PROGRAM REVIEW AND INVESTIGATIONS COMMITTEE

Minutes
2018 Interim

July 12, 2018

Call to Order and Roll Call

The Program Review and Investigations Committee met on Thursday, July 12, 2018, at 10:00 AM, in Room 131 of the Capitol Annex. Representative Lynn Bechler, Chair, called the meeting to order, led the audience in reciting the Pledge of Allegiance, and the secretary called the roll.

Present were:

Members: Representative Lynn Bechler, Co-Chair; Senators Perry B. Clark, Wil Schroder, Dan "Malano" Seum, Reginald Thomas, and Stephen West; Representatives Chris Fugate, Ruth Ann Palumbo, Rob Rothenburger, Arnold Simpson, and Walker Thomas.

Guests: Phillip K. Brown, Executive Director; Mike Hayden, Chief Operating Officer; Doug Hendrix, General Counsel; and Steve Murphy, Chief Financial Officer; Kentucky Communications Network Authority (KCNA).

LRC Staff: Greg Hager, Committee Staff Administrator; Colleen Kennedy; Chris Hall; Van Knowles; Jean Ann Myatt; William Spears; Shane Stevens; Joel Thomas; Richard Schufelt, Graduate Fellow; and Kate Talley, Committee Assistant.

Minutes for June 14, 2018

Upon motion by Representative Thomas and second by Representative Simpson, the minutes for the June 14, 2018, meeting were approved by voice vote without objection.

Selection of Study Topics for 2018

No Senate topics were proposed.

Overview of Kentucky Wired

Representative Bechler asked the secretary to read HR 337 aloud. The resolution, passed by the House in the 2018 Regular Session, urges the 2018 Program Review and Investigations Committee to investigate the Kentucky Wired Project.

Mr. Brown stated that the problems with Kentucky Wired originate with the contracts, signed during the previous gubernatorial administration in 2015. Pricing drove the agreements and the schedule. Expectations were that everything would proceed on schedule or even more quickly than industry standards. The project was designed to be difficult to exit. KCNA was established by executive order and then by statute in 2017. At this point, it would probably cost as much to shut down Kentucky Wired as to complete it, without any of the benefits it could provide. Completing the project requires the cooperation of utility companies, localities, and others.

Mr. Hayden listed the governmental agencies that were involved in starting the project. At the time, the Federal Communications Commission (FCC) was looking at incentives for states to build out private networks. Several Kentucky state entities such as universities were looking to build their own private networking capacity. There was a broadband gap in eastern Kentucky. A Kentucky team visited other states that had built networks and discovered that Kentucky state government was paying 2 to 10 times more for broadband services. The other states had done a good job and received federal funds to assist their projects but lacked a plan for sustainability. Kentucky chose to place large bundles of fiber for wholesale use because the additional cost was minimal. The state chose to use a public/private partnership (P3) for funding the project.

Mr. Brown explained that there were five third-party infrastructure partners, the main ones being Cincinnati Bell, Bluegrass Network, and Eastern Kentucky Network. These utilities save money for the project because they already have a lot of infrastructure, crews, and equipment.

Mr. Hendrix said that CTC [Columbia Telecommunications Corporation] was the technical advisor to the state for its request for information in April 2014. A request for proposals (RFP) led to an initial agreement with the Macquarie Consortium in November/December 2014.

In response to a question from Representative Bechler about the entities involved in the project, Mr. Hendrix said that in the legal agreements, KCNA executed a project agreement with the nonprofit Kentucky Wired Infrastructure Company (KWIC) to obtain tax-exempt status for bonds to be issued. KWIC executed an agreement for project responsibility with the Kentucky Wired Operations Company (KWOC). In turn, KWOC executed the agreement for construction and service contracts with NG-KIH Design-Build.

Mr. Brown said that the six binders on the table represent different agreements among the project entities. P3s allow governments to attract private investment and transfer some risk to private investors, but Kentucky ended up with most or all of the risk in this case. If the P3 law since enacted by the General Assembly had been in place, some elements of the project could not have been structured as they are.

