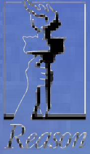
Focus on Telecommunications



Privatization Watch

Celebrating 30 Years of Privatization and Government Reform

Vol. 31, No. 6 2007

Companies Compete to Connect America

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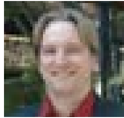
Privatization Watch



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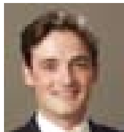

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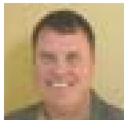

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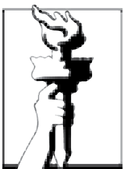

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Privatization Briefs

PA Tests Waters for Turnpike Privatization

In December, Pennsylvania Gov. Ed Rendell announced that his administration would solicit offers from private companies for the privatization of the Pennsylvania turnpike.

Gov. Rendell said the effort would gauge potential state revenue from a sale or concession agreement, estimated to range between $2 billion and $30 billion. Interested companies were also asked to detail measures to mitigate toll increases, to protect current turnpike workers, and to address public safety concerns. More than 180 million drivers used the Turnpike last year, generating more than $500 million in toll revenue.

Rendell noted that the solicitation does not begin a formal procurement process, leaving the door open for other approaches. "This is one of the options we're going to explore. There is only one option that is not on the table, and that is doing nothing."

The governor pledged that any privatization proceeds would be dedicated to transportation improvements. A study commission reported in November that Pennsylvania needed $1.7 billion annually to repair, maintain, and improve its transportation network.

AAA Weighs in on Tolling

A recent American Automobile Association (AAA) nationwide survey on transportation funding issues found that 64 percent of motorists judged traffic congestion to have worsened over the past three years, and over 70 percent think that more money is needed to maintain and improve the system.

When asked specifically to rank various funding options, the top choice (52 percent) was tolling. And within that broad category, the most popular option (39 percent) was to toll only new capacity. By contrast, only 21 percent favored increasing the gas tax, and only 15 percent supported increasing other taxes (such as sales, income, or property taxes) for transportation.

The results suggest that most Americans continue to support the user-pays principle of highway funding. With tolling evolving into a 21st-century technology that no longer requires toll booths or toll plazas, Americans are coming to see it as a more "pure" form of user-pays than dedicated fuel taxes.

AAA also released a new "Bill of Rights for The Nation's Motorists on Transportation Funding," which supports toll-

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Video Franchise Reform Catches Fire

By Steven Titch

As the consumer benefits become clear, more state legislatures are expected to adopt franchise reform measures over the course of 2007 and 2008 that permit new entrants to apply directly to the state to offer cable TV and cable-like video service.

Video franchises are the revenue-sharing agreements that cable TV companies sign with local governments for the right to offer video services to customers. In return for a portion of the gross video revenues the company pays to the municipality, cable TV companies get use of the city's right of way and a right to sell cable service in the area.

Statewide franchising eliminates the need for applicants to go from municipality to municipality to negotiate individual agreements, a process that can take 24 months or longer. Franchise reform lowers the legal burdens traditionally imposed by local franchise agencies—burdens that have made it costly, time-consuming and difficult for competitors to enter. In addition, statewide franchise reforms restrict or eliminate the sometimes arbitrary concessions imposed by local franchise agencies.

Opponents' predictions of slow rollout and phone company cherry-picking of wealthy customers have not come to pass.

Action in 11 States

As of January 2007, 11 states had approved video franchise reform legislation. Eight of these states, Texas, Indiana, North Carolina, South Carolina, New Jersey, California, Kansas and Michigan, created statewide video franchising processes. Two other states, Virginia and Arizona, stopped short of creating a statewide process but established a basic framework for local franchise agreements that municipalities will use going forward. In the eleventh state, Louisiana, statewide franchising passed both houses of the state legislature by near three-to-one margins, but the bill was vetoed by Gov. Kathleen Blanco.

With the start of the 2007 legislative calendar, Georgia was the first state where legislators introduced franchise reform, reviving a bill that had died in committee in 2006. Legislatures in Florida, Pennsylvania, Tennessee and Wisconsin are also expected to revive franchise reform measures in the first

months of the year.

In the U.S. House of Representatives, the Communications, Opportunity, Promotion, and Enhancement Act of 2006, a bill that will create a national franchising structure, passed 321-101. Franchise reform also was a provision in a telecom deregulation bill pending in the U.S. Senate, but the 2005-06 session adjourned without scheduling a vote. It is unclear whether the measure will be reintroduced in 2007. Meanwhile, the FCC ended 2006 with a vote to institute a 90-day "shot clock" for local approval of franchise applications, and sharply curtail local authorities' ability to demand build-out requirements as well as other costly concessions from applicants that often do not pertain to service.

Where enacted thus far, franchise reform's benefits have been undeniable.

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A Dynamic Perspective on Government Broadband

By Jerry Ellig

Debate over government provision of broadband has generated many of the usual arguments over the pros and cons of government service provision. On the one hand, such initiatives might make broadband more affordable and hasten its adoption. On the other hand, they could also generate significant costs for taxpayers and stunt incentives for cost containment. Such arguments commonly occur when governments consider direct provision of electricity, gas, water, roads, and many other services that tend to be provided by monopolies that invest in long-lived assets.

