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July 22, 1997

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

EX PARTE

William F. Caton
Federal Communications Commission
1919 M Street NW, Room 222
Washington, D.C. 20554

Re: CS Docket Nos. 95-184

Dear Mr. Caton:

OpTel, Inc. ("OpTel"), by its attorneys, hereby submits the attached *ex parte* letter and attached report regarding the above-referenced proceeding.

Respectfully,

W K Ferree

Attorney for OpTel, Inc.

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July 22, 1997

EX PARTE

Michael Riordan
Federal Communications Commission
1919 M Street NW
Washington, D.C. 20554

Re: CS Docket Nos. 95-184

Dear Michael:

During our last set of meetings regarding inside wiring issues, you expressed interest in the financial necessity of long-term exclusive contracts for new entrants into the cable television market. As Mike Katzenstein from OpTel explained at that time, without at least a ten-year exclusive period, it will be very difficult for private cable companies and other new entrants to compete with the established franchised cable operators and to attract adequate financing.

In support of this position, I am enclosing a report prepared for me by OpTel's Treasurer, Richard Alden, which provides analysis of the positive effects of exclusive arrangements on a new entrant's expected return on investment. As Mr. Alden's report demonstrates, in order to recoup the up-front investment in facilities needed to serve a typical MDU, new entrants require at least ten years of exclusivity. This minimum period, moreover, does not allow for the "time value of money," nor does it allow the investor to make any return on his/her investment to compensate for the risk involved in engaging in the project.

I have also attached a letter from Mr. Robert J. Gemmell of Salomon Brothers, one of the leading investment banking institutions in the U.S.. This letter makes clear that a limit on the life of exclusive contracts would have a negative effect on the ability of new entrants, such as OpTel, to obtain financing for operations and system expansion. If new competitors to franchised cable are going to emerge, they are going to need financing. Limiting their ability to enter into beneficial long-term exclusive contracts and thereby limiting their ability to obtain such financing can only help to preserve the franchised cable monopolies.

I hope this letter provides you with the information that you were seeking. I will be happy, however, to discuss the matter further with you if you have any questions.

Sincerely,

Henry Goldberg

cc: Thomas Spavins
John Nakahata
Rebecca Dorch

encl.

OpTel[SM]
The choice is clear.

Direct line: 214 879 8257
Direct fax: 214 634 3871

July 21, 1997

H. Goldberg
Goldberg, Godles, Wiener & Wright
1229 Nineteenth Street, N.W.
Washington, D.C. 20036

Dear Henry

FCC Proposals

I enclose a copy of report I prepared recently in connection with the proposals currently before the FCC to limit the life of exclusive contracts between MDUs and Multi-channel Video Programming Distributors. If you would like to discuss the content of this report please do not hesitate to contact me directly.

Sincerely

Richard Alden
Treasurer

1111 W. Mockingbird Lane Dallas, TX 75247 USA Tel: (214) 634-3800 Fax: (214) 634-3838

A Vidéotron Company

Resume

Richard Alden

Richard Alden is the Treasurer of OpTel, Inc, the largest private cable company in the US. Mr. Alden was Deputy Finance Director & Treasurer of Videotron Holdings Plc, a UK based integrated cable and telephone company, from 1995 to 1997. From 1985 to 1995 he was a senior manager with Deloitte & Touche, specializing in corporate finance transactions for telecommunications companies. Mr. Alden is a UK Chartered Accountant.

Proposals to limit the life of exclusive service agreements

1. Introduction

1.1 Proposals to restrict to no more than seven years the exclusive service agreements between Multi-channel Video Programming Distributors ("MVPDs") and the Multiple Dwellings Units ("MDUs") which they serve are inherently contrary to the consumers' interest because they will discriminate against new market entrants to the benefit of existing distribution methods, inhibiting the growth of competitive modes of delivery and therefore restricting customer choice.

