

# **Procurement And Financing Of KentuckyWired**

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**Program Review and  
Investigations Committee**

**November 22, 2019**

# KentuckyWired Background

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- Middle mile networks connect smaller networks and internet service providers to the internet
- Initially a regional middle mile concept in eastern Kentucky
- SOAR (Shaping Our Appalachian Region) recommended investment in fiber infrastructure
- Governor Steve Beshear and US Representative Hal Rogers announced statewide fiber network

# KentuckyWired Background

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- No reliable information on existing middle mile
- Economic alternative to private sector middle-mile broadband
  - Increase competition and internet speed
  - Lower costs
- High-speed broadband is an expected public utility like electricity
- Last mile is a major expense
- It is unknown to what extent KentuckyWired will enable last mile expansion

# KentuckyWired Background

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- Columbia Telecommunications Corporation became consultant for KentuckyWired
- 2014-2016 governor's budget – \$100 million
- General Assembly – \$70 million
  - \$20 million in federal funding
  - \$30 million in state bonds
  - \$20 million from third-party financing

# Estimated Cost

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- Request for information issued April 2014
- Estimated cost of KentuckyWired was \$410 million
- Columbia advised using a public-private-partnership (P3)

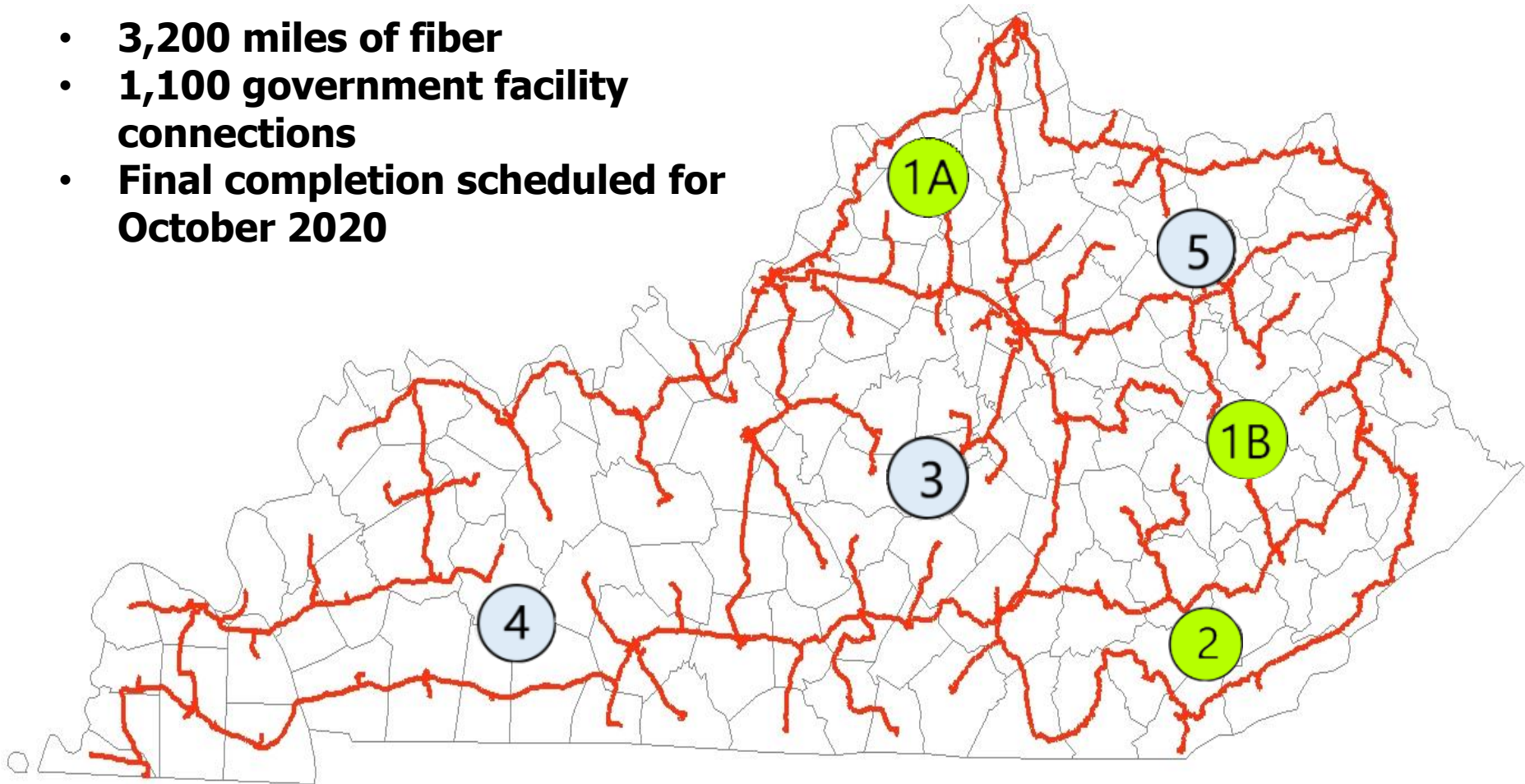
# Public-Private-Partnership

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- Macquarie Infrastructure Developments awarded P3 contract
  - Feasibility of finance, design, construction, operation, maintenance, and network refresh
- August 2015 – Kentucky Communications Network Authority (KCNA)
- New contracts in September 2015
- Construction cost of \$274.8 million
- Final completion is scheduled for October 2020

