MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. IM-2004-0461, Northwest Missouri Holdings, Inc. and Oregon Farmers Mutual Telephone Company

FROM: David G. Winter, Project Coordinator, Auditing Department
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/s/ David G. Winter 07/13/04	/s/ Cliff Snodgrass 07/13/04
Project Coordinator / Date	General Counsel's Office / Date

SUBJECT: Staff's Recommendation concerning application for approval of stock purchase.

DATE: July 13, 2004

On March 9, 2004, Northwest Missouri Holdings, Inc. (Northwest) and Oregon Farmers Mutual Telephone Company (Oregon Farmers) (collectively the Applicants) filed an Application pursuant to Sections 392.300, RSMo 2000, 4 CSR 240-2.060 and 4 CSR 240-3.535 seeking an Order authorizing Northwest and Oregon Farmers to perform in accordance with the terms of a Stock Purchase Agreement which will result in the acquisition by Northwest of all of the capital stock of Oregon Farmers. The application was docketed as Case No. IM-2004-0461.

The Applicants filed a Supplemental Application (Supplemental) on April 12, 2004. Specifically, the Supplemental states: "In order to facilitate the purchase, Northwest proposes to borrow certain sums, not to exceed $7,388,889, from the Rural Telephone Financing Cooperative (RTFC)." The Supplemental further requests the Commission to authorize Oregon Farmers to execute and deliver to the Rural Telephone Financing Cooperative a Deed of Trust, Security Agreement and Financing Statement (RTFC Loan) in order for Northwest to finance the purchase of Oregon Farmers.

Oregon Farmers is an incumbent local exchange company (ILEC) and the services it offers are classified as noncompetitive under Section 392.361 RSMo 2000.

DETRIMENT TO THE PUBLIC INTEREST STANDARD

Staff utilized the "detriment to the public interest" standard, as it is similar in acquisition cases as well as merger cases. If the Applicants fail to show that the proposed purchase of Oregon Farmers stock by Northwest is not detrimental to the public interest in Missouri (i.e., if it is demonstrated that the Missouri public will be harmed by the proposed sale), then the Commission should reject this application and not approve the proposed transaction. Staff Counsel has advised that the "not detrimental to the public interest" standard is based on case law generally cited in court opinions such as State ex rel. City of St. Louis v. Public Serv. Comm'n, 73 S.W.2d 393 (Mo. banc 1934); State ex rel. Fee Fee Trunk Sewer Co., Inc. v. Litz, 596 S.W.2d 466 (Mo. App. 1980). Staff Counsel also advises that the Commission has incorporated the "not detrimental to the public interest" standard in its rules. 4 CSR 240-3.535(C)

Consistent with Staff's position in other acquisition, merger and restructuring cases, Staff views the members of the "public" that are to be protected as those consumers taking and receiving utility service from Oregon Farmers in the State of Missouri.

In this case, Staff would define "public interest" as referring to the nature and level of the impact or effect that Northwest's acquisition will have on its Missouri customers. There is a fundamental concern in the regulation of public utilities that the public being served will not be impacted adversely or harmed by those responsible for providing monopoly services. Telecommunications companies in Missouri are charged with providing adequate facilities at just and reasonable rates. If this transaction results in adverse or negative impacts to Oregon Farmer's Missouri customers, then the Commission should not approve the Applicants' Application or, in the alternative, impose conditions sufficient to overcome the detriments of the stock sale.

CAPITAL STOCK ACQUISITION

Oregon Farmers provides telecommunications services to approximately 1,271 customers in one exchange located in Holt County, Missouri. Northwest was formed, among other things, to purchase all of the issued and outstanding stock of the regulated entity, Oregon Farmers and the issued and outstanding stock of a series of subsidiaries and affiliates not subject to Commission jurisdiction. Upon the execution of the Stock Purchase Agreement between Northwest and Oregon Farmers, Northwest will become the non-regulated parent corporation of Oregon Farmers.

The Application also states that the stock acquisition will not be detrimental to the public interest. Oregon Farmers will operate under the same name and in much the same manner as it does presently, with no change in rates or methods of operation. Northwest has committed to retain the existing management and employees. Staff believes that Section 392.455 RSMo. 2000, *Commission to establish certification process,* does not appear to be applicable in a stock acquisition case, as the case will generate, not grant or change in any certificate, nor will Oregon Farmers' current tariff be changed or modified in any respect. However, given that no personnel changes at Oregon Farmers are anticipated, Staff believes the Company will have the technical and managerial resources and abilities required by Section 392.455.1, RSMo. 2000, available after the stock acquisition.

FINANCING ISSUES

In order to purchase all of the issued and outstanding stock of Oregon Farmers and the issued and outstanding stock of a series of subsidiaries and affiliates not subject to Commission jurisdiction, Northwest proposes to borrow certain sums, not to exceed $7,388,889, and execute and deliver to the RTFC a Deed of Trust, Security Agreement and Financing Statement. The assets of Oregon Farmers will be used as collateral for the loan.

