CITY OF BURLINGTON
RESPONSE TO THE "LARKIN REPORT"
January 25, 2011

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MEMORANDUM

To: City Council

Fr: Bob Kiss, Mayor

Re: City's response to the Larkin Report

Da: January 25, 2011

Attached is the City's response to the Larkin Report. The response includes the following:

- **Larkin's methodology.** In drawing its conclusions, Larkin failed to speak with the City's independent auditors, Sullivan, Powers & Company, anyone from the City administration or Clerk-Treasurer's Office, or the City's financial advisers Dorman & Fawcett. In failing to do so, Larkin omitted key information that would have addressed or contradicted many of its concerns. This problem is exacerbated by Larkin's failure to incorporate and assess information regarding significant progress for BT, available before the report was issued, clearly relevant to its conclusions.
- **BT as a "going concern."** Larkin's analysis of this issue neglects a crucial element – the City and CitiCapital's mutual acknowledgment that the lease on BT's equipment has been terminated. Because Larkin appears to misconstrue the nature of the lease agreement, their analysis does not contemplate that the lease payments may cease to be an obligation of BT. News of the City and CitiCapital's acknowledgment of the lease's termination was public and available to Larkin prior to the report's issuance. Cash flow - or earnings before interest, taxes, depreciation and amortization ("EBITDA") - is the fundamental test of a business's viability. BT's cash flow, while modest, is positive.
- **The City's response to BT's financial issues.** Larkin makes several errors and omissions regarding the City's identification and communication of BT's financial issues. There is an extensive record on this subject available to Larkin but ignored.
- **Condition 60.**
  - Larkin's claim that City officials became aware of the Condition 60 violation prior to November of 2008 is based solely on assumptions drawn from interpreting one workpaper created by Sullivan, Powers & Company during the FY2007 audit process. Larkin never spoke to Sullivan & Powers, or anyone with the City, or BT about this claim to verify it. Workpapers are kept confidential by

Sullivan & Powers and were never shared with anyone at BT or the City during the FY2007 audit process or anytime prior to Larkin initiating its report more than a year ago. There was no discussion of a Condition 60 violation in the 2007 management letter issued by Sullivan & Powers in June of 2008.
    - Larkin's analysis of BT's compliance with Condition 60 since its inception appears to misunderstand the nature of the City's access to the Koch and CitiCapital financing. Until 2007, BT had first Koch and later, CitiCapital financing funds available to repay advances from the cash pool. When BT's CPG was issued, the record is clear that BT had funds available through the Koch financing that exceeded BT's negative pooled cash balance. Contrary to the assertion by Larkin, there was no restriction on the use of these funds to meet BT's debit to pooled cash (with the exception of the $1 million debt service reserve under the CitiCapital financing).
- **Accounting issues.** Larkin's analysis demonstrates a lack of understanding of municipal accounting practices. The City's accounting practices are consistent with established municipal accounting standards and most other Vermont municipalities. Larkin makes errors regarding pooled cash interest charged to BT, how expenses are booked, and timely posting of expenditures. Moreover, Larkin repeats issues raised in the City's audit management letters that were addressed by BT six months to a year prior to the report's issuance.

I encourage you to review these issues carefully. The Larkin report omits critical facts, contains inaccuracies, fails to verify assumptions and relies on dated information. Moreover, Larkin did not engage person-to-person with key City staff or the City's auditing firm and financial consultants.

We know that Burlington Telecom is a vital component of Burlington's, and potentially Vermont's, economic future. We need to move forward together in the interests of City residents. The City, through its financial advisers, has begun conversations with financial and strategic partners to finance replacement equipment for Burlington Telecom. These discussions include, as an essential element, the potential to recover the $16.9 million obligation to the City. Going forward, I trust that we will work together to address BT's challenges while fully appreciating its tremendous value as a long-term investment in the City's telecommunications infrastructure.

Please let me know if you have questions.

