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MEMORANDUM

TO: Roger Black, Chief Operating Officer, UTOPIA

CC: Paul Morris, Executive Director, UTOPIA

FROM: Jim Baller

DATE: June 16, 2004

RE: Response to Progress & Freedom Foundation Paper of February 2004

Late Thursday afternoon, June 10, 2004, you called to ask whether I could furnish you, by Monday morning, a written response to the Progress & Freedom Foundation's latest paper attacking municipal broadband initiatives, *Government Entry Into the Telecom Business: Are the Benefits Commensurate With the Costs?* (Release No. 11.3, February 2004). I replied that you had reached me in Washington State, that I would be traveling all day on Friday, that I already had a major project to complete over the weekend, and that I would do my best in the time available.

P&FF maintains that public entities should not enter the communications because they have numerous unfair advantages over their private-sector counterparts. Citing two earlier studies and three new case histories, P&FF also maintains that public communications ventures are likely fail. None of these arguments has merit.

In fact, P&FF's paper contains so many significant factual mistakes, unsupported claims, erroneous arguments, and outright distortions that it would take a paper many times the length of this one to respond to them all. Given the limits of time, I will focus on the main ones.

P&FF's Myths About Public-Sector Entry

P&FF argues that public entities should not be allowed to compete with the private sector because they enjoy numerous advantages over their private counterparts, including exemptions from taxes, the ability to raise capital through issuance of bonds that are both tax-exempt and guaranteed by the local governments, ownership of utility poles and rights of way, etc. P&FF at 5-6. P&FF also insists that the private sector is less risky and more efficient than the public

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sector, *id.* at 6-7. These are essentially the same arguments that private-sector monopolists have repeatedly invoked over the last century to thwart the emergence of meaningful competition from the public sector.^{1 2}

The American Public Power Association has written a comprehensive response to all of the arguments that P&FF and other opponents of public involvement in the communications field have made to date. APPA, *Community Broadband: Separating Fact From Fiction* (Jan. 2004), <http://www.appanet.org/legislativeregulatory/broadband/fact/BroadbandFactFiction.pdf>. As the APPA has shown, most of these arguments are based on errors of fact, and those that are correct are outweighed by countervailing factors that tip the playing field steeply in favor of the private-sector incumbents. These factors include municipal payments in lieu of taxes to local governments that often exceed private-sector taxes, private-sector access to financing at the best rates, and billions of dollars in annual tax incentives that are available only to the private sector.³

P&FF also argues that public entities should not enter markets that the private sector is already serving, or is willing to serve, citing Executive Office of the President, Office of Management and Budget, Circular No. A-76 (August 4, 1983; revised 1999),⁴ P&FF further maintains that “[t]he conclusion that government should avoid competing with the private sector is also consistent with longstanding federal policy and practice, which has drawn a clear line between governmental and non-governmental functions.” Once again, P&FF’s arguments are incorrect.

The Executive Order in question applies only to the federal government, and even as to the federal government, it does not support P&FF’s position. On its face, the Executive Order states that “[i]n accordance with the provisions of this Circular and its Supplement, the Government shall not start or carry on any activity to provide a commercial product or service *if the product or service can be procured more economically from a commercial source.*” *Id.* at § 5 (emphasis added). Here, the commercial product or service – fiber-based wholesale communications services that will enable retail providers to offer end users super high speed connectivity –

¹ See Jim Baller, *The Essential Role of Consumer-Owned Electric Utilities In Developing The National Information Infrastructure: A Historical Perspective*, <http://www.baller.com/library-art-history.html#25>; R. Rudolph and S. Ridley, *Power Struggle: The Hundred Year War Over Electricity* at 43-49 (1986); Moody’s Magazine, *Symposium on Municipal Ownership* (October and November 1906).

² It should come as no surprise that P&FF relies heavily upon the traditional arguments of monopolists, as its major supporters include BellSouth, Comcast, the National Cable & Telecommunications Association, Qwest, SBC, Sprint, Time Warner, the United States Telephone Association, and Verizon. <http://www.pff.org/about/supporters.html>.

³ MSB Energy Associates, *Major Tax Breaks for Investor-Owned Telephone Companies In the Year 2000*, <http://www.appanet.org/Newsroom/releases/MSBreport.pdf>.

⁴ <http://www.whitehouse.gov/omb/circulars/a076/a076.html>.

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cannot be procured *at all* from a commercial source, must less can it be procured more economically.