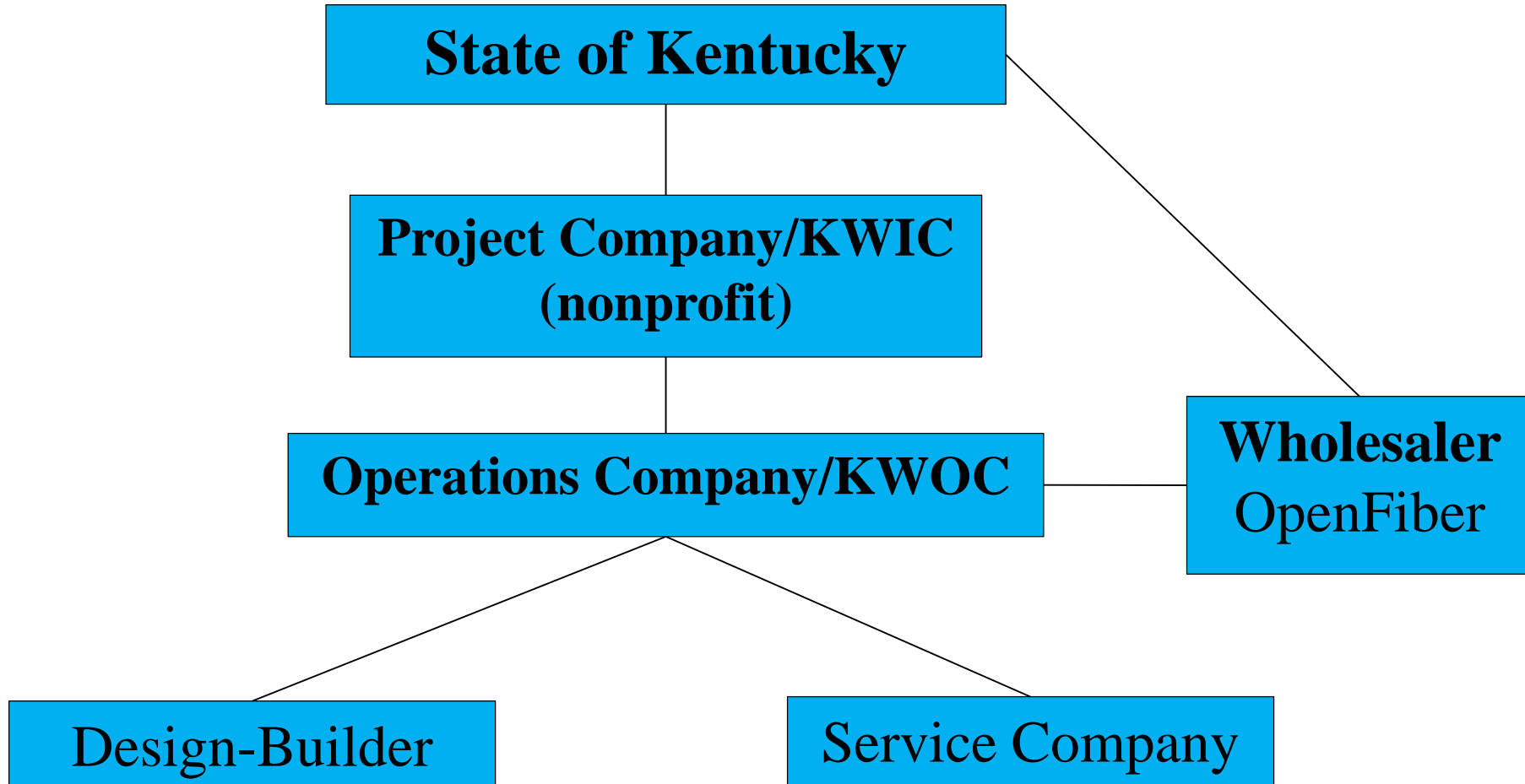
# Network Development

- **3,200 miles of fiber**
- **1,100 government facility connections**
- **Final completion scheduled for October 2020**



# KentuckyWired Project Structure

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# Financing Overview

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- \$311.4 million in bond funds went to Project Company
  - Total debt including interest was \$646 million
- Macquarie contributed \$6.5 million
- Common financing with P3s
- Availability payments used to pay borrowing and other costs

# Delays And Payments

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- Claims of supervening events caused delays and extra costs
- Settlement agreed December 2018
  - Estimated claims of \$191 million negotiated to \$101 million
  - New completion date October 2020
- New borrowing of \$110 million authorized

# Wholesale Revenues

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- Network designed with extra fiber to lease
- Macquarie projected more than \$1 billion wholesale revenue for state
  - Revenue projection is uncertain
  - Revenue could cover shortfalls and extra expenses
- Wholesale revenue might be shared with the Center for Rural Development (CRD)

# Oversight

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- Executive and legislative oversight
- Accepted procedures supported the actions during procurement and execution of KentuckyWired
- Commitment of state appropriations to repay debt without sufficient funds

# Executive Oversight

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- The Finance and Administration Cabinet (Finance) usually follows written policies and procedures
- The secretary's office may authorize deviation from policies and procedures
  - Most of the irregularities of the procurement were authorized in this way