Document List/Attachments

A. Letter to Public Service Board from Geoffrey Commons, April 23, 2010, RE: Docket No. 7044 – Schedule - www.ci.burlington.vt.us/docs/3355.pdf
B. Burlington Telecom CPG for Telephone Services, June 18, 2003 www.ci.burlington.vt.us/docs/3341.pdf
C. Mayor Kiss Memorandum to City Council, December 8, 2010, RE: Burlington Telecom www.ci.burlington.vt.us/docs/2932.pdf
D. Letter from William Ellis to Susan Hudson, November 23, 2010, RE: Docket No. 7044 www.ci.burlington.vt.us/docs/3356.pdf
E. City Council meeting transcript, December 17, 2007 www.ci.burlington.vt.us/docs/3357.pdf
F. November 7, 2007 Board of Finances meeting minutes www.ci.burlington.vt.us/docs/3340.pdf
G. Shanahan Report, December 5, 2007, as released in the Larkin Report (see http://publicservice.vermont.gov/dockets/7044/Exhibits/LA-14%20DPS%203-111.pdf)
H. Board of Finance Minutes, January 22, 2008 - www.ci.burlington.vt.us/docs/3321.pdf
I. Burlington Telecom FY09 Revenue and Expense Budget and Narrative (from City's FY09 Budget) - www.ci.burlington.vt.us/docs/3362.pdf
J. Council Resolution authorizing City's Petition to Amend Condition 17 of the CPG, August 11, 2008 - www.ci.burlington.vt.us/docs/3358.pdf
K. Petition to Amend Condition 17 www.ci.burlington.vt.us/mayor/BT/Docs/BT_Petition_to_Amend_Condition_17.pdf
L. Council Resolution authorizing City to request relief from Condition 60, October 5, 2009 www.ci.burlington.vt.us/docs/3359.pdf
M. City's Amended Petition to the Public Service Board Requesting Relief from Condition 60, September 30, 2009 www.ci.burlington.vt.us/mayor/BT/Docs/BT_Petition_of_Cond_60_Relief.pdf
N. Burlington Telecom 2007 Annual Report filed with the DPS www.ci.burlington.vt.us/docs/3349.pdf
O. Burlington Telecom 2008 Annual Report filed with the DPS www.ci.burlington.vt.us/docs/3351.pdf
P. November 25, 2008 pro forma spreadsheet summaries www.ci.burlington.vt.us/docs/3329.pdf, www.ci.burlington.vt.us/docs/3330.pdf, www.ci.burlington.vt.us/docs/3331.pdf, www.ci.burlington.vt.us/docs/3335.pdf
Q. Email from Mayor Kiss to City Council, December 13, 2009, RE: Piper Jaffray Letter of intent - www.ci.burlington.vt.us/docs/3339.pdf
R. Letter from Fred Duplessis to William Ellis, December 20, 2010 www.ci.burlington.vt.us/docs/3337.pdf
S. FY 2007 Audit Management Letter, June 26, 2008 www.ci.burlington.vt.us/docs/3327.pdf
T. BT Response to DPS Discovery Request 4-4 - www.ci.burlington.vt.us/docs/3360.pdf
U. Memo from Mayor Kiss to City Council, March 4, 2010, RE: Facts About Burlington Telecom - www.ci.burlington.vt.us/docs/1773.pdf
V. Board of Finance memo dated July 12, 2010, with attachments www.ci.burlington.vt.us/docs/3343.pdf
W. BT Timeline - www.ci.burlington.vt.us/docs/3361.pdf

1. Introduction

The City of Burlington has reviewed the report completed by Larkin and Associates with respect to Burlington Telecom ("Larkin Report"). The Larkin Report was initiated in October 2009 by the Vermont Department of Public Service ("DPS" or "Department") in relation to proceedings before the Vermont Public Service Board ("PSB" or "Board") in Docket No. 7044, the request of Burlington Telecom to amend Condition 17 of its Certificate of Public Good ("CPG"). This docket includes Burlington Telecom's request for relief from Condition 60 of the CPG. The scope of the proceeding was expanded by the PSB to include a review of BT's compliance with other CPG conditions. The report was described as a "forensic audit" for six months before the DPS acknowledged that description is incorrect.[1]

The Larkin Report was filed with the Board on December 10, 2010. The cost of the report, approximately $77,000 to date, was paid by Burlington Telecom. The report contains several conclusions related to BT's compliance with its CPG, knowledge of those compliance issues, accounting practices, and the viability of Burlington Telecom.

The City's review shows that Larkin's claims are marked by significant omissions, inaccuracies, and false assumptions. The methodology employed by Larkin was flawed. Larkin failed to speak with the City's independent auditors, Sullivan, Powers & Company, anyone from the City administration or the Clerk-Treasurer's Office, or the City's financial advisers Dorman & Fawcett. Although Larkin took more than a year to complete its report, it failed to review and incorporate significant developments over the last six months. These developments were reported by the City to both the DPS and the Board prior to the release of the Larkin Report.

Burlington Telecom is a significant asset of the City and its residents and businesses. Its future impacts not only Burlington but the entire State of Vermont. The claims of the Larkin Report need to be evaluated thoroughly. [2]

2. Burlington Telecom – a Brief History

On Town Meeting Day in March of 2000, Burlington voters overwhelmingly approved an amendment to Burlington's charter confirming the City's authority to engage in telecommunications services. To this date, Burlington Telecom is one of just a handful of municipal telecom enterprises nationwide, with a fiber-to-the-home model designed to deliver high quality services now and for years into the future.

In addition to its cutting edge technology, BT was conceived to address service and bandwidth inequities in Burlington that are pervasive to Vermont and similarly less-settled areas across the country. Even as Vermont's largest city, Burlington is far less

[1] See Letter from Geoffrey Commons to PSB Clerk Susan Hudson, April 23, 2010 (Attachment A).
[2] Throughout this process there has been little dispute over the importance and value of BT as a telecom asset. See e.g., Report of the Blue Ribbon Committee, pp. 4 and 7, www.ci.burlington.vt.us/docs/1648.pdf.

populous than many towns and small cities in other states. In 2000, Burlington faced the prospect of being underserved and uncompetitive with respect to one of the most important technological and social developments of the 20th century.

