



NEWS RELEASE

RESPONSE TO THE HEARTLAND INSTITUTE'S ATTACK ON THE LAFAYETTE FIBER PLAN

June 23, 2005 - In its latest "study" entitled *Municipal Broadband: Optimistic Plan, Disappointing Reality* (June 20, 2005), the Heartland Institute attempts to achieve two purposes simultaneously: (1) attack the municipal fiber project in Bristol, Virginia, and (2) use its criticism of the Bristol system to undermine the Lafayette fiber project. Heartland's paper contains so many mistakes, misinterpretations, unsupported and insupportable claims, irrelevancies, innuendos, key omissions, and obvious untruths in Heartland's latest harangue against municipal broadband that it would take a paper many times the length of this one to respond to them all.

Fortunately, it is not necessary for Lafayette Utilities System (LUS) to do so here. In a memorandum prepared at the request of the Treasurer of Louisiana, LUS has already furnished extensive responses to Heartland's previous arguments, and many experts and individuals with first-hand knowledge of the projects that Heartland and other incumbent-supported "think tanks" frequently disparage have provided point-by-point refutations to their false claims. These responses are collected at: <http://www.baller.com/barriers.html>.

Furthermore, the only new matters in Heartland's paper are its analysis of the OptiNet municipal fiber system in Bristol, Virginia, and its comparison of OptiNet's experience with LUS's proposed project. Heartland maintains that it compared the Bristol and LUS fiber projects for three reasons: (1) LUS has cited Bristol as an example of a successful fiber project; (2) CCG Consulting developed the feasibility plans for both Bristol and LUS; and (3) Bristol furnished Heartland the financial data that it sought. LUS agrees that this is a useful comparison and will focus here on vividly revealing the flaws in Heartland's discussion of the Bristol project.

In this paper, LUS will first quote and then respond to each of Heartland's main claims. As shown, far from supporting Heartland's attack on the LUS project, its analysis and arguments succeed only in exposing the depth of Heartland's bias against community broadband initiatives. A good test of whether Heartland is the paragon of impartiality that it claims to be is whether it will accept the corrections provided in this paper, apologize to Bristol and Lafayette and throw its support behind the LUS project.

I. ANALYSIS OF BRISTOL'S OPTINET

HEARTLAND'S CLAIM:

“OptiNet launched TV, Internet and phone service in 2002. As of its fiscal year ended June 30, 2004, it had a net operating loss of \$3.3 million. The 2004 loss was a 25 percent improvement from 2002, when OptiNet lost \$4.4 million. Even so, the loss came despite a sizable increase in revenues to \$4.7 million in 2004 from \$754,000 in 2003. OptiNet’s shortfalls are a function of its escalating operating expense, which increased 67 percent to \$6.5 million in 2004 from \$3.9 million in 2003. Operating costs represented a 148 percent increase over 2002. Non-operating costs, which are principally interest expenses, were \$1.5 million in 2004.”

LUS'S RESPONSE:

There are so many significant errors in and omissions from this statement that one scarcely knows where to begin to respond to them.

First, Heartland’s suggestion that OptiNet “launched cable TV, Internet and phone service in 2002” is incorrect. It is true that Bristol planned to bring OptiNet on stream in 2002, but interference by the incumbent service providers delayed that plan. Telephone service provider Sprint delayed OptiNet’s launch of telephone service by several months by filing an action against OptiNet before the Virginia State Corporation Commission. Later, cable television provider Charter Communications delayed OptiNet’s entry into the cable television business for many additional months by suing Bristol in the federal district court.

As a result of these disruptions by Sprint and Charter, OptiNet had to bear substantial legal and other costs, but it had no corresponding revenues (with the minor exception of limited revenues from system trials). All told, Bristol had to delay its provision of the full “triple play” of services until July 2003, more than a year after its planned launch date.

Second, even if OptiNet were in fact running at a loss – which, as shown below, is not the case -- that would not be unusual for a capital-intensive fiber project. “Rapid growth in capital expenditures is a natural part of any start-up enterprise, especially ones that are relatively capital intensive such as cable television. Consequently, [negative free cash flow] numbers during the early years of operations of [such systems] are not at all surprising.”¹

By emphasizing OptiNet’s early years of its fiber project, Heartland has sought to present the project in its worst light. In fact, Heartland knows perfectly well that it is inappropriate to draw

¹ John Kelly, *Paying the Bills, Measuring the Costs: Assessing the Financial Viability and of Municipally Owned Cable Television Enterprises* at 9 (2005), <http://www.appanet.org/files/PDFs/PayingtheBills.pdf>.