# Procurement Irregularities

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- Construction handled by Procurement Services
- Unusually broad contract changes
- Buyer involvement
  - Lack of buyer involvement in negotiations
  - Buyer unaware of assignment of contract
  - Signed off by secretary and others

# Irregularities With Related Contracts

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- Related contracts not recorded in accounting system until 2019
- CRD MOA (2015) attached Feb. 2019 as subsidiary agreement, no legislative review
- CRD lease agreement (2019) recorded 2 months after execution, no legislative review
- Six construction contracts not recorded at all

# Legislative Oversight

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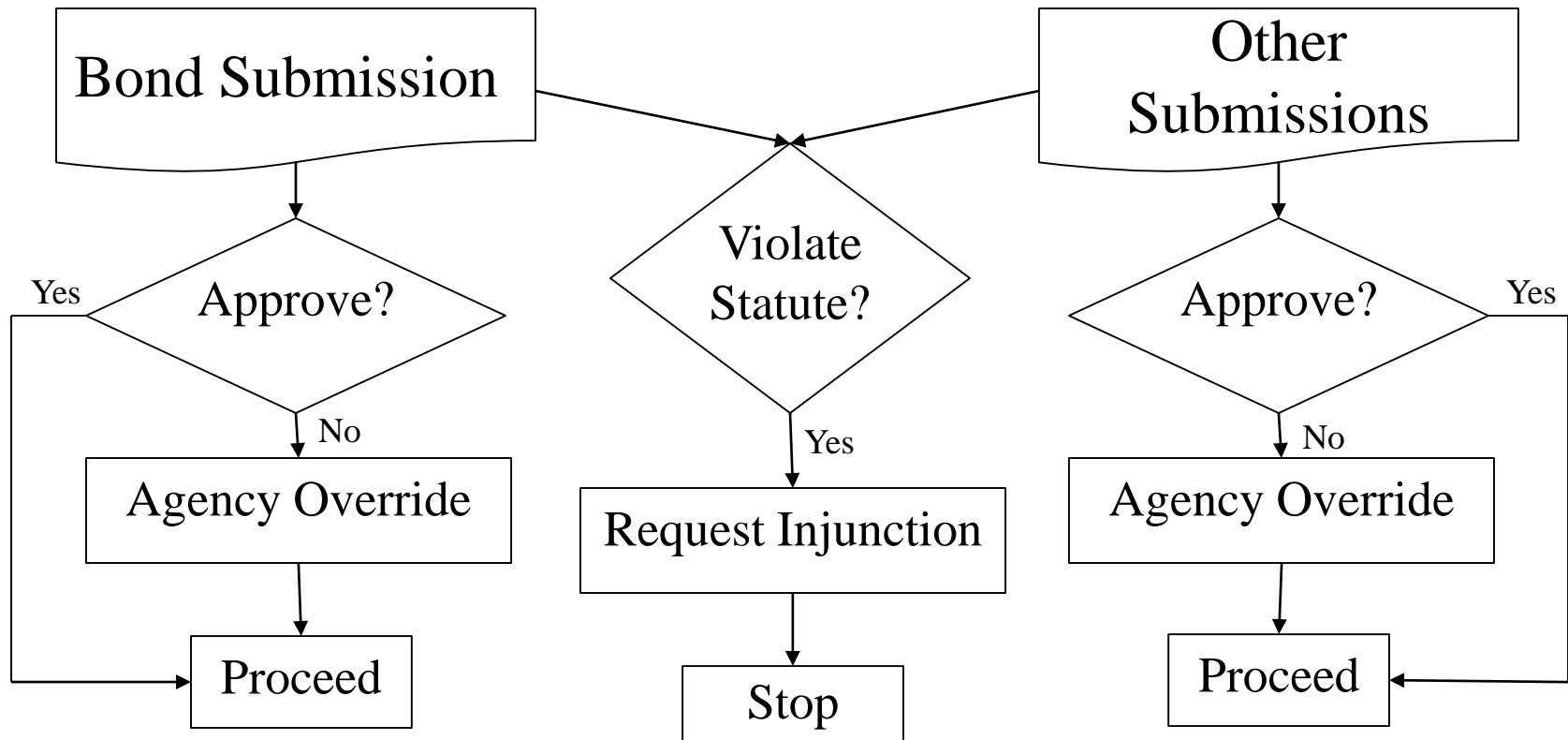
- Government Contract Review Committee had no direct role in KentuckyWired
- Capital Projects and Bond Oversight Committee oversees such projects



# Capital Projects And Bond Oversight Process

## Bond Oversight (KRS 45.810)

## Other Oversight (KRS 45.800)



# Bond Issue Oversight

## July 2015

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- Kentucky Economic Development Finance Authority submitted bond issue
- Committee canceled meeting—no quorum
- Finance secretary authorized proceeding
- Opportunity to request injunction in August before bond sale
- No knowledge of statutory grounds for injunction

# Fund Transfer Oversight

## September 2015

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- Usual procedure after bond sale
- Finance requested “appropriation increase” for amount of bonds
- Committee canceled meeting—no quorum
- Finance secretary authorized proceeding
- No knowledge of statutory grounds for injunction

# Risks And Supervening Events

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- Parties to a contract negotiate risks
- P3s often reduce risks to government
- Availability payments shifted risk to state
- Supervening events (SE) excuse inability to meet objectives
- SEs can result in costs and delays

