needs and interest findings appear at the end of this report.

II. THE FORMAL RENEWAL PROCESS IN TUCSON

A. The Formal Process in Tucson – Status.

The formal process in Tucson has been underway for over two years. As noted above and explained in detail in Part B, as part of that process, and consistent with federal law, the City conducted a detailed investigation into cable-related needs and interests and Cox' past performance, providing the public (including Cox) significant opportunities to provide information regarding cable-related needs and interests and past performance. This section describes the major actions undertaken by the City, and summaries the results of those actions. Among other things:

1. The City posted a survey form on its website regarding cable service and future needs and interests. It also published a survey in the newspaper. *About 67% of the over 400 respondents to the mail-in survey said that it was important for Cox to provide the PEG channels. 14 respondents wanted more PEG channels, and 12 wanted less. By comparison, about 13 respondents said there were too many shopping channels. About 66% of the respondents rates Cox' customer service good or very good. Respondents indicates that they wanted more high definition channels, on-demand services, and the ability to buy services "a la carte." While the survey was not statistically valid, what is interesting is that the results are consistent with the other studies performed by the City.*

2. The City commissioned a statistically valid telephone survey, which was conducted by an independent firm, FMR Associates Inc., received some comments on that survey from Cox, and received a response to Cox' comments from FMR. *The survey showed that over three quarters of subscribers rates Cox' cable customer service good or very good. The survey also showed that three-quarters of Tucson residents and three-quarters of cable subscribers thought that the current levels of support for PEG were about right. About 56% of all residents, and 63% of all cable subscribers thought that the PEG channels were important or very important. More than half of all subscribers watch the PEG channels, and a third of those watch the channels daily, or several times a week.*

3. The City commissioned a "PEG Community Needs Assessment" by Holly Hansen Consulting (the "Hansen Report"). As part of this study, the City's consultant conducted 14 focus groups with participants from 41 community groups. The consultant distributed questionnaires to focus group participants, interviewed key staff members representing each of the entities that program a PEG channel in Tucson, inspected equipment and reviewed proposed equipment budgets. *The Hansen Report found that there was a substantial need and interest in maintaining the current levels of support for PEG, found that there was strong support for each of the PEG channels, and found that PEG channel usage required delivery of at least seven PEG channels to subscribers initially. The Hansen Report also concludes that PEG programming should be available*

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on-demand when commercial PEG channels are available on demand. Staff believes that the needs and interests identified in the Hansen Report are accurate, and supported by the other data reviewed by staff.

4. The City conducted five Town Hall meetings at locations throughout the City. *A wide cross-section of the community participated in those Town Hall meetings. While there was certainly some criticism of PEG, by and large the meetings suggest that the PEG channels are important to this community. The transcripts of those meetings are available for review.*

5. The City commissioned an engineering review and evaluation of the Cox cable system, including an evaluation of demand for an “institutional network.” The work was performed by Lee Afflerbach of Columbia Telecommunications Corporation (the “CTC Report”). In addition, CTC was asked whether, from an engineering standpoint, it was necessary to reduce the number of PEG channels in order for Cox to provide high definition and on-demand cable services. CTC was also asked to estimate how long it would take to upgrade the cable system; how long it would take to install the facilities and equipment for on-demand services; and to identify how much PEG programming should be available initially on-demand. *The CTC report found that while the system had been maintained in good shape, it should be upgraded, and can be upgraded within 24 months. CTC found that on-demand equipment could be added in six months. It concluded that dropping PEG channels would not significantly enhance Cox’ ability to provide advanced services, and that an immediate upgrade and addition of on-demand services would alleviate any perceived problems. CTC also noted that Cox had not identified capacity problems as a bar to providing high definition services. Finally, CTC found that 2000 hours of on-demand programming would be reasonable.*

6. The City commissioned a review of Cox’ license fee and PEG fee payments by the independent accounting firm of Ashpaugh & Sculco (“A&S”). *The A&S report found that Cox had underpaid license fees by about \$1.75 million through September, 2005, and had improperly altered the way it calculated PEG fees in a way that would have underpaid PEG fees owed Fall 2005 to the present.*

7. The City also considered the effect of meeting cable-related needs and interests on rates, and the effect on subscribers of adopting alternatives proposed by Cox. It asked A&S, based on the information available to it, to indicate whether Cox could afford to meet cable-related needs and interests of the City. *A&S found nothing in the data available to it that would suggest that Cox cannot meet the cable-related needs and interests of Tucson.*

8. In addition, as suggested above, certain of the results from the investigation were provided to Cox, and Cox provided the City with comments on some of the reports, and described its own view of community needs and interests orally. This information was conveyed to consultants for the City, who provided additional information to the City in the form of letter reports.

9. Finally, staff conducted its own internal reviews of the municipal digital channel, which is used for public safety training; it reviewed published reports on the state of the Cox system in relation to other cable systems nationwide; and it reviewed public statements by Cox with regard to the effect of changes in technology on the company. The City reviewed capital requirements for its institutional network, and also reviewed the existing cable license and associated cable ordinance to evaluate how those documents were serving the community. It reviewed performance reports submitted by Cox, and compared those to performance requirements in the existing license. It also drew on its experience in cable regulation.

