



City of Palo Alto

Finance Committee Staff Report

(ID # 3657)

Report Type: Action Items

Meeting Date: 4/16/2013

Summary Title: Fiber Optics Fund Financial Forecast

Title: Fiscal Years 2014 to 2018 Financial Forecast for the Fiber Optics Fund

From: City Manager

Lead Department: Utilities

Recommendation

Staff recommends that the Finance Committee review and comment on the attached five-year forecast of revenues and expenses for the Fiber Optic Fund.

Motion

Motion to accept the Fiber Optic Fund five-year financial forecast and forward it to the full Council for review and input.

Executive Summary

Staff assessed major cost drivers, expected costs and the reserve guidelines for the Fiber Optic Fund for the next five years. The financial forecast shows that revenues are currently above costs, and are projected to continue as such for the five-year forecast horizon.

Background

The City of Palo Alto Utilities (CPAU) provides commercial dark fiber optic services within the boundaries of the City of Palo Alto. For customers with fiber optic licenses beginning prior to September 18, 2006, rates for service are published in Dark Fiber Licensing Services Rate Schedule EDF-1. EDF-1 was a promotional rate and was closed to new Dark Fiber licenses in 2006. Customer expenses for engineering, construction and connection to the fiber optic backbone are charged under Dark Fiber Licensing Services Rate Schedule EDF-2. New fiber customers are enrolled under Dark Fiber Licensing Services Rate Schedule EDF-3.

The Council-approved Dark Fiber Licensing Agreement (CMR 177:97) allows the commercial fiber optic fees charged under the EDF-1 and EDF-2 rate schedules to be adjusted annually in accordance with the Consumer Price Index (CPI), which is published by the United States Bureau of Labor Statistics. The CPI index used for this annual adjustment is the change in the December CPI. In Fiscal Year (FY) 2012, based on recommendations from the UAC and the Finance Committee, the Council directed that, if the only changes to Fiber rates were related to these CPI changes, then such rates could bypass UAC and Finance Committee review. Rate Schedule EDF-3 does not automatically increase by CPI annually, and any proposed rate changes to EDF-3 or non CPI changes to EDF-1 and EDF-2 will be reviewed by the UAC and the Finance Committee.

Discussion

Financial Projections

Table 1 below shows actuals, budgeted and projected financial information for the Fiber Optic Utility for FY 2012 through FY 2018.

Table 1: Five-Year Financial Plan (\$,000)

| City of Palo Alto <i>Fiber Optics</i> | | | | | | | | | |
|--|--|-----------------|----------------|-----------------|-------------------|--------------|--------------|--------------|--------------|
| Fiscal Year | | Adopted 2012 | Actual 2012 | Adopted 2013 | Projected 2014 | 2015 | 2016 | 2017 | 2018 |
| 1 | | | | | | | | | |
| 2 | Utilities Retail Revenue | 3,149 | 3,517 | 3,475 | 3,579 | 3,686 | 3,797 | 3,911 | 4,028 |
| 3 | Service connection charges and capacity fees | 200 | 137 | 100 | 200 | 200 | 200 | 200 | 200 |
| 4 | Other Revenues & Transfers In | - | 8 | - | - | - | - | - | - |
| 5 | Interest plus gain or loss on investment | 310 | 436 | 303 | 342 | 393 | 446 | 502 | 560 |
| 6 | Total Sources of Funds | 3,659 | 4,097 | 3,878 | 4,121 | 4,279 | 4,443 | 4,612 | 4,788 |
| 7 | | | | | | | | | |
| 8 | Allocated Charges | 405 | 310 | 386 | 385 | 396 | 405 | 415 | 425 |
| 9 | Administration | 490 | 294 | 356 | 369 | 382 | 392 | 408 | 424 |
| 10 | Planning/ Mktg/ Contracts | 208 | 276 | 182 | 184 | 190 | 195 | 201 | 207 |
| 11 | Operations and Maintenance | 433 | 414 | 437 | 456 | 473 | 486 | 507 | 528 |
| 12 | Rent | 25 | 25 | 26 | 26 | 27 | 28 | 29 | 29 |
| 13 | Other Transfers Out | 9 | 9 | 2 | 2 | 2 | 2 | 2 | 2 |
| 14 | Capital Improvement programs | 500 | 457 | 400 | 400 | 400 | 400 | 400 | 400 |
| 16 | Total Uses of Funds | 2,070 | 1,785 | 1,789 | 1,822 | 1,869 | 1,908 | 1,960 | 2,015 |
| 17 | | | | | | | | | |
| 18 | Into/ (Out of) Reserves | 1,588 | 2,312 | 2,089 | 2,299 | 2,410 | 2,535 | 2,652 | 2,773 |
| 19 | | | | | | | | | |
| 20 | Ending Rate Stabilization Reserve | 11,718 | 12,470 | 14,559 | 16,858 | 19,268 | 21,802 | 24,454 | 27,227 |
| 21 | Ending Plant Replacement Reserve | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 |
| 22 | Ending CIP related Encumb/Reapprop. | | 697 | | | | | | |
| 23 | Ending Operating Encumb/Reapprop. | | 84 | | | | | | |
| 24 | | | | | | | | | |
| 25 | Long Term Rate Stabilization Guidelines | | | | | | | | |
| 26 | Minimum (20% of Net Sales) | 670 | 670 | 715 | 716 | 737 | 759 | 782 | 806 |
| 27 | Maximum (50% of Net Sales) | 1,675 | 1,675 | 1,788 | 1,789 | 1,843 | 1,898 | 1,955 | 2,014 |
| 28 | | | | | | | | | |

