

October 29, 2004

Mr. Mark E. Recktenwald
Director
Department of Commerce and Consumer Affairs
State of Hawaii
335 Merchant Street
Honolulu, Hawaii 96809

Dear Mr. Recktenwald:

The Department of Commerce and Consumer Affairs (DCCA) requested that Merina & Company, LLP perform a review of the franchise fee collection and payment process. A verification of the "Carry-Forward Analysis" submitted to DCCA by Time Warner Entertainment Company, L.P. (TWE), doing business as Sun Cablevision (Kona) on the Island of Hawaii was a part of that activity. The Carry-Forward analysis covers the period July 1, 1995 through December 31, 2003. The purpose of the analysis was to derive certain financial balances relevant to DCCA's regulation of TWE:

- The cumulative carry-forward balance of the over- (or under-) collection of franchise fees. This balance expresses the difference between the amount of franchise fees collected from TWE subscribers on Hawaii (inflows to Kona), and the fees TWE paid to certain entities designated to receive franchise fee payments (outflows from Kona).
- Over- (or under-) payments by TWE of franchise fees due to the entities designated to receive payments.

This letter, accompanied with attached reports, on our verification of the TWE analyses is organized as follows:

- Background
- Overview of procedures
- Overview of the "Carry Forward Analysis"
- Conclusions and recommendation

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CABLE DIVISION
COMMERCE AND
CONSUMER AFFAIRS

Background

DCCA's applicable decisions and orders and rules specify three elements of the franchise fees relating to the Kona cable operations:

- Three percent of gross revenue for an "Access Operating Fee" is to be paid to the DCCA Director or the Director's designee (currently Na Leo`O Hawai`i)
- One percent of gross revenue is to be paid to the Hawaii Public Broadcasting Authority (HPBA Fee)
- One percent of a portion of income received from subscribers is to be paid to DCCA (Administrative Fee).

"Gross revenue" is defined differently for the Access Operating Fee and the HPBA Fee than it is for the Administrative Fee, and the definition applicable to the Access Operating Fee and the HPBA Fee changed during the period under analysis.

- DCCA Decision and Order No. 173 (July 1, 1995) defined "gross revenues" for the purpose of the Access Operating Fee and the HPBA Fee as:

"... all cash, credits, property of any kind or nature or other consideration derived directly or indirectly by TWE, its affiliates, subsidiaries, parents, and any other person or entity in which TWE has a financial interest or which has a financial interest in TWE, arising from or attributable to operation of the West Hawaii Cable System, including but not limited to:

- (a) Revenue from all charges for entertainment and non-entertainment services provided to Subscribers;
- (b) Revenue from all charges for the insertion of commercial advertisements upon the Cable System;
- (c) Revenue from all charges for the leased use of studios or Channels;
- (d) Revenue from all charges for installation, connection and reinstatement of equipment necessary for the utilization of the Cable System and the provision of Subscriber and other service; and
- (e) Revenue from the sale, exchange or use or cablecast of any programming developed for community use or institutional users."

In practice, franchise fees passed through to Subscribers have never been included in gross revenues by the cable operator. DCCA is aware of and accepts this practice.

- DCCA Decision and Order No. 261 (August 11, 2000) changed, in part, the definition of gross revenue applicable to the Access Operating Fee and HPBA Fee. The new definition, applicable since January 1, 2001, specifies that "gross revenue" excludes:

“...revenues from charges and collections for nonsubscription or nonsubscriber related sources such as advertising sales, home shopping commissions ...”

Hawaii Administrative Rules, Title 16, Chapter 132 defines “income received from subscribers” for the purpose of the Administrative Fee as:

“... revenues derived from the supplying of regular subscriber service and includes installation fees, disconnect and reconnect fees and fees for regular cable benefits. It does not include per-program or per-channel charges, leased channel revenues, advertising revenues and other income derived from the system.”

