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MEMORANDUM

TO: LSI Seminar Participants

FROM: Jeremy H. Stern, Esq.
William F. Bly, Esq.

DATE: November 21, 2003

RE: **MuniToons©: The Folly of Municipal Ownership of Broadband Facilities**

I. Background on Municipal Ownership of Cable and Telecommunications Systems

The roots of municipal ownership of cable systems trace back to the early days of the cable industry, when cable pioneers began laying down cable and charging a fee for television service that was otherwise provided for free from over-the-air broadcasters. In that era, when satellite service had not yet been introduced, and "CATV" was just a fledgling industry, municipal ownership provided a means for delivering television signals to largely rural areas that had poor broadcast reception and insufficient subscriber density to attract investment from private cable companies.¹ Municipal ownership thus provided a means for delivering television service to homes that otherwise would have virtually no service at all.

Over the last twenty years, however, the industry has changed dramatically, with CATV evolving from a mere antenna service in rural America to a source of new networks and original programming available to rural and urban customers. The changes in the last decade alone have been even more stunning, with the launch of Direct-To-Home satellite service—one of the most highly successful consumer product launches ever, and with the creation of "broadband" cable providing advanced digital services, such as digital television, high-speed Internet service, and telephony. In the midst of this transformation, Congress passed the Telecommunications Act of

¹ A survey conducted by the National Civic Review reported that in 1981 twenty-eight municipally owned cable systems were in operation. Of these twenty-eight communities, seventeen had fewer than 2,500 residents and twelve had fewer than 1,000 residents. Carl R. Ramey, *The Cable Act and Municipal Ownership: A Growing First Amendment Confrontation*, 46 Fed. Comm. L.J. 147, 156 (1993) (citing David W. MacKenna, *The Cabling of America: What About Municipal Ownership?*, Nat'l Civic Rev. 307, 310 (1981)). A review of the 2002 Cable Factbook and the 2002 American Public Power Association Directory found 32 municipal electric divisions offering cable service.

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1996, which opened the door to competition in the telecommunications industry, and added fuel to the boom and bust cycle of the 1990s and early part of this century.

During the heyday of the Post-1996 Act boom cycle, municipalities began articulating new arguments for entering the telecommunications industry, and indeed many large urban municipalities entered the market.² They saw a new “gold rush” in telecommunications and wanted in on the action. Thus, many began to view municipal ownership as a potentially valuable source of additional revenue and a logical extension of municipal ownership of traditional utilities, such as water, gas and electric. They also believed that they could speed the delivery of new services to their residents by deploying necessary infrastructure themselves, rather than waiting for industry to do it for them, and inject new competition into the industry.³

Is there any basis for these new arguments for municipal ownership? Are they based on fact, or mere folly? As set forth below, the evidence from case studies of municipal ownership suggests the latter. Moreover, municipal ownership of cable facilities as a means for providing competition in the cable television industry raises serious fairness and First Amendment concerns. Is it fair for an industry regulator to compete against the entities it regulates? Is ownership by the government of an increasingly important vehicle for delivering media content consistent with the parameters and intent of the First Amendment? The answer to both of these questions is no.

² “In recent years, larger communities have gotten into the act, with municipal cable systems now in operation or under development in larger cities, including Gainesville, Florida and Tacoma, Washington, and in suburban/exurban locations like Braintree, Massachusetts and Newnan, Georgia. Jeffrey A. Eisenach, Ph.D, *Does Government Belong in the Telecom Business?*, page 7, Progress on Point, Release 8.1 (Progress and Freedom Foundation January 2001) (“Eisenach Report”). Municipal utilities are also beginning to provide telecommunications services, such as fiber leasing, local dial tone and long distance telephone service. As of 2000, 58 municipal utilities are leasing fiber, 18 are providing local telephone service, 10 are offering long distance service, 61 are offering ISP services, and 32 are providing high-speed data service. *Id.* Most recently, the State of Connecticut granted the State’s first municipal cable overbuilder a franchise to compete with the private incumbent operator. *See Docket No. 02-02-18, Application of Groton Utilities*, Decision (Ct. D.P.U.C. Oct. 22, 2003).

