



May 18, 2005

CPWS is singing broadband blues

Refinancing of bond issue may be sought

By WILLIAM BOWERS
Staff Writer

Columbia Power and Water Systems authorities asked the City Council Tuesday to back the refinancing of the utility's \$15 million bond for its broadband division.

CPWS General Manager Jim Clark said the system needed to free up some funds to allow the business to continue to grow and to help keep cable and Internet rates down.

Clark presented a plan which would allow the system to repay its debt — used to build the infrastructure — over a 20-year period instead of the original 15 years.

"After careful analysis and review of our first two years of operation, it is appar-

ent our planned debt service repayment of \$1.4 million per year is too ambitious considering market conditions, the local economy and unexpected broadcaster fee increases," he said.

The broadband system has already borrowed money from the electric system to fund daily expenses and is considering requesting the Tennessee Valley Authority allow for further loans, CPWS Controller Cindy Layne said.

City Manager Mike Miller said the refinance would cost the system more money in interest and other fees.

Councilman Wayne Kennedy asked what the outcome would be of the system failing.

"Worse case scenario, who takes the hit?" Kennedy said.

"Taxpayers," Miller replied.

The city has backed the bonds promising to use tax dollars to pay for the business if it fails.

The refinance means the city would be liable for an additional \$3.75 million including the money borrowed from the electric system, City Finance

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Director Patti Baltzer said.

The refinance could cut payments from \$1.4 million to \$1.15 million annually, freeing up much-needed cash, Clark said.

"We're not selling enough to cover all our debts," Clark said. "We are not able to pay what we originally planned."

Miller said the worst-case scenario would mean the city would be liable for more than \$20 million.

"We would be in the hole for about \$22 million," Miller said.

In November 2000, Charter Communications representatives presented an analysis of CPWS's business plan by University of Denver Professor Ronald Rizzuto.

In his analysis, Rizzuto said the plan's internal rate of return was too optimistic. He also criticized the plan's estimated program cost increase. The plan, spearheaded by Georgia-based United Telesystems, Inc., called for an annual increase in wholesale programming costs of 3 percent.

"In the past several years, programming costs have

increased at high single digit/low double digit rates. Many industry observers estimate that programming cost increases will be in excess of 7 percent," Rizzuto wrote.

CPWS also told the public funds from other systems would not be used to support the broadband division.

In an information packet passed out at a meeting in 2000, CPWS said it was prohibited from "co-mingling funds."

"Electric rates and electric revenue use is governed by TVA regulations and power distributor contracts. TVA would not approve any electric rate (increase) or subsidizing of a telecommunications system," the packet stated.

Critics at the time argued

the plan was too ambitious and should be paid for without the backing of the city, but CPWS argued the lower rate the city's obligation could secure would allow the business to offer lower rates.

Clark said despite the comments in the study session Tuesday, the division was doing well.

"It is not all doom and gloom," Clark said. "We're just making an adjustment."

Clark said, based on projections, the refinance would allow the system to repay its debt to the electric division by 2010 and break even by 2011.

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The Hidden Problems with Government-Owned Networks

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I. INTRODUCTION

In his 2011 State of the Union Address, President Obama set a public policy goal aimed at providing broadband to 98 percent of Americans within five years, and provided significant funds to build out broadband to more American communities.

This is a laudable goal. Access to high-speed Internet provides consumers with tools important for healthcare, education and job seeking, among a whole host of other beneficial applications.

Economics and consumer welfare are important considerations in deciding how to best deliver broadband to all areas of the country. Many private providers have extended high-speed Internet service to areas across the country. However, the costs of deployment, maintenance and updating technologies means that some communities remain without broadband access as it is not fiscally feasible for providers to expand into those areas. In addition to the services provided by private enterprise, some local governments across the country have developed their own broadband networks (henceforth referred to as government-owned networks or GONs), both in areas currently served and unserved.

Unfortunately, efforts by municipalities to build broadband networks are not necessarily the best solution and have failed for several reasons:

- Government-owned networks use taxpayer funds and federal grants to build networks in areas where private providers already make high-speed Internet service available. This network overbuild is counterintuitive in that it requires taxpayers to fund and subsidize a network that duplicates an existing network.
- Many GONs fail because they lack a sustainable business plan and the long-term resources to invest in maintenance and necessary upgrades as technology evolves. When this has happened, taxpayers have had to fund the failures. Several case studies within this paper discuss this phenomenon in detail.

- Government-owned networks compete unfairly with existing providers. As a government entity, a GON can practice various anticompetitive activities which put private firms at a competitive disadvantage. Thus, municipalities that use taxpayer funds to build a broadband network actually act to forestall market entry and decrease competition. With GONs, consumers lose the benefits of competition and choice. They also lose tax revenue from a private network that might have otherwise entered that market, and taxpayers pay more in taxes as they subsidize the operation and maintenance of a GON.
- Instead of turning to GONs, communities could benefit by examining how to develop a fast and reliable broadband network while protecting taxpayers and maintaining the prices necessary to ensure the achievement of the President's goal of near-universal broadband service.

II. BACKGROUND

The United States is a market-based economy, which means the market is allowed to address economic wants and needs in the most efficient and cost-effective manner possible. The market has worked exceptionally well in meeting consumer demands and has allowed private enterprises to supply the market with an abundance of choices.

Faulhaber argues, "The private sector is absolutely best at competing with better prices, better service, higher quality, new innovations and exploring customers' preferences — far better than the government will ever be."¹

Most economists acknowledge, though, that the market does not always work perfectly - there are market failures, conditions under which goods are not produced, overproduced or underproduced.

The broadband marketplace, however, is not an instance of these market failures.

There is a significant public interest in working to ensure that all Americans benefit from broadband

technology and what it brings. There is also a significant cost associated with deploying, maintaining and upgrading broadband networks. Companies like AT&T, Verizon, Sprint, Comcast, Time Warner and Charter spend billions of dollars annually to enhance their broadband networks. Tapia and Ortiz note, "The market may do a good job of providing reliable infrastructure with reasonable quality of service, but it has no incentive to provide universal, ubiquitous coverage if it cannot generate sufficient profit doing so."² Occasionally, private firms cannot make a business case for building networks in areas of low population density or difficult terrain. In those areas, GONs may make sense – but consumers and taxpayers must understand the risks and secure protections to ensure the ongoing benefits.

III. GOVERNMENT FAILURE

Government provision of certain services is less efficient, more expensive for taxpayers, and less cost effective than private entities' delivery of those services.³ Broadband is a compelling example of a service that governments are ill-suited to provide.

According to Kahn, "The central continuing responsibility of legislatures and regulatory commissions [is] finding the best possible mix of inevitably imperfect regulation and inevitably imperfect competition."⁴ Thus, there is the possibility of government failure, especially in an emerging and highly competitive industry where regulators have difficulty keeping up with constantly changing technology.

It is important to consider whether a government possesses the expertise to develop and operate a broadband network. This is an especially important question in the broadband market where technology is constantly changing and firms need to be flexible and have the ability to constantly update their business plans. Communities that want to invest public funds must have well defined plans, goals and milestones.⁵

This advice is often overlooked when community leaders attempt to set up GONs. Salt Lake

City Mayor Rocky Anderson noted the pitfalls and hazards presented when the city considered joining UTOPIA, a GON. He stated, "During the UTOPIA debate, we thoroughly reviewed and analyzed the possibility of joining UTOPIA and concluded this endeavor posed unacceptable risks to taxpayers, particularly in light of emerging technologies."⁶

Adding to scholarly research on the issue, the Federal Trade Commission (FTC) has also recognized that the government "is slow to react to changing market conditions due to bureaucratic operating constraints."⁷

Unfortunately, as we will see, inability to efficiently operate these networks in the market has led to many problems.

IV. PROBLEMS WITH GONS

The history of GONs has been one of various problems: failure to achieve universal service in areas that they serve; the lack of a viable cost benefit analysis that has led to costs outweighing benefits; the inefficient use of scarce resources; the inability of GONs to cover their costs which has led to government failure; the unfair competitive advantages given a government entity which has resulted in anticompetitive behavior; the opportunity cost of using limited tax funds on GONs and not on more essential services; and the stifling of private firm innovation. We examine these various issues below.

A. Failure to Achieve Universal Service

The existence of a GON does not assure universal service because there is no guarantee that the network will be built out to reach all residents in a given geographic area. The cost to build the infrastructure to certain areas may be prohibitive because of terrain or density of population. This can be seen in the case of the Ashland Fiber Network (AFN) in Ashland, Oregon.

Case Study: Ashland Fiber Network

AFN was launched in the late 1990s and ultimately accumulated debt of \$15.5 million due to higher than expected construction and operation costs. Originally, AFN borrowed its startup funds from the Ashland Electric Utility. After several years of city departments

²Tapia, A. H. and Ortiz J.A., "Network Hopes: Municipalities Deploying Wireless Internet to Increase Civic Engagement" Social Science Computer Review, 28 (Feb.2010) 93-117.

³Hilke, J. Cost-Savings from Privatization: A Compilation of Study Findings, Reason Foundation, March 1993.

⁴Kahn, A, The Economics of Regulation: Principles and Institutions, Volume II (1988).

⁵Bell R., Jung J.and Zacharilla L. Broadband Economies, Creating the Community of the 21st Century, 2009

⁶Balhoff M.J. and Rowe R.C., Municipal Broadband: Digging Beneath the Surface, Balhoff & Rowe, LLC, September 2005.

⁷Muris, T.J, Testimony, Director, Bureau of Consumer Protection, Federal Trade Commission, Hearings on the Provision of Telecommunications and Information services by the Federal Government in Competition with the Private Sector; Hearings Before the House Government Information and Individual Rights Subcommittee of the Committee on Government Operations, 97th Congress, 1982.

covering AFN shortfalls, in August 2004 the city took out \$15.5 million in bonds with an annual debt payment of \$1.43 million. Between 2005 and 2007, AFN did not contribute anything to its debt payment and between 2008 and 2010 it contributed \$356,000. AFN hopes to pay \$700,000 in 2011 and plans to contribute \$409,000 in 2012.⁸

In January 2005, Ashland City Council voted to give a \$1 million subsidy to AFN, of which \$540,000 came 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 – a surcharge that was later rescinded after protests from citizens. In December 2005, \$500,000 was given from the electric department to help AFN pay its debt. Property taxes now help cover part of AFN's debt.⁹

Originally, about 1,300 households did not receive AFN services because it was too costly to build the infrastructure to service certain areas. In this case the GON was not willing to provide universal service to the entire geographic area because of the costs of servicing certain areas.¹⁰ Thus, residents who were not offered system access or who chose not to use it were still required to subsidize the network through higher property taxes. In declining to provide service to hard-to-reach areas, AFN engaged in the same business practices as private firms, namely, avoiding high-cost areas. However, unlike a private firm, when the GON declines to serve all households in its area, property owners who do not have access must still pay for the system in the form of higher taxes.

AFN's IT Director Rob Lloyd stated, "As people download movies and do other activities online that gobble up bandwidth, controlling costs is critical." He also stated that, "People who use excessive bandwidth -- up to 20 percent of customers -- will likely see higher charges of up to \$25 per month."¹¹ Such a pricing policy has been condemned when practiced by private firms.

B. Lack of Proper Cost-Benefit Analysis

Government owned network proponents have not provided quantifiable cost-benefit analysis. In his paper on municipal public networks, McClure states, "There is no proven business model for such networks, and cities are unable to show any realistic research data indicating how many people will use the service, whether they will pay for the service or how the city will pay for the network if the plan doesn't pan out."¹² Similarly, Ahn and Lee argue, "While municipal investments on wireline networks provide social benefits to the municipal residents, they also incur significant social costs with respect to recurrent investments and a possible hampering of market competition. Therefore, measuring the actual benefits and costs of municipal wireline networks is paramount in determining whether these investments are socially desirable."¹³

The financial models built by governments looking to deploy GONs fall short in four major areas:

- (1) The initial investment is generally higher than planned;
- (2) Penetration rates are systematically overestimated;
- (3) Revenues earned are lower than expected due to responses from competitors; and
- (4) Operating costs are almost always underestimated.¹⁴

Often, the governments looking to deploy GONs do not take into account the competitive response of incumbents. Unfortunately, this results in overinflated revenue estimates – since in reality both prices and subscribership are usually lower than projected. Bell, Jung and Zacharilla note, "When governments decide to spend public money on any kind of telecommunications investment, they should expect a competitive response from the private sector. This can come as a shock. Governments are not accustomed to competition."¹⁵ While even

⁸Ashland Fiber Network, Annual Report, How Ashland Connects, June 21, 2011.

⁹Aldous V. "Ashland, Ore., Transfer Funds to ISP" Jan. 18, 2006.

¹⁰Aldous, V. "Ashland Fiber Network's Chief Says He will Make Hard Choices", Mail Tribune, Aug. 6, 2010.

¹¹Ibid.

¹²McClure D.P. "Not In The Public Interest - The Myth of Municipal Wi-Fi Networks: The Myth of Municipal Wireless Networks", New Millennium Research Council, 2005.