The prescribed timing of the franchise fee payments differs among three fee elements:

- Decision and Order No. 173 specifies that the HPBA Fee be paid by January 31 each year based on the revenue reported for the previous calendar year (retroactive calculation).
- Decision and Order No. 173 specified that the Access Operating Fee be paid on the first day of the year based on an estimate for the year, and then reconciled the following year (prospective payment). However, Decision and Order No. 261 changed the payment schedule for the Access Operating Fee, making it retroactively based, effective with the January 2001 payment.
- Administrative Rule 16-132 set up a schedule for the Administrative Fee requiring two payments each year, in by the first day of June and by the first day of December.

Overview of procedures

- For the six months ending December 31, 1995 through calendar year 2003 Merina & Company, LLP performed the following procedures:
 - Reviewed DCCA’s applicable franchise fee requirements
 - Documented Time Warner Entertainment’s policies and procedures for preparing annual “Revenue Statements” that TWE submits to DCCA for franchise fee purposes
 - Determined if TWE’s revenue calculation was made in accordance with the applicable D&O
 - Traced amounts used in each franchise fee computation to TWE’s books of account for selected years
 - Checked the mathematical accuracy of each of TWE’s “Carry-Forward Analysis” calculations
 - Checked to assure that certain figures in the analyses agreed to supporting documentation for this period.

A more detailed description of the procedures is attached to this letter, along with Merina & Company, LLP’s opinion letters.

Overview of the "Carry-Forward Analysis"

Several key points will aid an understanding of the "Carry-Forward Analysis":

- Time Warner Entertainment itemizes franchise fees on subscriber bills. Over time the amount TWE had collected in itemized franchise fees differed from the amount remitted to the entities that receive franchise fee payments. This difference was attributable to timing matters and to the subscriber bill itemization methodology. Nothing came to our attention that would suggest TWE deviated from the billing and remittance methodology permitted by DCCA at that time.
 - The original prospective basis for the Access Operating Fee and the delayed payment schedule of the Administrative Fee meant that the payments that TWE made to the fee recipients in any given calendar year would, in all likelihood, not match to the fees collected from subscribers for the preceding year.
 - For much of the period under review the franchise fee itemization on subscriber bills was a selected flat amount for each subscriber, not directly tied to the amounts for cable services on each individual subscriber's bill. This practice meant that the amount itemized as the franchise fee would not necessarily conform precisely to the controlling "percentage of gross revenue" definitions cited above. TWE has since changed this practice: now the itemized amount on each subscriber's bill relates to the amounts for cable services shown on the bill.
- Time Warner Entertainment prepared the "Carry-Forward Analysis" to identify the cumulative amounts of the over (or under) collections of franchise fees from subscribers, compared to the amounts remitted to the entities receiving franchise fee payments. The basic outline of the "Carry-Forward Analysis" is as follows:
 - The analyses include separate computations for the Access Operating Fee, the HPBA Fee, and the Administrative Fee.
 - For each fee, the analyses begin with the date on which TWE purchased each system.
 - For each calendar year between July 1, 1995 through December 31, 2003, the analyses adjusts the cumulative balances to reflect both subscriber billings of the itemized franchise fee (inflows to TWE) and payments to the entities receiving the franchise fee payments (outflows from TWE).
 - The analysis culminates in cumulative balances of over- (or under-) collections as of December 31, 2003 (adjusted for certain accruals).
- One key issue subsumed in the analysis is whether TWE's franchise fee payments were compliant with DCCA requirements. The basic question is whether the amount of revenue TWE reported to DCCA each year for each element of the franchise fee complied with the gross revenue definition applicable to that element of the fee.
 - In an earlier assessment of Oceanic Cablevision's franchise fee computation for Oahu for the 1998 through 2000 period, franchise fee underpayments were identified and attributable to how Oceanic treated bad debt write-offs in the revenue reported to DCCA. This treatment of bad debts did not occur on Hawaii.

- Larger cable operators such as TWE receive payments from content providers and others for launch fees, marketing support credits, and co-op advertising. TWE, along with most other cable operators, has followed the practice of crediting these payments to expenses instead of revenues. This issue has yet to be resolved by the cable television industry as a whole. While TWE does not include these payments as part of their gross revenue calculation, DCCA does not necessarily agree or disagree with TWE's position and continues to monitor this issue and will take appropriate action once the matter is settled.