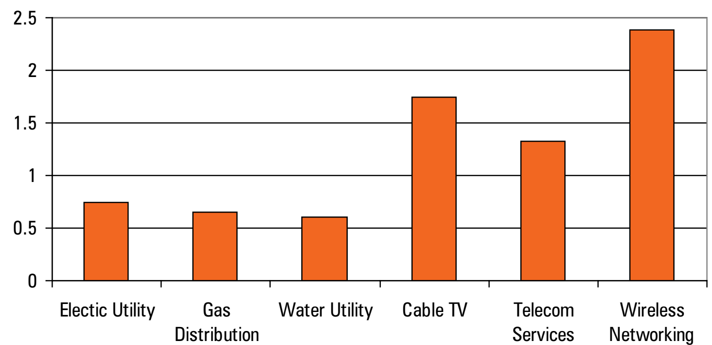
Less extensively discussed, however, are some unique challenges that arise because broadband is a new, fast-changing technology available from competing suppliers. Policymakers need to consider some unique problems when a government enterprise enters a dynamic market such as the provision of Internet services.

Issues for Decision-Makers

Scholarship on dynamic competition suggests seven new issues that are likely to be significant in municipal provision of Internet service:

Competition: Unlike a monopolist, an enterprise that faces competition cannot count on a captive market. In many cases, government-sponsored broadband will have to compete with incumbent firms, such as cable, telephone, and wireless companies that already have a substantial head start. After reviewing many cities' actual experience with cable and broadband enterprises, research concludes that an assumed penetration rate for a municipal system of more than 10 percent in the first year, or 20-50 percent in subsequent years, appears highly unrealistic in most cases. A wireless system might expect to serve about 25 percent of the residential market and 10-20 percent of the business market. The only exceptions might be small communities serviced only by expensive alternatives, or municipalities willing to commit to very large subsidies for their broadband systems.

Performance Competition: Competitive businesses seek to continually improve performance—or even develop new aspects of performance that were not previously thought capable of improvement. Speed is perhaps the most measurable aspect of performance. Comparing prices and services



offered by government-sponsored Internet provision to those in the private sector, the prices and performance of existing government systems are inferior to those of existing private systems. An effective government-owned competitor must be prepared to offer a price/performance combination that a significant number of consumers will prefer to those offered by competitors. If government ignores performance competition, it could end up offering a fairly plain service appealing only to customers who want relatively slow broadband speeds, and may not be willing to pay much for it. While such an approach might be attractive as social policy, it is unlikely to pay for itself over the long term and would likely require ongoing subsidies.

> Government faces the daunting challenge of entering a market where technological change is swift, the future is uncertain, and competitors' actions are unpredictable.

Continuous Improvement: One indicator of the extent of change is the pace at which prices of goods and services fall as technology improves, costs fall, or competition intensifies. This has occurred frequently in the market for Internet service, as well as in related or analogous markets such as wireless communications, telephone equipment, and telecommunications services. Real consumer price indices for wireless, telephone equipment, and long-distance service have fallen even faster—by 45-65 percent. If recent experience is a guide, government broadband operations will need to be prepared to continually improve in the future if they want to keep pace with private sector competitors.

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Lessons Learned from Provo's Municipal Broadband

By Steven Titch

The following is the executive summary from Reason's new report, Spinning its Wheels: An Analysis of Lessons Learned from iProvo's First 18 Months of Municipal Broadband, available online at www.reason.org/ps353.pdf.

After only two years, the municipal broadband system in Provo, Utah has begun to show the pattern seen in other cities that have mounted expensive fiber optic networking projects. With less than half the subscribers expected by this date, iProvo, the $39.5 million system launched in July 2004, has had to request $1 million in additional funds from Provo's electric utility to meet its costs.

The request for additional funding comes after a troubled first eighteen months of operation marked by slow growth and a rocky relationship with a retail partner that came to an abrupt end during a heated mayoral campaign. The sole bright spot is that iProvo construction has stayed on schedule. The iProvo Web site reports that all eight construction phases were completed by the initial July 2006 deadline.

iProvo is set up as a city-owned fiber optic network that wholesales capacity to retail service providers. The unit operates under the administration of the Telecommunications Division of Provo City's Energy Department. Construction on the iProvo network began in July 2004. As of December 1, 2005, fiber optic connections were available to more than half of Provo's approximately 27,000 residences and 4,100 small businesses, making it the largest municipal broadband system in the United States to date, according to Broadband Business Forecast, an industry newsletter. Local newspaper reports place the subscriber total at 7,700 as of October 2006. iProvo also owns and operates a cable television distribution facility.

Despite the advantages it had at the outset, just two years into the project, iProvo is dealing with the same struggles other municipalities have had in the past.

iProvo began with high hopes. But for all the optimism that the city had found a better formula in wholesaling, the experience remains a warning to other cities that municipalities, even when they take a wholesale role, cannot compete with the private market. Despite the advantages it had at the outset, just two years into the project, iProvo is dealing with the same struggles other municipalities have had in the past.

iProvo is behind on its business plan and being forced to borrow more money. In February 2006, Mayor Billings and iProvo officials have asked the Provo City Council to approve a transfer of $1 million from Provo's electric utility reserve to cover fiscal 2006 costs. In June, iProvo requested and received a line of credit for an additional $2 million to cover costs in fiscal 2007 and 2008. iProvo officials also said in October that the operation will need 12,000 to 15,000 customers to break even, an increase in the original break-even target of 10,000 customers. The original plan had anticipated iProvo achieving 10,000 customers by December 2005. With revenues and customer uptake short of goals, there is mounting pressure on asset value and cash flow. iProvo's "burn rate" (the rate at which expenditures exceed income) in fiscal year 2005 was $325,000 a week.

