Community Broadband

Financing Community Broadband

By Cathy Swirbul

Municipal utilities are expanding into offering broadband service for a variety of reasons. Some communities have a history of providing utility services through public ownership. Other areas pursue community broadband when the incumbent cable and telecommunications companies fail to provide the service. What these projects have in common is the need for financing. The reality of financing in today's market, though, may be different from commonly held perceptions.

Critics of publicly owned broadband contend that municipalities have an unfair advantage over private telecom providers because public entities have the ability to issue tax-exempt municipal bonds. But that is not necessarily true, said municipal broadband attorney Jim Baller.

"The supposed benefits of tax-advantaged financing can be illusory, particularly in today's financial market," Baller said. "Tax-advantaged financing comes with strings attached, and local governments may decide that the restrictions and burdens involved are simply not worth the potential savings in costs. As a result, local governments are increasingly financing broadband projects through taxable instruments. For example, the fiber-to-the-home (FTTH) system in Kutztown, Pa., was financed through taxable bonds. Critics of community broadband also fail to acknowledge that major cable and telephone companies have access to the best commercial rates, and they benefit greatly from being able to obtain financing for multiple projects at the same time rather than for each market separately."

Three primary vehicles exist for municipal utilities to fund broadband projects: bond financing; various types of loans; and grants.

"General obligation bonds typically are the least expensive for the municipality because the lenders know the municipality will be on the hook if the project doesn't succeed." Baller said. "At the same time, however, such bonds often have stricter procedural requirements, such as voter approval in many cases.

"Revenue bonds, by definition, are funded by the revenues of the project and thus do not put the municipality at financial risk if the project fails," Baller said. "As a result, they are riskier for lenders and more expensive for municipalities. Sometimes such funding may not be available at all, or may be prohibitively expensive, unless the municipality can pledge resources of some kind."

Banks and financial institutions a utility has worked with on other projects offer a good place for a municipality to start when seeking to issue bonds. "Electric utilities are regularly going to the market for upgrades and extensions," Baller said. "Working with banks and institutions that know a utility well can save everyone a lot of time and money. Even so, it is prudent to shop around for the best available financing."

The Lafayette Utilities System in Louisiana is using revenue bonds to build a fiber-to-the-home project. Last July voters approved up to $125 million in bonding.

"We suspected from the beginning that we would use revenue bonds, as that has traditionally been the borrowing approach for our utility," said Terry Huval, Lafayette Utilities System director. "The remainder of our local government tends to issue general obligation bonds, but because the utility is a stand-alone, revenue-producing entity, it issues revenue bonds. Our underwriters have advised us that the utility system's past financial strength allows revenue to be a very good option for our pursuit of this project."

Loans for broadband projects may be available through banks, from the municipality's other utilities (inter-utility loans), the federal government, and private investors. The municipality's other utilities are often the best source for loans. "To avoid claims of cross-subsidization, however, it is important to include a fair and reasonable rate of interest and other terms and conditions," Baller said.

"Incumbents will often try to scare the public into believing that inter-utility loans will result in losses for other utility ratepayers," Baller said. "A municipality must be prepared to allay these concerns during the extensive public dialog that will occur as the community considers every aspect of the proposed project. The best way to do this is to present a sound and conservative business plan that will succeed even if revenues fall short and costs exceed expectations."

Cedar Falls, Iowa, built its community broadband system in 1995 using $6 million in initial financing. Voters approved a $3 million general obligation bond issue, and the communications utility borrowed $3 million from the city's electric utility. The interfund loan carries a market rate of interest and is being repaid on schedule from cable TV and Internet service revenues.

"When our community voted to build a municipal communications plant, we structured it to stand on its own financially from day one," said Cedar Falls Utilities General Manager Jim Krieg. "The interfund loan generates a competitive rate of return on the relatively small portion of the electric utility's cash reserves that are invested in this way," he said.

"Our electric utility keeps cash and cash reserves of roughly $30 million in its normal course of business, and this money is always earning interest for us in various types of safe investments," Krieg said. "We make sure the electric utility earns as good a return by lending cash reserves to the communications

utility as it would from other safe investments."

