Why the UTOPIA/Macquarie Proposal is Bad for UTOPIA Cities and Residents

An Analysis of the Utopia/Macquarie Milestone 1 Proposal

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June, 2014

No. 1 - New Debt Obligations for Utopia Cities and Residents costs $1.83 billion

The three-year build out of UTOPIA's fiber optic system and a system wide upgrade in 2030 will require substantial, additional borrowing, and new across the board utility fees beginning at $240 for every household whether residents use the service or not. And the annual fee increases to $325 per household after 30 years with inflationary adjustment. With projected system upgrades, that represents an anticipated average cost to households in Utopia cities of over $12,000 for the life of the project.

If things do not work out well, if some cities decide to opt out, if the Internet Service Providers (ISPs) are not willing to market the system, and Macquarie Capital backs out of the deal, the 11 Cities will still need to continue paying the mandatory utility fee. Over the next 30 years the mandatory fee revenue will amount to $1.83 billion. The following two charts outline per household and per capita future debt.

Figure 1. Estimate of Macquarie PPP/UTOPIA Cities Debt/Cost to Cities and Residents, 2014-43

	New Debt\Costs Per City (High Estimate)	Households 2014	New Debt\Costs Per Household	New Debt\Costs Per Capita
West Valley	$ 510,922,786	40,000	$ 12,773	$ 3,858
Murray	224,798,626	19,000	11,832	4,658
Midvale	110,727,943	13,000	8,518	3,663
Orem	398,564,284	28,000	14,234	4,392
Lindon	56,185,295	2,600	21,610	5,381
Payson	36,959,557	7,000	5,280	1,952
Layton	305,237,421	23,000	13,271	4,445
Centerville	60,816,757	5,500	11,058	3,753
Brigham City	61,149,780	6,300	9,706	3,369
Tremonton	46,136,738	3,000	15,379	5,923
Perry	15,000,814	1,700	8,824	3,345
Utopia Cities	$1,826,500,000	149,100	$ 12,250	4,092

* Debt based on 2013 pledge amounts

No. 2 - Macquarie's Proposed Utility Fee would be Mandatory – Even for those who Don't Want the Service

It is difficult to imagine that all 11 UTOPIA Cities will vote to adopt a mandatory utility fee to initiate and complete the deal with Macquarie for building out and operating the fiber-optic cable system. Given the history of mismanagement, heavy debt burden and failure to reach take-out goals, many of the Utopia cities and their residents are understandably wary.[i]

Some cities have been reluctant to make their existing $13 million in pledge payments this year (Figure 3).[ii] In addition, homes and businesses that currently don't take UTOPIA are presumably satisfied with their current cable and Internet service, or with no service at all. These residents and businesses would howl if cities forced them to pay a fee for a service they don't intend to use, as witnessed by the recent Standard Examiner editorial.[iii] The fiscally conservative nature of Utah city councils and their high turnover rates, suggest that councils will be highly resistant to a new mandatory household and business fees. And while the mandatory fee starts at $240 per year per household, it will increase over time to $325 annually in 30 years. And the monthly charge could be even higher if some households are able to opt out as has been suggested by Macquarie, because the remaining households in the system would be required to absorb that additional cost for those who could opt-out.

Figure 2. UTOPIA Pledge for Existing Bond Payments, 2013

	2013 Pledge
West Valley	$ 3,593,091
Murray	1,580,908
Midvale	778,700
Orem	2,802,924
Lindon	395,126
Payson	259,920
Layton	2,146,598
Centerville	427,697
Brigham City	430,039
Tremonton	324,459
Perry	105,494
Utopia Cities	$ 12,844,956

No. 3 - The Milestone One Proposal Requires Additional $220 Million in Debt, Dropping the Probability of Success