¹³Ahn, H. and Lee T.H. "An Analysis on the Social Costs of Municipal Wireline Broadband Network Investments", International Telecommunications Policy Review, 17, 4(2010).

¹⁴Balhoff M.J. and Rowe R.C., Municipal Broadband: Digging Beneath the Surface, Balhoff & Rowe, LLC, September 2005.

¹⁵Bell R., Jung J. and Zacharilla L. Broadband Economies, Creating the Community of the 21st Century. 2009



private firms may not expect to make a profit in the first few years, the history of the financial feasibility of GONs has been, for the most part, disastrous.

Very few GON balance sheet estimates have come close to reality, with losses being much greater than anticipated. The use of taxpayer monies for GONs has been questioned, as they generally run over budget for construction, are not financially sustainable and require subsidies to survive.¹⁶ Bell et al. add, "Communities considering any role in building telecom systems must find an economic model that makes basic business sense and is highly conservative in its estimates of revenue and expenses. Revenue will take longer than expected to grow, due to countless obstacles that will be discovered after the network is activated. Expenses will be higher than expected because they always are."¹⁷

Similarly, studies have shown that almost all GONs are losing money. An examination of various GONs determined that virtually all of them have a negative net present value. This is true in rural areas where there is no competition as well as areas where competition exists. A major reason for this is that municipalities likely do not have the scale to deal with technology changes, cover costs and offer the variety of services needed in the constantly changing telecom environment.¹⁸ Gifford and Walker concur, "The financial record of municipal network operators in competitive markets is overwhelmingly poor, caused primarily by unrealistic business plans, including the inability of municipal operators to achieve the necessary scale to compete with larger network operators."¹⁹ Moreover, Kerton argues that there have not been any real success stories and believes that the rhetoric is not consistent with the technology.²⁰

For example, in 2010, there were nine municipal telecommunications providers operating in Tennessee, all of which were affiliated

with a different municipal electric companies. Together these nine providers have incurred deficits of around \$176 million.²¹ Also, only two of the nine networks had enough revenues in 2010 to cover the cost of operations.²²

Case Study: Chattanooga EPB's Fiber Optic System

Chattanooga EPB's Fiber Optic System has received a tremendous amount of publicity because it is the first city in the U.S. to offer speeds of up to one gigabit per second, broadband service 200 times faster than the average broadband speed in the U.S. and 10 times faster than the 2020 standard set by the Obama Administration.²³ However, what is often ignored in press accounts is the price of the service, \$350 per month, and the dire financial situation of the fiber optic system.

Lohr explains, "Verizon for example, has invested billions of dollars to upgrade much of its network for fiber optic Internet service, at speeds of 15, 25 and 50 megabits per second. Those speeds are three to 10 times faster than standard broadband service; the monthly charges are \$50 for 15 megabits, \$65 for 25 and \$140 for 50. And the vast major of customers, analysts say, choose the 15-megabit, \$50 service." When Harold DePriest, the president and CEO of EPB, was asked why EPB offers this, he responded, "The simple answer is because we can."²⁴ The price per month for the service makes it unlikely that many would subscribe. So, it is not an issue of demand.²⁵ DePriest also admits, "We don't know how to price a gig. We're experimenting. We'll learn."²⁶ It is clear that there is no real business plan concerning EPB's investment.

An examination of the 2010 EPB annual report sheds some light on the financial record of EPB Fiber Optics. Net assets at the end of the 2010 fiscal year were a negative \$16.8 million - a decrease of more than \$3.8 million from 2009. It currently has \$57 million in notes payable to the EPB's electric system and current assets of only \$52.9 million.²⁷

¹⁶Valvo, J. "Municipal Broadband's Record of Failure, A Profile in Market Intrusion" Americans for Prosperity, March 2009.

¹⁷Bell R., Jung J. and Zacharilla L. Broadband Economies, Creating the Community of the 21st Century. 2009

¹⁸Ibid.

¹⁹Gifford R.L. and Walker M.A. Glenwood Springs Residents Should say No to Municipal Broadband, Convergence Law Institute, April 2009.

²⁰McClure D.P. "Not In the Public Interest - The Myth of Municipal Wi-Fi Networks: The Myth of Municipal Wireless Networks", New Millennium Research Council, 2005.

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

²²Ibid.

²³Lohr S., "Fastest Net Service in U.S. Coming to Chattanooga" The New York Times, Sept. 12, 2010.

²⁴Ibid.

²⁵Ibid.

²⁶Barthold J., "Chattanooga Choo Choo? City-owned utility Set to Offer 1 Gig Broadband" FierceCable, Sept.10, 2010.

²⁷EPB, 2010 Senior Management & Financial Information, 2010.



C. Inefficiency and Waste

Government-owned networks create inefficiency and cause waste.²⁸ Building GONs in areas that already have broadband service creates an unnecessary duplication of networks, which in turn wastes resources. Cox states that “Governments, unlike companies, are not able to fail, and thus there is no competitive ‘check’ on mismanagement or waste.”²⁹

For example, GONs serving five cities in North Carolina – Wilson, Salisbury, Morganton, Davidson and Mooresville – had a combined 43,000 household subscribers and debt of \$148 million.³⁰ This is a debt of more than \$3,000 per subscriber. Below we examine the situation as it unfolded in Mooresville and Davidson.

Case Study: MI-Connection

In 2007, the cities of Mooresville and Davidson took over the former Adelpia Communications cable company, preempting a private offer from Time Warner Communications. The GON that resulted, MI-Connection, was shared by both towns, which agreed that their financial interest would be based on the system’s subscribership percentage. As of July 28, 2011, Davidson had 35.21 percent subscribership, and Mooresville 64.79 percent, with Davidson’s share increasing by two percentage points since June 30, 2010.

Local officials believed that MI-Connection was nearly a risk-free investment. Leamon Brice, Davidson’s town manager, declared in 2007, “The potential growth of customers, and therefore profits, is astronomical.”³¹ However, four years later the system has yet to turn a profit. Gross revenues increased by just three percent in the fiscal year ending June 30, 2010 - when they were projected to increase by 20 percent. Losses for the same period were \$5.7 million. As a result, for a second year in a row MI-Connection has received a warning letter from state officials concerning its financial conditions and outlook.³³

MI-Connection’s debt is \$89.9 million. Davidson’s 2011-2012 debt payment is \$1.94 million, about 21 percent of the town’s budget. Some local critics of the system have suggested that residents should not subscribe so the city will have a lower percentage of the ownership and thus less debt. In 2011, Davidson has 44 percent of the penetration rate whereas Mooresville only 34 percent. The chairman of MI-Connection, John Venzon, took note of the program’s unintended consequences, remarking that the more successful the program, the bigger portion of the debt a participating town carries.³⁴

In Davidson, some political candidates are calling for an exit strategy.³⁵ The towns are left with a Hobson’s Choice: They must either repay the system’s debt with general funds or default. Brice addressed the consequences of default, stating, “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.”³⁶

Davidson Mayor pro tem Laurie Venzon believes that other towns should not make the same mistake.³⁷ She has called on civic pride to help resolve the issue – asking residents to subscribe to MI-Connection – and has argued, “All we’re saying is support your local businesses. We’re not asking you to sign up for crappy service. We’re not asking you to sign up for something that’s astronomically priced. I’m asking you to support it so that the revenue will be there, so we don’t have to increase taxes or make any more cuts.”³⁸

D. Unfair Competition from GONs

Government-owned networks use their competitive advantage from the tilted playing field as well as the ability to artificially inflate competitors’ costs to foreclose entry into the market. As technology changes, a private firm may be able to make a business case for entry

²⁸Hilke, J. Cost-Savings from Privatization: A Compilation of Study Findings, Reason Foundation, March 1993.

²⁹Cox B. “The Viability of Municipal Wi-Fi Networks” in “Not in the Public Interest – The Myth of Municipal Wi-Fi Networks”, New Millennium Research Council, 2005.

³⁰Robertson, G.D. “Legislature Reach a Deal on rules Governing North Carolina Municipal Broadband” The Herald-Sun, 2011.

³¹Taylor J. A. “Davidson, Mooresville Taxpayers Face Bailout of Municipal Broadband Service,” Carolina Journal News, May 14, 2010.

³²Boraks D, “MI-Connection Revenues Weak on TV Customer Losses” Davidson News.net: July 29, 2011a.

³³Boraks D. “State Officials Repeat Concerns about MI-Connection Finances” Davidson News, Feb.24, 2011b.

³⁴Boraks D, “MI-Connection Revenues Weak on TV Customer Losses” Davidson News.net: July 29, 2011a.

³⁵DeLoache F, “MI-Connection Leaders Focus on Debt Burden” Mooresville Weekly, August 5, 2011.

³⁶Taylor J. A. “Davidson, Mooresville Taxpayers Face Bailout of Municipal Broadband Service,” Carolina Journal News, May 14, 2010.

³⁷Batten A., “Davidson Approves Changes to MI-Connection Board” The Herald Weekly, February 10, 2011

³⁸Taylor J. A. “Davidson, Mooresville Taxpayers Face Bailout of Municipal Broadband Service,” Carolina Journal News, May 14, 2010.



into high-cost areas. However, where GONs operate, such entry is unlikely to occur because of artificial barriers that deter private entry.

Similarly, Lott states that "To the extent that public enterprises value maximizing output rather than profits ... the social costs of public ownership may be substantially greater than previously believed. Predatory commitments by public enterprises are more credible since, unlike private firms, they have been shown to be made better off by the very act of predation and not just by the long-run returns from eliminated competition."³⁹ Others agree that the objective of public enterprises is to maximize output, and that the absence of stockholders makes it easier to achieve this objective.⁴⁰ Thus, public enterprises are able to keep more efficient firms out of the market while producing more than is economically efficient.

Given potential entry into the market or the existence of competition by private enterprise, GONs have essentially three options:

- (1) Compete;
- (2) Eliminate competitors through anticompetitive actions; or
- (3) Sell the network at a loss.

We will examine the second option. Other things being equal, private firms would need a considerable cost advantage over GONs for private entry to occur in such scenarios. Since GONs are losing money, they are pricing below cost, which results in predatory pricing. Such pricing is anticompetitive and makes it more difficult for private firms to compete. Given the losses that GONs incur, subsidies are needed for survival. A private firm under these conditions would leave the market.

An example of a public enterprise using its power to predatory price and thus unfairly compete with private enterprises is that of Deutsche Post in Germany, which the European Commission found "used profits from its state-granted monopoly in letter mail services to subsidize efforts to dominate the parcel delivery business in

Germany by pricing below cost and undercutting competitors."⁴² The company was ordered to repay 572 million Euros to the German government and divest its parcel delivery business.⁴³

Government can compete unfairly with private firms because it does not face the same burden of taxes, cost of capital, rights of way and liability insurance. Private firms are subject to income, sales and real estate taxes, as well as franchise and right-of-way fees. Government controls local taxes and right-of-way fees, so they are generally waived for GONs. Government-owned networks may also receive a lower cost of capital because their risks are lower as a result of their investment being backed by the government. Freedom from taxes is a special advantage to GONs since telecommunications services is one of the most highly taxed, if not the most highly taxed, industry.⁴⁴

Since local governments have direct control over some of the costs of private broadband companies, including franchise and right-of-way fees, they can block a private firm from market entry, or put the firm at a competitive disadvantage. It has been shown that public firms can deter entry by being in a unique position to raise rivals' costs through the establishment of industry rules that negatively impact competitors.⁴⁵

For example, in the *City of Hawarden v. US West Communications*, the city was sued concerning a discriminatory "user fee" of three percent that was imposed on non-municipal entities. The ordinance was put into place after Hawarden created a municipal communications utility - the Iowa Supreme Court found such a practice unconstitutional.⁴⁶

E. Opportunity Costs of GONs

The question now is: Who pays for the shortfall when theoretically sound GONs fail in the real world? Realistically, the only alternatives for making up a shortfall resulting from a GON gone bad are higher taxes, cross subsidization or a decrease in service quality. In some cases, property tax increases are used to provide broadband subsidies.

³⁹Lott, J. "Predation by Public Enterprises" *Journal of Public Economics* 43 (May 1990) 237-51.

⁴⁰Blais A. and Dion, S. "Conclusion: Are Bureaucrats Budget Maximizers?" in A. Blais and S. Dion, eds., *The Budget-Maximizing Bureaucrat: Appraisals and Evidence*, 1991.

⁴¹Rees R. "Positive Theory of the Public Enterprise: Concepts and Measurement" in Marchand M., Pestieau P. and Tulkens, eds. *The Performance of Public Enterprises: Concepts and Measurements*, 1984.

⁴²Sappington D.E.M. and Sidak, J.G. "Competition Law for State-Owned Enterprises, *Antitrust Law Journal* 71(2003a) 479-523.

⁴³Ibid.

⁴⁴Darby L.F. and Fuhr J.P. "Investing in Economic Growth Broadband Network Tax Forebearance" *Media Law and Policy* 18(2008) 1-42.

