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November 9, 2004

VIA E-MAIL AND U.S. MAIL

Catherine Lazorko
Town Information Officer
Town of Chapel Hill
306 North Columbia Street
Chapel Hill, NC 27516

RE: 2004 Rate Review – Time Warner

Dear Catherine:

Pursuant to the request of the Town of Chapel Hill, we are including with this letter a Report regarding review of rate changes proposed by Time Warner. The Town is served by two separate headends. This means there are two separate rate evaluations and the rates for each headend service area will be different.

We have attached to this letter a Report developed by our firm, working together with Charles Gramlich & Associates. Charles Gramlich provides technical and financial assistance to us and has in the past assisted in the rate reviews for the Town of Chapel Hill.

The Report is based upon information furnished to us by the Town. The information included two FCC Forms for each separate headend. The FCC Forms are Forms 1240 and 1205. These forms and the related worksheets were developed by the FCC to be used by cable operators in preparing the annual filing with the local franchising authority with respect to basic cable service rates and equipment, installation, and related charges. Those are the only charges subject to rate regulation. Further, as is outlined in the Report prepared by Charles, the rate reviews are based upon evaluation of Time Warner's proposed rate changes for compliance with the standards, procedures, and formulas developed in the rules of the FCC.

Please note on page 1 of the Report that it is the opinion of Charles that the rates for basic cable service as computed by Time Warner on the two FCC Forms, Form 1240 dated September 30, 2004 for basic cable service, and on Forms 1205 dated July 21, 2004 and September 30, 2004 for regulated equipment and installation costs have been accurately calculated according to the FCC rules and regulations. The proposed rate changes will be implemented, according to Time Warner, on January 1, 2005. This date of initiating the new rates is consistent with the requirements of the FCC. Those

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requirements are that the new rates cannot go into effect until 90 days after Time Warner has filed its forms with the Town. The letter from Time Warner was dated September 30, 2004, and we understand was received by the Town on October 1, 2004.

Inasmuch as the rate calculations and proposed rate changes of Time Warner are, according to our review, in compliance with the FCC rules, no further action is required by the Town. Therefore, it is our recommendation that you furnish a copy of this letter and Report to the Town Board for official receipt, review, and filing for the Town's record of review of proposed rate changes for the year 2005.

Charles' Report summarizes the information that has been provided to the Town by Time Warner as well as outlining the background for the Town's authority to review rates. Part of this summary includes an explanation of various FCC Forms. It is important to understand that only the basic cable service rates and the equipment, installation, and rental charges of Time Warner are subject to any form of rate review. Other tiers of service are no longer regulated by either the Town or the FCC.

Pages 5 and 6 of the Report includes a description of the basic cable service current and proposed rates for the Durham headend and the Chapel Hill headend (both of which serve the Town of Chapel Hill). You will note that with regard to the Durham headend, a slight increase in the basic rate from \$14.30 per month to \$14.50 per month will be effective January 1, 2005. The basic cable service rate for the Chapel Hill headend, currently \$11.25 will be decreased to \$10.60.

On page 6, other charges that are subject to review, including the hourly service charges, remote controls, converter boxes, and a new device called a "CableCARD" are also shown. The charges for equipment and installation as illustrated in the Charles Gramlich report will essentially remain the same.

On page 7, the rates, including Tier 2 and the Digital Tier (although not regulated) are illustrated in order for the Town to see what the total monthly rate will be for the combined services typically subscribed to in the community. Please note that the total monthly charge for the Durham headend service area will change from \$57.60 per month to \$61.80 per month. This is primarily due to changes in the Tier 2 and Digital Tier rates.

The charges, as illustrated on page 7, for the area served by Chapel Hill headend will total \$54.55 and will increase to \$58.30. This is due primarily to the unregulated Tier 2 and unregulated Digital Tier.

On page 3, a discussion is included with regard to CableCARDS and digital cable-ready television sets. Digital cable-ready television sets are in a state of transmission and currently will require a set top box in order for a subscriber to receive digital services. A link to a Time Warner website is included for more information regarding the transition of technology. It is very likely that there will continue to be major changes in the delivery of services, television sets, and broadband that may affect future rate reviews.

