



MIKE HARMON
AUDITOR OF PUBLIC ACCOUNTS

December 5, 2019

Deck Decker, Interim Director
Kentucky Communications Network Authority
209 St. Clair Street, 4th Floor
Frankfort, KY 40601

RE: APA Examination of KCNA – Phase 2

Dear Mr. Decker:

The Auditor of Public Accounts (APA) has completed its examination of the procurement process associated with the Kentucky Communications Network Authority (KCNA) and the KentuckyWired (NG-KIH) project. Initiated after the September 2018 release of our report on the examination of KCNA, the focus of the second phase of the examination was to establish the timeline of events from when the Request for Proposal (RFP) was issued to the time the major project agreements were signed, and evaluate the procurement activities within this timeframe. The time period covered by the examination will be July 8, 2014 to September 3, 2015, unless otherwise specified.

Our procedures included a detailed review of emails and documents shared among key players during the examination period, as well as interviews with numerous individuals involved in the procurement process. Based on the results of these procedures, the APA has identified areas of concern and formulated corresponding recommendations for corrective actions to be taken, all of which are presented in this letter to be addressed by KCNA.

Confusion During and After the Procurement Process

One issue discussed in the September 2018 report of our examination was the significant changes to the final structure of the project from the initial RFP response submitted by Macquarie, as stated in the project agreement. The majority of these changes occurred, not during the competitive negotiations period, but during a very long post-award negotiation period. Typically, key

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Confusion During and After the Procurement Process (Continued)

negotiations involving a contract are performed during the competitive negotiation period and prior to the date of the contract award, with subsequent minor changes reflected as contract modifications. However, in this case, the master agreement was awarded in December 2014, with post-award negotiations of key elements continuing until a project agreement was signed in September 2015.

Based on interviews with members of the original procurement scoring team, confusion existed over several elements which ended up a part of the project that were not contemplated when the contract was awarded to Macquarie in December 2014. The Finance and Administration Cabinet (FAC) buyer on the contract also expressed confusion due to the extent of negotiations occurring without her involvement after the December 2014 award. The following table provides a timeline for the major phases of the procurement process as they occurred concerning this contract.

Table 1: Timeline for the KentuckyWired Contract

Procurement Phase	Date/Time Period
Request for Proposal Issued	July 11, 2014
Deadline for Responses to Request for Proposal	September 16, 2014
Responses Evaluated by Committee	September - October 2014
Initial Cost Clarifications Requested	October 6, 2014
Competitive Negotiations Begin	October 16, 2014
Competitive Negotiations End/Master Agreement Awarded	December 22, 2014
Post Award Activities Occur, including:	December 22, 2014 – December 21, 2014
Negotiations Continue	December 23, 2014 – September 3, 2015
Project Agreement Signed	September 3, 2015

Source: APA, based on information provided by FAC.

A significant factor in awarding this project to Macquarie was the cost evaluation. When the costs were evaluated, the respondent with the lowest cost received the maximum possible score. The tool used to score the project cost proposals was a four by five grid that assumed all network locations would receive the same speed, investments by the Commonwealth tiered between \$0 and \$60 million dollars, and points were awarded based on a percentage of revenue share. This scoring criteria was flawed because it was known that all network locations would not receive the same speed and the Commonwealth's investment level assumptions did not account for known risks, such as concerns regarding the E-rate payments.

During the RFP evaluation process, the FAC buyer requested a cost clarification from both potential vendors. A second cost clarification was requested only from Macquarie, but Macquarie insisted that the Commonwealth's desired presentation of the costs for scoring purposes was not an accurate reflection of how the network would actually be set up, so Macquarie made no changes to their previously submitted information. When Macquarie responded as such to the

Confusion During and After the Procurement Process (Continued)

Commonwealth, FAC elected to employ a Finance Policy (FAP) addressing discrepancies between unit prices and the extended price. Evaluating costs using unit pricing is questionable given that this was a contract for fiber construction and service, not for commodities.

The language in FAP 110-10-00 (1)(f) supports this stating, “Unit price for each unit offered shall be shown and shall include packing and shipping, unless otherwise specified. A total shall be entered in the amount column of the schedule for each item offered. In case of discrepancy between a unit price and extended price, the unit price shall govern.” Based on Macquarie’s concern with the cost scoring method employed by the Commonwealth and the lack of relevance of unit cost in the context of this project, a different scoring method for total cost should have been pursued.