³ One study published in 1997 and updated in 1998 provided the following three reasons for municipal entry into the market: (1) fill in for a lack of quality service at an acceptable rate from the incumbent provider; (2) provide an economic benefit to the community by generating revenue to fund other services, and/or providing an incentive for new business development; and (3) provide a new source of revenue for the utility company. *Municipal Overbuilds: What Can You Do About Them*, CATA Brief, 1997-8, page 2 (November 1997, Revised as of October 21, 1998) (“CATA Brief”). Another study conducted by two professors at the University of Denver provided the following rationales for municipal entry into the telecommunications industry: (1) provide telecommunications infrastructure to enhance the municipalities electric power utility through demand side management; (2) provide additional revenue streams to replace revenues lost through the deregulation of the electric utility industry; (3) ensure that the community receives advanced telecommunication services; and (4) inject competition in the local telecommunications industries. Ronald J. Rizzuto and Michael O. Wirth, *Costs, Benefits, and Long-Term Sustainability of Municipal Cable Television Overbuilds*, page 1 (GSA Press, Denver, CO 1998) (“Denver Report”).

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II. Can Municipalities Really Do More For Less? The Truth About the Alleged Benefits of Municipal Ownership

Those that argue in favor of municipal ownership of broadband facilities tend to view those systems as a logical extension of other municipally-owned utilities, such as gas, electric or water,⁴ or as a source of new general fund revenues.⁵ They also view telecommunications infrastructure in the same manner as traditional infrastructure such as roads and highways.⁶ In so doing, these advocates often overlook many of the unique aspects of the business of providing broadband services and fail to recognize the significant disadvantages to municipal ownership of broadband systems. For example, providing cable television services does not merely involve stringing up a cable plant and turning on a switch and billing customers. The operator must determine what content to provide on its system (a task for which government is ill-suited) and then must negotiate sophisticated retransmission consent agreements with content providers in order to obtain content for the system. Large cable operators are able to promise content providers a large subscriber base, and thus have the ability to obtain more favorable carriage terms than municipally-owned systems. Moreover, large cable operators benefit significantly from economies of scale that allow them to spread administrative and operating costs over a larger revenue base.

In addition, municipalities that take customers away from the incumbent cable operators lose franchise fees (five percent of gross revenue) that the incumbent provides the City. And if the municipality ends up buying out the incumbent, which has happened in some locations,⁷ the municipality loses significant public benefits provided by the incumbent, such as grants for Public, Educational and Governmental Access, I-Nets, and taxes. Furthermore, from a state tax perspective, municipal ownership has the effect of robbing Peter to pay Paul. Municipalization of telecommunications facilities removes private sector assets from the tax base, thereby impacting state funds available to county governments and school districts. Ultimately, the taxpayers are harmed by this.

Even in situations where the municipality charges lower rates than the incumbent, these “savings” come at the expense of the financial health of the municipal utility or taxpayers, who must shoulder the burden of filling the gap between costs and revenues. It should come as no

⁴ See, e.g., Carlson, Steven C., “A Historical Economic, and Legal Analysis of Municipal Ownership of the Information Highway,” 25 Rutgers Computer & Tech. L.J. 1 (1999).

⁵ *Municipalization and Subsidized Utility Competition—The Taxpayers Perspective*, Cal-Tax Digest (California Taxpayer’s Association, April 1997) (“Cal-Tax Report”).

⁶ *Id.*

⁷ See, e.g., Rizzuto, Ronald J., *Municipal Telecommunication Overbuilds: The Track Record and New Incarnations*, page 8 (University of Denver February 28, 2002) (“Denver Report Update”).

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surprise then, that the following studies of municipally-owned broadband facilities show that in most circumstances municipal ownership is a poor public policy and economic choice.

- **Denver Report**

In 1998 two professors from the University of Denver completed a case study of four municipally-owned cable systems.⁸ This report concluded that municipal ownership of cable systems was generally not a good business decision. First, it concluded that none of the four systems that were analyzed were sustainable over the long run because each currently has, and has had, cash flow gaps. In order to be sustainable, each would have to either commit permanent subsidies for their cable operation or increase cash flow by increasing rates or subscribership, or by finding a new revenue stream.⁹ Second, the study found that all but one of the systems (Cedar Falls, Iowa) would have to upgrade its system to remain competitive with DBS in their core video business.¹⁰ Third, the study found that the systems studied appeared to create rate savings for their customers, but that these savings were, in reality, an illusion:

They are an illusion because, as noted earlier, the municipal cable system is not financially self-sustaining. These municipal power companies have had to subsidize operating expenses and capital expenditures, provide interest-free loans and levy taxes in order to keep cable rates low. If municipal power companies eliminated the subsidies by raising cable rates, the cable rate savings would be reduced substantially, particularly in Glasgow, Paragould and Cedar Falls.

