PROGRAM REVIEW AND INVESTIGATIONS COMMITTEE

Minutes

November 22, 2019

Call to Order and Roll Call

The Program Review and Investigations Committee met on Friday, November 22, 2019, at 8:00 AM, in Room 131 of the Capitol Annex. Senator Danny Carroll, Chair, called the meeting to order, and the secretary called the roll.

Present were:

Members: Senator Danny Carroll, Co-Chair; Representative Rob Rothenburger, Co-Chair; Senators Tom Buford, Perry B. Clark, Reginald Thomas, Stephen West, and Phillip Wheeler; Representatives Lynn Bechler, Al Gentry, Adam Koenig, Ruth Ann Palumbo, Steve Riley, and Walker Thomas.

Guests: Deck G. Decker, Interim Chief Executive Officer, Kentucky Communications Network Authority; Lonnie Lawson, President and John Gillum, corporate attorney, Center for Rural Development; Andrew McNeill, State Director, Americans for Prosperity.

LRC Staff: Greg Hager, Committee Staff Administrator; Greg Daly; Christopher T. Hall; Van Knowles; Catherine Moran; Jean Ann Myatt; Jeremy Skinner; William Spears; Shane Stevens; Joel Thomas; and Christy Young, Committee Assistant.

Minutes for October 4, 2019

Upon motion by Representative Palumbo and second by Representative Riley, minutes for the October 4, 2019 meeting were approved by voice vote without objection.

Staff Report: *Procurement And Financing Of KentuckyWired*

Mr. Thomas gave a brief description of the KentuckyWired project, including the role of broadband in economic development, the timeline and organizational structure of the project, financing, and potential wholesale revenue. The Center for Rural Development (CRD) began working on the idea for a regional middle mile network in eastern Kentucky that eventually became the statewide KentuckyWired project.

The state contracted with Columbia Telecommunications Corporation as a consultant on KentuckyWired in 2014. The Finance and Administration Cabinet (FAC) issued a request for proposals (RFP) for a public-private partnership (P3) and awarded the contract to Macquarie Infrastructure Developments in December 2014. Significantly revised contracts replaced the original contract in September 2015. The state was obligated to make availability payments starting when the first network sections became operational. The design included six interconnected rings. In August 2015, the Kentucky Communications Network Authority (KCNA) was established within the Governor's Office. KCNA is responsible for oversight of the KentuckyWired network.

The state created the nonprofit KentuckyWired Infrastructure Company, referred to as Project Company in the report. Its main purpose was to borrow using less expensive tax-exempt bonds. With the state's approval, Macquarie transferred to Project Company its responsibilities under the original contract for building and operating the network. Macquarie created the KentuckyWired Operations Company, referred to as Operations Company in the report. Project Company assigned Operations Company almost all its responsibilities.

Supervening events are situations in which the contractor claims compensation for extra costs or delays. Supervening event costs eventually exceeded $191 million but were negotiated down to $101 million in a 2018 settlement.

A wholesaler, OpenFiber, was created to market and lease the extra fiber built into the KentuckyWired network.

Mr. Knowles explained that the executive and legislative branches exercise oversight of capital projects. The secretary's office in FAC may authorize deviations from policies and procedures, which was done for several aspects of the KentuckyWired procurement and contract negotiations. It was unusual for a construction project to be handled by the Office of Procurement Services, for a contract to be revised so much, and for the cabinet's buyer not to be aware of all contract changes. Some related contracts were not entered into the accounting system until 2019. Two agreements that might have required legislative review were not presented to the Government Contract Review Committee, and six construction contracts had not been entered into the state accounting system as of October.

Mr. Knowles said that legislative oversight of capital projects is primarily the responsibility of the Capital Projects and Bond Oversight Committee. He explained the process by which the committee considers project debt and other actions for approval or disapproval, subject to an agency head's decision to proceed despite lack of approval. The committee also determines whether the project complies with applicable statutes and may request a court injunction to stop a project for noncompliance, the only sure way for the legislature to stop a project during a legislative interim. Both the bond sale and transfer of proceeds for KentuckyWired were submitted to the committee. In each case, the meeting that month was canceled for lack of a quorum, and the FAC secretary decided to proceed. The committee had no knowledge of statutory violations for which to request an injunction, so the project went forward.