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We trust that this Rate Review Report will furnish the Town with the information and our analysis and conclusions. Should you or others in the Town, including the Town Board, have additional questions regarding this review or any matters relating to it which will require further explanation, please contact me at the earliest opportune time.

Very truly yours,

Adrian E. Herbst

Adrian E. Herbst

AEH/dnd
Attachment

L-Catherine Lazorko (Rate Review)(11-9-04)

(10)

REPORT REGARDING REVIEW OF
TWO FCC FORMS 1240, WHICH ARE DATED SEPTEMBER 30, 2004,
AND TWO FCC FORMS 1205,
WHICH ARE DATED JULY 21, 2004 AND SEPTEMBER 30, 2004,
AND RELATED FORMS AND WORKSHEETS
SUBMITTED BY TIME WARNER CABLE
TO THE TOWN OF CHAPEL HILL, NORTH CAROLINA

PREPARED FOR:
THE TOWN OF CHAPEL HILL, NORTH CAROLINA

November 2004

PREPARED BY:

Charles Gramlich
of
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I. FINDINGS

1. Based upon my review of the information supplied by Time Warner Cable, ("TWC"), it is my opinion that the rates for Basic Cable Service as computed by TWC on the two Federal Communications Commission ("FCC") Form 1240s (dated September 30, 2004), for certain regulated equipment and installation cost as computed by TWC on FCC Form 1205 (dated September 30, 2004) and for the Cable CARD as computed by TWC on FCC Form 1205, Determining Regulated Equipment and Installation Costs (dated July 21, 2004), are accurately calculated according to FCC rules and regulations.

II. OVERVIEW OF FCC RATE REGULATIONS

In 1992, Congress passed the Cable Television Consumer Protection and Competition Act. The 1992 Cable Act included significant provisions regarding the regulation of cable rates, and directed the FCC to adopt rules prescribing rate regulation. Local franchising authorities that desire to regulate rates are permitted to do so by (1) filing FCC Form 328, (2) adopting the FCC's rate rules and (3) notifying the cable operator of its intent to regulate rates. The FCC has retained the obligation to oversee the regulatory process. A cable operator's basic service tier, certain in-home equipment charges, and certain installation charges are subject to rate regulation by local franchising authorities. Other cable television services and other services, which are provided by cable television operators, are not currently subject to regulation by either local franchising authorities or the FCC.

In implementing its rate regulations, the FCC adopted a uniform rate scheme that is applicable to both the rates for basic cable service and cable programming service tiers in areas where there is no effective competition. The 1992 Cable Act permits local franchising authorities to regulate the rates charged for basic cable service and certain installation and certain in-home equipment rates. The FCC had the sole authority to regulate the rates for cable programming service tiers. Over the last few years the FCC has adopted several modifications to the rules and regulations regarding cable television rates. On September 15, 1995, the FCC adopted rules giving regulated cable operators the option of filing for rate adjustments on an annual basis instead of the then existing quarterly system.

On February 8, 1996 President Clinton signed the Telecommunications Act of 1996 into law. The new law made sweeping changes to federal telecommunications law and policy. Under the new law, regulation of cable programming and some basic service tier rates will be lifted or gradually phased out, depending on the size of the cable system and presence of effective competition. In addition, the new law allows telephone and cable companies to compete in each other's business, and creates a new statutory entity know as an "open video system" to govern certain video programming. Many areas of cable regulation are not affected by the 1996 act. For example, local franchising authorities can continue to regulate rates charged for basic cable service and certain installation and certain in-home equipment rates, unless effective competition exists.

FCC Form 1240

Pursuant to the FCC rules FCC Form 1240 may be used to adjust the maximum permitted rate for the Basic Cable Service (which was determined either by Form 1200, a previously filed Form 1210 or Form 1240, a cost-of-service showing, or election of a streamlined rate reduction for qualified systems) for the following reasons: increases or decreases in external costs; the addition and deletion of channels from regulated tiers; and inflation. The FCC Order establishing the annual system calls for a series of calculations, involving both the projection of future events and an accounting of events that are known to have happened.

