

TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER

**DEPARTMENT: ADMINISTRATIVE
SERVICES**

DATE: APRIL 13, 2009

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REPORT TYPE: REPORTS OF OFFICIALS

SUBJECT: Recommendation to Terminate Ultra-High-Speed Broadband Request for Proposals Process Due to Lack of Financial Resources of the 180 Connect Network Services Inc./Packetfront Inc./Axia NetMedia Corporation Consortium's Proposal to Build a Citywide Ultra-High-Speed Broadband System and Approval of Actions for Proceeding with the Broadband Initiative

RECOMMENDATION

Staff recommends that the Council:

- 1) Terminate the Ultra-High-Speed Broadband Request for Proposals (the "RFP") process due to the lack of financial resources in the 180 Connect Network Services Inc./Packetfront Inc./Axia NetMedia Corporation consortium (the "Consortium") proposal for a Citywide Ultra-High-Speed Broadband System; and
- 2) Direct staff to continue to pursue federal economic stimulus and federal appropriations money to fund Network capital costs. Authorize the use of Fiber Optics Fund resources to pay for engineering, legal and other professional services needed to support the grant application process; and
- 3) Conduct a community interest survey to gauge citizen interest in the Citywide Ultra-High-Speed Broadband System and/or high-speed broadband wireless networks, including willingness to pay for broadband access to the Network (the access charge would be in addition to charges for content services to be rendered by third party retail service providers). Authorize the use of Fiber Optics Fund resources to pay for professional services needed to develop and conduct the survey; and

- 4) Develop a plan to proceed with a phased build-out of the existing backbone, independent of the Consortium.

BACKGROUND

At the Council's direction, a Citywide Ultra-High-Speed Broadband System RFP was issued on September 27, 2006. Two firms responded to the RFP and, on March 5, 2007, the Council directed staff to enter into negotiations with 180 Connect Network Services, Inc. ("180 Connect"). The Council provided staff with the following general policy direction: 1) leverage existing City assets; 2) make no General Fund cash contributions pledges or guarantees; 3) minimize financial investment and risk to the City; and 4) provide for eventual City ownership of the system.

The proposal of 180 Connect consisted of a consortium of firms that would partner with the City to develop the broadband network (the "Network"). The Consortium included 180 Connect, which would be responsible for design, engineering and construction of the system, and PacketFront, Inc., which would provide hardware, software and system operations. On May 12, 2008, Axia NetMedia Corporation ("Axia") joined the Consortium, to provide both additional expertise and financing.

On July 14, 2008, staff presented to the Council the Consortium's conceptual business plan for a fiber-to-the-premises Network in Palo Alto. Based on its business model, the Consortium concluded that there is a sound business case for building a Network in the City. The Council directed staff to enter into a Letter of Intent (the "LOI") with the Consortium by September 2008, covering key terms and conditions that would be included in appropriate bilateral contracts, and thereby enable the timely construction of the Ultra-High-Speed Broadband System envisioned in the City's RFP.

The Council directed staff to conduct contract negotiations with the Consortium in accordance with the following parameters:

- the City would provide 36-fibers on the City's dark fiber backbone at a new bulk fiber discount rate to be adopted by the Council;
- the City would use commercially reasonable efforts to purchase broadband service from retail service providers on the Network, provided that the purchase is effected in compliance with the competitive bidding requirements of the Palo Alto Municipal Code;
- the operator of the Network would provide management service for the City's dark fiber commercial license program and receive a management fee from the City for services rendered, after covering the Fiber Optics Fund's fixed costs;
- the City would contribute existing (but currently unused) fiber-to-the-home ("FTTH") trial assets;
- the City would provide access to spare conduit;
- assurances as practicable that the City's assets, integrated with and related to the Network, would revert to the City in the case of bankruptcy and that any transfer of these City assets would take place only with the explicit agreement of the City; and

- to the extent feasible, the Consortium would indemnify the City against third party legal action

On August 4, 2008, the Council approved funding in the amount of \$300,000 for legal and technical consultants to support contract negotiations. Staff subsequently hired several legal and technical consultants to support negotiations with the Consortium. In early 2009, Mayor Drekeimer re-appointed a three-member, ad-hoc Council subcommittee (consisting of Council Members Kishimoto, Klein, and Schmid) to provide staff with input on the Consortium's proposals along with the previously appointed community advisors.