1.2 The proposals discriminate against new market entrants because seven years is an inadequate time period for an MVPD to recoup the upfront investment in facilities needed to serve a typical MDU. The purpose of this paper is to explain the typical level of upfront capital investment required and to compare the average return that can be expected from such an investment with the typical return expected by investors. This paper will also explain that the typical return required by investors has certain characteristics which reflect the risk of investing in projects where well established competition exists.

1.3 The minimum amount of time necessary in order to generate a satisfactory return on the initial investment is at least 10 years. Without a satisfactory return there will be no investment and therefore no competition.

2. Initial Investment

2.1 The initial capital investment required to serve, via wireless network, a typical MDU of 300 units is approximately $185,000 comprised as follows:

Table 2.1 Initial investment required to serve a typical MDU of 300 Units

	$'000
Wiring & distribution (300 x $250 per unit)	75
Microwave receivers	35
Addressable interface (converters or similar) (300 x $140 per unit)	42
Distribution network (Master headend, microwave transmitters, repeaters and towers)	35
Total typical initial investment	187

2.2 Typical distribution costs and average ratios of MDUs to such distribution equipment is shown below:

Table 2.2 Explanation of distribution cost

	$'000	Approx. number of MDUs served	Cost Per MDU
Master headend	180	14	13
Microwave receivers	150	12	13
Towers	220	25	9
			35

2.3 The actual variation of actual costs around this mean is dependent upon geographic market, demographic concentration, topography and climatic features which affect signal quality.

2.4 Other costs of "acquiring" exclusive contracts include:

- "Key Money" - lump sums of money regularly paid on signing of an exclusive contract and typically expressed in terms of dollars per unit in the MDU. As amounts paid vary between $0 and in excess of $100 per unit an average of $50 per unit has been used in the financial evaluation. In practice, however, lower levels of Key Money are often more than offset by a commitment a higher revenue share to pay the relevant property owner.

- Sales commissions paid to the sales executive who secures the exclusive contract. A typical amount is $10 per unit under contract. Note that this cost does not include central selling expenses, any costs of the salesman's salary or any other support costs which could fairly be deducted in order to arrive at a true economic return in respect of the property.

- Other incentives given to a property owner, such the provision of free security cameras at the relevant property.

3. Expected Returns

3.1 Consider a typical MDU with 300 units. The US annual average vacancy rate is around 6%.

3.2 Of the occupied units an acceptance level of cable penetration would be between 55% and 65%. For calculation purposes we have used a penetration rate of 60% in the first year, increasing to 65% at the end of the tenth year.

3.3 Typical monthly revenues per customer are currently in the order of $25. This is comprised as follows:

Table 3.1 Average monthly revenues per customer

	$
Basic revenues	19.0
Premium services	5.0
Other fees	1.0
Total	25.0

3.4 After deducting the costs of programming which are paid to program providers, expected gross margins are in the order of 65%. Revenue sharing arrangements with property owners generally reduce this margin to around 58%. Revenue sharing consists of the average proportion of revenues given to property owners in order to secure the exclusive contracts initially necessary to generate competition. Typical revenue sharing percentages are currently in the range of 6% to 8%, but can easily be as high as 12% or 13%.

3.5 Customer specific costs further reduce this gross margin. These customer specific costs are comprised as follows:

Table 3.2 Average customer specific costs as % of revenues

	%
Bad debt	4
Billing & postage	1
Customer Service	6
Technical Support	6
Marketing	4

3.6 Therefore, the typical average monthly net return per cable customer, before allocation of central administrative expenses, is around $9 ($111 per annum), or around $5.65 per unit ($68 per annum), assuming 65% penetration and a 6% vacancy rate.

3.7 Note that these costs does not include allocation of central overhead or any other support costs which could fairly be deducted in order to arrive at a true economic return in respect of the property.

