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City Agenda Report

Report To: **CITY COUNCIL**

Report Date: June 8th, 2001 **Meeting Date: June 14, 2001**

Recommendation:

The recommendation to council based on the findings of the report is that the necessary criteria for consideration have not been met for a contribution from the municipality of $1 million. Therefore the City should not contribute to this project.

Subject:

The Station Project

Report Prepared By:	Recommended for Agenda:
Doug Nadorozny Doug Nadorozny General Manager Economic Development and Planning Services	J.L. (Jim) Rule Chief Administrative Officer
Authored By: Doug Nadorozny, General Manager, Economic Development and Planning Services	

Executive Summary:

City Council gave conditional approval of a $1M contribution to "The Station Project" subject to a number of conditions including a feasibility report being done.

The attached report from KPMG identifies a number of criteria that would likely not be met by the The Project and as such municipal funding cannot be recommended at this time.

The report does highlight a number of possible private sector partnerships that could be explored to develop many of the original goals of The Station Project.

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Background:

As per the resolution of council #2001-171, a feasibility report for The Station Project has been prepared by KPMG. The full report dated June 1st, 2001 including an addendum dated June 6th, 2001 is attached for the review of council.

A few days after the Council meeting of April 10th, 2001, a terms of reference was developed and reviewed with KPMG. It was agreed that depending on the outcome of the initial areas of the investigation, one or more of the original requirements may no longer be necessary to investigate, thereby lowering consulting costs.

A comprehensive consultation was then undertaken by KPMG which included input from local project proponents, local internet service providers, and other businesses that could be impacted by The Station Project. Additional advice was sought from the CRTC regarding certain regulatory issues.

Given the details of the resolution passed on April 10th, 2001, specifically:

> *"WHEREAS the City of Greater Sudbury has determined that Technology would be at the forefront of its vision for the future of the City of Greater Sudbury;*
>
> *AND WHEREAS the installation of a significant optical fibre network has given the City of Greater Sudbury an already sizable investment and a proactive move towards a truly wired and smart community status:*
>
> *AND WHEREAS it is the intention of the City of Greater Sudbury to become a world class city offering world class services including a world class network infrastructure and related applications to its citizens;*
>
> *THEREFORE BE IT RESOLVED that the City of Greater Sudbury commit up to $1 million dollars towards the project concept referred to as "The Station" in order to assist the project in leveraging at least $9 million in additional private and public funding."*

... the recommendation to council based on the findings of the report is that the necessary criteria for consideration have not been met for a contribution from the municipality of $1M. Therefore the City should not contribute to this project.

While the research indicates that, from a financial perspective, the Station does not represent a viable initiative, this is not necessarily reflective of the concept per se, but rather the current high cost of the technology involved in delivering fibre optic services to residential users and the limited market size of the Station's service area.

For further details, both the executive summary, full report, and the addendum report, as prepared by KPMG are attached.

Assessing the feasibility of

THE STATION TELECOMMUNICATIONS PROJECT

Submitted by:

kpmg
144 Pine Street
Sudbury, Ontario
June 1, 2001

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KPMG

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Mr. Jim Rule
Chief Administrative Officer
The City of Greater Sudbury
Tom Davies Square
200 Brady Street
Sudbury Ontario P3A 5P3

June 1, 2001

Dear Mr. Rule

The Station Telecommunications Project

KPMG is pleased to provide our comments concerning our review of the Station Telecommunications Project (the "Station"). We understand that our review was requested in order to assist Council in determining whether to allocate $1 million of funding towards the project.

The Station represents a unique concept for the City, one in which fibre optic capabilities will be made available to individual residents. The potential benefits of the Station, if successful, could be significant – improved and expanded telecommunications services for residents and increased utilization (and corresponding returns) on existing fibre optic investments made by the City are among a few of the benefits envisioned.

Despite these benefits, our review of the Station's business case has left us with significant concerns about its feasibility. Our research indicates that the Station would not only fall substantially short of the projected revenue and customer levels outlined in the business case, but would also be challenged to generate any form of profit at all. As a result, the establishment of the Station would result in an initiative that provides no appreciable return to its investors, consisting primarily of government agencies (the degree to which the private sector contributes financially towards the Station is limited). Our projections also indicate that the Station, if pursued, would generate ongoing deficits of $200,000 annually into the future – deficits that would likely be financed, in one form or another, by the City.