iProvo officials also said in October that the operation will need 12,000 to 15,000 customers to break even, an increase in the original break-even target of 10,000 customers.

iProvo's wholesale plan attracted only one retail partner, HomeNet Communications, in its first year of operation. That relationship proved a disaster that ended with HomeNet pulling out of the market in July 2005 and declaring bankruptcy. Of the some 2,400 customers HomeNet and iProvo started with, as few as 1,600 were left by the time HomeNet closed up shop. This occurred as Mayor Billings was in the middle of a heated re-election campaign in which iProvo performance was an issue. This put pressure on Billings to find replacements for HomeNet quickly, giving more leverage to would-be partners

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Protecting Property Rights in a Landslide

By Leonard C. Gilroy, AICP

Besides Democrats, the big mid-term election winners were homeowners in the nine states that passed initiatives protecting property rights and reining in government's power to take homes and businesses.

These initiatives were sparked by the Supreme Court's controversial ruling in the 2005 *Kelo vs. New London* decision, which gave the government a green light to use eminent domain to take private property and turn it over to developers for "economic development" purposes.

Most Americans were incensed at the notion that government could arbitrarily evict people from their homes, businesses, and churches simply because it could generate more local tax revenue if these properties were redeveloped as condos, offices, and hotels. Traditionally, eminent domain was only used to acquire private land for clearly defined public uses—such as roads, parks, and public buildings—but Kelo opened the door for government to condemn property for almost anything that it could argue had a public "benefit."

The backlash was immediate. Since the Kelo ruling more than two dozen states have passed legislation to curb eminent domain abuse, and in the November election, voters passed a variety of measures intended to do the same thing.

Traditionally, eminent domain was only used to acquire private land for clearly defined public uses, but Kelo opened the door for government to condemn property for almost anything that it could argue had a public "benefit."

An overwhelming majority of voters in Florida, Georgia, Louisiana, Michigan, New Hampshire, and South Carolina approved constitutional amendments that forbid the use of eminent domain to transfer land from one private party to another for economic development purposes. Similar voter-initiated constitutional amendments passed in both North Dakota and Nevada, though Nevadans will need to pass the same amendment in 2008 for it to take effect.

Of all states, voters in Oregon have taken one of the strongest stands in recent years to protect their property rights. Measure 39, a statutory initiative that reins in eminent domain abuse, passed in November by more than a two-thirds margin. Moreover, Measure 39 followed on the heels of voters' passage of Measure 37 in 2004, which was designed to protect Oregonians from "regulatory takings," a far more pervasive threat to private property rights than eminent domain abuse.

Local governments routinely pass restrictions on the ability of property owners to use their land in ways that were legal at the time they bought their property—resulting in enormous losses to private property values—without compensating owners. After several decades enduring egregious regulatory abuse, Oregonians passed Measure 37 to require government to either pay landowners for these "regulatory takings," or waive the regulations.

Local governments routinely pass restrictions on the ability of property owners to use their land in ways that were legal at the time they bought their property without compensating owners.

Voters in Arizona followed Oregon's lead and passed Proposition 207—the Private Property Rights Protection Act—by a 65-35 margin, breaking new ground in the process. Prop 207 was designed to address both eminent domain abuse and regulatory takings in one comprehensive set of property rights protections in what has come to be known as a "Kelo-Plus" initiative. Untested prior to this election, the passage of Prop 207 establishes "Kelo-Plus" as a feasible strategy to target the two biggest threats to property rights in one fell swoop.

However, two similar "Kelo-Plus" measures failed to pass. California's Proposition 90 was defeated by a 52 to 48 margin. Idaho's Proposition 2 also failed to pass. Opponents of these measures—including environmental groups, municipal associations, and urban planners—mounted a vigorous campaign

2006 Election Summary: Property Rights Ballot Measures				
Ballot Measure	**Status**	**Scope**	**%For**	**%Against**
Proposition 207	Passed	Eminent Domain/	65%	35%
Amendment 8	Passed	Eminent Domain	69%	31%
Amendment 1	Passed	Eminent Domain	83%	17%
Ballot Measure 5	Passed	Eminent Domain	55%	45%
Proposal 06-4	Passed	Eminent Domain	80%	20%
Question 2	Passed	Eminent Domain	63%	37%
Question 1	Passed	Eminent Domain	86%	14%
Initiated Constitutional Amendment 2	Passed	Eminent Domain	67%	33%
Measure 39	Passed	Eminent Domain	67%	33%
Amendment 5	Passed	Eminent Domain	86%	14%
Proposition 90	Defeated	Eminent Domain/	45%	52%
Proposition 2	Defeated	Eminent Domain/	24%	76%
Initiative 933	Defeated	Regulatory Takings	41%	59%

to defeat them, outspending measure proponents by a wide margin. Voters in Washington State also defeated Initiative 933—a regulatory takings measure modeled after Oregon's Measure 37—by a 56-44 percent margin.

Despite the success in Arizona and Oregon, the defeat of the California, Idaho, and Washington measures indicates that regulatory takings reform faces higher hurdles to voter appeal than pure eminent domain measures. Not only do they generate more opposition from a variety of special interests that benefit from government's unfettered ability to regulate, but the issue is inherently complex and largely unfamiliar to voters.

