

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of)
Electric Power Board and) WCB Docket No. 14-115
City of Wilson Petitions to) WCB Docket No. 14-116

Preempt State Laws

COMMENTS OF THE AMERICAN CONSUMER INSTITUTE

The American Consumer Institute (ACI) hereby submits its comments in response to the Federal Communications Commission (“Commission”) regarding the above-captioned proceedings on municipal-owned broadband networks.

Introduction and Summary

ACI is a nonprofit (501c3) educational and research organization with the mission to identify, analyze and protect the interests of consumers in selected policy and rulemaking proceedings in information technology, healthcare, retail, insurance, energy and other matters. While ACI is a member of the Commission’s Consumer Advisory Committee (CAC), and participates on the CAC’s Broadband, Healthcare Working Groups and IP-Transition Working Groups, the following comments are solely ACI’s views and do not necessarily represent the views of the CAC or its members.

Besides the constitutional question of whether the Commission has the authority to preempt state laws and overrule state government sovereignty over their municipal governments, government-owned networks produce a number of problems that make them anticompetitive and anti-consumer. As the empirical evidence in our comments will show, public provision of private goods, such as broadband services, often leads to unprofitable operations that push the recovery of losses to taxpayers and to other public

services; and barriers to entry which displace and crowd out private investment. The end result is anticompetitive and it raises consumer costs. As the evidence provided in our comments will show, government-run networks are exactly what policymakers and regulators should want to avoid, if encouraging private broadband investment and improving consumer welfare are goals. For these reasons, we urge the Commission to reject the petition.

Preemption is Likely Unconstitutional

If the Commission attempts to preempt state law, it would likely violate the Constitution and the interplay between state and local governments, including aspects of intergovernmental accountability, budgeting, social services, transportation, emergency services and law enforcement.¹ Essentially, preemption would interfere with the basic construct of state governments and their authority over local governments. We are not aware of any federal law that permits preemption of state restrictions on broadband or Internet services, and we believe that the Commission would need Congressional consent on this issue before overturning state laws.²

Constitutional questions aside, as the Institute's comments will detail, the record is clear that municipal-owned networks discourage private competition and investment, and do not enhance consumer welfare. For this reason alone, municipal-owned broadband networks are not in the public's interest, and the Commission should reject the petitions by the Electric Power Board and City of Wilson.

Problems with Municipal Networks

Municipal-owned businesses have a number of problems that make them poor producers of private goods and services. To start off, they lack the incentives to maximize

¹ Seth L. Cooper, "FCC Preemption of State Bans on Municipal Broadband Networks is Most likely Unlawful," *The Free State Foundation*, Vol. 9, No. 10, February 26, 2014.

² Lawrence J. Spiwak, "FCC Has No Authority to Preempt State Municipal Broadband Laws," *Bloomberg Law*, August 6, 2014.

revenues and consumer utility, while minimizing costs. Unlike private firms, managers of government-run enterprises often seek to maximize their workforce and spend their budgets.³ They are prone to create subsidized pricing and shift costs to other services.⁴

Whereas market inefficiencies are normally challenged with competitive rivalry and disciplined by market entry, because governments seldom go out of business and because their enterprises can sustain losses by pushing these costs to taxpayers or garnering subsidies from other government services, municipal-owned network services provide a formidable barrier to competitive entry. As a result, municipal-owned broadband services can exhibit gross inefficiencies, poor quality of service and slow speeds, while putting the public on the hook to cover the cost of failures. On the other hand, private markets do not have these disadvantages, and the public is not obligated to pay for its failures.

In smaller (secondary) municipal markets, these problems become even more magnified and harmful for consumers, since these markets can sustain so few competitors. In these cases, municipal-run services become monopolies, thereby completely locking out private investment and competition. These municipal businesses can produce the same outcomes as monopolies – higher prices and lower output – exactly what policymakers and regulators should want to avoid and exactly what the spirit of the Telecommunications Act of 1996 attempted to remedy.

In fact, the mere threat of entry by municipal broadband service providers, such as the intentions revealed by the petitioners, is sufficient to deter private investment into

³ William Niskanen, "Bureaucrats and politicians," *Journal of Law and Economics* 18, December 1975, pp. 617-43. This piece started a flood of research in economic journals, which is well summarized in Bruce L. Benson, "Understanding Bureaucratic Behavior: Implications from the Public Choice Literature," *Journal of Public Finance and Public Choice*, Vol. 8, No. 2-3, December 1995.