While our research indicates that, from a financial perspective, the Station does not represent a viable initiative, we believe this is not reflective of the concept per se, but rather the high cost of the technology involved in delivering fibre optic services to residential users and the limited market size of the Station's service area. The financial feasibility of the Station notwithstanding, we believe that current trends in the telecommunications and broadcasting industries do provide general support for the concept. A number of cable companies have received licenses for the delivery of video on demand services and Bell Canada has announced plans to introduce set top boxes that will allow users to access the internet over their televisions. These instances demonstrate that the industry is already investigating and implementing the services envisioned for the Station, but on a much larger scale than that envisioned by the Station and without the need to incur the significant costs associated with the delivery of fibre optic services directly to homes.

Based on this, we believe that the City's efforts may be better directed by encouraging cable and telecommunications companies to deliver those services included in the concept of the Station. This form of cooperation provides significant advantages to the City – it allows for the services to be delivered throughout Greater Sudbury (as opposed to individual sections as envisioned by the Station) without the need for municipal investment, both for initial capital costs and ongoing deficits.

* *

Should you have any questions concerning our report or the results of our review, we would be pleased to discuss them with you at your convenience.

Yours very truly

James G. Corless, FCA

Oscar A. Poloni, CA, CBV

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EXECUTIVE SUMMARY

The Station represents a unique concept for the City, one in which fibre optic capabilities will be made available to individual residents. The potential benefits of the Station, if successful, could be significant – improved and expanded telecommunications services for residents and increased utilization (and corresponding returns) on existing fibre optic investments made by the City are among a few of the benefits envisioned.

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While our research indicates that, from a financial perspective, the Station does not represent a viable initiative, we believe this is not reflective of the concept per se, but rather the high cost of the technology involved in delivering fibre optic services to residential users and the limited market size of the Station's service area. The financial feasibility of the Station notwithstanding, we believe that current trends in the telecommunications and broadcasting industries do provide general support for the concept. A number of cable companies have received licenses for the delivery of video on demand services and Bell Canada has announced plans to introduce set top boxes that will allow users to access the internet over their televisions. These instances demonstrate that the industry is already investigating and implementing the services envisioned for the Station, but on a much larger scale than that envisioned by the Station and without the need to incur the significant costs associated with the delivery of fibre optic services directly to homes.

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THE CONCEPT

The Station represents an initiative designed to bring fibre optic capabilities to individual homes. Currently, both Regional Cablesystems Inc. ("Regional") and Bell Canada ("Bell") use fibre optics for their local networks but do not provide fibre optic connections to homes directly.

The initial groundwork for the Station began just over four years ago, when Capreol Hydro invested surplus funds into the development of a fibre optic network in the community. Intended to provide a range of benefits by attracting employment to the community and improving local service levels, the Station anticipates building on this initial investment by improving both the quality and quantity of telecommunication services available to residents. In addition, it is hoped that the Station will act as a test case for other communities and telecommunication companies, who will look to Sudbury as a place to test new products and technologies.

PRODUCTS AND SERVICES

As envisioned in the business case, the Station will form a fibre optic network through which a variety of services will be offered. Our review of the business case indicates that the Station does not intend to deliver these services themselves – rather, its goal is to facilitate the delivery of services to residents by providing the necessary fibre optic infrastructure through which the services will be delivered by other parties.

We understand that the Station intends to offer the following services.

Internet access

Internet service providers ("ISP's") represent the main contact between residential users and the internet. Access to residential customers is gained through the existing networks of Regional or Bell. The Station intends to provide ISP's with a third alternative for accessing these customers, one that would be superior to both of the existing systems due to the higher speed provided by fibre optic cable[1].

Under the Station concept, access to the internet would be provided through the use of either traditional methods (i.e. personal computer and modem) or set top boxes, a relatively new technology that allows television sets to act as internet interfaces.