Mr. Murphy said that total 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 from the P3. State funds are mostly to be spent on equipment. Federal funds will be available when a certain amount of the project is finished. He described the three series of bonds, totaling more than $305 million, used to finance the project.

In response to a question from Representative Rothenburger, Mr. Murphy said that the initial bond was $30 million. The remaining bonds were issued by the Kentucky Economic Development Finance Authority and are secured by Kentucky.

Mr. Murphy stated that all the bonds represent special, limited obligations payable from project revenues. More than 95 percent of project revenues are Commonwealth Availability Payments that the state is contractually obligated to make. He presented a slide listing the annual availability payments, which range from $22.8 million in fiscal year 2018 to more than $56 million projected for FY 2045. Total availability payments are projected to be nearly $1.2 billion. So far, availability payments constitute payment only toward interest on the bonds. The first payments on principal will be in January 2019.

Mr. Brown said that supervening events are part of the 2015 project agreement. Mr. Hendrix said that there are approximately 45 types of supervening events. Mr. Brown explained that these are events that create immediate costs for the state. They can be compensation events if a payment is due or relief events that allow extra time. Kentucky assumed most of the project risk in the agreement for supervening events. There have been 228 supervening events claimed so far. For example, a construction crew encountered raw sewage during installation of a conduit. In some cases, the Transportation Cabinet's road encroachment permit review has extended beyond the 60 days called for in the agreement. Kentucky was responsible for two complex pole attachment agreements: AT&T and Windstream. An important cause of the delay was that AT&T and Windstream required that anyone attaching to their poles must be a CLEC [competitive local exchange carrier]. This was not achieved until November 2015, after the project agreement had been signed. This led to other delays. Most supervening events have been "cured," for example, when a delayed permit is approved.

Mr. Hayden said that there were 72 utilities subject to pole attachment agreements. Memoranda of understanding had to be negotiated with local governments. Mr. Brown stated that not all cities and counties cooperated immediately, but the plan had assumed they would. More interest has been earned than anticipated. There were also savings because service providers did not have to service sites that were delayed. These offsets have come to about $20 million.

Mr. Brown continued by saying that it is sometimes difficult to determine the appropriate amount of schedule relief. The long stop date is the date a year past the expected finish date, and it is the last date for project completion. The lenders' technical advisor can stop payments for construction if it appears the long stop date might not be met. This was a concern, so the state began to negotiate a global settlement to resolve 207 outstanding supervening event claims for $88 million and to change some terms of the contract. The negotiation, which is not final, would remove the risk of litigation and project collapse. In the original plan, all expected payments would have been made from revenue from connections to completed parts of the network. Kentucky sought a lower price and therefore assumed much of the risk.

Representative Bechler commented that the settlement may have reduced the threat of litigation, but such risk has not been removed.

In response to a question from Representative Bechler about the 84 percent of total financing coming from the P3, Mr. Murphy said that this was bond debt. Private investment was at most $21 million, the rest was Kentucky's responsibility. This is not unusual in P3 projects.

In response to a question from Representative Bechler, Mr. Brown said that a $2 million good faith payment has been made as part of the supervening event settlement.

In response to questions from Representative Bechler about Kentucky Wired's revenue, Mr. Hayden said it should have begun reducing payments to current Internet Service Providers in April 2016 and should have been fully funded by September 2018. Wholesale marketing of dark fiber was intended to cover future maintenance, replacement, and upgrades. The current project break-even point is October 2020.

Representative Bechler asked if all cities and counties had agreed to work with Kentucky Wired. Mr. Brown said that there was one pole attachment agreement with a municipal utility still outstanding after approximately 2 years of negotiation. No municipalities are impeding the project except for possibly one that the Bluegrass Network is responsible for.

Representative Bechler asked whether schools were contacted about the plan to use E-rate funds. Mr. Hayden replied that the Kentucky Department of Education (KDE) and FCC were involved in discussions of funding. FCC said that KCNA could not be the contractor to provide internet service to schools since it was part of the agency that also ran state procurements—the Office of Procurement Services within the Finance and Administration Cabinet. KCNA was moved to gain adequate separation. The cabinet issued an RFP as required by FCC, but there was a protest, and it was withdrawn.

