TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER **DEPARTMENT: ADMINISTRATIVE SERVICES**

DATE: MARCH 5, 2007 **CMR: 156:07**

SUBJECT: **REQUEST FOR COUNCIL DIRECTION ON OPTIONS CONCERNING CITYWIDE ULTRA-HIGH-SPEED BROADBAND SYSTEM REQUEST FOR PROPOSAL (RFP) RESPONSES**

REPORT IN BRIEF

At Council's direction, a Citywide Ultra-High-Speed Broadband System RFP was issued on September 27, 2006. The City received two responses: one from DynamicCity and one from 180 Connect Network Services, Inc. Although each vendor met basic requirements in the RFP, 180's proposal was more comprehensive and more in alignment with the public/private model outlined in the RFP. In addition, 180 along with its partners, demonstrated broader experience with projects similar to that envisioned for Palo Alto. There are, however, issues with 180's financial condition; their assumptions in developing preliminary financial forecasts for a broadband project; and two pending lawsuits. These will require additional discussion and resolution.

Staff is requesting Council direction on how to proceed with the proposals. Several options are provided for Council consideration. These range from conducting further discussions with one of the respondents to terminating the process for executing a broadband system. Should Council direct staff to continue the process, it will need to provide parameters, chiefly financial, within which staff can begin discussions with a respondent. For example, each respondent requires that the City contribute to the costs of developing a business plan. Significant additional staff time will be required to interact with a respondent, so staff seeks Council input on how this project is to be prioritized among other City priorities. If Council directs staff to work with a respondent, a series of "next steps" is provided in this report. These will involve an interactive, iterative process with the Council and the provider.

RECOMMENDATION

Staff requests Council direction on options concerning responses to the City's "Citywide Ultra-High Speed Broadband System" Request for Proposal.

BACKGROUND

At its January 17, 2006 meeting, the Council directed staff to issue a Request for Proposal (RFP) for the construction and operation of an ultra-high-speed bandwidth system. After several subsequent Council meetings were held, in which evaluation criteria and the selection process were reviewed, an RFP was issued on September 27, 2006.

In addition to posting the RFP on the City of Palo Alto Purchasing web site, 127 notification letters were sent out to different potential responders advising them of the Broadband Request for Proposal. On October 19, 2006, 24 people attended the pre-bid conference. From the attendee list, it appears that 16 different companies were represented. On January 9, 2007, the City received two proposals.

This report analyzes the proposals received and compares the responses to both the criteria (Attachment 1) and scope of services (Attachment 2) included in the RFP. In addition to the proposals, information gathered from telephone interviews and written questions and answers with respondents is incorporated into the analysis.

Staff was acutely aware of Council's desire to have members of the public participate in some manner in the evaluation process. Since only two proposals were received, staff believed that a simplified review process was warranted; hence, it compared the two proposals outside of a public participation process and it now seeks the Council's direction. Furthermore, on January 29, 2007, Council directed two of its Members to review the proposals and then present their recommendations to the Council. Staff has placed this report and the two proposals received into an earlier Council packet so adequate time was afforded to the public and the Council to review the material prior to the March 5 meeting.

DISCUSSION

Staff was interested to know why businesses attending the pre-solicitation conference did not respond to the RFP. Accordingly, in follow-up conversations with these businesses, the following concerns were raised: project risk was not shared equally between respondent and City (mentioned several times); competition would be strong from Comcast and other emerging providers such as AT&T; market penetration rate was uncertain; capital and construction costs would be significant; and financing and ownership issues were too challenging. To varying degrees, these issues permeate the proposals received and will continue to arise if Council directs staff to begin discussions or negotiations with one of the responders.

Dynamic City (DC) and 180 Connect Network Services, Inc. (180) each submitted a proposal. Each respondent stated that it could meet the primary objectives of the Broadband project:

- Capability of providing to each customer 100 megabits per second symmetrical service
- Provision of data, video, and telephony services
- Eventual City ownership of the physical system

In addition, each respondent indicated that an open system could be provided and that some type of public agency-private business entity relationship could be developed.

The two proposals differ in how they addressed the RFP's request for "ways of mitigating the financial risk to the City" and for experience with "engagements of similar scope and complexity."