As proposed in the business case, existing ISP's in Sudbury would continue to provide internet services to residents. In exchange for using the fibre optic network established by the Station, the ISP's would pay the Station a fixed monthly fee per customer. This arrangement is similar to those currently in place between the ISP's and Regional and Bell.

Video on demand

Unlike traditional pay-per-view services, which provide first run movies to customers at set times, video on demand allows customers the opportunity to view movies at any time. As video on demand provides movies in digital format, additional options such as rewind and fast forward capabilities are also available.

Through the Station's infrastructure, existing video rental businesses would deliver video on demand services to residents. In keeping with its intended mandate, the Station's involvement in video on demand would be limited to providing the fibre optic infrastructure through which the videos would be provided.

[1] The ability of fibre optic services to the home to improve the speed of internet services is debatable, as a potential bottleneck exists in the main telecommunications lines (which are separate from the Station's infrastructure) used by ISP's to connect local networks, such as the Station, to the internet.

Alarm monitoring services

The monitoring of smoke and carbon monoxide alarms would be another service made available through the Station. Consistent with the other services noted, these services would be offered by a private alarm monitoring company, who would use the Station's infrastructure to connect the alarms to the monitoring station.

Commercial services

While the majority of services provided through the Station are intended to be directed to residential customers, the business case also includes commercial revenue derived from:

- Local business advertising – Businesses in Sudbury would have the opportunity to place advertising on the website established by the Station.
- E-commerce – Depending on the advertising package selected, businesses would also have the opportunity to use the Station for e-commerce transactions.
- National business advertising – The Station will also provide advertising to national accounts, such as Sears. This advertising will most likely be in the form of so-called banner advertising, which will link customers to the sites of the national advertisers.

SERVICE AREA

Initially, the Station is intended to be introduced as a pilot project, whereby the provision of fibre optic services to homes will be limited to:

- 1,000 single family dwellings in the former Town of Capreol; and
- Ten apartment buildings (200 units each) in the former City of Sudbury.

Following this initial deployment of fibre optic services, it is anticipated that installations will continue in other parts of the City of Greater Sudbury. Specifically, we have been informed that communities such as Coniston and Levack would be the next choice for the expansion of the Station.

FUNDING PARTNERS

The estimated cost of establishing the Station is estimated to be in the order of $10.8 million, as follows:

Projected Station start-up costs

Type of Expenditure	Total Cost
Equipment and installation	$ 8,984,000
Computer servers and software	812,000
Start-up costs	1,000,000
Total	$ 10,796,000

The funds necessary to finance the establishment of the Station are intended to come from a mix of private and public sector organizations.

Projected Station financing

Funding Partner	Form of Contribution			
	Cash	Purchase Discounts	Inkind Contributions	Total
Northern Ontario Heritage Fund	$ 4,627,000	–	–	4,627,000
City of Greater Sudbury	1,000,000	–	–	1,000,000
FedNor	500,000	–	–	500,000
Greater Sudbury Telecommunications Inc.	200,000	–	250,000	450,000
Alcatel	–	3,298,000	–	3,298,000
IBM Canada Ltd.	–	764,000	–	764,000
Urbana.ca	–	157,000	–	157,000
Total	$ 6,327,000	4,219,000	250,000	10,796,000

FINANCIAL PERFORMANCE

Included in the business case are financial projections outlining the anticipated financial performance of the Station for a three year period following inception. The business case anticipates that after a breakeven performance during the first year, the Station will generate approximately $17.1 million of profits over the three year projection period.