FCC Form 1240 is used to adjust rates annually, instead of quarterly, to reflect changes in external costs, inflation, and the number of regulated channels that are projected for the 12 months following the rate change. A cable operator has the burden of proving that projected changes in external costs, inflation or the number of channels are reasonably certain and quantifiable. (The FCC rules recognize seven categories of external costs: retransmission consent fees, copyright fees, programming costs, certain cable specific taxes, franchise-related costs, franchise fees and FCC regulatory fees.) FCC Form 1240 is not used to compute franchise fees or FCC regulatory fees. An operator whose actual cost exceed its projections during a rate year may at the time of its next annual rate filing adjust or "true up" its rates. Generally, the FCC rules require a cable operator opting for annual adjustments to file a basic rate adjustment request with its local franchising authority 90 days prior to the effective date of the proposed change. After the 90 days, the operator may change the rate, unless the local franchising authority has rejected the change as unreasonable. A cable operator may ask whether the local franchising authority intends to issue a rate order after the 90-day review period, and if it does not respond within 15 days, the local franchising authority will lose its ability to order a refund or a prospective rate reduction.

FCC Form 1205

For cable operators using the annual rate method, changes to equipment and installation rates must be filed on FCC Form 1205 concurrently with FCC Form 1240. An operator must base proposed annual adjustments to certain in-home equipment and certain installation rates on past costs. The Hourly Service Charge is used to set all regulated installation rates.

FCC Form 1235

The Form 1235 provides for the recovery of system upgrade costs when the upgrade meets certain minimum technical specifications. The Form 1235 is filed in conjunction with Form 1240 and is an "add-on" to the Form 1240 maximum permitted rate. The Form 1235 "add-on" portion should only be charged to subscribers receiving benefits of the system upgrade.

III. OVERVIEW OF REPORT PREPARATION

Autumn 2003 marked the adoption of rules implementing the December, 2002 agreement between major cable operators and major consumer electronics companies setting the stage for the release of the first wave of Digital Cable Ready television sets (DCRs). These DCRs allow

cable subscribers to receive one-way digital cable services without the use of a set-top box. A security device called a CableCARD will allow cable customers to view encrypted digital programming after it is authorized to do so by the cable operator. The CableCARD plugs into a slot built into the digital television. Cable Television Laboratories ("CableLabs") and the cable industry have been developing CableCARD technology for some time, and the advent of DCRs will mark the first major deployment of devices that will use those security cards. In addition to television sets, it is anticipated that there will soon be other consumer electronic devices available at retail that will take advantage of this technology.

Because the DCRs being sold now are one-way devices, they do not have the capability to access cable's two-way services such as video-on-demand or interactive program guides. To access these services, customers will need to continue to use a digital cable set-top box. Cable operators and consumer electronics manufacturers are currently in discussions to develop requirements for digital TV sets that can receive cable's two-way services without a set-top box. See www.timewarnercable.com/nc/products/cable/cablecard.html for more information regarding this matter.

With a letter dated July 21, 2004, TWC submitted a FCC Form 1205, Determining Regulated Equipment and Installation Costs, (dated July 21, 2004). In the letter of July 21, 2004, TWC stated: "While it is not clear that the rates and charges for the CableCARD are subject to regulation under the FCC rules, we have prepared the attached Form 1205 for your information. As you will note, the attached Form 1205 establishes a maximum permitted rate for the Cable CARD of \$2.02. At this time we plan to charge \$1.75 for the Cable CARD."

With a letter dated September 30, 2004, TWC filed two FCC Form 1240s, Updating Maximum Permitted Rates For Regulated Cable Services (dated September 30, 2004), and one FCC Form 1205, Determining Regulated Equipment and Installation Costs (dated September 30, 2004), with the Town of Chapel Hill, North Carolina (the "Town"). Apparently, the Town received the letter on October 1, 2004. In the letter of September 30, 2004, TWC indicated its intention to implement the new rates on January 1, 2005.

One of the FCC Form 1240's is for the headend that is located in the vicinity of the Town of Chapel Hill and provides cable television service in the Town of Chapel Hill. The other FCC Form 1240 is for the headend that is located in the vicinity of the City of Durham and provides cable television service in the Town of Chapel Hill.