In Negaunee, the elimination of subsidies would have only a small impact on cable rate savings. The hidden cost in Negaunee is deferred technological reinvestment. Instead of reinvesting to modernize the plant, Negaunee has kept cable rates low. As a consequence, Negaunee has only a 35-channel analog system with two premium channels. There is no pay-per-view, digital video or data/Internet access capability.¹¹

⁸ Denver Report, *supra*, at note 3.

⁹ Denver Report at 4.

¹⁰ *Id.*

¹¹ *Id.* at 5.

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- **Updated Denver Report**

Dr. Rizzuto, one of the authors of the Denver Report, provided an update in a PowerPoint presentation he submitted at the Great Lakes Cable Expo in Indianapolis on February 28, 2002.¹² Dr. Rizzuto divided his analysis into two categories: (1) Traditional Municipal Cable Telecommunications Overbuilds;¹³ and (2) New Types of Telecommunications Overbuilds.¹⁴ With regard to the first category, Dr. Rizzuto concluded, among other things, that municipally-owned telecommunications systems have generated “cable rate savings,” but that the rate savings are not sustainable and, as he concluded in his earlier report, in fact an “illusion”:

Municipal power companies are willing to incur on-going negative cash flow, escalating debt levels, and increasing community taxes, additional subsidies and/or reduced reinvestment in telecommunication technology in order to maintain the illusion of large cable rate savings.

Dr. Rizzuto further concluded that in situations where the municipality prices its services very low, the incumbent cable operator often ends up selling out to the municipality,¹⁵ and that in moderate pricing situations the municipality generally does not generate enough revenue to maintain a state-of-the-art system.

The new telecommunication overbuilds that Dr. Rizzuto analyzed had not been in operation long enough for Dr. Rizzuto to reach definitive conclusions about their profitability; however, Dr. Rizzuto was able to provide some general comments. First, Dr. Rizzuto commented that a “data only” model is not likely to be viable as a stand-alone business. Second, Dr. Rizzuto commented a municipal system providing multiple revenue systems “looks like a commercial overbuilder strategy” and that this strategy “is still a work in progress.” Finally, Dr. Rizzuto questioned whether a municipality will have the proper discipline to manage the business, e.g., to make business decisions rather than political decisions.

¹² Denver Report Update, *supra*, footnote 6.

¹³ This category included four types of systems: (1) video only (low pricing), (2) video and data (low pricing), (3) video only (moderate pricing), and (4) video and data (moderate pricing). Denver Report Update, *supra*, page 3.

¹⁴ This category included case studies of three new systems: (1) Braintree, Massachusetts (data first, then video); (2) Glenwood Springs, Colorado (data only); (3) Coldwater, Michigan (video, data, voice and dial-up). Denver Report Update, *supra*, page 18.

¹⁵ Denver Report Update, page 16.

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- **CATA Brief**

A study prepared by the Cable Telecommunications Association also analyzed several municipally-owned telecommunications systems and similarly concluded that none had been successful.

No city has successfully operated its own system for more than five years without increased taxes or financial contributions from public funds. When municipal systems incur unanticipated expenses or fail to meet revenue expectations, the city has to make up the difference. Most often, this is accomplished by raising local taxes, issuing bonds obligating city revenues or, if the service is provided by a local utility, such as the power company, authorizing it to charge higher rates for its service in order to cover the cost of the cable service. The result is a “cable television tax” that is paid by everyone in the community whether they are customers of the municipal system, customers of the incumbent or competitive cable system, or aren’t cable customers at all.¹⁶

Along these lines, the CATA brief further quoted Barry Orton, a professor at the University of Wisconsin-Madison, and consultant for many municipalities as stating, “Most cities, when push comes to shove, find (municipal ownership) is too much work and it’s too much money.”¹⁷ Another municipal consultant, Al Powers of Carlisle, Iowa “warns cities to be aware of the risks of large, up-front costs, with no guarantee of recovery, before embarking on municipal ownership in competition with an incumbent operator.”¹⁸

- **California Tax Payers Association Study**

Regarding the City of Milpitas, California’s foray into a publicly-owned communications network, the California Tax Payers Association (“Cal-Tax”) questioned the financial viability of such a project. In particular, it cited a study conducted by Media Connections Group, a private consulting firm engaged by the City of Milpitas, which stated that the municipal communications network envisioned by the City “could not be operated successfully in a competitive environment by a commercial partner (of the City’s) unless very aggressive penetration levels are assumed for core telephone and/or cable services.”¹⁹

¹⁶ CATA Brief, *supra*, at 3.