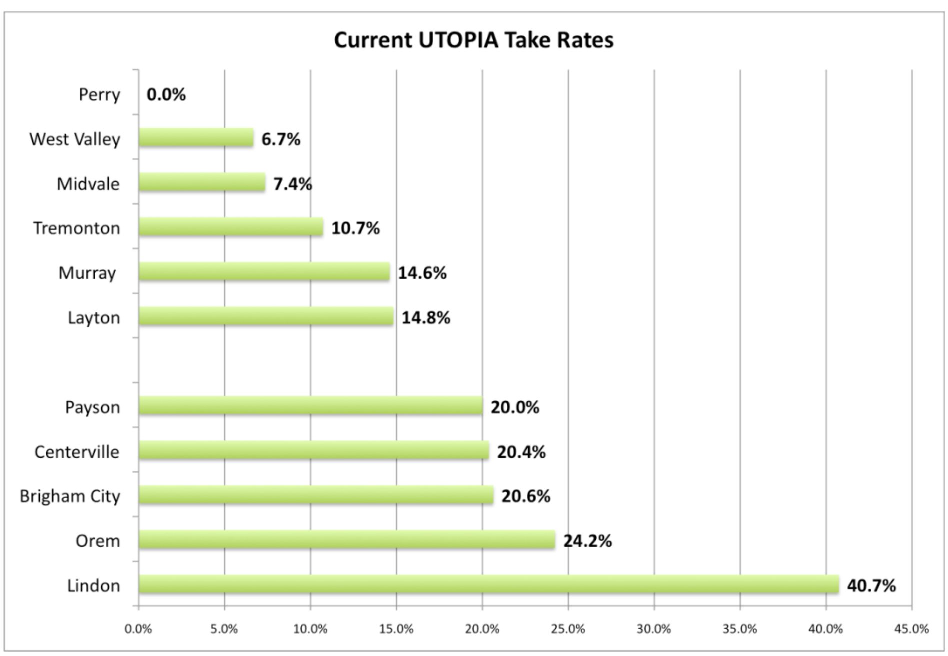
Macquarie's proposal fails to account for $220 million in additional capital needed to complete build out of the UTOPIA fiber optic system to 114,000 additional addresses in the next four years, according to a revenue and expense model constructed by Econowest. This model also provides a reasonable approach to estimating when and under what conditions UTOPIA becomes profitable.

We assumed that under the build out the Wholesaler and ISP's convinces 1 out of 5 of the remaining households or businesses to sign up compared to 1 out of 6 that have signed up with the current UTOPIA system. In order to reach 30% take out, however, they will need to convince 2 out of 5 new addresses they pass to sign up.

Even then, we are not sure that this will reach a breakeven point. Based on revenue to expense ratios in the 2013 UTOPIA audit it appears that the break even would need to be closer to 45%.

This model points to the enormous additional capital and debt necessary ($220 million) to finish the project. It also helps assess how difficult it will be to increase the overall "take out" rate to the break-even level of 30% and keep Macquarie Capital in the project.

Figure 3.



No. 4 - The Complexity of Macquarie's Operating Proposal Masks Daunting Challenges

Macquarie proposes forming a new Public/Private Partnership (PPP) that operates the network command center and the trunk line of the system. A "wholesaler" named First Solutions would do the accounting, marketing and coordination with the Internet Service Providers (ISPs). The ISPs would provide Internet service to clients in homes and businesses (Figure 4). If take-out rates approach 30% to 50% (depending on the Concessionary Agreement), First Solutions or Macquarie would share profits in a yet to be defined manner to help cities pay off their existing debt.

What can go wrong with this arrangement, if each partner has incentives to make a profit? First, the existing ISPs may not be willing to provide the connection into the homes and businesses. The ISPs are supposed to be motivated to work with the fiber optic carrier partnership by a $50–per-connection refund. But this amounts to a small percentage of the cost of connecting to each house or business, so it is not clear that the ISPs will cooperate.