This work provided staff the information required to make proposed findings regarding cable-related needs and interests, and past performance. Those findings are one important part of the federal renewal process, which we now describe.

B. The Federal Process

1. Overview

In order to operate, cable systems must occupy scarce and valuable public property – property that the public effectively pays to acquire and maintain. Cable operators place their facilities on poles and underground in rights of way throughout the City, and also place facilities on private property in utility easements. The City, as owner of the rights of way (and as trustee of the public’s interest in the rights of way and utility easements), has a compelling interest in ensuring that the companies use this property in a way that benefits the entire community. This means, among other things, that the City must ensure that public property is used in optimal ways, and that the public receives fair compensation – in the form of rental fees and other conditions – for the use of property to provide cable service.

In Arizona, this is accomplished through the cable licensing process, as governed by federal law. Cable television systems operate pursuant to licenses issued by local governments. A license authorizes the operator to provide cable service, and to occupy public rights-of-way for that purpose. The license sets out the terms and conditions under which service is to be provided. Cable service in this City is provided primarily by Cox, although Comcast serves a small portion of the community. Cox’ license is scheduled to expire in September, 2007. Cox has asked the City to renew its license.

Under federal law, when an operator applies for renewal, a community can respond in two ways to that request. First, a community can negotiate with the operator, and seek to resolve renewal disputes through negotiations. Second, the City can conduct a proceeding in accordance with 47 U.S.C. § 546(a)-(g) to determine whether the renewal request should be granted. The City must conduct this proceeding if the cable operator requests that it do so. Cox requested that the City conduct the proceeding. *The two processes are not mutually exclusive; the City and operator can negotiate while the “formal” process moves forward. If agreement is reached, the formal process ends. (also important: the process is not a competitive bidding process. The City cannot*

respond to a request for renewal by seeking competing bids, and award licenses to the highest bidders).

As indicated above, the formal process has been underway for more than two years now. However, the City and Cox have also been attempting to resolve issues informally. They have not been able to reach a negotiated resolution of renewal disputes thus far. Given the scheduled expiration of the franchise, that means the City must move forward with the formal process. The “formal” procedures give the operator the opportunity for a fair hearing on its renewal proposal. At the same time, the procedures insure that a City can deny renewal if an operator has performed poorly in the past, or is not qualified, or is not willing make a reasonable proposal for meeting the community’s needs and interests for the future.

Under the formal process, the City begins by conducting a proceeding to identify future, cable-related needs and interests, and to review the operator’s past performance. The City is given broad authority to define what the needs and interests of the community are. Once the initial proceeding is concluded, it is up to the operator to then submit a proposal that is reasonable to meet the community’s cable-related needs and interests, taking into account the costs of meeting those needs and interests (the focus is the entire community, not just the individual subscribers currently receiving service). The legislative history of the 1984 Cable Act explains:

The ability of a local government entity to require particular cable facilities (and to enforce requirements in the license to provide those facilities) is essential if cable systems are to be tailored to the needs of each community [and the legislation] explicitly grants this power to the licensing authority.

More specifically, the formal renewal process under the Cable Act is a four-stage process.

In the first stage, a City must conduct a proceeding to identify future, cable-related needs and interests of the community, and to review the past performance of the cable operators serving the community. *This is what the City of Tucson has been doing. Once the City adopts a report on needs and interests, it can conclude the first stage of the formal process.*

Once the first stage proceeding is complete, the City may issue a request for renewal proposals (“RFRP”) that requires an operator to submit a proposal containing commitments for PEG channels, PEG support, system upgrades and the like. However, a City need not issue an RFRP at all, and need not establish requirements in an RFRP. Instead, it can simply establish a deadline for submission of a renewal proposal.

In the third stage of the renewal process, the operators submits a renewal proposal either pursuant to an RFRP or on its own initiative. In either case, it is up to the operator

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to (a) submit a proposal by the City-set deadline (b) that satisfies cable-related needs and interests. If an operator submits a timely response, the City has four months to evaluate the proposal, and decide whether to grant renewal based on the proposal, or to preliminarily deny renewal. 47 U.S.C. Section 546(c).

If renewal is preliminarily denied, and an operator desires it, the City must commence an administrative proceeding. Federal law states that the proceeding is to consider whether:

- (A) the cable operator has substantially complied with the material terms of the existing license and with applicable law;
- (B) the quality of the operator's service, including signal quality, response to consumer complaints, and billing practices, but without regard to the mix or quality of cable services or other services provided over the system, has been reasonable in light of community needs;
- (C) the operator has the financial, legal, and technical ability to provide the services, facilities, and equipment as set forth in the operator's proposal; and
- (D) the operator's proposal is reasonable to meet the future cable-related community needs and interests, taking into account the cost of meeting such needs and interests.

If Cox fails to satisfy any of these four standards, its request for renewal can be denied.

This report thus is being prepared to discharge one of the City's important responsibilities under the Cable Act. It will serve as a vehicle for the City to obtain additional information about needs and interests, and pave the way for adoption of a final needs and interest report and performance evaluation. Once finally adopted, it will be up to Cox to submit a proposal that meets the needs and interests of the community.

