

DISCLAIMER

While the Staff has endeavored to verify all of the information disclosed in this interim report and accurately disclose that information, some of the statements made in this interim report are based on allegations and others are based on the Staff's best understanding of the information available to it at the present time. The Staff has endeavored to provide citations or source information that it relies on for the statements it makes in this interim report.

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Section 1. Summary

On January 14, 2005, the Missouri Public Service Commission (Commission) issued an Order establishing Case No. TO-2005-0237. In this Order, the Commission Staff (Staff) was directed to investigate all matters pertaining to the operations of Cass County Telephone Company (Cass County Telephone) and New Florence Telephone Company (New Florence Telephone). Both Companies were owned in part or operated by Mr. Kenneth Matzdorff, who has pled guilty to certain felony fraud charges relating to, in part, regulated telephone operations. Because of the charges against Mr. Matzdorff, the Commission ordered the investigation of the two Companies so that the customers of Cass County Telephone and New Florence Telephone could be protected.

The purpose of this interim report is to update the Commission on the status of this investigation. The Staff to date has obtained a significant amount of information relevant to the concerns expressed by the Commission in its January 14, 2005 Order, and certain pieces of that information are highlighted in this report. However, the Staff's progress in completing its investigation has been slower than anticipated, primarily due to: 1) slower than anticipated receipt of information through subpoenas from LEC, L.L.C., the principal owner of Cass County Telephone, and a part owner of New Florence Telephone; 2) longer than anticipated response times to discovery requests from Cass County Telephone and New Florence Telephone; and 3) the refusal to date of Cass County Telephone to provide certain information for the Staff's review. (The Staff is pursuing that information through a Commission subpoena.)

The Staff is currently in the process of initially reviewing and digesting significant amounts of information from LEC, L.L.C., obtained through subpoena, first available to the Staff in Mid-May of 2005. This information will form the basis of additional subpoenas to LEC, L.L.C., if necessary, as well as future planned depositions of certain LEC, L.L.C. employees.

At this time, based upon the information reviewed by the Staff so far, the Staff cannot represent, with reasonable confidence, that the books and records of Cass County Telephone and New Florence Telephone have been or are currently accurate. Nor can it recommend that the Commission certify the Companies to resume receiving federal Universal Service Support.

The Staff is endeavoring to complete its investigation of Cass County Telephone and New Florence Telephone as quickly as possible, while making to the Commission well-founded and reasoned recommendations based upon substantial evidence as how to best protect the Companies' Missouri customers. The Staff plans to file a further report to the

Commission on the status of its investigation no later than 90 days following the filing of this interim report (August 26, 2005). The Staff hopes its investigation will be entirely or largely complete by that time.

Section 2. Discovery

In order to obtain information from LEC, L.L.C. relevant to the matters raised by the Commission in its January 14, 2005 Order establishing this docket, two subpoenas were issued by the Commission and served on registered agents of LEC, L.L.C. on March 7, 2005. On March 17, 2005, LEC, L.L.C. filed a motion with the Commission to quash these subpoenas. On March 17 and 18, 2005, subpoenas were issued by the Commission and served on registered agents of Cass County Telephone and New Florence Telephone to obtain certain information pertaining to external auditor data from the Companies that Cass County Telephone and New Florence Telephone had objected to providing through data request responses. On March 25, 2005, Cass County Telephone and New Florence Telephone filed a motion with the Commission to quash these subpoenas as well.

After discussion between the Staff and LEC, L.L.C., agreement was reached on the LEC, L.L.C. information that would be disclosed to the Staff in response to the subpoenas served on LEC, L.L.C. Accordingly, on April 26, 2005, LEC, L.L.C. withdrew its motion to the Commission for the subpoenas to be quashed. Certain subpoenaed LEC, L.L.C. information was sent by mail to the Jefferson City offices of the Commission on May 13, 2005. Other subpoenaed LEC, L.L.C. information was made available to the Staff at the LEC, L.L.C. office in Peculiar, Missouri, starting on May 17, 2005.