Conclusions and recommendation

For the period July 1, 1995 through December 31, 2003 Time Warner Entertainment collected different amounts of franchise fees from subscribers than it was required to pay to the designated recipients. The results are summarized in the table below (adjusted to an accrual basis for the HPBA Fee due and paid in January 2004):

Kona	Franchise Fee Element			
	Access Operating	HPBA	Administrative	Total
Accrual basis over/(under) collected balances	\$ (154,296)	\$ 143,548	\$ (74,915)	\$ (85,663)

Both the Access Operating Fee and the HPBA Fee apply the same definition of gross revenue, and both are now determined based on the previous year's revenues. For these reasons we believe it is reasonable to treat their over (under) collection on a combined net basis.

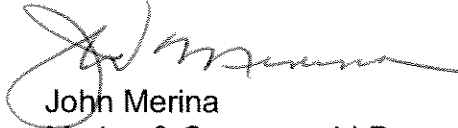
The Administrative Fee applies a different definition of gross revenue and its payment timing differs from the other two fees. Therefore, it is appropriate to consider this fee separately. The cumulative under-collection of franchise fees assigned to the Administrative Fee represents primarily a timing difference. It will drop each December and June as payments are made to DCCA, and then increase again until the time of the next payment.

The procedures we employed included steps to determine if the beneficiary has received the proper amount of franchise fees under the applicable D&O. The results of our procedures have disclosed no instances of PEG access organization, Hawaii Public Television, or DCCA not receiving the proper amount of franchise fees.

Kona	Franchise Fee Element			
	Access Operating	HPBA	Administrative	Total
Net payment due to (from) recipient entities	\$0	\$0	\$0	\$0

We recommend that DCCA accept the TWE "Carry-Forward Analysis." Merina & Company's opinion letter on the analysis is attached to this letter. The analysis applies only to TWE's franchise for the Kona system.

Sincerely,

A handwritten signature in black ink, appearing to read "John Merina", written in a cursive style.

John Merina
Merina & Company, LLP

Attachments:

Attachment 1 – Merina & Company, LLP Procedures Performed to Assess Time Warner Entertainment’s “Carry-Forward Analysis” for the Period July 1, 1995 through December 31, 2003

Attachment 2 – Independent Accountants’ Report on Time Warner Entertainment’s Revenue Statements

Attachment 3 – Independent Accountants’ Report on Time Warner Entertainment’s Carry-Forward Analysis Covering the Period July 1, 1995 through December 31, 2003

Attachment 1

Merina & Company, LLP Procedures Performed to Assess Time Warner Entertainment's Carry-Forward Analysis for the Period July 1, 1995 through December 31, 2003

We have issued our Independent Accountants' Review Report on the "Carry-Forward Analysis" prepared by Time Warner Entertainment Company, L.P. (TWE) for its cable television franchise on the Island of Hawaii (Kona) covering the period July 1, 1995 through December 31, 2003. Our report is dated October 29, 2004 and expresses an unqualified opinion on the Statement.

We applied the same procedures for all three elements of the franchise fees: the Access Operating Fee, the Hawaii Public Broadcasting (HPBA) Fee, and the Administrative Fee.

Procedures performed for the Independent Accountants' Report on the Carry-Forward Analysis

1. The balances at the beginning of the analysis period were stipulated by the Department of Commerce and Consumer Affairs (DCCA) to be the beginning balances for purposes of determining the current carry-forward (C/F) balances. Accordingly, the balance in 1995 when TWE took over the network of each franchise is the starting point for our test work. In the absence of correspondence or other documentation identifying the balances when the transfer was made, we relied on analytical procedures to satisfy ourselves as to the reasonableness of the beginning balances. These procedures included:
 - a. Reviewing the monthly customer billings for franchise fees during calendar year 1995 for month-to-month consistency. Calculating the revenues that would have been necessary to result in the billed franchise fees and agreeing those revenues to the certified annual "Revenue Report".
 - b. Agreeing franchise fee payments made to the General Ledger detail account analysis.
 - c. Concluding that the beginning balances were reasonably stated.