2. Relation of state law to federal law.

Cox has expressed concern that state law may prevent it from submitting a proposal that satisfies the cable-related needs and interests of the community. We do not read state law that way. First, it is clear that state law places no limits on the channels and support that can be provided for in a license extension or renewal that is effective prior to June 30, 2007. So, Cox could submit a proposal with caveat that it must become effective before June 30, 2007. Staff would certainly welcome such a proposal. Second, at most the state law limits reach what may be included in a franchise. Cox could enter into agreements with Access Tucson or other PEG entities; if those agreement collectively met the needs and interests of the community, short-term and long-term, that

could also satisfy the Cable act standards. In some communities – St. Paul, Minnesota, for example – the cable operator has an independent contract with the public access provider to provide support outside of the license agreement. Hence, as far as we can tell, state law provides no reason to alter or to depart from the federal process. If anything, it makes it important for the City to proceed with the process so that the renewal can be closed, and Cox can submit a proposal that would be effective prior to June 30, 2007.

III. PROPOSED FINDINGS REGARDING NEEDS AND INTERESTS

A. Basis for Findings.

Staff believes that the its proposed findings regarding needs and interests are supported by the reports and studies described above. Rather than repeat those reports and studies in detail, this section summaries some of the key alternatives considered, and why staff reached the conclusions it did regarding certain key issues. We then end by setting out our proposed findings on needs and interests.

1. Conclusions regarding PEG needs and interests

In the PEG area, the four key issues are (a) how many channels should be provided; (b) what tier of service should the channels be provided on; (c) what sort of support should be provided for PEG; and (d) how should PEG requirements be adjusted over time, and to meet changes in technology.

One alternative is to reduce the number of channels significantly, to fix the PEG channels at the reduced number, and to shift PEG channels from the basic service tier (where they are now, and which every subscriber receives) to a digital tier. However, the survey and focus group data indicated the following:

- PEG channels are highly valued in this community;
- With one exception, if the number of PEG channels being provided to subscribers is reduced, there would be a significant loss in PEG programming and benefits. One PCC channel could be dropped without much impact, if other steps were taken to address PCC requirements.
- The channels are seen as a community resource that should be available to any subscriber to cable television service, not just Cox subscribers, and not just subscribers who can pay a premium to receive service.

There is not support for a significant reduction in channels, and there is support for maintaining almost all current channels, and providing for future expansion. The City heard similar sentiments at the Town Hall meetings, although it also heard some positions to the contrary.

The City also reviewed the impact of shifting PEG channels from the basic service tier to a digital tier. Data it received indicated that currently, any person in the

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City can subscriber to a service that includes all the PEG channels for \$20 per month. About ten per cent of Cox' subs take advantage of this service. If PEG channels were moved to a "digital tier," under Cox' current pricing model, the subscriber would have to pay a minimum of about \$50 per month, a \$30 price increase. Many of Cox' subscribers purchase a non-digital service that is sometimes referred to a "expanded" or "standard" service for approximately \$40 per month. That service includes basic service, and so includes all the PEG channels. These subscribers would see a rate increase of about \$10 per month if PEG channels were shifted, unless Cox changed its pricing, or unless it converted all services to digital services.¹

To be sure, the impact of the move could be avoided if Cox shifted PEG channels to digital and agreed to provide subscribers a digital converter for a low price – in Florida, Cox offers such converters for \$3.75/mo. But at least under current models, a shift to digital is inconsistent with the needs and interests of the community.

The City also considered an alternative approach to PEG discussed by Cox during debates that led to passage of the current Arizona cable law. Cox suggested that it would enter into contracts with schools under which it would provide channels. While not technically "PEG" channels, these channels could serve functions similar to PEG channels. This is certainly an alternative that could meet the needs and interests of the community, but staff came to the conclusion that such arrangements could be very troubling if any of the following elements were true:

- (a) the schools were forced to contract with Cox, at the risk of losing the PEG channel altogether.
- (b) the contracts were exclusive, meaning that subscribers could only receive the service if the subscriber took cable service from Cox. There is significant effort being placed into encouraging cable competition. This type of exclusive contract could create a barrier to competition, and mean basic educational information would not be available to subscribers; it could also interfere with joint educational uses of the PEG channels.
- (c) at the end of the contract, there was no guarantee the contract would be renewed, and no way for the City to "revive" the PEG channel requirements.
- (d) the channels shifted immediately to digital, without addressing the "digital divide" issue outline above.

Given the value of the channels and their long usage, and the negative impact on subscribers, the staff concluded that the needs and interests of the City initially justify seven PEG channels to subscribers, as part of basic service tier, although staff does not foreclose the possibility that other arrangements could reasonably satisfy local needs and interests.

¹ Cox now provides services in analog and digital form. It is expected that eventually cable systems will go "all digital," but this may not occur for several years. The problem described above applies to non-digital subscribers. Even digital subscribers may see some price increases to receive PEG channels. In order to receive digital service now, subscribers require a digital converter for each TV set that receives the service. A subscriber now may have one set with a digital converter and a set without one; today that subscriber can receive all PEG channels. If channels are shifted to digital tiers, only the TV with a digital converter would receive all PEG channels.