A dispute still exists regarding information sought from Cass County Telephone in the form of external auditor workpapers supporting the recent external audits performed on Cass County Telephone by Warriner, Gesinger and Associates, LLC. On May 5, 2005, the Commission issued its Order denying Cass County Telephone's and New Florence Telephone's March 25, 2005, motion to quash these subpoenas. On May 13, the Companies filed a Motion for Reconsideration of the Commission's May 5, 2005, Order. (Subsequent to these filings, New Florence has agreed to provide the Staff access to the requested external auditor workpapers, and the Staff has made arrangements to review these documents on June 2 and June 3, 2005.) However, Cass County Telephone continues to object to providing these external auditor materials to the Staff. The Staff believes access to these workpapers is critical to investigation of matters within the scope of the Commission's January 14, 2005 Order in this proceeding. The Staff anticipates it will be necessary to seek Circuit Court enforcement of the Commission's subpoena to Cass County Telephone.

The Staff is obtaining information regarding Cass County Telephone and New Florence Telephone slower than it anticipated it would when it began its investigation. To obtain information in the possession of Cass County Telephone and New Florence Telephone, 185 data requests have been submitted by the Staff to the Companies under the TO-2005-0237 docket number. On a timely basis, the Companies have informed the Staff that they could not provide substantive responses to a majority of these data requests within the normal 20-day period. Of the 177 Staff data requests to date that were submitted as of May 3, 2005, 143 (or approximately 81%) were answered by the Companies after the normal 20-day deadline. For these 177 data requests, the average response time by the Companies has been approximately 31 days. The Staff raises these matters only for the purpose of pointing out that the course of events in this case regarding the data requests and subpoenas has necessarily meant that the Staff's access to much of the information it believes necessary to conduct this investigation have been significantly delayed beyond what it initially assumed would be the case.

Section 3. Call Center/Cash Collection/Disconnection

Cass County Telephone

Cass County Telephone is currently implementing new management practices as deemed appropriate by GVNW Consulting. There are a total of 28 LEC, L.L.C. employees that may charge their time to Cass County Telephone, and eight field personnel, who are Cass County Telephone employees. GVNW reports to the general manager of LEC, L.L.C., Mr. Matzdorff, on a monthly basis. GVNW stated that Cass County Telephone's performance measurements such as consumer complaints, number of bill discrepancies, average speed of answer and abandon call rate, etc. have not yet been established. One preliminary observation made by the Staff is the failure to adequately segregate financial and administrative duties.

LEC, L.L.C.

Initial observations made by the Staff concerning LEC, L.L.C. include: high percentage increases in salary, inconsistency in percentage increases in salary, nepotism, inconsistent administration of personnel policies, performance appraisals not performed each year and lack of proper documentation in employees' personnel files including current position descriptions.

New Florence Telephone

Initial work started at New Florence Telephone on May 25, 2005; therefore, the Staff has nothing to report at this time.

Section 4. Receipt and Disbursement of Federal Universal Service Funds

Cass County Telephone

According to the "Cooperation Agreement" dated January 7, 2005, and attached "Information" document (together, the "Cooperation Agreement"), reached between Mr. Matzdorff and the Offices of the United States Attorneys for the Eastern District of New York and the Western District of Missouri, additional Universal Service Funds were received based on payment of fictitious "consulting" and "management" fees to Overland Data Center, a computer services company. The total payments by Cass County Telephone to Overland Data Center were approximately \$11 million between 1998 and 2003. According to the Cooperation Agreement, the total value of the actual services performed during 1997 to 2002 by Overland Data Center for Cass County Telephone was estimated at \$240,000. Proprietary Attachment 1 is **

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Further, also according to the Cooperation Agreement, Cass County Telephone and later LEC, L.L.C., charged Overland Data Center for "consulting" and "management" fees as part of the overall fraud scheme. The payments from Overland Data Center to Cass County Telephone and LEC, L.L.C. totaled roughly \$11 million from 1998 to 2003, which served to offset the earlier overpayments made by Cass County Telephone to Overland Data Center. The effect of these charges to Overland Data Center was to make Cass County Telephone and LEC, L.L.C. "whole" for the cash earlier improperly paid out to Overland Data Center in order to inflate Cass County's Telephone's claimed expenses. These inflated expenses were used to receive additional federal Universal Service Funds. The payments from Cass County Telephone to Overland Data Center and from Overland Data to Cass County Telephone/LEC, L.L.C. were coordinated by FSE Consulting Corporation which was controlled by Mr. Daniel Martino. FSE Consulting Corporation is located in New York City, New York, and provided financial and accounting service to Overland Data Center. Daniel Martino has pleaded guilty to

federal charges related to phone cramming and internet porn scams as well as to the inflation of Cass County Telephone's expenses.

Pending further investigation, the Staff recommends Cass County Telephone not be certificated to receive federal USF high cost support.