Many neighborhoods and potential commercial centers lacked service altogether and the city as a whole faced a dearth of service providers. Residents and businesses were at the mercy of one or two large national telecom companies. The lack of competition meant rising prices and stagnant technology. This threatened to significantly impact Burlington's ability to attract and grow businesses.

The charter change passed in March 2000 was submitted to the Vermont Legislature for approval. BT competitors Adelphia and Verizon became involved in the legislative process. Ultimately, the charter change approved by voters was approved by the Legislature but amended in two significant ways: it added a requirement that "no losses" of the BT enterprise be borne by Burlington taxpayers, and added a requirement of "competitive neutrality" for BT. Adelphia Communications, now Comcast, advocated and successfully lobbied for these changes.

In 2003, the City procured initial financing of $2.6 million from Koch Financial for "Phase I" of BT's buildout. Phase I was to provide services for communications between the City and the school buildings. In November of 2004, the City procured additional financing of $10 million from Koch for Phase II and III of the buildout. Phase II added businesses that were located along the route of the Phase I fiber cable. Phase III was the buildout of the network throughout the entire city. In September of 2005, BT received its Certificate of Public Good from the Public Service Board to provide cable services.[3] In January 2006, the City then procured an additional $10 million in financing from Koch to cover construction and installation costs to continue the Phase III buildout. Phase III service was initiated in Burlington's south end in February of 2006. At that time, BT's lease-purchase arrangement with Koch Financial totaled approximately $22.6 million.

The City subsequently refinanced BT in August 2007 through a lease-purchase arrangement with CitiCapital totaling $33.5 million. With this transaction, the Koch financing was paid off and additional funds utilized to continue with BT's buildout of the fiber to the home network. Today, BT has built a network capable of providing service to over 15,000 residences and businesses in the City of Burlington.

BT's fiber-to-the-home system remains the gold standard for telecom services. The ultra-fast Internet speeds are symmetrical, with data upload speeds as fast as download speeds. Fiber-optic cable is a resilient and flexible medium that is less prone to weather disruptions. Burlington Telecom's head-end was built with the capacity to serve at least 100,000 households and therefore the potential to serve communities beyond Burlington.

[3] Burlington Telecom already possessed a Certificate of Public Good for telephone services that was issued by the Board in June 2003 (Attachment B).

3. Burlington Telecom's Viability as a Going Concern

Larkin concludes that:

> "If BT were operating as a separate entity it would in fact have a significant going concern issue. As discussed throughout the report there are concerns with the recurring losses, the accumulation of the $16.9 million obligation to the City and the current problem with meeting its $33.5 million obligation to CitiCapital."[4]

A going concern issue is created when a company does not have adequate cash flow to meet its obligations over the next 12 months. Larkin reached its conclusion based on the dollar amount of lease payments due in FY2011 without inquiring as to the status of the restructuring or the forbearance agreement between the City and CitiCapital. Moreover, Larkin's analysis of the obligation to CitiCapital is based on an incorrect reading of the lease and misses a fundamental term. The lease states that the obligation to make lease payments is a current expense and is not to be construed as creating a debt of the City of Burlington in contravention of any constitutional or statutory limitation or requirement concerning the creation of indebtedness.

The City of Burlington's lease with CitiCapital is subject to annual appropriations being made. The decision whether or not to budget or appropriate funds is solely within the discretion of the then-governing body of the City of Burlington (the City Council). As an appropriation was not made for the 2011 fiscal year, the lease terminated. The City of Burlington is to return the equipment that is subject to the lease. Upon termination, the City has no further obligation to CitiCapital. When the lease terminated, the City had already begun conversations with financial and strategic partners to finance replacement equipment. These discussions include, as an essential element, the potential to repay the $16.9 million obligation to the City.

The Larkin Report also cites the Blue Ribbon Committee ("BRC") report dated February 11, 2010 that "BT is not viable in relationship to its current debt load of $51 million and its ability to generate earnings to pay off this debt."[5] Despite this reliance on the BRC report, Larkin fails to mention the BRC conclusion that BT can be viable with a financial restructuring to reduce the debt burden.[6] The report included recommendations to address this issue including retaining an expert financial advisor to consider the short and long term strategies and restructure BT's debt to relieve the current debt burden.[7]

Pursuant to the Blue Ribbon Committee report, the City immediately proceeded to implement these recommendations by hiring Dorman & Fawcett in March 2010.[8] Dorman & Fawcett has been carrying out the mandate of the City Council appointed

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[4] Larkin at 49.
[5] See Blue Ribbon Committee Report dated February 11, 2010, www.ci.burlington.vt.us/docs/1648.pdf.
[6] Id. at 11.
[7] Id. at 11.
[8] See Council Resolution dated March 8 2010.

BRC to restructure the current debt load of BT, a critical piece missing from the Larkin Report.

This information was in the public record before Larkin issued its report. It was the subject matter of the letter from the City's attorney, William Ellis, dated November 23, 2010, and sent to the Board and the Department. It is the same information reported to the Board and DPS at a PSB status conference hearing on December 8, 2010.[9]

These developments were reported widely in the media. Larkin clearly had the opportunity to review this information and evaluate it.