4. Calculation of Return on Investment

4.1 Assuming:

- cable revenue growth of approximately 4% - this is well below the price increase employed by the franchised cable operators in recent years and is one of the key advantages to the consumer of encouraging competition.
- initial (year 1) penetration of 60%, growing over five years to 65%.
- a terminal value of 7 times is applied to final year calculations in order to project the value of the MDU contract in perpetuity. The 7 times multiple is indicative of the typical terminal multiple employed in the evaluation of hardwire cable systems today. In our financial analysis we have demonstrated the effect on the financial return of adjustments to this terminal multiple.
- a probability factor has been applied to cashflows at the end of the prescribed exclusivity period in order to reflect the likelihood of contract renewal at that time. For illustrative purposes the return on investment - the "Internal Rate of Return" ("IRR") - has been calculated based on a 25%, 50% and 75% probability of renewal.

Table 4.1 After tax IRR of investment

	Probability of renewal		
Contract Duration	25%	50%	75%
7 years	(6.8)%	(0.6)%	4.0%
10 years	1.0%	4.5%	7.2%

4.2 Details of the supporting calculations are set out in Appendices 2 through 4, attached.

5. Typical Investment Returns

5.1 The typical returns required by investors in similar new industries/ technologies is dependent upon the risk profile inherent in the investment instrument. Typical expected returns, derived from analysis performed by leading investment banks, are as follows:

Table 5.1 Expected return on investment - by investment type

US risk free rate	6.9%
Risk adjusted equity investment	16.7%
After tax risk adjusted cost of debt	8.6%

5.2 Based on a typical leverage ratio for a new market entrant (70% equity or similarly structured instruments, 30% debt) a typical after tax weighted average cost of capital ("WACC") would be approximately 14.3%. This means that a typical investor in this market would require a return of around 7.3% greater than the rate that would be earned by investing in risk free investments (US Treasuries).

5.3 Based on the returns set out in table 4.1 the typical investor would not achieve a WACC of 14.3% if the contract exclusivity was less that 10 years (even with a 100% probability of renewal at contract expiration). This explains why investors have been largely unwilling to commit significant amounts of equity to the private cable industry and instead the industry has typically had to rely more heavily on debt funding. It also explains why investors would be fundamentally opposed to committing funds to projects that have a potential maximum life of 7 years.

6. Payback Analysis

6.1 In table 2.1 we indicated that the approximate capital investment per average MDU is $187,000.

6.2 In section 3 we indicated that the average return per unit is approximately $68 per annum.

6.3 On this basis financial payback is only achieved after more than 9 years. This is the minimum period required before the investor can even recover his/her initial investment. It does not allow for the "time value of money" - the fact that inflation will have reduced the value of future dollars when compared to current investment. Nor does it allow the investor to make any return on his/her investment to compensate for the risk involved in engaging in the project. This demonstrates that 7 years is too short a time period to encourage investment.

7. The View of the Markets

7.1 The financial markets place a great deal of importance on the ability of a project to generate a satisfactory return.

7.2 Attached at Appendix 1 is a letter from Salomon Brothers, one of the leading US Investment Banks and a major adviser to the media and telecommunications industry. This letter indicates that a reduction in the life of an exclusive contract would have a negative impact on the ability of new entrants, such as OpTel, to obtain financing.

Appendices

1. Letter from Salomon Brothers
2. IRR of Investment - Assumptions
3. IRR - 7 Year Exclusivity period
4. IRR - 10 Year Exclusivity period

APPENDIX 1

Salomon Brothers Canada Inc
BCE Place, 161 Bay Street
Suite 4600 P.O. Box 631
Toronto, Ontario M5J 2S1

416-866-2301
FAX: 416-866-7484

Robert J. Gemmell
President and
Chief Executive Officer

Salomon Brothers

July 18, 1997

Mr. Bertrand Blanchette
Chief Financial Officer
OpTel, Inc.
1111 W. Mockingbird Lane
Dallas, Texas 75247

Dear Bertrand:

As you informed us recently, the FCC is considering proposals to limit to no more than seven years the exclusive service agreements between multichannel video programming distributors and the multiple dwelling units ("MDUs") that they serve. We feel that reducing the duration of exclusive contracts to seven years could have a negative impact on the ability of OpTel to obtain external financing.