DISCUSSION

For the past seven months, staff has negotiated at length with the Consortium in an attempt to reach agreement on the terms of the LOI. Unfortunately, the dramatic downturn in the economy restricted the Consortium's ability to obtain financing for the project. As a result, the Consortium planned to seek an equity investor, to provide approximately one-half of the project's capital requirements. In addition, the Consortium proposed that the City fully participate in a public-private partnership by contributing not only existing assets but a substantial fixed revenue stream of approximately \$3.4 million annually, or the equivalent of around 25 percent of projected Network revenues, to the project. As this annual amount is substantially in excess of Fiber Optics Fund resources, it could only be satisfied by the General Fund or from the imposition of a new fee or tax on residents and businesses. This change in direction was inconsistent with the general policy direction and specific negotiating parameters provided by the Council and would have required the City to assume much more of the financial and legal risks inherent in the project.

On February 25, 2009, staff held a Study Session with Council to provide information on the status of negotiations. Staff and the Consortium presented details on the Consortium's current proposal for the Network, including the additional contributions that the Consortium needed from the City to make the project economically viable and attractive to investors. Following the Study Session, on March 9, 2009, Axia informed the City that it wished to withdraw from its financial participation in the project (Attachment A). Given the constraints and time involved in identifying a funding source for this additional financial commitment needed from the City, and the competition faced from dominant incumbent providers (Comcast is currently rolling out 50/10 Mbps down/up service in the Bay Area.), Axia decided it could no longer consider this project. The letter from Axia (Attachment A) states, "Regretfully, in spite of genuine effort on both sides, we have not been able to agree to a model that works for both parties."

This development is unfortunate, because the provision of a robust fiber communications network will bring numerous economic, educational, environmental and social benefits to Palo Alto. However, it was not completely unexpected, as over the past several months it became clear that Axia and the other Consortium members required a substantial financial investment from the City that was contrary to Council's original direction and the scope of the original RFP.

In addition to Axia's withdrawal, staff has learned that the lead responder to the RFP, 180 Connect, is no longer an active participant in the proposal process. Having been absorbed by DirecTV, the engineering division of 180 Connect was dissolved. Between this development and Axia's withdrawal from the project as the financing partner, the Consortium's proposal fails to meet the financial resources criteria established by the Palo Alto Municipal Code, on which the City could award a contract to the Consortium. Staff therefore recommends that the Council formally terminate the RFP process and pursue other options for implementing a citywide next-generation broadband network.

Next Steps

After becoming aware of the financial implications of the commitment that the Consortium sought from the City, staff began to evaluate other options for proceeding with the project. Working in conjunction with the Broadband Council subcommittee and the community advisors, staff developed a preliminary proposal for federal economic stimulus funding and obtained letters of support from a number of local institutions. Staff is working with The Ferguson Group, the City's federal government lobbyist, to develop a plan for requesting federal economic stimulus and federal appropriations funding. Staff has initiated the preparation of a system-level design for the Network that will accompany the City's application for stimulus funds. The City recently sent letters to congressional representatives, and plans to meet with selected representatives and their aides, to ask for their support of the City's broadband initiative. Staff will also be contacting and working with the Governor's Office, as that office may be involved in submitting broadband grant proposals to federal agencies on behalf of California broadband-grant applicants.