Cost Drivers

The total uses of funds for the Fiber Optic Fund are projected to increase from the budgeted levels of \$1.8 million in FY 2013 to \$2.0 million in FY 2018, an average annual increase of 2.4%.

Operations and maintenance is the largest component of costs, followed by allocated charges and administrative costs. Salary and benefit cost projections, as well as other operating expenditures such as operations, maintenance, and rent are projected to increase per projections from the City's long-range financial forecast.

Capital Improvement Program (CIP)

The proposed FY 2014 CIP budget is \$400,000 and expected to continue at this level until FY 2018. Table 2 presents the expected CIP costs for the financial forecast horizon. Also shown in Table 2 are revenues, of \$200,000 per year, collected from new customer connection and capacity fees.

Table 1: Capital Improvement Program (FY 2014 – FY 2018)

| WBS | Desc. | 2013-14 | | 2014-15 | | 2015-16 | | 2016-17 | | 2017-18 | |
|--------------|----------------------|------------------|-------------------|------------------|-------------------|------------------|-------------------|------------------|-------------------|------------------|-------------------|
| | | Exp. | Rev. | Exp. | Rev. | Exp. | Rev. | Exp. | Rev. | Exp. | Rev. |
| FO-10000 | Fiber Optic Customer | \$200,000 | -\$200,000 | \$200,000 | -\$200,000 | \$200,000 | -\$200,000 | \$200,000 | -\$200,000 | \$200,000 | -\$200,000 |
| FO-10001 | Fiber Optic Network | \$200,000 | \$0 | \$200,000 | \$0 | \$200,000 | \$0 | \$200,000 | \$0 | \$200,000 | \$0 |
| Total | | \$400,000 | -\$200,000 | \$400,000 | -\$200,000 | \$400,000 | -\$200,000 | \$400,000 | -\$200,000 | \$400,000 | -\$200,000 |

Revenue Projections

Rate adjustments to the EDF-1 and EDF-2 rate schedules, per the licensing agreement, are implemented annually. The EDF-3 rate was implemented on September 18, 2006 and has not changed since that time. As contract terms for customers on the EDF-1 rate expire, customers transfer to the EDF-3 rate so that over time, the EDF-1 rate will cease to exist and all customers will be on the EDF-3 rate. Also, as CPI increases are implemented for the EDF-1 rate, some customers may voluntarily choose to move from the EDF-1 rate to the EDF-3 rate for cost saving purposes. Growth in new customer connections is projected at 3% per year.

Other revenues in FY 2012 included service connection fees (\$200,000) and interest and gains on investments (\$436,000). Annual interest income projections assume an interest rate of 2.2% throughout the forecast horizon. Other revenue categories are expected to remain relatively unchanged.

Reserves

Table 2 summarizes the minimum and maximum long-term guideline levels for the Fiber Optics Rate Stabilization Reserve (F-RSR) for FY 2013 through FY 2015.

Table 2: Fiber Rate Stabilization Reserve Long-Term Reserve Guideline Levels (\$M)

| Fiber Rate Stabilization Reserve (F-RSR) | FY 2013 | FY 2014 | FY 2015 |
|--|----------------|----------------|----------------|
| Estimated End of Year Balance | 14.6 | 16.9 | 19.3 |
| Minimum Long-term Guideline Level (20% of sales revenues) | 0.7 | 0.7 | 0.7 |
| Maximum Long-term Guideline Level (50 % of sales revenues) | 1.8 | 1.8 | 1.8 |

The F-RSR balance is expected to be \$14.6 million at the end of FY 2013. Based on current cost and revenue projections, reserves are expected to grow to \$27.2 million by FY 2018.

Commission Review

On April 3, 2013, the UAC reviewed the 5-year financial forecasts for the Fiber Optic Fund. The UAC did not discuss the financial forecast, but did have a broader discussion about the future of the fiber fund, including WiFi and fiber-to-the-premise. The excerpted draft notes from the UAC's April 3, 2013 meeting are provided as Attachment A.

Environmental Review

This recommendation does not meet the California Environmental Quality Act's definition of a "project" under Public Resources Code Section 21065.