negative conclusions from early-year losses in such projects. In the Heartland paper to which LUS previously responded, Heartland relied heavily on an incumbent-funded study by Ronald Rizzuto and Michael Wirth, *Costs, Benefits, and Long-Term Sustainability of Municipal Cable Television Overbuilds* (Denver, CO: GSA Press, 1998). In that study, Rizzuto and Wirth analyzed data for four municipal cable systems, including one in Cedar Falls, Iowa. Because the Cedar Falls system was then in only its third year of operation, Rizzuto and Wirth cautioned that “a thorough economic analysis ... is not possible at this time because the entity has been in operation for only three years.”²

Like Cedar Falls at the time of the Rizzuto and Wirth study, Bristol is now in its third full year of operation. Heartland's suggestion that Bristol is a failure due to what Heartland takes to be early year losses seems to be a convenient divergence from Rizzuto and Wirth's position concerning early year losses. Furthermore, compounding Heartland's error, Bristol is not losing money. When the data are properly analyzed, it becomes clear that Bristol is already bringing in more revenues than its costs.

Third, another problem with Heartland's analysis is that it uses the term “losses” in a vague, pejorative way, without acknowledging the typical industry standards used to describe the financial success of an entity such as OptiNet.

For example, one of the most common financial standards used in the communications industry is "EBITDA" - Earnings, Before Interest, Taxes, Depreciation and Amortization by description. The following is a representative explanation of the utility of that standard:

This earnings measure is of particular interest in cases where companies have large amounts of fixed assets which are subject to heavy depreciation charges (such as manufacturing companies) or in the case where a company has a large amount of acquired intangible assets on its books and is thus subject to large amortization charges (such as a company that has purchased a brand or a company that has recently made a large acquisition). *Since the distortionary accounting and financing effects on company earnings do not factor into EBIDTA, it is a good way of comparing companies within and across industries.*

² Rizzuto and Wirth ignored their own advice and went on to predict that the Cedar Falls system would fail without subsidies. Cedar Falls subsequently made mincemeat of this prediction by becoming a great success, particularly as an engine of economic development for the community. Doris Kelley, *A Study of the Economic and Community Benefits of Cedar Falls, Iowa's Municipal Telecommunications Network* (2004), http://www.baller.com/pdfs/cedarfalls_white_paper.pdf. Other studies of municipal communications projects have reached similar conclusions. See, e.g., George Ford and Thomas Koutsky, *Broadband and Economic Development: A Municipal Case Study from Florida* (2005), <http://www.aestudies.com/library/econdev.pdf>; Strategic Network Group, *Economic Impact Study of the South Dundas Township Fibre Project* (2003), <http://www.dti.gov.uk/industries/telecoms/sdcsfi270603.pdf>.

This measure is also of interest to a company's creditors, since EBITDA is essentially the income that a company has free for interest payments.³

A positive EBITDA means that a company is generating enough revenue (cash) to cover the daily operating expenses of running the business. That is particularly important here because a substantial portion of the “loss” shown in Table 2 on page 6 of the Heartland paper is attributable to non-cash depreciation. In short, Heartland’s inclusion of depreciation further biases its analysis by making OptiNet’s operating losses appear far greater than they actually are.

In its original business plan for OptiNet, CCG Consulting projected a negative EBITDA during the first three years of the project. Despite its one-year delay in launching full service, which the incumbents forced upon it, OptiNet will not only meet, but exceed the EBITDA-positive projection for 2005. In short, this means that the OptiNet system is already taking in more revenues than its costs.

As a reference, the financial results as compared to the CCG business plan are:

<u>CCG Business Plan</u>	<u>Actual Bristol OptiNet Financial Performance</u>
2002 (\$2.22 M)	(\$0.96 M) - This was the year before FTTH launch
2003 (\$2.61 M)	(\$2.32 M)
2004 (\$0.44 M)	(\$0.75 M)
2005 \$1.97 M	\$2.06 M - Projected ⁴

As the above numbers indicate, OptiNet is performing very well compared to the original CCG business plan. The positive EBITDA in 2005 will be more than enough to pay the bond obligations and cover operating cash needs. In other words, in less than three years of operations, Bristol is already bringing in more revenues than the sum of all its costs requiring cash outlays, including debt service and interest payments.

Another common standard to measure a private entity’s performance is “Net Income.” Having positive net income means that revenues exceed all expenses – operating expenses plus interest, taxes and depreciation. CCG’s original business plan predicted that OptiNet would not have a positive net income until 2008.

In fact, as the figures below show, OptiNet is ahead of its business plan, despite having lost a year of revenue-generating activity:

³ *Investorwords.com*, http://www.investorwords.com/5534/Earnings_Before_Interest_Taxes_Depreciation_and_Amortization.html

⁴ OptiNet’s fiscal year goes from July 1 to June 30 of each year, so 2005 is now nearly complete. The figures for 2005 are based upon ten months of actual performance and two months estimated.

