



POLICY BRIEF

When Government Enters the Telecommunications Market *An Assessment of Tacoma's Click! Network*

By
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I. Introduction

Tacoma Public Utilities (TPU) was founded more than a century ago as Tacoma City Light and was granted monopoly status and the charter to “meet community needs for electricity.”¹ More recently the utility has expanded its mission. In 1997 TPU embarked on an ambitious experiment to build a publicly-funded telecommunications system called the Click! Network. The system was intended to provide high-speed access for cable television, data transmission and Internet services for TPU customers.

Now that the fourth anniversary of the launch of the Click! Network has arrived, it is an appropriate time to make an objective assessment of how the project has fared. Is the Click! Network fulfilling its promises? Has it successfully met the challenges of building an advanced telecommunications network? What risks and costs has it incurred? Beyond these concerns, the Click! Network raises a deeper question about the role of government in our society. Should tax-subsidized municipal entities be allowed to compete directly against private companies?

The Click! Network is a prominent example of an ongoing trend. Other municipalities have also expressed interest in moving into the telecommunications business. Local leaders across the state are watching and weighing the Click! Network's performance. If deemed a success, the system will serve as a model for others who may decide to embark on the same path.

This Policy Brief presents an in-depth analysis of where the Click! Network stands today. It compares the promises made when the system started with its actual performance since 1997. The study assesses whether it is effective or desirable for public entities to enter this business and compete directly against existing telecommunications providers. It also assesses the impact of the Click! Network on Tacoma ratepayers and the system's prospects if it continues on its present course. Finally, the study presents policy recommendations about how the system can be improved.

¹ Click! Network information sheet at www.click-network.com/click/homewel/htm, March 2001.

II. The Trend of Public Utilities Expanding into the Telecommunications Market

As the first major city in Washington to take this step, the experience of the Click! Network is of pressing importance to the people of Washington state. As mentioned, other communities are considering similar outlays of public funds to build high-speed, publicly-owned telecommunications networks. Using their subsidized utilities, these public entities are considering expanding into areas of the economy that so far have been served largely by the private sector.

In an earlier study on public power, the Washington Institute pointed out the pitfalls of public utilities entering the telecommunications field: “In spite of risk and volatility, the highly profitable world of telecommunications is increasingly irresistible to government utility providers. Public utility districts...see in telecom a springboard of opportunity, with potential for nearly unlimited revenue growth well into the foreseeable future.”²

The analysis pointed out the particular attraction to public utilities of taking this route. In heavily urban areas public utilities long ago accomplished the task of building a reliable electrical network. Like most public entities, these utilities over time tend to both expand their current mission and to seek new ones. For many utility managers, moving into advanced telecommunications seems like a logical development of their organization’s traditional work, even if this encroachment occurs at the expense of existing private sector providers.

Another inducement to expansion was growing concern over the possible deregulation of the energy market. By the mid-1990s many public power monopolies feared they would soon face competition as federal and state policymakers lowered regulatory barriers to new suppliers. If business and residential customers were allowed to choose their own power supplier, public utilities wanted to be in a position to offer wider services that helped attract new customers and hold on to old ones. In Washington state the policy changes needed for energy deregulation never occurred, but the desire of local public utilities to expand into new areas remained. The perceived need to guard against increased competition for customers formed a powerful rationale for TPU to move ahead with the Click! Network.

III. Policy Concerns Over Government Entering the Telecommunications Market

The practice of public utilities like TPU moving into the telecommunications business raises the broader policy concern over whether government agencies should embark on projects that compete directly with private companies. The practice raises three fundamental questions: 1) Is it efficient? 2) Is it fair? 3) Is it the best way to

² “The Problem with Power: Public Threats to Private Utilities,” Washington Institute for Policy Studies, 1997, pp. 9 – 10.

achieve a public purpose? The following discussion examines each of these questions in turn.³

1) Is it efficient? Economists generally agree that government agencies, where valid comparisons exist, are much less efficient than for-profit companies. This is especially true in economic activities involving advanced technology that place a premium on constant change and innovation. Private firms have access to price signals from the market to inform company leaders and stockholders about the long-term health and direction of the organization. The inherent need to remain profitable acts as “an ultimate constraint” on bad decisions because companies “either make a profit or they go out of business.”⁴ Political scientist James Q. Wilson’s comparison of how private and public bureaucracies operate illustrates this point well.