Projected financial performance

	2002	2003	2004	Total
Set top boxes installed	1,400	10,100	17,200	17,200
Total revenue	$ 1,971,000	10,412,000	16,599,000	28,982,000
Total expenditures (excluding start-up costs)	1,990,000	4,321,000	6,434,000	12,745,000
Net profit (loss)	$ (19,000)	6,091,000	10,165,000	16,237,000

GOALS AND OBJECTIVES

On April 10, 2001, Council for the City of Greater Sudbury passed a resolution providing support for an investment in the Station of $1 million, contingent upon the following:

- Provincial and Federal funding of $5.5 million
- Private sector commitments of $6 million
- A review of the viability of the project and the business case to be undertaken by an independent consultant

Based on this resolution, we have structured our report to provide an overall assessment of the business case prepared by GSTI and the viability of the Station which includes:

- An analysis of the legislative and regulatory issues surrounding the establishment of the Station
- An assessment of the degree to which the private sector has committed to the project
- A review of the financial projections contained within the business case, as well as an indication of the potential financial performance of the Station if alternative assumptions were used

PROCEDURES PERFORMED

In undertaking our review, we have performed the following procedures:

1. Meetings were held with representatives of the City and GSTI who were involved in the development of the business case for the Station. The purpose of these meetings was to complement our understanding of the Station and identify key assumptions and critical success factors for the project.
2. Discussions were held with representatives of the CRTC to identify regulatory factors and licensing issues relating to the establishment of the Station. In addition, various regulations and statutes that could be relevant to the Station were reviewed, including:
   - The Canadian Radio-television and Telecommunications Commission Act
   - The Broadcasting Act
   - Public Notice 1997-83 – Licensing of New Video On Demand Undertakings
   - Public Notice 1997-150 – Broadcasting Distribution Regulations

3. Discussions were held with representatives of the Canadian Motion Pictures Distributors Association concerning non-proprietary rights for video on demand services.

4. The proposed funding for the Station was summarized and reviewed to determine the value of the contributions made by private sector funding partners and the intended use of the funds invested by the City.

5. Information concerning the Canadian telecommunications and cable industries was reviewed and summarized to gain an understanding of the total market size and cost structures for the following services:

   - Internet services
   - Internet advertising
   - Video on demand

   This information was obtained from a number of sources, including:

   - The Cable Industry Update prepared by Scotia Capital Equity Research, dated April 19, 2001
   - The Cable Industry in Canada – Year End Update prepared by Dominion Bond Rating Service Ltd., dated March 2000
   - The 2000 Annual Reports for the following cable and telecommunications companies:
     - Rogers Communications Inc.
     - Shaw Communications Inc.
     - Cogeco Cable Inc.
     - Regional Cablesystems Inc.

5. Information concerning alarm monitoring services was obtained through the Canadian Alarm and Security Association and the National Burglar and Fire Alarm Association.

6. Information concerning e-commerce and internet based advertising levels was reviewed and summarized to gain an understanding of the total market size for these services. This information was obtained from the following sources:

   - Profile of the Canadian Multimedia Industry, prepared by the Interactive Media Producers Association of Canada, dated January 2001
   - Internet Shopping in Canada, prepared by Statistics Canada, dated February 2001

7. The assumptions supporting the financial projections included in the business case were analyzed and compared to the information obtained through the above procedures. Where the assumptions contained in the business case were considered unreasonable, the financial projections were revised to reflect the results of our research.

8. Based on the results of the above procedures, an overall conclusion was made as to the feasibility of the Station.

THE STATION BUSINESS CASE

When our engagement first commenced, we understood that the business case for the Station represented a formal business plan. However, as our discussions with the proponents of the Station progressed, we were informed that the business case was not intended to be a formal business plan but rather a definition of the concept and an outline of how the Station could function, if a decision was made to proceed with the project. The proponents clearly indicated that the existing business case would require more work if it were to truly represent a formal business plan for the Station.

Based on this understanding, we have structured our study so as to "fill in any gaps" that may exist in the business case. Specifically, our procedures have been designed to test a number of key assumptions contained in the business case, including estimates of potential market demand for the Station's services and regulatory and legislative requirements relating to the services to be offered by the Station. In light of the nature of the business case and its intended purpose (defining concept rather than demonstrating feasibility), it is understandable that our procedures have, in a number of instances, yielded significant differences from the assumptions contained in the business case. Our comments and findings should be interpreted accordingly.

RELIANCE ON LOCAL INPUT

Our overall mandate for this engagement was to provide Council with an independent and objective review of the Station to be used in determining if the requested $1 million should be invested in the Station. This required our analysis and conclusions to be based on accurate information which was free from any potential bias, either real or perceived.