Larkin's going concern issue is also based on historical operating results instead of a review of the most recent financial performance. BT is currently generating a positive cash flow before debt service and has been for a number of months. Cash flow - or earnings before interest, taxes, depreciation and amortization ("EBITDA") - is the fundamental test of a business's viability. While BT's cash flow is modest, it is nevertheless positive.

The City and Dorman & Fawcett have developed a plan to preserve BT. Many businesses, particularly in the current economy, are routinely faced with a going concern opinion from their auditors. Typically, if the going concern is a result of future debt service, the business will seek to restructure some or all of its obligations - which is exactly the approach the City took with CitiCapital. At a minimum, Larkin's going concern commentary should contain a complete and accurate disclosure of the Citicapital lease and its status.

4. The City's Response to BT's Financial Issues

The Larkin Report incorrectly alleges that the City failed to recognize and communicate Burlington Telecom's financial issues.[10] In Larkin's view:

> "<u>The results of operations i.e. annual losses, were an obvious indication BT was being funded by the City.</u> A review of the growing negative balance in the Pooled Cash account would have been an obvious indicator that advances from the City were not being repaid in accordance with the terms of Condition No. 60." [11]

Larkin ignores numerous instances in the public record of the City addressing and communicating BT's financial condition and outlook in various situations.

[9] See Mayor Kiss Memo to City Council, December 8, 2010 (Attachment C or www.ci.burlington.vt.us/docs/2932.pdf); See also Letter from William Ellis to PSB Clerk Susan Hudson, November 23, 2010 (Attachment D).
[10] Larkin Report at 21
[11] Id. at 12 (emphasis added).

2007

Within weeks of the resignation of former General Manager Tim Nulty in November 2007, the City administration and the interim General Manager Chris Burns brought in a telecom consultant to review and make recommendations for BT's business plan and outlook. The consultant generated a report known as the "Shanahan Report." The Larkin Report claims without apparent support that "[n]otably, the City Council was apparently not informed of the finding on page 8 of the [Shanahan] report that BT would exceed its borrowing capacity under the current debt facility in March 2008."[12]

This statement is incorrect and contradicts the clear public record. On December 17, 2007, Chief Administrative Officer Jonathan Leopold and interim General Manager Chris Burns gave a report to the City Council in public session regarding Burlington Telecom which included that BT would utilize all of its financing by March or April 2008[13]. CAO Leopold further reported that BT's revenues and customer acquisition were significantly below budget, the capital expenditures would be significantly greater than budgeted and that BT would require additional financing.

Prior to the December report to the Council, CAO Leopold reported on BT at the November 7, 2007 meeting of the City's Board of Finance:

> "CAO Leopold provided the Board of Finance a status report on the finances of Burlington Telecom through October 31, 2007. In summary, the current customer hook-ups are 75% of the forecast and budget projections. If the shortfall in customers is not recovered, the loss of operating revenues would be the equivalent of $1 million annually. In addition, the capital budget for Telecom is projected to exceed the forecast and budget by more than $3.5 million. CAO Leopold noted that the Burlington Telecom business pro-forma and model needed substantial revision and the City was retaining an independent consultant to advise the City how to remedy the current shortfall in hook-ups and operating revenues. He advised the Board that a full report would be provided to the Board the first week in December."[14]

These minutes were transmitted to the City Council and were posted to the City's website. The minutes make clear that the City identified concerns about BT's finances, were developing a plan to address those concerns, and communicated these issues explicitly and publicly.

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[12] Id at 21.

[13] See copy of the transcript from the December 17, 2007 meeting (Attachment E). This transcript was provided to the DPS in the course of discovery. The video of the meeting is available on the CCTV website.

[14] November 7, 2007 Board of Finances meeting minutes (Attachment F).

2008

On January 16, 2008, the "Shanahan Report" was presented to the City's Board of Finance in executive session and made available for review by the City Council[15] after this presentation. The need for additional financing for BT was explicitly discussed during this meeting. Subsequently, at the January 22, 2008 Board of Finance meeting the agenda includes a report by CAO Leopold on the need for financing BT. The Board of Finance by a unanimous motion authorized Leopold to

> "proceed with Municipal Leasing Services…to pursue a refinancing of the outstanding lease/purchase obligations of Burlington Telecom and to secure additional financing as required…"[16]

The Larkin Report also fails to account for the following:

- BT's calendar year 2007 report to the Department of Public Service (DPS) dated April 14, 2008, showing operating income of $1.39 million and operating expenses of $4.66 million, for an operating deficit of approximately $3.27 million. Including depreciation and amortization, BT's net income in 2007 was negative $4.07 million. BT's 2006 operating deficit was approximately $2.34 million ($2.46 million when applying depreciation and amortization).[17]
- The City administration's development and Council's passage of an FY2009 budget with a deficit of $11.1 million for Burlington Telecom in June 2008. The budget narrative explicitly states that BT will require an estimated $8 million in debt financing for the year. This budget was and is publicly available.[18]
- The August 11, 2008 Council resolution authorizing the filing of BT's petition to amend Condition 17 of the CPG, also specifying that the build-out of the remainder of the City should occur as revenues allowed.[19]
- At a meeting of City and BT staff with DPS staff on November 25, 2008, pro formas showing the City's loan to BT of $10 million were shared with the Department. These spreadsheets showed an eventual loss by BT of up to $20 million.[20]

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[15] While this report was previously considered confidential, it was released with minor redactions as an attachment to the Larkin Report (Attachment G); see http://publicservice.vermont.gov/dockets/7044/Exhibits/LA-14%20DPS%203-111.pdf

[16] See January 22, 2008 Board of Finance minutes (Attachment H).

