TO: HONORABLE CITY COUNCIL
FROM: CITY MANAGER DEPARTMENT: ADMINISTRATIVE SERVICES/UTILITIES
DATE: JULY 19, 2004 CMR: 360:04
SUBJECT: UTILITIES ADVISORY COMMISSION RECOMMENDATION REGARDING FIBER TO THE HOME FINANCING OPTIONS

RECOMMENDATION
The Utilities Advisory Commission (3-2) recommends that the City Council:

1. Not place an advisory vote on the November ballot.

2. Halt consideration of further action on FTTH until a viable financial option emerges. Direct staff, over the next 6 months, to seek guidance from the investment banking community about possible financing options and continue to monitor the progress of other California cities in securing financing.

3. Continue with the FTTH trial for one year with an evaluation on whether to continue the trial at that time.

Staff recommends:

1. Halt consideration of the financing options discussed to date and, instead, monitor the financing methods and results of other California jurisdictions until such time as a viable financing option emerges.

2. Continue the FTTH trial for one year with an evaluation on whether to continue the trial at that time.

COMMITTEE REVIEW AND RECOMMENDATIONS
After providing a brief summary of the report (Attachment A) that answered questions from the May 5 Commission meeting, Commission questions and discussion focused on the rationale for continuing the FTTH trial and on additional investigation of FTTH financial options. Several Commissioners questioned the need for continuing the trial
and asked if all objectives had been met. In addition, one Commissioner queried as to whether staff had a time frame or milestones for finalizing the trial. Staff responded that while many objectives had been met, there was still more to learn about the evolving technology. Moreover, staff stated that cash flow from annual operations of the project was positive and that when it turned negative, staff would return with a recommendation to cease the project. It is important to note that fiber operations as a whole (dark fiber and FTTH) is cash positive only when depreciation and allocated charges are excluded. After hearing from staff that there were consulting firms eager to partner with Palo Alto on FTTH, one Commissioner wondered whether the City could pursue a relationship. Staff replied that it would keep an open mind and would consider a viable financing option when it emerged. Another Commissioner asked whether staff had talked with investment bankers who had the expertise and creativity to find financial solutions.

**DISCUSSION**

The principal differences between the UAC’s and staff’s recommendation is that the UAC recommended not proceeding with an advisory vote (staff had no recommendation on this point) and that staff, over the next six months, actively “seek guidance from the investment banking community about possible financing options” for FTTH.

Staff respectfully disagrees with the recommendation to actively seek guidance from the investment banking community over the next six months. While staff has not had many direct contacts with the investment banking community, it has gathered sufficient information to indicate that such contacts may not be fruitful. As stated in the attached report, a bond placement with a private investor will cost more than a traditional public offering. After using a “low-end” rate of return of 7.5 percent to a private investor for a three-year investment and holding the penetration rates in the FTTH business model constant, staff and the City’s Financial Advisor found that only $20.2 million of the anticipated $32.0 million in capital needs could be funded. Moreover, an additional $8.0 million is needed for start-up operating costs and that funding has not been identified. Preliminary information from Truckee indicates that a potential investor is seeking a rate of return closer to 13 percent and this deal has not closed. Staff has been advised by a professional in the financing arena that it will be exceedingly difficult to find private investors for the FTTH venture envisioned in the business plan.

It is staff’s recommendation to monitor the efforts of other California cities in seeking viable financing. One FTTH consultant has informed staff that a city in California is about to receive private financing for an FTTH venture. It appears prudent to await the outcome of this financing and then use its results to test potential outcomes in Palo Alto’s FTTH business model.
ATTACHMENTS
Attachment A: July 7, 2004 UAC Memorandum “Fiber to the Home”
Attachment B: Minutes from July 7, 2004 UAC Meeting

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