⁴⁵Sappington D.E.M. and Sidak, J.G. "Incentives for Anticompetitive Behavior by Public Enterprises" *Review of Industrial Organization*, 22(2003b) 183-206.

⁴⁶Tongue, K.A.. "Municipal Entry into the Broadband Cable Market: Recognizing the Inequities Inherent in Allowing Publicly Owned Cable Systems to Compete Directly against Private Providers", *Northwestern University Law Review*, 93, 3 (2001) 1099-1140.



In Ashland, AFN was unable to achieve build-out to the entire geographic area because the costs were too high.⁴⁷ Even though some people never received broadband access from the GON, they were nevertheless required to pay higher taxes to subsidize users. Cox states “When a service is not paying for itself, bureaucrats seek additional tax dollars to prop up their operations.”⁴⁸

Given the current economic environment, governments should be careful especially when entering into ventures that may cost taxpayers considerable amounts of money if they fail, especially if they provide little or no benefit to consumers. Government expenditures, as well as other goods, have an opportunity cost. Local governments must balance their budgets, and there is a practical limit to local tax levies. A better use of government revenues would more likely entail spending on essential services such as education, police and other services that may currently be facing budget cuts, rather than building and operating broadband networks.

A GON that faces financial difficulty has three choices:

- (1) Sell at a loss;
- (2) Continue using outdated technology; or
- (3) Introduce new investment and better technology, which will in turn increase its costs and lead to a bigger deficit with higher prices, higher taxes or a cross subsidy from other products in the case of multiproduct producers.

Gifford and Walker argue, “Subsidizing municipal communications services leads to higher taxes, jeopardizes bond ratings and increases the cost of other municipal services. It may also have the unrelated consequences of entrenching inferior communications technologies.”⁴⁹ City governments must be particularly vigilant stewards of dwindling taxpayer dollars in these difficult economic times. Unfortunately, the National League of Cities reports that the financial status of cities

continues to deteriorate and that declining revenues have forced cities to decrease their workforce, infrastructure and key services.⁵⁰ City finance officers report that 87 percent of cities are having more financial difficulties in 2010 than 2009 and that concern about the fiscal health is the highest it has ever been in the 25-year history of the survey.

As a result, cities are laying off personnel, delaying or cancelling infrastructure projects and cutting basic services. In a report for the National League of Cities, Hoene and Pagano found, “The most common responses to prospective shortfalls this fiscal year, by a wide margin were instituting some kind of personnel-related cut (79 percent).”⁵¹ Also, 25 percent of cities reported they planned to make public safety cuts.⁵² Cities across the country including Camden, New Jersey and Oakland, California are laying off police officers.

In a June 2010 letter to Congressional leaders, President Obama stated that “the devastating impact of budget cuts at the state and local level that are leading to massive layoffs of teachers, police and firefighters.”

Case Study: Burlington Telecom

Burlington Telecom in Vermont faces various issues. A state audit found that the GON has been violating its state license for the five years that it has been operating, and that there is no feasible way that it can repay its debts.⁵³ These debts include \$17 million, which city officials confirmed were improperly borrowed from taxpayers. When the Vermont legislature approved Burlington Telecom, *The Associated Press* reported that the legislature “required that the venture be a stand-alone entity and that it not use taxpayers’ money to support its operation.”⁵⁴

This \$17 million debt contributed to Moody’s downgrading of the city’s bond rating, which will increase its cost of borrowing and give Burlington a negative credit outlook. Also, the telecom company owes \$33.5 million to CitiCapital Advisors for lease of its equipment. The lease-purchase

⁴⁷Aldous V. “Ashland Fiber Network Director Resigns” Mail Tribune, June 2, 2011.

⁴⁸Cox B. “The Viability of Municipal Wi-Fi Networks” in “Not in the Public Interest – The Myth of Municipal Wi-Fi Networks”, New Millennium Research Council, 2005.

⁴⁹Gifford R.L. and Walker M.A. Glenwood Springs Residents Should say No to Municipal Broadband, Convergence Law Institute, April 2009.

⁵⁰Hoene C.W. and Pagano. M.A., “City Fiscal Conditions in 2010” National League of Cities, October 2010.

⁵¹Ibid.

⁵²Ibid.

⁵³Gram, D. “Vt. Telecommunications Firm not Viable, Audit Concludes” Associated Press, Dec. 11, 2010.

⁵⁴Ibid.



agreement was terminated in November 2010 as a result of Burlington Telecom's failure to make several payments. The company is trying to repossess the equipment and has filed a suit in federal court against the GON.⁵⁵

Case Study: FiberNet

One example of a GON being sold at a loss is FiberNet, an Internet service provider built by the city of Marietta, Georgia in 1996. Eight years later, the city sold FiberNet for \$11.2 million, a fraction of the \$35 million that was spent to build and maintain it. At the time of sale, Mayor Bill Dunaway addressed the need to constantly upgrade the system stating, "That's why we should not be in the business - you have to keep reinvesting ... [Its] negative cash flow once you consider reinvestment of capital."⁵⁶

There are substantial risks involved when a government entity enters the broadband industry, where technology changes rapidly and constant reinvestment is required. Thus, municipalities should proceed with caution when advocating for GONs because such government ventures shift the risk from voluntary investors to involuntary investors (i.e., taxpayers).

Proponents of government-owned networks fail to acknowledge that there is often a failure to generate enough revenue to cover all the costs associated with building and maintaining the network – including operating and capital costs, and especially debt payments. If costs exceed revenues, then some form of network subsidization becomes necessary.

F. Stifling Innovation

Government-owned networks and their anti-competitive behavior can also decrease innovation.⁵⁷ Tuerck contends that "a government that uses its powers to drive private providers from the market only to impose its own monopoly power would remove the incentive for future advances, threatening the technological progress that has

made the industry possible."⁵⁸ The Federal Trade Commission "Staff cautioned that government competition with the private sector may potentially stifle the development of innovative and competitive services in the private marketplace where government oversteps limits on its role in providing such service."⁵⁹

Even if public enterprises were to provide some benefits, these must be weighed against the potential cost that they may impose on consumers. According to Atkinson, economists "believe that broadband markets are characterized by significant economies of scale (especially in providing 'last mile' services) and that increased competition, especially that promoted proactively by government, could result in excessive and duplicative investments, thereby lowering industry productivity, limiting network upgrades and ultimately raising consumer prices."⁶⁰ All of these can lead to less innovation on the part of private firms.

V. SOLUTION TO UNSERVED AREAS: PUBLIC-PRIVATE COOPERATION

The market can provide much greater consumer welfare than GONs. If market conditions exist where there is no financial incentive for a private firm to enter, it does not necessarily mean that the only answer to an unserved market is a GON. A private firm can be induced to enter through subsidization, allowing it to operate. Subsidies to help build broadband networks in otherwise economically unfeasible areas are an external source that, in most cases, will provide a reasonable less expensive and less-risky alternative to GONs.

Cooperation between government and private firms will, in most cases, maximize consumer welfare. A community should look at the reasons why a private firm may not be entering the market. Barriers could take the form of regulations, high franchise fees, right-of-way fees or taxes. Some states have given tax incentives for broadband, but this incentive is usually outweighed by the high tax burden. It is

⁵⁵Briggs J. "Creditor's Lawsuit against Burlington Telecom could have Severe Impact" Burlington Free Press, Sept.11, 2011.

⁵⁶Marietta Selling City-owned Internet Company at \$24 Million Loss," USA Today, July, 29, 2004.

⁵⁷Sahr R.K. Prefiled Testimony Hearings on State and Local Issues and Municipal Networks: Hearings before the Senate Committee on Commerce, Science, and Transportation, 109th Congress, 2006.

⁵⁸Tuerck D.G. "The Competitive Effects of Municipal Provision of Wireless Broadband"

Not in the Public Interest – The Myth of Municipal Wi-Fi Networks, New Millennium Research Council, 2005.

⁵⁹Muris, T.J, Testimony, Director, bureau of Consumer Protection, Federal Trade Commission, Hearings on the Provision of Telecommunications and Information services by the Federal Government in Competition with the Private Sector; Hearings Before the House Government Information and Individual Rights Subcommittee of the Committee on Government Operations, 97th Congress, 1982.

⁶⁰Atkinson R.D., "Economic Doctrines and Network Policy" Telecommunications Policy, 35, 5 (June 2011) 413-25.



ironic that the government strongly supports the concept of universal broadband, yet severely taxes telecommunications. One should not tax what one wants to promote. Therefore, one way to promote private broadband service in high-cost rural areas is the elimination of taxes and fees on sales, real estate, franchise and right of way.

One way to subsidize private entry into high-cost areas is through the provision of free right of way, at least for a specific period of time. The community, in essence, will not lose revenue by giving such an allowance, since – without some subsidization – firms would not enter. Of course, the community would not have received any right-of-way fees if there is no entry.

As such, Balhoff suggests that, “policymakers remain important partners in the broadband markets, generally by removing barriers to investment, crafting appropriate incentives and supporting the commitments to social goals. [...] However, the data suggest forcefully that municipal intervention in most competitive markets is a financially risky and potentially anti-competitive incursion that simply should not occur.”⁶¹ Thus, GONs should be used as a last resort.

VI. CONCLUSION AND PUBLIC POLICY RECOMMENDATIONS

Across the country, local governments are struggling to balance their budgets. Especially in times like these, taxpayers have a right to question how city and county leaders are spending their money. Lawmakers have a responsibility to make sure limited funds go to such truly critical public services as law enforcement, fire and rescue, education and infrastructure.

Many cities and municipalities have entered into the broadband market with disastrous results. Government should not overburden citizens with ventures that result in no benefit and actually harm consumers. Government-owned networks have fared quite poorly because they have neither the resources nor the expertise necessary to provide consumers with reliable state-of-the-art broadband connections.

Government failure is especially prevalent in markets like telecommunications, which are subject to considerable technological changes in a short period of time. The result has been GONs subsidies to keep them afloat or the sale of the network at a loss. In a dynamic market such as broadband services, government ownership has proven to be an abject failure.

Government-owned networks often receive an unfair advantage over private networks because they do not operate under the same tax structures and regulatory rules. This makes private providers reluctant to make investments in an area where the deck is stacked against them, which then results in lower tax revenues. In addition to scaring away potential revenues, GONs are inefficient and are often great wastes of taxpayer money. They are often duplicative of private commercial networks and almost always add to taxpayers’ total debt burden.

Historically, the government has stayed out of telecommunication services provision, and most economists agree with this policy. The government should not be involved with broadband network ownership because markets are functioning properly. In unserved areas, public-private cooperation will lead to better results than GONs. Public policymakers should remove barriers to private investment and give firms the proper incentives to enter unserved markets.

Why Chattanooga is not the “Poster Child” for Municipal Broadband

George S. Ford, PhD*

January 20, 2015

Last year, Federal Communications Commission Chairman Tom Wheeler authored a blog entitled *Removing Barriers to Community Broadband*.¹ In this blog, Mr. Wheeler held out the municipal system in Chattanooga, Tennessee, as the “poster child” for why “it is in the best interests of consumers and competition that the FCC exercises its power to preempt state laws that ban or restrict competition from community broadband.” In anticipation of the 2015 State of the Union Address, the Obama Administration jumped on Mr. Wheeler’s bandwagon both by issuing a formal report² and by having the President give a speech about helping municipalities build their own broadband networks to compete with privately-funded broadband providers.³ And on top of that, the White House provided political cover for Mr. Wheeler’s efforts by stating that it intends to file a letter with the Commission formally asking it to preempt state laws that prohibit and restrict municipal broadband.⁴

Putting aside the glaring legal infirmities of the Commission’s preemption authority over state laws that restrict or prohibit municipal broadband for the moment (including Section 706),⁵ the Chairman made three central claims to support his desire to promote municipal broadband:

First, that the Chattanooga experience can easily be replicated elsewhere.

Second, that Chattanooga’s municipal network resulted in “spurred” economic growth.

And third, that Chattanooga’s municipal network provides significant “competition” to existing cable and telephone network providers who, in Mr. Wheeler’s words, would rather “legislate than innovate.”

These claims are echoed by the White House.

... the claim that Chattanooga is the reason why the FCC should use questionable legal authority to try to preempt state laws in order to allow local governments to build broadband networks glosses over several important details.

As I show in this PERSPECTIVE, however, while the White House’s and Mr. Wheeler’s proposals may make for good political theater, and even assuming Chattanooga’s fiber system is the most successful municipal broadband venture to date, the claim that Chattanooga is the reason why the FCC should use questionable legal authority to try to preempt state laws in order to allow local governments to build broadband networks glosses over several important details.⁶ While

Mr. Wheeler holds out Chattanooga as the "poster child" for community broadband—and the White House is playing along—once the facts are properly understood in context, generalizing the Chattanooga experience to the rest of the United States is a quite a stretch and is, as I see it, irresponsible.⁷ Chattanooga is unique in many respects, so care must be taken when generalizing this somewhat unique situation to other communities. Also, both Chairman Wheeler and the White House have shamefully evaded any recognition of many municipal broadband failures that have left taxpayers holding the bill, and these cases are every bit as important to good public policy as is the Chattanooga experience. In some cities a municipally-owned or municipally-supported system may be the only option for broadband, and a few cities may have the conscientious and skilled leadership necessary to make a go of it. Many will not. In any case, the widespread use of government money to build networks to compete with networks build with private sector money over many decades deserves an exceedingly careful analysis and not just grandstanding by the President and the Chairman.