<u>CCG Business Plan</u>	<u>Actual Performance</u>
2002 (\$2.65 M)	(\$1.31 M)
2003 (\$4.30 M)	(\$4.41 M)
2004 (\$4.16 M)	(\$3.32 M)
2005 (\$2.00 M)	(\$1.93 M) - Projected
2006 (\$1.29 M)	
2007 (\$0.91 M)	
2008 \$0.88 M	

In summary, Heartland’s harsh judgment of OptiNet for supposedly failing to eliminate “losses” within three years is wrong and unfair on multiple levels. Furthermore, it is also disingenuous for Heartland to try to create the impression that OptiNet’s costs have been escalating uncontrollably. True, as Heartland observes, OptiNet’s operating expenses increased 148% from 2002 to 2003 and 67% from 2003 to 2004. But Heartland fails to tie those increases to the revenue increases that OptiNet’s expense-generating activities caused. Those revenue increases were 84% from 2002-2003 and 517% from 2003-2004. When viewed in a more useful light, from 2002-2004, OptiNet’s revenues increased by 1035%, while its expenses only increased by 314% - a very impressive performance.

HEARTLAND’S CLAIM:

“Municipal broadband providers ... set extremely optimistic goals, as in Lafayette’s case, of obtaining 50% (penetration) within four years. By contrast, Comcast, which leads in market share among broadband Internet service providers, averages just 18% penetration across its markets. The national penetration rate (for broadband) is 45 percent.”

LUS’S RESPONSE:

LUS agrees with Heartland that it is useful to compare Lafayette's proposal to Bristol's performance – not to the distorted version that Heartland presents, but to the real version discussed above. But it still does not tell the whole story. Several considerations suggest that the Lafayette project could well be even more successful than Bristol’s.

Bristol's initial market surveys indicated that about 40% of its residential consumers would purchase service from Bristol if it offered lower prices than the competition. The original CCG business plan projected that Bristol's OptiNet project would obtain 45% of the residential customers in the city for cable TV and telephone services. Instead, despite its one-year delay caused by incumbent interference, OptiNet had the following penetration rates in April 2005, expressed as a percentage of the serviceable Bristol market:

Residential Telephone	56%
Residential CATV	57%
Residential High-Speed Data	34%
Business Telephone	18%
Business CATV	7%
Business High-Speed Data	15%

These figures are all the more impressive in the light of Bristol’s demographics and market conditions. Bristol is part of a region that has suffered steep declines in tobacco farming, coal mining, textile manufacturing and agriculture. The median household income in the City was only \$27,389 in 2000. Despite all this, OptiNet has substantially exceeded its projected penetration rates and is delivering high-speed Internet to nearly twice the percentage of households that, according the Heartland, Comcast is reaching nationwide. This observation alone could lead one to believe that Bristol is doing a substantially better job of stimulating and meeting community demand than Heartland would have readers of its paper believe.

Lafayette is a substantially larger and more prosperous community than Bristol. Lafayette serves as a regional retail and medical center, has a major university, and had a median household income in the Year 2000 of \$35,996 (a 31% higher than Bristol). When comparing Lafayette to Bristol, there is little question that Lafayette should be able to achieve at least as high, if not a higher, penetration level than Bristol.

In fact, in LUS's initial market survey, more than 70% of Lafayette households said they would sign up for LUS service if it offered lower prices than the competition. That was 30 percentage points (or 75%) higher than the 40% of households in Bristol that gave a similar response. As with Bristol, LUS also believes that its strategy of charging lower prices for better service and keeping the cost savings in the local economy will attract enough customers to make the 50% penetration rate readily achievable over the four years shown in LUS’s business plan.

Furthermore, broadband penetration rates are likely to continue to increase over time. According to a recent study by Jupiter Research, residential broadband penetration, currently at approximately 43 percent nationwide, is rapidly reaching a tipping point and “will increase dramatically from slightly under half of online households in 2004 to 78% of online households by the end of 2010.”⁵

HEARTLAND’S CLAIM:

“The chief contributors to OptiNet’s deficit are the cost of promotion and marketing, the cost of programming and the cost of borrowing.”

⁵ <http://www.jupitermedia.com/corporate/releases/05.06.02-newjupresearch.html>.

LUS'S RESPONSE:

First, Heartland's suggestion that "...there would be 100 percent uptake in areas when it was available, just like electricity and water..." indicates that Heartland has not considered the history of the electrification of America.

While most Americans now take electricity for granted and could not conceive of living without it for any length of time, this was not the case when electricity was introduced in the late 19th Century. At that time, lighting was the first main use of electricity, and electricity had stiff competition from several alternatives, including oil, kerosene, wood, natural gas and candles. As electric appliances emerged, electric utilities had to educate consumers about the value of these appliances and the need for electricity to use them. Many utilities created demonstration kitchens for this purpose, and that tradition has carried over into the broadband areas. For example, the municipal electric utility in Glasgow, Kentucky, has a model room to show residents how to set up and use high-speed Internet applications.