The RTFC is a not-for-profit cooperative financial organization affiliated with, and created by the National Rural Utilities Cooperative Finance Corporations (CFC). The CFC was created as a lender to rural electric systems to supplement loans they receive from the Rural Utilities Services (RUS). RUS is a federal organization.

Specifically, the RTFC loan is to be utilized by Northwest to: (1) refinance Oregon Farmers existing debt; (2) finance the acquisition of Oregon Farmers and its non-regulated subsidiaries and affiliates; and (3) purchase a 10% RTFC Subordinated Capital Certificate (SCC).

SCCs refer to the equity certificates that RTFC borrowers such as Northwest are required to purchase with each long-term loan. SCCs are generally amortized on an annual basis to maintain a 10% SCC-to-loan principal balance once the underlying loan has been fully advanced and the certificate paid in full. Amortized amounts will be paid in cash to Northwest.

The RTFC's has committed to a quarterly repayment schedule using the level debt service amortization method over a ** __ **-year period. The level debt service amortization method provides for equal periodic principal payments over the loan period. Principal payments will therefore commence in the first full billing cycle after the initial advance of the loan proceeds.

The terms and conditions of the RTFC loan also set out a number of stringent loan covenants. During the term of the loan, Northwest, on a consolidated (regulated and non-regulated entities) basis, must meet or exceed the following financial tests and loan requirements:

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John Kiebel, on temporary assignment to the Financial Analysis Department, reviewed the five-year pro forma financial statements of Northwest on a stand-alone basis and on a consolidated basis, as well as the Oregon Farmers December 31, 2003, financial statements, and the five-year pro forma financial statements.

Oregon Farmers' capital structure currently consists of 20.50% long-term debt, and 79.50% common equity. The debt component consists of series of debt issuances that are collateralized by first mortgage liens on the assets of Oregon Farmers. The terms of the RTFC loan requires that RTFC receive a first mortgage lien on the assets of Oregon Farmers and its non-regulated subsidiaries and affiliates.

As a result, the debt component of Oregon Farmers capital structure will be refinanced and the debt will be carried on Northwest's books and records. . After the acquisition by Northwest has been completed, the Oregon Farmers capital structure will be 100% equity on its books and records. Northwest will hold the new debt and its pro forma capital structure contains ** ______ ** long-term debt and ** ______ ** common equity.

John Kiebel investigated this Application for the traditional issues. The first issue was to evaluate the financing request for a concern referred to as "debt overhang." Debt overhang occurs when incurred long-term debt exceeds a regulated entity's rate base that raises concerns about the ability for the utility to support this level of debt. This filing is unique as the financing is related to both regulated and non-regulated operations. Northwest is borrowing approximately $7.4 million in part supported by approximately $3.9 million in regulated plant and about

$1.8 million in net plant. The debt overhang from a regulatory perspective in this proceeding is approximately $5.6 million.

The debt overhang issue is negated by the Northwest's consolidated projected operating cash flow. Northwest is generating significant operating cash flows from its non-regulated operations, which should enable Northwest to reasonably meet the covenants of the RTFC loan on a cash flow basis. Northwest projects that it will derive approximately ** ____ ** of its projected operating cash flow from Oregon Farmers (the regulated entity) and ** ____ ** from its non-regulated subsidiaries (cellular and cable television). The ** ____ ** regulated versus ** ____ ** non-regulated entity projected operating cash flow provides a necessary safeguard to ensure the regulated entity and therefore the ratepayer is not adversely impacted by this Application. The RFTC's financing requirements and their evaluation provides an additional level of safeguards. The applicant represented that the RFTC's due diligence investigation of this transaction revolved around the issue of operating cash flows and not the underlying value of the assets (regulated and non-regulated) to support the ** __ **-year loan. The RFTC's commitment for permanent financing is further confirmation that an independent evaluation of the operating cash flows projections were adequate and the debt overhang issue has been satisfactorily addressed.

Secondly, John Kiebel evaluated the situation regarding Northwest's low common equity ratio after the transaction. Though Northwest is a non-regulated holding company, a capital structure consisting of 40% common equity is an appropriate balance between the low cost of debt and the security of equity. As previously noted, the RTFC uses the level debt service amortization method, which provides that Northwest will be making equal periodic principal payments over the loan period commencing the first full billing cycle. Thus, immediately Northwest is required to reduce its debt level while improving its equity ratio. Further, the RTFC impose significant restrictions on Northwest's ability to pay dividends, redeem capital stock and issue additional indebtedness until such time as Northwest has achieved ** ______________________________ ** These restrictions will provide the Company an adequate incentive to improve its equity position as soon as possible in order for the Company owners to receive dividends. ** ________ ____ ** John Kiebel concluded that the immediate building of equity by Northwest and the RTFC's restrictions provide the adequate safeguards to address the low common equity ratio concerns.