Cost was not the only factor used to determine to whom to award the contract, but other qualitative factors in the RFP ended up materially changing and were not reflected in the final project agreement. Some of the positive aspects of the Macquarie plan the procurement team noted when scoring the project were rendered irrelevant by the time the project agreement was signed. One of the conclusions of the procurement team regarding the viability of the Macquarie proposal was, “off loading financial risk and have good subcontractors in order to do so” and “financial plans – no payments during construction – payments after they have built”. Although at the time of the scoring these project elements may have been included as part of Macquarie’s proposal, the evolution of the post-award negotiations from the master agreement to the project agreement radically changed the risk profile of the project, especially related to permitting and pole attachment risk. Regarding project viability, one of the negatives assessed by the procurement scoring team for Macquarie’s competitor to the RFP included the description “risk would be on Kentucky.” Other bidders may have been interested in pursuing this project had they been aware of the final, rather than preliminary, risk profile of the project. It is also questionable that the risk profile was negotiated after the project was awarded in December 2014, thereby making it impossible for competitive negotiations to occur with any entity other than Macquarie.

Interviews with current and former procurement officials at FAC indicated that FAC normally has a limited role in the contract negotiation process after the initial master agreement, or contract, has been awarded. In the case of this project, the most significant deviations from the RFP occurred post-award, a period outside of the state procurement cycle in which the FAC Office of Procurement Services (OPS) was the least involved with the project. When an FAC procurement official became aware of the frequency of negotiation meetings and changes that had occurred since the master agreement was signed, she inquired with KCNA as to why these changes were not being recorded in the Commonwealth’s accounting system, eMARS, as contract modifications. She was told by KCNA staff that there were too many agreements and amendments to those agreements to include them all in the system. Based on our review of eMARS, a mass of contract amendments – some of which were effective from the early stages of the project - were added in February 2019. In total, eMARS identifies 407 documents have been attached to the original master agreement.

Confusion During and After the Procurement Process (Continued)

The Commonwealth's procurement process at the time was not effective in scoring or awarding P3 projects of this complexity and scale. The agreement resulting from proposals scored by the procurement team would eventually be a 29 page master agreement signed in December 2014. From that point forward, at least 3,700 pages of documentation across approximately two dozen primary agreements were created that now govern the project. As late as August 2019, agreements were still being amended which will materially affect network revenue sharing. In discussing the frequency and breadth of changes being made to the master agreement due to post-award negotiations, the current OPS Director stated that, had these changes been passing through OPS as official modifications to the master agreement in real time, the staff would have noted multiple red flags concerning this procurement. The OPS Director indicated that the contracting entity "went rogue" and had OPS been aware of the proposed changes, it would have been less likely that KCNA would have reached the point of signing the project agreement in September 2015. Due to the significance and impact of changes compared to what was contemplated in the RFP, it appears it was premature to enter into the master agreement with Macquarie in December 2014.

Level of Involvement of Commonwealth Officials After Competitive Negotiations Had Ended

We questioned the level of involvement of the former Deputy Secretary in the procurement process of Black and Veatch, a project partner, in February 2015. The then FAC Deputy Secretary was contacted by First Solutions, a project consultant, working on the project about a "business friend" who was interested in the project. The then Deputy Secretary provided his cell number to First Solutions and encouraged them to pass it on to the individual.

The business friend's organization had placed a bid to supply equipment to Black and Veatch, a key project partner, but was not the lowest bidder. Black and Veatch alerted the Commonwealth that the business friend was not currently the lowest bidder and that someone should let them know that "they need to sharpen their pencil if they want to be considered." At that point, the then Deputy Secretary asked for the current subcontractor bids from Black and Veatch. The bids from the various companies, including the consultant's business friend, were then provided to the then Deputy Secretary. The Commonwealth injecting itself into negotiations is questionable. The RFP had been awarded to Macquarie two months earlier, although Macquarie was not included in the communications. Additionally, although the private contractors and subcontractors were not required to follow the government's procurement process, which would require the bids to be kept sealed, the appearance of this activity draws into question whether the FAC employee's influence was improper. The information provided did not identify further documentation regarding the final outcome of this decision.

Level of Involvement of Commonwealth Officials After Competitive Negotiations Had Ended (Continued)

We inquired with members of the negotiation team if this level of involvement was typical during the post-award negotiations, and they indicated numerous conversations were occurring with contractors and subcontractors in order to hit price targets. One of Macquarie's strengths listed in the procurement scoring phase was "took ownership of the project... demonstrated an understanding of the concessionaire model." Given this expectation, at a minimum, the Commonwealth appeared to be too involved in subcontractor negotiations for a fixed price, date certain arrangement.

