

**Press statement of Dr. Timothy Nulty regarding the recently released DPS Audit
Report of Burlington Telecom**

December 16, 2010

1. Foreword: There are about 50 municipal/community FTTH networks around the country. These are providing state-of-the-art telecom services at reasonable prices to their communities and, as such, are a critical element in community economic development and quality of life. To my knowledge only 2 of these have ever got into serious financial difficulties: UTOPIA in Utah and Burlington Telecom. Considering that over 75% of all private start-up companies fail, this is not a bad track record. That said, I am deeply saddened that Burlington has encountered the problems it has. A thorough, independent examination of what went wrong and how to fix it is long overdue.

For that reason, I welcome the audit report that has finally shone some light on BT's difficulties. The Report makes many useful observations, comes to three main conclusions that I largely support, and makes four recommendations that I fully support. These are enumerated together with my responses at the end of this statement.

Unfortunately, the Report also has a number of weaknesses which need to be pointed out.

1. The Report criticizes BT for not being profitable from its inception. This demonstrates a misunderstanding of fundamental facts about telecom enterprises. BT's original business plan was consistent with those of successful municipal and private companies with similar technologies all around the USA. It was vetted by numerous independent experts, including the analysts of Koch Finance who made the original investments, and experienced telecom operators. Enterprises like BT are highly capital intensive and are **never** "profitable" in the first few years. Indeed, Verizon's FiOS network (which is quite similar to BT) took almost 6 years to turn a profit. The question in the early years is whether the enterprise is on track to achieve profitability within the normal period for investments of similar sort. During my tenure, BT definitely was. Five months after I left, BT management stated that they were still connecting 40 new customers a week and were still on track to achieve profitability in 2009—5 years after its start (which would have been a better performance than Verizon's FiOS). Based on what I knew of the business at the time, I believe them. Obviously, the BT train has gone off the tracks since then....and a thorough examination of the reasons why is definitely called for. But to simply blame the "original business plan" does not constitute a useful or informed explanation.

2. The report failed to address the single most important question, gave a misleading assessment of another and failed to consult important sources of information that would have strengthened its analysis.

A. The Report does not answer the big question: "where did the money go?"

The Report confirms that in August, 2007, following the completion of the CitiBank lease and paying off of the previous Koch Lease, BT had a positive bank balance of approx. \$10 mln. and was fully compliant with its CPG. Between that date and October, 2009 an additional \$16.9 mln was spent by the City, allegedly on BT. This, too, is confirmed by the Report. That makes a total of \$27 mln of new cash money available to BT during the 26 months from August, 2007 to October, 2009. This is an enormous sum. The first task of the Audit should have been to provide a comprehensive

accounting of where that money went. The Report does not do that. In fact, all the Report does is to confirm that this money was, indeed, spent on something (Section K). But the real question is: what was it spent ON?? There is simply no comprehensive attempt by the Report to answer that question and account for that \$27 mln.

B) *The Report gives a misleading answer to the question: “when did BT become non-compliant with condition 60 (non-subsidization) of its CPG?”* In doing so, the auditor appears not to have understood how BT and the City Treasurer worked, did not look at key information and did not interview key people.

During my tenure as GM, BT maintained its own management accounts, independent from those maintained by the City Treasurer. The existence of these accounts was an important element in the decision of the PSB to award a Cable TV CPG to BT and their continuance was a requirement (condition 58) of the CPG. BT's accounts were reconciled with the Treasurer's accounts every month until the end of FY2006. After that, we continued to keep our own accounts but did not reconcile them on a monthly basis. The last full scale reconciliation with the Treasurer's accounts occurred in January 2007. (Whether BT continued to keep its own accounts after I left, I cannot say.) BT's accounts were on an “accrual” basis, which means that when BT incurred an expense (say, purchase of 1000 set-top boxes) it was immediately booked as such. These BT management accounts kept careful track of all accrued expenses and balanced them against cash available from revenues and from loans. Thus BT knew exactly what its true net cash position was with respect to the City at all times during my tenure. These accounts—and the net cash position they depicted—were openly available to anyone who asked and were explicitly provided on a monthly basis to the Telecom Advisory Committee appointed by the City Council to oversee BT. At no time from the beginning of the period under review by the Auditor until April of 2007 was BT in a net negative position vis a vis the City because of any expenditures which were actually made and authorized by BT management. As such, it is my firm conviction that the BT enterprise, itself, was never in violation of either the spirit or the intent of the CPG's ban on cross-subsidy from City taxpayers during that period.

