FOREWORD

This analysis has been prepared by Messrs. H. I. Grousbeck and Amos B. Hostetter, Jr., to provide background information on the Community Antenna Television (CATV) Industry and on a proposed CATV installation in Tiffin and Fostoria, Ohio.

Most of the work preliminary to construction of these systems has already been completed. As will be developed in this analysis certain franchises, contracts, options, engineering services, and bank support have been arranged for the installations. These arrangements have been concluded by the authors through Continental Cablevision, Inc., a Delaware company which we formed in May, 1963 to own and operate properties in the CATV industry.

Following a discussion of the CATV industry we have presented in this analysis a review of CCI's management, objectives, and activities in sponsorship of the Tiffin and Fostoria systems. The concluding section of this study focuses on the contemplated financing of the Tiffin and Fostoria systems.

It is planned that the systems be owned and operated by an Ohio Corporation to be organized by a group of 10 or fewer individuals. This new Company will be capitalized by the investors with $300,000 in common stock qualified for both Sub-chapter S and 1244 treatment. It is expected that as a result of the proposed financing the investors will be able to recoup a large portion of their original

investment within the first few years. Through an option arrangement CCI will have the right, between June 30, 1967 and August 31, 1974, to repurchase the Tiffin and Fostoria systems for either cash or stock of CCI. Regardless of whether or not this option is exercised and the form if exercised, we feel that within six years the value of the investors' position in the Tiffin and Fostoria systems will be several times the hard cost of their investment.

I. DESCRIPTION AND DISCUSSION OF THE CATV INDUSTRY

II. CONTINENTAL CABLEVISION, INC.

EXHIBITS

APPENDICES

Appendix

1. Franchises awarded to Continental Cablevision, Inc. by The Cities of Tiffin and Fostoria, Ohio

2. Agreements of Ohio Bell Telephone Company and Ohio Power Company permitting Pole Attachments of CATV Distribution Equipment.

3. Sample Agreement offered by Equipment Manufacturers for Turnkey Construction of a CATV System

4. Information Relevant to Projected Subscriber Buildups

   A. Saturation obtained since Formation by Broad Sample of CATV Systems
   B. Growth of Six CATV Systems selected for Comparability to Tiffin and Fostoria in Free vs. Cable Signals
   C. Growth of Tiffin and Fostoria Systems as Projected by some "Industry Experts."

5. Data on the Sales Prices of Systems which have recently changed Hands

6. Letter to Internal Revenue requesting and reply confirming the applicability of SubChapter S Status to Continental Cablevision, Inc.

7. Value Line Investment Survey of the CATV Industry

8. Television magazine article on the CATV Industry

9. Barron's commentary on the CATV industry

10. New York Herald Tribune article on the CATV industry

11. Business Week's coverage of a leading CATV industry broker.

12. Broadcasting magazine article on some aspects of the CATV industry's regulatory outlook

13. Television magazine article on Pay TV

14. Georgetown Law Journal survey of regulatory problems in the CATV industry

15. TelePrompTer Corporation: annual report

16. H & B American Corporation: proxy statement and annual report

17. Tower Antennas, Incorporated: offering statement

18. ABC Corporation [disguised]: balance sheet and income statement of a group owner of CATV systems

19. XYZ Corporation [disguised]: balance sheet and income statement of another group owner of CATV systems

20. New England Merchants National Bank's letter outlining major terms of its loan offered to Continental Cablevision, Inc.

21. Note Describing Provisions of Subchapter S and Section 1244 Stock

22. Pre-incorporation and subscription agreement

THE CATV INDUSTRY

CATV (Community Antenna Television) is a master antenna system designed to provide television signals through cables to cities and towns which, because of distance or intervening terrain, are unable to receive satisfactory signals through the use of ordinary roof-top antennas. By "pulling in" distant stations, the CATV systems provide additional programming to communities that otherwise would receive only one or two nearby stations.