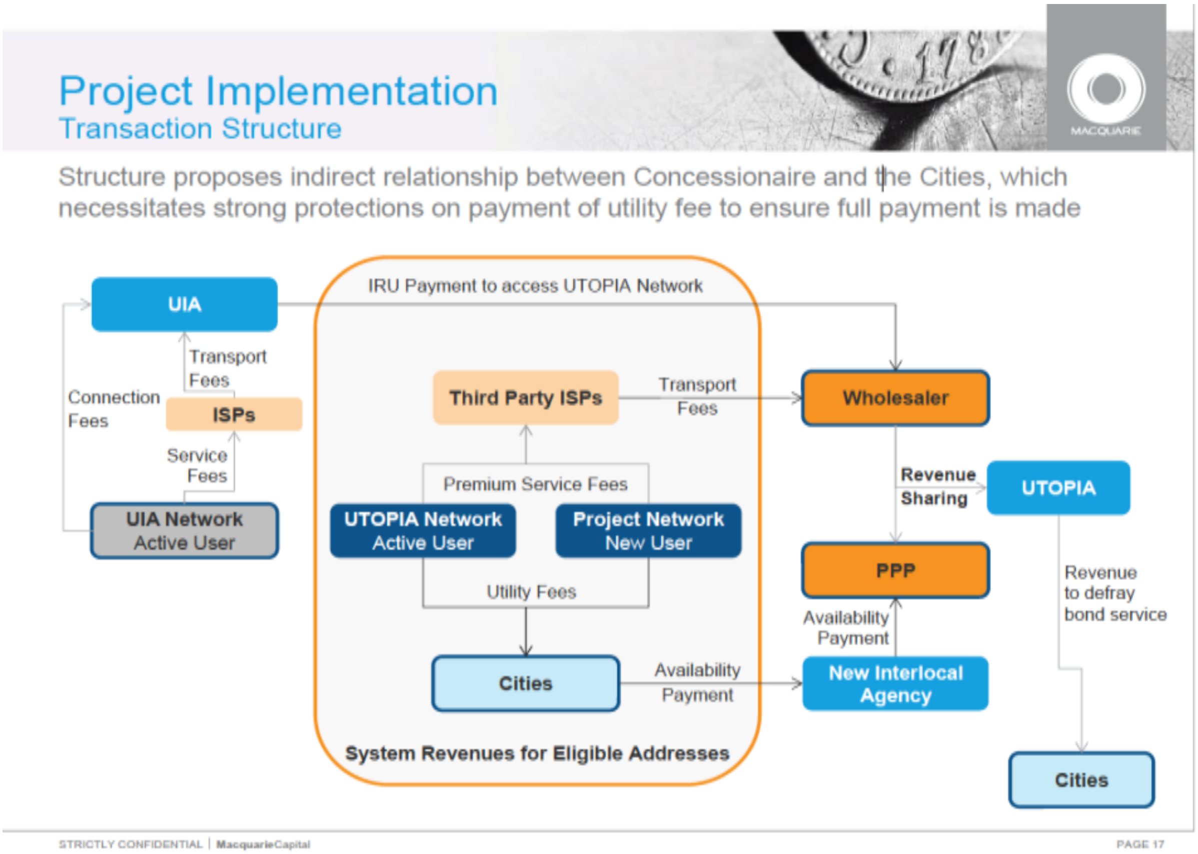
Second, if the ISPs are already providing video, Internet and phone via telephone landlines or cable, they may not have enough incentive to market the fiber optic connection. This would suppress take rates, potentially enough that in the first 10 years revenue would not be generated revenue for the PPP to share with the 11 cities.

Third, it is not clear what would happen if some of the 11 cities stop paying their interest on UTOPIA and UIA's existing debt. There do not appear to be adequate management controls to settle disputes between the PPP, Wholesaler, ISPs and 11 cities, which means lawsuits would be a possibility.

Finally, while Macquarie itself is a substantial investment banker that has invested in roads and tunnels in the United States, it may not be an ideal partner for UTOPIA cities. It has much less experience in providing and managing high optic fiber systems.

Worse still, in the case of a toll road in San Diego, Macquarie simply pulled out of its agreement when demand did not meet its expectations.[iv] Like San Diego, UTOPIA cities could be left with an unfinished project along with current and new debt, which could easily lead them into bankruptcy.