Furthermore, over the last four years, the United States has dropped from 4th to 16th place in the world in broadband penetration, as measured by the International Telecommunications Union, and to 12th place among the smaller group of nations ranked by the Organization for Economic Cooperation and Development. If the United States is to regain and retain its competitive position in the world economy, it must develop better ways to keep within close distance of the world's leading countries in per capita broadband penetration, access to high-bandwidth broadband, and cost per unit of bandwidth. Municipalities have a critical role to play in this, as they did a century ago in bringing the benefits of electricity to thousands of communities many years faster than the private sector alone would have done.⁶

The federal government has explicitly recognized that, given the vast benefits that high-bandwidth broadband can bring to all aspects of American life, government entities of all kinds should act vigorously to have America deploy high-bandwidth broadband infrastructure as rapidly as possible. For example, in 2002, the United States Department of Commerce published an extensive report documenting the multiple benefits that ubiquitous access to affordable, high-bandwidth broadband would produce for America.⁷ The report noted that "the current generation

⁶ In an earlier version of its paper, which BellSouth submitted to the Louisiana Bond Commission on May 19, 2005, Heartland candidly admitted that LUS, Consumers Federation of America, Free Press, and the Media Access Project had made "a compelling argument to be sure" that "[t]raditionally, local governments have proven vital in deploying necessary infrastructure. For example, local governments built municipal power systems as part of the efforts to electrify America in the first part of the century." *BVU OptiNet and Lafayette Utilities System: A study of a municipal broadband reality against a municipal broadband plan* (Heartland, May 19, 2005) at 4. For the purposes of this paper, Heartland has conspicuously omitted that concession.

⁷ U.S. Dep't of Commerce, *Understanding Broadband Demand: A Review of Critical Issues* (September 23, 2002), http://www.technology.gov/reports/TechPolicy/Broadband_020921.pdf.

of broadband technologies (cable and DSL) may prove *woefully insufficient* to carry many of the advanced applications driving future demand. *Today's broadband will be tomorrow's traffic jam, and the need for speed will persist as new applications and services gobble up existing bandwidth.*"⁸ The report then went on to encourage governments at all levels to act aggressively to stimulate broadband demand. Among other things, the report suggested that state and local governments do the following:

Encourag[e] Experiments (*e.g. Fiber-To-The-Home New Builds*). Planned communities are springing up around the nation, with fiber-to-the-home installations increasing by more than 200% in the past 12 months. (*FTTH Council, Aug. 2002*). In-Stat/MDR suggests the percentage of connected greenfield homes will skyrocket from 11% in 2002 to 61% by 2006, (*In-Stat, Feb. 12, 2002*). The Technology Policy Group has a (pre-publication) White Paper highlighting innovative local experiments around the country (expected for release in the Fall) such as Blacksburg Electronic Village and Berkshire Connect. These experiments and others should encourage innovation in applications and services.⁹

LUS embarked on its fiber project only after the incumbent cable and telephone companies repeatedly rebuffed the City's pleas for them to take the lead or partner with the City in providing a fiber-to-the-home system in Lafayette. Given this history, it is absurd for Heartland now to suggest that LUS's actions are somehow inappropriate or contrary to the public interest.

HEARTLAND'S CLAIM:

"In 2004, OptiNet spent more than \$220,000 on sales promotion. ... This is the cost of advertising, promotional material such as brochures and handouts and any event sponsorships designed to build brand awareness or sign-up customers. These costs were more than double the \$96,000 OptiNet spent in 2003. For every revenue dollar in 2004, OptiNet spent about 5 cents on promotion. By contrast, [Bristol]'s electric utility -- which has no competition and indeed offers a service that is a proven necessity -- spent \$44,500 on sales promotion in 2004, which amounts to about two-tenths of a cent on each revenue dollar. Water and wastewater units had no promotion costs at all.

...

"In the third year of operation, CCG projects LUS will spend \$505,000 on marketing and promotion. OptiNet, which serves a city one-fifth of the size, in its third year spent almost half of that, \$222,000. Further, in CCG's plan, marketing costs peak at the third year, and decrease in the fourth and fifth. In Years 3 through 5, LUS plans to triple its revenue while cutting marketing costs by almost

⁸ *Id.* at 6 (emphasis added).

⁹ *Id.* at 23 (emphasis added).

30 percent. Given the competitive nature of the market, and the strength of the competitors, this proposition is untenable.”

LUS’S RESPONSE:

Heartland apparently does not understand either the marketing figures that it presents or the realities of the marketplace in Bristol and Lafayette.

For most start-ups, the largest marketing expense is advertising geared primarily to creating brand recognition so that customers recognize the new provider and the products that it offers. Bristol and LUS have already been operating very successful businesses in their communities for a hundred years and already have excellent brand recognition that is transferable to their communications business. In addition, the very public battles that the incumbents waged to prevent OptiNet and LUS from entering into the communications field have provided excellent, free advertising for OptiNet and LUS. As a result, LUS will not have to spend nearly as much money as it might otherwise have had to spend to present itself to potential customers, particularly potential customers who resent the incumbents’ heavy-handed anticompetitive tactics.