P3s often reduce risks to the government, but in this case availability payments and negotiations shifted risk to the state as a way to lower financing and construction costs. These risks added construction cost in the form of supervening event claims primarily for pole attachments, easements, and highway rights-of-way.

Before September 2015, there were three milestones at which the state could have terminated the contract for less than $7 million, but after that the cost could have exceeded $300 million.

Mr. Skinner noted that the state's primary financial obligation in the contract is to make availability payments to Project Company. The state intended to fund the availability payments by diverting funds state agencies were already spending on internet service, so availability payments would have to match the internet spending of the government sites connecting to the network. Agencies that were expected to connect to the KentuckyWired network included the Kentucky Department of Education's (KDE's) K-12 network, state agencies, higher education, and the judicial branch. The redirected net spending of these sites was expected to be approximately $2.4 million per month, matching the baseline maximum availability payment. Mr. Skinner described how the state cut project costs to facilitate this matching.

Availability payments were scheduled to start with the completion of the first ring and the subsequent migration of sites to the network. Payments would increase as additional sites were connected to the network. Completion of network construction was originally scheduled to be August 2018, at which point the state would make the full baseline maximum availability payment less any performance deductions.

Supervening events caused delays that were deemed to be the state's responsibility. The project agreement specifies that in the event of delays due to supervening events, the state has to pay the availability payments as if the project were on schedule. In the 3-year period ending in May 2019, the state paid nearly $70 million in availability payments despite there being no contributing funds from state sites connected to the network.

Funding shortfalls are expected due to the availability payments exceeding network spending and due to expenses that are not covered by the availability payments. The largest funding gap is the lack of K-12 spending. E-rate is a federal program that provides schools with rebates of up to 90 percent of the cost of broadband services. Federal rules for E-rate eligibility require that services be procured through a competitive solicitation. Basing the project's affordability model on the assumption that KentuckyWired would automatically win such a solicitation was questionable. In 2015, after determining that the KentuckyWired contract was not eligible for E-rate, an RFP was issued to replace the KIH3 contract, which is the state's existing internet service contract that included K-12. KCNA was in the process of preparing a proposal for submission when AT&T, the existing provider, filed a protest. FAC canceled the solicitation in November 2015 without providing a reason.

The availability payments are subject to annual increases of approximately 2.5 percent, which means that the state's funding plan assumed that internet spending of education and state government sites would also increase 2.5 percent annually. Based on available data, the market price for broadband services has increased at less than this rate.

The state's expected availability payment obligation over the contract term is approximately $1.2 billion. Program Review staff estimated that state agency spending over the term will be $643.4 million, so the funding gap is estimated to be $564 million over the full contract term. If state agency broadband spending increases only 1 percent annually, the funding gap would grow by nearly $150 million to $713 million.

KDE officials have stated that they would consider a bid from KCNA on a future RFP for K-12 broadband services if KentuckyWired is operational and has demonstrated adequate reliability. KCNA officials have said that they do not plan to bid on future K-12 RFPs, deferring that responsibility to the wholesaler OpenFiber. KCNA officials also said that in the absence of a direct bid, OpenFiber could explore leasing fiber infrastructure to other entities that might want to bid for the K-12 service. Because OpenFiber would keep a share of revenue, such a plan would almost certainly bring in less money than a direct contract between KCNA and KDE. Another vendor might have a better proposal and win the contract, leaving the state with no K-12 spending to apply toward KentuckyWired.

The expected funding gap could be reduced by wholesale revenue, but projections of the state's potential revenue are highly speculative. A portion of the state's wholesale revenue share might go to CRD. A 2015 agreement with CRD stated that in exchange for $23.5 million in grant funding, CRD would receive a significant share of the state's wholesale revenue. This agreement was replaced by a new agreement in August 2019. CRD will now provide an additional $20 million in grant funding, increasing the total grant funding to $43.6 million, in exchange for ownership of a section of the network for which the state will pay an annual rent of $2 million for 30 years. The agreement would allow the state to pay for certain expenses not covered by the availability payments prior to CRD receiving a share of wholesale revenue. Once the required expenses were paid by the state, CRD will receive 25 percent of the remaining portion of the state's share of wholesale revenue generated from the I-75 corridor.