Warnings from Consultants and External Counsel Were Not Heeded

During our initial exam, our procedures revealed instances where warnings were received by Commonwealth officials regarding issues that eventually had significant negative impacts on the project operationally and financially. We referred to written advice from outside counsel, the contents of which we had not had the opportunity to review at that time due to delays in obtaining the information. During the second phase of our examination, we reviewed thousands of emails and documents within the timeframe of our scope to investigate the existence and content of the warnings alluded to in our September 2018 report and any other warnings Commonwealth officials may have received.

Several consultants were retained in order to assist the Commonwealth during the RFP process, competitive negotiation phase in 2014, and the post-award negotiations throughout 2015. Our review of correspondence identified that these consultants repeatedly raised concerns about the Commonwealth's approach to the project and related negotiations. The final structure of the project agreement brings into question the extent to which FAC officials took action to protect the financial interests of the Commonwealth based on these concerns. When current KCNA officials who were involved with the post-award negotiations were asked about the specificity of the warnings in relation to the costly issues with the project, they said that the consultant gave advice to the Commonwealth and Commonwealth officials did what they wanted with the advice. There was no documentation to justify why the advice was seen as unreasonable or not in the best interest of the project or the Commonwealth, so it remains unclear why the Commonwealth identified the need to hire consultants if their guidance would not be used. In fiscal years 2015 through 2017, the two primary consultants were paid a total of \$1,368,354 by the Commonwealth.

The assumption of certain project risks has led to substantial delays and at least \$110 million in additional debt financing in order to cover penalties incurred as a result of accepting those risks. In interviews with current and former state officials in both phases of our exam, assuming these contractual obligations were discussed as necessary to reduce the original price. However, based on our review of correspondence between the Commonwealth and various consultants during the period covered by our exam, the assumption of this risk appears to have been anything but calculated. Based on the clarity of the warnings, it appears officials accepted the assumptions of contractual risks that were certain to, or at best likely certain to, adversely affect the Commonwealth.

Warnings from Consultants and External Counsel Were Not Heeded (Continued)

Regarding the RFP and the Decision to Have the Project Agreement Supersede the RFP

The original RFP was issued on July 11, 2014, responses were due by September 2014, and oral presentations and scoring of the RFP happened later in the year. A month away from the awarding of the contract to Macquarie, in a memo dated November 3, 2014, CTC Technology and Energy (CTC), a consultant of the Commonwealth, cautioned the Commonwealth not to rush. Additionally, under the heading "Lack of shared risk", CTC staff wrote "Macquarie's proposal entails little to no risk to Macquarie...It is most definitely not a shared-risk engagement - and is therefore significantly different from what CTC and the Commonwealth had contemplated at the onset of the RFP process." This should have been a significant red flag to Commonwealth officials involved. However, on December 22, 2014, the master agreement with Macquarie was signed.

As discussed earlier, in a normal procurement process the substantive elements of contractual arrangements are determined during the competitive negotiation phase which ended with the awarding of the master agreement to Macquarie. In the case of KentuckyWired, however, significant operational, financial, and legal elements, which would eventually be codified in the "Project Agreement," were negotiated after the awarding of the contract to Macquarie.

After reviewing an initial draft of the project agreement, an email from Polsinelli, a legal firm, in January 2015 provides both general and specific comments and suggestions regarding a draft agreement provided to the Commonwealth by Macquarie's legal counsel. It begins with comments including, "[t]he agreement significantly shifts, most, if not all, of many risks, both financial and liability-based, to the Commonwealth. It is heavily weighted in favor of Macquarie's interests." More specifically regarding a section on page 23 of the document, the consultant writes, "[t]he section on permits seems to shift too much risk on the Commonwealth."

Polsinelli also had concerns with the project agreement not incorporating the RFP stating, "[t]he agreement does not create a framework envisioned by the RFP where the entire project is turned over to the concessionaire with little or no risk to the Commonwealth."; and "[t]he agreement does not incorporate the RFP, only references it in Recital "A", and should by reference incorporate it as an attached exhibit."

Polsinelli's concerns over the lack of incorporation of the RFP intensified when a new draft of the agreement indicated the Project Agreement would not only fail to incorporate, but expressly supersede the RFP. In an April 8, 2015 email, lawyers from Polsinelli wrote that section 17.5 of the currently revised draft project agreement "makes the revised Project Agreement superseding the RFP, the master agreement, the GMP Proposal, and strikes out language incorporating the RFP. I think the RFP should be incorporated, not superseded. There would be elements of the RFP that represent the Commonwealth's interests, goals, and legal parameters required for the project that might be lost. It is common to see the RFP incorporated and standing throughout the procurement process as a guiding document or framework for selection of contractors."