The first CATV systems in this country were started in the hills of Pennsylvania, West Virginia, and Oregon in 1949-50. In the 14 intervening years CATV has evolved to an industry of major proportions. As of June 1963, there were more than 1,100 operating systems in the U.S. serving over one million homes (about 2% of the nation's TV homes). Total plant investment was estimated at $450,000,000.

A. Broadcast Allocations - The Basis of the Industry

The idea which underlies the CATV industry is derived from the geography of broadcast allocations. It is the responsibility of the FCC to allocate communication frequencies in such a way as to allow the greatest utilization of available frequencies without overlap and interference among signals. Thus it has become the FCC's responsibility to specify and control the broadcasting hours, frequency, power output, signal direction, etc., of signals sent through the air. While the resultant TV allocations (UHF and VHF) may provide six or seven possible

channels of television for a resident of New York or Los Angeles, they may also bring about certain holes in coverage. Since television signals are limited to line-of-sight transmission, these holes are a function both of distance and intervening terrain. Though 94% of the households in this country have TV sets, less than 50% are able to receive more than two "viewable" signals. The genus of the CATV industry is thus derived from the technical limitations of signal reception. As CATV has been able to extend television's entertainment and education facilities, it has found overwhelming acceptance from a TV-hungry public.

B. The Mechanics of a CATV Installation

The mechanics of a CATV installation are relatively simple. A master antenna is erected at a location and elevation where the signals of the desired stations are available in sufficient field strength to provide good quality pictures. A coaxial cable or other type of lead extends from the antenna to the community to be served. Where longer distances are to be covered, a point-to-point microwave relay service is utilized. The signals received from the distant television stations, as well as from the local stations, if any, are transmitted from the master antenna through amplifying equipment along the coaxial cable system to the television receivers in the homes. The antenna lead and distribution cable facilities are generally supported on the poles of the existing electric power or telephone companies. Rental payments are made under contract for such attachment rights. In a few cases, distribution facilities are placed underground or on privately-owned poles. Easements and rights-of-way to use streets and

alleys are obtained from the municipal governments where necessary. Such easements are referred to in the industry as a "franchise." This is in many respects a misnomer.

C. The Economics of a CATV Installation

1. Competitive Elements

CATV has many of the economic characteristics of a utility. It is a business with limited competition. CATV, of course, competes indirectly for discretionary income with all forms of entertainment and educational facilities. However, CATV basically competes only with "free signals." Thus a major factor in market selection is the comparison of free signals with signals which could be made available by cable. Only one or two cases exist where two CATV systems compete for the same subscribers. Even in the absence of an exclusive provision in its franchise a CATV system establishes an effective monopoly position by virtue of its pole contracts and plant installation. Since spacing regulations on utility poles usually allow room for only one ancillary service, a second entrant must set his own poles ($25-$40 per pole) as well as duplicating the installation. As is discussed later, the possibility of technical developments in television transmission which could replace a cable system seems slight.

2. Revenue Characteristics

The installation and service rates in the CATV industry today vary over a wide range: $0 - $200 for installations and $1.50 - $15 per month for service charges. Such variations, reflecting differing

philosophies on recapture of original plant costs, have recently demonstrated some tendency toward convergence. Rates for systems installed in the past few years have averaged about $20 for installation and $5 per month for service. Despite rate variations, CATV revenues have generally shown characteristics similar to other utility services.

CATV systems seem to have a generally predictable pattern of growth. While this point will be developed in some detail in a subsequent section, it will suffice here to say that with a technically-sound installation, a well-chosen market and capable promotion and management, a 60-75% saturation can be expected in five to seven years. Further growth can be anticipated to correspond with increases in population within the cabled area.

A CATV system is also comparable to telephone, electric, and gas utilities in that its income seems relatively immune to business cycle fluctuations. Experience over the last decade with disconnection requests and bad debts in the coal-mining areas of West Virginia and Pennsylvania indicates that there is relatively little income elasticity for CATV service. In fact, some in the industry argue that within limits there is inverse income elasticity, as CATV probably provides one of the cheapest hourly forms of amusement.