[17] See Burlington Telecom 2007 Annual Report (Attachment N).

[18] See http://www.ci.burlington.vt.us/ct/budget/2009/FY09BudgetSection2.pdf. See also, Attachment I.

[19] See Council Resolution, August 11, 2008.(Attachment J).

[20] See spreadsheet summary pages (Attachment P). These documents were also provided to the DPS in the course of discovery.

2009

- BT's calendar year 2008 report (in April of 2009) to the DPS showed an operating deficit of approximately $3.12 million and a total net income deficit of $5.13 million in 2008.[21]
- The City administration's discussion of the Condition 60 violation and BT's substantial pooled cash debit to the Council on May 18, 2009 in executive session.
- The Council's October 5, 2009 authorization of the City's request to the PSB for relief from Condition 60.[22] This filing to the PSB which occurred on September 30, 2009, acknowledged the City's lack of compliance with Condition 60.[23]
- The City's pursuit of a refinancing proposal and subsequent presentation of the Piper Jaffray proposal to the Council in November and December of 2009. The amount of the proposed refinancing covered, at a minimum, existing CitiCapital financing and BT's debit to pooled cash.[24]
- Mayor Kiss's and the Council's joint agreement to appoint the Blue Ribbon Committee in December 2009.

The Larkin Report lacks any reference whatsoever to this information. The City's annual reports to the DPS are public. The operating deficits reflected in these reports are clear. Over the course of calendar years 2006, 2007, and 2008, BT's operating deficits totaled approximately $8.73 million.

In addition to the information included above, BT's deficits were reflected in the City's annual reports from FY08 and FY09. These preliminary annual reports were printed and distributed on Town Meeting Day in March of 2009 and 2010.[25] The perception that the City and BT ignored and hid BT's financial condition and performance from the Council, the Department, and the public is inaccurate.

5. Knowledge of the Condition 60 Violation

The Larkin Report alleges that the City was aware of the violation of Condition 60 prior to November 2008, which is the timeframe in which the City has stated it became aware of the violation. The sole evidence on which Larkin bases the allegation is a statement contained in a "workpaper" from the City's independent auditor, Sullivan, Powers & Company ("SPC"):

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[21] See Burlington Telecom 2008 Annual Report (Attachment O).
[22] See Council Resolution, October 5, 2009 (Attachment L).
[23] See Amended Petition to the Public Service Board dated September 30, 2009 (Attachment M).
[24] See Mayor Kiss's email to City Council, December 13, 2009 (Attachment Q).
[25] Final annual reports are located on the City's website at http://www.ci.burlington.vt.us/annual_report/index.php.

> "On workpaper PP1203, a planning document, we noted the following statement (emphasis added): **'Cash in Pooled account is very negative which [is] a violation of the CPG. No current plans to fund this negative.'** The workpaper is dated 1/08. That suggests that someone at the City should have known that BT was in violation of the CPG prior to November 2008 even if only relying on auditor workpapers."[26]

Larkin does, in fact, only rely on this auditor workpaper. The auditor's workpapers were never shared with anyone at Burlington Telecom or with the City, prior to the Larkin Report. In fact, as indicated by Fred Duplessis from SPC, workpapers are an internal tool for the auditing firm and are not designed to be released to anyone including the client.[27] Larkin makes the assumption, without any verification, that the workpapers represent a discussion with someone at the City about the negative pooled cash account being a violation of the CPG. Larkin further assumes that, if that discussion occurred, it was with or subsequently relayed to someone within BT or the City administration.

In making this allegation, Larkin never spoke to anyone at SPC, BT or the City to confirm or refute their assumptions. Discussions that occurred between the auditors and BT staff were in regards to BT's monitoring of the Certificate of Public Good for compliance. There was no discussion of a Condition 60 violation in the 2007 management letter issued by SPC.[28]

6. Non-Compliance with Condition 60 Since Issuance of the CPG

The Larkin Report asserts that BT has been out of compliance with Condition 60 the entire time that it has been subject to a CPG. The City has previously acknowledged its lack of compliance with Condition 60 from March 2007 through August 2007 and from January 2008 to the present.[29] BT's violation of Condition 60 continues due to the unreimbursed payment of $16.9 million from the City's cash pool that was incurred prior to October 2009. However, as confirmed in the Larkin Report, since October 2, 2009, BT has reimbursed the City's cash pool for all debits within the two month requirement.[30]

The intent of Condition 60 is explained by the hearing officer in the Public Service Board Order issued on October 8, 2010, as follows:

"In an effort to provide some flexibility for Burlington Telecom in managing temporary cash flow shortages without creating a risk for city taxpayers, the Board allowed a limited exception in Condition 60 that was intended to permit short-term advances from the cash pool on behalf of Burlington Telecom so long as such advances were offset by

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[26] Larkin at 8.
[27] See Letter from Fred Duplessis dated December 20, 2010 (Attachment R).
[28] See 2007 Management Letter dated June 26, 2008 (Attachment S).
[29] See DPS Responses 4-4. (Attachment T)
[30] Larkin at 16.

receivables that, in essence, would enable Burlington Telecom to repay such advances within two months."[31]

Until 2007, BT had first Koch and later, CitiCapital financing funds available to repay advances from the cash pool. When BT's CPG was issued, the record is clear that BT had funds available through the Koch financing that far exceeded BT's negative pooled cash balance.[32] Contrary to the assertion by Larkin, there was no restriction on the use of these funds to meet BT's debit to pooled cash, with the exception of the $1 million debt service reserve under the CitiCapital financing.

Koch and CitiCapital were both lease-purchase financing agreements. A lease-purchase agreement does not provide the entity a full advance of funds at closing, but rather provides periodic draws of funds after receipt of proper documentation. Protocol requires the borrowing entity to provide the agent with documentation including copies of invoices and cancelled checks. Due to the timelines associated with obtaining the documentation for Koch or CitiCapital, funds while available were not always promptly reimbursed to the cash pool within sixty days.

Larkin does not accurately characterize BT's available funding to repay pooled cash. When taking into account available funds from the lease purchase financing, the debit to pooled cash was covered throughout the period. In other words, BT's financial position was positive.[33]

7. Accounting Issues

The Larkin Report alleges that the City utilizes "unconventional accounting practices."[34] Larkin's conclusion evidences a lack of understanding of municipal fund accounting. This was exacerbated by their lack of inquiry or discussion with either the City's auditors or accounting staff. Contrary to their conclusion, the City's accounting practices are consistent with accepted municipal accounting standards. The accounting practices of the City conform to both GAAP and GASB standards, as stated in the City's annual audited financial statements,

> "The accounting policies adopted by the City of Burlington (the City) conform to generally accepted accounting principles (GAAP) as applicable to governmental entities. The Government Accounting Standards Board (GASB) is the accepted standard setting body for establishing accounting and financial reporting principles."[35]

[31] Order on Motions and Cross Motions for Partial Summary Judgment, Oct 8 2010, at 11. See http://psb.vermont.gov/sites/psb/files/orders/2010/7044OrderReSummaryJudgment.pdf.
[32] See Memo from Mayor Kiss to City Council, March 4, 2010, RE: Facts about Burlington Telecom (Attachment U or www.ci.burlington.vt.us/docs/1773.pdf.).
[33] See note 32.
[34] Larkin at 13.
[35] See http://www.ci.burlington.vt.us/ct/docs/Audit_20090630.pdf

Moreover, the City's accounting practices are similar to those of a significant number, if not a majority, of municipalities in both Vermont and the nation. Larkin could have ascertained this information by inquiring of the City's independent auditors or accounting staff.

The City has historically used fund accounting, a standard practice by municipalities. Fund accounting is often measured on a yearly basis against the budget appropriated for the fiscal year. Larkin's conclusion is undermined by the City's experience with its yearly audit, as the City's auditors has been able to audit BT and City records for the periods of investigation completed by Larkin.

It is unfounded for Larkin to state that their work was "complicated by the City's unconventional accounting practices." It was Larkin's work that was complicated by their lack of discussion with the City's auditors or the accounting staff of the Clerk/Treasurer's Office. These fundamental weaknesses in Larkin's analysis underlay other inaccurate conclusions from their report:

A. Repayment of principal and interest to pooled cash

Larkin states that "records cannot sufficiently identify the advances made and the repayment of either the principal or the interest." referring to Pooled Cash.[36]

This statement is simply incorrect and reflects Larkin's failure to discuss this matter with appropriate City accounting personnel. The City can identify the advances made, and the repayment of either the principal or the interest both generally and specifically. At all times BT has had a debit to pooled cash, it has paid interest to the City on the amount of the debit. It is again important to note that the audited financial statements for BT clearly and accurately identify interest charges. The City's approach for BT in both these respects is consistent across all funds of the City.

Larkin also criticized the City for not charging BT interest on a monthly basis for all periods of time reviewed by Larkin. There is no stipulation, per se, that interest must be booked monthly. Historically the City has calculated and booked interest as of the end of the fiscal year. The City recently began booking interest for all funds on a monthly basis. In either case, the City has a consistent methodology for posting interest for all funds in the City including Burlington Telecom. Larkin's claim that FY07 interest charges to Telecom were $264,873 recorded only to April 2007 and that interest was not charged for the remainder of the fiscal year is incorrect. It again reflects the lack of discussion with accounting personnel and lack of understanding of the city's accounting records.