Funding shortfalls that could exceed $400 million are also anticipated due to costs not covered by the availability payments. These include KCNA operating expenses, bonds to finance the supervening events settlement, and system refreshes. For system refreshes, the state is required to update and replace aging equipment and software prior to years 11 and 21 of the project.

Program Review staff estimated that expenses could be mitigated by an estimated $643 million in state agency spending and approximately $340 million in wholesale revenue. The OpenFiber wholesale model predicted that the state's share of revenue would be approximately $1.1 billion from FY 2018 to FY 2047. Staff adjusted the model so that the state's share starts in FY 2022 and ends September 2045, which resulted in a state share of $682 million. A KCNA official has stated that half the projected wholesale revenue would be a more conservative expectation. Given this, staff estimated the state's share of wholesale revenue to be $341.2 million. Based on these assumptions, the estimated total deficit for the project is $641.3 million.

Early termination of a P3 contract is complex. The state would be required to make a termination payment to Project Company in the event of a termination of the KentuckyWired project. In a termination for convenience, the state would be obligated, at a minimum, to make a termination payment equal to the outstanding senior debt, the fair market value of both the subordinate debt and any outstanding ownership interest in the Operations Company, and any employee payments and contractor breakage fees. The most significant cost would be paying the outstanding senior debt. KCNA indicated that just paying the outstanding principal and interest accrued through the termination date would not satisfy creditors who anticipate a return on their investment at least through the call date, which is the date on which bonds can be redeemed prior to maturity. It might be necessary for the state to pay bondholders at least a portion of the interest anticipated through the July 2025 call date.

If the project were to be terminated as of January 1, 2020, the remaining balance on the senior debt would total $288 million. The interest payments from then until the call date of July 1, 2025 would be nearly $75 million for a total of $363 million. It is unclear whether the full interest through the call date or a partial payment would be necessary to satisfy lenders. The other components of a termination payment are difficult to determine as they would be based largely on the timing of the termination. Other likely costs are related to the termination of other agreements such as wholesaler agreements with OpenFiber and the CRD lease agreement. Other possible costs, such as litigation, could be significant.

In response to questions from Senator Carroll, Mr. Knowles said although the initial request in the budget was for $100 million, the General Assembly only authorized $70 million: $20 million federal funding, $30 million state bonds, $20 million third-party financing.

Senator Carroll asked why the Macquarie bid was $274.8 million but the bond issue was $311.4 million. Mr. Skinner said that there are additional costs beyond construction such as interest expense and operating costs.

Senator Carroll asked whether staff found any documentation of what the overall projected cost would be and whether there was a thorough vetting of the project. Mr. Knowles said that the biggest issue was the lack of K-12 funding. At the time, the documentation indicates that decision makers thought that the funding and the project would work out.

In response to a question from Senator Carroll, Mr. Knowles said that the contract includes internet connections to state agencies.

In response to a question from Senator Carroll, Mr. Skinner said that the assumption for KentuckyWired wholesale revenue was that both the customer base and price would increase.

Senator Thomas asked whether additional appropriations are needed, how firm the October 2020 completion date is, and whether there are additional potential revenue sources. Mr. Knowles said that the report focuses on what happened in 2014 and 2015 and the consequences. KCNA is better able to answer these questions.

Representative Thomas, the current House co-chair of the Capital Projects and Bond Oversight Committee, said that he is troubled that meetings of the committee were canceled in 2015, so that the KentuckyWired bonds were not reviewed. The committee's has no other recourse if nothing illegal is found regarding a bond issue.