Furthermore, OptiNet also saved substantial marketing costs by establishing an unofficial sign-up list in its business office before the launch of its services. The sign-up list was never advertised, and knowledge of it was spread only by word of mouth. Even so, by the time that OptiNet was ready to go into business, more than 35% of the households in the City had already signed up for its services. Also, during OptiNet’s first few months of business, another 15% of households walked in to sign up. As a result, OptiNet had a 50% penetration – higher than predicted in the business plan – without spending any significant start-up advertising money.¹⁰

OptiNet does have one significant expense in the marketing category – to enable potential customers to familiarize themselves with OptiNet’s products and services, it offers one month of service free of charge. For broadband and telephone services, this is a largely cashless expense for which BVU OptiNet books one month of revenue offset by one month of expense.

CCG has done business planning for more than 300 public *and* private providers of communications – including incumbent and competitive local exchange carriers, Internet Service Providers, wireless providers and cable companies. According to CCG, none of its clients views or establishes marketing expenses as a percentage of revenues, as Heartland recommends. Typically, companies target marketing expense to achieve two purposes – to acquire new customers and to retain customers.

For the reasons discussed above, OptiNet and LUS have little need to spend significant amounts of money to acquire new customers. With regard to customer retention, OptiNet and LUS also benefit from customer loyalty due to the hometown nature of provision of utility services. The

¹⁰ OptiNet incurs routine marketing expenses for brochures, rate sheets and other consumer education materials, but these are not significant expense items.

most important factors are charging rates significantly lower than competitors and offering high-quality service in the community. As a result, OptiNet has experienced relatively little "customer-churn", and LUS is likely to have a similar experience.

In summary, Heartland is mistaken in suggesting that LUS has significantly underestimated its marketing expenses. OptiNet's experience confirms that LUS's approach to marketing will be successful. Lafayette consumers are already indicating on a daily basis that they are anxious to purchase LUS-provided communications services.

HEARTLAND'S CLAIM:

"Cable TV incurs high programming costs ... Programming acquisition is the most volatile cost in the cable industry today. In their respective 2004 annual reports, the major cable companies reported ... increases in programming acquisition over 2006 [ranging from 6.1 percent for Comcast to 12 percent for Time Warner]. Among municipalities, the cost of programming is often cited as the reason for rate increases."

LUS'S RESPONSE:

Again, Heartland makes incorrect and misleading claims based on unsubstantiated figures and critical omissions of pertinent information. The facts again trump Heartland's rhetoric.

OptiNet and LUS realize that programming costs will increase each year, and they have included an annual escalation of 4% of costs to account for these increases. Heartland's suggestion that this amount is too small is without merit. For one thing, the programming cost increases that Heartland reports for Comcast and Time Warner are curiously high – significantly greater than the national average cable rate increase of 5.4% in 2004.¹¹ At the same time, cable rates increased significantly less in markets in which incumbent cable operators faced competition from terrestrial (i.e., other land based cable TV, as distinguished from satellite) providers.¹² These considerations should have "squeezed" Comcast and Time Warner's earnings, but in fact, both Comcast's and Time Warner's profits have "soared" in the last year.¹³ In short, if the major cable companies had only passed though their increased video programming costs on a dollar-

¹¹ FCC, *In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection and Competition Act of 1992: Statistical Report on Average Rates for Basic Service, Cable Programming Service, and Equipment*, MM Docket No. 92-266, FCC 05-12 (rel. February 4, 2005) at ¶ 7.

¹² Cable rates were an average of 15.7 percent lower in competitive markets than in communities in which head-to-head competition among terrestrial providers did not exist. *Id.* at 12.

¹³ See, e.g., <http://www.techweb.com/wire/ebiz/59301184#> (Time Warner); <http://www.advancedpipeline.com/161601805> (Comcast).

for-dollar basis – as municipal utilities strive to do – rate increases would undoubtedly have been considerably lower than they have been in recent years.¹⁴ The difference in these increases, of course, points to the propensity for private cable TV companies to use programming rate increases to justify larger-than-necessary rate increases by including an extra significant profit mark-up.

Furthermore, and most important, nearly all cable operators in the United States other than the major incumbents obtain most of their cable programming through the National Cable Television Cooperative. Over the last five years, the average increase in rates for programming obtained from NCTC has been 4%. That is the number that LUS used to project programming cost increases, and it is eminently reasonable.

In any event, the exact amount of the cost increases that LUS encounters is immaterial, because LUS will not be operating in a vacuum. If programming costs rise for LUS, they will also rise for its competitors, with the difference being that the competitors will likely add new profits to their rate increases.