New Florence Telephone Company

As stated in the Staff's Initial Report, Tiger Telephone, L.L.C. purchased New Florence Telephone on July 31, 1998, from New Florence Telephone's individual stockholders. At the time of the purchase in 1998, New Florence Telephone was classified as an "*average schedule*" company for purposes of recovery of interstate access costs in the interstate jurisdiction and did not receive explicit federal Universal Service High Cost funding support.

On July 1, 2001, New Florence Telephone elected to become a "cost company" for purposes of federal USF support. *Cost* companies receive recovery of *interstate* access costs based on the completion of individual cost studies using the cost procedures outlined in Part 36 (47CFR36) of the FCC rules. These studies provide the basis for recovery of access service related costs from NECA, who files tariffs on behalf of hundreds of small telephone companies throughout the country. Moreover, cost companies are eligible to receive explicit federal Universal Service Funds.

Since New Florence Telephone's election in 2001 to become a cost company, it has received \$169,443 in explicit federal Universal Service High Cost Funds. New Florence Telephone has also received \$476,982 from other federal Universal Service funding mechanisms such as Local Switching Support (\$431,037) and Long Term Support (\$45,945). Due to the Commission's decision not to certify New Florence Telephone, all three (3) federal Universal Funding mechanisms have been discontinued as of October 2004.

Pending further investigation, the Staff recommends New Florence Telephone not be certificated to receive federal USF high cost support.

Section 5. Quality of the Companies Books & Records

Background

As a result of the Commission's January 14, 2005 Order establishing this docket, the Staff commenced to investigate the accounting and internal control procedures in place

during the period 1996-2004 for Cass County Telephone and New Florence Telephone, in order to determine whether both Companies' books and records during this period were accurately stated. Beyond the specifics of Mr. Matzdorff's guilty plea and his admission of falsifying Cass County Telephone's books and records to support payment of fictitious invoices, the Staff's concerns on this topic were caused by the following additional considerations:

- 1) the lack of internal control that allowed for the fraudulent activities to which Mr. Matzdorff pled guilty, which could also have allowed for other inappropriate or unlawful financial transactions being recorded on Cass County Telephone's and New Florence Telephone's books and records; and
- 2) the significant expenses charged to Cass County Telephone's and New Florence Telephone's books and records in the form of affiliated transactions, for which the vendors are owned entirely or in part by members of Cass County Telephone's and New Florence Telephone's management. These affiliated and related party transactions include the expenses charged to Cass County Telephone's and New Florence Telephone's books for alleged support services provided by LEC, L.L.C.

Cass County Telephone

Based upon information received from data request responses, the Staff has developed a chart (Highly Confidential Attachment 2) which summarizes LEC, L.L.C. service support charges to Cass County Telephone by year. These support cost charges make up well over 50% of Cass County Telephone's booked expenses for the period 1999-2003. Because of lack of access to LEC, L.L.C. information until very recently, the Staff to date has not been able to verify the nature of the costs charged to Cass County Telephone by LEC, LLC. or the specific methods used to allocate LEC, L.L.C. costs to Cass County Telephone.

As can be noted from Attachment 2, charges from LEC, L.L.C. to Cass County Telephone increased steadily and significantly from calendar years 1996 to 2003. However, for the period July 2004 to present, these charges appear to have been dramatically curtailed. The Staff has issued data requests to Cass County Telephone for an explanation of this change in LEC, L.L.C. billings.

The most recent audited financial statements by the Cass County Telephone's new external auditing firm of Warinner, Gesinger & Associates, LLC for the years 2002 (*restated*) and 2003 reference certain "adjustments" made by the new external auditor that have been performed on prior year support service expense amounts of Cass

County Telephone. To date, Cass County Telephone has refused to provide the Staff with the workpapers supporting these adjustments. Staff anticipates it will be necessary to obtain Circuit Court enforcement of the Commission's subpoena that this seeks this information.

Based upon information received from data request responses, the Staff has developed a spreadsheet of all checks issued in excess of \$1,000 paid to known affiliated companies and related parties to Cass County Telephone and its employees (including payments to LEC, L.L.C. for support costs). The amounts paid to these parties have been significant. Cass County Telephone Company has paid in excess of ** _____ ** between 1996 through 2004 to three affiliates or related parties alone: LEC, LLC - ** _____ **, Overland Data Center Inc. - ** _____ ** and Haug Construction, Inc. - ** _____ **.