3. Cost Characteristics

The CATV industry is characterized by the same high asset-sales and fixed-variable cost relationships as most utilities. Installation cost of a full channel system (Channels 2-13) approximates $4,500/mile in today's markets. Considered in terms of the population

density typical in rural towns (perhaps 60-100 homes per mile), this amounts to an outlay of $45-$75 per potential subscriber. If 70% saturation is reached in five to seven years the plant cost is roughly $65-$105 per subscriber.

Operating costs independent of S.G.&A. generally range from $750-$1000 per mile per year. S.G.&A. will vary slightly with the size of the subscriber base. However, the major expenses are capital-associated and total expenses are relatively fixed in nature. Personnel requirements are small; the average system is operated by a manager, several technicians and linemen, and some clerical help.

There is thus considerable operating leverage (around a breakeven of 25-30% of potential or about 15-30 subscribers per mile). As mentioned above, the industry of late has tended to place installation charges at about $20. The contribution on this installation is minimal, perhaps $5-$10, and is often foregone for promotions. Experience indicates that once a customer is installed the drop-off rate is amazingly low. By the time a system has reached 50-60% saturation it can often bring 50% of the $60 service income per subscriber through to operating profit (before depreciation, financial charges and taxes).[1/]

At present the IRS recognizes a five-seven year life on equipment involved in a CATV installation. Thus, a CATV system rarely reports earnings for the first two or three years and does not pay income taxes for five or six years. The cash earnings over this period, however, are often sufficient to return the cost of installation free of taxes.

1/ See operating statements in Appendices 15, 16, 18 and 19.

To date, "real" life has been more a function of obsolescence through equipment advances than of physical fatigue. Based on the experience of a sample of the industry's best-managed systems with which we are familiar, the outlays for maintenance, repairs, capital addition and replacement (whether capitalized or expensed) appear to range between 5% and 8% of gross plant, implying a 12-to-20-year "real" life.

The point is in some respects academic. Since the tax life has stimulated resale of systems on a periodic basis, there is a well-defined market in operating systems. An established system in today's market commands a price of from five to eight times operating income (before depreciation, financial charges and taxes). The price is dependent in part on the amount of growth remaining in a system. Expressed in terms of price per subscriber, the market is presently valuing systems at $200-$250 per subscriber. Thus the market prices of fully-depreciated systems are generally well in excess of original plant costs. Given this set of circumstances one must conclude that a large part of cash earnings are in fact real earnings.

4. Current Regulation

Despite the quasi-utility nature of the CATV industry it has been held not to be a public utility and consequently is not presently regulated by state or governmental agencies (except as regards certain mechanical guidelines, such as clearance over highways, methods of attachment to utility poles, spurious radiation from cables, etc.). CATV systems are not engaged in broadcasting and do not use the common air

for transmission. Until quite recently CATV has been viewed by the FCC as an extension of an individual's antenna, and has thus been held not to be under FCC jurisdiction.

Those systems which use microwave to relay distant signals are served by a common carrier microwave operator who is under FCC jurisdiction. There is ample evidence in the way the FCC has administered its authority in microwave allocations that it is covetous of broader regulatory powers over the CATV industry, particularly in areas of conflict between local broadcasters and CATV operators. In such cases of potential conflict, the FCC has stipulated as a condition of recently issued microwave certificates that the common carrier will not serve a CATV system unless that system agrees to carry the local television station, and also to avoid duplication of the local station's programming. The microwave certificates issued subject to these restrictions are to be reviewed following the outcome of FCC hearings on the CATV industry which are now in progress.

While at present, regulatory efforts have affected only systems using microwave, it should be assumed that the next few years will bring some legislation covering all CATV systems. The CATV industry's national association (NCTA) has mounted strong legislative opposition to the extension of the FCC's common carrier jurisdiction to regulate the end user (the CATV operator). It is the opinion of the association that regulation based on such questionable jurisdiction could produce numerous inequities. The NCTA has recently decided not to oppose regulation per se but to cooperate in determining a workable form and agent for regulation. Thus the NCTA staff is now cooperating with the FCC in a study of the industry and in the drafting of proposed legislation covering the area of

CATV-broadcaster conflicts. Such cooperation has been judged the best way to define and contain the scope of future regulation. The area of future regulation will be considered in detail in a subsequent section.