Dynamic City Proposal

Dynamic City proposes to act initially as a consultant to the City and subsequently to serve as a "coordinator" for construction of the network; a "negotiator" with service providers; and a "manager" of network operations. As a first step, DC proposes "a three-month Project Design and Financial Package" which would include developing a business plan, assisting the City in securing financing, and designing a phased roll-out plan. This work is estimated to cost the City $150,000. DC succinctly states, "before the network can be designed or construction can begin, Palo Alto needs to secure funding for this project."

DC recommended that the City take the steps necessary "toward immediate network" ownership. This translates into the City funding and bearing 100 percent of project costs and risks. DC provides an option to mitigate the City's risk. It would assist in identifying a private equity firm willing to invest some $5 to 10 million of the $41 million projected for total capital requirements (excluding financing costs). For this investment, DC states, the equity firm likely would expect a 20 percent return on its investment.

In terms of experience, DC has served as a consultant to the Utah Telecommunications Open Infrastructure Agency (UTOPIA) where a fiber network is being phased in for 14 cities. The project is 18 months into completion and is expected to be finished in 2008-09. DC has signed a 25-year Master Services Agreement with UTOPIA for project management, asset management, procurement, and other consulting services. The UTOPIA project comprises DC's sole experience in project initiation and implementation. In addition, DC is currently performing cost/revenue analysis for potential fiber projects in Portland, Seattle and Las Cruces, New Mexico.

Technically, DC has offered a somewhat theoretical solution for a broadband network. It identifies conceptual communication layers not unlike a hybrid of the International Standard Organization's Open System Interconnect (ISO/OSI) and TCP/IP network models. While this model demonstrates a thorough understanding of a robust fiber communication network, it avoids discussing specific equipment or technology to be implemented in Palo Alto. DC lists twenty-six different vendors as "potential suppliers for the network." This list of a broad range of providers could point to a lack of experience installing, configuring and supporting a network solution; an attempt to provide a "whatever you want" solution; or a conscientious attempt to meet potential, varied City needs. This approach leaves the impression that DC does not have the same field testing experience that a dedicated, proven solution provider could offer.

Staff's perspective is that DC's proposal is not consonant with key provisions in the RFP. Its funding recommendation, in which the City would bear 100 percent of project costs, does not address the RFP request for "mitigating the financial risk to the City." The City is looking for a type of partnership where the private party contributes substantial capital to the project while identifying and leveraging existing City assets. DC's secondary recommendation in which a private equity firm would invest 5 to 10 percent of project costs would not substantially reduce City risk. Moreover, the City's RFP called for "eventual ownership" of the broadband system and not "immediate ownership." By "eventual ownership," the RFP meant that the private partner would take the lead in owning and building a broadband system, and at some appropriate, agreed upon future time, the City would assume ownership.

Although there is no reason to doubt the long-term potential success of the UTOPIA project that DC has shepherded, or to doubt the high quality of their work, there is a concern about a substantial "track record" of accomplishments in this area. In staff's opinion, DC has not yet demonstrated the breadth and depth of experience that would be needed to implement the Palo Alto broadband project.

180 Connect Network Services, Inc. Proposal

180's proposal includes a consortium of firms that would partner with the City to build a broadband system. The consortium is comprised of: 180 Connect Network Services, Inc., which provides "engineering and construction for large scale communications deployments;" PacketFront, Inc., which has international experience in "developing, engineering, and operating solutions for Broadband Open Access fiber networks;" and Royal Bank of Canada's Capital Market (RBC), which has expressed interest in helping to finance the project. In addition, the proposal states that 180 would build, operate, and market the broadband system.

Staff believes 180's proposal aligns with key requirements in the RFP, albeit with important issues yet to be resolved. In terms of "mitigating the City's risk," 180 states, "RBC's fund raising could support the project without any additional assets or capital contribution from the City; however, the ability to secure and raise full financial support for the Fiber to the Home project would be achievable through the identification of assets to be contributed or used on the project by the City." As to "eventual ownership" of the system by the City, 180 said, "…we believe the City should own the network after a set period of time, typically after a 30 year operational agreement." During one telephone interview, 180 stated that the typical contribution of assets by a municipality toward a project was in the range of 20 to 30 percent of the total dollar capital investment. In a subsequent discussion, however, 180 indicated some jurisdiction's contributions were between 30 and 51 percent. It is evident that only through further discussions with the 180 consortium will the City's contribution to the project be clarified.