# KentuckyWired Risks

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- State reportedly took risk to lower cost
- Costs and delays primarily from
  - Pole attachments
  - Easements
  - Rights-of-way

# Early Termination Option

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- Milestones before September 2015 for early termination
  - Cost of less than \$7 million
- After September 3, 2015, cost would have exceeded \$300 million

# Availability Payments

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- Sized to cover debt service, private equity return, and ongoing operational costs
- Subject to annual escalations based on fixed and variable factors
- Program Review staff estimate that availability payments will total approximately \$1.2 billion over the course of the contract term

# Funding Of Availability Payments

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- The state intended to divert existing state agency internet spending to fund the availability payments
- The availability payments would have to match the existing internet spend of government sites connecting to the network



# Projected Customer Spending As Of 9/3/2015

<b>Source</b>	<b>Monthly Spending (In Millions)</b>	<b>% Of Total</b>
K-12 spending and savings*	\$1.04	43.44%
State agencies	0.72	30.17
Universities/KCTCS	0.39	16.29
Judicial Branch	0.16	6.89
Bulk Internet Savings*	0.05	2.05
Other Savings	0.03	1.15
<b>Total</b>	<b>\$2.39</b>	<b>100.00%</b>

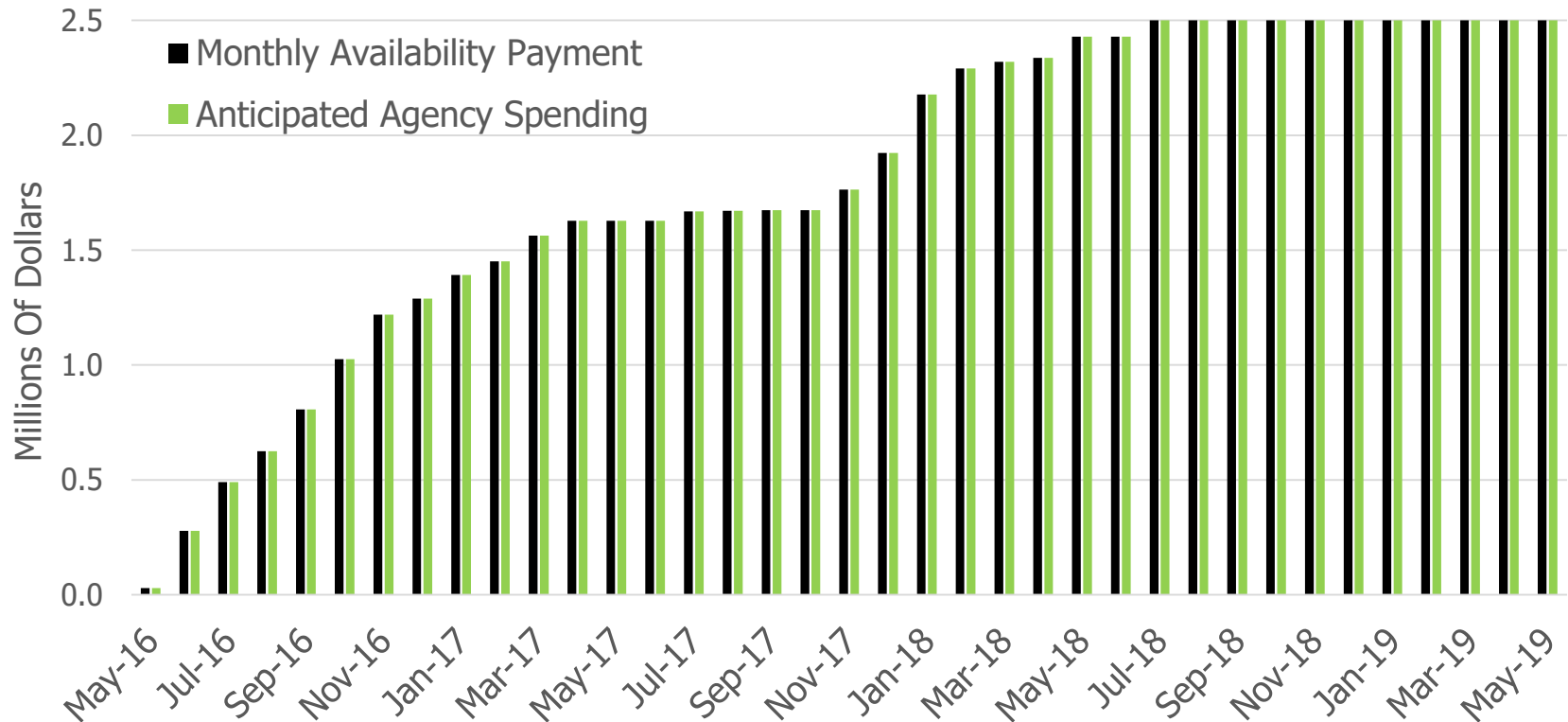
\*Bulk Internet savings attributed to KDE were added to the K-12 line and removed from the Bulk Internet Savings line.