In response to a question from Representative Bechler, Mr. Hendrix said that withdrawing the RFP did not imply that the cabinet agreed with the protest.

Representative Rothenburger asked whether any schools were participating in Kentucky Wired because it seemed they would lose E-rate funds if they did so. Mr. Hayden said that individual schools were not involved. E-rate provides funding for a single broadband connection to each school, and Kentucky Wired did not plan to provide services directly to schools. If there is a solicitation in the future, KCNA might bid on some aspect of it. The original expected revenue to KCNA from E-rate was approximately $2 million per month.

In response to a question from Representative Bechler, Mr. Hendrix said responsibility for the raw sewage delay was not resolved; it is part of the supervening events settlement.

In response to Representative Bechler's request that terms that have been used be defined for a general audience, Mr. Hayden, referring to the infrastructure map distributed at the meeting, stated that the red lines were the backbone linking communities together. The last mile is the wire from the pole to the building. Kentucky Wired provides last mile only to its own entities (state government). Kentucky Wired provides an access point in each county to allow Internet Service Providers or utilities to tap into the middle mile, which is what Kentucky Wired is responsible for.

In response to a question from Senator West, Mr. Brown said 760 miles were complete as of May, possibly 800 miles as of June.

Senator West asked whether the additional $88 million will be enough given that 800 of 3,200 miles are completed, but $240 million of $325 million has been spent. Mr. Brown responded that vendors are obligated to complete the project for the price they had agreed to. However, supervening events add costs for the state. Mr. Hayden said that a lot of costs were associated with getting poles ready. Much of that has already been paid, so remaining work should cost less.

In response to questions from Senator West, Mr. Hendrix said that the Finance and Administration Cabinet took the lead in negotiating the original agreement. He will provide the names of the attorneys who were consultants.

In response to questions from Senator West, Mr. Brown said the subcontractor was responsible for obtaining 70 of the 72 pole attachment agreements. It could be around 2 months after getting the utility engaged in negotiations to get an agreement, but it sometimes takes a while to get utilities engaged. Kentucky was supposed to have the two complex pole attachment agreements signed by September 2015. Utilities must grant attachments to any CLEC that requests them, but negotiation of terms can take time.

In response to a question from Senator West about anticipated revenues, Mr. Hayden said $28 million was assumed from a combination of KDE, state government users, the Administrative Office of the Courts, and the Council on Postsecondary Education. Mr. Brown said that Kentucky Wired intends to work with FCC to get K-12 schools into the system without endangering the E-rate funds, but it will not be on the same schedule as the rest.

Senator West asked for a list of all the contractors and subcontractors working on the project. He stressed that is important for the committee to continue looking into Kentucky Wired, particularly the early phases.

Senator Thomas said the project has to go forward and will cost more than the financed amount. He asked how much more. Mr. Brown said that it will be the $88 million settlement plus the cost of any future supervening events. He described make-ready engineering and construction. Every pole requires a plan to decide where to place the new fiber. Make-ready construction is the actual work of, when necessary, moving existing wires to make room for the new fiber. The utility companies prefer to do this themselves. Make-ready construction is a problem nationally and is a great risk to the schedule. KCNA has asked the General Assembly for $110 million: $88 million for the settlement of past supervening events and $22 million in anticipation of future events and other contingencies. It was a mistake not to include such costs at the beginning. In response to a request from Senator Thomas, Mr. Brown said he would attempt to come up with an estimate of how much more the project will cost.

Replying to questions from Representative Rothenburger, Mr. Brown said the $2 million good-faith payment is included in the $88 million supervening events settlement. Around $7.5 million was paid in direct loss payments last year, so total penalties for the project are $95.5 million.

In response to questions from Representative Bechler, Mr. Brown said one supervening event claim for over $20 million is not included in the settlement events but did arise in the time period of events covered in the settlement. A private easement is in dispute resolution and is likely to be litigated.