While we have discussed the Station with representatives of Bell, Regional, ISP's, alarm monitoring companies and video rental companies, we have not relied to a significant extent on the information provided by these parties due to potential concerns over the objectivity of the information provided. Rather, we have used these meetings to identify areas of significant concern and have attempted to gather independent information from other sources that either supports or disproves the assumptions made in the business case. As a result, we believe that our review, while reflecting the concerns of local businesses, has not been influenced by these concerns.

RESTRICTIONS

Our role in this engagement has been to evaluate the feasibility of the Station based on its perceived ability to meet certain legislative and regulatory requirements, as well as the extent to which it can operate profitably. As with any exercise involving an estimate of future performance, there exist any number of uncontrollable political, social, technological and internal factors that could affect the viability of the Station. As a result, our findings should be viewed in the context of being estimates based on sound information, which may or may not be influenced by unforeseen or uncontrollable events. We caution the reader that the ultimate feasibility of the Station (both from a regulatory and financial standpoint) can vary significantly from the findings outlined in this report due to future decisions of the City, regulatory changes imposed by senior levels of government, unexpected expenditures and strategies introduced by potential competitors. Accordingly, we will assume no responsibility or liability for any losses, damages or expenses incurred by any party, including the City of Greater Sudbury or Greater Sudbury Telecommunications Inc., as a result of their reliance on our report.

We have no intention of updating this report as new information becomes available.

SUMMARY OF FINDINGS

Our review of the business case indicates a lack of discussion relating to regulatory or legislative issues pertinent to the Station. Through our discussions with the proponents of the Station, we were informed that CRTC approval for the Station would not be required as the existing status of the GSTI as a non-dominant carrier would enable the Station to offer its services without further CRTC licensing.

Our research has indicated that while the Station would not require approval by the CRTC for internet and alarm monitoring services, video on demand services would require a CRTC license. The ability of the Station to obtain this license is questionable, given that at least one local organization has indicated it will challenge any such application.

The Station would also be required to purchase or otherwise secure non-proprietary exhibition rights for those films included in its video on demand services. However, our research indicates that it will be extremely difficult, if not impossible, for the Station to obtain these rights due to concerns over the potential piracy of films

Our conclusions concerning the licensing and regulatory requirements associated with the services to be offered by the Station have been confirmed by both the CRTC and the Canadian Motion Pictures Distributors Association.

CANADIAN RADIO-TELEVISION AND TELECOMMUNICATIONS REGULATIONS

Introduction

The CRTC is a Federal agency responsible for the regulation and supervision of all aspects of the Canadian broadcasting system, as well as regulating telecommunications providers. This authority is provided through a number of Federal Acts, including the Broadcasting Act, the Telecommunications Act and the Canadian Radio-television and Telecommunications Commission Act.

Licensing requirements

Under Section 9(1) of the Broadcasting Act, the CRTC is authorized to establish and issue licenses for broadcasting in Canada. Later sections of the Broadcasting Act contain relatively large penalties that can be imposed on persons or companies involved in broadcasting activities without a license.

32. (1) ***Broadcasting without or contrary to a license –*** *Every person who, not being exempt from the requirement to hold a license, carries on a broadcasting undertaking without a license therefore is guilty of an offence punishable on summary conviction and is liable*

(a) in the case of an individual, to a fine not exceeding twenty thousand dollars for each day that the offence continues; or

(b) in the case of a corporation, to a fine not exceeding two hundred thousand dollars for each day that the offence continues.

The Telecommunications Act provides the CRTC with the authority to regulate and license telecommunications services, defined as *"the emission, transmission or reception of intelligence by any wire, cable, radio, optical or other electromagnetic system, or by any similar technical system"*. As with the Broadcasting Act, the Telecommunications Act contains significant penalties for non-compliance.

The fundamental issue for the Station is whether a CRTC license is required for the services to be provided.

Internet services

Based on our discussions with representatives of the CRTC, the current status of GSTI as a non-dominant carrier[2] will be sufficient to allow the Station to provide the internet services anticipated in the business case. As a result, we do not anticipate any need for additional regulatory approval from the CRTC for these services assuming that the Station is owned or otherwise controlled by GSTI.