Furthermore, the federal communications laws contradict P&FF's claim that municipal involvement in the communications industry is inconsistent with "longstanding federal policy." To the contrary, the federal communications laws have long encouraged municipalities to compete with incumbent communications providers.

For example, since 1984, Section 613(e)(1) of the Communications Act, 47 U.S.C. § 533(e)(1), has provided that, subject to certain editorial restrictions, "a State or local franchising authority may hold any ownership interest in any cable system."⁵ In *Warner Cable Communications, Inc. v. City of Niceville, FL*, 911 U.S. 634, 635 (11th Cir. 1990), the court held that this provision "authorizes local governments to own and operate their own cable systems." While unwilling to read Section 533(e) as going so far as to empower local governments to provide cable services, another court found that the provision was at least "permissive." *Time Warner Communications Inc. v. Borough of Schuylkill Haven*, 784 F. Supp. 203, 213 (E.D. Pa. 1992).

Similarly, since the enactment of the Telecommunications Act in 1996, Section 253(a) of the Communications Act has provided that "No state or local statute or regulation or other state or local legal requirement may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service." In its so-called *Missouri Preemption Order*, the Federal Communications Commission found that Section 253(a) did not meet the Supreme Court's high standard of clarity for federal statutes that preempt traditional state powers, but the Commission made clear that public entry would advance the pro-competitive federal policies of the Telecommunications Act:

⁵ In enacting this provision, Congress explained,

Most cable systems are owned and operated by commercial cable interests. Municipal ownership and ownership by non-profit entities like cooperatives have traditionally evolved in communities where private companies were not particularly interested in offering cable services because of expected low return on investment.

More recently, however, a number of larger cities have taken a close look at building their own cable systems as a profitable means of making cable more responsive to city residents' needs. While proponents applaud municipal ownership as a way to meet local needs, critics raise first amendment concerns about government control of a part of the media. These concerns are addressed in the legislation.

H.R. Rep. 934, 98th Cong, 2d Sess., 1984 U.S.C.C.A.&N. 4655, 4666.

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The Commission has found that municipally-owned utilities and other utilities have the potential to become major competitors in the telecommunications industry. In particular, we believe that the entry of municipally-owned utilities can further the goal of the 1996 Act to bring the benefits of competition to all Americans, particularly those who live in small or rural communities. We emphasized this fact in our August 2000 report on the deployment of advanced services. In that report, we presented a case study detailing advanced services deployment in Muscatine, Iowa where the municipal utility competes with other carriers to provide advanced services to residential customers. We noted that the degree of advanced services deployment in Muscatine, which has three facilities-based, high-speed service providers for residential customers, including the municipal utility, is due in part to Iowa's legal environment, which has encouraged municipal involvement in the deployment of advanced telecommunications services. Our case study is consistent with APPA's statements in the record here that municipally-owned utilities are well positioned to compete in rural areas, particularly for advanced telecommunications services, because they have facilities in place now that can support the provision of voice, video, and data services either by the utilities, themselves, or by other providers that can lease the facilities. We are also encouraged by the comments of Missouri River, which states that it is comprised of municipally-owned utilities that serve communities with populations of less than five thousand people in Iowa, Minnesota, North Dakota and South Dakota, and that its members have installed fiber optic facilities that they could use to provide telecommunications services in markets where there are currently no competitive alternatives.

In the Matter of the Missouri Municipal League, 16 FCC Rcd 1157, 2001 WL 28068, ¶ 10 (footnotes omitted). In *Nixon v. Missouri Municipal League*, 124 S.Ct. 1555, 2004 U.S. LEXIS 2377 (2004), the Supreme Court of the United States agreed that Congress did not speak clearly enough in Section 253(a) to preempt the Missouri barrier to municipal entry, but the Court noted that its decision was not a ruling on the merits of municipal entry, that the municipalities “have at the least a respectable position, that fencing governmental entities out of the telecommunications business flouts the public interest;” that the Commission had “denounced the policy behind the Missouri statute;” and that three of the five commissioners had written separate opinions “to the effect that barring municipalities from providing telecommunications substantially disserved the policy behind the Telecommunications Act.” 124 S.Ct. at 1560.

In short, P&FF's insistence that federal policy disfavors municipal entry into the communications industry cannot be reconciled with the views of the agency empowered to administer the federal communications laws or with those of the Supreme Court of the United States.

