

**Old Snake Oil in New Bottles: Ideological Attacks
on Local Public Enterprises in the
Telecommunications Industry**

prepared by

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October 2001

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"The preservation of a large role in economic activity for local governments is widely accepted as an important social goal."

George Stigler

"We're owned by the people of Chattanooga and where we can improve local rates or service, we should look at providing these types of services."

Harold DePriest

The Progress and Freedom Foundation (PFF) believes that ownership of telecommunications services is not a legitimate role for local government.¹ In its report, *Does Government belong in the Telecommunications Business?*, it says "there is strong evidence that government operated telecommunications enterprises have performed poorly in the past" and that they "will not achieve [the] desired goals of lower costs and more rapid deployment of efficient telecommunications systems."² This is because, it says, "government entities are not well suited to compete in the dynamic world of telecommunications." PFF claims that the lower prices charged by government utilities are primarily the result of "extensive subsidies that burden taxpayers and distort the marketplace."³

PFF claims that its task is to examine the "surprising trend towards expanded government participation in the telecommunications business." But it goes far beyond mere examination of industry trends. PFF uses the report to recycle ideological opposition to public enterprise in general, and to local government utilities in particular. The same discredited, ideological arguments that PFF has used against the ownership and operation of electric utilities by state and local governments, i.e., "public power," are now being re-bottled and hawked with a new label. The arguments PFF has used to discredit public power have failed, and the arguments they are now using to discredit the entry of public enterprises in the telecommunications industry similarly fail.⁴

The evidence PFF presents to support its case against the entry of local governments in the telecommunications field can and should be rejected out of hand. The

number of utilities on which it basis its generalizations about municipal telecommunications utilities are ridiculously few and the substantive analysis seriously flawed. No evidence is presented that addresses the central issue of the relative economic efficiency of public and private systems. The report parrots flawed financial analysis instead of providing serious economic analysis.

The report is particularly disturbing because it is offered as objective, non-partisan research. The unbalanced presentation of information and its uncritical acceptance demonstrate the report is neither objective nor non-partisan. Important sponsors of PFF include companies, and organizations representing other businesses, that have lost or stand to loose customers and revenues from competition from municipal telecommunications enterprises.⁵ One sponsor, the Edison Electric Institute (EEI), is a trade association that represents private electric utilities. It is not surprising EEI should be a member of an organization that discredits public enterprises since EEI itself has for decades sponsored studies in an unsuccessful effort to discredit the effectiveness and legitimacy of state and local government enterprises in the electric utility industry. EEI and the private telecommunications companies want state and local enterprises eliminated as effective competitors and work actively at all levels of government to do so.

The main piece of evidence, a report published in 1998, that PFF relies on to make its case was partly funded by Tele-Communications, Inc. (TCI), a private company in direct competition with municipal telecommunications utilities.⁶ While this fact, in itself, does not mean that the analysis is wrong, it does mean that it should immediately be suspect and subject to close scrutiny.⁷ In addition to uncritically accepting the analysis of this suspect evidence, PFF fails to tell readers significant information about the funding of the report.

The major claims made by PFF and the evidence it puts forward to support them are examined here. Special attention is given to these issues: (1) the reasons local governments are entering the telecommunications field; (2) competition in the industry; (3) economic efficiency and the question of whether profits are a reliable measure of it; (4) relative cost advantages and their significance in explaining the creation of municipal telecommunications utilities; and (5) the economic and political effectiveness and legitimacy of state and local public enterprises. The most notable failing of PFF in all

these areas is the absence of direct, relevant evidence to support any of its negative assertions about municipal telecommunications enterprises.

I. The Not-So Surprising Entry of Local Governments into the Telecommunications Business -- "Economic Necessity" rather than "Enterprising Government"

PFF claims that there is a "surprising trend towards expanded government participation in the U.S. telecommunications business," and notes that "the number of [government utilities] entering the telecommunications business is growing by leaps and bounds."⁸ The pace of entry is "rapid and increasing" and "government owned entities already offer virtually every type of telecommunications and Internet-related service" Almost 6 of the 17 pages in the main part of the PFF report are devoted to a description of the number of government utilities in the telecommunications business. And almost 13 pages -- fifty percent -- of the complete report, including the appendix, are devoted to identifying and quantifying government telecommunications utilities.

It seems as if the intent of this emphasis is to bowl readers over with the mere fact that there has been a notable increase in the number of such utilities, and the increase itself is evidence that something is wrong -- that local governments should not be entering the industry.

PFF reports that in the year 2000 there were 109 cable television systems that were owned and operated by municipalities. The number has grown from levels of about 20 in the early 1980s and about 60 in the early 1990s. PFF adds that "municipal electric utilities are also expanding into more traditional telecommunications service, such as fiber leasing, local dial tone and long distance telephone service." It says that "58 municipal utilities are leasing fiber, 18 are providing local telephone service and 10 are offering long distance." In addition, 61 municipalities are offering ISP [Internet service provider] services and 32 are providing high-speed data" services.

Because data on the number of local governments that provide cable as well as other telecommunications services are not readily available, PFF points to Iowa and Tennessee as evidence of an accelerating trend. In Iowa, the citizens in 43 cities "voted to create government-owned telecommunications providers," and in Tennessee the state

"enacted legislation permitting its municipal electric utilities to enter the telecommunications and Internet access businesses."

There has been a notable increase in the number of municipalities (largely public power systems) that have entered the telecommunications business, more or less in accordance with the numbers PFF cites. But the numbers do not speak for themselves, regardless of what the absolute or relative increases may be. The important question is "why." Why have local governments decided to enter the telecommunications business in the first place? PFF is forced to address this question but instead of looking to the obvious for explanations, it prefers the farfetched.

Farfetched Explanations

PFF says that governments are entering the industry because they "see themselves as simply following one of the basic principles of 'reinventing government,' namely, the idea that [they] ... should find ways to get involved in the marketplace in creative ways and raise money through innovative techniques."⁹ They "see the emergence of competition in telecommunications markets as opportunities for growth and expansion." The evidence PFF provides to support these assertions is a tortured interpretation of a 1992 book by David Osborne and Ted Gaebler, *Reinventing Government*. The book discusses innovative ways governments could do a better job providing services, and the authors used the term "enterprising government" to characterize such approaches.