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Cal-Tax Report, *supra*, page 13.

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The Cal-Tax Report noted that lower costs of municipal power derive from subsidies, not more efficient operations. The subsidies provided to government-owned electric utilities include: (1) exemption from federal and state income taxes; (2) exemption from other taxes (included property, gross receipts and excise taxes); (3) the ability to secure tax-exempt debt structures; (4) access to low-interest government loans and loan guarantees; and (5) preferential access to low-price federal power.²⁰ Indeed, one study estimated that removal of the tax and interest subsidies would increase municipal power rates by 16 to 17 percent.²¹ Tax payers are ultimately harmed because these subsidies cost money—their money.

- **CALNET**

CALNET was a state-owned telecommunications system designed by the State of California to connect state agencies and other public entities with modern telecommunications services while saving taxpayers money.²² The State of California lost so much money on CALNET, however, that it privatized the system in 1998.²³ In 1997, Lee Kerscher, California's deputy director for telecommunications and networks stated to a reporter, "We've had continued financial losses associated with Calnet. Suffice it to say the legislature when establishing Calnet expected to achieve significant savings and those savings have not occurred."²⁴ The CTPA reported the following conclusions reached by a December 1996 strategic plan prepared by the California Department of Information Technology, which recommended divesting the state-owned system, CALNET: (1) "Owning and operating telecommunications networks are neither core competencies nor core responsibilities of the state"; (2) "State-owned network infrastructures have proven costly and cannot keep pace with the rapid developments in telecommunications technology"; and (3) there was an "inability of CALNET to meet, at competitive cost, the service requirements of...state agencies."²⁵

- **Tri-Cities Referendum Initiative**

In some communities, residents are recognizing the dangers associated with municipal ownership and soundly rejecting their elected officials' attempts to engage in this type of folly.

²⁰ Cal-Tax Report, pages 5-6.

²¹ *Id.* (citing a 1994 study done by Putnam, Meyers & Bartlett, Inc., for the Edison Electric Institute).

²² Eisenach Report, page 14.

²³ *Id.*

²⁴ Eisenach Report, page 14 (citing Arielle Emmett, "John Thomas Flynn's California Network Nightmare," civic.com (April 1997) at www.fcw.com/civic/articles/1997/CIVIC_040197_21.asp.)

²⁵ Cal-Tax Report at 14.

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Earlier this year, the governing officials in three suburban-Chicago area communities banded together to promote what has been billed as “an ambitious, multimillion dollar plan” to construct a municipally run broadband system providing cable television, telephone and Internet services. The mayors of the Kane County cities of Batavia, Geneva and St. Charles endorsed this project in the hopes that it would provide a less expensive and more responsive telecommunications option. The local residents, however, were not quite as eager to put their tax dollars at risk. In April 2003, these cities asked the voters whether they favored the municipal broadband system estimated to cost the communities \$62 million and which would be backed by tax dollars. Approximately sixty percent of the voters on this referendum rejected the cities’ planned network.²⁶

III. The Regulator as Competitor—Is This Fair?

Aside from questions regarding the financial viability of municipal ownership, there are serious questions regarding the fairness of having a municipality, which has regulatory authority over broadband systems, compete with the entities it regulates. These concerns become even greater considering that many municipalities have offered artificially low rates at the expense of the taxpayers and the financial health of the municipal utilities, and that in those situations the incumbent cable operator has often sold out to the municipality.²⁷

A. Overview of Municipal Regulatory Authority

A municipality has extensive regulatory authority over a cable television system.²⁸ For example, a municipality is entitled to require a cable operator to enter into a franchise agreement that specifies the terms and conditions under which the cable operator may access the public rights-of-way.²⁹ Franchise agreements may require the cable operator, among other things, to pay franchise fees in an amount up to 5% of gross revenues; dedicate channels on their system for public, educational and governmental (“PEG”) access; make payments for PEG facilities and equipment; operate PEG studios; wire and serve public buildings and schools; post performance bonds; obtain insurance; provide detailed reports of its operations, and comply with customer service obligations. Cable operators may be fined for failing to comply with certain provisions of a franchise agreement, and serious breaches may be grounds for termination of the franchise, thereby terminating the operators’ right to own and operate the system. Cable operators also may be required to receive permission from a franchising authority to transfer the franchise—for example, upon a sale or merger—and must periodically renew their franchises.

