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MEMORANDUM

DATE: October 2, 2017
TO: Eileen Blackwood, Esq.
FROM: Ralphine O'Rourke, Esq.
Primmer Piper Eggleston & Cramer PC (PPEC)
RE: Carried Equity Interest in New Burlington Telecom Enterprise and Blue Water Approval Rights

You have asked us to provide our thoughts with respect to the City of Burlington's (the "City") allocation of all, or a portion of, the net sale proceeds from the sale of Burlington Telecom ("BT") to acquire an equity interest in the new BT enterprise ("New BT") upon the sale of the assets of BT by Blue Water Holdings, LLC ("Blue Water") and the City to a third party.

You have also asked us to consider what approval rights Blue Water has in connection with the sale of BT.

1. Burlington Telecom Advisory Board ("BTAB") Findings with Respect to Carried Interest

There has been considerable discussion at the City level, with potential buyers and in the public at large suggesting the desirability of some sort of ongoing equity ownership position in New BT. BTAB specifically recommended that the City maintain a "meaningful interest in BT that enables financial recovery over the next decades." In addition, it stated in its recommendations that continued ownership provides "the indirect benefits of maintaining a strong telecom system, recognizing the potential of BT's fiber optic infrastructure to enable sustainable economic growth and job creation in an increasingly tech centric economy."

While the City will always have a community and political stake in the financial and operational health of New BT, the question at hand is whether having an ownership stake is permissible under the City Charter and, if so, what other requirements must be met to obtain such a stake.

2. Summary Legal Findings

Our summary findings are as follows: (1) the City Charter expressly allows the City to establish a joint venture or other business relationship to provide telecommunications services; (2) upon the City's exercising its authority to establish such a venture, it must be approved by the Vermont Public Utility Commission ("PUC"); (3) the PUC, in issuing a certificate of public good ("CPG") for such a joint venture, must ensure that any losses from the business are not borne by the City's taxpayers, and in the event of complete abandonment or curtailment, that the costs associated with investment in the telecommunication network are not borne by the City's taxpayers; (4) in order to obtain a CPG to that effect, the City (and the other owner of New BT) will need to be able to demonstrate that *no losses* will be borne by City taxpayers as a result of the joint venture; (5) the PUC has numerous and substantial other standards that it considers in connection with issuing a CPG, which include considerations relating to the management experience and financial stability of the petitioner and (6) if the petitioner for the CPG is a first-time operator, Blue Water has the right to "reasonably determine" if such first-time operator would be able to timely obtain a CPG from PUC.

3. City Charter Provisions

Section 449 of the City's Charter grants the City the power to:

establish a joint venture or any other business relationship with one or more third parties to provide telecommunications or cable television services within or without the corporate limits of the City; provided that before such joint venture or business relationship may sell telecommunications or cable television services, *it shall obtain whatever regulatory approvals are necessary*, and shall pay all taxes, franchise fees, and similar charges assessed by the City on an incumbent.

24 V.S.A. App. § 3-449 (emphasis added).

Under Section 438(c)(1) of the City's Charter, before issuing a CPG, the Public Utility Commission shall:

ensure that any and all losses from these businesses, and, in the event these businesses are abandoned or curtailed, any and all costs associated with investment in cable television, fiber optic, and telecommunications network and telecommunications business-related facilities, are borne by the investors in such business, and in *no event are borne by the City's taxpayers*, the State of Vermont, or are recovered in rates from electric ratepayers.

24 V.S.A. App. § 3-438(c)(1).

4. PSB Orders with respect to BT and Burlington Charter Provisions

In the original CPG for BT issued by the PUC on September 13, 2005 to operate a cable television system in the City of Burlington, the PUC explained that the purpose of the Charter requirement is to “safeguard against the imposition of costs and losses of the city’s commercial cable/telecommunications enterprise upon taxpayers, electric ratepayers and the State of Vermont’ in accordance with the legislative directive imposed on the Board under the city charter provision.” 2005 WL 2331507 (the “2005 CPG”). Later, and in connection with determining that BT violated its CPG, the PUC explained that the “charter provision appears to anticipate that the significant costs of investment in the network and facilities of the business would be financed by private investors and is directed at ensuring that taxpayers do not ultimately bear the cost of investment funded by private investors if the enterprise should fail.” 2010 WL 4052140 (the “2010 Order”). Further, the 2010 Order stated that the legislative intent of Section 438 was “to avoid having the residents of the City saddled with a debt resulting from a failed venture.” In discussing the PUC’s interpretation of the City Charter provision, the 2010 Order stated that the “sources of funds to satisfy the financing needs and obligations of Burlington Telecom were limited to private financing and Burlington Telecom revenues.”