The Chattanooga Experience Cannot Be Generalized

At the outset, it is important to recognize that the Chattanooga system was never a "greenfield" build. To the contrary, Chattanooga's broadband system is constructed and maintained by the city's municipal electric utility, the Chattanooga Electric Power Board ("EPB"). That's right: Chattanooga also get their electricity from a government-run electric monopoly. In fact, the initial justification for Chattanooga's fiber deployment was the cost savings it might generate for the electricity division.⁸ (These internal savings, as well as pure cost shifting, also make obtaining a clear picture as to the financial success of the broadband venture difficult to assess.)

The presence of spillover effects from its existing electric plant, and the ability to have the electric

division shoulder some of the costs of the broadband network, are significant and cannot be discounted in any honest evaluation of the Chattanooga experience.⁹ Spillovers between the electric and broadband segments reduce costs, thereby making profitable entry into broadband more likely (though success is not guaranteed).¹⁰ Where significant spillovers are absent, greenfield municipal networks—such as the infamous UTOPIA network—have failed miserably and cost taxpayers millions.¹¹ As discussed below, some municipal electrics also have failed miserably in their efforts to build broadband networks, passing on the losses to constituents and captive ratepayers.

... the help from Chattanooga's electric division was not limited to spillover effects in the form of reduced costs to entry. In particular, the construction of the broadband network was paid for by \$229 million in revenue bonds [serviced by captive electric ratepayers] and a \$50 million loan to the broadband division from the electric division.

The help from Chattanooga's electric division was not limited to spillover effects in the form of reduced costs to entry. In particular, the construction of the broadband network was paid for by \$229 million in revenue bonds and a \$50 million loan to the broadband division from the electric division.¹² It appears that the larger debt (\$229 million) is being serviced by captive ratepayers, not the broadband customers, for the purposes of Smart Grid technologies. (Note that Smart Grid applications do not require fiber optic connections, and home metering and real-time pricing can be accomplished using a 500

Kbps connection, well within the capacities of private-sector broadband networks.)¹³

Putting aside the financial support of broadband deployment by captive electric ratepayers for the moment, EPB's broadband system also received \$111 million grant from the U.S. Department of Energy—funds made available by the American Recovery and Reinvestment Act.¹⁴ Notably, this grant represents a gift from *all* Americans, not just Chattanoogaans, of about \$2,000 per subscriber (or about \$650 per electric customer in EPB's footprint).¹⁵ Such government subsidies stand in stark contrast to investment decisions by the private sector, as the nation's major broadband service providers do not receive such generous financial help from the federal government help to serve mostly urban markets (in fact, they receive nearly nothing to do so).

This sizable federal grant again makes generalization of the Chattanooga case problematic. First, for the most part, such federal funding for broadband deployment has dried up. Second, assuming other municipal systems required such help to get going, federal grants matching that in Chattanooga for the rest of nation would amount to about \$220 billion.¹⁶ By any measure, \$220 billion a lot of dough, especially when spent to overbuild existing broadband infrastructure. Including the full initial cost of the network's buildout (\$390 million), the money required for a nationwide municipal buildout is about \$780 billion (and that's for, on average, a third wireline broadband provider).¹⁷

What if the private-sector was the recipient of such largess? EPB's market includes about 170,000 units and it received a federal grant of \$111 million to serve them, or about \$650 per unit passed. Comcast, the nation's largest provider of broadband services, has about 54 million units passed.¹⁸ One has to wonder what could be accomplished if the government gave Comcast (not loaned it) the units-passed

equivalent of about \$35 billion in upfront capital to upgrade and expand its network; an amount about 11-times the annual investment of Comcast in its broadband infrastructure (about \$4 billion annually, excluding NBCUniversal investments). I suspect Comcast's network would be one of the most advanced in the world given that type of money. What would AT&T do if the government gave it (not loaned it) \$30 billion to support its planned expansion of U-Verse to an additional 30 million homes?¹⁹ Certainly, this gift would be a significant influx of investment cash that would greatly improve and expand AT&T's increasingly fiber-based network.

Putting aside the financial support of broadband deployment by captive electric ratepayers for the moment, EPB's broadband system also received \$111 million grant from the U.S. Department of Energy—funds made available by the American Recovery and Reinvestment Act. Notably, this grant represents a gift from all Americans, not just Chattanoogaans, of about \$2,000 per subscriber (or about \$650 per electric customer in EPB's footprint).

I don't think these federally-funded cash injections are probable, but it is interesting to grasp the magnitude of the grant and the advantage given to the municipal system in Chattanooga relative to what is provided to the private sector. Given the size of the equivalent grants, it seems fairly clear that it is unreasonable to compare the deployment and upgrade schedules of the private sector against municipal systems that are the recipients of

massive federal cash infusions. As the Commission itself has recognized on numerous occasions, investors, unlike the federal government, don't give money away without any expectation of a return.²⁰

Finally, it is important to recognize that the scope efficiencies that could improve the financial case for broadband deployment by municipal electric systems are, obviously, limited to areas that have municipal electric systems. Today, only about 14% of customers are served by government-owned electric utilities, and these systems often serve rural markets where network deployment costs are very high.²¹ This essentially means that for the remaining 86% of Americans, municipal entry will have to take some form of a greenfield build. Thus, the Chattanooga experience again cannot be generalized to municipal broadband for the rest of the United States.²²

In fact, success isn't guaranteed even in markets where a municipal electric utility builds a broadband network. Consider the case of Groton, Connecticut. Groton Utilities is, like EPB, a municipal utility offering electricity services. The city decided to build a modern cable, telephone, and broadband network to compete with Comcast.²³ The city borrowed \$27.5 million to build the network. After incurring \$11 million in losses from the operation of the network, the broadband network was sold to a private investor for \$550,000 (the initial agreed upon selling price to the sole interested party was \$150,000). The \$38 million tally of debt and losses is being passed on to the city's captive electric ratepayers. One has to wonder why Chairman Wheeler traveled to Chattanooga for a photo-op instead of Groton?²⁴ Likewise, one must question why the *White House Report* failed to mention Groton even once? The answer seems obvious enough—the push for municipal broadband isn't thoughtful policy making, but is showmanship.

Economic Migration is Not the Same as Economic Growth

Is this government largess worth it? I doubt it. While Mr. Wheeler and the White House note the economic development attributed to the Chattanooga network, which may be considered a benefit, here's what Mr. Wheeler says: "Smaller businesses such as Claris Networks, Co.Lab, EDOps, and Lamp Post Group relocated to the city, and Chattanooga is also emerging as an incubator for tech start-ups." "Relocated" is the operative word here, implying that the economic payoff from the Chattanooga network is derived from stealing businesses from other cities. Oddly, through the federal grant given to Chattanooga, it is the very people in these cities losing businesses that are funding the broadband network in Chattanooga that is destroying their economy. Also, such business stealing is not sustainable. As more and more cities get the fiber networks, there is less and less incentive to "relocate."

... much of the benefit Mr. Wheeler and the White House attribute to municipal broadband deployment results from economic migration rather than from overall economic growth. Stated another way, the benefits of fiber deployment by municipalities come largely from business stealing rather than absolute economic improvements.

Chattanooga may be wise to get a first-mover advantage in business stealing, but it's a "first-mover" advantage not available to municipal late-comers. I can see a city's leadership wanting advantage its city over others, but I'm not sure why a federal regulator should be so supportive of a particular project, since what helps one city hurts another. That's not to say

there isn't some overall economic gain from fiber deployment, but much of the benefit Mr. Wheeler and the White House attribute to municipal broadband deployment results from economic *migration* rather than from overall economic *growth*.²⁵ Stated another way, the benefits of fiber deployment by municipalities come largely from business stealing rather than absolute economic improvements.

Promoting Competition or Crowding Out?

The number of competitors in a market is an equilibrium outcome, not a policy choice.²⁶ Generally speaking, the number of competitors in a market is determined by the ratio of market size (in expenditures, adjusted for the intensity of price competition) to fixed entry costs.²⁷ Wireline broadband is a big market, but it also a hard business that requires massive capital investments. Among U.S. firms, AT&T and Verizon rank first and second for annual capital expenditures.²⁸

The number of competitors in a market is an equilibrium outcome, not a policy choice.

Accordingly, if we view the equilibrium number of firms (N^*) as fixed, then the entry of a new firm, municipal or otherwise, must lead to the exit of another. The *National Broadband Plan* expressed some concern about the exit of broadband providers even absent municipal entry, so we should expect, other things constant and absent some radical technological innovation that significantly lowers entry costs, less private-sector provision of broadband services in response to municipal entry.²⁹ However, as the *National Broadband Plan* bluntly observed, "Municipal broadband has risks. Municipally financed service may discourage investment by private companies."³⁰ Successful municipal entry therefore cannot be viewed as

increasing competition, since there is a possibility of displacing private-sector investment.³¹ In the short run, we may see private sector firms invest more in an effort to protect their embedded investments to survive or win outright (consider the Groton experience discussed above), but in the end, firms will acknowledge that past investments are sunk. Eventually, the decision must be made as to whether or not to continue to invest in light of marketplace realities, including the realization or threat of a government's entry into your market using public funds.

For municipal broadband networks, the estimated breakeven penetration rates are often around 40-60%. If a 40% penetration is required to financially break even, then only two firms can survive. Thus, in most U.S. cities, a financially viable municipal broadband system means the loss of at least one private-sector provider.

An easy way to think about the crowding out issue is the concept of a breakeven market penetration rate. Communications networks are expensive to build and are thus subject to substantial economies of scale. As a result, financial success requires the acquisition of many customers. The breakeven penetration rate is the share of homes passed required for the network to earn a sufficient return to be viable. For municipal broadband networks, the estimated breakeven penetration rates are often around 40-60%.³² If a 40% penetration is required to financially break even, then only two firms can survive.³³ Thus, in most U.S. cities, a financially viable municipal broadband system means the loss of at least one private-sector provider.

Certainly, the threat of widespread municipal entry increases the risk of private investments; all entry does, but government entry imposes unique risks. In the long-run, the threat of municipal entry could curb privately-funded broadband expansion and upgrades, even rendering areas that would be profitable without such a threat too risky to enter with it.³⁴ As a consequence, the need for municipal financial support could rise with municipal entry—a potentially costly cycle.

Reducing Prices for Consumers?

Finally, we come to the empirics on competitive pricing. Last January, I authored a PERSPECTIVE challenging the New America Foundation's study that purported to show that municipal networks provide lower prices than their private sector counterparts.³⁵ Among the case studies provided was Chattanooga. When I corrected for New America's errors by comparing like services between the private sector and Chattanooga, it turns out that the Chattanooga prices were not lower than private sector offerings.

In the long-run, the threat of municipal entry could curb privately-funded broadband expansion and upgrades, even rendering areas that would be profitable without such a threat too risky to enter with it. As a consequence, the need for municipal financial support could rise with municipal entry—a potentially costly cycle.

For comparison, consider Comcast's services. For \$139.99, Comcast offers a 50 Mbps broadband service with about 170 channels of video and fully-featured, unlimited-calling voice

service. EPB's comparable triple-play, including a 100 Mbps broadband connection,³⁶ its largest programming tier of about 150 channels, and a fully-featured, unlimited-calling voice service, is priced at \$139.38. So, it appears that for comparable services, EPB and its private-sector rival are charging roughly equal prices.

While not serving the Chattanooga market, Verizon also offers across its FiOS footprint a 50 Mbps service as part of a triple-play. Verizon's bundle also includes about 215 video channels and a fully-featured, unlimited-calling voice service for the price of \$89.99. Verizon's price is much lower than is EPB's price, again leading to the rejection of the claim that municipal providers offer lower prices than do their private-sector counterparts, at least for comparable bundles of services.

Conclusion

Municipal broadband has its place, and admittedly the boundaries of that place can be blurry. Using government funds to supply broadband in unserved areas is sensible enough (subject to cost-benefit analysis), but to use government funds to add supply in a market already served deserves, at a minimum, close scrutiny. Notwithstanding, without any thought of a proper cost-benefit analysis, Chairman Wheeler and now the White House are vocal advocates of municipal broadband and in recent statements both labeled Chattanooga's fiber-optic deployment as an archetype for government entry into telecommunications.

Whatever one thinks about the Chattanooga system (and it is certainly an interesting case), it is not an archetype for widespread municipal fiber buildouts. First, the fiber deployment offers the electricity division cost efficiencies, and only about 14% of the nation is served by government-run power companies. Also, the Chattanooga system received \$111 million in federal support (about \$2,000 per subscriber). Extending the Chattanooga experience to the rest of the country would cost over \$220 billion

in grants, and the cost burden on municipalities would equal \$780 billion nationwide. There is no federal, state or city grant program available that could cover such expenditures.