Pursuant to a request from Adrian E. Herbst, representing the Town, Charles Gramlich of Charles Gramlich & Associates reviewed the information provided by the Town and TWC concerning the above mentioned FCC Forms 1240 and 1205 and related forms and worksheets.

The review included:

1. Communications with representatives of TWC, including Paul Baccellieri, Vice President Finance, Raleigh Division of TWC and Claudia T. Pileggi, Financial Manager, Raleigh Division of TWC, regarding the rate filings for the Town and related exchanges of information.

2. Mathematical verification of all steps and assumptions necessary to complete the forms, worksheets and accompanying schedules.

Please note, however, that Charles Gramlich & Associates has not undertaken an "on-site audit" of TWC's books and records to determine whether the information included in the Forms and worksheets or the accompanying schedules has been accurately identified. Such an on-site audit would require physical presence by employees of Charles Gramlich & Associates, or a qualified accounting subcontractor, at the premises of TWC to review the books and records and verify that entries have been accurately recorded and assumptions properly calculated. In completing the worksheets and schedules of the FCC Forms and related worksheets, cable operators are required to make certain assumptions and report information to the best of their ability. In some cases, it may be appropriate for local franchising authorities to verify the accuracy of the information reported by a cable operator by conducting an on-site audit of the operator's books and records. Currently, I do not believe that such an on-site audit is necessary, based on the information I have reviewed in TWC's FCC Forms and related worksheets and the other relevant information I have reviewed. However, I make no representation with respect to the accuracy of the information reported by TWC on its FCC Forms and related worksheets but simply base my conclusions and analysis on the information TWC has provided.

Based upon my review of the information supplied by TWC, it is my opinion that the rates for Basic Cable Service as computed by TWC on the two FCC Form 1240s (dated September 30, 2004) and for certain regulated equipment and installation cost as computed by TWC on the two FCC Form 1205s (dated July 21, 2004 and September 30, 2004) are accurately calculated according to FCC rules and regulations.

The Basic Cable Service is regulated by the Town. The Basic Cable Service includes the lowest level of cable television service offered by TWC in the Town. Other cable television services and other services, which are provided by cable television operators, are not currently subject to regulation by either local franchising authorities or the FCC.

According to TWC:

1. The Basic Cable Service, currently, consists of approximately 22 channels of mainly broadcast stations that are received off the air and public, educational & governmental access channels.
2. Tier 2, currently, consists of approximately 51 channels for both the Durham headend and the Chapel Hill headend.
3. The Digital Tier, currently, consists of an additional approximately 72 video channels.
4. TWC last increased the monthly rate for Basic Cable Service on January 1, 2004.

CGA asked specific questions of TWC regarding the inflation segment of the computations. In response, TWC stated: "Our practice is to use the most currently published FCC inflation factors at the time of the filing. At the time of our filing at about, the last published FCC inflation factor was for the first qtr of 2004. Hence, we assumed that factor for the rest of this year, as well as 2005. We will always make the appropriate adjustment to the

inflation factors within the true up mechanisms allowed in the subsequent year's filing.”

Since TWC has selected monthly rates for Basic Service, which are less than the MPR, the use of a later inflation factor would not lower the rates paid by subscribers during the next year. In any case, the appropriate adjustment is made during the subsequent year's true up segment.

Outlined on the following Rate Change Checklist are the current and the proposed Maximum Permitted Rates ("MPR") and the current and proposed Operator Selected Rates ("OSR"). The MPR is the maximum rate that TWC can charge as calculated by TWC using the FCC's rules and regulations. The OSR is the rate that TWC has indicated that it will charge subscribers. The OSR cannot exceed the MPR.

The new proposed rates for Basic Cable Service, certain regulated in-home equipment and installation can become effective 90 days after the Town actually received the completed FCC Forms 1240 and 1205.