⁴ As one author notes, "one can guess that the purpose [of municipal ownership] is to subsidize a small number of community residents and businesses who want the highest quality broadband services but aren't willing to pay the full price for them." See Joseph L. Bast, "Municipally Owned Broadband Networks: A Critical Evaluation," *The Heartland Institute*, No. 100, November 2002, p. 8.

these secondary markets. Allowing municipalities to provide broadband services, in defiance of state law, will make Internet Service Providers (ISPs) and investors think twice about entering these markets. In this way, the petitioners are doing a disservice to consumers living in these markets.

The next sections will provide the empirical evidence, which finds that public provision of private goods, such as broadband services, tend to: lose money; push costs to other public services and to taxpayers in the form of taxes and implicit subsidies; and eliminate competition by displacing and crowding out private investment.

The Economics of Public vs. Private Provision

Private investment in ubiquitous broadband networks produces sizable increases in employment, economic output and consumer welfare benefits. Over the years, however, some municipalities began to build telecommunications and broadband networks on their own, discouraging these private market forces. Before looking at how municipality-owned production of broadband services has fared, it is useful to review the well-documented economics of government production of private goods.

Professors Bennett and Johnson reviewed numerous studies that compared the performance of services that were governmentally and privately produced, including refuse collection, fire protection, debt collection, ship repair, electricity services, airline services, ambulatory care, and other services.⁵ Their analysis found that government production was far more costly than private production. They also found that government financial data often excluded comparable costs (such as net interest, pensions, taxes, and other opportunity costs) that, when included, made government production twice as costly as private production. Their conclusions confirmed earlier

⁵ James T. Bennett and Manuel H. Johnson, *Better Government at Half the Price: Private Production of Public Services*, Caroline House Publishers, Inc. Ottawa IL And Ossining, NY, 1981.

findings that government production of goods and services was roughly twice as expensive as private production.⁶

Works by these and other economists supported the subsequent deregulation and privatization that has swept much of the globe. There is ample evidence that industry deregulation, particularly in airlines, trucking, railroads, long distance telecommunications and brokerage services, led to falling consumer prices, increases in market efficiency, the development of intermodal competition, growing consumer demand, and large increases in consumer welfare benefits – collectively equaling over \$100 billion per year.⁷

As will be shown, like the previous examples of higher cost and inefficiency, government production and provision of communications services exhibits dismal performance that is anticompetitive and reduces consumer welfare.

Municipality-Owned Communications Services: Early Examples of Financial Losses

Interest in municipality-owned production gained some popularity when broadband deployment lagged in some markets. Because municipality-owned electric utilities have an existing market presence, construction capabilities, rights-of-way, and, in some cases, fiber-optic networks, it seemed natural to permit these utilities to build the city's network to provide broadband services, as well as telecommunications and cable TV services. The idea was that these companies would have lower costs as a result of economies of scale and scope, resulting from joint production of power, cable, telephone services, and Internet access services. At least that was the thinking.

⁶ "The Bureaucratic Rule of Two." See Thomas E. Borchering, "The Sources of Growth in Public Expenditures in the U.S. 1902-1970," *Budgets and Bureaucrats: The Sources of Government Growth*, ed. Thomas E. Borchering, Duke University Press, Durham, NC, 1977, p.2.

⁷ For estimates of the benefits of deregulation see Elizabeth E. Bailey, "Price and Productivity Change Following Deregulation: The U.S. Experience," *The Economic Journal*, March 1986, pp. 1-17; Clifford Winston, "Economic Deregulation: Days of Reckoning for Microeconomists," *Journal of Economic Literature*, Vol. 31, Sept. 1993, pp. 1263-1289; and Robert Crandall and Jerry Ellig, *Economic Deregulation and Customer Choice*, Center for Market Processes, George Mason University, Fairfax, VA, 1996.

As several municipality-owned electric utilities began offering broadband and other network services, there were several studies that investigated the financial performance of these early projects.⁸ One report summarized these studies and provided a financial assessment of each of these government ventures.⁹ The performance of these ventures is summarized in the figure below.