HEARTLAND’S CLAIM:

“OptiNet’s interest expenses have grown from \$251,253 in 2002 in 2002 to \$1.4 million in 2003 to \$1.6 million in 2004. OptiNet’s interest expense is almost twice that of the [Bristol] electric operation. Moreover, the electric, water and wastewater units have a significant degree of interest income, which offsets some of the expense. ... OptiNet’s \$1.6 million in expense was offset by only \$94,026 in interest income.... OptiNet’s liabilities exert their weight on the balance sheet. OptiNet’s net deficit in 2004 was \$8.6 million, or about \$1,075 per Bristol household. This was a 36 percent increase over 2003.”

LUS’S RESPONSE:

Heartland’s comparison of the interest expense levels of the Bristol electric system with those of Bristol’s electric system is like comparing apples to...carpets – the comparison leads nowhere. The Bristol electric system has been in service for a century. Much of its capital costs have already been paid through the years and, as a result its current debt load is very low. By comparison, the Bristol OptiNet system is a brand new communications enterprise that has not had any opportunity to spread its capital costs over decades. Just by these few facts alone, it

¹⁴ Of course, most of the major national cable operators have little incentive to resist programming rate increases because they have significant ownership interests in the more popular video programming distributors. For example, in 2004 Comcast had ownership interests in ten national programming networks; Time Warner had an ownership interest in 29 national programming networks; and Cox had an ownership interest in 16 national programming networks. FCC, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming: Eleventh Annual Report*, MB Docket 04-227, FCC 05-13, at ¶¶ 145-52 (rel. February 4, 2005).

should be easily understandable to the objective person as to why the Optinet system has a greater level of debt service.

As far as the 2002 to 2004 in interest payments are concerned, the project was just starting in 2002 and OptiNet had not drawn down the full amount of the bond and, as a result, paid interest for only a few months. By 2004, the full bond was in effect. Bristol's bonds operate similar to home mortgages -- in the early years, a large portion of the payment on the bond is interest, with only a small amount applied to principal. In the final years, payments will be mostly principal, with a small and decreasing amount of interest. Thus, over the life of the bond, the amount of interest expense will decrease steadily each year.

Comparing the interest expense of the two divisions tells us nothing positive or negative about the communications venture, but tells much about Heartland's agenda.

II. Comparing OptiNet and LUS

HEARTLAND'S CLAIM:

“The success of the [LUS] plan is tied to extremely fast growth of revenues – faster and more aggressive than OptiNet has seen in its market.”

LUS'S RESPONSE:

This is untrue in several ways. First, OptiNet went from zero customers to over 50% of the Bristol residential market in only 18 months – those are facts, not projections. This growth was much faster than CCG had projected for OptiNet. Once OptiNet was able to remove the legal hurdles thrown at it by Sprint and Charter and was finally able to launch its business, the demand for service was so high that management decided to hire extra contractors to accelerate the construction necessary for new service installations.

Second, the LUS plan also predicts growth to 50% residential penetration. In LUS's case, however, CCG predicts that it will take four years from the date of serving the first customer for LUS to get to 50% penetration. Four years for Lafayette is obviously much *slower* than 18 months for Bristol. The LUS plan thus plainly does not project more aggressive growth than Bristol experienced. Like Bristol, however, it is very likely that consumer demand will require that LUS accelerate its installations to new customers. Of course, with each new installation, there is also a new revenue stream that makes the financial results of the deployment even more attractive.

HEARTLAND'S CLAIM:

“CCG has pegged the third year of operation as the point where LUS will be cash flow positive. But [Bristol] was still losing money in the third year.”

LUS'S RESPONSE:

First, OptiNet's third year is 2005, the current fiscal year that runs from July 1, 2004, through June 30, 2005. Heartland continues to assume that 2002 was OptiNet's first year, even though incumbent interference kept OptiNet from getting into business until the 2003 fiscal year. CCG predicted that OptiNet would be EBITDA-positive (revenues exceed operating expenses) within three years of activating service to its first customer. As is shown above, OptiNet will have a \$2 million positive EBITDA in its third year of operations, just as projected. If LUS performs as the CCG business plan predicts, it will also have a positive EBITDA by the third year after it initiates service to its first customer.

HEARTLAND'S CLAIM:

“The CCG revenue plan is heavily dependent on LUS being successful in cable TV. The system's primary revenue source will be cable TV – even though LUS tends to emphasize the importance of a high-speed broadband connection for its citizens and the local economy.”

LUS'S RESPONSE:

LUS has always emphasized all of the benefits of this superior fiber system to its citizens. It has been very straightforward that the most significant long-term benefit of the fiber system will be true high-bandwidth Internet service, but that a business plan that offers the “triple play” of cable TV, telephone and Internet is required to pay for such a state-of-the-art network. LUS believes that significantly high-bandwidth Internet connections will transform the city by attracting technology firms to locate in Lafayette, by supporting education, and by enabling existing businesses in Lafayette to compete in a global economy. At the same time, residents of Lafayette will also benefit from lower rates for cable TV and telephone service. Furthermore, LUS believes that the incumbent providers will cut rates in the City in order to compete with LUS, thus benefiting all residents of the City whether they sign up for LUS service or stay with the incumbents.

