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Fitch: Kentucky Wired Dispute Puts Project, Commonwealth Ratings at Risk.

Fitch Ratings-New York-10 April 2018: A commonwealth budget dispute regarding appropriations and additional bonding authority for the Kentucky Wired public private partnership (PPP) project puts the ratings of related project debt and the commonwealth itself at risk, and also raises questions about the viability of PPP projects in Kentucky, says Fitch Ratings. A failure by Kentucky to meet its obligations under the PPP contracts will also create some uncertainty among market participants, including contractors, infrastructure investors and lenders regarding the vitality of PPP finance for infrastructure more generally.

Political dispute around the larger budget bill, and a related tax measure, are further complicating issues. The Kentucky Wired project represents only a small portion of the roughly \$25 billion general fund budget for the commonwealth's upcoming biennium, beginning July 1, 2018. Fitch rates the Kentucky Wired project bonds 'BBB+' /Rating Watch Negative, and the commonwealth's counterparty obligation for the project 'A' /Outlook Stable. The counterparty obligation rating is notched off the commonwealth's 'AA-' /Outlook Stable Issuer Default Rating. The state undertook the PPP to build out state wide broadband access, the first such state wide effort in the country.

The funding issues come amidst a challenging overall commonwealth budget situation with the governor's executive budget recommending sizable cuts across a broad range of government agencies. On April 2, Kentucky's legislature passed a budget bill (HB 200) for the upcoming biennium (beginning July 1) that classified essentially all of the governor's proposed appropriation for availability payments for the Kentucky Wired PPP (as made to the Kentucky Communication Network Authority [KCNA]) as necessary government expenses (NGE) to be paid upon direction from the governor. NGEs are a regular budget management tool used by the commonwealth to fund items without a line-item appropriation and require certification from the commonwealth's secretary of finance, appointed by the governor. The NGE designation for KCNA in HB 200 includes the specific dollar amounts originally requested in the governor's executive budget.

On Monday, April 9, the governor announced his intention to veto both HB 200, and the related tax bill (HB 366) for various reasons including unhappiness with the tax measures in HB 366 and what he considered continued budgetary imbalance in HB 200. In his address, the governor specifically cited Kentucky Wired as a project the commonwealth was fully committed to and he criticized the legislature for designating the requested funding as NGEs, rather than providing a line item appropriation. Fitch considers the NGE designation a solid financial commitment from the commonwealth, but recognizes that this designation does require the governor to potentially find offsetting budget actions to ensure funding is provided for KCNA. In Kentucky, veto overrides require only a majority vote of each chamber to override and both HB 200 and HB 366 had sufficient votes at passage last week to override any vetoes.

TENTATIVE SETTLEMENT AGREEMENT AT RISK

In a related but distinct project funding issue, KCNA is also seeking legislative authorization for

bonding authority to support a tentative settlement agreement that could resolve outstanding project issues. Kentucky Wired has faced multiple delays since it began in 2015 and the commonwealth is currently engaged in negotiations over a settlement with the project company and construction subcontractor. The tentative settlement agreement requires \$88 million in additional funding from the commonwealth, beyond the appropriations request for availability payments. KCNA has requested \$110 million in bonding authority to cover costs for the tentative settlement agreement and to provide contingency for potential future project costs. The bill (SB 223) has not advanced beyond committee, but the legislature will reconvene on April 13 and 14 (Friday and Saturday) for the last days of its 2018 regular session to consider the governor's vetoes, and could pass legislation at that point.

Failure of the legislature to authorize funding for the settlement agreement through KCNA's proposed legislation or another mechanism, threatens the viability of the settlement agreement and the project itself as Fitch noted in a recent rating action commentary on the project debt ("Fitch Maintains Rating Watch Negative on Kentucky Wired Infrastructure Company's Senior Revs" dated April 10, 2018). It would also raise concerns for Fitch about Kentucky's willingness to abide by terms of the project agreement and could lead to negative rating action on the project debt, the commonwealth's counterparty obligation rating, and Kentucky's IDR. In Fitch's view, counterparty obligations under PPP project agreements extend beyond simply making availability and milestone payments to also include adherence to all terms of the agreements as well as related commitments such as those in the proposed settlement agreement.

Fitch rated the commonwealth's counterparty obligation for the Kentucky Wired PPP project using our "Public-Sector Counterparty Obligations in PPP Transactions Rating Criteria" and notched it from Kentucky's IDR given the strength of the commonwealth's legal commitments under the project agreement. Failure by Kentucky to provide for funding necessary to sustain the project and meet its counterparty commitments would raise concerns about the commonwealth's willingness to pay other long-term financial obligations and may be reflected in a lower IDR for the commonwealth. All of Kentucky's approximately \$8 billion in outstanding debt is appropriation-supported, and the ratings on those bonds are linked to the commonwealth's IDR.

A default by the commonwealth would also signal to Fitch that PPP commitments entered into by Kentucky are subject to a higher level of political risk than previously understood. Kentucky's prior governor, a Democrat, entered into the project agreement in 2015. The current Republican governor expressed concerns about the project when he took office but his administration has since affirmed its support, including through the appropriations request for the upcoming biennium, and advocacy for the additional bonding authority. Rejection of the governor's requests by the legislature could indicate that the commonwealth's own fiscal challenges in a difficult budgetary environment take political precedence over PPP project obligations.

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