**Telecommunications and Broadband Services:
Municipality-Owned Ventures Cited in Progress & Freedom Reports**

Company/City	Services	Performance
Glasgow Electric Plant Board / Glasgow, KY	Cable, High-Speed Data and Telephone	Lost \$716 per household
Paragould City & Light Paragould, AR	Cable and Telecommunications	Lost \$641 per household
Negaunee, MI	Cable and High-Speed Services	Lost \$124 per household
Click! Network Tacoma Public Utilities Tacoma, WA	Telecommunications, CATV, High-Speed Data and Internet Services	Lost over \$700 per customer
OptiNet Bristol, VA	Fiber Network, Telephone, Data and Cable	Lost \$2,100 per customer
Hometown Utilicom Kutztown, PA	Fiber Optic and High-Speed Services	Lost \$624 per customer
Ashland Fiber Network Ashland, Oregon	High-Speed Internet and CATV	Lost \$480 per customer

Note: This information was collected from Thomas M. Lenard, "Government Entry into the Telecom Business: Are the Benefits Commensurate with the Costs?" *Progress and Freedom Foundation*, Progress on Point release 11.3, Feb. 2004. Comparisons of performance cover different time spans.

What the report showed was that all of the municipal electric utilities' telecommunications ventures proved unprofitable, averaging \$770 in losses per subscriber. It is very likely that these estimates are conservative, since these companies often receive preferential access to rights of way, as well reduced costs from the use of

⁸ Thomas M. Lenard, "Government Entry into the Telecom Business: Are the Benefits Commensurate With the Costs?" *Progress and Freedom Foundation*, Progress on Point release 11.3, Feb. 2004.

⁹ Thomas M. Lenard, "Government Entry into the Telecom Business: Are the Benefits Commensurate With the Costs?" *Progress and Freedom Foundation*, Progress on Point release 11.3, Feb. 2004.

public property and capital. In addition, as previously noted, some costs are not always included in the income statements of government enterprises, making them difficult to compare with private enterprises.

These examples show that a number of municipality-owned electric utilities were failures from the beginning. In some cases, these broadband ventures were subsequently sold and some ventures continued with the help of subsidies tacked onto consumers' electricity bills. The losses from these older examples show that municipal-owned production of broadband services is a bad idea.

Municipality-Owned Broadband Services: Recent Examples of Financial losses

The failures of government provision of broadband services, as like the early examples, continue to be commonplace. The following are just a few of the more recent documented examples of unprofitable ventures by municipalities:

- Quincy, Florida spent \$3.3 million on a municipal network, NetQuincy, and it never obtained a positive return on its investment. In 2005, its revenues were \$415,000 and costs were \$930,000 – again, a twice the cost. The network eventually went out of business.¹⁰
- In total, Groton City, Connecticut borrowed \$34.5 million for Thames Valley Communications. After losing money in every year it operated, the company was sold for \$550,000 in February 2013. Groton Utilities is assumed \$27.5 million debt of its subsidiary. Also, Moody's has reduced Groton City's bond rating twice.¹¹
- Provo, Utah, sold its government-owned network, iProvo, for one dollar after spending \$39 million to build it. It never made a profit and it cost the city an estimated \$1.7 million to hand over the company.¹²

¹⁰ Joseph P. Fuhr Jr. "Who Should Provide Broadband Access?" The Journal of the James Madison Institute, Winter-Spring 2014, pp. 45-46. At the permission of the author, the following examples include excerpts taken directly from his written research.

¹¹ Ibid.

¹² Ibid.

- Orlando experimented with a public Wi-Fi system in 2005. The network was designed to serve a mere 200 users, but the city couldn't even meet that very low target. Over the 17 months the network was operational, an average of 27 people used the service each day.¹³
- In 2005, Philadelphia's Wi-Fi system promised citywide Internet services, but that eventually not was not be the case, as subscriptions fell short of projections and now serves only the municipal government.¹⁴
- Failing in 2012, Wireless Hollywood in Florida never worked and blocked other wireless Internet devices from working.¹⁵
- FiberNet was an Internet service provider built by the city of Marietta, Georgia in 1996. In 2004, the city sold FiberNet for \$11.2 million, a fraction of the \$35 million spent to build and maintain it.

There are many more examples of municipal broadband failures. However, as the next section will show, the ability of cities to recover losses from taxpayers or to impose surcharges on other city services poses risks on consumers, and it should raise serious concerns with policymakers and regulators.

Broadband Services Push Costs to Taxpayers and other Municipal Services

Because many municipal broadband providers are not in good financial footing, cities sometimes fund the resulting revenue shortfalls by raising taxes or by increasing prices for other municipal services, like electricity, sewer and water. For the municipality, this advantage represents a barrier to entry that competitors, who do not pose these public risks, cannot tap into for funding. Moreover, these taxes and subsidies

¹³ Joseph P. Fuhr Jr., "Don't Look to Government for Broadband Access," *Tallahassee Democrat*, December 2012.

