MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. TF-2008-0298, Ellington Telephone Company, Inc.

FROM: David Murray, Financial Analysis Department
Myron Couch, Telecommunications Department

/s/ David Murray 5/12/08	/s/ Dennis Frey 5/12/08
Financial Analysis Department	General Counsel's Office

SUBJECT: Staff Recommendation for conditional approval of the Application of Ellington Telephone Company, Inc. to borrow an amount not to exceed $3,000,000 from CoBank under a Twelve (12) Year Secured Credit Facility and in connection therewith to execute a lien and security interest.

DATE: May 12, 2008

Ellington Telephone Company, Inc.

1. (a) **Type of Issue:** Twelve (12) Year Secured Credit Facility.

   (b) **Amount:** Up to $3,000,000.

   (c) **Rate:** Either a Weekly Quoted Variable Rate or a Long-Term Fixed Rate Option as quoted by CoBank, ACB.

2. **Proposed Date of Transaction:** As soon as possible after Commission authorization.

3. (a) **Statement of Purpose of the Transaction:** The Applicant proposes to apply the net proceeds to fund various capital improvements, finance operating needs, make an investment in a wireless venture, and for general corporate purposes.

   (b) **From a financial perspective, does Staff deem this purpose reasonable?**

   Yes _X_ No

4. **Type of Transaction:** Senior secured facility in the form of a Master Loan Agreement and First Supplement to the Master Loan Agreement.

5. **Copies of executed instruments defining terms of the proposed transaction:**

   __ (a) If such instruments have been previously filed with the Commission, a reference to the Case Number in which the instruments were furnished.

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_X_ (b) If such instruments have not been executed at the time of filing, a commitment to provide the terms and conditions of the instruments when they are available has been made.

___ (c) If no such instruments are either executed or to be executed, a statement of how the securities are to be sold.

6. **Certified copy of resolution of the directors of applicant, or other legal documents authorizing the proposed transaction reviewed:**

Yes _X_ No

7. **Capital expenditure schedule reviewed:**

Yes _X_ No

8. **Journal entries are required to be filed by the Company to allow for the Fee Schedule to be applied:**

Yes _X_ No

9. **Recommendation of the Staff:**

____ Grant by session order (see Comments)

_X_ Conditional Approval granted pending receipt of definite terms of transaction (see Comments)

___ Require additional and/or revised data before approval can be granted (see Comments)

___ Formal hearing required (see Comments)

___ Recommend dismissal (see Comments)

COMMENTS:

Ellington Telephone Company, Inc. (Ellington, Applicant or Company) is a Missouri corporation with its principal office and place of business at 200 College Avenue, Ellington, Missouri 63638. Applicant is subject to the jurisdiction of the Commission and is engaged in providing telecommunications service to customers in five (5) exchanges located in the Missouri counties of Reynolds and Shannon. Ellington had ** ______** residential exchange access lines and ** ___ ** business exchange access lines as of the end of 2007.

Ellington has filed an Application requesting that the Commission authorize the Company to borrow up to $3,000,000 in aggregate principal amount through a 12-year secured credit facility from CoBank, ACB (CoBank), in order to fund various capital improvements, finance operating needs, make an investment in a wireless venture, and for general corporate purposes. The Company attached a summary of the terms and conditions of this facility as Appendix 2 to the Application. As security for the loan, the Applicant proposes to place an encumbrance on all of the Applicant's real and personal assets, along with its stock, in its wholly-owned, non-regulated subsidiary. It is Staff's understanding that Ellington's regulated, as well as non-regulated, assets will be pledged as security for the proposed loan. The Applicant proposes to execute and deliver a mortgage, security agreement, and financing statement substantially in the form of the Real Estate Deed of Trust and Security Agreement.

Use of Funds.

Staff members from the Telecommunications Department inspected Ellington's facilities on April 22, 2008. They visited various locations within the Company and talked extensively with the President of the Company, Dee McCormack, and Assistant Manager, Michael McCormack. Specific plans for use of the proceeds are discussed below.

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_______________. **

The Company plans to use ** _______ ** to replace the Nortel DMS-10 digital telephone switch the Company installed in 1993. **

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_________. **

The last use of the proceeds of this loan will be to replace cash reserves used to make previous plant additions. The cash allocated will be ** ** Company officials assert that these reserves need to be replenished as a hedge against unexpected expenses in the near future.