Krieg said the general obligation bond portion of the utility's initial financing is paid solely from communication service revenues. "We had 70 percent voter approval on the general obligation bond in 1994, and we have over 75 percent market share in cable TV today," he said. "Our citizens have made the city's broadband system successful by signing up for service with us."

In California, the city of Lompoc's broadband project is divided into two phases: building broadcasting antennae for a wireless system and eventually building a fiber to the home system. Lompoc has used loans from its electric fund to finance the wireless operation. That loan will be repaid using revenue generated by subscriptions.

The federal government offers broadband loans through the U.S. Department of Agriculture's Rural Development telecommunications program. The loans are available to communities of 20,000 or fewer residents to cover construction, improvement and acquisition of facilities, but not for operating expenses. A municipality must have either 20 percent in equity or a year's operating expenses to get a loan from the Rural Development program.

The Rural Development program has yet to provide a loan to a municipality, but the agency has had very few applications. "A community needs to contact someone in the RD broadband team and develop an application," said Claiborn Crain, a USDA legislative and public affairs adviser. "The finances are the part that make the application the most challenging for a community. As a government agency, we must look at the ability of the project to pay back the loan."

The value of USDA broadband loans is low compared to other financing avenues open to municipal utilities, said Baller. "The application process is burdensome and the requirements are too high to obtain an RD loan. It's unfortunate because the purpose of the RD funds is to finance these very types of projects. An RD loan would not save a municipality very much money over public-sector financing."

Burlington Telecom in Vermont is building its broadband project primarily through private investor Koch Financial Corp. of Scottsdale, Ariz. The first and second phases of the Burlington Telecom project consisted of an all-fiber city government network providing Ethernet connectivity, Internet and voice services to 40 municipal sites and a dozen outside institutions. This was financed as a tax-exempt capital lease from Koch Financial. It was secured by "subject to appropriations" backing from the city (meaning the recourse is moral only—there is no legal obligation) as well as the de facto service contract with the pre-eminent customer being the city government. The total cost was approximately $2.6 million.

The next phase of the Burlington Telecom project involves extending a voice/data/video fiber-to-the-premises network to the entire city of about 20,000 residential and business subscribers. Because of the strong performance of the first phase, Koch agreed to finance the second phase on the same basis—even though there is not the same customer security as there was with the first. The initial portion of this phase—about $10 million—has been disbursed and will cover central office equipment, cable head-end and other details, plus wiring about 40 percent of the city.

Voters have twice approved a resolution to raise the money by issuing bonds but thus far the utility has avoided a bond issue. Timothy Nulty, who has spearheaded the project and heads Burlington Telecom, is adamant that funding won't come from taxpayers.

"We call this the "Build the Barn You Can Afford" approach," Nulty said. "The formula is simple: start small based on guaranteed markets. If all goes well—construction is on time and under budget, performance is per specifications, and finances are satisfactory—build an addition to the barn, install more cows and go on from there … bit by bit, building from within, making sure that each stage of expansion is economically solid before embarking on the next. And never expose too much of your capital."

USDA's Rural Development program also issues grants through its Community Connect program. The program is closed for 2005 but will be accepting 2006 grant applications sometime after the first of the new year. This program is contingent on funds appropriated by Congress.

"Community Connect is a very competitive program," Crain said. "We had $9 million in grant funds and applications requesting $70 million to $100 million. A community must have no more than 20,000 residents.

"We hook up central broadband facilities for their fire, police, rescue, local government, schools and library," Crain said. "In return, they set up a community center or library with computers hooked to the Internet that the public can use. Making the broadband service available to the public, there will be more demand for service in their homes or businesses."

Federal grants may also be available through:

- The Department of Commerce's Economic Development Administration, which issues grants through state offices for infrastructure development;
- The Department of Homeland Security, which has awarded $19 billion to the states, including grants for interoperable communications systems;
- The Justice Department, which awards grants for emergency-preparedness projects; and
- The Appalachian Regional Commission, which has funding for wireless projects in 13 Appalachian states.

Broadband financing options may be limited now, but Baller sees that changing in the next several years. "As more broadband projects get moving, there will be more traditional and new lenders to whom municipals will be able to turn for financing," Baller said. "These lenders will have a growing body of experts who won't need to start from scratch with each project." ●

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