Figure 4. Milestone One Project Implementation Diagram

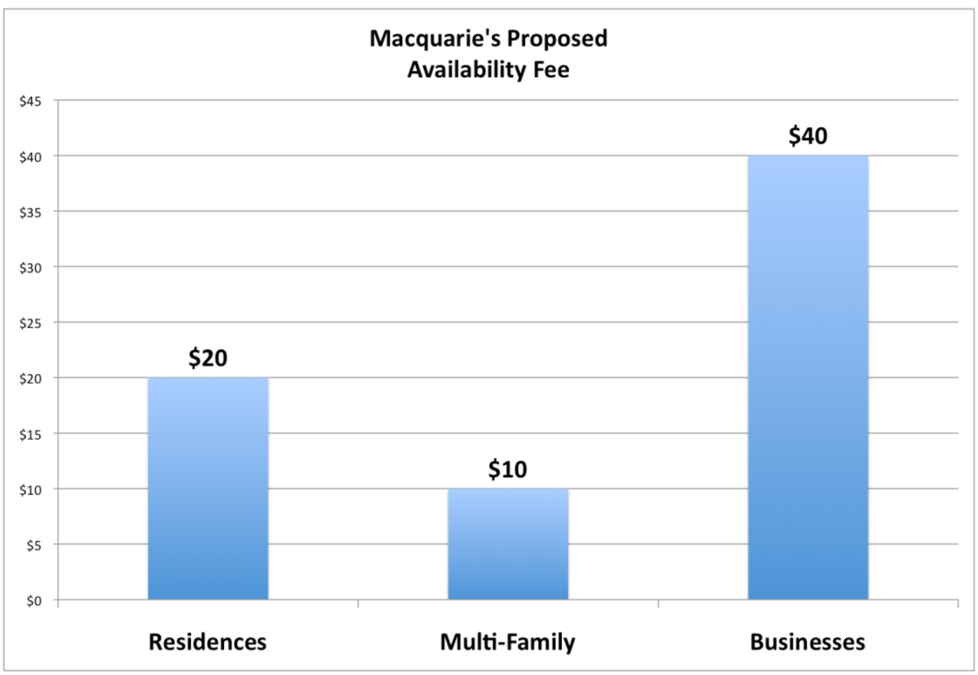


No. 5 - ***Households Will Subsidize Business Connections Due to the Mandatory Utility Fee Schedule***

There are serious equity considerations in implementing the Macquarie mandatory utility fee schedule (Figure 5). Even though businesses will pay a mandatory utility fee ($480 annually) that is double the fee for households, businesses would receive much higher benefits based on their needs and use. Even Macquarie admits that few residents want or need the highest Internet speeds provided by fiber optics. Yet a single person who uses internet only for email would receive only a 50% reduction on the monthly utility fee paid by massive retail stores, high-tech service companies, or manufacturers.

To make matters worse, an apartment dweller would receive only a 50% discount on the fee paid by a homeowner even though a single fiber optic trunk connection can serve every unit in a building of any imaginable size. Essentially, the PPP and the 11 cities would receive windfall revenue relative to the marginal cost of serving a multifamily dwelling.

Figure 5. Macquarie Capital's Proposed Across-the-Board Fee



No. 6 - The Current $355 Million of UTOPIA Debt is a Sunk Cost With a Small Chance of Being Repaid

The current economics of UTOPIA from a business perspective requires the business owners, in this case the 11 Cities, to view the in-the-ground investment as a sunk cost. In making the decision to either:

1.) Shut down;

2.) Sell off beginning with a Request for Proposal;

3.) Hire an independent third party expert financial analyst to weigh the alternatives; and

4.) Step up to Milestone Two with a Macquarie Public Private Partnership.

UTOPIA should view the existing infrastructure valued between $1 and $83.6 million[v] and $228 million[vi] to $355 million[vii] in outstanding debt as a **"Sunk Cost"**:

> A cost that has already been incurred and thus cannot be recovered. A sunk cost differs from other, future costs that a business may face, such as inventory costs or R&D expenses, because it has already happened. Sunk costs are independent of any event that may occur in the future. [viii]

Shutting down a project with well-documented cost overruns, mismanagement, and inability to accurately reach targeted goals after 10-years of effort is not really such a bad decision, when faced with the distinct probability of another mountain load of debt and a high probability of not being able to pay back the existing debt if take rates fall short.