Video on demand services

The authority of the CRTC to license video on demand services is established in Public Notice 1997-83 – Licensing of New Video on Demand Programming Undertakings[3]. This authority is further demonstrated by the fact that the CRTC has already issued nine video on demand licenses, the most recent being issued on November 24, 2000.

The business case for the Station does not anticipate requiring CRTC approval for the provision of video on demand services. This is based on the assumption that the current status of GSTI as a non-dominant carrier will permit it to carry video on demand services without additional CRTC approval.

Our review of applicable legislation indicates that video on demand services fall under the regulations of the Broadcasting Act, while GSTI's status as a non-dominant carrier relates to telecommunications services, which are covered under the Telecommunications Act. As a result, GSTI's status as a non-dominant carrier has no relevance to the delivery of video on demand services. Accordingly, CRTC approval would be required before video on demand services could be offered.

In the event that the Station does pursue a video on demand license from the CRTC, we anticipate that its efforts would be challenged by at least one local company which indicated that it would "strongly oppose" any attempt by the Station to obtain a license for video on demand services. At this time, however, we cannot determine the effect of such challenges on the outcome of the licensing process.

Alarm monitoring services

We do not anticipate any requirement for the Station to obtain additional CRTC approval for the alarm monitoring services envisioned in the business case.

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[2] A non-dominant carrier represents a provider of telecommunications facilities that does not enjoy market dominance.

[3] The CRTC does provide licensing exemptions for experimental video on demand systems. In order for a system to be considered experimental, it must be used to test and develop video on demand technology. As the Station intends to introduce video on demand services as a commercial product, it would not qualify for this exemption.

NON-PROPRIETARY RIGHTS

The issue of non-proprietary rights relates primarily to video on demand services. Specifically, the Station will require some form of agreement from the motion picture studios that hold the rights to those movies to be distributed over the video on demand system.

As outlined in the business case, the Station intends to offer video on demand services through an agreement with a local video rental company. In exchange for a fixed price per movie shown, the video rental company would make available to the Station movies in digital format to be distributed over the video on demand system. However, the video rental company would need to obtain the non-proprietary rights to distribute the films in digital format over a video on demand network.

While the requirement does exist to obtain the non-proprietary rights for the films to be distributed by the Station's video on demand services, we do not anticipate that the Station will be successful in doing so. Our discussions with representatives of the Canadian Motion Pictures Distributors Association indicate that non-proprietary rights for films to be shown through video on demand services are currently not available due to security concerns. As video on demand entails transmitting movies in digital format, a significant risk of video piracy exists since digital movies can be stored on computers and distributed free of charge over the internet. Video on demand technology is not perceived as being sufficiently advanced to allay this concern and until the technology does provide sufficient security, non-proprietary rights will not be forthcoming.

Our discussions with the Station's proponents indicates that they are aware of both the need to obtain non-proprietary rights for movies to be distributed over a video on demand network and the potential difficulties that may be experienced in obtaining these rights.

SUMMARY OF FINDINGS

Based on our review of the business plan and the proposed financing of the capital and start-up costs of the Station, we have determined the amount of "true" private sector investment in the Station to be approximately $1.6 million. While the business case indicates total private sector investment of $4.2 million, this contribution is in the form of discounts from the list price of equipment to be purchased. Given that a significant portion of these discounts appear to be available to any customer, they cannot be considered as a real contribution to the Station. In addition, two of the companies providing the discounts are expected to sell additional equipment to the Station. These subsequent sales may allow the companies in question to recover some or all of the purchase discounts provided.

As a result of the above, we do not believe that Council's requirement for $6 million of private sector commitment, as outlined in the motion, has been met.

ANALYSIS OF FUNDING CONTRIBUTIONS

In order to finance the projected total start-up costs of $10.8 million (which include capital and developmental costs), the Station intends to rely on a combination of public and private sector contributions.

Public sector contributions

The business case anticipates a total of $6.6 million of public sector funding, the majority of this representing cash contributions[4].