In August 2008, Council approved funding in the amount of \$300,000 to support the Citywide Ultra-High-Speed Broadband System contract negotiations. To date, staff has spent \$102,000 and encumbered \$77,000 to pay for professional services in connection with the negotiation of contracts with the Consortium and for consultant assistance in applying for stimulus funds. This leaves a balance of \$121,000 from the original appropriation. Staff recommends that the Council authorize the use of the remaining funds to pay for engineering, legal and other professional services that may be needed to support staff in the application process for economic stimulus funds. Staff is currently working with a technical consultant to develop a project and design that can be submitted for stimulus funding and partially build out the network.

Staff also began to explore the utilization of Fiber Optics Fund resources to independently proceed with a phased build-out of the existing backbone to achieve the City's vision of a universally fiber-connected City. Phase one would include an expansion of the backbone to promote institutional linkages to business, educational institutions, and health and human services agencies. The objective of phase one would be to improve the current income stream in the Fiber Optics Fund, allowing it to support future phases of the project. The speed with which the Network could be rolled out would depend upon the outcome of the City's economic stimulus grant application and the income streams in the Fiber Optics Fund. Again, it is recommended that Council authorize use of the remaining authorized funds to pursue this goal. In the event initial applications for stimulus funds are unsuccessful, this effort would continue.

At the end of fiscal year 2007-08, the Fiber Optics Fund had reserves of approximately \$5.3 million. Based upon its performance for the first six months of Fiscal Year 2008-09, the Fiber Optics Fund is expected to end the year with reserves of around \$7.0 million. At current income levels, it is estimated that the Fiber Optics Fund could support a modest debt issuance (\$5 to \$6 million), which would provide for some of the initial capital requirements of the system. Staff would need to carefully consider the level of debt that could be supported by the Fiber Optics Fund, given the current status of the credit market, the fluid nature of the telecommunications industry, and the competition faced by incumbent providers. It should be noted that investors are likely to view debt supported by the income stream of a telecommunications network as more risky than an electric or water bond issue.

RESOURCE IMPACT

In July 2008, the Consortium requested that the City dedicate resources of about \$15 million to the project, which then was the equivalent of 30 to 40 percent of the proposed Network's projected capital cost of around \$44 million. The Consortium's last proposal requested that the City make an additional financial commitment to the project far in excess of \$15 million (a minimum commitment of \$65 million and a maximum commitment of \$102 million over the proposed 25-year term). This request did not comply with the Council's direction to "minimize financial investment and risk to the City" and "make no General Fund cash contributions, pledges or guarantees."

In July 2007, the Council authorized the use of Council Contingency funds in the amount of \$65,000 to support the City's negotiations with the Consortium. To date, staff has utilized \$19,000 of this amount to pay for consultant costs. In August 2008, the Council approved funding in the amount of \$300,000 for technical and legal consultants to support expedited LOI and contract negotiations. To date, staff has utilized \$179,000 of this amount to pay for professional services in connection with the negotiation of contracts and for stimulus application assistance.

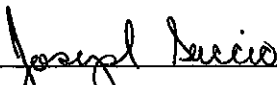
POLICY IMPLICATIONS

This report is consistent with the Council's policy and program direction provided to staff.

ENVIRONMENTAL REVIEW

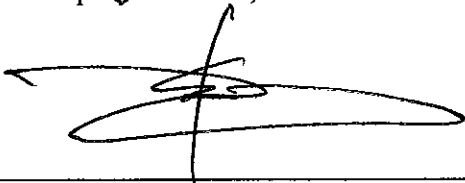
The actions requested in this report do not constitute a project for the purposes of the California Environmental Quality Act. Build out of the Network is subject to the requirements of the California Environmental Quality Act due to the installation, construction and maintenance of facilities in the public rights-of-way. Necessary environmental review will occur when appropriate.

PREPARED BY:



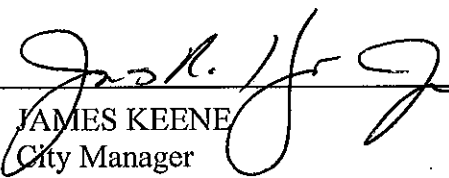
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ATTACHMENTS:

Attachment A: March 9, 2009 Letter from Axia