“Government agencies are especially vulnerable to bad changes because, absent a market that would impose a fitness test on any organization change, a changed public bureaucracy can persist in doing the wrong thing for years. The Ford Motor Company should not have made the Edsel, but if the government had owned Ford it would still be making Edsels.”⁵

Without regular feedback from the daily behavior of customers, competitors and suppliers, government managers lack the information needed to consistently make effective decisions. They also lack the powerful personal incentives possessed by managers of private firms who, if not able to perform over the long run, know they will eventually be forced to look for other work.

2) Is it fair? Public systems enjoy government-created advantages over competitors that distort the market. When a government agency enters a private market, the companies already operating in that market face more than just another competitor. They must now compete against an organization supported by taxpayers. Since their existing customers are also taxpayers, these customers are, at least partly, paying for the service they receive twice: once by paying a private provider (through, say, a monthly cable bill) and again through taxes and power rates. This is clearly unfair to the existing private provider and its cable customers.

The situation creates a strong incentive for customers to end at least one of the overpayments they face. Since paying local taxes and power rates is mandatory, customers have a logical inducement to shed the one cost that they do control, their private monthly cable bill. Influencing the rational behavior of consumers is one of the major ways government intervention distorts the efficiency of the marketplace.

The distortion government-sponsored entry brings to the market feeds on itself. If deemed successful, the model of competing against private enterprise encourages an ethic of “empire building” among government leaders. Once established in one market,

³ For a more extensive analysis of government’s role in the telecommunications market see, “Does Government Belong in the Telecom Business?” by Jeffrey A. Eisenach, Ph.D., in *Progress on Point, Periodic Commentaries on the Policy Debate*, The Progress and Freedom Foundation, Release 8.1, January 2001 at www.pff.org/pff_publications.htm#telecom.

⁴ Eisenach, p. 12.

⁵ “Bureaucracy,” by James Q. Wilson, Basic Books, New York, 1989, p. 227.

government agencies may move on to seek growth opportunities in other economic activities. This is especially true when public agencies believe they may be about to lose a protected monopoly they already enjoy. While government managers may meet this objection by assuring the public that they intend to penetrate only “this far and no farther” into the private sector, TPU has already demonstrated that a well-established public agency is more than capable of deviating far from its historical mission.

3) Is it the best way to achieve a public purpose? All agree that members of the public expect and deserve the best cable and Internet service available for their community. The challenge facing policymakers is to identify and encourage the best way to provide it. Promoters of public ownership of telecommunications services argue that it is an essential public service, like a fire station, and that government should simply provide it, regardless of whether it loses money or adversely impacts existing providers.

This defense overlooks the significant risks involved in public ownership. Public operation of a telecommunications system shifts significant financial liability to taxpayers. Losses must be made up through public subsidies in the form of direct payments, lowered reserves, higher prices for other services or public borrowing. When private companies provide a service to the public, they assume all of these risks, leaving public resources and management expertise free for uses that have a higher public priority, such as transportation and public safety.

IV. TPU’s Proposal to Create a Cable Network

In 1996, the City of Tacoma hired SRI Consulting of California to explore a telecommunications growth strategy. In its report SRI advised Tacoma to consider “playing a significant role in the advanced communications business.”⁶ One reason given for the utility’s proposed “increased involvement” was to offset “a flat or decreasing revenue stream from energy production and distribution.”⁷ A major rationale for entering the telecommunications field was a desire by TPU to seek new sources of income, as proceeds from its traditional service infrastructure leveled off.