Based upon the foregoing, the Staff recommends that the Commission approve Northwest's financing with the following condition:

> That nothing in the Commission's order shall be considered a finding by the Commission of the value of these transactions for ratemaking purposes, and that the Commission reserves the right to consider the ratemaking treatment to be afforded these financing transactions and their results in cost of capital, in any later proceeding.

ACCOUNTING ISSUES

The acquisition by Northwest of all of the capital stock of Oregon Farmers does *not* create an acquisition adjustment. The value of Oregon Farmers' assets and liabilities with the exception of debt component previously discussed in this recommendation will *not* be restated for either financial or regulatory purposes. The value of Oregon Farmers' Net Original Telecommunications Plant in Service as of December 31, 2003[1] is $1,817,099 and will *not* be restated nor change in any manner due to this transaction. The transaction/acquisition costs (legal, title insurance, misc., etc.) of acquiring Oregon Farmers will be recorded on the books of Northwest. Northwest has agreed to forego recovery of any incremental acquisition costs.

DEPRECIATION ISSUES

The Engineering and Management Services Department recommends that the Commission retain the currently authorized depreciation rates for Oregon Farmers. These rates, as shown in the attached Schedule A, were authorized in Case No. TT-2001-328.

RECOMMENDATION

Based on the "Detriment to the Public Interest Standard" discussed above, the Staff recommends that the Commission approve the purchase of the Oregon Farmer's stock by Northwest. The Staff recommends that the Commission issue an order:

1) Authorizing the Applicants to enter into and perform in accordance with the terms of the Stock Purchase Agreement;

2) Authorizing Northwest to purchase or acquire, take or hold all of the total issued and outstanding capital stock of Oregon Farmers;

3) Authorizing Oregon Farmers to execute and deliver a Deed of Trust, Security Agreement and Financing Statement;

4) Authorizing Oregon Farmers and Northwest to do any and all other things as may be reasonably necessary in furtherance of all acts specifically authorized;

5) Granting any such relief as the Commission may deem just and proper under the circumstances;

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[1] Source: Oregon Farmers Mutual Telephone Company, Incumbent Local Exchange Carrier Annual Report to the Missouri Public Service Commission for Period Ending December 31, 2003.

6) Holding that nothing in the Commission's order shall be considered a finding by the Commission of the value of these transactions for ratemaking purposes, and that the Commission reserves the right to consider the ratemaking treatment to be afforded these financing transactions and their results in cost of capital, in any later proceeding; and

7) Re-authorizing the depreciations rates (Schedule A) for Oregon Farmers.

OREGON FARMERS MUTUAL TELEPHONE COMPANY
DEPRECIATION RATES
Case No. IM-2004-0461

ACCOUNT	ACCOUNT NUMBER	DEPRECIATION RATES	AVERAGE SERVICE LIFE (YEARS)
MOTOR VEHICLES	2112	11.63%	8.6
GARAGE WORK EQUIPMENT	2115	7.69%	13.0
OTHER WORK EQUIPMENT	2116	7.14%	14.0
BUILDINGS	2121	2.86%	35.0
FURNITURE	2122	7.14%	14.0
OFFICE EQUIPMENT-OFICE SUPPORT	2123.1	10.00%	10.0
OFFICE EQUIPMENT-COMPANY COMMUNICATIONS	2123.2	11.90%	8.4
GENERAL PURPOSE COMPUTERS	2124	15.63%	6.4
ANALOG ELECTRONIC SWITCHING	2211.0	6.67%	15.0
DIGITAL SWITCHING	2212	6.67%	15.0
SATELLITE AND EARTH STATION FACILITIES	2231.1	8.85%	11.3
OTHER RADIO FACILITIES	2231.2	8.85%	11.3
CIRCUIT EQUIPMENT-DIGITAL	2232.1	10.00%	10.0
CIRCUIT EQUIPMENT-ANALOG	2232.2	10.00%	10.0
PUBLIC TELEPHONE TERMINAL EQUIPMENT	2351	9.71%	10.3
OTHER TERMINAL EQUIPMENT	2362	11.49%	8.7
POLES	2411	4.76%	21.0
AERIAL CABLE-NONMETALLIC	2421.1	4.76%	21.0
AERIAL CABLE-METALLIC	2421.2	4.76%	21.0
UNDERGROUND CABLE-NONMETALLIC	2422.1	3.57%	28.0
UNDERGROUND CABLE-METALLIC	2422.2	3.85%	26.0
BURIED CABLE-NONMETALLIC	2423.1	3.57%	28.0
BURIED CABLE-METALLIC	2423.2	4.17%	24.0
SUBMARINE CABLE-NONMETALLIC	2424.1	4.76%	21.0
SUBMARINE CABLE-METALLIC	2424.2	4.76%	21.0
CONDUIT SYSTEMS	2441	2.00%	50.0