The Two Prior Studies Cited In P&FF's Paper Are Seriously Flawed

Before turning to its new case histories, P&FF summarizes two prior studies that supposedly demonstrate that municipal entry into telecommunications is a bad idea. In one of these studies, completed in 1998, professors Ronald Rizzuto and Michael Worth of the University of Denver found wanting the performance of the municipal cable systems of Glasgow, Kentucky; Negaunee, MI; Paragould, AR; and Cedar Falls, IA.⁶ In the second, completed in 2002, Paul Guppy of P&FF criticized the municipal cable system of Tacoma, Washington.⁷

At the outset, P&FF has failed to mention that Rizzuto and Worth expressly qualified their study in three significant ways: (1) the study only took into account revenues from cable television service and did not consider the additional revenues that the municipalities could derive from using the same facilities to support simultaneously the provision of broadband, telecommunications and other communications services; (2) the financial models used in the study were designed to evaluate the performance of private-sector providers and did not necessarily reflect the way that public projects were ordinarily evaluated; and (3) some of the municipal systems under study were in their early stages, when costs were high and revenues low, which made predicting the future hazardous. Without more, these qualifications render the Rizzuto/Worth study of little current value here.⁸

The relevant facts also undermine P&FF's negative conclusions about the viability of municipal communications systems. As P&FF grudgingly acknowledges, Rizzuto and Wirth themselves provided "scenarios under which Negaunee's rate of return would be positive – placing it in a better position than the other municipalities studied." P&FF at 9. Furthermore, the Glasgow, Paragould and Tacoma systems are all doing very well – far better than Rizzuto/Worth and Guppy predicted. See <http://www.tricitybroadband.com/failures.htm>.

The history of the municipal communications utility in Cedar Falls, Iowa, furnishes an especially good example of the significant positive contribution that an advanced municipal communications system can make to the economic development of its community. In "A Study

⁶ Ronald J. Rizzuto and Michael O. Wirth, *Costs, Benefits, and Long-Term Sustainability of Municipal Cable Television Overbuilds*, GSA Press (1998). As P&FF acknowledges, this study was at least partially underwritten by a grant from the former giant cable provider Tele-Communications, Inc.

⁷ Paul Guppy, *When Government Enters the Telecom Market: An Assessment of Tacoma's Click! Network*, Progress on Point 9.7, The Progress & Freedom Foundation (2002).

⁸ For an analysis of the flaws in the economic underpinnings in these and other P&FF studies, see John Kelly, *Old Snake Oil in New Bottles: Ideological Attacks on Local Public Enterprises in the Telecommunications Industry*, <http://www.appanet.org/Newsroom/reports/Revisedtelecom.pdf>.

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of the Economic and Community Benefits of Cedar Falls, Iowa's Municipal Telecommunications Network," <http://www.iprovo.net/projectInfoDocs/economicAndCommunityBenefitsStudy.pdf>, Doris Kelley compares Cedar Falls to its next-door neighbor – Waterloo – on a broad range of criteria and shows that the two cities are virtually identical in all but one major respect – Cedar Falls built a municipal communications utility in the late 1990s and Waterloo did not. The existence of the municipal communications utility in Cedar Falls is thus the only consideration that can account for the two vastly different experiences that the two cities had during economic downturn that burdened most of the Nation in the 2001-2002 – in Cedar Falls, economic development and new construction surged, while next door in Waterloo, it fell sharply. In fact, during the last three years, Cedar Falls has attracted approximately 125 new businesses, including a major Target Corporation staging center, while Waterloo has attracted less than 10. Cedar Falls has also recently announced a tax reduction.

According to P&FF, “[n]one of the ventures [that Rizzuto/Worth and Guppy studied] has proved to be a good investment for its taxpayer owners.” P&FF at 7. That conclusion is utterly inconsistent with the facts.

P&FF's New Case Studies Are Also Full of Significant Errors

As new evidence that municipal communications utilities cannot succeed, P&FF offers up the experiences of Bristol, VA; Kutztown, PA; and Ashland, OR. P&FF acknowledges that these systems have only recently come on stream and that “it is risky to extrapolate from only a short period's performance.” P&FF at 11. Nevertheless, P&FF concludes, “It is difficult to see how these ventures will ever be able to cover their costs and pay back their initial investment.” *Id.*

As indicated above, P&FF's analysis contains so many errors that it is impossible to address all of them in the limited time available. That is particularly true of P&FF's new case histories. I will therefore focus on the major errors and omissions that seriously detract from the value of P&FF's analysis.