In April 1997 the Tacoma City Council voted to give TPU the authority it needed to begin building the Click! Network.⁸ The Council’s approval relied on a specific proposal presented by TPU officials describing what the Click! Network would look like and what it would achieve for the people of Tacoma.⁹ The Click! Network provides cable TV, Internet and high-speed data transmission services. TPU initially proposed issuing municipal bonds for financing, but instead tapped existing reserves to build the network. A current assessment reveals that so far the Click! Network is falling well short of its original goals. The results of this assessment are as follows.

⁶ “Telecommunications Strategy Assessment,” SRI Consulting, prepared for the Light Division of Tacoma Public Utilities, May 21, 1996.

⁷ Ibid.

⁸ Resolution No. 33668, “Approving the development of a broad band telecommunications network including the Business Plan and authorizing the Department of Public Utilities to proceed with implementation of said system,” approved 8 to 0, with 1 member absent, April 8, 1997.

⁹ Telecommunications Study, Tacoma Public Utilities, 1997.

V. The Proposal vs. Results: Assessing the Click! Network

The TPU proposal approved by the Tacoma City Council laid out specific financial goals that the new network expected to achieve within a certain timeframe. After initial start-up costs, the plan stipulated the network should: 1) cover operating expenses; 2) pay back debt incurred, if any, plus interest and; 3) build up a reserve fund to pay for network improvements. This section presents the benchmarks set forth in TPU's proposed plan and compares them with actual results.¹⁰

Proposed Plan: Start operation on September 15, 1997.

Results: The Click! Network signed up its first cable customer on July 27, 1998, more than ten months late.

Proposed Plan: Sign up 34,312 cable customers by the end of 1998.

Results: The Click! Network had just 17,260 cable customers at the end of 2000. Even when the system's late start is taken into account, the actual number of customers signed up still does not meet the number projected.

Proposed Plan: Earn revenue of \$22.7 million in 1999.

Results: The Click! Network had revenue of \$2.7 million by December 31, 1999, well below the cost of operating the system.

Proposed Plan: Build the initial system with an estimated capital budget of \$40 million.

Results: Capital costs for the Click! Network had grown to \$86.5 million by October 2000.

Proposed Plan: Earn a profit of \$1.9 million by the end of 1998.

Results: The Click! Network has yet to earn a profit, or approach the break even point.

Proposed Plan: Achieve estimated earnings of \$36 per customer per month in 1999.

Results: Actual per customer revenue per month in 1999 was \$29. Costs per customer were \$68, a systemwide shortfall of \$39 per customer per month.

Proposed Plan: Maintain estimated operating expenses in 1999 of \$14.3 million or less.

Result: Actual operating expenses in 1999 were \$6.3 million. With far fewer customers than expected to share fixed costs, however, the system faces expenses per customer about three times greater than expected.

¹⁰ Sources for this assessment are: City of Tacoma Council Meeting Minutes and Study Session Minutes, April 8, 1997; Overview: A Local Telecommunications Business Plan, Tacoma Public Utilities, 1997; City of Tacoma, Department of Public Utilities, Light Division, Financial Reports for 1998 and 1999; TPU Click! Network Operation Summary, January, 1999; TPU Click! Network Performance Review, Price Waterhouse Coopers, April 24, 2000; An Analysis of TPU's 1997 Telecommunications Study, Arthur Andersen, February 7, 2001.

Proposed Plan: Cover all the communities in TPU's service area.