D. Current Activity

Fifteen years ago, CATV activities were fostered by home-owners in some communities who were bent on increasing by one or two channels the signals available for their families and neighbors. In other communities appliance dealers, desiring to promote the sale of television sets, built systems to provide satisfactory television reception for their markets. As the economics of the industry became clear, many wealthy patrons made installations, spurred not only by service and profit considerations but also by tax advantages.

Recently the industry has begun to attract the attention of major investing groups and has received more widespread commentary in the financial journals.[1/] While multiple-system ownership was a rarity five years ago, certain groups, particularly in allied industries, have become quite active of late in acquiring and operating properties.

Jerrold, Entron and Spencer-Kennedy Labs (equipment manufacturers), H & B American (diversified manufacturers), TelePrompTer (sports promoters), RKO-General and General Theaters (originally movie producers and theater operators) and most major broadcasters began CATV operations as sidelines, but now all have evidenced increased interest in the steady and expanding earnings of system ownership. Other groups such

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1/ See Appendices 7 - 13.

as the Rosenwald Estate (Television Communication Corp.), the Cox interests (Ohio) and the Johnson interests (Texas) are recent and active entrants into the field.

As conceived by its pioneers, CATV was probably limited to areas receiving no more than two good signals. Few in the industry today would recognize such limitations. Systems are now operating successfully in markets receiving three free signals, and the current flurry of activity in Connecticut suggests that installations in areas with even more than three free signals are considered both feasible and desirable. CATV seems to have evolved to a new point of merchandising emphasis. The present package includes (a) clarity and reliability of signals; (b) elimination of unsightly and hazardous roof-top antennas; (c) prompt professional service; (d) more and better programming, and (e) specialized programming such as educational service to schools, FM, weather, etc.

E. Outlook

Few if any of CATV's pioneers could have foreseen the strides which were taken in the industry's initial 15 years. There are many straws in the wind today which suggest that the potential of this industry has barely been scratched. A recent issue of "Television Digest," a broadcaster's organ, had this forecast:

> Continued greater penetration into larger markets, offering more and more national hookups for special events. More efforts to impose federal controls. Operators will seek congressional help to tone down FCC's regulatory moves. Tougher and tougher battles for franchises. Greater and greater capital required. . .NAB [National Association of Broadcasters] will find its job increasingly tough as more and more of its influential members go into CATV while more and more members worry about potential CATV competition.

The accelerated growth of CATV has brought into focus several major questions which will affect the industry's future form and scope. While the final resolution of these questions will only be known over time, we consider it worthwhile here to highlight some of the problem areas for further consideration. Let us caution that particularly in this section this analysis must be recognized as highly subjective. While every effort has been made to substantiate our conclusions they remain in large part personal judgements.

1. Risk Areas in the Industry's Future

Broadly speaking, we feel there are four major risks to the continued prosperity of the CATV industry. These risks involve the areas of: (a) technical obsolescence; (b) competition from other established utilities; (c) regulation by federal, state or municipal authority, and (d) taxation.

(a) Technical Obsolescence:

The risk contemplated here involves changes in present technology which could supplant cable systems with a wireless means of television transmission. While this risk will always exist from as yet unknown technical advances, we believe that economic and institutional factors argue against replacement by any foreseeable technical advances.

When a community has poor TV reception, the present alternatives to CATV systems are additional local television stations, devices called "boosters" and "translators," which are essentially slave rebroadcasting stations, and finally, the possibility of a satellite TV transmitter. All of these methods suffer from certain limitations.

As mentioned earlier, allocation of new broadcast frequencies is the responsibility of the FCC. At present all the available VHF (2-13) frequencies have been allocated and are operative.