HEARTLAND'S CLAIM:

“As LUS grows, business needs will demand that LUS give most of its attention to cable service and cable customers. This is actually sound business strategy – as it is content and customer service that serve as critical competitive differentiators. However, low-paying Internet-only customers, the very demographic that LUS is ostensibly being taxpayer-funded to serve, will likely get short shrift.”

LUS'S RESPONSE:

At the outset, Heartland is well aware -- should be well aware -- the LUS project is not “taxpayer-funded.” There simply is no taxpayer money being used to pay for the project.

As to Heartland's main point, LUS will indeed emphasize customer service – which Heartland concedes to be “sound business strategy” – but not just for cable customers. Rather, LUS will do so for all of its customers, giving none “short shrift.” In a city like Lafayette, every customer of a municipal provider is also a voter, and the City utility system has always sought to meet the needs of every customer. Despite Heartland's suggestion otherwise, all LUS communications customers, whether rich or poor, will receive the same priority and level of service. This is very different from the way large companies like Cox and BellSouth conduct customer service, where profits are more important than treating all customers in a fair and equitable way.

HEARTLAND'S CLAIM:

“Once OptiNet implemented a minimum purchase requirement, universal broadband service took a backseat to ‘average revenue per customer.’”

LUS'S RESPONSE:

Every utility service provider sets a minimum charge for services (unless they provide such services for free). Thus, it is hard to understand Heartland's point. It appears that Heartland has again failed to make a coherent argument, backed by solid facts.

Bristol and Lafayette both see, in their similar business models, tremendous opportunities to provide Internet connectivity to all of their citizens. The underlying concept has been clear and consistent from the outset. Many consumers already receive telephone and cable TV services. In fact, studies have shown that cable TV tends to have a strong penetration in low-income residential areas because cable TV is considered to have high entertainment value. If Bristol's and Lafayette's pricing for a "triple play" of cable TV, telephone and Internet services is virtually the same as customers today encounter for cable TV and telephone services alone, then more citizens will take advantage of the "triple play" at essentially no additional cost to them. Contrary to Heartland's suggestion, this means that more, not fewer, low-income families will be able to afford Internet service, which can provide new opportunities for those citizens.

Bristol and Lafayette's value proposition to customers remains consistent and community-focused.

HEARTLAND'S CLAIM:

“LUS will be taking on substantial debt to finance the Lafayette system. It has requested up to \$135 Million in funding, an increase from the \$90 Million project(ed) last year. In addition, the CCG study anticipates intercompany transfers and loans. The gradual increase in funding was also seen in Bristol. A \$15 Million revenue bond issue originally funded OptiNet. In 2004 the municipal cable operation was refunded at its current \$27.49 million.”

LUS'S RESPONSE:

LUS has no idea where Heartland got the \$90 million initial estimate for the system, as LUS used no such estimate in any of its presentations. Once CCG was commissioned to help develop a more detailed engineering and financial model, it estimated costs of \$110.5 million, based on 50% customer penetration. That estimate has been used consistently since that time.

When LUS moved forward with requesting bond authorization, it requested a higher level of authorization than might be necessary. This approach is typical of all previous Lafayette bond issues. In this case, LUS requested an authorization limit of \$125 million. LUS fully expects its \$110.5 million estimate to prevail, but variations in interest alone could change that situation. LUS's request for authority to borrow as much as \$125 million is therefore not only consistent with past practice, but a prudent business decision.

Heartland also notes that CCG has forecast "intercompany loans and transfers" from the LUS electric division to the communications division. The only internal loan anticipated in the LUS business plan is a loan that would allow for the transfer of the existing fiber network from the electric division to the communications division. In effect, the communications division will be buying the existing fiber network. This transfer makes sense to LUS because the primary use of the fiber network will be by the communications division. This intercompany loan is not a cash transfer to LUS over and above the bond issue, but rather a way for LUS to comply fully with the Louisiana law governing municipal networks. In fact, this loan represents a cash transfer from the communications division back to the electric division.

Heartland further observes that Bristol has increased the amount of debt on its books. This is correct. The initial bond issue of \$15 million was intended to fund OptiNet's growth to a 45% share of the market. When OptiNet exceeded the 45% market penetration rate, it had several options – stop growing, borrow more money with a second bond issue, or borrow the money internally. OptiNet chose to borrow the money internally rather than issue new bonds. This additional borrowing does not represent any failure or cost overrun on OptiNet. To the contrary, it is a consequence of OptiNet's extraordinary success.