We had extensive contact with potential and actual investors in private cable companies when we lead-managed the $225 million high-yield offering for you in February 1997. Your current ability to enter into exclusive contracts of sufficient long duration (ten to fifteen years) with MDUs was one of the key selling features for investors. We feel that reducing the exclusivity period to seven years would make it more difficult to attract new investments in OpTel. As you are aware, failure to raise sufficient funds on terms acceptable to OpTel on a timely basis may require you to delay or abandon some of your future expansion or expenditures, which may have a material adverse effect on your growth and your ability to compete in the cable television industry.

Please do not hesitate to contact me if you would like to discuss this further.

Best regards,

Robert J. Gemmell

Robert J. Gemmell

Private Cable
IRR Analysis - Assumptions

Appendix 2

July 21, 1997

Operating Assumptions

		1	2	3	4	5	6	7	8	9	10
Cable price increases		4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Number of units		300.0	300	300	300	300	300	300	300	300	300
Vacancy rate		6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
Cable Penetration		60.0%	60.6%	61.1%	61.7%	62.2%	62.8%	63.3%	63.9%	64.4%	65.0%
Annual revenue per unit	$25.0	$300.0	$312.0	$324.5	$337.5	$351.0	$365.0	$379.6	$394.8	$410.6	$427.0
Revenues		$50,760	$53,274	$55,909	$58,668	$61,559	$64,588	$67,760	$71,083	$74,563	$78,208
Direct Variable Costs											
Programming fees	35.0%	$17,766	$18,646	$19,568	$20,534	$21,546	$22,606	$23,716	$24,879	$26,097	$27,373
Revenue Sharing	6.0%	$3,046	$3,196	$3,355	$3,520	$3,694	$3,875	$4,066	$4,265	$4,474	$4,692
Total Direct Variable Costs		$20,812	$21,842	$22,923	$24,054	$25,239	$26,481	$27,782	$29,144	$30,571	$32,065
Direct Operating Costs											
Bad debt	4.0%	$2,030	$2,131	$2,236	$2,347	$2,462	$2,584	$2,710	$2,843	$2,983	$3,128
Billing & Postage	1.0%	$508	$533	$559	$587	$616	$646	$678	$711	$746	$782
Customer Service	5.0%	$2,538	$2,664	$2,795	$2,933	$3,078	$3,229	$3,388	$3,554	$3,728	$3,910
Technical Support	6.0%	$3,046	$3,196	$3,355	$3,520	$3,694	$3,875	$4,066	$4,265	$4,474	$4,692
Marketing	3.5%	$1,777	$1,865	$1,957	$2,053	$2,155	$2,261	$2,372	$2,488	$2,610	$2,737
Total Direct Operating Costs		$9,898	$10,388	$10,902	$11,440	$12,004	$12,595	$13,213	$13,861	$14,540	$15,251
Acquisition Costs											
Key Money	$50.0	$15,000									
Sales Commission	$10.0	$3,000									
Total acquisition costs		$18,000	0	0	0	0	0	0	0	0	0
Capital Expenditure											
Wiring & distribution	$250.0	$75,000									
Microwave receivers	$116.7	$35,000									
Addressable interface	$140.0	$42,000									
Distribution network	$116.7	$35,000									
Total Capital Expenditure		$187,000	$0	$0	$0	$0	$0	$0	$0	$0	$0