The staff considered whether there could be a significant reduction in current levels of support for PEG. Support is now provided through two different PEG-related fees on subscriber bills, totaling about \$1.35 per subscriber per month. The City also provides a portion of its license fee for PEG support. The survey data showed that the majority of participants in focus groups (and survey respondents) support at least this level of support, or more. It appears that this support, in real dollars, is required at a minimum in order to satisfy capital and operational needs and interests over a new franchise term. The Hansen Report, for example, estimated that PEG users will require between \$8.3-\$10.7 million for capital improvements to production and playback equipment and studio facilities. This is in addition to costs that may be required for buildings, physical connections between facilities, and so on. Experience showed that reducing PEG budgets has adversely affected PEG programming in the past. The results of the focus groups (combined with the survey results and analysis of PEG capital requirements) appeared to confirm that, if anything, an increase in support for PEG is justified.

With respect to future needs and interests, the focus groups revealed a significant need and interest in taking advantage of advanced cable system capabilities. One such capability is the ability of cable systems to deliver programming on demand. In Tucson today, Cox provides a service known as “near video on demand.” The same program is shown on several channels, starting at slightly different times. A viewer can order the program at a convenient time, but has no way to otherwise control what is received. On-demand systems work via a menu. A subscriber picks a program (an episode of the Sopranos, for example) and the program is immediately delivered to the subscriber. The subscriber can stop the program, fast forward it, reverse it, and basically control it as if it were a DVD. Some on-demand services are provided at no additional to digital subscribers. For example, a subscriber to HBO may receive HBO on-demand for no additional charge. The on-demand service, in other words, serves as a supplement to the traditional service.

An on-demand service has obvious implications for PEG. While it is important to cablecast City Council meetings live, it would also be useful to have old meetings stored and accessible to the public as needed. This might prove a particularly important way for preserving and enhancing access to information about issues that are addressed over several meetings and a long period of time. Similarly, a PCC could enhance the utility of its classroom offerings if those were stored and available to a student over a semester. The same is true of teacher training tapes. On-demand may ultimately prove a more bandwidth effective way of delivering important information that a subscriber only needs at particular times. For example, a video on City parks might be particularly useful to a resident at the time an event is being planned – the same would be true of a guide to City permitting processes. CTC has advised the City that, as a technical matter, it is reasonable to expect Cox to provide “on-demand” capacity for PEG, and that the cost of doing so is such that it would be reasonable for Cox to provide 2000 hours initially, which could be increased as on-demand capabilities increase. Initially, on-demand would enhance PEG, but would only be available to digital subscribers. As noted above, it is

expected that over the next few years, cable systems will become all digital. At that point, on-demand may provide a substitute for some traditional PEG programming, or limit the need for additional channels. It is not a perfect substitute because of technical limitations – there are limits to how many people can order the same program at the same time, for example. However, it is important to provide for on-demand capabilities to meet the needs and interests of the community.

The needs assessment work performed by outside consultants provided limited data on the needs and interests for the continued provision of an existing, municipal digital channel, often referred to as the “fire channel.” This channel serves an important community function by transmitting video training information to firefighters in fire stations – allowing firefighters and public safety personnel to obtain needed training while still being in a location where they can respond to an emergency should one arise. The channel was supported participants in the focus groups, However, the training provided on the fire channel is not live. The channel is not available to all subscribers, but only to authorized public safety personnel. The function of the channel could be served if the programming were loaded onto an “on-demand” server, and then available for selection as needed by authorized public safety personnel. On-demand service is only available to digital subscribers. However, in this case there would be no “digital divide” impact, as the fire stations are already effectively “digital subscribers.” In this particular circumstance, the existing digital municipal channel could be replaced by a “virtual” on-demand channel, if adequate on-demand capabilities are proposed by Cox.

The company has traditionally provided free drops to schools and public buildings. The company then provides service at no charge via these drops. These drops ensure that the schools, for example, have access to PEG programming, and to other educational programming provided over the cable system. The same is true of the drops to public buildings. In addition, the drops allow the quality of the signal on the cable system to be monitored. The TUSD has told the City that there is a need and interest in these drops. That is true for the City as well.

2. Conclusions regarding system upgrades

The main issue with respect to system design is whether the system includes the facilities and equipment required to meet the needs and interest, or whether it needs to be upgraded. If the system needs to be upgraded, the question is: by when?

The CTC report noted three deficiencies with the current system: (a) the capacity is not state of the art; (b) it does not include all the equipment and facilities required to deliver services on-demand; and (c) it carries a limited number of high definition channels. While staff does not minimize the importance of high definition channels, Cox has represented that its offerings are limited because of contractual issues with providers. Assuming that is correct, the issue does not appear to be based on problems associated with the Cox facilities. It has to do with decisions about services that are best left to the company.

The system capacity and on-demand issues are system issues, however. CTC concluded that Cox should have upgraded the system sooner. Our own investigation suggests the same thing.