And given that regulatory takings frequently occur in conjunction with zoning regulations preventing development on agricultural land or open space, the issue resonates more with rural voters than city dwellers, as the geographic breakdown of voting for California's Prop 90 suggests. Support for Prop 90 was strongest in the Central Valley, the Northeast, and Southern California, while opposition centered in the Bay Area and Los Angeles County. The key for future campaigns will be to craft a message that more effectively connects with urban voters.

However, viewed in total, the election results indicate that the property rights movement is alive and well. Millions of citizens nationwide sent a clear message to elected officials: they care very deeply about property ownership, and they understand that the government is there to protect the right to that property, not to take it away.

Leonard Gilroy is a senior policy analyst at the Reason Foundation. ■

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BRIEFS

ing and public-private partnerships as long as the revenues are dedicated to transportation purposes and higher charges lead to improved service.

Competitive Contracting Underused in Washington State

Despite its potential for generating cost savings and performance improvements, a recently released legislative audit found that state agencies in Washington State have made little use of competitive contracting. Out of 23 agencies and higher education institutions surveyed, only three have used competitive contracting since it became available in 2005.

Agency managers offered two main reasons for the low rate of usage. First, they found the process, with its time-consuming compliance requirements, to be complicated and confusing. Second, state rules make an agency's ability to competitively contract subject to collective bargaining, giving unions the ability to remove the contracting option during labor negotiations and creating disincentives for agency participation. ■

What Now for Tolling and PPPs? Movement Towards Privatization is a Bipartisan Effort

By Robert W. Poole, Jr.

The historic Democratic sweep of Election Day 2006 has sent a chill through many advocates of the new paradigm of investor-owned tollroads as the wave of the future.

Yet, the fundamentals for the new transportation paradigm still look very good. First, several key champions of the new approach—especially Texas Gov. Rick Perry—got re-elected. Florida's pro-tolls Jeb Bush will be succeeded by his friend, Republican Charlie Crist. Pro-PPP Sonny Perdue was re-elected in Georgia.

The second thing to keep in mind is that the changeover in Congress does nothing to alter the ongoing momentum for tolling and PPPs in the states, which will continue to be supported by the great team in place at the U.S. DOT and the positive provisions of SAFETEA-LU (the 2005 federal surface transportation reauthorization bill).

Third, the fundamentals driving the move toward tolling and PPPs are all still with us—ever-worsening urban traffic congestion, fast-growing truck traffic, and the inability of fuel taxes to fund much more than adequate maintenance and repair of the existing highway system.

And fourth, it is important to remember that the movement toward privatization has been supported by Democrats as well as Republicans. In Illinois, it was Mayor Richard Daley who pushed to privatize the Skyway, and it's Democratic state senator Jeff Schoenberg leading the effort to do likewise for the state toll road system. Expect continued interest in toll road PPPs from Democratic governors Ed Rendell (PA), Jon Corzine (NJ), and probably even newly elected Eliot Spitzer (NY)—at least to the extent of authorizing a PPP to replace the aging Tappan Zee Bridge.

It will likely be easier for Democrats to support toll-based PPPs for new (and replacement) facilities than for the lease of existing toll roads. As former Congressman Dick Gephardt put it in a pre-election op-ed piece published in Texas, projects like the Trans-Texas Corridor "reflect a progressive and democratic tradition of pragmatic public works that have served working people well and driven the state's prosperity." He also addressed the issue of non-U.S. firms' involvement, pointing out correctly that getting overseas investors to put billions of dollars into U.S. infrastructure is a kind of "reverse outsourcing" that we all should welcome.

But while Gephardt also praised Daley and Daniels for creatively mining their existing toll road assets to meet pressing governmental needs, the anti-privatization backlash in Indiana—a generally conservative, Republican state—indicates that benefits of privatization may have been lost on voters in that state. In the overall process of creating an investor-owned toll roads industry, getting under-performing state-owned toll roads into commercial hands is a positive thing:

- It helps break down the old 20th-century idea of tolls as flat rate and temporary (till the initial bonds are paid off);
- It helps create a market for financing toll projects, and demonstrates the availability of large amounts of global capital for the U.S. tollway market;
- It brings world-class toll road management and marketing to a sector that, with some exceptions, has been stodgy and politicized.

But those are points only policy wonks and financial analysts can appreciate. They are hard to get across to reporters, legislators, and voters. It may be time to think about new approaches to privatizing existing toll facilities. Highway users

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Don't Expect Feds to Hike the Gas Tax

By C. Kenneth Orski

Many observers believe that the chances of enacting a gas hike in the next Congress are slim. There are several reasons for this conclusion: the almost certain veto of such a measure by the White House, the resurgence and likely influence of the conservative anti-tax "Blue Dogs" in the Democratic 110th Congress, and the desire by the newly elected Democratic congressional leadership to avoid being painted as earmarks-driven, tax-and-spend liberals during the presidential campaign two years from now.

With no immediate prospect for additional federal money and with the Highway Trust Fund balance nearing the bottom, the search by financially strapped state governments for supplementary sources of transportation revenue can only intensify. And this cannot but enhance the outlook for tolling, private road concessions and public-private partnerships.

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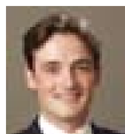
Improving Efficiency in Indiana

By Leonard Gilroy



In December 2006, Indiana's Office of Management and Budget (OMB) released a long-awaited government efficiency report containing over 150 recommendations to consolidate, eliminate or competitively source a range of government agencies, services, and functions. Some of the report's recommendations would require legislative action to implement, while others could be ordered by Gov. Mitch Daniels.