# Maximum Availability Payment

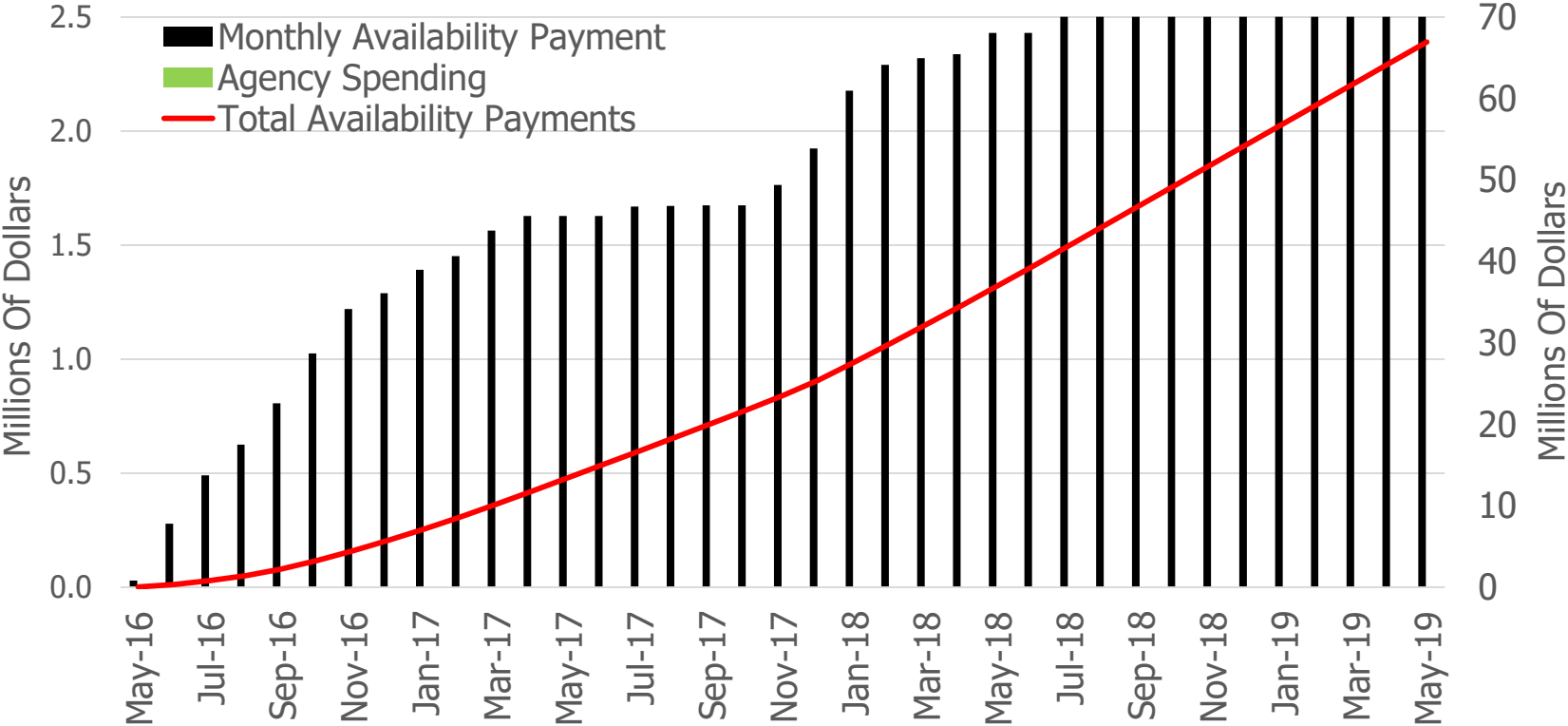
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- Baseline maximum availability payment set at nearly \$2.4 million per month
- State reduced availability payments by:
  - Primarily using tax-exempt financing
  - Eliminating a reserve for system refreshes in the availability payments
  - Lengthening the project's term to 30 years
  - Including a milestone payment

# Availability Payment Funding Plan Through May 2019



# Availability Payments Accrued Through May 2019



# Funding Shortfalls

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- Availability payments exceed network spending
  - Loss of K-12 spending
  - Market price projections
- Expenses not covered by availability payments