The auditor appears not to have consulted BT's independent management accounts—and seems to have been unaware of their very existence. Instead, he appears to have only examined the City Treasurer's accounts. These differed from BT's accounts because, while BT booked and expense as soon it was accrued, BT did not control any cash and was not empowered to write any checks or make any payments itself. Instead, it sent the actual invoice(s) to the Treasurer for payment. The Treasurer frequently (usually?) paid these invoices out of City funds but held the invoices for many months before bundling them together and submitting them to the escrow account where the funds from BT's Lease were held for re-imbusement. The Treasurer's accounts, therefore, were on a “cash” rather than accrual basis. The Report criticizes the Treasurer's office for this practice as not following the letter of best technical accounting practice...and there is some justification in that. However, what the Report fails to appreciate is that so long as the totality of such invoices was less than the cash available to it (as spelled out in condition 60) this did NOT constitute a violation of the CPG except in the narrowest technical sense (and, arguably, not even then). To conclude otherwise implies that the loan amounts in the escrow account should not have been included as “resources” under the meaning of Condition 60. I would strongly dispute that is either the actual or intended meaning of the Condition 60 language.

[NB: There is one caveat to the above description: Since BT management did not control actual payments, it could not be certain whether there were any payments, over and above what BT management actually authorized, that may have been made by the Treasurer's office and "booked" to BT's City account. There was, in fact, no way that BT management could even know about any such payments (if they occurred) and, for that reason, I cannot testify that there were none. *What I can say is that at no time from Sept 25, 2005 until April 2007 was BT in violation of Condition 60 with respect to any payments that were authorized by BT management.*]

Regarding the period from April to August, 2007 the matter is a bit grayer. BT and City Hall were well aware from late 2005 that the original Koch financing would not be sufficient to carry BT all the way to full positive cash flow—largely due to the delay in the project and revenues caused by the protracted litigation with Adelphia over BT's cable CPG. However, it was decided not to borrow the final amount likely to be needed to reach "positive overall cash flow until later in order to minimize the cost of debt service. In January, 2007 it became clear that BT would need the final infusion of capital by, approximately April. BT's estimate of the amount required was between \$4 and \$8 million. Accordingly, the Treasurer began the process of seeking such financing. This took longer than anticipated and around April, 2007, BT "ran out of money". I suggested that BT suspend new investment pending completion of the financing but the Treasurer instructed me to continue constructing new network. Therefore, from that date on, I knew that BT was in a negative position. While the Treasurer's strategy would not have been my personal preference, I knew that with the 60 day grace period provided in the in the CPG and with the financing process well underway, there was every reason to believe that the new financing would arrive in time to clear any deficit. As such, I had no reason to believe that the CPG was—or would be--violated.

In fact, the new financing was concluded in mid-August, 2007...so it is possible that there was a period immediately preceding that date when the BT and the City were in violation of Condition 60. However, I was not in a position to be certain...and, in any event, the period of possible violation was short and quickly erased. The Report confirms this and states that, upon completion of the CitiBank Lease, all previous deficits were paid off and BT returned to full compliance with condition 60.

