Agenda Report

September 13, 1999

THROUGH: FINANCE COMMITTEE

TO: CITY COUNCIL

FROM: CITY MANAGER

SUBJECT: APPROVAL OF A LEASE AGREEMENT WITH GST TELECOM, INC. FOR THE LEASE OF THE CITY'S FIBER OPTIC BACKBONE

RECOMMENDATION

It is recommended that the City Council:

(1) Authorize the City Manager to enter into a lease agreement with GST Telecom, Inc. for the purpose of leasing the City's fiber-optic backbone. Competitive bidding was not required pursuant to City Charter Section 1002(F) Contracts for Professional or Unique Services, and
(2) Recognize $1,000,000 in unanticipated revenues to the City's Telecommunications Fund and authorize the Director of Finance to appropriate this amount to account number 146100.

EXECUTIVE SUMMARY

In December of 1997, the City Council authorized staff to begin construction of a 19-mile fiber optic backbone. The project piggy-backed on a Water and Power Department capital project which envisioned the replacement of aged copper wiring between the department's facilities. The backbone consists of 144 fiber strands, of which, twenty-four are reserved for the city's and the utility's use; the remaining 120 strands are the subject of this lease agreement. The City's General Fund Capital Reserve advanced $1.8 million for the project with the anticipation that resulting revenue would be first used to repay the loan and later to be placed in the Telecommunications Fund to be used at the discretion of City Council for general City or utility purposes. The proposed contract satisfies both the repayment of the loan as well as providing a new revenue source to the City.

Concurrent with the construction of the fiber-optic backbone, staff undertook a Request for Proposals (RFP) process in which any interested party could make a business proposal for the use and lease of all, or part of, the 120 strands in the fiber-optic backbone. Staff recommends the City enter into a lease agreement with GST Telecom, Inc. as a result of this process. GST Telecom, Inc. has been a competitive local exchange carrier since 1994, providing voice and data services with a solid track record in the telecommunications field (see company profile below).

In addition to the direct monetary benefits derived from this contract (over $4 million in revenue over a twenty year lease), it is anticipated that there will be corollary benefits to the City and the community as more local competition in telecommunications services should result in lower customer rates. The operation of this fiber-optic backbone by GST Telecom, Inc. also enhances Pasadena as a desirable destination for businesses that market future broadband services and technologies currently under development. Lastly, this project avoided the expense of a Water & Power capital project to link all their facilities with fiber optics estimated at approximately $800,000.

BACKGROUND

In December of 1997 the City Council approved a Telecommunications Network Business Plan. The plan called for the expenditure of approximately $1.8 million dollars of Charter Capital Reserve funds for the construction of a 19-mile broadband fiber-optic telecommunications network backbone. It also authorized the issuance of a Request for Proposals (RFP) process to establish a strategic business relationship with a private sector telecommunications firm or firms for use and expansion of the backbone (Attachment A – December, 1997 Agenda Report).

That business plan outlined the goals of the proposed project which included meeting the current and future telecommunications needs of the Water & Power Department, generating new revenue, fostering economic development and encouraging availability of a wide variety of competitively-priced telecommunications services to Pasadena. Staff's recommendation meets all of these goals.

Construction

Initially, staff proposed the construction of a 19-mile fiber-optic backbone roughly circling the City with extensions to the Jet Propulsion Laboratories to the north and the Biotech Corridor to the south. However, during the planning phase, the project was expanded to 25 five miles to reach other strategic points previously overlooked. The construction schedule, which was expected to last twelve months using in-house resources, was extended to eighteen months as a result of the expanded scope and the unavailability of Water & Power crews who had to be supplemented with an outside contractor. The City's lengthy contractor selection process was the most significant factor in this delay. The backbone construction has been completed including technical testing and certification and the backbone, shown on Attachment B – Fiber Optic Backbone Location Map --is now ready for lease and operation.

Request for Proposals (RFP)

Concurrent with the construction of the backbone, staff undertook an RFP process in which telecommunications service providers were allowed to propose any use of all, or part of, the 120 strands in the backbone. Staff received five responses, one being a letter of opposition to the project from Pacific Bell (Attachment C – Response to Issues Raised by Pacific Bell from Telecommunications Attorney). Of the remaining four, one was deemed unresponsive and three were analyzed and ranked by staff and a professional consultant from the telecommunications field (Attachment D – Rating Criteria). The following is a summary of the evaluation team's rankings and comments:

Rating Criteria:	ComElectric	Nanospace	GST Telecom
Proposed Use of the Fiber Ring	5	12	15
Proposed Partnership	3	11	13
Proposed Return to the City	0	5	20
Firms Qualifications	8	12	18
Affirmative Action	15	15	15
Local Business Presence	5	5	0
TOTAL	**36**	**60**	**81**

ComElectric, Inc., while rated high for its knowledge of the project's goals and objectives, the proposal suffered in that it did not address any type of repayment of the City's investment or revenue potential. In fact, it proposed further funding by the City of approximately $2 million in the first two years of the project to pay for its services. Furthermore, the proposal did not address the lease and operation of the backbone, but rather consulting services that would be of more use to the actual lessee and operator of the backbone.