Warnings from Consultants and External Counsel Were Not Heeded (Continued)

Regarding the RFP and the Decision to have the Project Agreement Supersede the RFP (Continued)

The decision to not incorporate the RFP by reference in the project agreement led to the Commonwealth losing key protections that were contemplated in the RFP. Interviews with KCNA officials indicated their assumption was that leaders at the time believed that FAC had been a party to the post-award negotiations and, therefore, was aware of the changes and incorporating the RFP was unnecessary. This brings into question the purpose of the RFP process on the whole if a project can be bid, competitively negotiated, awarded and subsequently changed to such a degree that the original RFP is deemed contractually irrelevant. Additionally, this information is inconsistent with claims reported that the Commonwealth was not aware of the risks being accepted throughout the procurement and post-award negotiation process.

Regarding Adverse Financial Risks

One goal of this phase of our examination was to attempt to put the negotiations into the proper context by understanding what Commonwealth officials knew of the project risks and when they became aware of those risks. This is especially important for those risks that have had the most adverse financial impacts on the Commonwealth.

Prior to the master agreement being awarded to Macquarie, and eleven months from issuance of the project debt, consultants warned in a report dated September 30, 2014, that the discussion of permitting in Macquarie's proposal "is high-level, boilerplate, may underestimate complications related to make-ready and permitting" and, in summary states, pays "[l]ittle attention to construction risk." Early correspondence between Macquarie and the Commonwealth showed project price was a key driver in competitive negotiations. In a November 26, 2014 letter to the FAC buyer during the competitive negotiation stage discussed above, Macquarie executives wrote that they understood the Commonwealth had affordability constraints, so they identified a variety of areas in which savings may be generated. One of the eleven suggestions was "[o]ptimization of risk allocation, including sharing with the Commonwealth certain risks that it may be able to mitigate more effectively (e.g. permitting and pole attachment and cable locate pricing)". These risks, particularly related to permitting and pole attachment issues, would eventually lead to significant cost overruns absorbed almost entirely by the Commonwealth.

A December 8, 2014 memo from CTC discusses a range of issues to be considered during competitive negotiations with Macquarie. In the memo CTC stressed, "In our view, there is some conflict of interests as between Macquarie and the Commonwealth with regard to key aspects of the business models to be developed, and that awareness of this conflict could help the Commonwealth structure the relationship in the most advantageous way." One of the recommendations to mitigate this was to "Ensure that Any Risk Related to Delays or Costs

Warnings from Consultants and External Counsel Were Not Heeded (Continued)

Regarding Adverse Financial Risks (Continued)

Associated with Poles, Make-Ready, and Working with Local Companies Be Allocated to Macquarie". This recommendation was provided, in part, because "[the consultant] was unsure of whether Macquarie understands many of the challenges of competitive fiber construction, in either metropolitan or rural areas." CTC staff go on to state that "Macquarie is expert at negotiating agreements that minimize or eliminate its own financial risk." Therefore, as of this date, both Macquarie and CTC provided risk sharing strategies, and the Commonwealth chose to accept Macquarie's strategy to have lower up-front cost, which ultimately led to significant compensation events.

In an email dated May 27, 2015, the Commonwealth's contracted legal counsel, Baller Stokes & Lide, P.C. (Baller) pointed out differences between Macquarie's RFP response and Macquarie's phrasing during the first workshop (discussion) on potential compensation events after the contract had been awarded. In the RFP response, Macquarie officials wrote "[t]he Macquarie team provides certainty for the Commonwealth" and "[t]he Concessionaire, following a negotiation period with the Commonwealth, will submit a binding proposal to develop, operate and refresh the NG-KIH over the 20 year concession period. This proposal will be on a fixed price and date certain basis, transferring project risks to the Concessionaire and creating cost and schedule certainty for the Commonwealth." At the workshop, Macquarie put forth that compensation events were "[u]nder direct Commonwealth control" and "[s]hared risks where Concessionaire/DB/O&M takes the 'first loss risk' (commensurate with affordability) and Commonwealth self insures catastrophic risk with the low expectation of occurrence".

Macquarie's line of reasoning had apparently evolved from creating cost and schedule certainty for the Commonwealth by assuming the risks to assuring this cost certainty would be achieved by the "low expectation of occurrence [of compensation events]." The protection from negative financial consequences because the event that may cause them is unlikely to occur is much less secure than the protection offered by another party contractually assuming the financial consequences if those unlikely events do occur. Macquarie's position during post-award negotiations appears to have changed from their position as stated in the RFP response. In any case, as post-award negotiations continued through 2015, warnings related to the likelihood of compensation events being triggered should have eliminated any Commonwealth expectation they were unlikely to occur.