The efficiency report was the first analysis released as a result of OMB's effort to design a program performance evaluation tool known as Program Results: an Outcome-Based Evaluation (PROBE). Modeled after the federal Program Assessment Rating Tool—developed during Gov. Daniels' tenure as director of the federal Office of Management and Budget—the eighteen-month inventory of state operations was developed to assess the effectiveness of state programs in achieving desired results and outcomes while considering the efficiency of service delivery. Another PROBE review will be conducted in two years to measure progress achieved since the first inventory and offer guidance for further improvements.

The major finding of the PROBE report is that a majority of state programs do not measure performance and report results; more than half of the programs reviewed under PROBE were unable to demonstrate results because no results-based measures had been created. According to the report, "Hoosier taxpayers and citizens have to take it on faith that their government is operating in an effective and efficient manner."

The PROBE report also finds that Indiana state government today is "unmanageable, unaccountable, and inefficient," having 73 agencies and over 300 boards and commissions.

The report lays the groundwork for a shift toward performance-based budgeting, basing state agency funding decisions on demonstrated results and outcomes. As a first step, OMB will require that all agencies and entities create outcome-based performance measures for all programs. During early 2007, OMB will work with agencies to help develop these measures and benchmark measures and targets with the best practices of the market or other states. Performance results will be reported quarterly to OMB and included in every agency's future budget requests, providing the executive and legislative branches with the tools necessary to achieve budget-performance integration. "Demanding proof that government programs work, before spending additional money on them, must become standard operating procedure," according to Gov. Daniels. "The process of examining what works and doesn't work was long overdue."

OMB also identified numerous opportunities for the state to compete inherently commercial governmental activities against the private sector to generate improved service delivery and cost savings. Among the functions recommended for competitive sourcing efforts are:

- Fleet maintenance
- Facilities management
- Print and mail services
- Highway maintenance (Indiana Department of Transportation)
- Employee benefits administration
- Bureau of Motor Vehicles branch operations
- Department of Correction (DOC) adult and juvenile education

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Texas's Retail Electricity Market Is Working

By Bill Peacock

Competition and retail choice are working in the Texas electricity market. But instead of celebrating this success, critics are blaming retail electricity providers for problems caused by the increasingly dysfunctional, legislatively mandated Price-to-Beat.

The Price-to-Beat was originally the regulatory price at which existing (default) providers had to sell their electricity. Meanwhile, it was hoped that new providers could earn a profit selling electricity at a lower price.

By the time 2006 rolled around, it was clear there was no longer any need for the Price-to-Beat. Competition, not regulations, now keeps prices low. Texas consumers are able to choose from up to 41 different plans offered by as many 18 providers, with over 60 percent of residential customers having exercised identifiable choice.

Fortunately, the Price-to-Beat is set to expire on Jan. 1, 2007. But it isn't going down without a fight. For instance, the Price-to-Beat is serving as a psychological price floor, more than likely keeping prices higher than they would be otherwise. Additionally, since changes in the Price-to-Beat are limited to two per year, it has distorted market prices and added uncertainty in the marketplace at a time when natural gas prices have been changing rapidly.

By the time 2006 rolled around, it was clear there was no longer any need for the Price-to-Beat. Competition, not regulations, now keeps prices low.

While natural gas prices rose by an average of 49 percent between April and November, 2005, political factors led to no increase in the Price-to-Beat during this time. So default providers were not able to recover their increased costs. In other words, for eight months many consumers avoided paying the costs incurred by the increase in natural gas prices. However, if a default provider had pockets deep enough to ride this out, it could actually use the Price-to-Beat to gain a competitive advantage over a new, smaller provider that must raise its prices to cover costs—or go out of businesses. So not only is the Price-to-Beat poorly designed for today's market, the political intervention in the market it accommodates further harms competition and consumers.

Despite these problems, the market is already beginning to look past the Price-to-Beat as industry participants anticipate its demise. Default providers are preparing for an increase of competition against each other as well as against the new providers that have sprung up under the Price-to-Beat. A number of new rate plans have been announced designed to attract and retain customers after termination. Some new plans facilitate risksharing, like one that closely tracks the market price of gas. Others offer greater certainty if customers pay for it, such as a plan that offers price protection from changes in the cost of natural gas. Many critics, however, can't see past the Price-to-Beat. Despite the discounts and new offerings, the main question being asked of default providers is why they haven't lowered their Price-to-Beat—with the threat of stronger price controls looming if they don't do so soon.

If Texas wants to stay on top, more deregulation—not price controls—is the only way to go.

Markets are always competitive except when the government interferes with them. Imposing price controls is guaranteed to harm the burgeoning competition in the electric market and dash the expectations of all market participants—retailers, producers, investors and consumers.

Texas is about to become the first state in the country to operate an electric market where the vast majority of prices are deregulated. Texas is also the national leader when it comes to telecom deregulation and tort reform. This is why Texas was recently rated the second best business climate in the nation. If Texas wants to stay on top, more deregulation—not price controls—is the only way to go.

Bill Peacock is the director for the Center for Economic Freedom with the Texas Public Policy Foundation. He may be reached at bpeacock@texaspolicy.com. ■

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TOLLING

(who are also voters) may perceive that there could be some gains for them from privatization: more customer-friendly management, more timely widenings, more predictable (and modest) toll increases rather than years of flat rates followed by huge increases. But the one thing they know will be a consequence of privatization is higher tolls than would likely be the case under continued state ownership and operation. Is there any way to compensate for that perceived negative?