IV. CHAPEL HILL - RATE CHANGE CHECKLIST - 2004

<u>TYPE OF SERVICE</u>	<u>Current</u>	<u>Proposed</u>	
Basic Cable Service (Durham headend):			
Maximum Permitted Rate	\$14.99	\$14.91	Note 1
Operator Selected Rate	\$14.30	\$14.50	

The following table summarizes the changes to the maximum permitted rate for the Basic Cable Service (Durham headend) as per the different elements in the FCC Form 1240:

Prior maximum permitted Basic Cable Service Rate	\$14.99	
Remove Prior Period		
External Cost	\$1.77	
Markup Method	\$0.00	
True-up Segment	\$0.37	
Inflation Segment	<u>\$0.25</u>	
Portion Subject to Inflation		
Inflation True Up Periods	\$.26	
Projected Periods-		
External Cost	\$1.21	
Markup Method	\$0.00	
True-up Segment	\$0.53	
Inflation Segment	<u>\$0.31</u>	
Proposed Maximum Permitted Rate	\$14.91	Note 1

Basic Cable Service (Chapel Hill headend):	<u>Current</u>	<u>Proposed</u>	
Maximum Permitted Rate	\$11.44	\$10.61	Note 2
Operator Selected Rate	\$11.25	\$10.60	

The following table summarizes the changes to the maximum permitted rate for the Basic Cable Service (Chapel Hill headend) as per the different elements in the FCC Form 1240:

Prior maximum permitted Basic Cable Service Rate	\$11.44	
Remove Prior Period		
External Cost	\$1.74	
Markup Method	\$0.00	
True-up Segment	\$.53	
Inflation Segment	<u>\$.17</u>	
Portion Subject to Inflation		
Inflation True Up Periods	\$.18	
Projected Periods-		
External Cost	\$1.18	
Markup Method	\$0.00	
True-up Segment	\$0.04	
Inflation Segment	<u>\$0.21</u>	
 Proposed Maximum Permitted Rate	 \$10.61	 Note 2

Hourly Service Charge:	Current	Proposed	
Maximum Permitted Rate	\$37.50	\$37.81	Note 3
Operator Selected Rate	\$37.50	\$37.50	

Remote Control (All Types):		
Maximum Permitted Rate	\$0.34	\$0.33
Operator Selected Rate	\$0.34	\$0.33

Converter Box (Addressable):		
Maximum Permitted Rate	\$7.99	\$8.82
Operator Selected Rate	\$7.61	\$7.62

Converter Box (Non-Addressable):		
Maximum Permitted Rate	\$0.68	\$0.76
Operator Selected Rate	\$0.68	\$0.68

CableCARD		
Maximum Permitted Rate	\$2.02	\$2.02
Operator Selected Rate	\$1.75	\$1.75

According to TWC, all rates exclude FCC fee, sales tax, if any, and franchise fee. All rates are monthly, except for the Hourly Service Charge.

Note 1 – Includes \$2.11 from an FCC Form 1235 that was filed approximately five years ago upon the completion of

the cable system upgrade. CGA has not reviewed the FCC Form 1235.

Note 2 – Includes \$1.81 from an FCC Form 1235 that was filed approximately five years ago upon the completion of the cable system upgrade. CGA has not reviewed the FCC Form 1235.

Note 3 - Hourly Service Charge is used to calculate certain installation fees, for unwired & prewired homes, additional outlets and other regulated installations.

The following charts outlines the current monthly rates for the Basic Cable Service, Tier 2 and the Digital Tier, and the operator selected monthly rates for each.

	<u>Current (Durham headend)</u>	<u>Proposed</u>
Basic Cable Service	\$14.30	\$14.50
Tier 2	\$29.80	\$31.75 – not regulated
Digital Tier	<u>\$13.50</u>	<u>\$14.80</u> – not regulated
Total	\$57.60	\$61.05

	<u>Current (Chapel Hill headend)</u>	<u>Proposed</u>
Basic Cable Service	\$11.25	\$10.60
Tier 2	\$29.80	\$32.90 – not regulated
Digital Tier	<u>\$13.50</u>	<u>\$14.80</u> – not regulated
Total	\$54.55	\$58.30

According to representatives of TWC, the monthly rates for additional outlets will not change from the currents rates of \$1.00 for the Digital Tier and \$0 for the Premium Service additional outlets. Rates for additional outlets are not regulated.