In fact, Telecom was charged $51,470 as interest expense for the remainder of the fiscal year April through June 2007. Thus, the total interest charged on negative pooled cash

[36] Larkin at 20.

for fiscal year 2007 was actually $316,343. This interest expense agrees to the general ledger, and the audit for that year balance to the general ledger.

B. Accuracy of pooled cash balance and timely posting of BT payroll

Larkin claims there is an "understatement of the amount of BT's Pooled Cash draws was associated with payroll which, on a number of occasions, was not posted on a timely basis to BT's accounting records."[37]

The City's payroll is booked weekly to expenses, but not to pooled cash. The short window to process payroll for a large employee base is a challenge. Even with these challenges, the City posts payroll expenses weekly. In today's market, this standard exceeds that of a majority of organizations and is a significant accomplishment.

The timing and delayed receipt of all benefit information, and the reconciliation process will always result in a timing delay of the required journal entry to pooled cash. This delay was not particular to BT but was consistent for all funds of the City covered under pooled cash.

A payroll clearing account was created for the purpose of making the reconciliation of payroll easier on staff. The process to streamline and automate the allocation to pooled cash was improved over a three year period. As of fiscal year 2010, the entries for all payroll and benefits are completed weekly for Burlington Telecom which is an exception unique to BT. All other funds are booked monthly.

C. City's alleged "failure" to post Capital acquisitions during the fiscal year[38]

This finding by Larkin is incorrect and again reflects Larkin's failure to communicate with City accounting personnel. Capital acquisitions are in fact posted during the fiscal year. However, it is the City of Burlington's policy not to book capital acquisition expenditures to assets until year-end. Until that point, capital expenditures are booked separately in order to show monthly expenses incurred, and to compare to the approved capital budget.

D. Posting of operating expenses to capital accounts[39]

The City has properly recorded Burlington Telecom's operating and capital expenditures for the period of time reviewed by Larkin. The City's audited annual financial statements identify both operating and capital expenditures. As part of the audit process, these expenditures are reviewed to verify proper classification and the accuracy of the fixed asset report.

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[37] Larkin at 9.
[38] Larkin at 47.
[39] Id.

The startup of Burlington Telecom required feasibility studies, recruiting and hiring, development costs, integration services, and deployment costs. As a result, some expenses typically booked to operating expenses were properly charged directly to capital. The classification of these expenses as capital was consistent with Generally Accepted Accounting Principles ("GAAP") which provide for capitalizing such start up costs related with the implementation of a plan, project, or business.

The high volume of invoices with BT's startup and build out provided workload challenges for staff. After the close of the fiscal year through the reconciliation and year end audit process, certain capital expenses were reclassified as operating expenses.

Finally, is important to note that both operating and capital expenses are a use of cash, and have the identical impact on the pooled cash. Pointedly, Larkin's verification of the posted general ledger did not disclose any entries, or invoices that did not have the required backup.

E. Approval of payment vouchers for BT General Managers Nulty and Burns

Larkin inaccurately claims that BT's General Managers were solely responsible for approval and payment of their own invoices.[40] As General Manager of Burlington Telecom, both Mr. Nulty and Mr. Burns effectively functioned as the equivalent of a Department head for BT. Typically, a department head is responsible for approving the submission of vouchers for their department including invoices pertaining to them personally. However, all vouchers are reviewed and approved by either a Senior Accountant or the Chief Accountant in the Clerk-Treasurer's Office before the invoice is processed and a payment made.

When Mr. Burns succeeded Mr. Nulty, he was and remained on a contractual basis. His contract provided for regular fixed amount payments. All payments to him were in accordance with his contract and were reviewed by Clerk-Treasurer staff.

F. Compliance with Condition 58

The Larkin Report expressed a "concern that Burlington Telecom is in full compliance with Condition 58, and tracking Burlington Telecom's costs, including financing in a transparent and auditable manner."[41]

It is difficult to address this issue since the Larkin Report does not provide financial documentation or footnotes to substantiate this "concern." The Larkin investigation does not conclude that the City is out of compliance but speculates it may be out of compliance.

[40] See Larkin at 43.
[41] Larkin at 20.

The fact is that the City auditors, Sullivan Powers & Company, have been able to audit BT and City records for the periods reviewed by Larkin. If the records for BT were not auditable, the auditors would have been required to issue a "scope limitation" statement to that effect.

8. "Cross-Subsidization" of City services

The Larkin Report states that BT is providing services to various City departments at below-market rates that are below BT's cost of service and the "fact that BT is providing services to various City departments at below-market rates that **may be** below BT's cost of service, which could be viewed as a form of cross-subsidization, is a problem."[42] BT is not providing services to City departments "below BT's cost of service." Larkin could have readily allayed this concern either by reviewing the information provided to the DPS in discovery or through a brief inquiry to BT staff.

Furthermore the Larkin Report states that BT should not be allowed to provide discounted services to City Departments as this is a violation of Condition No. 12 of the CPG.

Condition 12 provides that:

> Prices for services not subject to rate regulation by the Board shall at all times be reasonable, having regard to the costs of providing such service.

Condition 12 is intended to prevent excessive rates, not reduced rates. This condition protects customers from price-gouging. Furthermore, while Larkin is correct that BT provides voice and data services to various City departments at a below-market rate,[43] "below-market" is not synonymous with not recovering the costs of providing the service.

