

CAPITAL PLANNING ADVISORY BOARD

Minutes of the 1st Meeting of the 2018 Calendar

August 21, 2018

Call to Order and Roll Call

The 1st meeting of the Capital Planning Advisory Board was held on Tuesday, August 21, 2018, at 10:00 AM, in Room 169 of the Capitol Annex. Representative Daniel Elliott, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Stan Humphries, Co-Chair; Representative Daniel Elliott, Co-Chair; Senator Whitney Westerfield, Representative DJ Johnson; Charles Byers, Carole Henderson, John Hodgson, William M. Landrum, and Katie Shepherd.

Guests: Phillip K. Brown, Executive Director, and Steve Murphy, Chief Financial Officer, Kentucky Communications Network Authority.

LRC Staff: Shawn Bowen, Julia Wang, and Jennifer Luttrell.

Approval of Minutes

A motion to approve the minutes of the October 17, 2017 meeting was made by Mr. Landrum, seconded by Senator Humphries, and approved by voice vote.

Introduction of New Member

Representative Elliott introduced Mr. John Hodgson from Fisherville. Mr. Hodgson was appointed by Governor Bevin on August 8, 2018, as a member at large. He is replacing Jane Driskell.

Information Items

Ms. Bowen updated the members on the two information items included in the members' packets. The first item was an update on the executive and judicial branch budgets, and the Transportation Cabinet budget.

The executive budget authorized a \$6 million bond-funded maintenance pool for the Kentucky State Fair Board and included 23 capital projects selected by members during the last planning period as high priority for funding. The executive budget also authorized two of the largest capital projects submitted last year – the Department of Revenue Integrated Tax System project, and the Kentucky State Police 2-Way Radio System Replacement project.

The second information item included legislation enacted during this last session related to the board. Senate Bill 86, sponsored by Senator Humphries, increased the threshold for capital construction and IT projects from \$600,000 to \$1 million for executive branch agencies. The new thresholds now match the current ones for postsecondary institutions.

KentuckyWired Presentation

Representative Elliott asked Phillip Brown, Executive Director, Kentucky Communications Network Authority (KCNA), to update members on the progress of the KentuckyWired project. KentuckyWired is an open-access broadband network that will, upon completion, consist of more than 3,000 miles of fiber infrastructure referred to as the “middle mile.” Construction started in 2015 in Eastern Kentucky, and work in this part of the state should be complete by fall 2018; concurrent construction will begin in other parts of the state with full completion of the network by 2020. To date, approximately 800 miles of fiber infrastructure has been laid, and \$240 million has been spent.

Mr. Brown said the KentuckyWired project was designed in a manner that includes an excessive amount of risk to the state. The project has an aggressive schedule for completion, and problems are due to the project contract that was executed in fall 2015. Six third-party infrastructure partners will help build the network - Cincinnati Bell, Bluegrass Network, Eastern Kentucky Network, Brandenburg Telecom, Owensboro Municipal Utilities and MuniNet. By utilizing companies that already have infrastructure in place, the state will save money, avoid overbuilding existing broadband infrastructure and, in most cases, meet the original project schedule.

The total project financing is \$365,202,000, of which \$30,000,000 is state funding (general fund bonds), \$23,500,000 is federal, and \$311,702,000 is private. Federal funds will be available when a certain amount of the project is finished. The \$311,702,00 private funds are conduit bonds issued through a series of three bonds issues. Mr. Brown said in an effort to reduce construction costs, more than 1,000 K-12 education system sites were dropped from the network’s original scope of work. The state must confront the challenge of reincorporating these sites into the network, or else accept a project revenue deficit for the foreseeable future that will require supplemental funding for KentuckyWired to make its availability payments required by contract.

Mr. Brown explained that availability payments are a performance-based mechanism commonly used in public-private partnership (P3) financing structures. These payments represent the sum of a project’s expense components, adjusted for annual escalation, and subject to upward or downward adjustments for changes, and in the case of the KentuckyWired project, outages. Availability payments that support the KentuckyWired project are subject to annual appropriation by the Kentucky General Assembly. Availability payments are intended to cover all construction project costs, as

well as service provider costs, bond repayment costs and financing costs. Over the 30-year period, these payments will cover over \$1.1 billion of the project costs.

Mr. Brown explained that supervening events are unforeseen delays that cause project complications and impact project schedules. Kentucky assumed most of the project risk in the agreement, and to date, there have been 228 supervening events claimed. In 2015, KCNA negotiated a settlement with companies that would resolve 207 supervening events that occurred through January 1, 2018. The settlement will provide the builder with the scheduled relief they are due under their contract, remove the risk of litigation and project collapse, and implement contract changes to minimize the risk of future supervening events. The total amount of the settlement is \$88 million. [Senate Bill 200, passed by the 2018 General Assembly, authorizes KCNA to incur debt up to \$110 million. KCNA will borrow \$88 million to fund the cost of 207 supervening events, and the remaining \$22 million will serve as project contingency.]