# Loss of K-12 Spending

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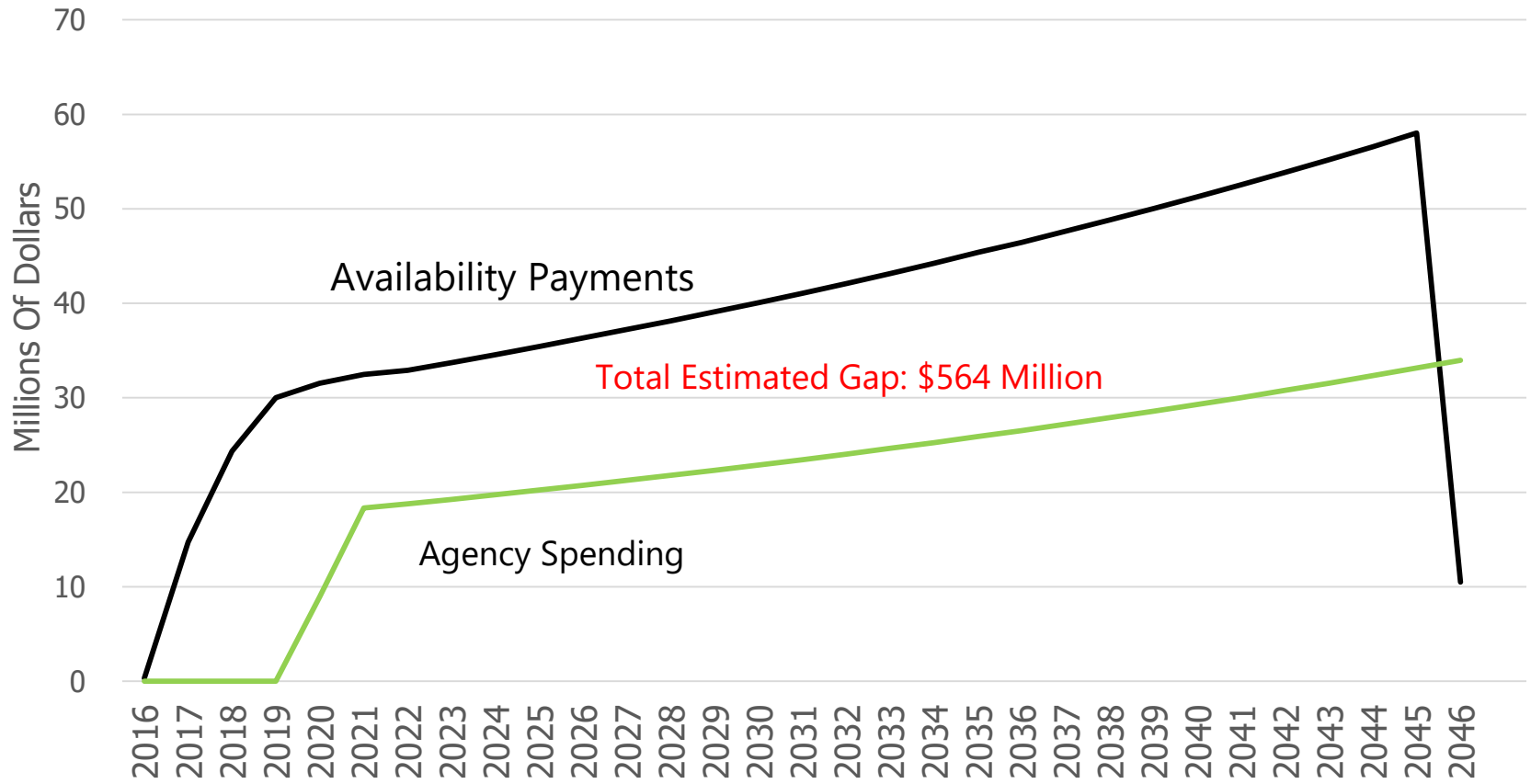
- E-rate program provides school with rebates of up to 90 percent
- E-rate eligibility requires that services be procured through a competitive solicitation
- Relying on K-12 spending to fund a large share of the state's payment obligation was questionable

# Market Projections

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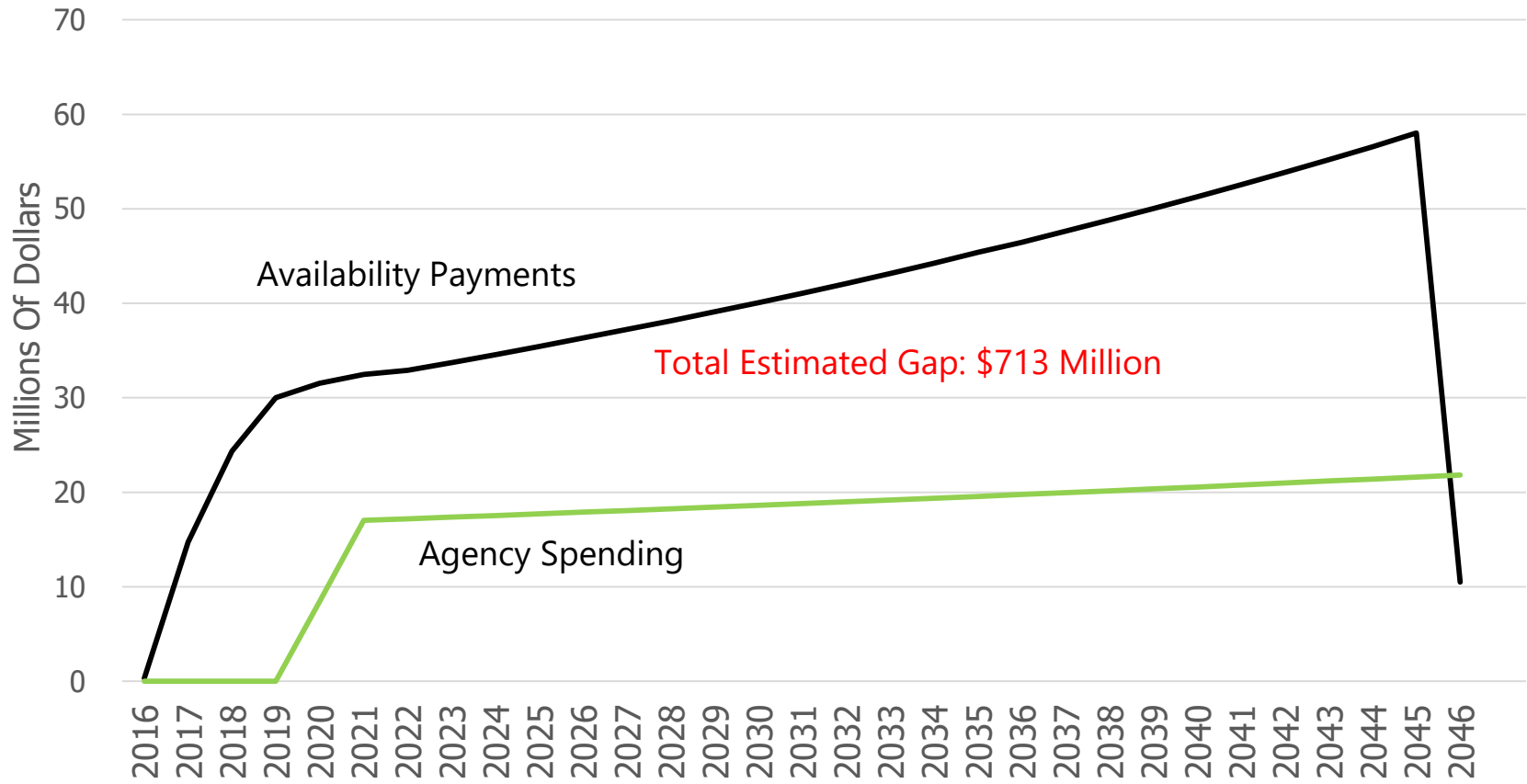
- State assumed steady increases in market price and demand for broadband services
- Broadband market prices have decreased by 40 percent in recent years in Kentucky
- Bureau of Labor Statistics shows a 0.1 percent increase in internet and information services prices over the past year