Second, since a large share of economic benefits of such fiber networks come mostly from stealing businesses from other cities (cities whose population subsidize the Chattanooga system), it's unclear why a federal regulator should have a position on the topic; one city's gain is another's loss so there is little net gain at the federal level.

Third, the evidence does not suggest the municipal systems offer any price cuts to consumers relative to the privately-funded broadband providers. Since municipal systems are new construction, they are typically fiber and thus capable of far more bandwidth than presently needed. These high-capacity networks are intriguing, but good policy is not made by focusing on shiny things; good policy is made by reasoned analysis – at least, that's the goal.

Finally, given the economics of supplying wireline broadband service, a successful municipal venture is unlikely to lead to a long-term increase in the number of providers; more likely, the exit of private-sector providers will probably ensue in the long-run.

NOTES:

* Dr. George S. Ford is the Chief Economist of the Phoenix Center for Advanced Legal and Economic Public Policy Studies. The views expressed in this PERSPECTIVE do not represent the views of the Phoenix Center or its staff.

- ¹ T. Wheeler, *Removing Barriers to Competitive Community Broadband*, OFFICIAL FCC BLOG (June 10, 2014) (available at: <http://www.fcc.gov/blog/removing-barriers-competitive-community-broadband>).
- ² *Community-Based Broadband Solutions: The Benefits of Competition and Choice for Community Development and Highspeed Internet Access*, Executive Office of the President (January 2015) (available at: <http://www.whitehouse.gov/sites/default/files/docs/community-based-broadband-report-by-executive-office-of-the-president.pdf>) (hereinafter "White House Report").
- ³ Remarks by the President on Promoting Community Broadband, Cedar Falls Utilities, Cedar Falls, Iowa (January 14, 2015) (<http://www.whitehouse.gov/the-press-office/2015/01/14/remarks-president-promoting-community-broadband>).
- ⁴ FACT SHEET: *Broadband That Works: Promoting Competition & Local Choice In Next-Generation Connectivity*, The White House (January 13, 2015) (available at: <http://www.whitehouse.gov/the-press-office/2015/01/13/fact-sheet-broadband-works-promoting-competition-local-choice-next-gener>).
- ⁵ See L.J. Spiwak, *FCC Has No Authority to Preempt State Municipal Broadband Laws*, BLOOMBERG BNA (August 6, 2014) (available at: <http://www.phoenix-center.org/BloombergBNAMuniBroadband.pdf>); see also M. Berry, Remarks of Matthew Berry, Chief Of Staff to FCC Commissioner Ajit Pai, at the National Conference of State Legislatures' 2014 Legislative Summit Minneapolis, Minnesota (August 20, 2014) (available at: https://apps.fcc.gov/edocs_public/attachmatch/DOC-328916A1.pdf).
- ⁶ The White House reports also mentions two other municipal electric broadband systems in Wilson, NC, and Lafayette, LA. See *White House Report*, *supra* n. 2.
- ⁷ A similar point is made by Harold DePriest, head of Chattanooga's municipal broadband system, at a hearing before the Tennessee State Legislature ("This stuff is not cheap, it is not easy, and [] I'm not really telling you that every community is going to run out and build broadband, that doesn't make sense to me (at 8:32)") (available at: <https://www.youtube.com/watch?v=oRtzmNMGILo&index=19&list=FLeDkoYbc2YqmOTN6BcfU0IQ>). The entire video is worth watching as Mr. DePriest makes a respectable case for municipal broadband.
- ⁸ See Electric Power Board of Chattanooga, Tennessee Petition for Preemption of a Portion of Section 7-52-601 of the Tennessee Code Annotated Pursuant to Section 706 of the Telecommunications Act of 1996 for Removal of State Barriers to Broadband Investment and Competition at pp. 23-24 (available at: <https://www.epb.net/downloads/legal/EPB-FCCPetition.pdf>).
- ⁹ For example, such spillovers explain, in large part, cable's entry into the telephone market. See, e.g., G.S. Ford, T.M. Koutsky and L.J. Spiwak, *Competition After Unbundling: Entry, Industry Structure and Convergence*, 59 FEDERAL COMMUNICATIONS LAW JOURNAL 331 (2007).
- ¹⁰ See, e.g., L.J. Spiwak, *Utility Entry Into Telecommunications: Exactly How Serious Are We?* PHOENIX CENTER POLICY PAPER NO. 1 (July 1998) (available at: <http://www.phoenix-center.org/pcpp/PCPP1Final.pdf>).
- ¹¹ T.A. Schatz and R. Van Tassell, *Municipal Broadband Is No Utopia*, WALL STREET JOURNAL (June 19, 2014) (available at: <http://online.wsj.com/articles/municipal-broadband-is-no-utopia-1403220660>).
- ¹² See, e.g., C. Davidson and M. Santorelli, *Understanding the Debate over Government-Owned Broadband Networks: Context, Lessons Learned, and a Way Forward for Policy Makers - Chattanooga Case Study*, New York Law School (June 2014) (available at: <http://www.nyls.edu/advanced-communications-law-and-policy-institute/wp-content/uploads/sites/169/2013/08/ACLIP-%E2%80%93-Chattanooga-Case-Study-%E2%80%93-June-2014.pdf>); C. Mitchell, *Broadband at the Speed of Light: How Three Communities Built Next-Generation Networks*, Benton Foundation (April 2012) (available at: <http://www.ilsr.org/wp-content/uploads/2012/04/muni-bb-speed-light.pdf>).
- ¹³ P. Fuhr, W. Manges, T. Kuruganti, *Smart Grid Communications Bandwidth Requirements: An Overview*, SG COMMUNICATIONS TECHNOLOGY REVIEW (February 2011) (available at: <http://trustworthywireless.ornl.gov/pdfs/Smart-Grid-Communications-Overview-Bandwidth-2011.pdf>).

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- ¹⁴ K.E. McCarthy, *Chattanooga High Speed Broadband Initiative*, OLR RESEARCH REPORT 2012-R-0515 (December 14, 2012) (available at: <http://www.cga.ct.gov/2012/rpt/2012-R-0515.htm>).
- ¹⁵ EPB Financial Statement (2013) (available at: https://www.epb.net/flash/annual-reports/2013/downloads/EPB_Financials_2013.pdf).
- ¹⁶ Scaling requires a few calculations. First, I must scale to the population. EPB passes about 100,000 households. In 2013, there were 123 million U.S. households. Second, Chattanooga is also a relatively urban area, so deployment costs are cheaper in that city than the national average. Using the FCC's Hybrid Proxy Cost Model, average national loop costs are about 1.7 times larger than loop costs in Chattanooga (available at: <http://transition.fcc.gov/wcb/tapd/hcpm/welcome.html>). The total scaling ratio is about 2,000:1.
- ¹⁷ *In the Matter of Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996, as Amended by the Broadband Data Improvement Act*, FCC 12-90, 27 FCC Rcd 10342 EIGHTH BROADBAND PROGRESS REPORT (rel. August 21, 2012) at Chart 1 (available at: <http://www.fcc.gov/reports/eighth-broadband-progress-report>).
- ¹⁸ Comcast Form 10-K (2013) (available at: <http://www.cmcsa.com/annuals.cfm>).
- ¹⁹ AT&T Form 10-K (2013) (available at: <http://phx.corporate-ir.net/phoenix.zhtml?c=113088&p=irol-SECText&TEXT=aHR0cDovL2FwaS50ZW5rd2l6YXJkLmNvbS9maWxpbnmcueG1sP2lwYWdlPTk0MTM4NDQmRFNFUT0wJlNFUT0wJlNRREVTOz1TRUNUSU9OX0VOVEISRSZzdWJzaWQ9NTc%3d>).
- ²⁰ *See, e.g., CONNECTING AMERICA: THE NATIONAL BROADBAND PLAN*, Federal Communications Commission (March 16, 2010) (available at: http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-296935A1.pdf) (hereinafter the *National Broadband Plan*) at p. 136 (When "service providers in these areas cannot earn enough revenue to cover the costs of deploying and operating broadband networks, including expected returns on capital, there is no business case to offer broadband services..."); *The Broadband Availability Gap*, FCC OMNIBUS BROADBAND INITIATIVE (OBI) TECHNICAL PAPER NO. 1 (2010) at p. 1 ("[p]rivate capital will only be available to fund investments in broadband networks where it is possible to earn returns in excess of the cost of capital. In short, only profitable networks will attract the investment required.") (available at <http://download.broadband.gov/plan/the-broadband-availability-gap-obi-technical-paper-no-1.pdf>); *but see* Wheeler, *supra* n. 1 ("The [Chattanooga] network was partly built out of necessity. Local phone and cable companies chose to delay improvements in broadband service to the Chattanooga area market.")
- ²¹ <http://www.publicpower.org/files/PDFs/USElectricUtilityIndustryStatistics.pdf>
- ²² It is interesting to note that while there are a number of cases where municipal-electric systems have deployed fiber, we don't see investor-owned utilities making such investments. To blame, in part, are regulations on private sector power companies, which are different and more onerous than those faced by municipal systems, discourage such investments. Here is one advantage that the public sector has that private sector firms do not. For example, private sector power companies are generally not permitted to allow broadband network costs influence power bills, though municipal systems often face no such limitation. It was noted during the debates over Chattanooga's system that if the broadband network was a total failure that the average electric ratepayer would face a cost increase of \$2 to \$3 per month. *See Broadband at the Speed of Light, supra* n. 12, at p. 35. This figure was intended, I believe, to argue that the venture was low risk, but any Investor Owned Utility ("IOU") offering a similar rate increase for a prospective business failure would be laughed (or booted) out of its state regulator's office. While Chairman Wheeler talks big about eliminating rules limiting municipal entry, he has failed to even mention state regulations that discourage investor-owned utility investments in broadband. Investor-owned utilities, like municipal utilities, have spillover opportunities into the broadband marketplace. Perhaps this omission says something about Chairman Wheeler's preference for government, rather than private-sector, provision of broadband services. Perhaps not.
- ²³ G. Smith, *Groton's Deal to Shed TVC Finalized as New Owners Take the Reins*, THE DAY.COM CONNECTICUT (February 1, 2013) (available at: <http://www.theday.com/article/20130201/NWS01/130209982/-1/zip06&town=Norwich&template=zip06art>); D. Straszheim, *How a Promising Idea Went Terribly Wrong in Groton*, GROTON PATCH (January 6, 2013) (available at: <http://groton.patch.com/groups/politics-and-elections/p/how-a-promising-idea-went-horribly-wrong-in-groton>); Groton Utilities (available at: <http://www.grotonutilities.com>).

NOTES CONTINUED:

²⁴ See Wheeler Blog, *supra* n. 1.

²⁵ *White House Report*, *supra* n. 2 at p. 14 (“helped the City attract a new community of computer engineers, tech entrepreneurs and investors (emphasis added)”).

²⁶ G.S. Ford, T.M. Koutsky, and L.J. Spiwak, *Competition After Unbundling: Entry, Industry Structure and Convergence*, 59 FEDERAL COMMUNICATIONS LAW JOURNAL 331 (2007)(available at: <http://phoenix-center.org/papers/FCLJCompetitionAfterUnbundling.pdf>).

²⁷ *Id.*

²⁸ D. Carew and M. Mandel, *U.S. Investment Heroes of 2013: The Companies Betting on America's Future*, Progressive Policy Institute (September 2013) (available at: <http://www.progressivepolicy.org/issues/economy/investment-heroes-who%E2%80%99s-betting-on-america%E2%80%99s-future>).

²⁹ *Supra* n. 20.

³⁰ *Id.* at p. 153.

³¹ In a paper published in 2007 (using 2004 data), I presented evidence that municipal investments in communications networks did not crowd out, but rather stimulated, entry by CLECs. Given changes in FCC policy, CLECs are now largely a bygone. G.S. Ford, *Does a Municipal Electric's Supply of Communications Crowd Out Private Communications Investment? An Empirical Study*, 29 ENERGY ECONOMICS 467-478 (2007).

³² See, e.g., *Martinsville, Virginia: Fiber to the Premise Feasibility Study*, CCG Consulting, LLC (November 30, 2012) (available at: http://www.martinsville-va.gov/content/File/fiber_optic_report_feasibility_study_nov_2012.pdf) (breakeven penetration rate 42% to 62%); *Municipal Fiber to the Home Deployments: Next Generation Broadband as a Municipal Utility*, FTTH Council (October 2009) (available at: www.ftthcouncil.org/d/do/69); *Austin, Minnesota: Ultra-broadband Feasibility Study*, CCG Consulting, LLC (March 27, 2014) at p. 66 (40% to 46% breakeven penetration) (available at: http://gigaustin.org/uploads/Ultra-broadband_Feasibility_Austin_3-27-14_1.pdf).