The Pole Attachment Process

Pole attachment agreements are necessary whenever fiber must be attached to poles owned by other entities. These pole attachment agreements are necessary to conduct the "make-ready" process which involves the modification or replacement of a utility pole, or the modification or replacement of the lines or equipment on the utility pole, to accommodate additional facilities on the pole. Based on interviews conducted for our September 2018 report, a key assumption made

Warnings from Consultants and External Counsel Were Not Heeded (Continued)

The Pole Attachment Process (Continued)

by the Commonwealth while negotiating the project agreement was that the Commonwealth would have the needed pole attachment agreements in place prior to the start of construction or would be able to compel the pole owners to enter into agreements that facilitated attaching fiber in accordance with the aggressive timelines of the project schedule.

Shortly after the project agreement was signed in September 2015, the Commonwealth realized they could not compel the for-profit entities to take action on the pole attachment requests. In order to proceed, the Commonwealth requested to be designated as a competitive local exchange carrier (CLEC). This designation would, per federal regulations, require the pole owners to allow access to their poles. In the initial phase of our exam, we discussed that partly due to officials taking so long to apply for CLEC status, pole attachment agreements were not obtained timely.

Contractual timelines regarding the pole attachment process have been costly for the Commonwealth. The Commonwealth has paid \$8.7 million in penalties and has had to borrow an additional \$110 million to fund a settlement with the private contractors and create a contingency for future compensation events. Unfortunately, in the correspondence reviewed by auditors, the warnings related to the pole attachment process appear to have been more direct and clear than other issues that have plagued the project.

Based on these warnings, the pole attachment process appears to have been poorly managed by the Commonwealth and their partners despite having received several warnings related to this. As post-award negotiations progressed, it appears there was confusion regarding the shifting of CLEC status to the Commonwealth. In an email dated March 9, 2015, Baller confirmed that they did not "recall any discussions among the attorneys, and certainly no agreements, about shifting the risk of common carrier status to the Commonwealth" despite the vendor's legal counsel stating he thought this was "consistent with prior conversations."

Proposed timelines for pole attachment applications developed over the course of 2015. A version of those timelines generated the following warning on May 29, 2015. CTC staff stated "[discussions with others] confirmed my concern on times being to[o] short- given the volume of activity that a given agency or utility might be facing. The timeframes on slide 10 represent pretty good typical numbers for small projects, but we can expect this project is likely to overwhelm resources for most of these permit authorities, so expect challenges there without political escalation. The timeframes on slide 5 are also just good averages for applications with few poles, but if they expect to submit applications with 50 or more poles at a time, these will likely slip and backlogs will form." Given that, according to the Project Agreement, all but one of the dozens of anticipated pole owners owned more than 50 poles needed for the network, it seems clear that some requests would include more than 50 applications at a time.

Warnings from Consultants and External Counsel Were Not Heeded (Continued)

The Pole Attachment Process (Continued)

The pole attachment timeline situation appeared to grow more serious in the summer of 2015. A June 15, 2015 email from a CTC executive reads "[m]y main concern is that Macquarie appears to be unloading all the permitting and make ready risk to the Commonwealth. At the time of the finalist interview and all along afterwards we have been emphasizing this to Macquarie as an area of risk and immediate action but only in the past two months have they expressed their uncertainty. We at CTC feel that they took this risk on when they put in their bids and agreed to the schedules."

Two main concerns were expressed by the Commonwealth's legal counsel after review of the make-ready timelines in that version of the project agreement. First, the language of the compensation event was described as "very superficial and [it] glosses over many important distinctions. For example, what is a 'reasonable' period of time for responding to an application for attachment... will depend on multiple factors."

Secondly, Baller expressed concerns about the make-ready timelines proposed by Macquarie. They wrote, "[t]he specific time periods for the make-ready process that M/L propose are unreasonably short, compared to the time periods prescribed by the FCC's rules. If we accept M/L's proposal, not just many, but probably most, applications will fail to meet M/L's criteria, and each such failure will be a Compensating Event." Based on the warning that most applications would fail to meet the proposed contractual timelines, and by extension cause financial burden to the Commonwealth, adjusting the timelines, or allocating the risk to other parties, should have been a key negotiating priority.

Considering the suggestions of the consultants, and comparing that draft language to the final project agreement, it appears that, despite the concerns, the timing related to make ready work did not change.

On July 31, 2015, Baller emailed Commonwealth officials and other external attorneys and stated "fees and make-ready are separate issues, and make-ready can ultimately be much more problematic than fees. I urge you not to leave pole attachments until you have arrived at an acceptable solution to the troublesome language on make-ready in the definition of "Compensation Events." The same is true of the permitting issues in Attachment 2E."

