to pass through to subscribers the programming costs associated with new channels as well as a mark-up of 7.5% on new programming expense.

In the Sixth Order on Reconsideration and Fifth Report and Order ("Sixth Reconsideration Order"), 59 FR 62614 (December 6, 1994), the Commission inter alia, supplemented its existing going forward rules by creating an alternative channel adjustment methodology. Cable operators adding channels to CPSTs or single-tier systems may recover from subscribers (a) a flat per channel mark-up of up to 20 cents per subscriber per month, subject to a cap on the total amount recovered through December 31, 1997, and (b) programming costs, subject to a cap that applies through December 31, 1996. Operators adding channels to CPSTs or single-tier systems on and after May 15, 1994 may use either the new rules or the existing rules to adjust rates after December 31, 1994, but must use either the existing rules or the new rules consistently with respect to all channels added after December 31, 1994.

In the Sixth Reconsideration Order, the Commission also adopted a special streamlined cost-of-service procedure that permits independent small systems and small systems owned by small multiple system operators ("'MSOs") to recover the costs of upgrading their headend equipment when they add new channels to CPSTs. A small system is a cable system that serves 1,000 or fewer subscribers from the system's principal headend, including any technically integrated headends and microwave receive sites. See 47 CFR 76.901(c). A small MSO is defined as a MSO that has 250,000 or fewer total subscribers, owns only systems with less than 10,000 subscribers each, and has an average system size of 1,000 or fewer subscribers. See 47 CFR 76.922(b)(5). To prevent the potential for unreasonably sharp rate increases to small system subscribers, the amount a small system can recover for each channel added was limited to programming costs incurred plus the lesser of the actual cost of the headend equipment or \$5,000. Headend costs that are to be recovered through increased rates must be depreciated over the useful life of the equipment. In addition, the rate of return the small system may earn on such headend costs may not exceed 11.25%. Small systems that increase rates as a result of any channel additions pursuant to this methodology may be reimbursed for the addition of a maximum of seven channels to CPSTs between May 15, 1994 and December 31, 1997. Qualifying small systems adding channels to CPSTs were allowed to choose between this

streamlined cost-of-service procedure and the going forward rules applicable to all systems.

B. Discussion

On our own motion, we find our requirement that qualifying small systems elect between the per channel adjustment methodology and the streamlined cost-of-service procedure for upgrading headend equipment insufficient to give qualifying systems an appropriate incentive to add new channels. Although the return of up to 11.25% on the cost of headend equipment was intended to allow small systems a profit when they added channels, we now believe that our formula as a whole may give such systems an insufficient incentive to add channels. This is the case because, except for very small systems, the per subscriber rate adjustment associated with the streamlined cost-of-service showing would be less than the 20 cents per subscriber per month allowed under our general going forward regulations. If the maximum \$5,000 in headend costs is depreciated by a 1,000 subscriber system with an 11.25% rate of return, for example, the monthly per subscriber cost would be just over five cents, assuming a 15 year depreciation period. The Commission has not prescribed depreciation rates for headend equipment, but requires cable operators to follow reasonable depreciation practices in depreciating equipment over its useful life. The Cable Services Bureau, acting on delegated authority in examining cost-of-service rate justifications, concluded that operators generally assign 15-year useful lives to headend equipment and adjusted cable operator's proposed useful lives upward to reflect that norm.

Accordingly, independent small systems and small systems owned by small MSOs will not be required to choose between the per channel adjustment methodology and the streamlined cost-of-service procedure for upgrading headend equipment. Instead, we will allow independent small systems and small systems owned by small MSOs to recover for each channel added by using both the per channel adjustment methodology and the streamlined cost-of-service procedure for upgrading headend equipment in the following manner. First, such operators may recover the lesser of the actual cost of the headend equipment or \$5,000 associated with the channel addition. The recovery of the lesser of the actual cost of the headend equipment or \$5,000 shall otherwise remain subject to the conditions set forth in the Sixth Reconsideration

Order, namely that the headend costs be depreciated over the useful life of the equipment, the rate of return on this investment not exceed 11.25%,1 and the headend costs may be recovered for no more than seven channels through December 31, 1997. Second, in addition to recovery of headend upgrade costs in a streamlined cost-of-service proceeding, such operators may make rate adjustments to reflect channel additions and programming expenses that all other operators are permitted to make under the existing going forward rules. Specifically, operators may make per channel adjustments under either the new or the "old" going forward rules. As explained in the Sixth Reconsideration Order, operators that elect the new going forward rules are allowed to recover programming expenses associated with adding channels subject to the License Fee Reserve and the Operator's Cap. Of course, headend costs are not included in the Operator's Cap.

In addition, we believe that limiting eligibility to use the streamlined cost-ofservice procedure for upgrading headend equipment to independent small systems and small systems owned by small MSOs may fail to give slightly larger systems an appropriate incentive to add channels. Accordingly, we have decided to allow larger systems to use the streamlined cost of service approach subject to the same conditions as independent small systems and small systems owned by small MSOs provided that (a) the systems are either independently owned or owned by small MSOs and (b) the monthly per subscriber cost of the additional headend equipment necessary to receive an additional channel is one cent or more.² We are providing this relief for systems that are slightly larger than those that fall under the definition of a small system because we believe that such operators may have higher than average costs and may not always have access to the financial resources or other purchasing discounts of larger companies. However, since average equipment costs were built into the per

¹ Operators are permitted to recover an 11.25% rate of return on the lesser of the actual cost of the headend equipment associated with adding a channel or \$5,000. Therefore, if the cost of the headend equipment associated with adding a channel is \$5,000 or more, the operator is entitled to recover \$5,000 plus an 11.25% rate of return on the \$5,000 investment.

²The monthly per subscriber cost of the additional headend equipment necessary to receive the additional channel must be one full cent or more. For this purpose, operators may not round up monthly per subscriber costs of less than one cent. Additionally, operators must depreciate these costs at the same rate as they depreciate all similar equipment.