This dilemma faced Margaret Thatcher in the 1980s, as her government was privatizing Britain's electricity, gas, water, telecommunications, and airport industries. While there were some prospects of lower rates, where competition would be introduced, there were also very real prospects of rate increases, after many decades of non-market operations of these enterprises. One of the key tools in the Thatcher toolbox was therefore widespread public share offerings. In other words, the utility customers might face somewhat higher bills, but they also stand to get dividends and capital gains as shareholders. In many cases, major tranches of shares in the IPO of such an enterprise were reserved for individual investors (and smaller amounts for employees). Since share-ownership was not a common middle-class phenomenon in the United Kingdom. in those days, each IPO was preceded by a major marketing campaign aimed at explaining the specifics to individual investors.

One could imagine a similar effort at the state level, led by Democratic governors doing long-term concessions. Gov. Rod Blagojevich might be persuaded to liberate the $24 billion (Credit Suisse estimate) locked up in the Illinois Tollway system if, say, one-third of the shares could be offered first to Illinois residents. Since it would still be important to have a highly qualified company at the helm, a controlling interest could still be offered to whichever pre-qualified consortium made the best bid for that portion of the shares in the concession. The balance could then be offered to all other investors—individuals nationwide, plus institutional investors worldwide.

IPOs have been used overseas for toll road concessions—Autostrade in Italy, BRISA in Portugal, and several green-field toll roads in Australia. So this is hardly a radical idea. And it just might make a significant difference in the new political climate, post Election Day 2006.

Robert Poole is director of transportation at Reason Foundation. A version of this article recently appeared in Public Works Financing. ■

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INDIANA

The PROBE report also highlights the potential for tremendous cost-savings through the implementation of shared services—the consolidation of administrative or support functions (such as information technology and procurement) from multiple departments or agencies into a single organizational entity. OMB identified a number of potential shared services opportunities within Indiana's state government, including:

- Financial management for non-cabinet agencies;
- Real estate management;
- Retirement funds' administrative functions;
- Engineering and public works;
- Contract monitoring and management;
- Call centers

The report also lists a number of organizational recommendations, such as creating a single state historic preservation/cultural promotion agency by combining the State Library, State Archives, State Historical Bureau, State Museum, Arts Commission, and the Department of Natural Resources (DNR) Division of Historic Preservation and Archaeology. Similarly, the report suggests merging the Indiana Department of Labor, Department of Workforce Development and Worker's Compensation Board into a single agency.

The PROBE report also finds that Indiana state government today is "unmanageable, unaccountable, and inefficient," having 73 agencies and over 300 boards and commissions.

The PROBE report also finds that Indiana state government today is "unmanageable, unaccountable, and inefficient," having 73 agencies and over 300 boards and commissions. Over 20 of the 73 state agencies have less than 20 full-time employees. OMB will be coordinating the executive branch's participation in the sunsetting of boards and commissions as recommended by the state's Government Efficiency Commission. Further, OMB will develop a reorganization plan for executive branch agencies aimed at breaking down "silos" and improving accountability and efficiency.

The full PROBE report is available online at: http://www.in.gov/omb/gefp/2006PROBEReport-Full.pdf

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PROVO

to extract favorable concessions from the city.

Cable and Internet prices charged by iProvo partners are not significantly lower than pricing from Comcast or Qwest. An original goal of iProvo had been to offer broadband services at "affordable" rates, implying the rates charged by private service providers are too high. Yet, when compared with similar service packages from the incumbent cable and telephone companies, iProvo's two current retail partners (Veracity Communications and MStar Metro) do not offer sizable discounts.

There is little evidence to suggest iProvo has generated any significant growth in broadband usage or penetration in Provo. All reports suggest that the great majority of iProvo's 5,000 customers had broadband service prior to iProvo, either as customers of bankrupt Provo Cable or as customers of Veracity and MStar.

iProvo's current retail partners, Veracity and MStar, are two local Internet service providers (ISPs). They replaced HomeNet in August 2005. While the city of Provo funds construction and maintenance of the fiber optic backbone and cable head-ends, fiber-to-the-premises (FTTP) connections to each home and business are the responsibility of Veracity and MStar, which are principal points of contact for consumers. The two iProvo retailers compete with other broadband and cable TV providers, including Qwest Communications International and Comcast Corp., as well as direct broadcast satellite (DBS) companies and other ISPs. Large users, such as Brigham Young University, do business directly with iProvo. The city of Provo is also a customer of iProvo.

Cable and Internet prices charged by iProvo partners are not significantly lower than pricing from Comcast or Qwest.

Yet just two years into operation, iProvo has had to call on the city's power of the purse. In the free market, failing companies close shop, and that is the end of the financial loss. In requesting an allocation from the city's electricity reserve, iProvo can do what no private company can: cross-subsidize broadband operations from other utility funds. The electricity reserve fund was created as a hedge against price increases in the cost of electricity, a volatile market as it is. Provo's electricity customers, not its broadband users, pay into it. Although iProvo seeks only $980,000 of the $17 million in the reserve, it establishes a precedent and leaves the electric utility, and its customers, that much more vulnerable.

In addition to engaging in overt cross-subsidization, iProvo demonstrates more subtle problems municipal broadband systems create for taxpayers and the local economy when they attempt to compete with the private sector. For example, when the city of Provo sold Provo Cable's customers to HomeNet at 40 percent of true market price, it indirectly subsidized HomeNet's market entry. In selling a key asset for less than what it was worth, Provo cheated both local commercial service providers and Provo taxpayers. Yet, when compared with similar service packages from the incumbent cable and telephone companies, iProvo's two current retail partners do not offer sizable discounts.