As of August 4, 2015, the contractual timelines referred to by the external counsel still reflected the timelines that were in place during the email exchange in mid-July. Baller stated, "the MQ/Subs timelines are far shorter than the FCC's timelines. As a result, if the Commonwealth agreed to MQ/Subs' proposed section (z), Compensation Events might be the rule rather than the exception for make-ready." This warning seems to reiterate that Macquarie's proposed language and timeline for pole attachment agreements would trigger a compensation event for which the Commonwealth would be held responsible.

Warnings from Consultants and External Counsel Were Not Heeded (Continued)

The Pole Attachment Process (Continued)

To support the assertion that compensation events would occur frequently, Baller provided the Commonwealth data comparing "the FCC's timelines with those proposed by MQ/Subs in section (z) of the definition of Compensation Event." At this point, the project agreement still provided for the following timeframe for make-ready pole attachment applications: "approval of an application for make-ready work (without a restriction on the timing to commence such work) within 30 calendar days of receipt by the Utility company, local authority or other like body..."

On the same day this was sent from Baller, Commonwealth officials discussed the issue over email. They noted that removing compensation events from the project agreement, especially the one in question regarding pole attachment application timing, would extend the schedule and increase the amount of availability payments. Based on the project agreement, the decision was made not to address the issue and another FAC Deputy Secretary at the time concluded, "Hey, ultimately it's a business decision". On August 19, 2015, weeks before the project agreement is signed, one of the primary contractors warned that ATT pole attachment agreements would not be finalized until the Commonwealth met the requirements of a CLEC entity. Because of the number of poles owned by ATT, this was a significant indication the project timelines were in jeopardy.

The following table is derived from guidance from the FCC, which mirrors the make-ready timeframes provided by Baller on August 4, 2015. A table reflecting the timeline in the project agreement has been included to illustrate how aggressive the 30 day approval expectation was in relation to industry and regulatory norms under a best case scenario.

Table 2: Pole Attachment Application and Make-Ready Timeline Comparison

FCC Timelines	Stage			
	Survey	Estimate	Acceptance	Make-Ready
Day	0-45	to 59	to 73	133-148
Stage in Days	45	14	14	60-75
Project Agreement Timelines	Stage			
	Survey	Estimate	Acceptance	Make-Ready
Utility Day	0-30			65
Utility Stage in Days	30			35
Telecom Day	0-30			114
Telecom Stage in Days	30			84

Source: APA based on FCC information and the Project Agreement.

Warnings from Consultants and External Counsel Were Not Heeded (Continued)

The Regulatory Permitting Process

When laying fiber in the vicinity of other infrastructure, often local, state, or federal permits must be obtained in order to begin construction. Our September 2018 report noted that over 60% of all supervening events claimed as of January 2018 were due to regulatory permitting delays. Clear warnings were provided regarding regulatory permitting as well.

Emails from mid-July 2015, just two months prior to signing the project agreement, show Baller and CTC had concerns about regulatory permitting time periods at that point in the process. In an email dated July 14, 2015, Baller asked CTC to review the time periods proposed by Macquarie and Ledcor, saying "[t]hey want to treat as Compensating Events any delays past the time periods set forth in the charts. That would require the Commonwealth to continue to make availability payments, without deductions...This stuff really scares me..." As discussed in the initial phase of our exam, this scenario of availability payments without deductions, and without a completed network, is exactly the position the Commonwealth currently finds itself.

CTC responded to Baller, "I took a quick look at these numbers and am concerned that they are an attempt to do a smooth average over a wide range of circumstances, and that the risk to the Commonwealth is enormous... permitting always gets the blame when a project is late or over budget."

On July 16, 2015, CTC provides an alternative schedule of expected permit timing by permit class and type, with ranges they consider typical and reasonable. A Commonwealth employee's assessment of the CTC schedule the next day states that it represents "a wide range for each permit class". However, later in the email, a Commonwealth employee states that "I don't think [the contractors] will accept a wide range. Their proposal for each permit class was at the low end of [CTC's] proposed ranges. Perhaps we counter with the maximum amounts...and drop back to settle at a mid-point..." Ultimately, the Commonwealth did not adjust the timing, and in some cases the timelines were actually shortened, which was a costly decision.

Of 14 contractually defined classes of permits in the final project agreement, 11 classes ended up with more aggressive timelines than even the Macquarie proposals discussed in the July 16, 2015 email conversation. A significant permitting issue in the early phases of the project involved encroachment permits submitted to the Kentucky Transportation Cabinet (KYTC). Although the KYTC timeline remained the same from the draft to the final version, it would have been in the best interest of the Commonwealth to have heeded the consultants' warnings and lengthened the timeframe for this permit class rather than retain the draft timeline. Delayed permitting requests have been blamed for well over 100 supervening events.