180 Connect and PacketFront do appear to have experience with implementing fiber projects. 180 has worked on various fiber projects in the California cities of Ontario and Shafter; UTOPIA (Utah); Silicon Valley Power (Santa Clara); and the Franklin County Public Utility District (Washington). PacketFront has worked on Fiber to the Home projects in Vestras, Sweden; Dubai City; the Netherlands; and Canada. These projects include the triple-play services and bandwidth the City is seeking.

180 appears technically competent. It is proposing a specific model and operational solution that has been deployed and been operated successfully. 180 identified the equipment to be used from end-to-end, customer premises, network infrastructure, and administrative application.

However, the following issues with 180's proposal require attention. Since 2003, 180 had annual net operating income losses ranging from $4.7 million to $13.3 million. In response to a question on these losses, 180's CFO stated its company:

- has grown very quickly from $48 million in revenues in 2002 to $225 million in revenues in 2006
- has acquired companies which drove up its goodwill and liabilities
- has been cash-positive, but the non-cash expenditures have dropped its net income into the red

Although it is not uncommon for growing companies to experience net operating income losses, the ongoing financial health of 180 is a concern.

Also meriting careful scrutiny are the assumptions 180 used in its preliminary financial projections. In years 3 and 4 of operations, 180 assumes "take rates" (i.e., homes receiving one or more broadband services) of 48 and 56 percent, respectively. These rates appear to be especially high when they are compared to Comcast's current take rate of around 50 percent and are considered in light of the anticipated entry of other providers (such as AT&T) in the Palo Alto market. In addition, these take rates exceed those mentioned in the DC proposal, which are 44 and 49 percent in years 3 and 4, respectively. The prior business plan sponsored by the City (written by Uptown Associates) indicated take rates of 35 and 37 percent in years 3 and 4, respectively. Admittedly, the Uptown numbers were based upon a market survey that each responder says must be updated. However, both proposals – 180's more so than DC's – include take rate assumptions that are robust and could be considered overly optimistic.

180 Connect has two class action lawsuits pending: one that deals with a lunch break issue (which is near resolution) and one that alleges racial discrimination. The information on these cases, however, does not permit the City to deem the proposal as non-responsive. The Council may consider this matter as part of its evaluation of any staff report or recommendation concerning the Broadband RFP.

Telephone conversations with 180 Connect indicate that when upper management found out about the discrimination issue, they hired a retired National Labor Relations Board member to investigate the issue and the general work environment. According to 180, the investigator found no evidence of a hostile workplace. He discovered that all ethnic groups were represented equally across all pay scales. 180 soon will be filing its response to the lawsuit and hopes to have the case dismissed. 180 Connect did sign the "Certificate of Non-Discrimination" that is enclosed with all Requests for Proposals.

<u>Business Plan</u>
Both DC and 180 each claim that a full business plan must be developed before proceeding with a project. DC included the cost of developing a plan in its suggested $150,000 engagement fee. 180 recommends doing a high-level feasibility study at its cost, which would further analyze take rates, define the project, and determine its viability. Like DC, 180 would then develop a project business plan. When asked if they would bear the cost of the plan, the response was that the firm and City would share the costs; the allocation is unclear. If the City proceeds, it will have to identify funding for the plan as well as additional resources for departments participating in the

process. For example, the Administrative Services Department cannot continue to absorb staff costs within its budget given other significant priorities and requests to reduce staff to meet the $3 million infrastructure goal.

For a high level, side-by-side comparison of the two proposals according to RFP criteria, please see Attachment 3.

<u>Proposer References</u>

Conversations with respondent references indicate high levels of satisfaction with work performed by both firms. One reference for which DC performed a cost/revenue analysis stated, “We were very pleased with DynamicCity's report… and …have been extremely pleased with their forthrightness and cooperation--they are a very good outfit, and we are following the Utopia project with keen interest.”

180 project references speak in a similar vein. One agency, describing the fiber optic backbone and collocation facility installed by 180, said “several people have looked at these and said, ‘these are top-notch.’ ” Another reference stated, “if you can keep 180 focused on what you want to do, they’re great.” The City “has changed the game plan several times, and that’s hurt a bit. But it’s not 180’s fault…Technically, they’re at the top of their game.”

Based on these reference checks, there are no exceptions to call to Council’s attention.