First, it is worth noting that much of the growth in the number of government telecommunications utilities took place well before publication of Osborne and Gaebler's book and the general promotion of the ideas in it. The data that PFF cites on the growth of municipal cable television systems shows that about 64, almost 60 percent, of the 109 systems that existed in 2000 were already in operation before Osbrone and Gabler's book appeared.

More importantly, the primary focus of the book was general service government activities such as police, fire and health care. These are services -- unlike those of public enterprises -- for which economic efficiency is not as easily measured as market-type undertakings. Osbrone and Gaebler devote less than 2 pages of their 359-page book to public enterprises, and there is nothing in their book that suggests that general service departments of government or public enterprises should engage in businesses unrelated to

their spheres of public responsibility. These words the authors use to describe what they mean by "enterprising government" conflict with PFF's characterization:

An enterprising government exposes its subsidies to public light, relies on public pressure to do away with them—and then finds ways to make money from the services involved. It raises its greens fees for golf. It asks softball teams to get sponsors. It limits its tax subsidies. If it gets truly creative, it might even charge those convicted of drunk driving for the cost of processing the arrest...; or charge those whose malfunctioning security systems set off false alarms... or charge motorists who run into city-owned trees ...¹⁰

Another reason PFF offers for the entry of government into the telecommunications industry is that "deregulation in the electricity marketplace also creates incentives for expansion as government-owned electric utilities seek ways to fend off new entrants in their home markets."¹¹ The evidence that is offered to support this assertion is a quote from a news story in the industry trade press.

It is not imperative that public power systems get into the telecommunications business in order to remain viable enterprises. The electric rates charged by public power systems are, and have been, substantially below those charged by private companies. And the misguided deregulation policies in many states (which ignore the large amounts of monopoly power in wholesale power markets) make the economic position of public power systems even more economically viable. Consequently, there is no need for them to rush into other industries in an attempt to lower costs, find additional sources of revenue, or offer new services simply to fend off competition in the electric business.

Furthermore, PFF contradicts itself in attempting to make its point. On the one hand it asserts that public power systems are going into the telecom business as a way to lower electricity costs, but then later says that government-run telecommunications services are being subsidized by government-run electricity operations. It hardly makes sense for a municipal electric utility to enter the telecommunications business with the intent of lowering its costs (by sharing common costs with telecommunications services) and then turn around and increase its electric rates to subsidize telecommunication services. Which is it?

Neither the story about "enterprising government" nor the one about "fending off new entrants" is a credible explanation of why state and local governments have been entering the telecommunications industry.

The Real Reasons

The reason for the increase in the number of local governments offering telecommunications services is that consumers are dissatisfied with the price and the quality of service provided by private companies. In some cases, various services are not even offered by private companies. These problems result from a lack of effective competition in service and geographical markets. Local governments enter these markets only after communities have made *considered* judgments that the price and quality of service is not what it should be, and that effective competition is unlikely to develop in a reasonable amount of time, or at all.

Consumer complaints about private cable providers are legion, and problems with insufficient competition in other telecommunications services are reported routinely in the pages of the business press. The *Wall Street Journal*, which has no affinity for public enterprise, reports that the reason municipal governments are entering the telecommunications industry is because they are being spurred by local business and consumer dissatisfaction to do so. After municipal governments start providing telecommunications services, the price and quality of the private incumbents improves significantly.¹²

Even a related, cautionary article dealing with the costs and possible risks of municipal governments entering the telecommunications field was forced to acknowledge the basic motivations for municipalities getting into the telecommunications business. The *Wall Street Journal* noted that the citizens of Grant County in Washington state decided to allow its local government utility, Grant County Public Utility District No. 2, "to embark on its unusual all-fiber program after growing frustrated with its local phone and cable providers." And "some patches of the 2,777-square-mile county still lack[ed] phone service of any sort."¹³

Anecdotal news reports about customer dissatisfaction are confirmed by more rigorous research. As mentioned, PFF uses Iowa as an example of the "surprising rise" in telecommunications services offered by municipal government. A study by Professor

Montgomery Van Wart, et al., provides explanations for this "surprising rise." The study covered 265 of Iowa's approximately 950 cities, and "more than 25 in-depth interviews with local and telecommunications industry experts."¹⁴ The researchers found that the reasons Iowa cities decided to start offering telecommunications services were familiar ones: lower prices and improved quality of service. The deregulation of cable television had "not brought significant competition," and "competition in the local telephone market has been minimal to date." For example, annual increases for cable TV service were about seven percent, and "some regional telephone providers ... [withdrew] their local experts to service hubs to cut costs."¹⁵

The city of Hawarden is illustrative of the types of problems faced by Iowa cities and demonstrates the reasons why many of them decided to offer telecommunications services. Hawarden is a town with a population of about of 2,500, and its citizens were dissatisfied with the quality of service and concerned about their community's future. In 1994, 96 percent of the 63 percent of the electorate that voted favored an "all-purpose city communication utility." Eventually, the city was able to provide telecommunications services "at below-market averages. Its quality is good to acceptable in some areas, such as channel access (39), and excellent in such areas as Internet speed...."¹⁶

Telecommunications services are also an important part of a community's infrastructure and this is another reason why the Iowa cities entered the industry. In some cases the cities created the utilities as "an economic development strategy ... in the wake of private sector abandonment." Again, Hawarden serves as an example. In addition to being dissatisfied with its private telecommunications provider, the citizens of Hawarden wanted its telecommunications infrastructure to be progressive rather than being left behind like a "backwater" town. So the city constructed a fiber optic system, "completely bypassing the outdated copper wire system" of the private company.

Such endeavors by local governments are not new and should not be surprising. They have a long, commendable history, of which more will be said later. For now, the basic reason why communities create local public enterprises can be summed up in a comment by Harold DePriest, the president of the Electric Power Board that oversees the operations of the public power system serving Chattanooga, Tennessee: "We're owned by the people of Chattanooga and where we can improve local rates or service, we should look at providing these types of services."¹⁷ The reasonableness of Mr. DePriest's words

is lost on the PFF. This quote is used disparagingly by PFF in its report because it does not believe that it is a legitimate function of local governments to make such improvements.

II. Ignore Market Power, Assume Competition

High prices and unacceptable service are symptoms of a more basic problem -- lack of effective competition. The PFF makes vague references "to the monopoly problem" that was responsible for regulation of the telecommunications industry in the first place, and contends that entry by state and local governments "slows the development of private-sector competition."¹⁸ The first assertion ignores the fundamental issue and the second begs the question. Given the economic nature and institutions in the industry, how much effective competition is it reasonable to expect, what is the probability that such competition will be realized and how long will it take? These are the real-world issues that citizens and communities face.