Warnings from Consultants and External Counsel Were Not Heeded (Continued)

Conclusion on Warnings Regarding the Pole Attachment and Regulatory Permitting Process

Concerns were not limited to conversations between Commonwealth officials and consultants with an intimate understanding of the nuances of the negotiations. Even outsiders were worried about the regulatory permitting and pole attachment process. In an August 24, 2015 article by The National Council for Public-Private Partnerships discussing the KentuckyWired project, the editor wrote "Moody's Investors Service assigned the authority a provisional Baa2 rating with a stable outlook, saying that, although network construction will be "straightforward," the need "to obtain all right-of-way permits and approvals, pole attachment and railroad crossing agreements and direct coordination with the 1,098 nodes and end-users for site access" will be challenging and could throw the project off schedule."

Reading these warnings and reviewing the final project agreement language does not support the position that the Commonwealth accepted risks that just happened to go poorly. The warnings indicate that Commonwealth officials were aware of the likelihood that the risks would play out to the detriment of the Commonwealth. Even if the risks were taken to lower the initial contract price, a lower up-front price is artificial in substance if material penalties are certain to occur.

Regarding E-rate Funding and the Proposed KIH4 Contract

In our September 2018 report, we highlighted warnings from officials within the Commonwealth regarding the continued eligibility of the Commonwealth to receive E-rate funds given the planned governance structure of the KentuckyWired network and the procurement process surrounding the KIH4 contract. The RFP for the KIH4 contract, issued October 12, 2015 for infrastructure, statewide lit bandwidth, and fiber IRU services for approximately 525 sites, including K-12 public school districts and public libraries eligible to receive E-rate funding, was canceled on November 30, 2015 by FAC officials after a protest letter was filed by the current service provider, AT&T. Additional external warnings came to light during our recent review of communications from Commonwealth consultants to Commonwealth officials regarding E-rate funding in the context of this RFP.

In an email dated May 13, 2015, a CTC executive states that, regarding a recent memo on E-rate potential, "I'm in agreement with you that it's too good to be true. I have concerns about how optimistic these projections are, and that the Commonwealth would presumably hold the risk in the event that these funds did not materialize. I also think there is risk created by the competitive bidding process, as well as considerable political risk."

Warnings from Consultants and External Counsel Were Not Heeded (Continued)

Regarding E-rate Funding and the Proposed KIH4 Contract (Continued)

In an August 10, 2015 email to the Commonwealth, a CTC executive stated that "I think that you are likely to get significant pushback from AT&T regarding the fiber strategy, both with respect to the full effort and with respect to any E-rate element. Even if this opposition is somewhat muted right now, it may intensify after Governor Beshear leaves office, depending on how receptive the next governor is to the opposition." The executive then goes on to recommend benchmarking current AT&T pricing and service attributes to those in other states to provide to the next governor's team.

In our September 2018 report, we noted that the then Secretary of FAC alleged in interviews to have been unaware of the importance of E-rate and K-12 funding to the financial viability of the project. Documents reviewed during this phase of our examination draw that assertion into question. On August 27, 2015, a document titled KentuckyWired Executive Update was sent to both the Secretary of Finance and the then Secretary of the Executive Cabinet. Under "Issues and Concerns" the following were included: ATT (Concerning pole attachments), Timing of pole attachments, ProjectCo – Formation of non-profit as an instrumentality of the Commonwealth – timing of transition to new entity, and KIH4 (competitive bid process). Because the issues of concern listed an item related to the competitive bid process of KIH4, it appears that there was likely some understanding that the E-rate funding tied to this project required a competitive bid, and as such was not a guaranteed source of funding.

Conclusion and Recommendations

Unfortunately, due to the number of agreements, complexity of those agreements, and the dramatic evolution of the project from the awarding of the RFP to the actual project agreement, it was difficult to determine, based on documentation available, who at the Finance Cabinet was making the final decisions in terms of negotiations. Based on interviews of multiple current and former Commonwealth officials, Steve Rucker, who served as the Deputy Secretary of the Finance and Administration Cabinet and later as the Executive Director of the Kentucky Communications Network Authority was most often pointed to as the lead on the project for the Commonwealth. However, numerous Commonwealth officials, both current and former, were involved in the competitive and post-award negotiations.

The September 2018 report on our examination of KCNA and the KentuckyWired project resulted in questions about how the project could be procured and awarded without necessary safeguards for the Commonwealth. This warranted expanding the examination to further review the procurement, award, and post-award negotiating aspects of the project.