Nanospace, Inc., a start-up telecom firm, proposed a repayment and revenue sharing scenario in exchange for use of the fiber. The repayment schedule lasted 18 months with revenue sharing beginning in month 19 of the project. Revenue sharing was contingent on Nanospace's increasing use of the fiber backbone in future years. In that respect, the proposal was speculative, which staff felt was at odds to the risk-averse nature of the project presented to City Council.

It is important to stress that although Nanospace's proposal may have generated greater revenues over the long term under a best case scenario, the speculative nature of the proposal created some serious concerns. The greatest concern is that the City must maintain a level playing field among all telecommunications providers. This is mandated under the federal Telecommunications Act of 1996. Having a city revenue source be dependent on the success of one telecommunications firm over its competitors would, at a minimum, appear to violate the spirit of the level playing field concept. This issue is also highlighted in Pacific Bell's letter of opposition to the project (Attachment C – Response to Issues Raised by Pacific Bell from Telecommunications Attorney).

A second concern is the viability of the proposal itself. Nanospace is a relatively young company with a short track record in an industry that is seeing cataclysmic changes. While its senior management team is impressive, many of these young companies do not survive or cannot live up to their commitments as recently seen in the case of the City of Anaheim in which the City and FirstWorld Communications (formerly SpectraNet) are now in litigation over a similar arrangement. A last concern, mentioned earlier, is the non-speculative and risk-averse nature of the project that was approved by the City Council. For these reasons, staff overwhelmingly rated GST Telecom, Inc.'s proposal as the most responsive to the City's needs and the project's goals.

GST Telecom, Inc., a full service competitive telephone company submitted the highest rated proposal due to the accelerated repayment of the City's investment, the historic and financial stability of the company, and its proposed use of the fiber. In addition, GST Telecom, Inc. proposed escalating lease payments independent of any speculative or performance basis.

.

GST Telecom, Inc. – Company Profile

GST was organized in 1994 when it began developing competitive local exchange carrier (CLEC) facility-based networks. It is publicly traded on the NASDAQ.

Scope of Operations

GST has a networks in 48 US cities in eight States, including California. It owns and controls 1,300 long haul route miles today and is in the process of constructing 1,800 additional miles by the end of 1999. The long haul routes will connect its local market operations. The Company believes the economics of its network will give it an advantage in the market place, especially in the Western US region.

Its local market services are primarily business focused and include switched services, Internet connection, high speed data transport, digital private line and long distance. GST owns and leases its facilities, but has a strategy to move services "on-net" as its facilities are developed. It uses a success basis approach to its market expansion. As new areas in a community develop a threshold of demand that justifies plant extension, GST will build to that market sector. This approach is common to many CLEC's operating in the market today.

Based on its regional strategy, staff anticipates GST will focus on medium to large customers who will have a regional or wider presence, thereby demanding the long haul services of GST. The company indicates a willingness to sell, lease or swap capacity with other carriers. This approach to facilities-based network development is helpful in the broad development of infrastructure of the GST's market cities, including Pasadena.

In fact, GST is no stranger to Pasadena. GST has constructed infrastructure in Pasadena over the past few years, and currently serves local customers such as Earthlink and JPL.

Staff anticipates that GST's existing local infrastructure will allow the company to begin using the City fiber to provide expanded service very quickly.

GST is also a member of a Department of Defense consortia developing advanced networking technologies. The company provides the San Francisco to San Diego high-speed link for the consortia. Last month, JPL became the first organization to test research applications on the high speed National Transparent Optical Network.

GST has assets of approximately $1.2 billion, approximately equal to its total long term debt. Over the past four years, the company has incurred public and private debt to build its network and base of operations. In 1998 it spent approximately $248 million on capital improvements, mostly related to network extensions in its local markets and for its long haul backbone. A similar amount is planned for 1999.

Revenues

Total revenue for the three month and six month periods ended June 30, 1999 increased $32.4 million, or 82.0%, and $58.0 million, or 83.4%, respectively, over the comparable three and six month periods ended June 30, 1998. The increase in revenues resulted in large part from increased local, long distance, data, and Internet services revenue as the Company launched new products and entered new markets.

Operating Expenses

Total operating expenses for the three and six month periods ended June 30, 1999 increased $23.9 million, or 36.2%, and $53.4 million, or 44.1%, respectively, over the comparable three and six month periods ended June 30, 1998.