PFF does not trouble itself with problems of market structure, market power, economic institutions, or the myriad other complexities of real-world economics. It is content to assume that the real world mirrors the theoretical world of perfect competition, or that it's close enough. Instead of examining the reasonableness of its assumptions, it prefers to, in effect, characterize the community leaders in the hundreds of towns across the country that are providing telecommunications services as empire builders. PFF has the causality backwards. The reason local governments are getting into the telecommunications business is not to co-opt the role of private companies; rather, it is a response to the fact that effective private-sector competition has been slow in coming, and not even on the horizon for some communities.

PFF contends that "the new technological revolution is transforming the market for telecommunications services, blurring previously clear distinctions between products such as local and long distance telephony, or telephony and cable television."¹⁹ It says that "convergence is contributing directly to deregulation and, generally speaking, a smaller role for government in the telecommunications market."²⁰ For support, it quotes a 1999 FCC report that says by the year 2004 it expects the "U.S. communications market to be characterized by vigorous competition."

The present economic reality is that hundreds of communities around the country have not experienced the arrival of such competition and have lost confidence that it will arrive soon, if at all. The daily pages of the financial press provide numerous examples that competition in the industry is weak and its prospects questionable. The *New York Times* reports that "digital subscriber lines" (D.S.L.) are dominated by four regional phone companies. Many businesses and consumers "complain that D.S.L. remains too costly and too difficult to obtain," and the field should not be ceded to a few large companies.²¹ Internet service providers complain that the large phone companies "unfairly use their market dominance and control of local phone networks to make it difficult for them to provide" D.S.L. service. One Internet provider complains that the phone companies try to "get away with whatever they can" in their charges for D.S.L. and will try "for as long as they can, until someone makes them stop." And the *Wall Street Journal* reports that "cable consolidation is moving into an even higher gear, with big implications for consumers and the media companies that supply cable with programming."²² Although there are still thousands of small cable companies, the top ten control about 90 percent of the market.

The experience of German cable television provides a cautionary, if not sobering, example of a significant and "natural" economic force at play in the telecommunications industry. It pushes in the direction of monopoly, not competition. In the fall of this year cable systems in Germany were sold -- to U.S.-based companies -- with the result that two companies there now control 80 percent of the cable systems.²³ The common justification companies give for large mergers is increased efficiency. But a more realistic view is that their primary purpose is to eliminate competition in order to gain more control over pricing.

The PFF report says nothing about market power in the telecommunications industry or its prospects for the future. Instead, it prefers to promote the elimination of an important source of competitive pressure in the industry -- local government utilities.

III. Relative Efficiency: Evidence Presented, Reality Ignored

PFF contends that "there is a wealth of evidence that suggests" that government operations of telecommunications enterprises in the United States are less efficient than

their private sector counterparts, but it provides only one study.²⁴ PFF begins its attack on government telecommunications enterprises by trying to make a general case against government, as such. It employs selective references and glib comments to do this. In attempting to make its specific case against local government utilities, it uses a study -- partly funded by a private telecommunications company -- of three municipal cable utilities. The alleged financial and economic experience of these three entities is the primary basis for PFF's generalizations about municipal telecommunications utilities.

The General Case -- Twisted and Glib

PFF says that "Most economists--regardless of their ideological leanings--believe the incentives provided by the marketplace make private business generally more efficient than in the public sector." Again, this statement "begs the question." It assumes that markets are effectively competitive and that appropriate incentives already exist, or that these conditions will exist in the near future. If it is reasonable to expect that the structure of an industry and the institutions in it will allow for effective competition, then, of course, economists and others would favor private operations. But in regard to important infrastructure-type industries in which the development of effective competition is questionable or unlikely, such a consensus would quickly vanish.

It's worth noting that PFF hedges its assertion, saying that "the marketplace [will] make private business generally more efficient than the public sector." And the quote from economist Joseph Stiglitz that PFF uses is also qualified: "... popular prejudice is, by and large, correct: *Private sector activities, while not necessarily more efficient, are on average so.*" These statements clearly leave open the possibility that at least some government enterprises are as, or more, efficient than private ones. The only way to discover in which industries this may be so is by performing or relying on thoughtful and objective empirical research. PFF does neither.

PFF's use of Stiglitz's words deserves more attention because they are particularly inappropriate. Rather than giving support to PFF's strong aversion to government involvement in the economy, Stiglitz's 1994 book, *Whither Socialism*, presents some of the best conceptual arguments and practical evidence on why government intervention in markets is necessary, and why such intervention should not be dismissed out of hand, as PFF is inclined to do. The researchers in PFF's employ must not have read or reviewed

Stiglitz's book thoroughly, for its substance and message are at direct odds with PFF's view that there is seldom a legitimate role for government in the economy.

The focus of Stiglitz's book was not about efficiency of local public enterprises, such as electricity, gas, water or telephone, either in the United States or in other countries. Its focus was on the underlying assumptions about the efficacy of largely unrestrained markets, and their superiority over government interventions. Stiglitz concludes that developments in modern economic theory "should have led to greater doubts concerning the effectiveness of market processes."²⁵ And he warns against the use of "folk theorems" in economic analysis. He defines them as widely known theorems, "the origins of which can not easily be traced." One example is the belief "that anything that the government can do, the private sector can do as well or better."²⁶ The PFF report does not even give a nod to the reservations modern economic theory has about the effectiveness of market processes in all situations. It is content with folk theorems.

More specifically, in regard to the quote PFF uses from Stiglitz, it would be too strong a statement to say it was taken out of context. But this is largely due to the fact that the nature of the quote itself makes it difficult to do so. However, the use of the quote is clearly not in the spirit of the point Stiglitz was discussing -- the general distinguishing features of public sector activity that may account for it being less efficient than private sector activity. At the beginning of the paragraph from which PFF quotes, Stiglitz says:

The force of the argument so far has been that (1) what scanty evidence we have concerning the relative efficiency of the different modes of production is ambiguous—particularly when account is taken of the *nature* of the activities involved—and (2) there are theoretical reasons for suggesting considerable similarity. Both face delegation problems, in both limited use of incentive schemes is employed, and in both rent seeking is prevalent.²⁷

It is in this context that Stiglitz says, "Yet I do think that the popular prejudice is, by and large, correct." From the general context of his book it is unlikely that Stiglitz had local government enterprises in mind here. Again, he was focusing on general (non-enterprise function) government activities and national, centralized government enterprises. They are not characteristic of local government enterprise activities in the United States.