Result: The Click! Network recently announced that due to lack of capital funds plans to extend the system have been postponed indefinitely.¹¹

As of September 2000, the Click! Network had lost \$15.7 million. Combined with the \$86.5 million in capital expenses already dedicated, the system has spent a total of \$105 million since its inception. As a public entity, TPU must cover its losses with revenue from ratepaying electricity customers. So far TPU's cable system losses have added about \$709 in new costs for each of the utility's 148,000 power customers. It is likely that the need to make up Click! Network losses figured into TPU's decision recently to impose a 50% surcharge on local electric bills, and in the utility's need for an additional \$100 million in borrowing authority.¹² If limited only to Click! Network subscribers, the cost of the system to date equals about \$5,250 per customer.

VI. Prospects for the Future

Costs for the Click! Network are expected to continue to grow. TPU plans to spend an additional \$36.2 million on the system over the next two years. \$4.6 million, or 12.7%, will be devoted to covering additional operating losses.¹³ The remaining \$31.6 million will go to further capital expenditures. Total costs are projected to be \$138 million by the end of 2002, of which \$20.3 million, or about 14.7%, will be made up of ongoing operating losses.¹⁴ So far management of the Click! Network's finances are following the pattern of many "dot.com" Internet businesses, which operate at a loss for years on the expectation of future profitability.

In an effort to rectify its public image as a money-loser, Click! Network officials announced in August 2001 that the system had "turned the corner" on profitability. General Manager Dana Toulson told business reporters the network had brought in \$3.6 million in revenue during a period when it spent \$3.5 million.¹⁵

On examination this claim proves to be misleading. Saying the network had "turned the corner" on profitability does not mean it is profitable. The Click! Network accounting that shows \$100,000 in "profit" is only possible if \$450,000 in annual depreciation costs are not factored in. The period used for the accounting only refers to the past year. It ignores the large liabilities the system has incurred since its inception in 1997. Even the Click! Network itself had committed to earning a profit by the end of 1998. Having consistently failed to meet its own goals, the network is attempting to establish new ones.

¹¹ "Tacoma's Click won't expand reach," by George Erb, *Puget Sound Business Journal*, May 11, 2001, p. 3.

¹² "Study: Munny Overbuilds Are Bad for Business," by Joe Estrella, *Multi-Channel News*, April 2, 2001, p. 43. This citation refers to the source of the figures only, not to our analysis for why rates increased.

¹³ An Analysis of TPU's 1997 Telecommunications Study, Arthur Andersen, February 7, 2001.

¹⁴ Ibid.

¹⁵ "Click! turns the corner on profits as AT&T steps up its criticism," by Steve Dunkelberger, *South Sound Business Examiner*, August 6, 2001.

Another of TPU's initial goals for the Click! Network was to build up a reserve fund to pay for future upgrades of the system. This is common practice in the private sector and an essential contingency for any high-tech enterprise. At present TPU has no reserve fund set aside for future upgrades and with continued losses has no way to start one without cutting back on services, shifting costs to ratepayers, or incurring new debt.

VII. Possible Strategies for Stemming Ongoing Losses

At present it does not appear that the Click! Network can become profitable within the foreseeable future. Based on its revenue and operating cost structure for cable television and Internet services, the system would need 80,000 total paying customers to reach the financial break-even point. The Click! Network had about 20,000 customers in November 2001.

To have a chance of approaching its financial goals, the Click! Network has three potential strategies available:

- 1) Draw more than half of the paying customers away from existing cable providers, that is, at least 52% of all subscribers available in 1999;
- 2) Draw all new cable customers available from current non-subscribers;
- 3) Accomplish some combination of the two.

Realistically, the third option is the only one that offers any hope of making the Click! Network sustainable. Even if the system accomplished everything possible under the second strategy, it would still fall short. Given the losses that have been incurred so far, even gaining 100% of all available cable non-subscribers would not be enough to bring the system to the financial break-even point.

Pursuing the first option alone would also prove impractical. The private cable service provider currently serves 81.5% of the market in the Tacoma area, down from 100% before the Click! Network began. Any private provider, in this case AT&T, would be expected to vigorously resist further market encroachment by offering strong incentives to customers to stay with their current service. Such inducements would likely be enough to at least partly offset the Click! Network's natural advantage as a publicly-subsidized entity.