In response to questions from Representative Bechler, Mr. Brown said the settlement covered events through January 19, 2018. Mr. Hendrix said there have been about 13 event claims since then; he can provide the exact number. One has been closed at no cost to the state. Mr. Hayden said contractors have to give notice of possible cost, even if it turns out there is no cost. Mr. Hendrix described the procedure to settle disputes.

Representative Bechler asked what percentage of supervening event claims are settled in favor of the state. Mr. Hendrix said the events being discussed have not been resolved. Mr. Brown said that a vendor can file a claim after an event has occurred if the vendor did not realize there was a loss until later, even months later. He said the Transportation Cabinet has added staff to expedite approving road permits. The 60-day period for permitting is not a cabinet procedure but is in the Kentucky Wired contracts, likely because it allowed the project schedule to work out as desired. Other unrealistic time frames seemed to have been set in order to make the schedule work.

In response to Representative Bechler's question about the cost of events since January, Mr. Brown said that he thought none of them would result in a cost to the state, but not resolving them could lead to delays and further costs. There are some potentially significant events that KCNA is trying to head off. The settlement would include a period of time to try to mitigate events before a claim is made.

In response to a question from Representative Fugate, Mr. Brown said the supervening events under discussion are for the whole project, not just for the 800 miles completed.

Representative Simpson asked as a maximum price contract whether there were performance bonds on completion of the project and the time of completion. Mr. Hayden said there were date guarantees that varied by site, and the vendors have performance bonds. Mr. Murphy said the bonds were for $108 to $110 million, around 40 percent of the total project cost.

In response to a question from Representative Simpson, Mr. Brown said the original long stop date was September 2019, but this would have to be adjusted. Under the settlement, the new long stop date would be in 2021 and projected completion in 2020.

In response to questions from Representative Simpson, Mr. Brown said that there has been no income so far but there will be revenue prior to completion. The Louisville and northern Kentucky sites and the Frankfort Data Center could begin providing services when they are ready. Mr. Hayden explained why the presentation today showed no income. In the original plan, the Louisville, northern Kentucky, and Lexington sites had to be connected in a ring, the Frankfort Data Center had to be on line, and Internet provider services needed to be secured. Louisville and northern Kentucky are finished, but the Frankfort Data Center is not.

In response to questions from Senator West, Mr. Hayden said that the Frankfort Data Center would probably be ready in spring 2019; its completion is necessary for any state government use. Mr. Brown said there are many make-ready construction jobs in the next year. Many requests are over a year old, even though the time frames for the utilities were supposed to be 5 to 12 weeks. The new schedule in the settlement is based on performance experience so far and should be more realistic. KCNA was not intended to manage day-to-day operations but would do so to help expedite operations.

In response to questions from Representative Simpson, Mr. Hayden said that other states had experienced delays and overruns but they relied on leases of existing infrastructure. Kentucky is unique in building new infrastructure. Mr. Brown said a principal cause of problems is that the planners could have anticipated delays in pole attachments and the need to establish a CLEC prior to negotiating pole attachments, especially with the two large utilities. Negotiations with local governments could have been done earlier. The project could have been done one ring at a time instead of the entire state. Virginia used state rights of way. For P3 projects, planners need to know the risks and who holds the risks. For P3s, the cost of credit will be higher because state tax-exempt credit is blended with private credit. There needs to be a benefit to justify it. Cost, litigation, project, timing, and credit risks need to be considered.

Representative Simpson noted that in the Kentucky Wired project, risk was transferred to the state that should have fallen to the private sector. Mr. Brown said there is often a lot of optimism about P3 projects, but Kentucky should have agreed to pay more in order to assume less risk.

Representative Bechler said the Kentucky Wired contract was signed before there was P3 legislation in Kentucky. The legislation might have helped reduce risk. Representative Simpson said the state should be cautious even with the law.

Representative Bechler said the Auditor of Public Accounts was conducting a special examination of Kentucky Wired and would appear before the committee when it is ready.

Representative Bechler said the report from the Office of Education Accountability on preschool and kindergarten would not be presented today because of the time. Senator Thomas said early childhood education has been a priority of Senate Democrats. He requested that the presentation be scheduled for the next committee meeting.

The meeting adjourned at 12:02.