More importantly, even if he were including local government enterprises, the efficiency features Stiglitz lists undermine PFF's objections to local government utilities. Stiglitz asks why is it that "government activities are, frequently, if not in general, less efficient" than private sector activities. The reasons he offers are:

1. Competition in the public sector is weaker;
2. The threat of termination of the organization—the threat of bankruptcy in the case of private firms—is weaker;
3. Government enterprises often face additional constraints not imposed on private sector firms; and
4. Government often faces problems making commitments.²⁸

In regard to the first point, competitive pressures, as discussed, can be expected to be more intense for local government telecommunications utilities. And the reason these utilities entered the industry in the first place was because there was "weak" competition among private firms, and effective competition was not expected to develop in a timely manner, if at all.

As for the threat of termination, this is a constant pressure that local government utility managers face. Both they and their organizations can be terminated if rates and service are not acceptable to consumers over extended periods of time. Utility managers can be replaced and utilities systems can be privatized.

It is true that government enterprises face additional constraints not imposed on private firms and sometimes are restrained in making commitments. But these factors cut against the arguments that their rates are lower because of special advantages, and that governments are inherently less efficient. To the extent such factors impair efficiency and do not serve another overriding public purpose, they can be changed or eliminated.

The glib reference PFF makes to the equally glib comment by James Wilson, in his book *Bureaucracy*, betrays a basic lack of knowledge of public enterprises in the United States, or its bias against them. PFF quotes this paragraph from Wilson:

Government agencies are especially vulnerable to bad changes because, absent a market that would impose a fitness test on any organizational change, a changed

public bureaucracy can persist in doing the wrong thing for years. *The Ford Motor Company should not have made the Edsel, but if the government had owned Ford it would still be making Edsels.* (Emphasis added by PFF.)²⁹

Wilson's statement about government employees, to the extent it has any validity, is far too broad and misses the mark in the case of public enterprises. It is not clear from the excerpt PFF uses whether Wilson intended to include local public enterprises in his generalization, but it is clearly PFF's intention. If utilities that are owned and operated by local governments fail to provide the rates and level of service demanded by local consumers they will not continue in business, as PFF suggests they would.

Local government telecommunications utilities are public enterprises with the same important market pressures to operate efficiently as their private sector counterparts, plus some. Over sixty years ago respected utility economist James Bondbright recognized that these government enterprises are businesses -- "even when directly owned and operated by the government."³⁰ He noted that the services are designed to be sold at cost, including interest to investors, and that they are not subsidized by some to be provided to all. This is in contrast to other *non-enterprise* municipal services -- police, fire protection, public schools, etc. -- where there is no serious attempt to apportion taxes with the benefits citizens receive. As under private ownership, customers of municipal utilities are "free to take whatever types and amounts of service they are ready to pay for at rates that reflect the cost of producing the service."³¹

For private enterprises profits provide an incentive for businesses to control their costs, though not necessarily their prices. Public enterprise managers have an effective proxy for profits that puts pressure on them to control their costs -- the difference in the prices they charge versus those of private (as well as other public) enterprises in nearby markets. This difference is an important indicator of efficiency to those who are, in effect, their "stockholders" -- local consumers. This difference is a constant source of economic pressure exerted on public enterprise managers.

Local public enterprises, like their private sector counterparts, also raise money in capital markets and are continually scrutinized by investors. Financing is typically done with revenue bonds and the scrutiny of public enterprise operations may be even more

intense because bond investors are likely to be more "risk averse" than most other investors. In any event, public enterprises are subject to the economic pressures that financial markets place on all businesses to operate efficiently. To the extent there may be initial financing from the city government when a public enterprise is established, the stewardship of such funds is subject to direct, local regulatory review.

Finally, managers of public enterprises are subject to political pressures as well. These pressures reinforce the market pressures for managers to do their jobs efficiently, keeping prices relatively low and service high. For example, in the electric utility industry, managers of public power systems typically appear at least once a month at open public meetings to report on the operations of their utilities and to answer questions from local regulators and the public. In addition, because consumers live in close proximity to utility offices and managers, it is relatively easy for them to bring complaints directly to the management of the public enterprises.

Specific Evidence: Irrelevant, Inadequate and Confused.

PFF contends that government telecommunications utilities are less efficient than private ones but never provides a definition of "economic efficiency" -- the standard by which it claims to be judging the legitimacy of local government telecommunications enterprises.

Midway through its report, in chameleon-like fashion, PFF changes its criterion for judging the legitimacy of local government telecommunications utilities from "economic efficiency" to "economic efficiency and fiscal responsibility" and then to "profits." Economic efficiency, as such, is not so subtly pushed aside. In its place the inappropriate proxy of profit is used, and the error is compounded by using a flawed definition of profit. PFF relied on a study -- partly funded by a private telecommunications company -- titled *Costs, Benefits, and Long-Term Sustainability of Municipal Cable Overbuilds*, by Ronald Rizzuto, a professor of finance, and Michael Wirth, a professor of mass communications and journalism. At least one of them, Mr. Wirth, has done a significant amount of consulting work on behalf of private cable companies, and TCI was among these clients.

Profit does provide an incentive for private firms to operate efficiently, but it falls far short of being a reliable indicator of economic efficiency. Indeed, industry profits that

are excessive and persistent are an indicator of inefficiency. Economic efficiency requires not only that goods and services are provided by using the least expensive combination of inputs, it also requires that, over time, prices reflect the economic costs of supply. PFF claims that the evidence "strongly suggests" that municipal cable companies have not met the standard of economic efficiency, but it makes no reference to these most basic standards of economic efficiency, let alone providing any comparative analyses of public and private enterprises based on them.

There is also the basic logical issue of whether it makes sense to use profit as a criterion to measure the relative efficiency of for-profit and non-profit enterprises. Even if there were some logical basis for doing so, this immediately leads to the practical, methodological problem of how to go about doing it. These questions are left unanswered by both PFF and Rizzuto and Wirth (R&W).