²⁶ “Broadband Plans Heads To A Defeat,” Chicago Tribune, Apr. 2, 2003; “Broadband Idea Fails To Catch On,” Daily Herald, Apr. 2, 2003; “Voters Reject Broadband,” Kane County Herald, Apr. 2, 2003.

²⁷ Denver Report Update, pages 14-16.

²⁸ See Communications Act of 1934, as amended, 47 U.S.C. §§ 541-549.

²⁹ *Id.* at § 541.

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A municipality has significantly less regulatory authority over non-cable telecommunications services; however, the municipality still has authority to require permits for use of the rights-of-way, and may own the poles that are leased to the cable companies. Moreover, municipalities frequently argue that they have authority to regulate customer service for non-cable services, and in recent years it has been commonplace for local regulators to exceed their authority over telecommunications companies, by attempting to impose franchise-like requirements on telecommunications companies that seek use of the public rights-of-way.³⁰

B. Anti-Competitive Implications of Municipal Ownership

A municipality's entry into the cable television market presents special constitutional problems. In particular, the municipality's dual role as regulatory authority and chief competitor inherently raises questions implicating the cable operator's constitutional right to due process. This is because a cable operator's franchise may not be revoked, or not renewed, without affording the cable operator due process.³¹ To the extent that a municipality operates a competitive system in a manner that disadvantages the incumbent and either drives the incumbent out of business or to sell its system to the municipality, a due process violation may exist. Therefore, the specter of anti-competitive animus necessarily clouds any decision or policy the regulator makes that benefits the municipally owned system and/or disadvantages the existing operator.

For example, the municipality may dramatically add to the cost of providing service, micromanage customer service, and threaten continued operation of a system by invoking breach proceedings and imposing unreasonable demands during transfer and renewal proceedings. The

³⁰ One such situation was litigated in *City of Auburn v. Qwest Corp.*, 247 F.3d 966, *superceded on rehearing*, 260 F.3d 1160 (9th Cir. 2001), *cert. denied City of Tacoma v. Qwest Corp.*, 2002 U.S. LEXIS 232, 122 S. Ct. 809 (2002). In that case, Qwest challenged the requirements contained in telecommunications ordinances adopted by several Washington municipalities, including the Cities of Auburn, Olympia, and Tacoma, on the grounds that they violated state and federal limitations on municipal franchising of telecommunications providers. In the ordinances, which are typical of those advanced by municipal consultants nationwide, the municipalities sought to require telecommunications providers to: file an application containing detailed information unrelated to the rights-of-way; negotiate certain terms of the franchise with the cities; undertake extensive reporting and approval processes for transfers of ownership and stock; provide the municipalities with network capacity; and offer the municipalities favorable rates. The Ninth Circuit's opinion provides the most authoritative statement to date regarding the limitations on municipal telecommunications franchising. The court held that Section 253 of the Communications Act is a "virtually absolute" preemption on municipal franchise requirements. Section 253's "purpose is clear— certain aspects of telecommunications regulation are uniquely the province of the federal government and Congress has narrowly circumscribed the role of state and local governments in this arena." Accordingly, the court found that Section 253(c) "saves" only those municipal requirements that are "directly related to management of the rights-of-way."

³¹ See, e.g., *City of Issaquah v. Teleprompter Corp.*, 611 P.2d 741 (1980); *Teleprompter of Erie, Inc. v. City of Erie*, 537 F. Supp 6 (W.D. Pa. 1981); *Three Rivers Cablevision v. City of Pittsburgh*, 502 F. Supp 1118 (W.D. Pa. 1980); *Birmingham Cable Communications, Inc. v. City of Birmingham*, 1989 U.S. Dist. LEXIS 7475 (N.D. Ala. 1989).