# Gap In Availability Payments Without K-12 Revenues Assuming 2.5 Percent Annual Increase





# Gap In Availability Payments Without K-12 Revenues Assuming 1 Percent Annual Increase In Customer Spending



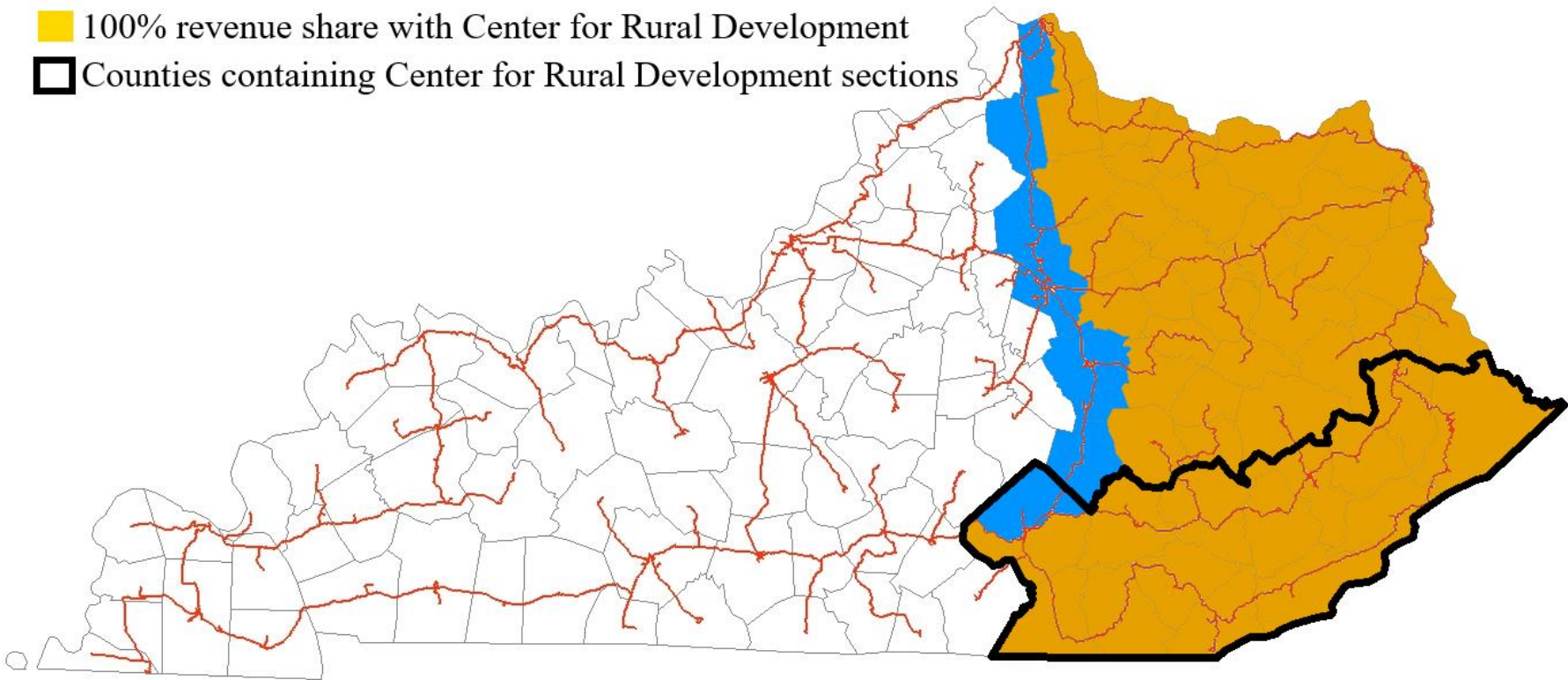
# Wholesale Revenues

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- Wholesale revenue could reduce, or even eliminate, shortfall
- Revenue projections are highly speculative
- A portion of the state's wholesale revenue share might go to the Center for Rural Development (CRD)