<u>*Financial Analysis.*</u>

Financial Analysis Department Staff analyzed the impact of the issuance of the full amount of debt on the financial risk of the Company. Although Ellington is requesting authority to borrow $3 million, it is not certain it will draw down the entire amount at the closing of the loan. According to Ellington's response to Staff Data Request No. 0003, the credit facility is set up as a "Term Revolver" where funds will be drawn as needed. Although the entire amount of funds may not be issued at the close of the loan, it is Staff's understanding that Ellington intends to eventually draw down the entire $3 million. Staff's analysis of the financial impact of the proposed financing assumes a full drawdown at closing, which is consistent with the pro forma financial statements Ellington attached as Appendix 4 to the Application.

The financial statements attached to the Application were for the 2006 year-end because, at the time the Application was filed, 2007 year-end financial statements were not available. Staff requested the past five years of financial statements in Staff Data Request No. 0001 issued on March 18, 2008, and Ellington's response did not include 2007 financial statements. Because of the nature of the transaction and its pro forma effects, Staff did not deem it essential to use 2007 financial statements to evaluate the effects of the proposed transaction. However, because Ellington had filed its 2007 Annual Report to the Missouri Public Service Commission before this recommendation was completed, Staff did analyze these statements before filing its recommendation. The Staff did not detect any significant changes, such as a significant increase in outstanding debt, which would cause Staff to require the use of 2007 financial statements to analyze the pro forma impacts. The pro forma impacts did not include any additional future cash inflows as a result of the capital expenditures and investments made in association with the proposed loan. Additionally, the year-end 2006 financial statements included Universal Service Fund high cost payments of $448,092. In response to Staff Data Request No. 0008, Ellington indicated that based on information provided by the National Exchange Carrier Association (NECA), it anticipated Universal Service Fund support of $748,176 for 2008, based on expenses and investments incurred as of December 31, 2006. Staff compared Ellington's pro forma financial ratios to those proposed as financial covenants in the Terms and Conditions attached as Appendix 2 to the Application. Staff also compared the Company's pro forma financial ratios to

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the 3-year averages of four comparable companies rated by Standard & Poor's (S&P). Staff chose these four companies as comparables because they were classified as rural local exchange carriers (RLECs) by S&P in a June 12, 2006, S&P research report, "Rural Local Exchange Carriers: No Longer Isolated From Competition." Although there were other companies identified in this research report, Staff used the companies that had recent S&P data available. Although it is useful to compare Ellington's financial ratios to those provided by S&P for these four companies, it is important to note that S&P does not provide the average debt service coverage ratios in the data it publishes. This ratio is of particular interest because the proposed debt instrument will be an amortizing loan (principal as well as interest will be due periodically). Consequently, the coverage ratios reported by S&P are not as relevant to the proposed loan transaction, which is more typical for private bank loans than for bond issues. The average S&P corporate credit rating of the four companies is BB-, with three of the four having this corporate credit rating and one having a BB corporate credit rating. Credit ratings in the BB category are considered non-investment grade, which appears to be typical of the RLEC industry for all but the largest companies, such as CenturyTel. Neither Ellington nor its debt is rated by any credit rating agencies.

Ellington currently has only a small amount of debt outstanding. According to Ellington's December 31, 2006, Balance Sheet, it has a debt to total capital ratio of only ** ** percent. According to Ellington's year-end 2002 through 2006 Balance Sheets, Ellington's debt has averaged approximately ** ** percent of total capital. Consequently, although Ellington's pro forma amount of debt to capital of ** ** percent is low compared to the financial covenant maximum amount, and the average amount of debt to capital for the four comparable companies, it is much larger than Ellington typically carries on its balance sheet. However, the ratio should decrease due to the amortization of principal, assuming no additional debt is incurred. According to financial statements Ellington provided in response to Staff Data Request No. 0001.1, Ellington has used much of its internally generated cash to fund its capital expenditures. Ellington had annual average capital expenditures of ** ** from 2002 through 2006, and annual average cash provided by operating activities of ** ** over the same period. Ellington's average dividend payout of only ** ** percent of earnings over this same period explains the Company's ability to maintain consistently low debt to capital ratios.