2. We performed procedures on TWE's "Revenue Reports" submitted to DCCA to determine that the revenue base used to calculate the franchise fees and hence, the carry-forward analysis, was in accordance with the applicable decisions and orders and rules. We employed procedures we customarily use in other reviews of franchise fee compliance.
 - a. Documented the revenue definition in the applicable Decision and Order.
 - b. Identified applicable franchise fee rates.
 - c. Determined the operator has complied with all reporting requirements on a timely basis.
 - d. Documented the operator's policies and procedures for preparing the annual "Revenue Reports".
 - e. Met with management to:
 - i. Determine management's interpretation of the franchise fee calculation, including the definition of revenue.
 - ii. Inquire if any adjustments have been made between amounts reported in TWE's accounting records and the "Revenue Reports" submitted to DCCA.
 - f. Traced all amounts used in the 2001 through 2003 franchise fee computation to the books of account without exception. Determined that there were no personnel or accounting system changes that would warrant expanding the procedure.
 - g. Through inquiry or a scan of the detail general ledger, determined if any revenues were recorded as an offset to an expense rather than as a credit to revenues. Examples include:
 - i. Launch fees
 - ii. Marketing co-op payments
 - iii. Advertising/marketing fees net of commissions
 - h. Inquired if certain other potential revenue sources, such as employee discounts, were excluded from the franchise fee computation.
3. For the calendar years beginning with the starting date of the analysis through 2003 we:
 - a. Proved the mathematical accuracy of the C/F analysis.

- b. Determined that franchise fee payments made agreed to check copies.
 - c. Determined the adjustments for overpayment of estimated franchise fees to the Director's designee were based on the actual revenues subject to the fee and were calculated correctly.
 - d. Agreed revenues used to compute actual franchise fee payable to the annual Revenue Reports" submitted to DCCA.
4. Concluded the C/F balance at December 31, 2003, as adjusted for discrepancies identified, was properly stated.

Sincerely,



John Merina
Merina & Company, LLP


Attachment 2

Independent Accountants' Report

We have examined the accompanying Revenue Statements for the years ended December 31, 1995 through December 31, 2003, as prepared by Time Warner Entertainment Co., LP, dba Sun Cablevision (Kona), covering Kona's operations under the regulation of the Hawaii Department of Commerce and Consumer Affairs (DCCA) on the Island of Hawaii. DCCA Decision and Order No. 261 and Administrative Rule 16-132 define how gross revenues are to be determined for the purpose of calculating franchise fees. Kona's management is responsible for the company's compliance with those requirements. Our responsibility is to express an opinion on management's assertion about Kona's compliance based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about Kona's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination and this report is not a legal opinion on Kona's compliance with specified requirements.

In our opinion, management's assertion that Kona has complied with the aforementioned requirements during the years ended December 31, 1995 through December 31, 2003 is fairly stated in all material respects.


Merina & Company, LLP
West Linn, Oregon
October 29, 2004

**Time Warner Entertainment Co., LP, dba
Sun Cablevision (Kona)
Revenue Statements**

For the Period Ending December 31, 1995

	<u>PEG</u>	<u>Hawaii Public Broadcasting Authority</u>	<u>Admin</u>
Total Revenues (6 months)	\$ 3,367,180	\$ 3,367,180	\$ -
Basic Revenues (12 months)	-	-	4,378,941
Less: Roadrunner Revenues	-	-	-
Less: Write-Offs	<u>(30,708)</u>	<u>(30,708)</u>	<u>-</u>
Revenues subject to Access Operating Fee Rate	<u>3,336,472</u> 3%	<u>3,336,472</u> 1%	<u>4,378,941</u> 1%
Access Operating Fee Due	<u>\$ 100,094</u>	<u>\$ 33,365</u>	<u>\$ 43,789</u>