Added to these deficiencies are significant statistical ones. The R&W report discussed only four municipal cable television systems and offered conclusions on three of them. From this meager number PFF presumes to generalize not only about 100 or so municipal cable systems but also about the more than 200 public enterprises offering cable and other telecommunications services (such as, Internet access; high-speed data; local telephone; long distance telephone; fiber leasing; broadband data resale; and municipal data networks).

At least ten times the number of utilities that PFF relies on for its generalizations would be needed to draw valid inferences about the larger population of local government telecommunications enterprises. And this is assuming that the utilities were randomly selected, which raises another important statistical question. There is no indication that the three utilities in question were randomly selected. That they were "case studies" and part of a report that was partly funded by a private telecommunications company suggest that they were not.

These deficiencies, individually and together, are sufficient to dismiss the R&W conclusions as credible evidence to support PFF's contention about the relative efficiency of local government telecommunications systems. But they are only preliminaries to the vagaries of the R&W report itself.

The R&W analysis is the best evidence PFF offers to support its assertions about efficiency. Quoting the authors, PFF says that the three utilities reviewed "have been poor

investments from a pure business perspective" and have incurred cumulative losses of \$6.6 million.³² This is, essentially, the evidence PFF provides to support its sweeping claims. But just a critical sampling of the R&W calculations and conclusions readily reveals their serious logical and quantitative defects.

R&W contend that their analysis of the three municipal cable television utilities shows that all three have been unsuccessful investments "from a pure business perspective," and, absent the cost advantages and subsidies the utilities have, they could not "be sustained over the long run in a competitive market place." But then, almost immediately following these words, they contradict themselves, conceding that since the investments of the three utilities "are long term in nature, it is artificial to look at the returns over a mid-range time frame such as we have done above."³³ In effect, they dismiss the relevance of their own study.

The artificiality of the R&W analysis does not stop here. They carry it over to their calculation of "rates of return" for the utilities. They say they use a conventional measure of rate of return, but it is far from conventional. From the operating income of the utilities they subtract capital expenditures, plus a few other adjustments, to arrive at something they call "free cash flow." This is supposed to be an indicator of profit. But if, as the authors concede, telecommunications investments are long-term ones, then capital expenditures should not be subtracted from operating income to obtain a realistic picture of profitability. If this were the correct criterion for judging good investments, then numerous otherwise promising companies on the national stock exchanges should cease operations immediately. This is especially so for relatively young companies whose capital expenditures can be expected to approximate or exceed their operating income.

What Evidence is Needed?; What Evidence is There?

Representative, objective and otherwise reliable studies on the relative efficiency of public and private enterprises in the telecommunications field are difficult to find. Putting together such analyses involves important conceptual, data and statistical challenges, and the work is tedious and time-consuming besides. This does not mean, however, that other analyses based on sound concepts and an accumulation of direct evidence will not yield prudent and correct public policy imperatives. For example, the relevant criterion for judging the cost to a community for creating its own

telecommunications utility is the economic notion of "opportunity cost" -- what the community foregoes by establishing or not establishing its own system.

This simple but central economic notion is played out in the decisions cities make in choosing between public or private telecommunications services. Consequently, the cost to consumers is not, essentially, a function of the income or operating efficiency of the utilities serving them but of the prices they are paying and of the prices they would likely pay under the best practical alternative. This might seem to make the correct calculation of the true economic costs especially difficult. But it is much less so when done by the actual decision makers, the customers themselves. This fact argues strongly for laws, regulations and institutions that put the power of decision making into the hands of those who can best ascertain the relevant economic costs -- consumers. And the societal institutions best equipped to do this are local communities and their local governments.

In contrast to PFF's explanations, it is reasonable to believe that citizens would approve the creation of a municipal telecommunications system only if they were significantly dissatisfied with the price or service of the incumbent private provider, or if, as has been the case in many areas, there was no other alternative. And, at the same time, they had reason to believe (e.g., based on feasibility studies) that they would be better served by a public system. The experience of the seven hundred cities that have entered the telecommunication industry supports this belief. Less obvious but more important is the fact that such entry places pressure on prices to more closely reflect the economic costs of service and, thereby, promotes general economic efficiency.

One objection that PFF would surely have with the last statement is that the lower prices charged by public enterprises are largely the result of undue cost advantages. So it is important to take a closer look at these alleged advantages in order to determine which are real and which are not, and the appropriateness and economic significance of the former.

IV. Cost Advantages, Subsidies and The Level Playing Field

PFF says that hidden subsidies allow municipal utilities, among other things, to "undercut the prices charged by private competitors," and lead to numerous other unhappy consequences. This assertion is part of a four-paragraph harangue in a brief

subsection titled "The Myth of the Level Playing Field." Like most tirades, it is filled with contradiction and blatant error.³⁴

In the paragraph where PFF claims that subsidies are the reason municipal utilities are able to charge lower prices than private firms, it also states that "most of [the subsidies are] hidden from view and difficult or impossible to quantify." The obvious question, then, is how can PFF make sweeping claims about subsidies when it acknowledges that most of the required information to do so isn't readily available, and fails to produce the necessary facts?

PFF claims that municipal utilities can not be used as a benchmark for efficiency because they "benefit from a plethora of tax and regulatory advantages not available to the private sector." Specifically, it mentions tax-free debt, preferential access to rights of way, franchise fees and other taxes private companies must pay. It also claims that local government utilities are not subject to generally accepted accounting practices (GAAP). For good measure, it claims that these utilities "often receive interest-free loans or outright public subsidies."

The particular types of advantages PFF cites do not fit the conventional economic notion of what constitutes a subsidy, i.e., government payments that form a wedge between the prices consumers pay and the costs incurred by producers. But even if they did, this does not preclude municipal utilities from being used as benchmarks. The obvious solution involves simple arithmetic: just subtract the estimated effects of the subsidies from the price local government utilities charge. It is not enough to say that such advantages exist, they must be quantified to find out how much of the price difference between public and private utilities can be explained by them. Again, PFF fails to provide the evidence needed to support its claims.

The use of tax-exempt financing by state and local governments is a basic and legitimate source of financing and can not be properly characterized as a subsidy.³⁵ This is a cost advantage, but as a practical matter it can be expected to explain a very small part of the price difference between public and private telecommunications systems. For example, in the capital-intensive electric utility industry, it explains less than one-eighth of the unadjusted price difference between public power and private utilities.³⁶

As for municipal uses of rights of ways, these public assets are used for the benefit of local citizens to keep prices for services low, not as a means to increase profits.