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municipality also has the power to undercut the incumbent's rates at the expense of the municipality's taxpayers or municipal utility. In addition, when a municipality itself enters the broadband market, it has the power and strong incentive to disadvantage the incumbent and favor itself. Indeed, its very existence depends on its ability to take business away from the existing operator. This can, and often has, led to the municipally-owned utility driving out the incumbent.³²

However, few courts have considered the implications of municipal ownership on an operator's due process rights. In one case, *Warner Cable Communications, Inc. v. City of Niceville*,³³ Warner Cable challenged the municipality's decision to construct a cable television system, alleging, among other things, that the "City's conflict of interest, arising from its projected dual role as Warner's regulator and competitor prevents it from fairly and impartially regulating a company with which it hopes to eventually compete."³⁴ The court concluded that Warner Cable's due process claim was not ripe because the company had not pointed to any tainted decisions that implicated its due process rights. The court did not, however, "foreclose the possibility that the City's dual role as Warner's regulator and competitor might, in particular circumstances, give rise to a valid due process claim."³⁵ In fact, the court expressly noted that there might be some circumstances that would give rise to a valid claim:

If a dispute arises in which the City is called upon to be "complainant, jury, judge and 'executioner'" *Cruz v. Ferre*, 755 F.2d 1415, 1422 (11th Cir. 1985) (quoting *Cruz v. Ferre*, 571 F. Supp. 125, 133 (S.D. Fla. 1983)), there may exist an intolerably high risk of self-interested, unfair governmental action, particularly since the City's competitor in this case is a first amendment speaker. We recognized in *Cruz* that, because of the "potentially great impact upon first amendment rights[,]...regulation of communicative activity must adhere to more narrowly drawn procedures than regulation of ordinary communicative activity."³⁶

Another case, *USA Media Group v. Truckee Donner*,³⁷ provides an excellent example of the inherent conflicts and dangers of tainted decision-making a cable operator faces when a municipality decides to operate as both regulator and competitor. In this case, which settled in

³² Denver Report Update, page 16.

³³ 911 F.2d 634 (11th Cir. 1990).

³⁴ *Id.* at 640.

³⁵ *Id.* at 642.

³⁶ *Id.*

³⁷ Case No. 99-CV-2315 (E.D. Cal November 22, 1999).

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April 2003, the cable operator alleged that the Truckee Donner Public Utility District, a publicly owned utility, hindered the operator's attempt to upgrade its plant to provide high speed Internet access by making it difficult for the cable company to obtain access to the rights-of-way and enter into pole attachment agreements. Coincidentally, or maybe not so coincidentally, the city's municipally-owned electric utility also had plans to provide high speed Internet access.

Even before the suit settled, at least one board member of the TDPUD was quoted as saying that he thinks that the municipal system will put the existing operator out of business.³⁸ Since settlement, the TDPUD's plans have been delayed, while it attempted to find financing and underwriting. Three years into the project, the TDPUD is not yet able to serve customers and is looking at \$14 million in start up costs.³⁹ Perhaps taking a lesson from the failed Tri-Cities initiative, or perhaps recognizing the inherent risks to the local tax base, TDPUD has decided to forego public funding and has solicited private funding and underwriting.⁴⁰ In addition, TDPUD has decided to engage an outside, *private* company to provide the service packages. Is this a tacit, market-driven admission that a true public system is too risky a venture?

The Truckee system raises some other interesting questions. Will the City of Truckee fairly and evenly regulate both providers on non-discriminatory terms? How will the City deal with the inherent conflict of interest associated with the fact that it has a significant financial (as well as political) stake in one of the competitive entities it is regulating? To a large extent, the TDPUD's ability to recoup its start up expenses and achieve success in the broadband business necessarily depends on the existing operator's failure. With looming concerns that the district may have to raise the costs of other utilities to pay for the communications network, this case illustrates the potential for anti-competitive behavior that exists when the regulator is a competitor and owns and controls essential facilities such as the utility infrastructure.

Some communities are not shy about leveraging their positions as regulators. For example, the City of Healdton, Oklahoma recently launched a coaxial cable television system funded through municipal bonds. The Assistant City Manager touted the benefits of the municipal system by explaining that one of the reasons it was able to provide competitive services was because "there are no franchise fees added and, because we are a municipality, there is no tax added." Interestingly, Healdton's City Manager, in explaining the City's interest in municipal broadband, stated that the City's was interesting in "profiting from cable TV and Internet."⁴¹ What remains to be seen is whether the City will be able to generate enough profits

³⁸ "Utility Broadband Plan Moves Ahead," *Sierra Sun*, Feb. 27, 2003.

³⁹ "Utility broadband plan on tight schedule, original conduit sale agreement falls through in '11th hour,'" *Sierra Sun*, June 25, 2003.