The Auditing Staff continues to analyze data provided by Cass County Telephone. Further support for the general ledger, access to audited financial statements, and additional invoices from affiliates still are needed before the Staff can determine the quality of the books and records of Cass County Telephone, and make recommendations to the Commission on this topic. At this time, based upon: 1) the high number and large amounts of the dollars of financial transactions entered into by Cass County Telephone with affiliated entities and related parties; 2) the evident lack of internal controls necessary to guard against improper self-dealing and other abuses that are inherent with affiliated transactions; and 3) lack of information to date, the Staff cannot make any representations with reasonable confidence that the books and records of Cass County Telephone have been or are accurately stated.

New Florence Telephone

The Staff has conducted an initial review of billing invoices for support services from LEC, L.L.C. to New Florence Telephone for the years 1998 through 2004. The Staff is performing the same type of analysis on this data as it has for Cass County Telephone. Because of lack of access to LEC, L.L.C. information until very recently, the Staff to date has not been able to verify the nature of the costs charged to New Florence Telephone by LEC, L.L.C., or the specific methods used to allocate LEC, L.L.C. costs to New Florence Telephone.

Based upon information received through data request responses, the Staff developed a spreadsheet of all checks issued in excess of \$1,000 paid to known affiliated companies and related parties to New Florence Telephone and its employees (including payments to LEC, L.L.C. for support costs). The amounts paid to these parties have been significant.

New Florence Telephone Company has paid in excess of ** _____ ** between 1998 through 2004 to four affiliates or related parties alone: LEC, L.L.C. - ** _____ **, South Holt - ** _____ **, Cass County Telephone Company - ** _____ ** and Matzco - ** _____ **.

The Auditing Staff continues to analyze data provided by New Florence Telephone. Further support for the general ledger, access to audited financial statements, and additional invoices from affiliates still are needed before the Staff can determine the quality of the books and records of New Florence Telephone, and make recommendations to the Commission on this topic. At this time, based upon: 1) the high number and large amounts of dollars of the financial transactions entered into by New Florence Telephone with affiliated entities and related parties; 2) the evident lack of internal controls necessary to guard against improper self-dealing and other abuses that are inherent with affiliated transactions; and 3) lack of information to date, the Staff cannot make any representations with reasonable confidence that the books and records of New Florence Telephone have been or are accurately stated.

Section 6. Ongoing Fiscal Viability

Cass County Telephone

The Staff is assessing Cass County Telephone's financial viability in the event it incurs fines that may be levied by both the Commission and the FCC. The total amount of the Commission's possible fines have been estimated at \$3 million. The FCC's possible fines have been estimated at a range of \$3 million to \$5 million. Using the high end of the estimate of FCC fines, then Cass County Telephone may be assessed up to \$8 million in fines. A compounding factor that may affect Cass County Telephone's financial viability to pay these fines is its current suspension of federal USF support. According to Cass County Telephone's 2004 Annual Report filed with the Commission, the amount of federal USF support it received in 2004 was \$2,114,296. However, according to the Management Agreement between LEC, L.L.C. and GVNW Consulting, this support could have been as high as ** _____ ** in 2005. The Staff has not included any federal USF support in its analysis of Cass County Telephone's financial viability if it incurs possible monetary fines.

On a preliminary basis, the Staff's initial analysis shows that with the suspension of the federal USF support and the current possible monetary fines of \$8 million, Cass County Telephone would not be able to cover its debt service if it incurred \$8 million in fines. This conclusion assumes that the fines are assessed during the same calendar year. Cass County Telephone would need approximately \$5.65 million in additional funds to cover

its debt service. Even if Cass County Telephone received the estimated
** _____ ** of USF support for 2005 mentioned in the Management Agreement
between LEC, L.L.C. and GVNW Consulting, Inc., Cass County Telephone would fall
\$1.35 million short of covering its debt service..

The above conclusions are based on the best information that the Staff had available to it
as of the filing of this report. Some of this information may change before the Staff files
its final report in this investigation. The Staff will continue to work on refining its
estimates of Cass County Telephone's financial exposure to possible fines from
regulatory authorities

New Florence Telephone

The Staff is not aware of the possibility of New Florence Telephone being assessed
monetary fines by regulatory authorities. Therefore, the Staff to date has not analyzed the
financial impact of such fines on New Florence Telephone.

ATTACHMENT 1

HAS BEEN DEEMED

PROPRIETARY

ATTACHMENT 2
HAS BEEN DEEMED
HIGHLY CONFIDENTIAL