The basic problem with his analysis of the period prior to that point is that the auditor appears to have been completely unaware that BT kept its own set of detailed, independent management accounts, booked on an accrual basis and checked monthly against the balance of all cash resources. This, of course begs a question: why wasn't he aware of these? ...especially since the existence of these management accounts was an important reason why the VT PSB granted the Cable TV CPG in the first place—and their continued maintenance was an explicit condition (#58) of the CPG.

C) A third weakness of the Report is that the auditor never contacted, interviewed or attempted to question three of the most knowledgeable insiders to BT and City financial practices. These three are: a) myself, GM of BT from early 2002 until October 22, 2007. My background is in economics and finance as well as telecom and I oversaw all aspects of BT financing up until the end of 2006 when the Treasurer took full control of such matters into his hands. I was never contacted by the auditor, nor asked a single question; b) John Van Vught; IT director of BT and de facto chief book-keeper from mid-2002 to October 1, 2010. No-one is more intimately familiar with the details of BT

finances than he—and he was at BT throughout the period when the audit was being conducted. John was similarly not questioned by the auditor; c) John Stewart; Chief Accountant for the City of Burlington from before the BT project began until mid 2007 when he resigned to take a position with S. Burlington Schools. John was extremely capable and fully knowledgeable about how Burlington managed its side of the BT accounts during the first two years of the period covered by the Report. To my knowledge he was also never contacted by the auditor.

3. Findings of the Report that are worthy of deserve positive comment:

A. The Report concluded that there may have been over payments to contractors. Unfortunately the Report does not attempt to estimate the sum of such overpayments. In particular, it makes no attempt to estimate whether they constitute a significant portion of the \$27 mln mentioned in section “A” above. Nevertheless, regardless of how much it was: i) it should not have happened; ii) control procedures should immediately be tightened to ensure that it does not recur; and, iii) efforts should be made to identify and recover any such overpayments. Accordingly, the City should do a through review and insist that contractors refund any over payments that are confirmed. Any honorable contractor that was overpaid will surely comply.

B. The Report documents a pattern of ignoring warnings of the regular auditors regarding City accounting with respect to BT. This is a serious criticism and should be rectified immediately.

C. The Report calls attention to weaknesses in cost coding and similar basic elements in financial control. These are also important observations that should be attended to forthwith.

D. The Report raises serious questions about the ability of BT to carry on as a going concern under its current constraints and with its current structure. I believe these questions are justified by the performance over the last two years or so.

4. IN SUMMARY: The Report outlines three main conclusions and four recommendations. My response to these is as follows:

Conclusions:

A. “BT was not in compliance with Condition 60 from September 25, 2005 until the date of the Report”. As discussed above, I consider this to be inaccurate. In my view, BT, itself, was fully in compliance with Condition 60 from September 25, 2005 until (approximately) April, 2007. It may have been out of compliance to some degree for a short while during the period between April, 2007 and August 2007 and then returned to full compliance until I resigned 10 weeks later. I have no comment as to whether it was or was not in compliance after that date.

B. BT’s capacity to survive as a going concern under its current circumstances (legal structure, management, financial structure etc) is seriously in question. I agree with this...as did the Blue Ribbon Commission that studied the enterprise for the City Council at the beginning of the year. Indeed, it is difficult to imagine how any knowledgeable business person could think otherwise.

B. There are numerous weaknesses and questions regarding accounting practices of BT and the City of Burlington. I heartily agree. I have only one caveat: the auditor appears not to be aware that, up until I resigned, BT maintained independent management accounts that fully complied with Condition 58. I cannot comment as to whether they continued to do so after I left.

Recommendations: The Public Service Board should:

A. Require BT/Burlington to conduct a detailed inventory of assets, installed and uninstalled;

B. Require BT/Burlington to provide a plan to bring BT into compliance with all provisions of the CPG;

C. Require BT/Burlington to address the “going concern risk” to the City’s taxpayers;

D. Consider revoking its CPG if it is not satisfied that BT/Burlington has satisfactorily met the requirements A,B,C above.

I concur with all these recommendations