The Northern Ontario Heritage Fund is expected to be the largest public sector contributor. As presented in the business case, $4.6 million of funding will be sought from the Heritage Fund.

The City contribution, amounting to $1 million, is not intended to finance capital costs but rather is required to fund the operating costs incurred during the establishment of the Station, including any costs incurred prior to the Station's revenue generating activities becoming operational.

[4] GSTI is projected to contribute $250,000 of fibre optic infrastructure already purchased by the company. This represents the only inkind contribution from the public sector.

Private sector contributions

The business case identifies total private sector contributions amounting to $4.2 million to be provided by three companies:

- Alcatel - $3.3 million
- IBM Canada Ltd. ("IBM") - $764,000
- Urbana.ca - $157,000

In all instances, these contributions represent discounts provided by the companies on the sale of equipment or software to the Station. In the case of Alcatel and IBM, these contributions represent a percentage discount from the list price of the equipment to be purchased by the Station (68% from Alcatel and 30% from IBM). The Urbana.ca contribution represents the waiving of a licensing fee in connection with software to be sold by Urbana.ca to the Station.

Based on our discussions with representatives of the computer industry, we understand that it is common practice for computer and telecommunications companies to provide discounts from list prices to all customers. Our research indicates that the standard discount from list price offered to government agencies is normally in the range of 30% to 40%. Based on this finding, it would be reasonable to assume that a significant portion of the private sector contributions (60%) represent discounts that are available to any customer and, as such, do not represent incremental contributions to the project.

Summary of routine vs. incremental purchase price discounts

	List Price of Equipment	Standard Discount[5] (A)	Actual Discount (B)	Incremental Contribution (B) – (A)
Alcatel	$ 4,825,000	1,689,000	3,298,000	1,609,000
IBM	2,546,000	891,000	764,000	–
Total	$ 7,371,000	2,580,000	4,062,000	1,609,000

In addition, we note that both IBM and Urbana.ca will be involved in additional equipment sales or leasing arrangements with the Station. These subsequent transactions, which we understand have no associated discounts, could provide these companies with the opportunity to recover some or all of the initial discounts provided. Specifically, IBM is expected to sell to the Station computer servers with a selling price of $485,000, while Urbana.ca will lease set top boxes to the Station at a monthly lease cost of $11.15 per unit.

[5] Represents the estimated discount that is provided to all customers. For the purpose of our analysis, we have assumed that the standard discount is 35% of list price (representing the average of 30% and 40%).

SUMMARY OF FINDINGS

As a result of our review, we have significant concerns over the future financial performance of the Station, due primarily to the small market demand for the services to be offered. Overall, our analysis indicates that the Station will experience total deficits in the order of $200,000 in each of the three years following its inception.

This conclusion differs significantly from the financial projections contained in the business case, which estimates that the Station will generate more than $16 million in profits over three years. A large part of this difference may be due to the intended purpose of the business case, which was to define the concept rather than act as a formal business plan.

As a result of our review, we have concluded that, from a financial standpoint, the Station does not represent a viable initiative. Should the City and GSTI proceed with the project, we caution that the operations of the Station would be characterized by ongoing deficits totaling over $600,000 over a three year period. Responsibility for financing these deficits would likely rest with the City or its wholly-owned subsidiary, GSTI.

ANALYSIS OF FINANCIAL ASSUMPTIONS

Introduction

Included in the business case for the Station are financial projections outlining the anticipated financial performance of the Station over a three year period. As noted earlier, the business case estimates that the Station will generate $16 million of profits over three years.

Our assessment of the likely financial performance of the Station involved a detailed review of the assumptions supporting the financial projections, and we have outlined our findings below.

Projected revenue

The business case anticipates that total revenues for the Station will increase from just under $2 million in its first year of operations to $16.6 million within three years, consisting of the following:

Projected revenues by service line

	2002	2003	2004	Total
Internet services	$ 1,311,000	5,535,000	8,074,000	14,920,000
Video on demand services	97,000	931,000	1,585,000	2,613,000
Alarm monitoring services	64,000	611,000	1,040,000	1,715,000
Local business advertising	136,000	566,000	1,133,000	1,835,000
E-commerce commissions	11,000	46,000	83,000	140,000
National business advertising	352,000	2,723,000	4,684,000	7,759,000
Total	$ 1,971,000	10,412,000	16,599,000	28,982,000

Internet services

Internet services are expected to represent the largest source of revenue for the Station, accounting for more than 50% of total revenues.