Numerous private utilities that -- through the states' eminent domain powers -- have been granted stewardship of rights of way have used their control to stifle competition. This was, and is, the case for electricity transmission service, and it is also occurring in telecommunications, as noted.

In regard to "franchise fees and other taxes," part of the claim is incorrect and the remainder largely irrelevant. Local government utilities may not pay franchise fees, as such, but they typically make what are called "payments in lieu of taxes" to local governments. In the case of the electric utility industry, these payments are essentially the same portion of revenues that private companies pay to state and local governments.³⁷ PFF does not say what it means by "other taxes," but it would be a mistake to include "income taxes" in this group and consider it a subsidy. Local utilities don't pay income taxes because they are non-profit enterprises, so there isn't a significant amount of "net income" to pay taxes on in the first place.

Whether government utilities are or are not subject to GAAP accounting is largely irrelevant to the central issues at hand. But because PFF's claim is such an egregious misstatement of fact, it merits a response. Quite simply, public enterprises, including municipal utilities, are subject to GAAP accounting through the Government Accounting Standards Board (GASB). The GASB is the public sector counterpart to the Financial Accounting Standards Board.

PFF does not provide the necessary data to demonstrate that "a plethora of tax and regulatory advantages" account for the difference in the rates charged by private and public telecommunications enterprises. Instead, it suggests that this is true for other local government utilities and, therefore, will also be true for local government telecommunications utilities. But cost advantages fall far short of explaining the relatively low rates of local public enterprises at least one major industry -- the electric power industry. PFF ignores the evidence from this major industry that contradicts its generalizations.

The most comprehensive and statistically sophisticated attempt, to date, to explain the price difference between public and private utilities is contained in John Kwoka's book *Power Structure*.³⁸ Using data for 396 relatively large public power systems and 147 large private utilities, his results show that the large majority of the price difference between public and private electric utilities is due to public ownership itself.³⁹ His analysis adjusted for cost of

capital, taxes, types of generation, region of the country and other factors that are likely to have a significant effect on costs.

While his study is not the definitive explanation of the price difference between public power and IOUs, it is a highly credible analysis that shows that public power's significantly lower rates are not primarily due to cost of capital, taxes or access to federally generated hydropower. It is reasonable to expect similar results -- that lower prices cannot be explained away by real or alleged cost advantages -- in comparisons of local government telecommunications services to private companies.

Kwoka's econometric results are consistent with those obtained from direct analysis of utility financial and operating data, which are readily accessible and more easily understood.⁴⁰ Consequently, with little effort, the general reasonableness of assertions about the influences of cost of capital, taxes and other factors on the prices charged by public and private utilities can be checked. There are limitations to both the Kwoka analysis and direct analysis of industry financial and operating data that suggest that the estimates of price between public and private electric utilities are conservative. Discussing these limitations here is not relevant, except for one that has consequences for the quality of public and private telecommunications services.

One important limitation of conventional statistical analyses of prices is that the analyses fail to capture differences in quality of service. In economic terms, substantive quality differences signify different products. So to the extent there are such differences between local government telecommunications utilities and large regional or national private ones, price comparisons are compromised. This issue goes beyond the debate over public versus private enterprise and is more a question of the quality of service between relatively small, local enterprises versus very large regional or national ones. That local access to service providers is an attribute many consumers consider important is evidenced by the frequent advertisements companies prepare to emphasize that their companies are either headquartered or have an otherwise significant physical presence in a local community.

There is another side to these issues that PFF ignores: the significant advantages private telecommunications companies have over public utilities. These include incumbency, rights of way and significant financial resources. The latter can be used to stifle competition by shaping public opinion and policy. This is done by being able to outspend local communities by as much as 10 to 1 to block municipalization of

telecommunications services.⁴¹ And even more damaging -- not just to competition but to the democratic process itself -- is the economic and political power that large, private telecommunications companies exert on state legislatures to prohibit municipalities from entering the telecommunications business. For example, the August 2001 *Wall Street Journal* reported that "Most of the 10 states that have already restricted or banned municipalities from running telecom systems acted after industry pressure."⁴² Most, if not all, of these prohibitions were in place in time for PFF to address them in its report. But nothing was said about these restrictions which don't just "tilt" the playing field, they block competitors from even stepping on it.

Finally, PFF's repeated assertion that the true costs of local government telecommunications services are somehow "hidden" is particularly offensive to the public officials involved in operating and monitoring them. The facts are just the opposite. These utilities are public bodies and all their records are in the public domain. Their decisions about capital expenditures and operating expenses are open to the public and continually under public review. Moreover, because these utilities are local ones, they are readily accessible to consumers. The openness of local government utility finances and operations is far greater than that of private companies.

For those who look at local government utilities from a "pure business perspective" such openness is a distinct disadvantage. Hiding and controlling information is one way monopoly-minded private firms increase their market power and profits. But for local government utilities and the customers they serve openness is not a disadvantage. They are interested in keeping costs and prices low, and an important requirement for doing this is providing information for public scrutiny.

V. The Political and Economic Legitimacy of Local Government Enterprises

Economic historians tell us that while the preference for private enterprise has always been strong in the United States, there is also a willingness to use public enterprise when necessary. "The choices between public and private enterprises, and in the combination of the two, reveal a pragmatic approach toward appropriate solutions for particular needs, including a search for solutions which compromise contending interests."⁴³ "Public enterprises have been established . . . for practical and pragmatic reasons and not" because of adherence to any doctrine.

"In various situations public enterprises have appeared to be the best, or at least the most satisfactory, way to solve particular problems and meet particular needs."⁴⁴

Prominent economists at the beginning of the 20th century did not view the municipal utility provision of electric service as an unwelcome interference with the economy. Rather, the notion of public enterprise was viewed as a legitimate economic response to market imperfections. Although the municipal ownership movement was controversial from its beginning, so was the behaviour of private utilities. For example, the "development of the electric power industry occurred during a period when rapid industrialization, the rise of 'Big Business,' and growing urbanization created problems that caused many to doubt that solutions could be provided by unfettered private enterprise and laissez-faire public policy."⁴⁵

"These views were expressed most forcefully by leaders of the Progressive movement ... in their crusade for municipal reform." Vigorous allies of the Progressives included a group of economists who founded the American Economic Association, such as Richard T. Ely, Henry C. Adams, Edward W. Bemis and R.A. Seligman. They rejected the laissez-faire attitudes of classical economics. Instead, they "advocated various types of social control of market processes, including government ownership of a class of businesses they designated as 'natural monopoly' and which included municipal gas companies, water works, street railways, and electric utilities."⁴⁶

These references discuss the motivations for the establishment of public enterprises in the United States, and provide a useful historical context. But there are also solid economic foundations for the existence of public enterprises.