> When making business or investment decisions, individuals and organizations typically look at the future costs that they may incur, by following a certain strategy. A company that has spent $5 million building a factory that is not yet complete, has to consider the $5 million sunk, since it cannot get the money back. It must decide whether continuing construction to complete the project will help the company regain the sunk cost, or whether it should walk away from the incomplete project.[ix]

It is very possible that with proper outreach, a local or national buyer may appear under a competitive bid. For example, Google recently purchased Provo's fiber optic system for $1. This implies there may be other, less costly alternatives for UTOPIA's 11 cities.

It might be very advantageous to the UTOPIA cities, rather than paying Macquarie to undertake their own self-serving Milestone Two report for $980,000, to hire a nationally known, independent financial and management consulting company to review the alternatives to a Macquarie public/private partnership.

No. 7 - The Current Mountain of Debt for Utopia Cities is Not Fully Addressed in the New Macquarie Proposal, and will Most Likely Increase in the Future

In 2012, the Office of Legislative Auditor General stated that UTOPIA had an outstanding debt load of $185 million. Today that amount has almost doubled to $355 million according to Macquarie's Milestone One report.[x] Dividing the total UTOPIA and UIA outstanding debt based on the 2013 Pledges to pay of each of the 11 cities gives a sense of the scale of the debt: **$ 795 per person** (Figure 6).

By way of comparison, the State of Utah's outstanding per capita debt is **$ 1,161 per person**. So, UTOPIA and UIA debt is equivalent to 69% of total State debt, but while the latter's debt represents working capital, like highways and higher education buildings, UTOPIA and UIA's is partially stranded or unused at this time.

Figure 6. Current UTOPIA and UIA Debt by City

	Existing Debt Per City *	Bureau of Census Population 2013	Existing Debt Per Capita
West Valley	$ 99,303,361	132,434	$ 749.83
Murray	43,692,041	48,263	$ 905.29
Midvale	21,521,171	30,229	$ 711.94
Orem	77,465,273	90,746	$ 853.65
Lindon	10,920,219	10,442	$ 1,045.80
Payson	7,183,489	18,938	$ 379.32
Layton	59,326,189	68,677	$ 863.84
Centerville	11,820,394	16,203	$ 729.52
Brigham City	11,885,120	18,149	$ 654.86
Tremonton	8,967,173	7,790	$ 1,151.11
Perry	2,915,570	4,484	$ 650.22
Utopia Cities	$ 355,000,000	446,355	$ 795.33

* Based on 2013 Pledge

No. 8 - Economic Decisions by Utopia Management and Officials Have Been Wrong in the Past

Providing government sponsored, financed, and operated high-speed fiber optic cable service fails two key principles of whether it is a legitimate "Public Good". First, it is not a "non-exclusionary" good. If each user can be assessed for the service, then the private sector should provide the good.[xi] Second, providing fiber optic cable to additional households has high marginal costs particularly in the installation and also medium-level service costs.[xii] In short, the private sector is better suited to take the risks associated with providing new high-tech products.

For these reasons, Utah cities should be very hesitant to directly provide a system of high-speed fiber optic cable to its citizens. Even if well-meaning individuals want to provide such a service, it will tend to crowd out the private sector efforts and probably lead to higher costs. UTOPIA's 10-year history of poor management selection, not putting bond proceeds to productive use, and the inability to reach major goals is evidence of the public sector's inability to provide a high-tech solution in its own communities.[xiii]

Figure 7. Office of the Legislative Auditor General, 2012 UTOPIA Audit Summary

Chapter III: UTOPIA's Financial Woes Attributed to Many Different Causes

Poor Planning, Mismanagement, and Unreliable Business Partners Have Contributed to the Agency's Financial Difficulties. UTOPIA's board members, staff, and outside consultants readily admitted that mistakes were made during the rollout of the network. To summarize, the mistakes they described generally began before UTOPIA's current management's tenure and fall into one of the following three categories: (1) poor construction planning, (2) mismanagement, and (3) unreliable business and finance partners.