³³ A 40% penetration is of all homes passed, and only about 80% of total homes passed subscribe to any broadband service. See, e.g., A. Banerjee and M. Sirbu, *Towards Technologically and Competitively Neutral Fiber to the Home (FTTH) Infrastructure*, Working Paper (2003) at p. 23 (“if a 35-40% penetration is required for profitability, then in the long run at most two firms can profitably serve the same market”) (available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2060612).


³⁴ While opposition to municipal entry by larger providers is frequently discussed and disliked, smaller competitors in the Chattanooga area are also not happy competing with the government, and have noted to difficulty of obtaining financing under such conditions. See A. Rued, *Chattanooga Broadband: High Speeds at an Even Higher Price*, AMERICAN LEGISLATOR (April 15, 2013) (available at: <http://www.americanlegislator.org/chattanooga-broadband-high-speeds-at-an-even-higher-price>).

³⁵ G.S. Ford, PHOENIX CENTER POLICY PERSPECTIVE NO. 14-01: *Do Municipal Networks Offer More Attractive Service Offerings than Private Sector Providers? A Review and Expansion of the Evidence* (January 27, 2014) (available at: <http://www.phoenix-center.org/perspectives/Perspective14-01Final.pdf>).

³⁶ EPB's lowest speed offering is 100 Mbps, but I doubt most consumers could tell the difference between 50 and 100 Mbps.

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CU Fiber Study 'not overly optimistic'

Posted Wednesday, June 24, 2015 11:28 am

By RICK NORTON Associate Editor

Details won't be released until July, but Cleveland Utilities President and CEO Ken Webb is saying this much about a one-year telecommunications study that has been completed and is now under review by utility staff: "... It's not overly optimistic."

The chief obstacles CU could be facing in its hoped leap into the telecommunications industry — a myriad of Internet, telephone and cable services — can apparently be summed up in two words: "Money" and "money."

In a formal monthly session Tuesday of the Cleveland Board of Public Utilities, Webb said the \$59,000 study contracted to Uptown Services of Boulder, Colo., will be presented to the group in full at its next formal gathering scheduled for July 23.

"It was about this time last year that we started talking about that [a telecommunications study]," Webb said Tuesday. "The study has been completed. We are in the process of digesting it as a staff, and what our plans are is to have a report for you at the July meeting."

But it's not looking good.

"I will go ahead and tell you that it's not overly optimistic ... about us providing triple-play services," Webb said of what he described Tuesday as the Fiber Study. "The capital requirements are extensive and the startup costs could present issues."

For a public utility that remains about \$70 million in debt, based on the 2015-16 budget document, that's not what CU leaders wanted to hear. At the same time, it's not necessarily a shock.

Over the past several years, CU has commissioned telecommunications studies three times. The most recent came about eight years ago and capital outlay expenses were again a major concern.

Last July, Webb told board members the time had come again for another look; if for no other reason, then because the utility already has a vast network of fiberoptics that could be utilized for telecommunications; and, because Internet is no longer considered a luxury. In most corners, it is a mandate.

During the July 2014 board gathering, Webb recommended the third telecommunications study to board members.

"You all know as well as I do that Internet connection now is the electric connection of the 1930s and 1940s," Webb said then.

However, the veteran utility man stressed this caveat, one that was apparently based on potential costs. He said, with the board's approval, that the utility would proceed in the study with caution. He said board members would be kept updated on all stages of the study, and that no official actions would be taken without the group's approval.

Webb's update Tuesday may have prepared board members for disappointment. However, it also put the group on notice that a mini-package of services might be available.

"... One thing we're going to do in our review of that study, and we'll be getting you copies of it, is that we'll review the possibilities of offering some services that are not necessarily full-blown services," Webb said.

He later added, "A lot of decisions are yet to be made and a lot of review is still to take place."

In speaking to the board, Webb didn't fully define the phrase "... offering some services that are not necessarily full-blown services," but it could be a reference to limited provisions such as Internet.

Even during the months that Uptown Services has conducted the telecommunications study, the issue of Internet provision has dominated the electronic headlines; at least, in Tennessee.

The question came up months ago when EPB of Chattanooga filed for permission with the Federal Communications Commission to extend its telecommunications services outside its established service territory in Hamilton County. One of its targets was about 800 Bradley County residents in the southwest corner who do not have access to high-speed broadband.

FCC eventually approved a pre-emption of state laws restricting EPB fiberoptics to the municipal utility's electric service area; however, at least one telecommunications competitor — AT&T — announced it would file lawsuit against any such action by the government-linked EPB.

The threat of litigation, and heavy lobbying in Nashville against the FCC ruling, tempered the Tennessee Legislature's momentum to move ahead with the plan, and on April 2 members of the Bradley County delegation acknowledged the bill had been halted; at least, until January.

State Rep. Dan Howell, R-Georgetown representing the 22nd Legislative District, stressed "... The issue is not dead." He later added, "I am sure this issue will come up again in January."

State Rep. Kevin Brooks, R-Cleveland representing the 24th Legislative District, served as sponsor of House Bill 1303. In an appearance before the House Business and Utilities Subcommittee, Brooks asked that the bill be rolled into the start of the next legislative session in 2016.

"A lot of great work has gone into this bill," Brooks said of the House. But, on the Senate side of the hallway, more opposition was being encountered, he suggested.

But that was then. Both legislators hope for better times in the next General Assembly.

"In an attempt to preserve the hard work and hard-fought support we've found, we simply pushed the 'Pause' button until next Session," Brooks told the Cleveland Daily Banner in early April.

Howell concurred.

"We did not kill the bill," the freshman state lawmaker stressed then. "This bill is not dead. The bill is on hold until we return in January. We will work diligently during the offseason to gain even further support in both the House and the Senate."

In the meantime, the CU telecommunications study continued to progress. But, cost was always a concern. And now, it appears cost could be the stumbling block based on Webb's brief report to the CU board Tuesday.

The CU board's session on July 23 will begin at 3 p.m. in the Tom Wheeler Training Center.



STATE OF TENNESSEE
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August 28, 2014

Honorable Mayor and Board
City of Clarksville
1 Public Square, Third Floor
Clarksville, TN 37040

Honorable Mayor and Board:

I have performed a limited review of the annual financial report on the CDE Lightband for the fiscal year ended June 30, 2013, as audited by Crosslin and Associates, PC, Certified Public Accountants. This report has been filed as part of the public records of the State of Tennessee.

The statements of net position for the Broadband Division reported deficits in total net position of \$(14,472,512) and \$(13,151,453) as of June 30, 2013 and June 30, 2012 respectively. The responsible officials should look into this situation and take necessary actions to ensure that sound financial condition can be achieved for the CDE Lightband Broadband Division.

In addition, Broadband Division reported an unrestricted deficit balance of \$(16,506,020) and \$(15,929,979) as of June 30, 2013 and June 30, 2012 respectively. The responsible officials should look into this situation and take necessary actions to ensure the unrestricted deficit balances are eliminated.

If you have any questions concerning the above, please contact this office.

Sincerely

Timothy M. Hardy, CPA, CFE
Division of Local Government Audit

1262

xc: Crosslin and Associates, PC
Certified Public Accountants
3803 Bedford Avenue, Suite 103
Nashville, TN 37215

CDE Lightband
2021 Wilma Rudolph Boulevard
Clarksville, TN 37040

SECTION

B

GREATER MEMPHIS

THE COMMERCIAL APPEAL | SATURDAY, FEBRUARY 5, 2005

Networkx asking for \$3 million more

It expects
to be
profitable
by end
of year

By TOM CHARLIER
charlier@commercialappeal.com

Having spent nearly \$36 million anted up by local ratepayers and private investors, the fiber-optic cable venture launched by the Memphis Light, Gas and Water Division needs more money.

Memphis Networkx plans to seek \$3 million in additional financing to cover the

costs of extending service to several large customers, said John McCullough, chairman of the Networkx board and MLGW's chief financial officer.

The firm should be able to get the money from the private partners who own 20 percent of Networkx, McCullough said. But, failing that, it might move to spend the more than \$3 million still available from past allocations approved by MLGW's

board and the Memphis City Council.

McCullough said the need for additional financing doesn't reflect problems at the firm. Instead, the money would put Networkx on track to grow and prosper in the hotly competitive telecommunications field.

"Networkx is rapidly expanding right now. They're in their high-growth stage," said McCullough, who declined to name

the prospective customers.

"You wouldn't want to miss opportunities for growth here."

The financing bid follows renewed concerns raised by local officials regarding Networkx and MLGW's entry into the telecommunications industry, which has been rocked by high-profile failures in recent years.



John
McCullough

See NETWORKX, B2

During November budget proceedings, City Council members voiced alarm over losses at Networx, and MLGW president Joseph Lee has commissioned a study to determine whether the utility should maintain or sell its investment in the firm. The study was spurred in part by huge losses from fiber-optic ventures experienced by public utilities in other cities.

Phone calls to the two Networx board members representing the private partners — Andrew Seamons and Luke Yancy — were not returned.

Networx is a limited partnership between MLGW, which owns 80 percent, and Memphis Broadband, a venture assembled by an investment group representing some of the city's leading businessmen. The firm is building a fiber-optic "backbone" network serving businesses and institutions with an array of high-speed data services.

The firm has spent some \$29 million provided by MLGW and about \$7 million invested by the

private group.

The utility has set a cap of \$32 million on its total investment, with more than \$3 million remaining unspent because of unresolved accounting and regulatory issues.

Council members and other local officials said they're uncertain about whether Networx should be able to draw from the remaining \$3 million. But they're opposed to raising the cap beyond the current \$32 million.

"I doubt there's any support for that at all," council member Carol Chumney said. "It seems like MLGW did get beyond its mission and purpose" with the Networx venture, she added.

When developing the venture in 1999, utility officials said their goals included making Memphis more competitive with other cities through improved broadband accessibility, bridging the "digital divide" by providing service to poor areas, and generating a return on MLGW's investment.

Initial projections indicated Networx eventually could generate \$16 million or more in annual revenues for the utility.

Networx has lost money every year since its creation, McCul-

lough said. But company officials say the lean early years were expected and Networx should be turning a profit by the end of this year.

Despite the large investment of ratepayer funds, Networx officials have denied requests by The Commercial Appeal to review financial records. They contend the firm is private and not subject to Tennessee's Open Records Law.

Competing telecommunications firms opposed the 2001 state licensing of Networx and claimed the venture represented a risky investment by MLGW. Today, officials with those companies say the market is tougher than ever.

"It's a very competitive market," said Linda Brashear, vice president of marketing and public affairs for Time Warner Cable.

Although Time Warner contested the licensing, it hasn't tracked Networx too closely in part because of its relatively small "footprint" in the local telecom market.

"Once they (Networx) got up and running we kind of stepped back ... and let the market work," Brashear said.

McCullough acknowledged major troubles have shaken the telecommunications field during the past five years. But he said an improving economy has brought new life to the industry, generating recent growth.

"The outlook now, I'd say, is threefold better than it was two years ago."

McCullough called Networx a "survivor" with an excellent staff. As to whether MLGW made a wise investment in it, it's too early to know, he said.

"We have not accomplished our three goals yet, nor have we failed."

THE COMMERCIAL APPEAL

SUNDAY

MEMPHIS, TENNESSEE | 165TH YEAR | FEBRUARY 20, 2005

MLGW's Networkx losing millions

By TOM CHARLIER
charlier@commercialappeal.com

Six years after its creation, MLGW's telecom venture has lost at least \$21 million, yet "the company is right on track with what we projected," its CEO says.

Sales grew fivefold in 2004, said Memphis Networkx chief executive officer Mark Ivie, and by the end of this year the company should be turning a profit.

But financial statements reviewed by The Commercial Appeal show that losses at the public-private telecommunications company grew steadily from 2001 through 2003. The losses came as the company's costs for connecting new customers remained nearly twice as much as the revenues it received from them.

MLGW, a public utility owned by the people of Memphis, owns 80 percent of Memphis Networkx, which it launched as a potential source of new revenue. A private investment group of some of the city's leading businessmen owns the rest.

The company provides wholesale and retail telecom services over a high-speed fiber-optic "backbone" connecting business and institutional customers. The system is in direct competition with purely private firms like BellSouth and Time Warner Cable.

Until now, the public has had little financial information on which to gauge Networkx's performance. Audited financial statements for 2001 through 2003 were made available after several public records requests by The Commercial Appeal.

The figures in the statements, coupled with interviews, depict a company that has been plagued by unpredictable outside market and regulatory forces and some questionable spending of its own.

Although Networkx had gathered investments totaling \$30.6 million, most of it from MLGW, the assets shown as of Dec. 31, 2003, amounted to only \$10.66 million with depreciation figured in.

Networkx is talking with private investors in a search for additional financing to enlarge its system to serve new customers.

Amid mounting concerns over the company's future, MLGW recently commissioned a study to assess its \$28.6 million stake. Some other municipal utilities, including one in Marietta, Ga., have sold their telecom startups at huge losses.

Industry officials describe the Networkx losses as understandable for a startup company that's weathered the collapse of the telecom industry, an economic downturn and an unexpectedly long and costly licensing process.