Several counties have entered into third-party agreements to assist with construction of the project. In response to a question from Representative Elliott, Mr. Brown said in counties where KCNA does not have a third-party agreement with a provider, either the existing broadband provider in the area was not interested, or the construction cost estimates submitted by providers were too high.

In response to a question from Representative Elliott, Mr. Brown said fiber optic ring 2 encompasses counties in Eastern Kentucky and should be complete no later than July 2020. For purposes of this project, the state is divided into six sections known as fiber optic rings.

In response to a question from Representative Johnson, Mr. Brown said the project will pay for itself in two ways. The money Kentucky currently pays broadband providers for service will be used to make the availability payments required to cover the cost of the bonds. The anticipated revenues from the system, initially estimated to be \$28.5 million from all state agencies, will be applied towards the availability payments. Additionally, the state will have an extra 50 percent capacity to lease to the private sector. Mr. Brown noted that the \$28.5 million assumption included K-12 education would be part of the network, but because K-12 is not envisioned to be part of the system, there is a challenge in that the system revenue that was relied on when the project was put together does not exist today.

In response to additional questions from Representative Johnson, Mr. Brown said they have planned for and projected inflation in terms of the availability payments schedule. At the start of the project, \$28.5 million annually for 30 years was projected, however, they knew internally the cost of inflation would cause those payments to rise annually.

Representative Johnson asked if there are other sources of funding available besides state funds. Mr. Brown responded that there are no other potential sources of funding available for the project. The state has given KCNA bonding authority during this last legislative session in Senate Bill 200 for up to \$110 million; \$88 million will cover the cost of the supervening events settlement, and the remaining \$22 million will provide for a contingency fund.

In response to additional questions from Representative Johnson, Mr. Brown said there is private sector interest in the project and demand for service from “last mile” providers. Over the last two years, there have been significant inquiries from providers about the network and when it will be operational. He said the cable being utilized is durable, and they are not concerned about capacity and obsolescence.

In response to a question from Representative Johnson, Mr. Brown said the \$365 million project cost includes construction costs and financial costs. The total cost of availability payments over the life of the 30-year project is \$1.1 billion. Included in the cost of the availability payments is the cost for a service provider to ensure the network can be fixed if it breaks down. The service provider is Leducor Group, and the contract cost is \$250 million. The Leducor contract has a term of ten years, with two ten-year renewal options. Also included within the \$1.1 billion figure are bond payments, and the ongoing cost of capital, labor, and materials.

In response to another question from Representative Johnson, Mr. Brown said it is impossible to project additional future costs or to say there may not be any additional supervening events.

Representative Johnson asked how the bonds will be repaid. Steve Murphy, Chief Financial Officer, said the bonds will be paid in two stages. The initial bond issue funded a portion of the bond payments, this is known as capitalized interest, wherein part of the \$365 million paid the interest on the bonds during the construction period. Once availability payments start, those payments will cover the debt that is secured by the project fund. The project fund has three sources of revenue: the initial bond proceeds, the interest earned on balances and future availability payments. The availability payments began in 2016 as sites came on.

In response to questions from Senator Westerfield, Mr. Brown said KCNA executed a project agreement with the KentuckyWired Infrastructure Company (KWIC). KWIC is the non-profit established by the state to serve as the conduit issuer for the bonds. The company has an ex-officio board of directors and technically has the responsibility to build the network, however, KWIC passed its responsibilities to the KentuckyWired Operations Company via a project implementation agreement. The KentuckyWired Operations Company, comprised of private partners, is responsible for project obligations, project

management, and project financing. The partners include Macquarie Capital, Leducor Group, and First Solutions. Macquarie Capital will serve as the lead developer.

Senator Westerfield commented that the project was originally designed to provide service in underserved areas such as Eastern and Western Kentucky. Rather than focusing on the urban areas, he said the project should focus on those underserved areas first.

In reference to a chart provided to members, Senator Westerfield noted that the KentuckyWired Operations Company has spent about \$6.5 million. He asked for further clarification of the amount spent. Mr. Brown said this figure represents the total amount KentuckyWired Operations Company has spent since its inception. The company has a budget of approximately \$1.1 million annually, which represents costs for expenses such as salaries and insurance, among other things.

Representative Elliott asked if the state will have to provide additional funding to complete the project. Mr. Brown said the project has a fixed price contract and the subcontractor must build the network at the price they bid. He said they cannot project the future cost of direct loss claims, and the most important thing they can do to avoid the need for future funding is to complete the project.

Other Business

Representative Elliott announced that the next meeting is tentatively scheduled for September 18 at 10 a.m.

Adjournment

There being no further business, the meeting was adjourned at 10:58 a.m.