A Lack of Sufficient Subscribers Also Contributes to UTOPIA's Condition. In addition to UTOPIA's problems with poor planning, mismanagement, and unreliable business partner performance, a lack of sufficient customers is also a cause for the agency's slow progress. UTOPIA's historic and current subscriber rates, coupled with its revenues, strongly suggest either a lack of consumer demand or an agency inability to meet the consumer demand that does exist. A contributing factor to UTOPIA's difficulty in meeting targets may also be its wholesale-only operating model.

ENDNOTES

[i] Utah Office of the Legislative Auditor, "A Performance Audit of the Utah Telecommunication Open Infrastructure Agency," 2012, pp. i, ii.

[ii] "Selling the network, much like shutting it down, would thus result in the Cities continuing to service the existing debt from a combination of sales tax pledges and franchise fees." Macquarie Capital, Milestone One Report, p. 12.

"Cities have indicated limited appetite for joint and several liability or general fund pledges in the event of a shortfall." Business Risks, 3.7, Macquarie Capital, Milestone One Report, p. 44.

"Additionally, the Cities appear to have limited appetite to pledge further sales or franchise tax revenue to the network; the outstanding revenue bonds and associated swap contracts could consume up to ***$500 million of tax pledges*** between 2014 and 2040. The quantum of funding required to increase the number of last mile connections by a factor of 10, coupled with mixed attitudes towards the Agencies among key decision makers and the broader community, suggests that continued public delivery of the project network is not a viable option." p. 9

[iii] Standard Examiner, "Our View: Only UTOPIA users pay, May 7, 2014, http://www.standard.net/Opinion/2014/05/11/Our-View-Only-UTOPIA-users-pay-1.html

[iv] SourceWatch.org and Matt Sledge, South Bay Expressway: Bankrupted Toll Road Tests Transportation Department Program, *Huffington Post*, December 27, 2011

[v] Keddington & Christensen CPA LLC, "Utah Telecommunication Open Infrastructure Agency Financial Statements," June 30, 2013, p. 5.

[vi] Ibid.

[vii] Ibid, Milestone One Report.

[viii] http://www.investopedia.com/terms/s/sunkcost.asp

[ix] Ibid.

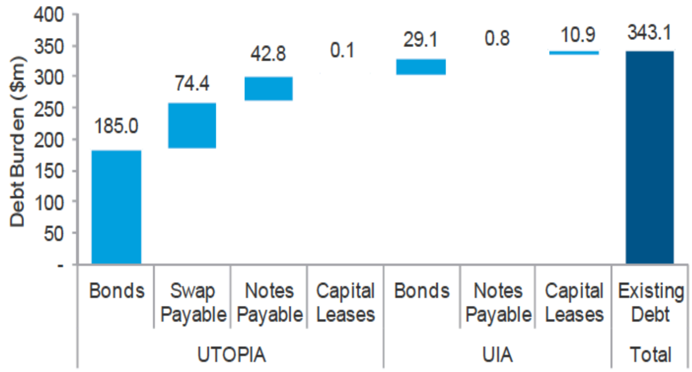
[x] Milestone One Report, p. 68.

4.4 Financing Strategy

4.4.1 Outstanding Revenue Bonds

The Agencies had approximately $343 million of debt obligations as at June 30, 2013. However UIA issued a further $12 million of bonds in July 2013, increasing the total debt outstanding to approximately $355 million. These obligations are primarily the UTOPIA and UIA revenue bonds and the swap liability associated with the UTOPIA bond refinance in 2011. The balance consists of notes payable to the Cities (direct loans to fund the Agencies' cash losses) and approximately $11 million of capital leases for equipment.

Figure 16: UTOPIA/UIA Existing Debt Burden



Macquarie is investigating opportunities to incorporate the UTOPIA and/or UIA bonds into the project, either through a refinancing or alternative mechanism. Macquarie's initial assessment of the bonds suggested this would be extremely challenging, particularly given the material swap liability associated with the UTOPIA bonds, which was marked to market at $74.5 million in June 2013. This liability has reduced over the last

[xi] Joseph E. Stigliz, The Economics of the Public Sector, p. 128-133.
[xii] Ibid.
[xiii] Ibid, Utah Office of the Legislative Auditor