Bristol, Virginia

P&FF contends that Bristol's borrowing is so high and its subscribership is so low that it will never become self-sufficient, let alone pay back the costs of its capital investment in its fiber-to-the-home system. P&FF at 16-18. P&FF also contends that Bristol is paying for its ongoing communications operations through cross-subsidies from its other utilities and that Bristol's prospects for improvement appear to be severely limited by stiff competition from its private-sector competitors. *Id.* at 18.

Yet again, the facts undermine P&FF's arguments. For one thing, the validity of P&FF's analysis depends heavily on the accuracy of its subscribership counts, and here P&FF's numbers are way off the mark. P&FF recognizes that Bristol is a full year ahead of its subscribership projections, but rather than assume that Bristol's yearend projections for 2004 should also be

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advanced by at least a year, P&FF inexplicably assumes that Bristol's yearend projections for 2004 will continue to be what they originally were. P&FF at 17. For example, with respect to telephone service, P&FF assumes that Bristol will still have only 3400 subscribers by the end of 2004, as originally projected, even though it had reached that level of subscribership by the end of 2003. In fact, by early March 2004, Bristol's telephone subscribership had increased to approximately 4800, which is more than 40% higher than P&FF assumed that Bristol would have at yearend 2004.

There is also no merit to P&FF's suggestion that Bristol is cross-subsidizing its communications services with funds from its other utilities. The Virginia State Corporation Commission has been reviewing Bristol's practices carefully to ensure that it is not unlawfully cross-subsidizing its local telephone service, and the Commission's staff has recently recommended that the Commission find that Bristol has not done so.⁹

With regard to Bristol's ability to meet competition from private-sector providers, its record of extraordinary success speaks for itself.

Kutztown, Pennsylvania

As with Bristol, P&FF asserts that the Borough of Kutztown, a college town of about 5000 in central Pennsylvania, is not recovering the costs of its fiber-to-the-user system and will probably never do so. Observing that Kutztown's first-year subscribership fell off during the summer months, P&FF concludes that Kutztown's growth must have reached a plateau of about 500 subscribers as a result of stiff competition from the incumbent cable company. P&FF 22-23. P&FF fails to appreciate that the dip in subscribers was due to the departure of many of the college's students for the summer. As of mid-February 2004, Kutztown had 651 customers and was right back on its own projections. Kutztown's actual subscribership was thus 30% greater than P&FF had thought possible.

P&FF also fails to recognize a major benefit that the municipal system has bestowed upon the residents citizens of Kutztown, a benefit that is not reflected in the revenues that the municipal cable system receives. When Kutztown's fiber system began to operate in August 2002, the incumbent cable operator immediately dropped its prices in Kutztown – but not in neighboring towns – by more than 40 percent. These price reductions, coupled with the municipal system's relatively low rates, saved Kutztown's residents more than \$200,000 in cable rates in just the first year of the municipal system's operation.

⁹ Virginia State Corporation Commission, *Report of the Division of Communications, Division of Economics and Finance* (March 3, 2004).

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Furthermore, in 2003, the very year in which P&FF maintains that Kutztown's fiber-to-the-home project was a failure, it won the "Governor's Award for Local Excellence in Information Technology."

Ashland, Oregon

As P&FF notes, the municipal cable system in Ashland, Oregon, has struggled in its early years. With refreshing candor, its director has readily acknowledged that the system was more expensive and took longer to build than projected, and its revenues have been lower. Although Ashland has done well with its cable television and cable modem service, its difficulties have stemmed primarily from the failures of many of its data customers during the economic downturn in 2001-2002. Furthermore, the incumbent cable operator is charging prices in Ashland that are well below the prices that it is charging in surrounding communities.

Still, it would be premature and inappropriate to label the Ashland system a "failure." Ashland is currently considering options to restructure its operations and financial obligations. If these efforts succeed, Ashland may well be back on track to long-term profitability.

Conclusion

According to P&FF, "there are more than 350 public entities providing telecommunications services, [but] little work has been done to evaluate whether these ventures are successful and benefit the citizens of the entities that have undertaken these ventures." P&FF at 7. P&FF seeks support for its negative views about municipal entry in two past studies and three new case studies, but, as seen above, none of these studies supports these views. P&FF thus adds little, if anything, useful to the debate over whether UTOPIA should go forward.