⁴⁰ "Eagle Broadband Shifts Gears With Truckee Donner," *Broadband Business Report*, Nov. 18, 2003.

⁴¹ "Healdton Hopes To Tune In On Profit," *The Associated Press State & Local Wire*, Sept. 27, 2003.

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from the cable television system to cover the revenue in franchise fee and taxes that it otherwise would have collected from subscribers to the private system, without raising other taxes.

The anti-competitive implications of municipal ownership extend beyond the realm of communications network. For example, in *United States v. City of Stillwell*,⁴² the court prohibited the City of Stillwell, Oklahoma from requiring purchase of electric service as a condition of receiving water or sewer service. The case arose out of a complaint filed by the United States, which alleged that the city was involved in an illegal tying of services. Ultimately, the city consented to entry of judgment without trial or adjudication. Pursuant to the judgment, the city was “enjoined and restrained from requiring any consumer of electric energy to purchase retail electric service...as a condition of receiving water or sewer service...”⁴³ The city was also “enjoined and restrained from denying, withholding, or delaying any service, license or permit, or otherwise threatening, discriminating or retaliating against any person that has not agreed to purchase or does not purchase electric service...unless [the] reason for such conduct is unrelated to such person’s choice of retail electric provider.”⁴⁴ As more and more municipally-owned utilities branch into communications services, cable operators will be forced to become more and more vigilant to ensure that public utilities do not attempt to impose tying arrangements such as those described in *City of Stillwell* on communications services.

C. Alternatives To Dealing With The Anti-Competitive Threat

If a municipality does operate a system in an unfair manner that disadvantages the incumbent, one option for the incumbent, other than filing a due process claim or First Amendment Claim (as discussed below), is to seek a modification of its franchise under Section 625 of the Cable Act.⁴⁵ Under so-called “commercial impracticability” provisions of Section 625, a cable operator is entitled to demand a reduction in its existing franchise obligations if circumstances change in an unexpected manner. Such an application resulted in litigation in Naperville, Illinois.⁴⁶ In that case, when Naperville issued a more favorable franchise to an overbuilder—Ameritech New Media—the federal district court ruled that the incumbent was allowed to suspend access studio support, franchise fees, and other franchise obligations.

⁴² 1998 U.S. Dist. LEXIS 18203 (E.D. Ok. Nov. 5, 1998).

⁴³ *Id.* at 3.

⁴⁴ *Id.*

⁴⁵ 47 U.S.C. §545

⁴⁶ *See Cable TV Fund 14-A, Ltd., v. City of Naperville*, 1997 WL 433628, 24 (N.D. Ill 1997)

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Significantly, once a modification request is filed, the operator can begin implementing the proposed modifications immediately.⁴⁷

IV. First Amendment Implications of Municipal Ownership.

Municipal ownership of broadband facilities implicates the First Amendment to the extent that the municipality acts in a manner that favors itself over the incumbent cable operator. Under well-settled law, a content-neutral government regulation that results in an incidental burden on First Amendment freedom must: 1) be within the constitutional power of the Government; 2) further an important or substantial governmental interest; 3) be unrelated to the suppression of free expression; and 4) restrict no more speech than is essential to the furtherance of that interest.⁴⁸

Applying this standard, a court has held that the First Amendment requires a city to set a content-neutral, non-discriminatory fee for the cable television franchise and prevents use of the fee as a vehicle for selecting a preferred operator.⁴⁹ Still another court has held that a franchising authority may not impose a policy that has the effect of permitting only one company to operate a cable franchise in the franchise area.⁵⁰ Under this case law, a municipality would clearly violate the First Amendment if it regulates the incumbent cable operator in a manner that favors itself over the incumbent operator. This is especially true if the favoritism results in the incumbent operator selling its rights and assets to the municipality.

V. Other Considerations

A. Section 253 Implications

In general, a municipality's authority to regulate is derived from the laws of the state in which it is located.⁵¹ Some states, such as Texas and Missouri, have prohibited municipal ownership of broadband systems. These prohibitions have been challenged by municipalities as a violation of Section 253(a) of the Telecommunications Act, 47 U.S.C. § 253(a), which provides that "No State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or

⁴⁷ See *Tribune United Cable of Montgomery County v. Montgomery County*, 784 F.2d 1227 (4th Cir. 1986); *Cablevision Systems Corp. v. Town of East Hampton*, 862 F. Supp. 875, 887-88 (E.D.N.Y. 1994); and *Cable TV Fund 14-A, Ltd., v. City of Naperville*, 1997 WL 433628, 8-10 (N.D. Ill 1997).