Press reports indicate that Cox Communications made a tactical decision to make it a priority to roll out its telephone service. Recently, Cox announced that it had completed its rollout of telephone service in all of its 35 major markets.² Unfortunately, for customers in Arizona, Cox's focus on telephony has negatively impacted investments in its cable service infrastructure. According to the Wall Street Journal, Phoenix was the only big city in America to fall on a list of "have not" cable cities.³ Phoenix's system, which was similar to that in Tucson, offers telephone service but, among other things, did not offer the facilities and equipment necessary to provide services on-demand.⁴ According to CTC, on-demand systems could be installed within six months. The system could be entirely upgraded to add additional capacity within 24 months. Given Cox' own complaints that it requires more capacity on its cable system, as well as subscriber interest in additional channels, we conclude that community needs and interests are such that Cox should be upgrading its system now, in accordance with this timetable.

3. Past performance

The City reviewed Cox' performance in light of the requirements of the existing cable franchise and ordinance. Generally Cox was in compliance, except in the important area of license and PEG fees. There, the A&S audit found a past deficiency of about \$1.75 million through September 2005. A&S also found that Cox had altered the way that it calculated PEG fees just at the end of the audit period. This reduced its payment to the City. Cox never alerted the City to this change. A&S concluded that this change violated the license requirements. Since September 30, 2005, Cox appears to have continued to significantly underpay license and PEG fees. Total liability now should exceed \$2 million.

Cox has challenged the underpayment on two grounds. One area of underpayment has to do with advertising revenues received by the company. The company sells ads through a wholly-owned subsidiary, which then passes a portion of the ad revenues to Cox's local operations. A&S concluded that the entirety of the revenue ought to be included for purposes of the gross revenue calculation given the language of the license and so that Cox could not avoid its license fee obligations. Moreover, A&S concluded that Cox's local operation received a less-than-normal portion of total revenues compared to what it would have received if it were not engaged in self-dealing. Under the circumstances, we believe the A&S conclusions are reasonable.

Second, Cox has claimed that it has overpaid fees. It contends that federal law has for years required that PEG fee amounts be used only for capital, and it contends that

² "Cox Offers Telephony in All Markets," T. Spangler, Multichannel Newswire, Oct. 27, 2006.

³ "Cable TV's Haves and Have-Nots," P. Grant, Wall Street Journal, May 6, 2006.

⁴ *Id.*; "This is the Week to Voice Your Opinion about Cox Cable TV," D. Hatfield, Inside Tucson Business, June 16, 2006; "Cox Offers Telephony in All Markets," *supra*.

the PEG fees received by the City were also used for operations. The City disagrees with the basic premise. The PEG fee provisions were agreed to as a settlement of past tax claims, and as part of that settlement, the City agreed to forgo potential tax claims (and the additional revenues it might have obtained) in return for an explicit agreement that a portion of the PEG fees could be used for any PEG-related purpose, including operations. This use has never been questioned until now by Cox, which is striking, because the license *requires* the company to notify the City if it believes that a provision is unenforceable, and then requires the company to enter into negotiations to restore the relative burdens and benefits of the contract. No notice was ever provided. At best, then, if Cox pursues this claim, it would be placing itself in violation of another license provision. Given the timing of the claim, we do not think it justifies any underpayment.

4. Can Cox afford to satisfy local needs and interests?

As noted above, under federal law an operator's request for renewal can be denied if the operator submits a proposal that is not reasonable to meet the future, cable-related needs and interests of the community in light of the costs thereof. As part of this study, the City staff attempted to determine whether it would be reasonable to require Cox to satisfy the identified needs and interests.

First, the City asked A&S to review financial data to determine whether the company could reasonably be expected to continue current levels of support. While the information available to A&S was limited, A&S concluded that there was nothing in the data available to it that would justify a failure to meet cable-related needs and interests.

Cox contended informally that changes in the cable industry, including increased competition and subscriber dissatisfaction with rates also prevented it from continuing to provide the same support and channels that it now provides. Surveys and focus group data indicated that in Tucson, subscribers are not dissatisfied with amounts now paid to support PEG. Setting this data aside, the staff reviewed recent statements by Cox in other contexts to determine whether this claim would justify a failure to meet cable-related needs and interests.

Cox' claimed competitors include satellite providers such as EchoStar and DirecTV, telephone companies offering video via Internet protocol (AT&T and Verizon)⁵ and others. However, according to Cox and other cable operators, the cable industry is in a very strong position in the marketplace. Cable companies' ability to bundle services into a "triple play" package – video, telephone and broadband – gives them an advantage over competitors (like satellite) that cannot offer the same service. Cable companies are adding customers in telephony and broadband at a rapid clip, and after years of losing cable subscribers to satellite cable companies have begun winning those subscribers back. More importantly, cable companies are increasing their number of premium subscribers,

⁵ Neither AT&T nor Verizon is the incumbent telephone operator in Tucson and neither company is presently planning to roll out IPTV service in the City. Qwest, the incumbent telephone operator is not presently offering IPTV services. "Qwest Plays a Wait-and-See on IPTV," K. Brown, Multichannel News, Feb. 20, 2006.

who pay more for services, and at the same time and increasing rates. As a result, cable companies are enjoying increasing profits. Overall, annual revenues for cable companies are expected to almost double in the next three years to \$120 billion.