Even noted economist George Stigler, no friend of undue government intrusions into the economy, acknowledges that there is a wide range of legitimate activities that local governments might undertake, ranging from libraries to skating rinks. He says: "The preservation of a large role in economic activity for local governments is widely accepted as an important social goal." A good political system "adapts itself to the different circumstances and mores of different localities." The system "should allow legitimate variations of types and scales of governmental activity to correspond with variations in the preferences of different groups of citizens." And the different choices made by different localities are "surely an area of legitimate freedom," and "there is no correct distribution of expenditures among functions."⁴⁷ If a local skating rink passes Stigler's test as a legitimate function of a local government, then ownership and operation of telecommunications services by local governments surely should.

And Bonbright, again discussing public ownership, says that “in the utility field [public ownership] cannot be widely condemned, even by economic conservatives, as the 'entering wedge of socialism.' The case for and against this type of ownership should depend on the test of relative efficiency as judged by actual experience, not on a doctrinaire dispute as to whether the utilities belong in the sphere of business or the sphere of government.”⁴⁸ Elaborating on this point, he noted that the literature on the utility industry had many examples of attempts to block proposals for the establishment of public enterprises by appealing to ideology and characterizing government ownership of utilities as “creeping socialism.” But if socialism is used to characterize municipal electric service, then it is important to note that these activities are “enterprises,” not socialized services. Again, they are businesses “even when directly owned and operated by the government.”

The formation of local government utilities in general, and of telecommunications utilities in particular, is consistent with current economic views on institutional change. “Economic theory predicts that market competition among self-interested individuals results in economic efficiency. Recent theories of the economics of institutions show that the manner in which economic institutions are created, how they develop and how they change is analogous to the process of economic exchange under competition. There is, in effect, a market for institutions.”⁴⁹

Local government telecommunications utilities provide an example of an economic process, the outcome of which is increased efficiency. Local communities, like individual consumers, that are dissatisfied with a service provider pursue their self-interest by searching for better ways obtain the service. In many cases the result is the formation of a new economic institution in the community, for example, a telecommunications utility. As in the case of establishing public power systems, citizens make “economic decisions through existing democratic processes, they maximize the welfare of the community.” Local citizens behave “in accordance with the precepts of economic theory, rationally selecting between relevant economic alternatives in order to maximize their objectives—low rates and quality service—and by doing so, they [create] economic efficiency.”⁵⁰

VI Conclusion

PFF's central contentions are that the ownership and operation of telecommunications services by local government is not a legitimate endeavor, and that

there is a wealth of evidence that suggests such endeavors are less economically efficient than in the private sector. However, PPF does not provide a balanced presentation of the evidence, and the evidence it does present it accepts uncritically. PPF does not provide the necessary conceptual framework for a serious discussion of important economic issues or credible evidence to support its claims.

Local governments have been entering the telecommunications business because their local citizens have been dissatisfied with the price and quality of service of private providers, not because they just want to do something new. The increased entry is due to the lack of effective competition for many telecommunications services in various product and geographical markets. The fact that many local government telecommunications utilities are pricing services significantly lower than private sector companies is an indication that they are providing greater overall economic efficiency. In addition, the experience of local government utilities in the electric industry suggests that locally owned telecommunication utilities would enhance the economic efficiency of the industry.

Any cost advantages that local government telecommunications utilities enjoy are likely to be a relatively small proportion of the rate difference between them and private companies, as is the case in the electric power industry. Also, any advantages should be balanced against those enjoyed by private companies, the ultimate one being their successes in many states in prohibiting the entry of local governments into the telecommunications industry. Finally, even noted and respected economic conservatives concede that there "is a large role in economic activity for local governments," and the different choices made by different localities are "surely an area of legitimate freedom" and "there is no correct distribution of expenditures among functions."

One dictionary definition of "snake oil" describes it as "a liquid substance with no real medicinal value sold as a cure-all or nostrum...." This definition aptly describes the content of the PPF report. Its claims are not solid ones and can be easily refuted. Essentially, it views the elimination of government enterprises from the telecommunications industry as a cure-all, or nearly one, for the competitive problems that exist in the industry. This solution has no real value, and is counterproductive; it would exacerbate the problem of a lack of effective competition in the industry. The problem is a lack of effective competition, not public enterprises.

In the concluding chapters of his book, Stiglitz describes the primary requirement for markets to work:

The first is to emphasize the importance of competition—not pure price competition but simply old-fashioned competition, the rivalry among firms to supply the needs of consumers and producers at the lowest price with the highest qualities. As I argued in earlier chapters, the difference between competition and monopoly is the distinction of first-order importance, rather than the distinction between private and state ownership.⁵¹

The final conclusion here is that policy makers should, as a general matter, rely on the final words of advice that Stiglitz offers in his book -- not on PFF's cure-alls and nostrums:

The final word of advice is, “pose the problem correctly.” Do not see the question of “markets” versus “government,” but the appropriate balance between markets and government, with the possibility of many intermediate forms of economic organization (including those based on *local government*, cooperatives, etc.)[Emphasis added].

Imperfect and costly information, imperfect capital markets, imperfect competition: These are the realities of market economies—aspects that must be taken into account by those countries embarking on the choice of an economic system. The fact that competition is imperfect or capital markets are imperfect does not mean that the market system should not be adopted. *What it does mean is that in their choices, they should not be confused by theorems and ideologies based on an irrelevant model of the market economy.* Most important, it means that in deciding on what form of market economy they might adopt, including what role the government ought to play, they need to have in mind how actual market economies function, not the quite irrelevant paradigm of perfect competition.)[Emphasis added].⁵²

¹ Jeffrey A. Eisenach, *Does Government Belong in the Telecom Business?* Progress on Point, 8.1, January 2001, The Progress & Freedom Foundation, p. 12. There is a disclaimer in the report that says the views expressed in it are the author's own and "do not necessarily reflect the views of the Foundation...." Throughout this review of the report it will be referred to as the "PFF report." This is because it is reasonable to assume that the report does largely, if not entirely, reflect the views of the PFF. It is consistent with other reports critical of public enterprises that have been sponsored by the Foundation. Also, it is highly improbable that the author, who is also the President of the PFF, would publish a report under the auspices of PFF with which the Foundation does not largely, or entirely, concur.