¹⁴ See Brad Grimes, "Two Municipal Wi-Fi Projects Go forward," GCN, October 4, 2005, <http://gcn.com/articles/2005/10/04/two-municipal-wifi-projects-go-forward.aspx> and Kevin McCaney, "Municipal Broadband's Jekyll and Hyde," at GCN, December 8, 2010, <http://gcn.com/articles/2010/12/08/municipal-broadband-success-and-failure.aspx>.

¹⁵ Tonya Alanez, "Hollywood's Failed Wi-Fi Rankles Residents," *Sun Sentinel*, July 2, 2012.

demonstrate that broadband prices are actually higher than advertised to the public, because they can be used to prop up failing municipal broadband services.

Going back to an earlier example demonstrates this risk. The Ashland Fiber Network (AFN) in Ashland, Oregon was launched in the late 1990s and accumulated debt of \$15.5 million because of higher than expected construction and operation costs.¹⁶ Originally, AFN borrowed its startup funds from the Ashland Electric Utility. After several years of city departments covering AFN shortfalls, in August 2004 the city took out \$15.5 million in bonds with an annual debt payment of \$1.43 million. From 2005 to 2007 AFN did not contribute anything to its debt payment. In January 2005, Ashland City Council voted to give a \$1 million subsidy to AFN -- \$540,000 from the wastewater fund and \$460,000 from the electric fund. In October 2005, the city of Ashland adopted a surcharge of \$7.50 on all electric bills to subsidize AFN, which was rescinded after protests from citizens. In December 2005, \$500,000 was given from the electric department to help AFN pay off its debt. Property taxes now cover part of AFN's debt. If the private sector did this, it would be considered fraud or crony capitalism, but for municipal broadband service providers, it's business as usual.

And, there are other examples of the same. In 2002, the 11 cities joined the Utah Telecommunications Open Infrastructure Agency (UTOPIA) by undertaking a \$135 million bond.¹⁷ In August 2012, an audit report to the Utah Legislature revealed UTOPIA as never having a profitable year.¹⁸ UTOPIA lost \$18.8 million in a recent fiscal year; had a negative net value of \$120 million; and owed interest totaling \$500 million until 2040.

¹⁶ Joseph P. Fuhr Jr., "Hidden Problems with Government-Owned Networks," Coalition for the New Economy, January 6, 2012, <http://www.coalitionfortheneweconomy.org/wp-content/uploads/2012/01/1-6-12-Coalition-for-a-New-Economy-White-Paper.pdf>.

¹⁷ M.J. Balhoff and R.C. Rowe, "Municipal Broadband: Digging Beneath the Surface," Balhoff & Rowe, LLC, September 2005.

¹⁸ "Report to the Utah Legislature: A Performance Audit of the Utah Telecommunication Open Infrastructure," Agency, August 2012.

That is not all, in fiscal year 2013, residents of the 11 UTOPIA cities were scheduled to pay nearly \$13 million for debt services.

For Burlington Telecom, the primary issue is the system's debt load. A state audit by a Blue Ribbon Committee found the government-owned network had violated its state license for the five years it had been operational, and that it had no feasible way to repay its debts.¹⁹ The system's debt totaled \$51 million. Another issue with Burlington is that \$17 million of its \$51 million debt was illegally borrowed from taxpayers. Burlington's massive burden and poor financial performance resulting in the city's bond rating being lowered three times in just two years and was only one step above junk bond status. In its response to Moody's, the ratings service, Burlington acknowledged:

*"The most troubling finding of the FY11 audit was that the City has very limited liquidity. The Burlington Telecom situation is by far the largest driver of this situation..."*²⁰

In 2007, the cities of Mooresville and Davidson took over the former Adelpia Communications cable company, preempting a private offer from Time Warner Communications. Local officials believed that it was nearly a risk-free investment and Davidson's Town Manager Leamon Brice declared "The potential growth of customers, and therefore profits is astronomical." However, by 2010, the municipal broadband system (MI-Connection) had still not turned a profit. Revenues increased by just 3 percent in the fiscal year ending June 30, 2010, when they were projected to increase by 20 percent; and losses were \$ 5.7 million down from \$6.8 million the previous year.²¹ Also, for a second year in a row, MI-Connection had received a warning letter from state officials concerning its financial conditions and outlook.²² The two towns must either

¹⁹ D. Gram, "Vt. Telecommunications Firm not Viable, Audit Concludes," Associated Press, Dec. 11, 2010.