Cox, the fourth largest cable provider in the nation,⁶ is reaping the benefits of being in this strong position in the marketplace. The company has had tremendous success in its ability to offer bundled service. It has had the most success of all cable providers in gaining new telephone customers, and dominates the broadband market in Arizona at a much higher rate than do cable companies nationally, and has seen an increase in the number of cable subscribers, including those it has taken back from satellite competition. The company has also raised rates in Arizona twice in the past two years, something that defies its claim that it is being hampered by increased competition.

State of the Cable Industry

As of September, 2006, there were approximately 65.6 million cable subscribers nationwide, which amount to 58.9 percent of all television households in the country.⁷ Among households subscribing to multi-channel video services (other than broadcast television) the cable industry accounts for approximately 68% of the nationwide market.⁸ The satellite industry, telephone companies and all other multi-channel competitors combined have approximately 30.5 million customers,⁹ or less than half of the number of cable subscribers. Total residential cable revenues nationally are expected to grow more than 9 percent in 2006 to \$69.5 billion, after growing 9 percent in each of the two previous years.¹⁰ It appears that Cox' revenues in Tucson are growing at that or at a higher rate. In addition to video, the cable industry provided high speed Internet service to approximately 28 million subscribers as of September, 2006,¹¹ which significantly exceeds the number of broadband lines (DSL) provided by telecommunications companies – 22.7 million.¹² Cable companies are expected to increase that number to 31 million by the end of 2006.¹³

In addition to video and broadband, the cable industry also has been successful at adding telephone subscribers, while telephone companies have had limited success adding video subscribers. According to the Wall Street Journal, cable companies have added approximately 7 million telephone subscribers, taken largely from incumbent telephone companies, while telephone companies have fewer than 100,000 TV

⁶ NCTA Website, Statistics, <http://www.ncta.com/ContentView.aspx?contentId=54> (5,407,000 subscribers as of June 2006).

⁷ NCTA Website, Statistics (citing to Kagan Research LLC).

⁸ "The Video Market is Fully Competitive: More than 30 Million Consumers Now Subscribe to Cable's Competitors," NCTA, June 30, 2006, at 1.

⁹ *Id.*

¹⁰ NCTA Website, Statistics (citing to Kagan Research LLC). *See also*, "Cable Revenue to Hite \$119.8B by 2015?", S. Donahue, Multichannel Newswire, Aug. 30, 2006 (predicting growth of 9.6% to \$68.2 billion in residential cable revenues).

¹¹ *Id.*

¹² "Broadband-Subs Count's Up 2.5M," Multichannel Newswire, Nov. 13, 2006.

¹³ "Study Sees Cable Widening Gains," Multichannel Newswire, Sept. 25, 2006.

subscribers.¹⁴ In the second quarter alone, cable companies added 676,000 telephone subscribers, an increase of 60% from the previous year.¹⁵ A recent study by an industry consulting company predicts that U.S. cable companies will have 24% of the telephony market by year-end 2009, up from the present 5% share of the market.¹⁶ This is because the cable industry has a sizable advantage in the number of its customers that subscribe to multiple services. Forty five percent of cable companies' residential customers subscribe to broadband service, while only 25% of phone companies' residential customers subscribe to digital subscriber line broadband service.¹⁷ The expected progression of this trend will be a "rapid" increase the number of cable customers who migrate from traditional phone service to voice over Internet protocol telephone service, as cable companies make the service available.¹⁸ Telephone companies are expected to lose 9% of their customer base in 2006 after losing 8% in 2005.¹⁹ In Arizona, where there is no immediate prospect of Qwest offering a wireline triple play service (Qwest does offer a service in combination with satellite providers), it seems likely that Cox' prospects are even brighter.

Overall, the U.S. cable industry added 2 million revenue-generating units during the second quarter of 2006, an increase of 33% from the same quarter the previous year.²⁰ In the same quarter 2006, cable companies generated \$4.6 billion of earnings before interest, debt, taxes and amortization.²¹ One study predicts that the cable industry will enjoy annual revenues of \$120 billion by the end of year 2009.²² Several analysts have concluded that, at the present, the cable industry is "winning the war" against telephone companies for customers of bundled service, including video, broadband and voice.²³ With respect to their satellite competitors, cable companies have reversed the trend of losing subscribers due largely to their ability to offer bundled services, which has been very popular with consumers.²⁴ Analysts suggest satellite providers are disadvantaged by their inability to offer such bundled services, which has caused investor concern about future losses of subscribers.²⁵

State of Cox Communication

¹⁴ "Cable Industry May Need to Spend Heavily on Broadband Updates," Wall Street Journal, Aug. 17, 2006.

¹⁵ "Fitch Sees MSO Momentum," Multichannel Newswire, Sept. 14, 2006.

¹⁶ "Study Sees Cable Widening Gains," Multichannel Newswire, Sept. 25, 2006.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ "Fitch Sees MSO Momentum," Multichannel Newswire, Sept. 14, 2006.

²¹ *Id.*

²² "Cable Revenue to Hite \$119.8B by 2015?," S. Donahue, Multichannel Newswire, Aug. 30, 2006.

²³ "Cable Industry May Need to Spend Heavily on Broadband Updates," Wall Street Journal, Aug. 17, 2006.