The advent of the all-channel television set will probably result in construction of additional TV stations operating on UHF channels (14-83). Less than 100 such stations are now operative. It must be recognized, however, that the economics of television limits broadcast facilities to those areas where the high cost of operation can be justified by a sufficiently large audience (and resultant advertising income). Technical characteristics limit UHF broadcast coverage to less than one-half the distance (one-quarter the area) of VHF coverage. The slow rate of UHF station formation evidences the economic difficulties of such a limited market and has been of considerable concern to the FCC. It would thus seem that the area of competition between UHF and CATV will be extremely limited.

The economics of boosters and translators also seem to limit their threat to CATV. Though relatively inexpensive to install, they have proved extremely difficult for communities and civic associations to finance, due to their continuing maintenance and service requirements. There is no way that the signal of a booster or translator can be denied to households which refuse to pay for maintenance.

Satellite transmission of television signals capable of reception by home TV sets requires such large amounts of power as to be unfeasible at this time. More important, there is no foreseeable way of

pinpointing the propagation of satellite transmission. Given the limitation of frequency availability and the wide signal range of satellites, broadcasts direct tothe individual TV set from a space vehicle would severely restrict the opportunities for local television. Since Congress and the FCC have historically been eager to foster and preserve autonomous local stations, such a frequency reallocation seems highly unlikely.

It seems appropriate here for us also to make a few comments on the relationship of "Pay TV" to CATV. "Pay TV" as used in the industry today differs from CATV in that it involves program origination and broadcasting (in some form) as opposed to an antenna service.

Although there are Pay TV experiments presently being conducted in Hartford and Denver, most observers feel that Pay TV will continue to be slow in development and will rely heavily for distribution on the CATV industry. The reasons for this conclusion are as follows. Pay TV depends for its revenue solely on its ability to offer certain programming to those who will pay and to deny that programming to non-payers. This involves two critical elements: (1) the ability to offer programming only to those who pay, and (2) the ability to produce programs for which there is sufficient demand to offset production costs in the absence of advertising revenue.

Two approaches presently seem feasible for meeting the first requirement. The first is to broadcast over cables, which is by definition a perfectly selective method and can be charged either to the system as a whole or to the individual subscriber by installation of a monitoring unit comparable to a water meter. The second approach involves

broadcasting through the air some form of "scrambled" signal. Reception of the signal requires an unscrambling unit which can be used as the basis of selection and billing. Such broadcasting, of course, falls under FCC authority. Though that agency has granted an experimental frequency in Denver, its posture has generally been one of opposition to the allocation of frequencies for Pay TV.

The second element critical to the progress of Pay TV involves the economics of programming. At present it appears that there are very few forms of programming for which there is sufficient potential subscription income to cover production costs. In the absence of advertising revenue, most observers feel that in the foreseeable future, only championship sports could attract a sufficiently large viewing audience.

Many indicators suggest that the future of Pay TV - if, in fact, it has a future - will be based on microwave and cable transmission and will bear a cooperative rather than competitive relationship with the CATV industry. 1/

(b) Competition from the Established Utilities:

Over 95% of the CATV systems operating in the country today are supported on poles rented from the local power and telephone companies. This results from the attempt to minimize unsightly overhead obstructions as well as from the economics of pole plant construction. Some figures may be helpful here. A typical mile of system will require contact with about 50 poles. To set these poles would cost the CATV operator $25-$40 apiece, depending on the distance from a pole source. Assuming the CATV operator could obtain from local authorities the rights

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1/ See Appendix 13 for a more detailed discussion of the problems confronting Pay TV.

and easements necessary to set poles, this would increase the cost of an installation by 22-44%. Since a pole plant serving all dwellings in an area already exists (often under joint use by both the telephone and power companies), it is logical for the CATV operator to use these poles where spacing allows, since rental charges seldom exceed $5/year per pole.