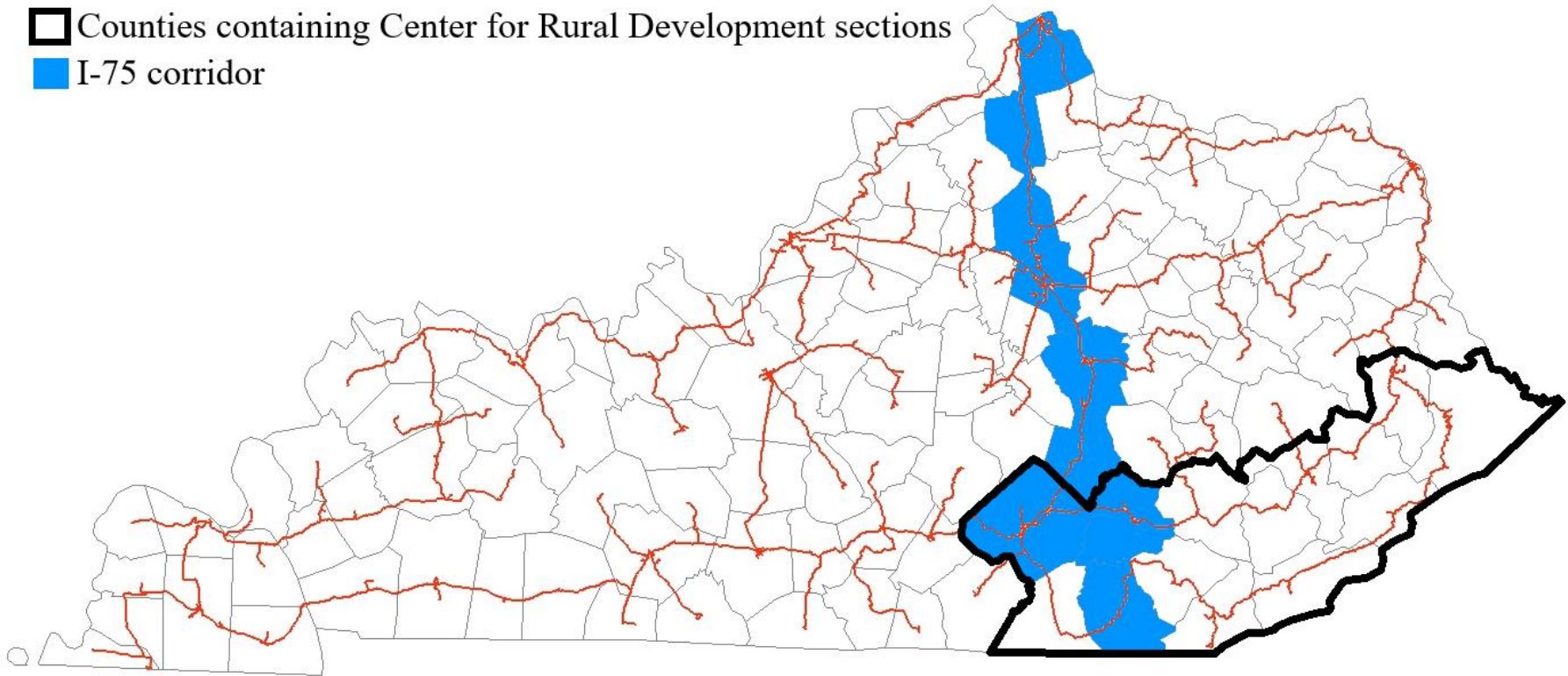
# 2015 Revenue Sharing Agreement With CRD

- Counties containing I-75 spine
- 100% revenue share with Center for Rural Development
- Counties containing Center for Rural Development sections



# 2019 Dark Fiber Lease Agreement with CRD

- Counties containing Center for Rural Development sections
- I-75 corridor



# Estimated Expenses Of KentuckyWired

<b>Expenses</b>	<b>Estimated Cost (In Millions)</b>	<b>% Of Total</b>
Availability Payments	\$1,207.7	72.43%
KCNA Operating Expenses	108.1	6.48
Settlement Bonds	201.4	12.08
System Refreshes	96.6	5.79
Milestone Payment	23.5	1.41
Repay State Bond Principal	30.0	1.80
<b>Total Of Known Amounts*</b>	<b>\$1,667.3</b>	<b>100.00%</b>

Note: Percentages shown do not add to 100.00 because of rounding.

\*There are several costs for which there is no known estimated costs. These include the cost to repay interest on the \$30 million in state bonds, CRD rent (unknown net cost), and the purchase value of the CRD section.

# Estimated Sources Of KentuckyWired Funds

<b>KCNA Income</b>	<b>Amount (In Millions)</b>
Estimated state agency spending*	\$643.4
Wholesale Revenue	341.2
Construction proceeds from settlement	17.0
Reduced construction cost (settlement)	24.4
<b>Total</b>	<b>\$1,026.0</b>
Less estimated costs	\$1,667.3
Surplus/(Deficit)	(\$641.3)

Note: Estimated income values are not reliable but are presented simply for comparison with expenses that were calculated using similar assumptions.

# Termination Scenarios

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- The amount owed will depend on the timing and type of termination
- Termination For Convenience:
  - Senior Debt
    - \$288 million in principal as 1/1/2020
    - \$75 million in expected interest through call date
  - Fair Market Value of Subordinate Debt and Operations Company
  - Employee Payments and Breakage Fees