⁴⁸ See *United States v. O'Brien*, 391 U.S. 367, 377 (1968).

⁴⁹ *Group W Cable, Inc. v. City of Santa Cruz*, 679 F. Supp. 977, 980 (N.D. Cal. 1988).

⁵⁰ See *Preferred Communications v. City of Los Angeles*, 13 F.3d 1327 (9th Cir. 1994).

⁵¹ See, e.g., *Sailors v. Board of Educ.*, 387 U.S. 105, 107-108 (1967).

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intrastate telecommunications service.” The courts are split on whether a municipality is an entity protected by this statutory prohibition.

- *City of Abilene Texas v. FCC.*⁵² This case concerned the validity of a Texas statute that prohibited municipalities from providing telecommunications services. The case was originally brought before the FCC, which determined that Section 253(a) does not preempt the Texas statute. The case was then appealed to the D.C. Circuit, which affirmed the FCC ruling, stating that “Federal law...may not be interpreted to reach into areas of State sovereignty unless the language of the federal law compels the intrusion.”⁵³ The court held that the term “any entity” did not necessarily include a municipality and therefore was insufficient to overturn the state statute.⁵⁴
- *Missouri Municipal League v. FCC.*⁵⁵ This case invalidated a Missouri statute that prohibited the state’s local subdivisions from obtaining certificates necessary to provide telecommunications services or facilities directly or indirectly to the public. The case was initially brought before the FCC, which relied on the *Abilene* decision to uphold the state statute. The Eighth Circuit rejected the reasoning of the D.C. Circuit in *Abilene* and overturned the FCC’s decision: “we conclude that because municipalities fall within the ordinary definition of the term ‘entity’ and because Congress gave that term expansive scope by using the modifier ‘any,’ individual municipalities are encompassed within the term ‘any entity’ as used in § 253(a).”⁵⁶ In June 2003, the Supreme Court granted certiorari to hear this case and this case is now pending before that Court.

B. California’s Proposition 218

A municipality that seeks to build and operate a telecommunications facility obviously must raise money to fund the project. Typical options for doing so include selling municipal bonds, and imposing taxes. In California, if the project were funded by imposing a tax, Proposition 218 would require approval by a two-thirds vote of the people.

The relevant portions of Proposition 218 prohibit local governments—including charter cities—from imposing, extending or increasing any general or special taxes, unless or until the taxes are submitted to a vote of the people. In the case of a general tax, only a simple majority is

⁵² 164 F.3d 49 (DC Cir. 1999).

⁵³ *Id.* at 52.

⁵⁴ *Id.* at 53.

⁵⁵ 2002 299 F.3d 949 (8th Cir. 2002), *cert. granted* 123 S. Ct. 2606 (2003).

⁵⁶ *Id.* at 17.

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required.⁵⁷ In the case of a special tax, a two-thirds majority is required.⁵⁸ A special tax is one imposed for a specific governmental purpose.⁵⁹ Under this law, a tax levied for the purpose of funding a municipally-owned utility would constitute a special tax and require a two-thirds vote of the people.⁶⁰

V. Conclusion

Although many municipalities tout municipal ownership of broadband systems as a new and valuable potential source of revenue, the evidence shows that municipal ownership is rarely a good public policy or economic choice. In fact, any rate savings to the customer are generally offset by a number of countervailing factors, including higher taxes. As a result, municipal ownership often merely shifts the costs of service from the customers using the service to taxpayers in general, creating only an illusion of savings. Moreover, municipal ownership tends to remove valuable private assets from the tax base, which impacts the state funds available to county governments and school districts. Municipal ownership also is subject to abuse that skews competition in the marketplace in adverse ways. Finally, if political pressures cause the municipality in its dual role as regulator and operator to favor itself over the incumbent, the incumbent may have a valid due process or First Amendment claim.

⁵⁷ Cal. Const. art. XIII C, § 2, subd. (b).

⁵⁸ Cal. Const. art. XIII C, § 2, subd. (d).

⁵⁹ See, e.g., *Rider v. County of San Diego*, 1 Cal. 4th 1 (1991) (sales tax imposed for the purpose of financing a jail and a court house was a special tax, because it was levied to fund a specific governmental project).

⁶⁰ *Id.*