In response to questions from Senator Carroll, Mr. Knowles confirmed that five committee meetings were canceled, including the two related to KentuckyWired. The procurement irregularities were approved by the secretary or deputy secretary of FAC, which is acceptable according to statute. In response to a question from Representative Rothenburger, Mr. Knowles said that staff found no documentation for why the normal policies and procedures were not followed.

In response to questions from Representative Rothenburger, Mr. Knowles said that the buyer is the designated person in the Office of Procurement Services for overseeing the RFP process and contract negotiations. Staff found no documentation for why the buyer was not involved in the usual way. Staff have not been able to determine whether this violates statute. He said that he is unaware whether anyone is looking into this, but it is on the list of what Program Review staff could review further. Representative Rothenburger said that he is concerned that so many meetings of the Capital Projects and Bond Oversight Committee were missed because of a lack of quorum and that special meetings were not called.

In response to a question from Representative Rothenburger, Mr. Knowles said that staff found no documentation for why it took so long for contracts to be recorded in the accounting system. More than 300 documents were sent to the Office of Procurement Services in February 2019 at the office's request for everything related to KentuckyWired. Representative Rothenburger said that he will not be satisfied until answers are provided regarding the lack of oversight and transparency.

Senator Carroll said that the committee has a long-range plan to get testimony from decision makers who were involved in the process.

In response to questions from Senator West, Mr. Knowles said that the recent agreement with CRD has not gone through the Government Contract Review Committee. Mr. Skinner said that part of the impetus for the new agreement is that the original agreement with CRD did not cap wholesale revenue that would go to CRD, which could have been hundreds of millions of dollars. The new agreement lowers the percentage of revenue from the I-75 corridor that goes to CRD from 50 to 25 and also deducts specified expenses before CRD gets a share of revenue. Mr. Knowles said that the state auditor's office and Program Review staff had raised questions about whether the original agreement was done properly.

In response to questions from Senator West, Mr. Knowles said that the six outside construction contracts have been posted on the KCNA website but are not in the accounting system. The contracts were signed at the secretary level.

In response to questions from Senator West, Mr. Skinner said that the estimate in the report of $634 million in projected state agency spending for internet service does not include K-12 education revenue. At the time of contract closing, the state broadband cost was assumed to keep increasing over time. In reality, broadband costs are not necessarily increasing. Mr. Knowles said there is an opportunity for state agencies to obtain better service, the question is whether the General Assembly considers it worthwhile to pay for this.

Senator Carroll said that the wholesaler will have the opportunity to bid for the K-12 contract. There will be competition from private entities in parts of the state, which will reduce prices.

In response to questions from Senator Carroll, Mr. Knowles said that Stephanie Williams, Assistant Director of Procurement Services, was the buyer. It is fair to say that she was not pleased not to have been involved more.

In response to a question from Representative Bechler, Mr. Knowles said that the six contracts were not included in the accounting system as of a month ago. Mr. Decker said that they are in the system. Mr. Knowles said that they were included as attachments to the KentuckyWired contract in the submission of documents in February but were not in the system separately.

In response to questions from Representative Bechler, Mr. Skinner said that the $641 million deficit shown in the report is mostly for the period through 2045, but some settlement bonds are for beyond this date. Senior debt totals $363 million, including $75 million in estimated expected interest. Representative Bechler proposed that if the project were terminated, then the savings would be $288 million ($641 million minus $263 million) minus any extra costs. Mr. Skinner said that other costs, including potential litigation, cannot be estimated at this point. Representative Bechler said that it seems unlikely that the unknown costs would eat up the $288 million in savings. This further affirms his belief that the cost to taxpayers would be less if the agreement were terminated immediately.

Senator Buford said that this is a good lesson regarding P3s. If this is such a good idea, the private sector would have done it already. This will be a good system if it is ever completed. The system will likely be obsolete by the time the bonds are paid off. At this point, the issue is mitigating losses. He said that the key questions are what the original estimated cost was, what the current cost is, and what the appropriations request will be for next year.

Mr. Lawson said that the project originated with an idea he proposed to the CRD Board in 2012. The goal was to build a middle mile network in eastern Kentucky. The center worked with US Representative Hal Rogers, Governor Steven Beshear, Senator Stivers, and Representative Stumbo. Governor Beshear wanted to take the project statewide. The center has continued to look for funding to build out in eastern Kentucky.