In requesting an allocation from the city's electricity reserve, iProvo can do what no private company can: cross-subsidize broadband operations from other utility funds.

Set up under a wholesale model, iProvo also was touted to be immune from the problems municipalities have had with retail FTTP systems. That has turned out to be a false hope. Indeed, while financial reports looked good in the first year of operation, much of iProvo's revenues were generated from interest accruing on bond funding that had been banked. Although the warning signs were there, namely in the form of poor customer growth, iProvo officials chose to play them down. It was only in its second year, when cash from the bond issue began to deplete, that iProvo's revenue shortfalls and cash flow problems came into high relief.

For a project that began as an example of innovative urban planning and pro-active technology policy, iProvo has had an inauspicious 18 months. In its first year, certain aspects of its balance sheet and revenues appeared sound, but they do not stand up on closer examination. Because it calls for a smaller investment, the wholesale model appears more attractive. The wholesale model is getting more consideration as more cities contemplate municipal wireless networks. Yet the cautionary tale of Provo is that operating as a wholesaler is not enough of a hedge against the financial and logistical problems that occur when a city seeks to compete with commercial service providers in a competitive business sector. ■

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BROADBAND

Technological Change and Lock-In: "Lock-in" occurs when an initial decision gives one technology a slight edge, then sets in motion a process which leads that technology to dominate the market. If the technology that gets locked in is truly the superior technology, then there's no harm done. But if an inferior technology gains a temporary edge in market share, some scholars argue that it might remain dominant even though it is inferior. The market gets locked in to the inferior technology due to the decisions of the early adopters, and often has to rely on subsidies to stay afloat when better technology is available elsewhere. Government broadband plans should squarely address the potential for lock-in and explicitly evaluate whether subsidies would give an inferior technology an artificial boost.

Obsolescence: In a dynamically competitive market, networks become obsolete faster. Technology improves more rapidly, and as a result capital investment becomes obsolete more quickly. Business plans for government broadband enterprises need to assume faster depreciation rates, and concomitantly higher prices, than have traditionally been used for government utilities. For example, a workable plan for municipal Wi-Fi needs to assume that revenues will not just cover operating costs plus interest, but also recover the initial capital outlay in three to five years.

Risk: Financially, investment in a dynamic field such as Internet provision is less of a "sure thing" than a conventional government monopoly. That means the cost of capital should carry a higher risk premium than normally considered appropriate for government enterprises. But just how risky is it? Comparing risk levels shows clearly that investments in electric, gas, and water utilities have involved much less risk than investments in firms that sell broadband or wireless data services. Electricity, gas, and water are precisely the types of static, monopolized industries where governments have traditionally invested. In terms of risk, broadband is a whole new ballgame. Investing in broadband is much riskier than investing in the overall stock market. Nevertheless, some governments have financed broadband initiatives as if they were traditional, low-risk investments in infrastructure that provides necessities. A government enterprise that faces an artificially low cost of capital is more likely to waste the public's money by "investing" in capabilities that produce little value for customers, or do so only after an excessively long time.

Uncertainty: A private business firm's shareholders bear uncertainty as well as risk. The prospect of additional, higher returns entices them to bear that uncertainty. The fact that uncertainty affects shareholders' financial fortunes gives them strong incentives to seek out management that will exercise sound judgment. The most likely method would be to organize the enterprise as a for-profit company, with explicit expectations from the owner (the government) that it be successful. The most credible way governments make these types of commitments is by enacting a plan to privatize the enterprise. But in this context, a privatization plan would beg the question of why the government is getting into the broadband business to begin with! For government broadband enterprises, taxpayers bear the uncertainty in their role as the ultimate owners. At a minimum, therefore, effective accountability requires that government broadband initiatives should have accountability and transparency for taxpayers at least as good as that which publicly held companies must have for their shareholders. These transparency measures may not be sufficient to make government managers as accountable to uncertainty-bearing taxpayers as corporate managers are to uncertainty-bearing owners. But it is difficult to see how accountability is possible without them.

The factors outlined above need not imply that government-provided broadband is a bad idea. However, no plan for government-sponsored broadband should be considered complete or responsible unless it addresses many factors. Government faces the daunting challenge of entering a market where technological change is swift, the future is uncertain, and competitors' actions are unpredictable—a playing field fundamentally different from the stable, predictable utility markets that have traditionally attracted public investment.

Jerry Ellig is a senior research fellow at the Mercatus Center at George Mason University. The above article is a summary of Reason's December 2006 study, **A Dynamic Perspective on Government Broadband Initiatives,** *available online at www.reason.org/ps349.pdf* ■

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FRANCHISE REFORM

Compared to most other policy initiatives, especially in telecommunications, video franchise reform has evolved relatively rapidly. Sparked largely by the move of the nation's largest telephone companies—Verizon Communications and AT&T—into cable TV and cable-like, multi-channel video services, in less than a year franchise reform initiatives have earned bipartisan support.

Opponents' predictions of slow rollout and phone company cherry-picking of wealthy customers have not come to pass. As documented in the Reason study *Better Prices and Better Services for More People: Assessing the Outcomes of Video Franchise Reform*, Verizon has garnered 500,000 customers for its FiOS fiber-to-the-home (FTTH) service, which accounts for half of the 1 million homes that are purchasing FTTH. All told, Verizon's FiOS service was available to a total of six million homes in its region at the end of 2006, according to the company.