Conclusion and Recommendations (Continued)

These expanded procedures highlight that the initial RFP was not properly developed to meet the intended needs of the Commonwealth and that the procurement process was deeply flawed. The subsequent project agreement reflects those flaws, leaving the Commonwealth with a significant additional burden to the taxpayers than contemplated when the project was conceived.

We make the following recommendations in addition to those communicated in the September 2018 report of this examination:

1. We recommend that in the future, when consultants are providing clear guidance and significant warnings as was the case in this project, the rationale for not adhering to such guidance should be documented by those conducting the negotiations. This is important to evidence that project consultants were not frivolously hired, but that sound reasoning in the best interest of the Commonwealth outweighed the professional guidance initially determined to be necessary.
2. Those involved in the negotiations appeared to have negotiated from a position of needing to achieve a “fixed price” in form only. Given the warnings, those involved knew the price agreed to was likely temporary and would rise as penalties were incurred. In the case of complex projects, Commonwealth officials should consider factors of such projects in the context of all possible costs that could be, or in this case were all but certain, to be incurred.
3. Penalties should be included and enforced in contracts and other agreements for infractions of state law and, when relevant, breaches of Commonwealth procurement policies.
4. All employees involved in project management, contract monitoring and oversight, and other communications with contractors should be given firm guidance to avoid potential conflicts of interest or applying influence in ways that could give the appearance of impairing fair competition in the contractor’s procurement process.

Thank you for your attention to these matters. Your response to these findings is included as an attachment to this letter.

We would like to thank KCNA, as well as the Finance and Administration Cabinet, for its cooperation with this review. If you have any questions regarding this letter, please contact me or Libby Carlin, Executive Director at 502-564-5841.

Thanks and God Bless,



Mike Harmon
Auditor of Public Accounts

Attachment: KCNA Response to Examination



Commonwealth of Kentucky
Governor's Office

Matthew G. Bevin
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Bernard "Deck" Decker
Acting Executive
Director

December 9, 2019

Mike Harmon
Auditor of Public Accounts
209 St. Clair Street, 1st Floor
Frankfort, KY 40601

Mr. Harmon,

KCNA is in possession of your draft audit titled APA Examination of KCNA - Phase II. KCNA appreciates the hard work your staff has undertaken to review the procurement process and negotiations leading up to the award of the contract for KYWired. Your investigation has confirmed many of the issues that I have found in my time as Interim Executive Director for KCNA. I have read the documents, and agree with your findings set out in the audit.

I would like to point out details of the APA Examination that have put the Commonwealth at great financial risk. Section 17.5 of the Project Implementation Agreement superseding the RFP, the master agreements, and proposals seem to violate the Model Procurement Code. FAP 110-00-04-N states that contracts must "Accept any contract awarded on the terms and conditions of the solicitation", which is the standard for competitive sealed bids, and 200 KAR5:307 Section 7 states "The terms and conditions of the contract shall not in any material respect deviate in a manner detrimental to the purchasing agency from the terms and conditions specified in the solicitation for proposals", and is the standard for competitive negotiations. In my opinion Section 17.5 of the Project Implementation Agreement is in direct violation of these policies. As these are set policies, the Secretary of Finance would not have the legal authority to waive these. In addition outside attorneys made the Finance and Administration Cabinet aware of the problems with waiving the Terms and Conditions of the solicitation. Section 17.5 of the Project Implementation Agreement makes it an unfair solicitation for the other vendors who responded, as they were held to a different standard. I also believe the Commonwealth has no legal obligation to follow this section, as it was not legally allowed.

The examination also found confusion with who was responsible for the procurement process during the solicitation and negotiations. I have been involved in public procurement for 15 years and was formally a Certified Public Procurement Officer. It has always been my understanding that all communications during the solicitation and negotiations must go through the procurement officer responsible for the solicitation. The Model Procurement Code requires that for the very reasons laid out in this Examination. Unfortunately, the Commonwealth has had to pay for the egregious violations of standard protocols during this process.

Mike Harmon, Auditor of Public Accounts

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In regards to the ignoring of outside counsel recommendations, I would point out that their warnings to the Commonwealth have all been realized. I would assume you ask for outside counsel's advice due to lack of internal knowledge. By ignoring those that actually knew what they were talking about, those involved in this contract have increased the cost to the Commonwealth by hundreds of millions of dollars that they did not have a right to risk.

Thank you for the opportunity to respond to the Examination,

Bernard "Deck" Decker

Interim Executive Director of Kentucky Communications Network Authority