² Eisenach, p. 2.

³ Eisenach, pp. 2, 17.

⁴ See Michael K. Block and Thomas M. Lenard, *Creating Competitive Markets in Electric Energy: A Comprehensive Proposal*, Progress and Freedom Foundation, March 1997. For analyses that refute the claims about public power made in this PFF report see, *Explaining Public Power's Low Rates: A Critical Review of the EEI-Sponsored Report: "Subsidies and Unfair Competitive Advantages Available to Publicly Owned and Cooperative Utilities*, a Report prepared by MSB Energy Associates for the American Public Power Association, April 1996; and other references relating to examples from the electric power industry contained in this evaluation of the PFF paper "*Does Government belong in the Telecommunications Business?*"

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- ⁵ Some examples are: AT&T Foundation, BellSouth, National Cable & Telecommunication Association, Qwest Communications International, Inc., Telecommunications Industry Association, United States Telecom Association, and Verizon Communications.
- ⁶ In a merger in 1999 TCI merged with AT&T as part of AT&T Broadband.
- ⁷ The author of this analysis is, after all, an employee of the American Public Power Association and is predisposed to look favorably on public enterprise activities. Consequently, the arguments, facts and sources used here should be carefully scrutinized. Likewise, the report PFF relies on that was partly funded by TCI, a direct competitor of municipal government cable systems, and the PFF report itself require the same scrutiny. Their authors are or were in the direct or indirect employ of private telecommunications companies in competition with local government utilities.
- ⁸ Eisenach, pp. 2, 5.
- ⁹ Eisenach, p. 5.
- ¹⁰ David Osborne and Ted Gaebler, *Reinventing Government*, Massachusetts 1992, p. 218.
- ¹¹ Eisenach, p.5.
- ¹² *The Wall Street Journal*, Friday, August 17, 2001, A1.
- ¹³ *The Wall Street Journal*, Friday, August 17, 2001, A1.
- ¹⁴ Montgomery Van Wart, Dianne Rahm and Scott Sanders, "Economic Development and Public Enterprise: The Case of Rural Iowa's Telecommunications Utilities," *Economic Development Quarterly*, May 2000, p. 134.
- ¹⁵ Van Wart, pp. 136-137.
- ¹⁶ Van Wart, p. 139.
- ¹⁷ Eisenach, pp. 8-9.; Ronald J. Rizzuto and Michael O. Wirth, *Costs, Benefits, and Long-Term Sustainability of Municipal Cable Television Overbuilds*, Denver: GSA Press, 1998, p.2
- ¹⁸ Eisenach, p. 17.
- ¹⁹ Eisenach, p. 3.
- ²⁰ Eisenach, p. 4.
- ²¹ *The New York Times*, Monday, August 6, 2001, C1.
- ²² *The Wall Street Journal*, Monday, August 27, 2001, A1.
- ²³ *The New York Times*, Monday, September 10, 2001, C7.
- ²⁴ Eisenach, p. 12.
- ²⁵ Joseph E. Stiglitz, *Whither Socialism?* (Cambridge, Mass.; MIT Press, 1994), p. 24.
- ²⁶ Stiglitz, p. 31.
- ²⁷ Stiglitz, p. 237.
- ²⁸ Stiglitz, p. 237.
- ²⁹ Eisenach, p. 12.; Rizzuto and Wirth, p.2
- ³⁰ James C. Bonbright, *Public Utilities And The National Power Policies*, New York: Columbia University Press, 1940., pp. 22-23.
- ³¹ Bonbright, p. 24.
- ³² Eisenach, pp. 12-13.; Rizzuto and Wirth, p.2.
- ³³ Rizzuto and Wirth, p. 3.
- ³⁴ Eisenach, p. 15.
- ³⁵ Maxwell A. Miller and Mark A. Glick, "The Resurgence of Federalism: The Case for Tax-Exempt Bonds," *Texas Review of Law & Politics*, Spring 1997, PP 25-59.; Lon L. Peters, "The Economic Analysis of Tax-Exempt Debt in the Electric Power Industry," *State Tax Notes*, March 13, 2000, pp. 841-846
- ³⁶ American Public Power Association, *The Public Power Rate Advantage*, June 2000, p 1.
- ³⁷ American Public Power Association, *1998 Payments and Contributions by Public Power Distribution Systems to State and Local Governments*, May 2000, p. 1.
- ³⁸ John E. Kwoka, *Power Structure: Ownership, Integration, and Competition in the U.S. Electric Utility Industry*. Boston: Kluwer, 1996.
- ³⁹ Kwoka, pp. 30 and 78.
- ⁴⁰ American Public Power Association, *1998 Payments and Contributions by Public Power Distribution Systems to State and Local Governments*, May 2000, 10 pages; and American Public Power Association, *The Public Power Rate Advantage*, June 2000, 10 pages.
- ⁴¹ *The Wall Street Journal*, Friday, August 17, 2001, A1.
- ⁴² *The Wall Street Journal*, Friday, August 17, 2001, B1.
- ⁴³ Emmette Redford, *American Government and the Economy*. New York: Macmillan, 1965, p. 613.

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- ⁴⁴ James Anderson, *Politics and the Economy*. Boston: Little Brown, 1966, p. 206.
- ⁴⁵ William J. Hausman and John L. Neufeld. *Public versus Private: A Summary of the Empirical Literature on the Comparative Performance of U.S. Electric Utilities*. prepared for the American Public Power Association, October 1990, p. 2.
- ⁴⁶ Hausman and Neufeld. p. 2.
- ⁴⁷ George J. Stigler, “The Tenable Range of Functions of Local Government”, in *Private Wants and Public Needs: Issues Surrounding the Size and Scope of Government Enterprise*, ed., Edmund S. Phelps. New York: Yale, 1962, p. 137.
- ⁴⁸ James C. Bonbright, *Principles of Public Utility Rates*, New York: Columbia University Press, 1961, p. 59.
- ⁴⁹ Lorel E. Wisniewski, *The Visible Hand: The Choice for Public Power*, prepared for the American Public Power Association, May 2001, p. ii.
- ⁵⁰ Wisniewski, p.2.
- ⁵¹ Stiglitz, p. 255.
- ⁵² Stiglitz, p. 267.