It's "not uncommon" for telecom startups to operate in the red for several years, said Sean Hackett, a senior analyst in telecom industry strategies for The Yankee Group, a Boston-based analytical firm.

"It's a very capital-intensive industry, especially when you're deploying your own network," Hackett said.

Launched in late 1999, Networkx wasn't licensed by the Tennessee Regulatory Agency until June 2001. Company officials said they had no audited financial statements for 1999 and 2000. The 2004 statement isn't ready yet.

The records show revenue rises from nothing in 2001, when construction on the system had barely begun, to \$122,464 the following year to \$675,477 in 2003. But operating expenses were soaring at the same time — from \$3.54 million in 2001 to nearly \$5 million two years later.

The company's cost of sales, meaning the amount it spent gathering new customers, grew less onerous as work on the fiber-optic network progressed, the figures show.

In 2002, the company spent nearly \$7 for every \$1 in revenue it collected. By the following year, sales costs amounted to slightly less than \$2 for every dollar in revenue.

In the early going, much of Networkx's cash went to consultants and lawyers. In 2001, fully 55 percent of the operating budget was consumed by consulting fees (\$1.3 million) and professional fees (\$637,504).

Ward Huddleston, the first CEO of Networkx, said much of that spending was unavoidable because of the unexpected difficulties in getting franchise approval by the City Council and the TRA license. The state approval, which took a year and a half, was held up when competitors intervened.

Throughout the licensing process, the state required Networkx to maintain certain staffing levels even though there was little or no work for some of the employees to do until the approval came, Huddleston said.

"The delay cost several million dollars in staff and legal expenses," he said.

The money to top-drawer consulting firms such as Arthur D. Little paid for highly complex spreadsheets and business plans detailing possible services to be offered and the charges for them.

Those costs multiplied when turmoil in the industry prompted the development of alternative plans after a new management team came aboard, Huddleston said.

MLGW had launched the telecom venture during the boom of the late-1990s. But by the time the state licensing was approved, the industry had begun to implode amid high-profile bankruptcies and scandals.

The overall economy, already in recession, was about to be further convulsed by the Sept. 11, 2001, attacks.

For telecom firms like Networkx, those conditions dried up sources for investment capital.

In the 1990s, "you could walk down Wall Street and say 'telecom,' and someone would throw money at you," said Ed Horrell, a Memphis author, speaker and consultant on telecom issues who has worked for MLGW and Networkx.

Networkx didn't get started until a "nuclear winter" had descended on the telecom industry, bankrupting many firms, Horrell said.

Although he was retained for several months as a vice president, Huddleston said he was ousted as CEO in July 2001 after a group of private partners — an entity involving the Memphis Angels, a capital investment group — joined Networkx.

Huddleston and other former Networkx officials say that after the new team took over, at least four executives — none of them still with the firm — commuted for more than a year from homes in St. Louis and Atlanta. Networkx picked up the travel costs.

The financial statements don't show individual salary levels for executives. Huddleston said he was making \$120,000 a year, but salaries for the incoming team were "much, much higher."

Ivie, who replaced Huddleston, declined to specify his salary. But he did say he agreed to take a recent pay cut.

In July 2002, Luke Yancy, who represented a group of minority investors in Networkx, wrote a letter to MLGW president Herman Morris complaining of "out-of-control spending" at the firm. He cited bonuses, immediate pension plan-vesting and indefinitely extended housing allowances for executives.

Yancy later issued a statement saying his concerns had been dealt with. Efforts in recent days to contact Yancy, now a Networkx board member, have been unsuccessful.

The financial statements indicate a drop in total payroll from \$2.25 million in 2002 to \$1.97 million the following year.

Ivie said Networkx, which now has about 20 employees, experienced another 10 percent drop in payroll last year.

"We run this very much like it is — a startup business that is very conscientious about how it spends stakeholders' money," Ivie said.

For all the troubles Networkx has experienced, officials say its system is well designed and provides good service.

"It's a well-built, tight network," Horrell said.

"Could it have been built for less? It's like saying, 'Could your house have been built for less?' Probably so."

The major challenge facing Networkx now is competition.

But Ivie contends his small company has the advantage of being nimble and able to respond quickly to market changes. He said Networkx should enjoy its first full year of profitability in 2006 and possibly begin returning dividends to MLGW in 2007.

Ivie said it would be a mistake for the utility to sell its ownership in Networkx now. The continuing turmoil in the telecom industry means it's unlikely MLGW could get much of its money back from a buyer.

In its search for new financing, the company could draw more than \$3 million from the total MLGW investment cap of \$32 million approved by the utility's board and City Council in 2002. But Networkx board member and MLGW chief financial officer John McCullough said the firm would ask the utility's board before doing so.

Whatever its past troubles, Networkx has accomplished a lot just by surviving and growing in an industry where so many companies went under, Ivie said.

"We're a success story," he said.

— Tom Charlier: 529-2572

Networkx loses line of credit

MLGW no longer majority owner

By Bill Dries
dries@commercialappeal.com

The City Council cut off the public line of credit to Memphis Networkx, the telecom venture Memphis Light, Gas and Water Division owned 83 percent of until Tuesday's council vote.

The \$6 million line of credit the utility wanted would have been used to guarantee bank loans the company said it was about to secure.

But after approving \$32 million of ratepayers' money for Networkx since it was founded in 1999 and watching the company lose money every year, six of 11 council members present decided to turn down a third round of financing.

"I still don't know what you did with the money," council member Joe Brown told utility and Networkx officials. "I can't vote on something I can't see."

The council's decision means that MLGW's ownership share falls to 48 percent and a private investors group becomes majority owners, said Mark Ivie, Networkx chief executive officer.

"The real situation here is less about Memphis Networkx and all about MLGW's ownership stake in the company," Ivie said. "Regardless of what happens today, Memphis Networkx will get the funds that it needs to continue to grow the busi-

See NETWORKX, B2

Continued from page B1

NETWORKX

ness."

Networkx provides wholesale and retail telecom services over a high-speed, fiber optic network. It competes with similar services offered by private firms.

Ivie and MLGW president Joseph Lee forecast that the company should break even by the end of this year. But financial statements reviewed by The Commercial Appeal show losses at the company grew steadily from 2001 through 2003, with costs for connecting new customers nearly twice as much as the revenue it received from them.

Council members pointed to the losses and a lack of public disclosure of specific financial data in turning down the line of credit that had been approved by the MLGW board last month.

When Brown asked Ivie for gross receipts, Ivie "respectfully" declined to answer, saying the information would benefit

competitors.

"Then respectfully I decline to vote for this," Brown answered.

Council member Jack Sammons said if it was his money he would not invest further in the venture.

"I think it would be nearly impossible to communicate to the public that we're making an appropriate decision to put \$6 million in an endeavor so that our children, perhaps, may experience a profitable situation."

Council member Barbara Swearengen Holt favored the line of credit as a way of protecting the city's investment, but admitted it was a "hard sell."

"A burned child fears the fire. And we've really been burned."

Lee, who was not president of the utility when Networkx was founded, acknowledged his own reluctance. "But for the fact that we made the investment, I wouldn't be here," he told council members before the vote. "If this fails, the council won't see me up here any more asking for money for Memphis Networkx."

— Bill Dries, 529-2643

GREATER MEMPHIS

THE COMMERCIAL APPEAL | FRIDAY, APRIL 22, 2005

Memphis & Region

Visible Schools: Raising awareness and money | B3

DAYBREAK/02

DEATHS/B4-5

VIEWPOINT/B6-7



Boost sought for Networx

MLGW board OK's \$6 million

By **BILL DRIES**

dries@commercialappeal.com

Memphis Light, Gas and Water Division's line of credit for its telecom venture Memphis Networx would increase by \$6 million under a resolution approved Thursday by the utility's board.

The increase to \$38 million requires City Council approval. The MLGW board and City Council would have to approve any use of the loan money whether or not the line of credit is increased.

Networx provides wholesale and retail telecom services over a high-speed, fiber optic network. It competes with similar services offered by BellSouth and Time Warner Cable, private firms.

The six-year-old company has lost at least \$21 million. It has spent about \$29 million of its loan from the utility.

MLGW officials said Networx is about to close on a private loan, and increasing the cap would help guarantee that financing.

MLGW chief financial officer John McCullough, who also sits on the Networx board, said Thursday the company, of which MLGW owns 80 percent, is "close to being self-sufficient."

Board member Lynn Evans called for a financial projection of the firm's finances and a plan for retiring its debt.

Council approval may be tough given the city's budget problems and past council debates about Memphis Networx.

Every proposal for funding is being scrutinized by the council after Mayor Willie Herenton this week proposed a 54-cent increase in the property tax rate.

In the past, several council members have been vocal in their specific opposition to raising the cap on the loan.

— Bill Dries: 529-2643

THE COMMERCIAL APPEAL

TUESDAY, JUNE 12, 2007 | COMMERCIALAPPEAL.COM

MLGW eats loss in sale of Networx

Bitter fare: Nearly all \$29M

By MICHAEL ERSKINE
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What was billed as a smart investment for Memphis' publicly owned utility company in 1999 is proving to be a financial boondoggle for ratepayers.

Memphis Light, Gas and Water Division would lose nearly all of its roughly \$29 million investment in the public-private venture called Memphis Networx if a proposed sale of the fiber-optics firm is approved.

MLGW confirmed late Monday that an agreement has been reached to sell Networx to a Colorado holding company for \$11.5 million.

But according to early projections, after Networx's debts are retired, fees are paid and other adjustments made, just about \$2 million will be left over for its investors.

MLGW will get back just \$994,000 of its \$28.6 million investment. Networx's private investors, who include a group of wealthy and well-connected area businessmen, are

projected to receive about \$1 million.

"It's a horrendous loss for the ratepayers of MLGW," said utility board member Nick Clark, who also sits on the Networx board.

Despite initial projections that Networx could eventually generate \$16 million or more in annual revenues for MLGW, Networx never returned a profit to its investors.

MLGW's interim chief utility officer Jerry Collins said Monday the proposed sale is "most assuredly" in the best interest of ratepayers, though he declined to comment on the financial details.

Collins, who just started in the MLGW post last week, said MLGW decided to sell Networx because the fiber-optics company needs additional investments to ensure its continued growth and expansion.

"This is a junction in which Networx needs additional cash, and we're not in a position to provide them with that cash," Collins said.

Clark said it was apparent when he joined the Networx board 2 1/2 years ago that there had been a "very substantial loss of value" in MLGW's investment in Networx, which brought the market value of the company down to about \$5 million.

And the national market for these types of sales has not recovered since the 2001 technology meltdown, Clark said.

"The Networx board recommended selling Networx at this time because it was believed that a public-private partnership was an impediment to securing additional capital, and that we needed to be honest with ourselves and the respective partners as to what the market value was," Clark said.

Approval for the sale will go before MLGW's board of commissioners on June 21. The transaction will also require approval of the Tennessee Regulatory Authority.

The buyer is Communications Infrastructure Investments (CII), a Boulder-based holding company. CII's five institutional investors — Battery Ventures, Centennial Venture, Columbia Capital, M/C Venture Partners and Oak Investment Partners — have earmarked \$225 million for the holding company, said CII co-founder

Dan Caruso.

The Commercial Appeal reported Sunday that MLGW and its private partners were deep into negotiations to sell Networx to an unidentified Colorado firm. Networx board members and utility officials declined comment, even though an agreement to sell the firm already had been reached last week.

MLGW launched Networx in late 1999, initially pledging \$20 million to the startup in an attempt to capitalize on the telecom boom of the 1990s.

A group called Memphis Broadband, whose investors included FedEx chairman and founder Frederick W. Smith, AutoZone founder J.R. Pitt Hyde and William B. Dunavant Jr. of Dunavant Enterprises, joined as partners in Networx in 2000.

The utility later boosted its approved maximum investment to \$32 million — about \$28.5 million of which has been spent — as Networx built a fiber-optic "backbone" network to serve business and institutional customers with an array of high-speed data services.

Memphis Networx would be just the second acquisition of the newly formed CII.

In May, CII announced plans to acquire PPL Telecom, a subsidiary of Allentown, Pa.-based energy company PPL Corp., in a deal valued at \$60 million.

Caruso said he sees promise for both PPL Telecom and Networx under the umbrella of his company, which he said plans to further invest in and grow the firms.

He said the sale would be a "positive event for the Memphis" employees.

"This network got built like many other networks got built during the early 2000s, when the telecom boom was in progress and the dot-com boom was happening," Caruso said. "They invested a lot in those years and then they had to get through a tough period. ... It was tough times for the entire industry and Memphis Networx was no different."

"... You can't always turn back the clock of time to the pre-telecom boom era," he said. "What we need to do, what are we going to do is we're going forward. ... We see ourselves as longtime operators."

— Michael Erskine: 529-5857

(Boulder) Daily Camera
business writer Alicia Wallace
contributed to this story.

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Networkx Down

Why is Memphis throwing away \$29 million?