Private Cable
IRR Analysis

Appendix 3

July 21, 1997

Return on an MDU of 300 units - 7 Year Exclusivity Period

Cable

($)		1	2	3	4	5	6	7	8	9	10
Revenue		50,760	53,274	55,909	58,668	61,559	64,588	67,760	71,083	74,563	78,208
Variable Costs		(20,812)	(21,842)	(22,923)	(24,054)	(25,239)	(26,481)	(27,782)	(29,144)	(30,571)	(32,065)
Gross Margin		29,948	31,432	32,986	34,614	36,320	38,107	39,978	41,939	43,992	46,143
Operating Costs		(9,898)	(10,388)	(10,902)	(11,440)	(12,004)	(12,595)	(13,213)	(13,861)	(14,540)	(15,251)
EBITDA		20,050	21,043	22,084	23,174	24,316	25,512	26,765	28,078	29,452	30,892
Taxes @	35.0%	(7,018)	(7,365)	(7,729)	(8,111)	(8,511)	(8,929)	(9,368)	(9,827)	(10,308)	(10,812)
Unlevered Net Income		13,033	13,678	14,355	15,063	15,805	16,583	17,397	18,251	19,144	20,080
Acquisition Costs		(18,000)	0	0	0	0	0	0	0	0	0
Capital Expenditure		(187,000)	0	0	0	0	0	0	0	0	0
Free Cashflow		(191,967)	13,678	14,355	15,063	15,805	16,583	17,397	18,251	19,144	20,080
Terminal Value								140,518			
Net Free Cashflow		(191,967)	13,678	14,355	15,063	15,805	16,583	157,915	18,251	19,144	20,080

Sensitivity Analysis - IRR

Terminal multiple		5.5x	6.0x	6.5x	[redacted]	7.5x	8.0x
	25.0%	(8.4%)	(7.9%)	(7.3%)	[redacted]	(6.2%)	(5.7%)
Probability of contract renewal	50.0%	(3.0%)	(2.1%)	(1.3%)	[redacted]	0.1%	0.8%
	75.0%	1.2%	2.2%	3.1%	[redacted]	4.8%	5.6%

Private Cable
IRR Analysis

Appendix 4

July 21, 1997

Return on an MDU of 300 units - 10 Year Exclusivity Period

Cable

($)		1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Revenue		50,760	53,274	55,909	58,668	61,559	64,588	67,760	71,083	74,563	78,208
Variable Costs		(20,812)	(21,842)	(22,923)	(24,054)	(25,239)	(26,481)	(27,782)	(29,144)	(30,571)	(32,065)
Gross Margin		29,948	31,432	32,986	34,614	36,320	38,107	39,978	41,939	43,992	46,143
Operating Costs		(9,898)	(10,388)	(10,902)	(11,440)	(12,004)	(12,595)	(13,213)	(13,861)	(14,540)	(15,251)
EBITDA		20,050	21,043	22,084	23,174	24,316	25,512	26,765	28,078	29,452	30,892
Taxes @	35.0%	(7,018)	(7,365)	(7,729)	(8,111)	(8,511)	(8,929)	(9,368)	(9,827)	(10,308)	(10,812)
Unlevered Net Income		13,033	13,678	14,355	15,063	15,805	16,583	17,397	18,251	19,144	20,080
Acquisition Costs		(18,000)	0	0	0	0	0	0	0	0	0
Capital Expenditure		(187,000)	0	0	0	0	0	0	0	0	0
Change in Working Capital		0	0	0	0	0	0	0	0	0	0
Free Cashflow		(191,967)	13,678	14,355	15,063	15,805	16,583	17,397	18,251	19,144	20,080
Terminal Value											162,183
Net Free Cashflow		(191,967)	13,678	14,355	15,063	15,805	16,583	17,397	18,251	19,144	182,263

Sensitivity Analysis - IRR

Terminal multiple		5.5x	6.0x	6.5x	[redacted]	7.5x	8.0x
	25.0%	0.1%	0.4%	0.7%	[redacted]	1.3%	1.6%
Probability of contract renewal	50.0%	3.2%	3.6%	4.1%	[redacted]	5.0%	5.4%
	75.0%	5.6%	6.2%	6.7%	[redacted]	7.7%	8.2%