Senator Carroll asked for information about the original agreement. Mr. Lawson said that there was a feasibility study in 2014. The goal was to have a hotel access point near Cincinnati with a spine down I-75 and connected rings. Because the center was contributing federal funds, a revenue share was negotiated for the I-75 spine and the eastern Kentucky rings. The goal was to generate revenue that could be used for last-mile construction for communities in eastern Kentucky that could not get access otherwise. In response to further questions from Senator Carroll, Mr. Lawson said that the original contribution was $23.5 million. If the state wishes, $43.6 million is now available. Given how the revenue would be used, there was not great concern about how the agreement would be perceived outside the region. CRD is taking a risk in supplying the federal funds. The main concern for a long time has been that the middle mile would not be built. Federal grant funding has not been transferred to the state yet. Grant guidelines require that CRD own the rings funded through the grants. Once the funds are transferred, CRD is on the hook for the funds, which will fully cover the cost of Ring 2. It will not cover the cost of

Ring 1B because construction had proceeded too far when the additional funding was obtained.

In response to questions from Senator Carroll about the new agreement, Mr. Lawson said it is a cleaner document because it is an actual lease of assets. Revenue will be less than it potentially would have been under the previous agreement. CRD has no liability for the project other than the grant funding.

In response to questions from Senator Carroll about connections to the middle mile in eastern Kentucky, Mr. Lawson said that there many providers willing to build out the last mile with assistance. Fiber to all homes is not realistic, but wireless providers are willing to step in.

In response to questions from Senator Carroll about costs, Mr. Lawson said that no one understood the bottom line costs of pole agreements, easements, rights of way, and make ready construction. He said that he is unaware of any consultants who were brought in regarding these issues.

In response to a request, Mr. Lawson said the 2014 feasibility study referenced earlier would be sent to committee staff. In response to questions from Representative Rothenburger, Mr. Lawson said that CRD and the state are not counting the same wholesale revenue from the I-75 corridor in their projections. It is still a goal to do the last mile in eastern Kentucky with high speed internet in every county. CRD will use other funding to provide "meet-me" points to reduce the cost of the last mile. Companies and local governments will be eligible to apply for grants through CRD to offset costs. The state will be responsible for maintenance of the middle mile. CRD was not involved in any of the original negotiations that resulted in changes in the KentuckyWired contract.

In response to questions from Senator Carroll, Mr. Skinner said that too much information is unknown for payments to CRD to be included in the projected costs in the report. Mr. Lawson said the projected lack of wholesale revenue for 5 years will affect CRD, but overall the wholesale revenue will allow CRD to proceed with its plans. Mr. Daly said that CRD will be paid $2 million per year in lease payments. Once I-75 corridor revenue reaches a threshold, then CRD gets a share. Mr. Lawson said that the cost of supervening events and other costs are deducted first.

In response to a question from Senator West, Mr. Lawson said that Ring 2 in eastern Kentucky is one of the more difficult rings to construct.

Senator Carroll said that the need for this project is understood; the issues are the cost and how decisions have been made.

Mr. McNeill said that the takeaway is that there is a $500 million to $700 million funding gap. Requests for general fund appropriations will be substantial. This will be looked upon in the future as a debacle, to which the Steve Beshear administration and CRD contributed. CRD has not contributed any of its own funds. The state provided $10 million in matching for CRD to get the federal grants. These grants in turn gave CRD leverage to get a lease agreement under which it will receive at least $60 million in payments over 30 years. CRD owns the eastern Kentucky fiber but the state is responsible for maintenance and refreshes. Under the original memorandum of agreement, CRD would have not received any revenue for years.

Mr. Decker suggested that the committee call Mary Lassiter [former Secretary of the Governor's Executive Cabinet] to testify.

Senator Carroll said that this project will be a tremendous cost to the state. The best that can be done is to ensure transparency given the poor decisions that have been made.

The meeting adjourned at 10:08 AM.