The utilities generally refuse to execute any long-term contracts for fear of limiting control of their pole facilities; they prefer instead to use so-called "self-renewing" agreements. Since the CATV operator is rarely in a favorable negotiating position vis-a-vis the utilities, this is the form of almost all attachment agreements. The CATV operator is generally unable to make an installation without such agreements and in many respects he is a captive once the installation is made.

To date this situation has caused minimum difficulty for the industry. Telephone and power companies are particularly sensitive about their public relations and have refrained from abusing their position for fear of adverse public opinion which could result if CATV service were threatened. It seems unlikely that the future will raise any areas of potential conflict between CATV operators and the power companies. CATV systems are generally warmly received as steady and sizeable customers by the power industry.

There is, however, more cause for concern in the relationship of the CATV and telephone industries. First, there is not a particularly strong customer-supplier relationship. More important, a

sufficiently broad definition of the telehpone industry's function could include distribution of CATV service. Until recently the telephone industry in this country seemed to regard CATV as a fad. This was not the case in Canada where the telephone companies generally refused to allow attachments and offered the alternative of leasing an appropriate installation to the CATV operator on a basis considerably less favorable than what the CATV operator could do if allowed attachment rights. Recently several of the small independent telephone companies in this country have taken an interest in installing and operating cable systems in their franchised areas.

Thus, under certain circumstances the telephone industry could be viewed as potential competition. It is our feeling that this situation could result in increased friction over the next five years. This would be particularly true if CATV interests were successful with plans to offer microwaved signals from New York and Chicago in other metropolitan areas. Such a success would highlight the remaining potential of CATV and certainly elicit attention from the major telephone interests.

At present, few conflicts have actually occurred, although pole rental rates of the telephone companies have increased noticeably above those of the power companies. It seems appropriate, however, to consider the impact of a decision by major telephone companies to enter the CATV field.

Ignoring the necessary justification and authorization of this extension of function, one can easily see that the telephone industry would represent formidable competition. Their entry on a major

scale would preempt most of the attractive franchises and, therefore, greatly reduce new construction by present operators. For existing operations, however, the effect would vary from case to case, depending on the degree of reliance on telephone vs. power facilities, the ability to obtain rights to set poles, and financial strength.

It seems unlikely to us that the telephone industry can react and expand its functions quickly, say within the next five years. It should also be noted that if such a move takes place, it will not necessarily be a setback for existing CATV operators. Such a move would increase the stature of and funds available for the CATV industry, and could considerably increase the value of existing CATV properties.

(c) Regulation by Federal, State or Municipal Authority:

A great deal has been written in the last year on what form, if any, regulation should take in the CATV industry. Most observers now feel that regulation is both necessary and desirable; the questions which arise relate to the form and agency of such regulation.

The scope of contemplated CATV regulation is focused on the areas of presumed broadcaster-CATV conflict.[1/] On several occasions during the mid and late 1950's, broadcasters brought before the FCC appeals which claimed that CATV systems were threatening the continued operation of local broadcasting. The FCC originally refused action for lack of jurisdiction but in the historic Carter Mountain case (1959),

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1/ Appendix 8, a reprint from Television magazine, offers some insight into the broadcasters' view of CATV.

the Commission reversed this position and exercised their jurisdiction over the microwave company as a means of controlling the end user, i.e., the CATV operator. In the intervening years the FCC application of this indirect control has often been inconsistent and has appeared to many to be quite arbitrary. As CATV has shown the ability to penetrate increasingly large markets without the use of microwave, it has become clear that the FCC's attempt to regulate only CATV systems served by microwave will leave a regulatory vacuum in many areas of conflict.

A comprehensive review of the history of and outlook for CATV regulation recently appeared in the Georgetown Law Journal.[1/] The conclusions reached in that discussion support the recent decision made by the National Community Television Association. Following a history of opposition to all regulation, the NCTA wisely reversed its stand in 1963. Its present position is that regulation should be effected through new legislation. The NCTA staff is now assisting the FCC in the study and drafting of specific legislation which will apply in areas of broadcaster-CATV conflict. A summary of the two parties' positions at present may be helpful in pointing up the probable form of this legislation.

