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Connect America Fund Phase II Opportunity Analysis

By Fox Management Advisors

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In early January, the Federal Communications Commission (Commission) put out a [draft Public Notice](#) outlining the procedures for the Connect America Fund (CAF) Phase II auctions. The auctions will provide nearly \$200 million annually over the next ten years to provide voice and broadband services in unserved high cost areas. The Commission previously released the final list of census blocks eligible for support in the Auction, which presents some significant opportunities for companies willing and able to participate.

Anticipated Schedule:

According to the draft Public Notice, the deadline to submit a short-form application to participate in the auction will be March 30, 2018, and the auction will begin on July 24, 2018. Prospective bidders will also need to know what the final maximum support amounts will be per census block, so that they can prepare their bids and obtain necessary financial documents, including the required Letter of Credit (more on this below).

Opportunities and Challenges:

The CAF II Auction presents some significant opportunities for companies, but not without some issues that require thoughtful consideration. The amount of potential support funding varies by state and census block, but can be quite significant in many cases (there is over \$50M in available funding in some states). Furthermore, for companies who already have operations near (or within) the census blocks which will be made available for support funding, this opens up opportunities for expansion into areas in which companies may already have interest or long-term plans for expansion. In those cases, this auction is both ‘good news and bad news’. The good news is that it presents very real opportunities for existing operations to use support funding to accelerate current expansion plans. On the other hand, it also presents the same opportunities for competitors to open operations adjacent to incumbent operations. This could result in competition not only next door, but potentially in your back yard!

Other challenges include meeting the Commission’s bidding eligibility requirements, which have to be presented in a company’s short form application. The Commission

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requires all applicants to provide sufficient basic information that will enable the Commission to review each application to assess the applicant's eligibility, BEFORE the entity commits the time and resources necessary to participate in the auction. This information includes, but is not limited to, certification that the applicant has provided voice, broadband and/or electric distribution or transmission services for at least two years (note: the fact that the Commission specifically mentions 'electric distribution' presents a very real threat to existing telco ILEC and CLEC operations). Secondly, the Commission requires applicants to submit audited financial statements for the prior fiscal year with the short form application. Finally, the Commission requires interested bidder to identify in the short form application whether or not they have been designated as an ETC in the areas they intend to bid.

In addition to the short-form application requirements, if a company is a winning bidder, prior to receiving funding, in the long-form application filing, they will be required to submit a letter from a qualifying bank committing to issue a letter of credit (LOC) sufficient to cover the amount of support funding to be awarded as a result of the Phase II auction. A sufficient LOC enabling the Commission to immediately reclaim support funds in the event that a winning applicant does not fulfill the buildout requirements must be in place before the Commission will release any funding.

Letters of Credit are challenging financial instruments. One bank CEO told me that they would rather provide companies loans than issue letters of credit. Furthermore, LOCs are not cheap financial instruments. In essence, the bank is guaranteeing these funds are available to the Commission in the case of performance default. Therefore, banks will require hard asset collateral. The same bank CEO told me that they would like for company deposit cash, in the form of CDs, to be held by the bank for the duration of the LOC. The banks will also charge both initial and annual fees for the LOC, usually much higher than any interest the company will earn from the CDs. Thus, you are effectively paying the bank to hold your money in the CDs. However, since the LOC is a non-negotiable requirement established by the Commission for the Phase II auction, what are your options?

In the May 2016 Order, the Commission did relax some prior rules for a qualifying LOC. First, they will release the LOC once a company has certified that it has completed all buildout performance requirements. This will provide a major incentive for companies to complete the buildout as quickly as possible and, therefore, reduce the costs for the LOC. The second relaxation from prior rules is that the Commission originally required that companies use large national banks with very large assets. This limited the pool of eligible banks to the 100 largest US banks, most of which small rural companies have never dealt with and, therefore, had no existing relationship. Two significant exceptions are CoBank and CFC since both financial institutions meet other requirements sufficient to place them in the top 100 banks in the USA with a qualified rating. However, in the Order, the Commission did revise these requirements to be based upon qualifying bank ratings, rather than simply size. This change effectively increased the pool of eligible banks from 100 to approximately 3600, increasing the likelihood that rural companies interested in

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participating in the auction may already have an existing working relationship with a qualifying bank.

Mountains of Data, Limited Time:

As you can imagine, the amount of data which needs evaluating prior to a company deciding to participate (or not) in this auction is daunting. This short memo only scratches the surface. Companies also need to carefully consider all of the requirements (both before and after the auction), many of which are not obvious or clearly stated in the Order. And, once you've won the bid, the Commission will not accept, 'Gosh, I didn't quite understand that requirement before we bid!' You also have very little time; 3-4 months! Finally, you need to start working on the LOC immediately (if not sooner), as this could be one of the more challenging requirements to meet for many small rural companies.

Next Steps: Consider Your Options

FMA partners and associates have dozens of years of experience working in all areas of the rural telecom industry. Our experience includes, but is not limited to, operational management (up to and including GM and CEO), engineering, regulatory management (state and federal), financial management, policy and strategic planning. We have the ability to help you sift through all of the pertinent information and data and make decisions in time to participate in the auction, if that is what you want to do. We can also help with the nitty gritty work associated with the short-form and long-form applications, including helping you to obtain a LOC from a qualifying bank.

If you have questions or would like further information, please contact me at your convenience:

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