<u>Council Options</u>

Council has a number of options concerning the responses to the Broadband RFP:

1. Direct staff to pursue discussions with one of the responders and provide direction to staff as indicated below.

2. Terminate process to provide broadband services. Reasons may include:
   a. Stated and implied City financial contribution or risk is high
   b. Small number of responses to RFP indicate issues with partnership model proposed in RFP
   c. Competition from the incumbent provider and new providers such as AT&T
   d. Lack of demonstrated, long-term, financially independent broadband initiatives by public agency or public agency-private entity partnership broadband efforts

3. Reissue an RFP indicating a higher level of City financial/asset commitment that may attract more responders

Should Council direct staff to move forward with one of the responders, staff envisions an iterative, interactive process among staff, Council, and the potential partner firm.

To be clear, discussions with a firm may not culminate in an executed contract unless and until the parties can agree on mutually acceptable financial, operational, and service terms and conditions. Yet to move on with this process, staff must begin such discussions, and therefore requests Council direction on parameters within which to conduct the conversation. For example, Council has indicated that it wants to identify existing assets that can be leveraged in a broadband project, such as:

- Existing dark fiber backbone
- Spare conduits
- Useable facility space or locations

Other resources that could potentially be made available are discounted permit fees and staff time to guide the project through review and permit processes.

As mentioned, DC and 180 expect the City to pay all or part of the costs for a business plan. How much is the City willing to pay for such a project and where will the funds come from? The consensus reached from prior staff analysis and Council discussion is that the General Fund will bear the costs associated with this project. As the City grapples with identifying $3 million in resources for existing infrastructure improvements, what priority and funding level does Council wish to assign to the broadband business plan and project?

Although a clearer picture of the City's financial responsibilities must be obtained, potential City contributions have been cited in the proposals. These include: cash, physical assets, letters of credit, credit enhancements such as assets or pledges of revenue (e.g., sales tax) to back bonds, and long-term contracts guaranteeing a revenue stream. Each respondent indicated that one or more of the above may be required to secure financing. While the City seeks to mitigate its financial risk, staff needs direction from the Council on what the City is willing to risk. Pledging sales tax revenues to creditors in case of a default, for example, theoretically could lead to a downgrade in the City's credit rating and a reduction in services. In conclusion, staff requests resource guidance for exploring a broadband relationship.

<u>Next Steps</u>

Assuming the Council directs staff to move forward, the following, initial steps would be taken:

1. Staff will return to Council with a recommendation on required staffing for the Utilities, Planning, and Administrative Services Departments, and the City Attorney's Office.

2. Staff will return to the Council with a list of available City assets that could be leveraged for a broadband project.

3. Preliminary, high-level discussions with the respondent would be held on:

    - Exploring in more depth the feasibility of the project based on financial and performance assumptions
    - Defining further the respective contributions to the project
    - Determining the costs of a business plan and how the costs will be allocated between the parties

4. Staff would return to Council with information gathered in steps 1, 2 and 3 and request further direction.

RESOURCE IMPACT

Significant staff time has been devoted to this project since the Council gave direction to issue the RFP. Six senior staff and two analysts (from the Administrative Services and Utilities departments as well as the City Attorney's Office) have participated in the evaluation. This has cost, at a minimum, $75,000 in salaries and benefits to arrive at this point. It is expected that a similar if not higher amount of staff time and expense will be required to work through additional discussions with a respondent.

As stated, the City will be expected to pay for all or part of a broadband business plan. DC included costs for such a plan in its $150,000 fee and 180 stated the City would share in such costs. Moreover, additional non-salary resource impacts can be expected if the City moves forward with a broadband project.

POLICY IMPLICATIONS

This report and the attached RFP are consistent with Council's policy and program direction provided at its September 18, 2006 meeting.

ENVIRONMENTAL REVIEW

The actions requested in this report do not constitute a project for the purposes of the California Environmental Quality Act.

ATTACHMENTS

Attachment 1: Evaluation Criteria for Ultra-High Speed Broadband System
Attachment 2: Project Background and Scope of Work
Attachment 3: Summary Comparison of Broadband Proposals
Attachment 4: Dynamic City RFP
Attachment 5: 180 Connect RFP

PREPARED BY: ______________________________

JOSEPH SACCIO
Deputy Director, Administrative Services

DEPARTMENT HEAD APPROVAL: ______________________________

CARL YEATS
Director, Administrative Services

CITY MANAGER APPROVAL: ______________________________

EMILY HARRISON
Assistant City Manager