The FCC is seeking legislation which will require a CATV system to carry on its cables, without degradation, the signals of all stations whose A or B coverage (roughly 40 + 60 miles) reaches the CATV's market. Upon request from such stations, the CATV system will avoid

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1/ See Appendix 13.

duplication of any programming from these stations for a period of 30 days before and after broadcast. The NCTA, on the other hand, is attempting to confine protection to truly "local" stations (i.e., those located in the same community with the CATV system). The NCTA proposed that all such local stations be carried on the CATV cable without degradation. The NCTA proposes to avoid only simultaneous duplication. Further, they proposed that this protection be granted only in the case of a market with one "local" station (i.e., the CATV system is clearly the only competitor), and only when the local broadcaster can demonstrate economic hardship. The burden of proof is to lie with the injured party. The pivotal issues are, of course, under what circumstances a broadcaster is to be afforded protection and what form that protection should take.

While the outcome of these discussions remains uncertain, we feel that certain conclusions regarding the form and agency of future regulation can be anticipated. It seems certain that jurisdiction in the CATV industry will fall to the FCC by means of legislation extending the Federal Communications Act. It also seems probable that the guiding principle will be one of economic impact, although the definition of market areas, the forms of protection offered and the responsibility for proof are less easily predicted. Our assessments are: that "A" coverage will be agreed upon as the definition of co-location;that protection will be limited to simultaneous duplication; that this protection will be required, if requested by the broadcaster, only in a one-station market (the burden of proof to be left to the CATV operator in such a case); and that in all other markets the broadcaster who appeals must show proof of economic injury.

It is our opinion that such regulation will not work extreme hardship on the CATV industry. It is useful to note that radio, television and common carrier microwave, now under FCC regulation, are extremely vital and profitable industries. Federal legislation based on a doctrine of economic impact should in theory result in equitable solutions, particularly when compared with alternative measures for filling the present regulatory vacuum.

We consider broad scale state and municipal regulation to be rather unlikely, particularly if federal regulation is enacted. As television reception has been held not to be a public necessity, it would appear that state utility regulation can be confined to requirements regarding plant construction and maintenance. While municipal regulation (in the form of covenants appearing in franchises) has shown a recent tendency to increase, we do not feel this will have any significant impact on CATV operators in the future.

It may occur to some that the quasi-utility characteristic of CATV makes it subject to the same possibilities of seizure or nationalization as exist for utilities in times of extreme extension of governmental authority. The industry's present attempt to cooperate in drafting legislation suggests a general sensitivity to the dangers of protracted conflicts which could bring on such governmental action. We consider seizure of CATV systems in any form highly unlikely and feel that if such action should occur, some recourse for equitable compensation would exist.

(d) Taxation:

CATV systems are presently subject to municipal and state property and income taxes. These constitute a normal cost of doing business. In some cases municipalities have also imposed so-called "franchise taxes." Like any direct tax on a monopoly (which within limits enjoys an inelastic demand) the incidence of this tax can be passed on to the ultimate consumer. We do not feel that any substantial problems will arise for the CATV industry as a result of such taxes.

As was noted earlier, the CATV industry historically has received extremely favorable Federal tax treatment. It is only reasonable to assume that possible changes in this tax treatment might occur. We feel that there are three areas in which possible alterations of the historical tax treatment should be considered: (1) the treatment of gains realized from sale of depreciable assets, (2) the right to amortize payments made for franchises, and (3) the taxable life of fixed assets.

The guidelines for the tax life in this industry now call for a five-seven year write-off of all fixed assets. It has previously been possible, on sale of a fully-depreciated system, to qualify all gains as capital gains. Since the going concern value of CATV properties is generally in excess of the fair market value of the fixed assets, the practice has been for the buyer to attribute this excess to the value of the franchise. This excess has then been recouped by amortization against taxes over the life of the franchise. In some cases this has involved requests to municipal authorities to shorten existing franchises.