LUS will face the same dilemma some day if it surpasses the 50% penetration rate. Fiber to the Home and Business is a capital-intensive business, and additional capital will be needed to extend the system if LUS performs better than the current plan has predicted. Should LUS obtain more than a 50% residential penetration, it will need another bond issue or will need to borrow the money internally to keep growing. This is actually a very good situation as every incremental dollar of new revenue is significantly greater than the incremental costs to provide new services to new customers.

HEARTLAND'S CLAIM:

"OptiNet raised cable rates in 2004 to reflect the increases in the cost of programming."

LUS'S RESPONSE:

OptiNet did increase cable rates in 2004, but the increase was intended primarily to reverse an initial pricing decision based on politics rather than sound business judgment. CCG's original business plan called for a 15% customer discount from the rates of the incumbents. When OptiNet presented this plan to the Bristol City Council, the Council decided to increase the discount to 20%. Both CCG and OptiNet management vehemently opposed this additional 5% price cut, but to no avail. However, had the OptiNet residential customer penetration stopped at the projected 45%, no customer rate increase would have occurred.

Once OptiNet surpassed 45% residential market penetration, it became clear to OptiNet that, because of the additional 5% discount that the Council had voted, the project would not generate enough cash to fund further expansion. In addition, cable-programming costs had increased during the two years since OptiNet's rates were set, but OptiNet had only been delayed in earning revenues from cable service for one year because incumbent interference prevented it from offering the service. The City Council reluctantly agreed to raise rates back to 15% discount that CCG and OptiNet had originally proposed.

Even with this rate increase, today's OptiNet's rates are 15% lower than the incumbent's rates. In the future, OptiNet will increase rates when and if necessary to recover all of its costs, as Virginia law requires.

CONCLUSION

Bristol, Virginia, and Lafayette, Louisiana, are parts of a growing effort by municipalities across the United States to bring the infrastructure of the future to their citizens today. Bristol and Lafayette belong to a family of 2000 communities whose past leaders had the foresight a century ago to bring the new electric infrastructure into their communities, at a time when no private companies were willing to do so. As is common with publicly owned utility systems, Bristol and Lafayette are in harmony with their consumers, who are not only their "rate payers" but also their "shareholders." In doing so, Bristol and LUS's motivations are significantly different than commercial (investor-owned) utility companies that view consumers only as opportunities to generate maximum value to distant shareholders. This fundamental difference in philosophy yields a significantly different approach to every aspect of doing business in the community.

The Heartland Institute prides itself on its devotion to free enterprise and capitalism. It sees the competitive marketplace as the arena in which America's greatness has prevailed. But a true competitive marketplace has not emerged in communities such as Bristol and Lafayette. Instead, the incumbent providers have settled into a duopoly in which neither pushes the other very hard to lower prices, improve quality, or introduce capital-intensive improvements in infrastructure of the kind necessary to make Bristol and Lafayette competitive in the emerging global economy. In the meantime, formerly third-world countries have surpassed the United States in broadband deployment, where the United States has plummeted to 16th in the world.

America's native entrepreneurial spirit will not allow such a regressive environment to persist without action. Unfortunately, providing an open and competitive environment in the

telecommunications arena has failed, due in very large part to the strength of incumbency of existing telecommunications providers – providers whose basic infrastructures have been largely paid for by the taxpaying public, either through tax breaks or through regulated (and guaranteed) return on investment.

Now, Bristol, Lafayette and many other communities across the United States are stepping forward to meet their own needs for advanced communications capabilities and services, just as municipalities created their own electric utilities a century ago when the private sector was slow to meet their needs for electric power. Like the power companies of a century ago, the telecommunications and cable incumbents are now doing everything possible to stop these local self-help efforts – that is, everything except providing the capabilities and services that the communities want. Fortunately, the power companies failed, and, as a result, the communities involved and the Nation as a whole benefited greatly over the last century. The same beneficial results are likely to occur if the communications giants similarly fail to thwart local initiatives.

The Heartland Institute, far from being the independent, unbiased analyst that it claims to be, has allowed itself to become just another tool that incumbents use to thwart communities from entering the field. Heartland's latest paper is so laden with misstatements, misinterpretations, and misrepresentations that its main achievement is to undermine the anti-municipal arguments that Heartland tries to make.

Unlike Heartland, local governments that operate their own utility systems have a long-term stake in the communities they serve. Their credibility is critically important to them, and they cannot simply walk away from significant mistakes. Local officials live and work in their own hometowns, under a type of intense public scrutiny that would be unbearable for officials of commercial telecommunications companies. At the same time, however, it is the deep commitment of these officials to the well being of their communities, rather than the well being of distant shareholders, that enables them to look beyond the short-term and make decisions that will bring benefits to their neighbors and children for decades into the future. That is what distinguishes Bristol, Lafayette and other public power communities from organizations such as the Heartland Institute.

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**FOR MORE INFORMATION, CONTACT:
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