This strategy may be closed off to Click! Network in any case. At the current add-on rate of only about 420 new subscribers per month, the system is still well short of meeting customer sign-up projections.

VIII. Increased Financial Risk and the Impact on TPU's Core Mission

Because it is part of a public utility, the Click! Network is forcing the citizens of Tacoma to take risks that normally would be borne by private stockholders. The result is

that the Click! Network is adding unnecessary costs to the already-rising trend of Tacoma's energy prices.

There is also a high opportunity cost for continuing the Click! Network. Any government-subsidized economic activity that tries to operate at a profit has the effect of crowding out other beneficial economic activity that would otherwise take place. The Click! Network is not structured to draw financing from private capital markets, and therefore is unable to leverage the kind of long-term investment that a private firm could. The Click! Network does have access to public borrowing, but this would only increase the financial exposure of area taxpayers.

A further opportunity cost of the Click! Network is the way it siphons resources from TPU's core mission of supplying affordable and reliable power to its customers. For example, in 1998 an additional \$600,000 was sought to pay the contracting crews building the telecommunications network. TPU managers reported to their Board that "the Line section is...heavily impacted with the make-ready construction for Click! Network."¹⁶ For this reason more funding was needed because "the Line section will need to contract out the extra work brought on by the Click! Network project."¹⁷

The Click! Network has also increased risk to taxpayers by depleting the reserves TPU needs to meet unexpected contingencies. As noted, the Click! Network has been unable to expand as planned because, TPU says, "soaring electricity prices drained Tacoma Power's cash reserves."¹⁸ Actually, these reserves have already been depleted over the last four years because they were devoted to building the Click! Network. TPU has used the reserves "as a source of working capital for building its telecommunications network."¹⁹

The Click! Network's drain on TPU reserves has left the utility financially weakened and less able to cope with sharply-rising energy prices. This is hampering TPU's effort to deal effectively with soaring energy prices and maintain affordable power service. These adverse effects are not surprising. TPU is experiencing the high opportunity costs and significant risk that naturally come with entering the telecommunications market.

IX. Problems Experienced by Other Municipal Systems

Tacoma is not the first city to encounter serious problems stemming from a municipal telecommunications venture. Examination of other such utilities shows that they often fall well short of meeting their goals for economic efficiency and fiscal sustainability. A recent study of three city-owned cable utilities in other states concludes

¹⁶ City of Tacoma, Tacoma Public Utilities Board Meeting, agenda item #5, "Increase contract for augmented crews with Hawkeye Construction, Inc., Hankel & McCoy, Inc. and Potelco, Inc. through fall 1998," minutes of August 12, 1998, p. 3.

¹⁷ Ibid.

¹⁸ "Tacoma's Click won't expand reach," by George Erb, *Puget Sound Business Journal*, May 11, 2001, p. 3.

¹⁹ Ibid.

that two of them “will never reach payback, and it will take [the third] 23 years to pay back its initial investment.”²⁰

In Palo Alto, the public’s response to a municipal system that offers broadband Internet access has been described as “tepid,” with high built-in costs and promotional missteps by the city cited as the leading cause. The system also failed to account for the formidable competition it would face from more reliable and cheaper technologies such as cable modems.²¹

In Iowa, the publicly-owned Iowa Communications Network regularly receives major subsidies in order to continue operations. The system has an annual operating budget of about \$53 million, yet managed to lose more than \$24 million in fiscal 1999. Even after being provided with public subsidies of \$23 million, the system continued to sustain losses.²²