Based on the pro forma financial statements, if the entire $3 million of debt is incurred, the debt service coverage ratio will be ** **, which is above the minimum financial covenant of 1.50 times (see Schedule 1). Assuming the Company does not improve its cash flow from its 2006 level, the debt service coverage ratio should still improve over time because the proposed loan requires the amortization of principal, with a resulting reduction in annual interest expense.

The pro forma financial statements indicate that Ellington's Debt to EBITDA (earnings before interest, taxes, depreciation and amortization) ratio would be approximately ** **. This satisfies the financial covenant maximum of 4.00 times in the proposed loan agreement, and is also below the 3-year average of 4.58 times for the four companies rated by S&P (see Schedule 1).

The pro forma EBITDA Interest Coverage ratio for Ellington is approximately ** ** which is higher than the 3-year average of 1.58 times for the four companies rated by S&P. A higher EBITDA Interest Coverage ratio indicates that there is more cash flow available to pay interest expense. Of course, as indicated previously, because Ellington's proposed loan is an amortizing loan, the debt service coverage ratio is more relevant for purposes of evaluating its ability to service its debt. This is most likely the reason there is no financial covenant for the EBITDA Interest Coverage ratio.

** ____ ______________________ **, Staff believed it was prudent to determine the financial impact of a complete loss on this investment. Because no anticipated dividends from the investment were projected in the pro forma financial statements, the amount of debt and cash flows in the current pro forma financial statements would remain the same. As a result, three of the four ratios analyzed by Staff would not be impacted by writing off this investment. However, Ellington's capital structure would be impacted by the write-off because it would no longer have an asset supported by the debt. This would result in a dollar for dollar deduction to the common equity balance on Ellington's balance sheet. Based on the pro forma financial statements submitted by Ellington, the debt to total capital ratio would increase to ** ** based on the initial value of ** __________ **. Therefore, even with a complete write-off of the investment, Ellington's capital structure ratio would still be in compliance with the financial covenant of no greater than a 50 percent debt to total capital ratio contained in the proposed loan agreement.

Based on Staff's financial analysis, Ellington's financial risk from the proposed debt should not impair the Company's ability to attract capital. In fact, because most of the capital invested in the Company in the past five years has come from internally generated cash, it would appear that the Company will not need to seek any significant additional third-party financing for its normal capital expenditures. This assumes that Ellington's future capital expenditures are consistent with average annual past capital expenditures, which the Company asserted in response to Staff Data Request No. 0006.

OTHER ISSUES:

The Staff has verified that the Company has filed its annual report and is not delinquent on any assessment. The Staff's Budget and Fiscal Services Department has reviewed the circumstances in this finance case and believes that the Company's proposal under Paragraph 11, of the Application, will suffice for determining if the fee schedule should apply, as set forth in Section 386.300 RSMo 2000.

RECOMMENDATION AND CONDITIONS:

The Staff recommends the Commission approve Ellington's Application subject to the two conditions below. It is the Staff's opinion that these improvements will benefit Ellington's consumers and allow the Company to gain sufficient technology for the foreseeable future.

With the conditions below, Staff does not believe the proposed transaction is detrimental to the public interest.

1. That nothing in the Commission's order shall be considered a finding by the Commission of the value of this transaction for rate making purposes, which includes, but is not limited to the capital structure, and that the Commission reserves the right to consider the rate making treatment to be afforded these financing transactions and their effect on cost of capital, in any later proceeding.

2. That, within thirty days of the execution of the transaction, the Company shall file with the Commission all final terms and conditions of the proposed financing.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Application of Ellington Telephone Company for Authority to Borrow an Amount not to Exceed $3,000,000 from CoBank under a Twelve (12) Year Secured Credit Facility and In Connection Therewith Execute a Lien and Security Interest	Case No. TF-2008-0298

AFFIDAVIT OF DAVID MURRAY

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

David Murray, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Recommendation in memorandum form, to be presented in the above case; that the information in the Staff Recommendation was developed by him; that he has knowledge of the matters set forth in such Staff Recommendation; and that such matters are true and correct to the best of his knowledge and belief.

David Murray

David Murray

Subscribed and sworn to before me this 12th day of May, 2008.

Nikki Senn

Notary Public

NIKKI SENN
Notary Public - Notary Seal
State of Missouri
Commissioned for Osage County
My Commission Expires: October 01, 2011
Commission Number: 07287016

SCHEDULES 1 AND 2

HAVE BEEN DEEMED

PROPRIETARY

IN THEIR ENTIRETY