Despite a reduced rate offering, payments by City departments exceed the cost of providing the service. Larkin provided no evidence as to how they determined BT's rates to the City are not "reasonable" in relation to costs. Larkin also failed to update their report to reflect that effective July 1, 2010, BT now charges the City of Burlington 90 percent of the fair market value for its services.

9. Excessive Quantities of Equipment

The Larkin Report claims that BT has purchased too much equipment for the amount of customers that BT currently has in service. Specifically, Larkin identifies the quantity of set-top boxes (commonly referred to as top boxes in the Larkin Report) and Optical

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[42] Larkin at 27 (emphasis added).
[43] Based on BT's review of commercial rates. This information was presented to the Board of Finance on November 9, 2009.

Network Terminals ("ONT"s) that were purchased by BT. Larkin does not account for: 1) the fact that the average customer has two set top boxes in each household; 2) the high number of disconnects and new connections in the City due to the fact that this is a college town or 3) that a 502 ONT is not the same as a 504 ONT and therefore does not serve the same customer.

The Larkin Report also does not take into account that BT typically purchases inventory based on a forecast of subscribers, which is done with the budgetary cycle. BT factored in considerable growth in residential and business customers thereby purchasing ONTs and set-top boxes to accommodate this growth. BT adjusted the budgetary numbers in 2009 and cancelled a shipment of over 1500 ONTs and has not placed an order for standard definition set-top boxes since 2009. All of this information was readily available to Larkin prior to issuance of the report.

On a related issue, Larkin's lack of diligence is also clear with respect to its claim that "considering the customer base that BT has, the installation appears high."[44] This is a misleading statement and indicative of Larkin's lack of familiarity with the telecom industry and the industry's infrastructure. Typically, an assessment of the cost per home passed is measured on several factors including but not limited to construction and head-end costs. Furthermore, "installation costs" include capital equipment and labor associated with the installation. Finally, while expressing "concern" that costs may be high, Larkin provided no benchmark or supporting data.

10. Management Letter Issues

The Larkin Report spends a considerable amount of time reviewing the 2007, 2008 and 2009 audit reports and management letters.[45] However, the listing fails to include management responses despite the fact these were provided to the DPS. Larkin cites numerous issues previously identified by the city's auditor, and remedied by BT months and in one case, an entire year, prior to the release of the Larkin Report.

In September 2009, BT staff instituted a quarterly system to monitor CPG compliance. Moreover, Larkin fails to report that in the spring of 2010, the City instituted a process for monitoring resolution of all issues in both management letters and single audit reports. In April 2010, the FY2009 audit management letter identified four material weaknesses, 3 significant deficiencies and 19 other recommendations for BT. Most of these deficiencies were related to documentation of policies and procedures.

BT staff developed a checklist to address all of the identified deficiencies with all deficiencies to be cured by June 30, 2010. This checklist and strategy was presented to the Board of Finance in June 2010. Subsequently, BT presented an update to the Board of Finance in July 2010 demonstrating that all of the identified deficiencies except for one

[44] Larkin at 44.
[45] Larkin at 40.

were remedied by the June 30, 2010 deadline set by BT staff.[46] The attached memo and spreadsheet list all the deficiencies that were corrected and the memo explains the one that was not addressed. The July 2010 Board of Finance meetings were conducted in public months before the release of the Larkin Report.

As a result of this effort, by June 30, 2010, all outstanding issues regarding Telecom were addressed and all but one was successfully resolved. Similarly on a city wide basis the majority of all management and audit issues have been addressed prior to the issuance of the Larkin Report.

Finally, it is important to note that it is standard practice in an audit to identify and include significant subsequent events. Larkin devotes considerable space to these management issues yet failed to note the resolution of the BT issues both within the timeframe covered by Larkin (through June 30, 2010) as well as the period prior to completion of the report.

11. Other Larkin Conclusions

The Larkin Report, while flawed in several areas, does include several conclusions that support BT and the City's statements for the past year.

- $16.9 million is the accurate total of BT's debit from pooled cash.[47]
- Since October of 2009, BT has repaid all new debits to the cash pool within two months per Condition 60 and the City Council Resolution dated November 20, 2009.[48]
- BT is current on its obligations to vendors.[49]
- BT has expended all the funds it has received, including funds from the cash pool, for Burlington Telecom.[50]

CONCLUSION

BT is moving forward and is fully committed to remaining a valuable asset to the residents and businesses in the City of Burlington. As explained to the Public Service Board at the status conference on December 8, 2010, BT with Dorman & Fawcett is in the process of conducting a physical inventory of assets, working with potential financial and strategic partners and devising a plan to secure replacement equipment.

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[46] See Board of Finance memo dated July 12, 2010 (Attachment V).
[47] Larkin at 15.
[48] Id. at 16.
[49] Id. at 28.
[50] Id. at 39.

Now is the time to focus on maintaining this asset and curing the violations. BT represents a long-term investment in technology infrastructure that can serve residents and businesses in Burlington and across the state for years to come.