Net Income/Loss

Net loss for the three month period ended June 30, 1999 decreased $1.0 million, or 2.1%, to $44.6 million from $45.6 million for the three months ended June 30, 1998. Net loss for the six month period ended June 30, 1999 increased $71.7 million, or 275.0%, to $97.8 million from $26.1 million for the six month period ended June 30, 1998.

Liquidity and Capital Resources

The Company has incurred significant operating and net losses as a result of the development and operation of its networks. The Company expects that such losses will continue as the Company emphasizes the development, construction and expansion of its networks and builds its customer base. Cash provided by the Company's operations will not be sufficient to fund the expansion of its networks, longhaul fiber optic facilities and services. At June 30, 1999, the Company had approximately $1,160.4 million of indebtedness outstanding.

At June 30, 1999, the Company had cash, cash equivalents, and investments, including restricted investments, of approximately $232.8 million. The Company believes that such amounts will be sufficient to fund the Company's operations through the end of Fiscal 1999. Divestitures and other management actions may prolong capital availability into the fiscal year 2000 and beyond. Thereafter, the Company expects to require additional financing.

Summary From 1998 SEC Form 10K

SELECTED FINANCIAL INFORMATION					
	1994	1995	1996	1997	1998
Total Revenue (Thousands)	6,001	18,681	41,229	119,008	163,317
Net Loss (Thousands)	(3,491)	(11,315)	(60,378)	(130,297)	(154,690)
Capital Expenditures (Thousands)	1,486	33,922	97,561	214,359	247,683
Cash & Cash Equivalents 12/31	4,219	6,204	61,343	199,053	86,070

Comparison to Similar Competitive Local Exchange Carriers

The City's consultant has analyzed GST's performance relative to similar CLECs, including Startec, e.spire, PLD Telkom, Nextlink Communications, Total-Tel and Viatel. In 1998, none of the companies posted a positive net income, a positive earnings per share or a positive price/earnings ratio, which is consistent with the capital intensive nature of the young CLEC industry.

Of the seven companies, GST had the highest revenue figure and the second highest operating loss. GST has the second best debt service coverage ratio, which was 0.6. The best ratio was posted by PLD Telkom -- 0.8. An investment grade coverage ratio is generally considered to be 2.0, which is one indication that these young companies are not being judged on standard financial tools because several of them, including Nextlink and GST have found significant support for their high yield debt offerings in the financial markets.

Terms of the Proposal

Staff and GST Telecom, Inc. have agreed on the following key terms of the lease agreement:

1. GST Telecom, Inc. will pay the City $1,000,000 upon execution of the contract and an additional $1,000,000 on September 1, 2000.

2. GST Telecom, Inc. will pay the City its third annual lease payment of $100,000 on September 1, 2001. This annual payment will increase by 5% every year for the remainder of the contract term.
3. The term of the contract is for twenty years with provisions for a ten-year extension (with terms subject to agreement of both parties at that time.
4. Any extensions of the backbone to customer facilities constructed by the City revert to the City at the end of the lease or in case of default.
5. The Water & Power Department will provide construction and maintenance services to GST Telecom, Inc. at a cost to be agreed between the parties.

FISCAL IMPACT

The proposed lease agreement will generate revenues of $4,813,238 over its twenty-year life that is calculated to have a net present value of $3,319,006. For the current fiscal year (FY2000), the proposed lease agreement will generate $1,000,000 in revenue that will be applied to the project's Capital Reserve loan. In fiscal year 2001 the balance of the loan and interest will be fully repaid. The project will begin a positive cashflow of $264,000 the following year. All revenues will be deposited into the City's Telecommunications Fund. Detail information on the project's financing and revenue projections is presented in Attachments E & F.

As mentioned in the Executive Summary, there are other indirect financial benefits to this lease agreement such as the avoidance of an $800,000 expense to the Water & Power Department for construction of its own telecommunications facilities, enhanced service delivery and lowered costs for Water & Power Department operations reduced costs for the City's telecommunications needs and the overall benefit of lower rates to businesses resulting from competition. Lastly, this lease also provides the City with broadband capabilities that many high-tech businesses require for their operations and should be a strategic economic tool for the attraction and retention of high-tech businesses.

Respectfully submitted,

CYNTHIA J. KURTZ
City Manager

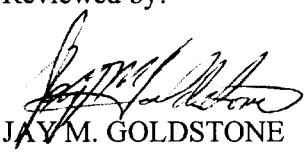
Prepared by:

LORI SANDOVAL
Technical Planning Manager

Approved by:

ROBERT K. PERSON
Assistant to the City Manager

Reviewed by:



JAY M. GOLDSTONE
Director of Finance
Department

RUFUS HIGHTOWER
General Manager, Water & Power