For the Year Ending December 31, 1996

	<u>PEG</u>	<u>Hawaii Public Broadcasting Authority</u>	<u>Admin</u>
Total Revenues	\$ 7,199,959	\$ 7,199,959	\$ -
Basic Revenues	-	-	4,909,665
Less: Roadrunner Revenues	-	-	-
Less: Write-Offs	<u>(78,519)</u>	<u>(78,519)</u>	<u>-</u>
Revenues subject to Access Operating Fee Rate	<u>7,121,440</u> 3%	<u>7,121,440</u> 1%	<u>4,909,665</u> 1%
Access Operating Fee Due	<u>\$ 213,643</u>	<u>\$ 71,214</u>	<u>\$ 49,097</u>

See Independent Accountants' Report

**Time Warner Entertainment Co., LP, dba
Sun Cablevision (Kona)
Revenue Statements**

For the Year Ending December 31, 1997

	<u>PEG</u>	<u>Hawaii Public Broadcasting Authority</u>	<u>Admin</u>
Total Revenues	\$ 7,705,887	\$ 7,705,887	\$ -
Basic Revenues	-	-	5,406,162
Less: Roadrunner Revenues	-	-	-
Less: Write-Offs	(40,233)	(40,233)	-
Revenues subject to Access Operating Fee Rate	7,665,654 3%	7,665,654 1%	5,406,162 1%
Access Operating Fee Due	<u>\$ 229,970</u>	<u>\$ 76,657</u>	<u>\$ 54,062</u>

For the Year Ending December 31, 1998

	<u>PEG</u>	<u>Hawaii Public Broadcasting Authority</u>	<u>Admin</u>
Total Revenues	\$ 8,662,039	\$ 8,662,039	\$ -
Basic Revenues	-	-	6,048,615
Less: Roadrunner Revenues	-	-	-
Less: Write-Offs	(86,941)	(86,941)	-
Revenues subject to Access Operating Fee Rate	8,575,098 3%	8,575,098 1%	6,048,615 1%
Access Operating Fee Due	<u>\$ 257,253</u>	<u>\$ 85,751</u>	<u>\$ 60,486</u>

See Independent Accountants' Report

**Time Warner Entertainment Co., LP, dba
Sun Cablevision (Kona)
Revenue Statements**

For the Year Ending December 31, 1999

	<u>PEG</u>	<u>Hawaii Public Broadcasting Authority</u>	<u>Admin</u>
Total Revenues	\$ 9,274,132	\$ 9,274,132	\$ -
Basic Revenues	-	-	6,442,411
Less: Roadrunner Revenues	-	-	-
Less: Write-Offs	<u>(97,076)</u>	<u>(97,076)</u>	<u>-</u>
Revenues subject to Access Operating Fee Rate	<u>9,177,056</u> 3%	<u>9,177,056</u> 1%	<u>6,442,411</u> 1%
Access Operating Fee Due	<u>\$ 275,312</u>	<u>\$ 91,771</u>	<u>\$ 64,424</u>

For the Year Ending December 31, 2000

	<u>PEG</u>	<u>Hawaii Public Broadcasting Authority</u>	<u>Admin</u>
Total Revenues	\$ 10,105,262	\$ 10,105,262	\$ -
Basic Revenues	-	-	6,943,311
Less: Roadrunner Revenues	-	-	-
Less: Write-Offs	<u>(109,237)</u>	<u>(109,237)</u>	<u>-</u>
Revenues subject to Access Operating Fee Rate	<u>9,996,025</u> 3%	<u>9,996,025</u> 1%	<u>6,943,311</u> 1%
Access Operating Fee Due	<u>\$ 299,881</u>	<u>\$ 99,960</u>	<u>\$ 69,433</u>