Attachments:

- Attachment A: Excerpted Draft Minutes of April 3, 2013 UAC Meeting (PDF)

**Excerpted Draft
Utilities Advisory Commission Meeting
Minutes of April 3, 2013**

ITEM 3: DISCUSSION: Review of Fiber Optics Financial Forecast and Potential Uses of Fiber Fund Reserves

Director Fong stated that there was no staff presentation on the fiber financial forecast and staff could answer questions on the forecast, but that this item is an opportunity for the UAC to have a broad discussion about any aspect of the fiber fund, including the dark fiber system, WiFi, or fiber-to-the-premise.

Public Comment

Herb Borock said that the City should use sources of funds it has separate from the Fiber reserves, including its bonding capacity to extend the dark fiber system throughout the community. The City should develop a lit fiber utility in the future, too. The net revenue of the fiber fund is sufficient to pay the debt on the loan.

Borock suggested that voters could decide if the City should expand the fiber network to allow all customers to connect, or alternatively, a system that offers the choice to connect could be offered to customers. The system could be built by a contractor, or multiple contractors all working simultaneously throughout the City, and revenue bonds could be used to build the dark fiber backbone. Borock also suggested that more information is needed regarding the dark fiber fund.

Commissioner Melton thanked staff for the 5-year financial plan. He noted that tonight is a continuation of the discussion begun last month at the joint meeting of the Commission and Council with primary questions being how to proceed and what role the UAC sees for itself. He also noted that following the joint meeting, the Mayor appointed a Council committee to do the same thing as the UAC was contemplating. He also noted that he had a conversation with one of the members of the new Council committee. He indicated to the Council member that he thought contact should be made with Google and the Cities of Lafayette and Chattanooga to gain information and learn about their systems. He said the Council member responded that the Committee has a similar plan of action and posed the idea of a joint UAC/Council committee to avoid duplication of efforts. Such a committee might comprise 4 council members and 3 UAC members working together as one committee. As a result of that conversation, Commissioner Melton said he changed his mind about what should be discussed at the current meeting.

Vice Chair Foster noted the idea of fiber-to-the-premise (FTTP) has been floating around Palo Alto for many years. He noted that his own views changed even over the past year. He noted that whereas he had earlier been neutral on the issue of the feasibility of a fiber build-out, he now supports trying to find a way to make it happen. He supports efforts to develop a recommendation on *how* to do it including the pros and cons of moving forward. He viewed

the PBS report on Chattanooga and see benefits to Palo Alto to offer high speed Internet to community. He noted the need to hire expertise in the form of a consultant and remarked that it would be good to hear from Commissioners Melton and Waldfogel on their thoughts on how it would all work.

Commissioner Hall asked his fellow commissioners what the goal was. He suggested the need for a vision and framework. He indicated that he found the meeting with the Council very refreshing. He also said that we really need to figure out what we want and we need a vision for what will be achieved including quantification of benefits and review of financing considerations.

Council Member Liz Kniss was acknowledged and invited to speak by Chair Cook. Council Member Kniss explained that she is the Chair of Council's new ad hoc committee which includes herself, Mayor Scharff, Vice Mayor Shepherd and Council Member Klein. Council Member Kniss noted that 20 years ago she introduced the idea of dark fiber which at the time was extraordinarily unpopular but since has surprisingly made money. She noted her surprise that private individuals are also connected to the dark fiber optic network and they are very happy with the service. Council Member Kniss informed the Commission that the ad hoc committee was so new that there have not yet been any assignments, but she also assured the Commission that the committee will rely heavily on the Commission's advice. She noted that surprisingly, for the first time there is not a single engineer on the Council.

Commissioner Melton said that the Commission's two leading technologists, Commissioner Waldfogel and Commissioner Eglash are absent from the meeting, and that he would like to hear from them.

Chair Cook remarked that the Fiber Fund reserves are projected to grow to \$20 million plus, providing the opportunity to use the funds to provide a community service. He noted that it is the responsibility of the Commission to do this well and to spend the funds wisely. He noted his disappointment with staff's earlier recommendation from the prior year and said that finally things are heading in the right direction with the Mayor's desire to move to FTTP. Chair Cook noted his skepticism that the community WiFi gets us anything because there is a need for bandwidth.

Commissioner Melton noted that Council Member Burt suggested there could be an equity problem where not everyone might be able to access the fiber or sign up for fiber services, but WiFi could be made available for the entire community and for that reason WiFi makes sense.

Vice Chair Foster stated that there are some in the community who are concerned that the WiFi piece is the FTTP killer with WiFi being the weaker substitute. He suggested that it might make sense to look at WiFi separately from a fiber build-out. However, both projects cost money and, if they both come from the same pot of money, that could be a problem.

It was suggested by the Commissioners that the topic of a fiber expansion be added to the May agenda to permit the Commission to hear from Commissioners Chang, Eglash and Waldfogel on the matter.