The City now proposes to use some or all of the sales proceeds from the transaction to reinvest in New BT and it has assumed that those sale proceeds are not the City’s general revenue funds, but rather BT revenues that are part of BT’s accumulated retained earnings and held in the BT Revenue Fund.¹ The purpose of investing in New BT is two-fold: (1) to continue to enable the City possible additional financial recovery and (2) to allow for the exercise of some local governance through its minority interest. It is unclear, however, whether the PUC would consider those sale proceeds appropriate for an at-risk equity investment. While the inherent nature of an equity investment is that it is subject to total loss of its value, it does not saddle the City residents with any new debt (because sale proceeds are only what would be used) and the City will not be liable for New BT’s own debt. The pro forma financial plans for New BT from each bidder provide that all operating expenses will be funded by New BT revenues and any capital expansion will be funded either solely by revenue or by a combination of revenue and capital contribution of the majority owner. The bidders’ offers vary substantially in their contribution amounts.

While such an equity investment is not a new debt responsibility, it is possible under a business failure scenario that the City could lose the value of its entire equity investment. Without other measures of protection in place, it is hard to see how the City’s taxpayers would not suffer a loss of the value of such an investment in the event of business failure. However, there are a number

¹ The \$16.9 million of advances from the City’s cash pool have been restructured and no longer appear as a non-current liability of the BT Revenue Fund or as a deficit of the City. This memo assumes the net proceeds from the sale would not be considered general revenue funds and would be available without any lien, encumbrance, charge or third party beneficial interest.

of options that could protect the value of such an investment upon a business failure or other strategies to avoid investment risk altogether.²

During the CPG process, the PUC will weigh whether the reinvestment will promote the public good. The City's response to that inquiry should allow for the possibility of (i) taking the proceeds fully in cash or, alternatively, (ii) demonstrating that the City's carried interest provides for further financial recovery without the attendant risk normally associated with equity investment and further that (iii) the City's investment creates a stronger New BT more likely to provide other benefits to taxpayers that are consistent with BTAB recommendations. Obviously, the stronger the proposed majority owner is, the more likely the minority investment will pass PUC approval. With some of the investment protections in place, it is feasible that the PUC could conclude that a minority investment by the City is in the public good.

5. PSB Criteria for issuing a CPG

In addition to the finding that the PUC must make in connection with Section 438 of the City Charter discussed above, it also must approve the transaction considering all of the other PUC criteria. The PUC issued the 2005 CPG to the City under Sections 231 and 503. A person desiring to own or operate a business over which the PUC has jurisdiction must obtain a CPG pursuant to Section 231(a). Other applicable sections of Title 30 also require prior approval of the PUC and the issuance of a CPG. In determining whether to issue a CPG, the PUC must find that it will promote the general good of the State of Vermont. Under Section 231, the PUC's finding has generally been guided by its assessment of the following criteria: (1) technical expertise, (2) adequate service, (3) facility maintenance, (4) balance between customer and shareholder interests, (5) financial stability, (6) company's ability to obtain financing, (7) business reputation, and (8) customer relations. *Joint Petition of Consolidated Communications Holdings, Inc. 2017 WL 2844182 at 8*. Under Section 504 (CPG for Cable Television Systems) there are five additional considerations related to cable television systems. In addition, the PUC will also use the EMCO criteria in determining whether to approve or reject a petition requesting a certificate of public good for a cable system service area.³

² For example, the City should consider requiring the following protections from the majority owner:

- (i) Put Right—a right of the City to require the majority owner of New BT to repurchase the City's equity interest at its election at least for the value originally invested (and possibly some appreciation) for some period of years;
- (ii) Escrow portion of put purchase price;
- (iii) Capital Commitment by the majority owner of New BT to fund all operations and capital projects with no right to call for additional capital contribution from the City;
- (iv) Provide for ongoing financial reporting and auditing rights to verify financial status of New BT;
- (v) Providing majority owner to commit to conservative budget plan and other financial controls;
- (vi) Provide for Option to Purchase Equity at future date—to allow for more consideration by City Council on merits of equity investment and use of sale proceeds;
- (vii) Limiting the amount of the equity investment and investing the remaining cash conservatively to hedge all or a portion of the equity investment;
- (viii) Obtain some contractual protections consistent with minority ownership without investing cash.