²⁰ City of Burlington's Responds to Moody's Investors Service Downgrade, Press Release, June 12, 2012.

²¹ Boraks D, "MI-Connection Revenues Weak on TV Customer Losses" Davidson News.net: July 29, 2011.

²² Boraks D. "State Officials Repeat Concerns about MI-Connection Finances" Davidson News, Feb.24, 2011.

repay the systems debt with general funds or default. Davidson's Town Manager stated the consequences of default:

"That would have severe repercussions. First, the two towns wouldn't be able to borrow again, and second a default would affect bond ratings and interest rates for not only our towns, but for towns across North Carolina and the nation."²³

The past history of one of this docket's petitioner, the Electric Power Board (EPB), is worth noting. Specifically, EPB of Chattanooga's 2010 Annual Report sheds some light on the financial record of EPB Fiber Optics. In 2010, its net assets at the end of the fiscal year were \$16.8 million in the red, a negative increase of over \$3.8 million from 2009. It more recently had \$57 million in notes payable to the electric system and current assets of only \$52.9 million. In Tennessee in 2010, there were nine municipal telecommunications providers operating, all of which were affiliated with a municipal electric company. According to Professor Rizzuto "Municipal electric utilities in Tennessee have incurred deficits of approximately \$176 million for these communications ventures."²⁴

For Wilson, another petitioner in this docket, there apparently is a lot of money to be lost in providing broadband services to consumers, and they just want their fair share of it. The fact is that Wilson's marketplace performance raises questions that should concern policymakers and regulators. As the *Carolina Journal* noted, when Wilson it began losing money on its broadband services, it began shifting those costs to its electricity customers:

"According to its financial statements, Wilson has taken more than \$11 million from its electric and gas funds to subsidize its competitive foray

²³ Taylor J. A. "Davidson, Mooresville Taxpayers Face Bailout of Municipal Broadband Service, *Carolina Journal News*, May 14, 2010.

²⁴ Rizzuto, R.J. *Financial Performance of Tennessee's Municipal Cable and Internet Overbuilds*, March 21, 2011.

*into the cable business. No wonder Wilson's electric rates are 50 percent higher than that of Progress Energy and its natural gas rates are 30 percent more than PSNC Energy rates."*²⁵

In summary, there are numerous examples of inefficient operations by municipal broadband providers who then push their losses onto the consumers of other municipal services and/or to taxpayers. This fiscal malpractice harms consumers and it should be an issue that state governments should have full discretion to address. Among the 22 states that have placed limitations on government-owned broadband services, some, like in North Carolina, do not prevent new municipal broadband service providers from entering the market. Instead, some of these laws merely require local voters to approve that entry.

In the spirit of democracy and fiscal accountability, voters should be concerned about fiscal decisions that raise the costs of their municipal services and they should have the right to protect themselves against mismanagement of public funds. That should be a decision for voters and consumers to make, not the Commission.

V. Conclusion

Municipal broadband networks crowd out private investment. As our review of municipal ventures shows, once a municipal-owned network provider enters a market, they can lose money and still survive by pushing financial losses to other municipal services and to taxpayers. In addition, the desire by the petitioners to expand into adjacent markets should give private broadband providers pause about entering these markets. For these reasons, municipal-own networks are anticompetitive.

²⁵ Ed McMahan, "Our Experiment With Municipal Broadband Has Failed," Carolina Journal, March 24, 2011, http://www.carolinajournal.com/opinions/display_story.html?id=7562.

Municipal broadband providers lose money and shift costs. This means that the effective price paid by consumers is much higher than advertised. Because broadband services are relatively price elastic, increases in cost can result in decreases in demand. The combination of higher prices and lower demand means that municipal-run broadband networks produce lower consumer welfare than their private counterparts. For these reasons, municipal-own networks are anti-consumer.

Creating government run enterprises is exactly what regulators and policymakers should want to avoid, if improving consumers welfare is the goal. Instead, public policies need to encourage private investments, if broadband is to be fully deployed and consumers are to fully benefit.

In closing, based on the poor performance of municipal broadband service providers and the risks posed to consumers and competitors, the Commission should reject the petition by the Electric Power Board and the City of Wilson.