²⁴ "EchoStar's Revenue Rises 16% on Strong Subscriber Gains," E. Sheng, Wall Street Journal, Nov. 7, 2006.

²⁵ *Id.*; "DirecTV's Profit Surges But Customer Growth Slows," E. Sheng, Wall Street Journal, Nov. 8, 2006.

Cox is considered to be in the best position in the entire field in the market for providing bundled services, including cable companies and telephone companies.²⁶ The company had 3.3 million bundled subscribers at the end of the third quarter, representing 57% of its total residential customers, a 16% increase over the previous year.²⁷ The company increased its cable subscribers by 1.6% in the third quarter, and its digital-cable customers by 14%, compared to the same quarter the previous year.²⁸ The company has also begun to recapture cable customers from satellite companies at an accelerated rate, according to Cox itself.²⁹ The company, which does not report earnings since it went private in December 2004, claims that between July 2005 and July 2006 it added 84,000 basic cable customers, including 9,200 who switched over from satellite.³⁰ Cox also provides telephone service in every single one of its major U.S. markets.³¹ The company has 1.9 million residential telephone customers – almost a third of all phone customers of cable companies -- and 150,000 business customers.³²

Significantly, Cox enjoys a much greater share of the broadband market in Arizona than do cable companies nationally. Arizona companies, led largely by Cox, had 549,613 broadband subscribers at the end of 2004, four times the amount of digital subscriber lines offered by phone companies.³³ By its own admission, Cox “tend[s] to dominate the State” in the broadband market.³⁴ So dominant in the State is Cox that the head of the Arizona Consumer’s Council likens the situation to a monopoly, resulting in higher prices.³⁵

Future Competition

While Cox has suggested that competition in Tucson will prevent it from meeting local needs, in other contexts it has suggested that competition will not create significant problems for it.³⁶ The cable industry has argued that it has the more economically sound technology. Cox’ chief technology officer has stated “The very nature of the hybrid fiber-coaxial cable plant makes it very extensible. When you look at those things combined, we will be the winning platform, hands down.”³⁷

In short, it appears reasonable to expect Cox to satisfy the cable-related needs and interests of this community.

²⁶ “Study: Cox is King of Broadband Bundlers, K. Brown, Multichannel Newswire, June 26, 2006.

²⁷ “Cox: It’s Not All About Video,” M. Farrell, Multichannel Newswire, Oct. 24, 2006.

²⁸ *Id.*

²⁹ “Cox Touts Takeaways from Satellite Service,” M. Farrell, Multichannel Newswire, Aug. 21, 2006.

³⁰ *Id.*

³¹ “Cox Offers Telephony in All Markets,” T. Spangler, Multichannel Newswire, Oct. 27, 2006

³² *Id.*

³³ “Cable is King in Fight for Net Customers,” K. Alltucker, The Arizona Republic, Jul. 12, 2005.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *See, e.g.*, “Cable Industry May Need to Spend Heavily on Broadband Upgrades,” P. Grant, Wall Street Journal, Aug. 17, 2006; “CTOs: Cable Has Bandwidth to Compete,” M. Stump, Multichannel Newswire, Apr. 17, 2006.

³⁷ “How Cable Will Counter IPTV,” M. Stump, Multichannel Newswire, Mar. 20, 2006 (quoting Cox Communications Chief Technology Officer Chris Bowick).

B. Detailed Proposed Findings – Cable-Related Needs and Interests.

1. System design.

- a. There is a significant need and interest in having Cox upgrade its cable system by January 2009. *Cox contends that it does not have enough capacity to provide all the services it desires to provide over the cable system. The needs assessment indicates that eliminating the PEG channels is not a good solution for the problem identified; upgrading to increase system capacity is. Engineers advise that the system capacity could be upgraded (from the current 750 MHz to 860 MHz) in 24 months or less, providing the capacity Cox claims it needs. Dropping PEG channels is not necessary to allow Cox to provide high definition, on-demand or other services. .*
- b. There is a significant need and interest in having Cox install the facilities and equipment so that services can be provided on-demand by June 30, 2007. *Many major urban cable systems already include the equipment required to offer services on-demand. This upgrade is needed to bring the system up-to-date, and respond to consumer demands. Adding on-demand should also free up channel capacity on the Cox system.*

2. PEG – channels.

- a. There is a significant need and interest in having Cox provide at least eight PEG channels initially, rather than the nine television and one radio PEG channel now provided. *There is significant support for PEG channels in Tucson, and most existing channels are heavily used. One channel now used by PCC could be dropped without significantly impacting the community, if other PEG needs and interests are satisfied. The PEG FM channel is not being used, and there are no apparent plans for its use. It can be dropped. One PEG channel, the City “fire channel” is needed now, but could be provided on an “on-demand” basis to authorized users in the future, if Cox meets PEG needs and interests for on-demand services.*
- b. There is a significant need and interest in having Cox provide the channels as part of basic service, or in some other manner that avoids a “digital divide.” *Studies show*

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that there is significant interest in ensuring that the PEG channels are available to every cable subscriber in the community, without additional cost.