In the Pacific Northwest, Eugene, Oregon sought to build an extensive, 800-mile digital telecommunications network designed to reach all of its ratepaying customers. After spending \$6.4 million for a more limited high-speed system, the city’s electric utility realized the daunting financial risks involved. The city has been advised it could cost as much as \$240 million to complete the original plan, and further work to extend the system has been suspended.²³ “What we learned was that it’s hard to show enough revenue to cover the costs,” says project manager Ken Beeson, “Building a universal system in the short term doesn’t appear to be feasible or cost-effective.”²⁴ The Oregon legislature is now considering legislation to bar cities from entering the telecommunications business unless strict financing, public disclosure and regulatory conditions are met.²⁵

X. Conclusion and Recommendations

The disappointing results of Tacoma’s foray into the telecommunications business indicate that traditional public utilities are not well equipped to pursue construction and operation of high-technology infrastructure projects. Such a public system can exist by operating at a loss and relying on revenue from its existing subsidized services, but it cannot sustain itself financially over time.

Government can play important, indeed vital, roles in fostering an effective local telecommunications market, but owner and market competitor is not one of them. Running a sophisticated telecommunications and cable service is simply not a core

²⁰ Eisenach, p. 12, and “Costs, Benefits, and Long-Term Sustainability of Municipal Cable Television Overbuilds,” by Ronald J. Rizzuto and Michael O. Wirth, GSA Press, Denver, 1998.

²¹ “In Silicon Valley, Zippy Web Lines Spark a Surprise: Slow Demand,” by Scott Thurm, *Wall Street Journal*, January 20, 2000, p. B1.

²² Eisenach, p. 14.

²³ “Broadband’s Broad Price Tag, Faced With Hard Numbers, Eugene is Scaling Back Plans for a Citywide Telecom Network,” by Janet Colwell, *Oregon Business*, April 2001, p. 40.

²⁴ *Ibid.*

²⁵ HB 2680, introduced March 2, 2001 by Representative Witt, Oregon Legislative Assembly, Salem Oregon, 2001 Regular Session.

function of government. Government can monitor the marketplace, enforce contracts, protect consumer rights and insure Internet access to schools, libraries and government buildings. Local government can also act as an “anchor tenant,” providing the level of assured business needed to attract private providers.

Recommendations: At a meeting in December 2000 the Tacoma city council discussed selling the Click! Network as a way to avoid imposing a surcharge on electricity bills. At that time the proposal was rejected and the surcharge was approved.²⁶

As losses mount, the City of Tacoma should reconsider selling the Click! Network to the private sector. This can be done either through issuing stock ownership on the open market, or by creating a private holding company that can assume responsibility for the system’s assets and liabilities. The system could also be sold to an existing cable operator. The solution that is in the best interests of the people of Tacoma would be to auction the network through a controlled bidding process. Potential bidders include the current local cable franchise holder, any alternate cable company, a group of local investors, or even a non-profit corporation established for the purpose.

Regardless of which option is chosen, the people of Tacoma should be relieved of the financial burden of supporting a money-losing telecommunications network. This action would recoup some of the losses the system has incurred so far, and serve to ease the skyrocketing energy prices the city is experiencing. A further advantage is that selling the system would allow the Click! Network to gain access to greater financial resources for capital and operating investments, and could avail itself of the valuable experience of private sector telecommunications managers.

Most importantly, divesting itself of the Click! Network would free Tacoma Public Utilities to refocus efforts on its core mission: providing affordable, reliable electrical service to the residents and businesses of Tacoma.

²⁶ “Tacoma OKs 43% Surcharge,” by Martha Modeen, *The Tacoma News Tribune*, December 20, 2000.

About the Author

Paul Guppy is a graduate of Seattle University and holds a Master of Arts degree in government and public policy from Claremont Graduate University, and a Master of Science degree in political science from the London School of Economics. He completed higher education programs at The Sorbonne, Paris and at Gonzaga University in Florence, Italy. He served for 12 years in Washington D.C., mostly as a Legislative Director in the United States Congress, before joining the Washington Policy Center in 1998 as Vice President for Research. He is the author of previous Policy Center studies on civil rights, labor policy, tax policy, insurance regulation and health care reform.

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