Last fall, AT&T rolled out its television service offerings in the form of U-Verse IP video over digital subscriber line (DSL), supported by its $4 billion Project Lightspeed fiber-to-the-node initiative in San Antonio, Texas. The company introduced service in Houston and Connecticut in December and was on track to offer U-Verse and a total of 15 markets in the first quarter of 2007.

Undeniable Benefits

Where enacted thus far, franchise reform's benefits have been undeniable. Consumers have enjoyed greater choice and a range of new services, including on-demand video and "a la carte" content selection, at lower cost. Incumbent cable providers have responded to new competition by lowering costs and improving service.

After Texas created statewide video franchising in August 2005, Verizon began extending its new FiOS fiber-to-the-home

What Franchise Reform Does for Customers

Franchise reform decreases, but does not eliminate, local authority over cable systems. Under statewide regimes, franchisees still pay franchise fees to the local authority, not some new statewide agency. Set-aside requirements (but not always funding) remain for public, education and government (PEG) channels. Local agencies retain control over rights-of-way.

Local franchise authorities lose their ability to extract concessions that have little to do with the provision of cable service, but simply increase the cost of service for consumers. In previous franchise negotiations, cities have demanded parking lots, free televisions for every "house of worship," and discounts for select customers. One town asked for a new recreation center and pool.

Statewide franchises also codify what qualifies as "gross video revenues." At the local level, the definition of what counts as "video revenues" traditionally has been a negotiating point. Hence, in addition to applying the 5 percent assessment to subscriber fees for cable service, some localities have included local advertising revenues, commissions from home shopping channels, and even promotional fees paid by cable networks in the calculation of the franchise fee. While some states retain these extra revenues in their statewide laws, the standardization of the definition of gross video revenues represents a loss of power to the local governments.

The debate is whether preservation of local hegemony—in essence the power to extract costly concessions from a particular group of local businesses—is worth sacrificing the benefits franchise reform brings. Increasingly legislatures have concluded the benefits of franchise reform to consumers outweigh the costs to local franchise agencies.

Local franchise authorities—and the cities and towns they represent—have lined up in opposition fearing loss of revenues and regulatory control. Some appear willing to hold up competitive entry to sort it out. For example, the city of Milwaukee has sued to halt AT&T from making any broadband or video upgrades to its existing and otherwise legally compliant network until the court determines whether the company requires a separate video franchise to do so.

network in Keller, Texas, which had until that point been operating as a pilot project, into surrounding communities in north Texas. By the end of that year, Charter Communications, the incumbent cable company in Keller, had cut some cable rates by 27.5 percent.

When applied judiciously, a fair system can serve everyone's needs—the municipality, the customer and poor communities—without closing the market to competitors.

As AT&T ramped up its 2006 U-Verse launch in San Antonio, Time Warner Cable boosted the speed of its Road Runner Internet service. Once AT&T went on-line, Time Warner began discounting TV and phone plans, throwing in premium movie channels and faster Internet connections. In October, Time Warner introduced an innovative new service feature called "Start Over" that allows viewers tuning in late to watch their shows from the beginning.

After statewide video franchising took effect this past summer in Indiana, Verizon stepped up FiOS deployment. Comcast responded by increasing the speed of broadband service in Verizon territories such as Howard County to keep up.

Widespread Build-Out

Few franchise reform opponents challenge the overwhelming evidence that competition produces lower prices and better service. Instead they claim that only the wealthy benefit from competition, even though there is no evidence in any other competitive market to suggest this. In fact, judging from Texas and Indiana, the two states with the longest history of franchise reform, the outcome has been quite the opposite.

In Ft. Wayne, Ind., Verizon began deployment of FiOS service in the low-income Hanna-Creighton neighborhood. AT&T has rolled out U-Verse service across all parts of San Antonio, not just the tony neighborhoods. Where video franchises are still negotiated locally, the phone companies are not restricting their applications for franchises to the richest communities. When Verizon began offering FiOS service in New York's Nassau and Suffolk counties, it launched service in Laurel Hollow, where per capita income is $83,366, as well as Massapequa, Mineola, Valley Stream and Roosevelt, where per capita incomes are $32,532, $28,840, $25,636 and $16,950 respectively.

The ultimate goal of both the phone and cable companies is to create rich broadband networks that can integrate various types of data. Franchise reform speeds this process. Moreover, at base, franchise fees are little more than a special tax, perhaps once justified by the notion that cable TV was "entertainment," that today place an extra cost burden on a service more and more policymakers regard as essential.

The best statewide franchise bills cap franchise fees at 5 percent and require the funds to pay for the use of right-of-way. They also permit incumbent cable companies to apply for statewide franchising terms upon entry of a competitor. As the statewide franchise trend shows, the babies of revenue, local control and service to the poor do not have to be thrown out with the bathwater of franchise fees. When applied judiciously, a fair system can serve everyone's needs—the municipality, the customer and poor communities—without closing the market to competitors.

Steven Titch is a Reason Foundation telecom policy analyst. His two recent reports on franchise reform, **Better Prices and Better Services for More People: Assessing the Outcomes of Video Franchise Reform, and I Want My MTV: Reforming Video Franchises for Competitive TV Services**, *are available at www.reason.org/telecom.* ■

Who, What, Where

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