See Independent Accountants' Report

**Time Warner Entertainment Co., LP, dba
Sun Cablevision (Kona)
Revenue Statements**

For the Year Ending December 31, 2001

	<u>PEG</u>	<u>Hawaii Public Broadcasting Authority</u>	<u>Admin</u>
Total Revenues	\$ 10,304,456	\$ 10,304,456	\$ -
Basic Revenues	-	-	7,228,513
Less: Roadrunner Revenues	(789,995)	(789,995)	-
Less: Write-Offs	(104,216)	(104,216)	-
Revenues subject to Access Operating Fee Rate	<u>9,410,245</u> 3%	<u>9,410,245</u> 1%	<u>7,228,513</u> 1%
Access Operating Fee Due	<u>\$ 282,307</u>	<u>\$ 94,102</u>	<u>\$ 72,285</u>

For the Year Ending December 31, 2002

	<u>PEG</u>	<u>Hawaii Public Broadcasting Authority</u>	<u>Admin</u>
Total Revenues	\$ 11,463,425	\$ 11,463,425	\$ -
Basic Revenues	-	-	7,349,907
Less: Roadrunner Revenues	(1,569,779)	(1,569,779)	-
Less: Write-Offs	(190,927)	(190,927)	-
Revenues subject to Access Operating Fee Rate	<u>9,702,719</u> 3%	<u>9,702,719</u> 1%	<u>7,349,907</u> 1%
Access Operating Fee Due	<u>\$ 291,082</u>	<u>\$ 97,027</u>	<u>\$ 73,499</u>

See Independent Accountants' Report

**Time Warner Entertainment Co., LP, dba
Sun Cablevision (Kona)
Revenue Statements**

For the Year Ending December 31, 2003

	<u>PEG</u>	<u>Hawaii Public Broadcasting Authority</u>	<u>Admin</u>
Total Revenues	\$ 10,573,932	\$ 10,573,932	\$ -
Basic Revenues			7,804,683
Less: Roadrunner Revenues	-	-	-
Less: Write-Offs	-	-	-
Revenues subject to Access Operating Fee Rate	<u>10,573,932</u> 3%	<u>10,573,932</u> 1%	<u>7,804,683</u> 1%
Access Operating Fee Due	<u>\$ 317,218</u>	<u>\$ 105,739</u>	<u>\$ 78,047</u>

See Independent Accountants' Report

Attachment 3

Independent Accountants' Report

We have reviewed the accompanying Carry-Forward Analysis for the period July 1, 1995 through December 31, 2003, as prepared by Time Warner Entertainment Co., LP, dba Sun Cablevision (Kona), covering Kona's operations under the regulation of the Hawaii Department of Commerce and Consumer Affairs (DCCA) on the Island of Hawaii. This statement is the responsibility of Kona's management.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the Carry-Forward Analysis statement. Accordingly, we do not express such an opinion.

We performed procedures we considered appropriate in the circumstances, applicable to subsequent calculations made by Kona. The purpose of these procedures was to test the accuracy of Kona's calculation, proper assessment, collection, and payment of franchise fees for its Hawaii operations.

Based on our review, and with the exception that, under Kona's interpretation of DCCA Decision and Order No. 173, certain amounts received by Kona were not considered revenues for purposes of franchise fee calculation, nothing came to our attention that caused us to believe that the statement of the Carry-Forward Analysis is not presented, in all material respects, in conformity with the criteria established by the State of Hawaii, Department of Commerce and Consumer Affairs, Cable Television Division.



Merina & Company, LLP
West Linn, Oregon
October 29, 2004

**Time Warner Entertainment Co., LP, dba
Sun Cablevision (Kona)
Carry-Forward Analysis
December 31, 2003**

	PEG and HPBA	Admin	Total
Cash basis over collected balances	\$ 70,491	\$ (50,415)	\$ 20,076
Adjustments:			
Customer Billings - 1999	10,000	(10,000)	-
Customer Billings - 2000	14,500	(14,500)	-
Adjusted cash basis over collected balances	94,991	(74,915)	20,076
Accrual basis conversion			
2003's HPBA fees due & paid 1/04	(105,739)	-	(105,739)
Accrual basis over/(under) collected balances	<u>\$ (10,748)</u>	<u>\$ (74,915)</u>	<u>\$ (85,663)</u>

See Independent Accountants' Report