Recently in connection with its issuance of a CPG for the merger of FairPoint Communications (“Fairpoint”) into Consolidated Communications (“Consolidated”), the PUC discussed Sections 107, 108, 109 and 231 and required Consolidated Communications (the majority owner post transaction) to carry the burden of proof on the question of whether the new company was competent to own and operate the assets and services at issue. The PUC assessed this by (1) detailed analysis of managerial competence, (2) technical competence and (3) business reputation. In addition, Consolidated had to show whether it was financially sound. This was tested by whether borrowing to buy stock was required; the plan for ongoing debt financing; various financial ratio analyses and the availability of access to additional capital, credit ratings, cash flow analysis and other tests. See *Joint Petition of Consolidated Communications Holdings, Inc.* 2017 WL 2844182 at 11-12. The management competence was analyzed by looking at industry experience by senior management and technical competence was measured by length of company existence and operational experience. The PUC reviewed the applicant’s business reputation. This PUC decision also looked at terms of service, adequacy of service quality and customer service. To measure these points, the PUC looked at regulatory service quality reports, data analytics and the plan for customer service. *Id.* at 13-19. The PUC specifically noted in connection with its approval that “of significant importance in our conclusion that the transaction will promote the public good are the capital investment commitments that Consolidated has agreed to [make].” *Id.* at 21.

As a regulatory matter, we note that BT’s status as a telecommunications provider is significantly different from FairPoint’s status. Under the authority of 30 V.S.A. § 227c (Nondominant Carriers), the PUC in 2006 adopted a new rule that gives relaxed regulatory treatment to so-called “nondominant carriers,” meaning carriers that do not exercise sufficient market power to set prices in their service territories. For regulatory purposes, FairPoint is an “incumbent local exchange carrier” and so is automatically classified as a “dominant carrier” in Rule 7.505(B)(1). By contrast, BT is a “competitive local exchange carrier” and so is automatically classified as a “nondominant carrier”. As a nondominant carrier, Burlington Telecom is exempted by Rule 7.505(B) from the regulations usually imposed by 30 V.S.A. §§ 104, 105, 107, 108, 109 and 311. This includes the requirements to obtain prior PUC approval

³Rule 8.214—the criteria known as the EMCO criteria:

- (1) financial soundness and stability, both of the applicant generally and the particular proposal;
- (2) the present proposed service offerings to customers, including the number of channels and the ability and capacity of the system to offer additional varied services in the future, and the ability to provide public access;
- (3) commitment to a construction and in-service schedule;
- (4) experience and ability of the applicant to run and manage a cable tv system;
- (5) rates proposed to be charged to customers;
- (6) consumer policies, particularly re: complaints and problems;
- (7) availability of service to maximum number of residences;
- (8) quality of the engineering and materials used in the system;
- (9) logical fit with neighboring systems.

for mergers, sales and financings. However, Rule 7.500 does not exempt nondominant carriers from the regulatory requirements of 30 V.S.A. § 231, governing Certificates of Public Good.

Thus if BT was just a telecommunications provider (rather than both a telecommunications provider and a cable television system), most of the regulatory requirements cited in the memo would not apply to this transaction. Nevertheless, BT has drawn substantial scrutiny from the PUC in the past over compliance with its CPGs. Consequently, the City should expect that the PUC will use its §§ 231 and 503 powers (along with the full regulatory jurisdiction it has over cable television systems under 30 V.S.A. § 502(a)) to give a thorough review to the proposed transaction.

PUC approval is required for the sale of BT, all decisions about which entity is the best buyer for the City must be measured by not only all of the BTAB considerations, but also against the PUC standards. In a far simpler summary, this process will favor the experienced and well capitalized provider and the less experienced and undercapitalized provider will face higher hurdles.

6. *Provisions of the Management and Sale Agreement (the "MSA") with respect to Blue Water Approval*

Pursuant to the terms of the MSA, the City has until December 31, 2018 to find a "Qualified Purchaser" to purchase the assets of BT and the City may direct a sale to such Qualified Purchaser during that timeframe.⁴ Such a sale is subject to Blue Water's consent, not to be unreasonably withheld or delayed and, under the MSA, Blue Water may consent in advance to a sales price or to a particular purchaser. Blue Water has provided advance consent provided the sales price is over a certain threshold. However, if the selected purchaser is a first-time operator, Blue Water has the right to reasonably determine that such purchaser is likely to timely obtain a certificate of public good from the PUC. Therefore, any first-time operator will have an additional hurdle to meet.

⁴ Direction of sale is a different schedule from allocation of proceeds; to maximize proceeds to the City, it must execute contract by Dec. 31, 2017.