As a result of our review of the financial projections, we make the following observations.

- **Capacity levels** – The financial projections are based on the assumption that the number of internet customers will increase to 27,600 customers over the three year projection period, despite the fact that the Station's computer servers have a maximum capacity of 10,000 users, as noted in the business case[6].

Projected internet customers

	2002	2003	2004
Accessing through set top boxes	1,400	10,100	17,200
Accessing through personal computers	2,600	5,300	10,400
Total internet customers	4,000	15,400	27,600

[6] See Table 5.2 of the business case (page 22). These capacity levels have been confirmed by proponents of the Station.

- **Penetration rates –** The business case calls for the installation of fibre optic services to 3,000 in the City of Greater Sudbury (consisting of 1,000 homes in Capreol and 2,000 apartment units in Sudbury). Based on 4,000 internet customers in the first year of operations, this results in a penetration rate of 133% (4,000 customers ÷ 3,000 homes). In comparison, the average penetration rate for high-speed internet services in Canada, while growing, is 11.4% for cable companies and 5.7% for telecommunication companies such as Bell Canada.

National high speed internet penetration rates – cable companies[7]

	1999	2000	2001
Number of high speed internet customers (A)	392,398	796,061	934,270
High speed internet ready homes (B)	6,224,175	7,423,272	8,204,338
Penetration rate (A) ÷ (B)	6.3%	10.7%	11.4%

National high speed internet penetration rates – telecommunications companies[8]

	1999	2000	2001
Number of high speed internet customers (A)	94,037	392,195	n.a.
High speed internet ready homes (B)	3,994,248	6,840,351	n.a.

- **Pricing –** Projected revenues from internet services are calculated based on a monthly customer charge of $29.95 per month. In comparison, other providers of high speed internet services are currently charging $39.95 per month[9].

[7] Source – Scotia Capital Cable Industry Update. Figures for 2001 are for the first quarter only.

[8] Source – Scotia Capital Cable Industry Update. Data for 2001 was not available.

[9] We understand that fees paid by customers for internet service will not be paid to the Station but rather the ISP, who will then pay a third party access fee for the use of the Station's fibre optic network. However, the financial projections are based on the assumption that the Station will collect the revenues from internet customers and forward a commission to the ISP's on a per customer basis. We have therefore structured our comments accordingly.

Based on these observations, we do not believe that the projected internet revenues outlined in the business case are attainable. Rather, we have estimated the total market for high speed internet services in the Station's service area (3,000 households) to be between 363 and 411 customers.

Estimated high speed internet customers in the Station's service area

	2002	2003	2004
Number of homes serviced by the Station	3,000	3,000	3,000
Internet penetration rate[10]	12.1%	12.9%	13.7%
Total high speed internet customers in the Station's service area	363	387	411

As this represents the total number of high speed internet customers in the Station's service area, we anticipate that the actual number of internet customers will be lower than this amount, as it will be extremely difficult for the Station to achieve 100% market share. Based on an assumed market share of 80% (which was arbitrarily determined by us) and a revised customer fee of $39.95 per month (which is consistent with the current pricing structure for high speed internet access), we estimate that the maximum revenue from internet services for the Station will be in the range of $139,000 to $158,000, compared to the $1.3 million to $8.1 million indicated in the business case.

Estimated internet service revenue

	2002	2003	2004
Total high speed internet customers in the Stations service area	363	387	411
Projected market share	80%	80%	80%
Total internet customers	290	310	329
Monthly fee	$ 39.95	$ 39.95	$ 39.95
Projected annual internet service revenue	$ 139,000	149,000	158,000

[10] Based on the average high speed internet penetration rate for Canadian cable companies in 2001, adjusted for annual growth of 6.5% per year (representing the growth in penetration rates from 2000 to 2001).