Let's begin with a very simple statement of facts: MLGW, Memphis' taxpayer-owned public utility, has invested somewhere in the neighborhood of \$30 million in a fiber-optic system called Memphis Networkx. It has co-owned Networkx for eight years with a group of prominent Mid-South business leaders incorporated under the name Memphis Broadband LLC. MLGW is now selling its share in Networkx for \$994,000 to Communications Infrastructure Investments (CII), a telecom-savvy holding company in Denver, Colorado.

To be more accurate, CII is paying \$11.5 million for the company and the majority of its assets. After debt retirement, the private investors get to split \$2 million among them while the city of Memphis gets a hard rock to suck on. To date, MLGW's accounting for this unprecedented mishandling of rate-payer money amounts to little more than an official "oopsie." Yet somehow, public outrage seems minimal.

If people are confused, it's little wonder. Networkx has always been something of a mystery, and media coverage of the hastily announced sale has been skeletal at best, conflating at every turn the interests of the private investors (profit) with the public concern and the historic function of a civic utility (sustainability and service). Reports of the sale have further confounded the issue by questioning the wisdom of MLGW's initial entrance into the telecom industry, rather than exploring the circumstances surrounding its hasty, financially devastating exit. Again, let's take things slowly.

Memphians don't know what Networkx is, and it's tempting to suggest that's by design. The company was never intended to be a service provider, though it sold itself to the city with fairy tales about bringing high-speed communication to underserved areas and — as one member of the City Council put it — "the Internet to poor people." If our civic leaders had bothered to read the fine print, they would have known that the company's promises were predicated on Networkx turning a profit. And, from a net perspective, it never did.

So what exactly is Memphis Networkx? Pretend that the market for drinking water is fragmented, with many different providers each claiming to have the tastiest, cleanest, best water.

The problem is, they don't have a way to get their product to the customer. The providers don't want to cut their profits by spending the capital to install a better delivery system, so the city builds its own pipeline and rents that system to the providers, who in turn sell water to the citizens. Some of the providers sue the city, fearing that it will become a competing water provider with an unfair advantage over the private sector. Replace the word "water" with "digital technology" and you'll have a rudimentary understanding of what Memphis Networkx does.

Memphis Networkx is a loop of 144 high-speed fibers running underneath the entire city. In addition to the subterranean fiber, Networkx' major physical assets include a secure, earthquake-proof data center with a satellite hookup and a pair of 2,000-gallon diesel generators in case the power goes out and a lot of high-tech gadgetry.

So what went amiss? According to MLGW commissioner and Networkx board member Nick Clark, the technology and business plan began to fail in 2002, but that's merely a signpost pointing the way to the current precipitous juncture.

Private venture capitalists and public utilities have a very different set of expectations. Public utilities plan over a 50-year horizon, according to Herman Morris, who was president of MLGW when Networkx was created in 1999. Venture capitalists expect to see a return in three to five years. To that extent, Networkx was handicapped out of the gate when the licensing process was drag out over 18 months by telecoms like Time Warner, which wanted to prevent Memphis from obtaining a competitive edge in the industry. By the time Networkx was fully launched in 2001, the telecom-industry boom was nearing collapse. But the problem cuts deeper.

Networkx could have started out on a better foot by doing some of the good things it promised, like bringing Internet connections to underprivileged neighborhoods. The profits wouldn't have shown up right away, but such a move would have given the company a civic-oriented face. It would have built brand awareness and pride within the community. But all of these positive developments were predicated on eventual profits. However, big bonuses for executives were not tied to profits,

neither were generous housing expenses, instantly vested retirement plans, or fat, private-sector salaries. And all of this rampant spending was going on back when MLGW still owned an 80 percent share in the company it couldn't watchdog or control.

In June 2005, MLGW president Joseph Lee, who was no fan of the Networx deal, put his personal reservations aside and lobbied the city to put more funds into the company.

"We don't believe that having a \$32 million stake in [Networx] and failing to get a \$6 million loan guarantee should result in us losing such a strong equity position," he said, stressing the value of the Memphis utility's majority share in the public/private telecom venture. But the City Council, unable to see where all the money had gone, refused to provide Networx with additional finances. At that point, MLGW's 80 percent share dropped to 49 percent, and Networx became virtually invisible. As projected, however, Networx posted its first, miniscule profit for the 2005 business cycle. The news went largely unheralded.

Clark admits that he's harbored concern for Networx' fiscal health for over two years. Why didn't he say anything about it? Because "that information was not required to be publicly revealed."

Responding to mild, if somewhat misdirected, criticism posted by media critic Richard Thompson at mediaverse-memphis.blogspot.com, Clark wrote, "The very act of publicly commenting on the financial stresses of a venture capital entity can have the adverse consequences of causing the opposite of what is in the best interest of the rate-payers." So instead of commenting, and potentially scaring off, a few Networx customers, Clark and MLGW CFO John McCullough kept mum.

Clark recently released all of Memphis Networx' financial summaries to the media, but the broad numbers don't retroactively explain even half the story. Clark was simply playing by the rules as they were established on day one. What's private is private, and what the private side does with the public's money is also private.

What's frustrating is that there were provisions in the Networx operating agreement that would have allowed MLGW to break off its relationship with Memphis Broadband to seek other partners or operate the network independently with greater transparency and oversight. Based on the current deal, MLGW could have paid the private investors \$2 million and become its sole owner. In debt, yes. In dire need of capital, yes. But also subject to the same open-financial-records policy as any other taxpayer-owned entity.

All that is history now. But it is imperative that

Memphians — and their government representatives — understand that dumping Networx at a \$29 million loss would be a big mistake. Two independent sources have confirmed that Memphis' telecom property was a major factor in enticing ServiceMaster to relocate much of its operations here. Although that doesn't show up on Networx' ledger as a profit, it's a significant return on the city's investment, and there's more where that came from. It's also difficult to place a value on the streamlined linking of Memphis' fire and police departments and the benefits and savings that might be realized by using Networx' data center to centralize more of the city's sprawling IT network. Businesses are going to continue to require data security and storage. Across the country, broadband will expand, and in broadband-poor cities like Memphis, it will expand spectacularly.

There are many questions remaining to be answered concerning the Networx deal: Why did the company obliterate its sales staff? Who is COO Dan Platko, and why does he live in Atlanta (or Denver, depending on whom you ask or which online networking tools you trust). Why weren't local investors given first dibs on the deal? But the biggest question is a simple "why." After scraping its way to near sustainability and surviving to the point where broadband is a necessity and municipal wireless is catching on, why sell Networx now? ■

"Give light and the people will find their own way."



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Memphis Publishing Company, 495 Union Ave., Memphis, TN 38103

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The Avalanche, 1867

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EDITORIALS

Networkx sale needs review

NOT SO FAST

MLGW's board shouldn't rush to sell Memphis Networkx while City Council members still have questions.

IF YOU WERE BUYING a car and the salesman said you had to close the deal immediately or the asking price would go up, you might be a little suspicious.

That analogy works just as well for the proposed sale of Memphis Networkx, a joint venture between the city-owned utility company and a group of private investors.

The Memphis Light, Gas and Water Division's board of commissioners is being asked to sign off on a deal today to sell the financially plagued telecom business to a Colorado company for \$11.5 million.

After paying off debts and other expenses and giving the private investors their share of the sale proceeds, MLGW would get a little less than \$1 million. That would be a whopping loss on a \$28.6 million investment of ratepayer funds.

But it gets worse: There's a clause in the proposed sale agreement that says if the deal requires approval from the Memphis City Council, the Colorado company will drop its offer by \$1 million.

That's a huge red flag. If this deal is on the up and up, it should be able to withstand a little public scrutiny.

At a meeting Tuesday, council members asked the MLGW board to delay its approval of the sale until some questions can be answered.

Like, oh, let's see, is the Colorado company's offer really the best one out there?

At least one other prospective buyer claims to be willing to pay more. That certainly bears checking out.

Also, council members are right to ask for answers to some of their other questions about Memphis Networkx's operations. Among them, why didn't the venture show profits as quickly as they were expected? Was some of MLGW's money misspent on excessive corporate salaries or other ill-advised expenses?

How will MLGW's private partners fare in the deal? Will some of them walk away with profits while others essentially get cleaned out? If so, who's profiting from this?

After the sale goes through, the council's ability to get answers to those questions will be all but lost.

At that point, Memphis Networkx will be a privately held company without ties to Memphis city government.

Before that happens, council members owe it to their constituents to get as much information as they can about what went wrong with this venture, so future mistakes can be avoided.

Technically, the MLGW board could approve the deal in spite of the council's wishes for more review.

But MLGW commissioners must surely realize how a move like that could backfire since the council approves their budget each year.

It may be too late to recover MLGW's investment in this project. It's not too late to try to learn from it.

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EDITORIALS

Networkx needs council's input

WHAT'S THE RUSH?

A decision that involves the loss of almost \$28.6 million in public funds should be reviewed by a body that's accountable to voters.

THE SAD SAGA of Memphis Networkx hasn't produced many heroes, but City Atty. Elbert Jefferson Jr. just might qualify.

On Thursday, Jefferson informed the Memphis Light, Gas and Water Division board that the City Council would have to sign off, at least indirectly, on a deal to sell the telecommunications venture.

Jefferson pointed out that telecom businesses must have franchise agreements in order to operate in the city.

And because a change of ownership would require an amendment to the Memphis Networkx franchise agreement, Jefferson concluded that council approval would be

required.

That's good news, particularly since the council's own attorney, Allan Wade, had said last month that the council couldn't stop the sale.

The MLGW board agreed Thursday to sell Memphis Networkx to a Colorado company called Communications Infrastructure Investments, subject to approval from the Tennessee Regulatory Authority. But the board vote was only 2-1, with commissioners Rick Masson and Nick Clark voting yes, Lynn Evans voting no and Bill Taylor abstaining.

Since Clark also serves on the Memphis Networkx board, it's debatable whether he should have abstained from the vote as well.

In any case, if the transaction is completed, MLGW stands to lose almost all of the \$28.6 million in ratepayer funds that have been invested in this enterprise.

That's a big decision for two people to make — and the MLGW commissioners aren't elected by anyone.

It only seems right that the council, which is elected by the public, should have some say-so about the proposed sale. It's unfortunate that Memphis Networkx was put up for bids before council members were brought into the loop in the first place.

Now, at the very least, council members should have an opportunity to discuss the bids that have been submitted and determine if CII's offer is really the best one.

There are some legitimate questions about why The McLean Group, an investment banking firm hired to evaluate the bids, recommended CII over two other bidders that offered more money.

For example, American Fiber Systems claims its bid would give MLGW \$350,000 more in cash, plus stock reportedly worth \$3 million.

Also, The McLean Group was dismissive of BTI Corporate's higher bid due to a supposed lack of financing, but a BTI representative has said his firm has lined up pledges from banks.

MLGW board members were told they needed to unload Memphis Networkx quickly, because the financially struggling enterprise only has about 30 to 45 days' worth of cash on hand. Well, from the perspective of MLGW's ratepayers, so what?

As it stands, those ratepayers would lose virtually everything they've invested in Memphis Networkx. That being the case, there's no harm in having the council give this transaction the kind of careful scrutiny it deserves.

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Lifting Networkx information tap

STATE GETS INVOLVED

Pressure is building for an accounting of what went wrong with an investment that cost the public \$28 million.

WITH A CITY COUNCIL AUDIT in the works and state regulatory authorities looking over their shoulders, Memphis Networkx officials should finally be getting the message.

Concealing information about the fiber optics venture founded by Memphis Light, Gas and Water Division has been counterproductive and needs to end.

Two members of the MLGW board approved the sale of Networkx to Colorado-based Communications Infrastructure Investments for \$11.5 million on July 5. One member voted against it, and another didn't participate in the vote.

The sale price leaves less than \$1 million for MLGW and its customers, who have put more than \$28 million into the venture.

The company has released some of the documents related to its finances.

Last week, however, the Memphis City Council voted to spend up to \$33,000 for an audit. The council has given up on its efforts to delay the sale, but still believes the public deserves information about why Networkx failed and so much money was lost. Information released so far does not paint the complete picture.

And the Tennessee Regulatory Authority, which must approve the sale, asked Networkx and MLGW to answer questions about such issues as the identities of its other investors, its customers, creditors, employees and the salaries and perks paid to Networkx executives.

Members of the Shelby County legislative delegation have been pressing the TRA to wring more information from Memphis Networkx.

The TRA is properly playing its role in the process, not rushing into approval of the change of control petition filed by an attorney for CII on July 27. The TRA has requested answers from officials of the company and MLGW by Aug. 28.

An effort to block the sale has been filed in Chancery Court by American Fiber Systems, an unsuccessful bidder in the hastily arranged sale.

Its petition contends that City Council approval is legally required for the sale to go through.

And state legislators concerned about the deal also have requested an investigative hearing on the business partnership between MLGW and Memphis Networkx.

If more information is not produced in a timely manner, a hearing could prove useful. MLGW ratepayers have no way of knowing if the utility has been treated fairly in the financial freefall at the company or if the investment turned into a windfall for someone else.

The company has put up a good fight, but it's past time that MLGW ratepayers were fully informed about what happened to their money.