- c. There is a significant need and interest in ensuring that PEG channels can send provide signals to subscribers of a quality similar to the quality of commercial broadcast channels. There is a significant need and interest in having Cox carry PEG on cable channels that are not subject to significant interference. *The PCC channels are subject to significant interference from over-the-air channels.*
 - d. There is a significant need and interest in having Cox publicize the PEG channels adequately. This would include a need and interest in providing information regarding PEG channels and programs on menus and sub-menus comparable to the information provided about commercial programs.
 - e. There is a significant need and interest in having Cox provide capacity that will allow PEG users to provide access programming “on demand.” *City consultants advise that this is feasible, and that it would be reasonable to require up to 2000 on-demand hours initially.*
 - f. There is a significant need and interest in continuing to have Cox provide a free service to schools and public buildings that permit those locations to receive the PEG channels. There is a significant need and interest in providing additional connections to new schools, and certain existing locations. *Otherwise, significant benefits associated with the channels as a tool for distance learning/communication could be lost.*
3. PEG – support.
- a. There is a significant need and interest in having Cox provide at least the level of PEG support that it is providing now in real dollars. *Studies indicate that there is majority support for the current level of financial support provided by Cox, or a higher level. Cutting the support levels is likely to significantly and adversely affect PEG programming in the City. At least maintaining current levels of funding in real dollars is also necessary in order to satisfy items 3.b – d below.*

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- b. There is a significant need and interest in upgrading and replacing PEG equipment over the next license term. *Existing equipment is outdated or non-functional in some instances, and equipment will need to be replaced in light of technology changes.*
 - c. There is a significant need and interest in upgrading and maintaining PEG facilities for the next license term. *In particular, Access Tucson will continue to require at least the space it occupies now, and that space needs improvements.*
 - d. There is a significant need and interest in operational support for public and K-12 educational access for a new license term.
 - e. There is a significant need and interest in maintaining and upgrading existing connections, routers and other electronic equipment that allow PEG users to transmit PEG programming to Cox and on to Cox' subscribers and subscribers in Tucson that are served by Comcast, and subscribers in surrounding communities.
4. License fee. There is a need and interest in ensuring the City can charge the maximum license fee permitted by law throughout the license term, and at least 5% of gross revenues as defined under federal law. *The license fee is a rent for use of the rights-of-way, and compensates the public – including those who do not subscribe to cable – for use of public property. The City uses a portion of that rent to provide operating support for PEG. A reduction in the fee would adversely affect the general fund, and funds available for PEG support, unless Cox enters into operational support arrangements with PEG providers*
5. Term; changes during term.
 - a. If Cox' proposal for renewal satisfies the identified needs and interests of the community, experience suggests it would be reasonable to issue a license for a ten-year term. A ten-year term does not serve the needs and interest of the community otherwise.
 - b. There is a need and interest in ensuring changes to Cox' cable system do not adversely affect PEG.

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- c. There is a need and interest in reviewing PEG usage from time-to-time, and making reasonable adjustments to channels, facilities and equipment requirements up or down based on usage, technological developments and demand.
6. Miscellaneous.
- a. In addition to the foregoing, the City's existing Cable Ordinance and Cox Cable License contain a number of provisions (including customer service provisions, requirements that service be provided throughout the City, transfer provisions and the like) that the City believes it can impose unilaterally, but which experience indicates protect subscribers and non-subscribers, and are justified in light of the needs and interests of the community. *As far as we can determine, there is no serious question regarding these provisions, which we would propose to maintain during a new license term.*
 - b. There is a substantial need and interest in promoting competition. To that end, there is a substantial need and interest in ensuring that Cox does not enter into agreements that would create a significant barrier to entry, or that would require residents to subscribe to Cox in order to receive PEG programming. *For example, Cox should not be able to enter into exclusive arrangements that effectively prevent access to important educational programming.*
 - c. There is a significant need and interest in providing the Tucson Unified School District capacity on an institutional network provided by Cox, and linking all schools and administration buildings for high speed data communications. *Such a system could among other things, permit the schools to take advantage of state distance learning initiatives, while reducing costs to the schools. The current data system being used by the schools is not adequate.*
 - d. There is a significant need and interest in additional capital support for the institutional network constructed by Cox (and its predecessors) for the City. This network is used for basic City communication and for important public safety functions. Staff estimates that institutional network capital costs will be approximately \$350,000 a year, not including maintenance, which will cost an estimated \$80,000 per year. *However, staff also believes that this need and*

interest can be satisfied through the license fee, if other needs and interests are satisfied.

- e. To the extent not specified above, staff adopts the needs and interests set forth in the Hansen Report.

C. Findings – Evaluation of Past Performance.

Based on a review of the information provided by subscribers, and evaluations by engineers and auditors for the City, the staff concludes:

1. Generally, Cox has maintained its plant in good condition and provided good customer service to its customers.
2. Cox has not complied with all its obligations under the existing license. Based on the City's independent financial audit, Cox has failed to pay the full license fee owed, and it is failing to pay the full fees for PEG owed. Its failures in these regards are substantial and material.
3. Cox has not provided an adequate level of service to subscribers. Its cable system should have been upgraded before now. Cox in Tucson (and in other parts of Arizona) has lagged behind other operators in the provision of cable services.