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September 25, 2009

BY ELECTRONIC FILING

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: WC Docket No. 09-82 — Comment Letter

Dear Ms. Dortch:

As his counsel[1], I am submitting this letter on behalf of Jeffrey J. Prosser, the former beneficial owner (with his wife) of Innovative Communication Corporation ("ICC").

This letter is submitted[2] to address the misstatements and underlying assumptions made in the submissions to the Commission by both the National Rural Utilities Cooperative Finance Corporation ("CFC") and the Trustee for the ICC Chapter 11 Estate.

There are two areas of misrepresentation: (i) CFC knew and approved of distributions by ICC to its shareholders, including those distributions to or for the benefit of Mr. Prosser and his family of which it now complains (it did not just "fail to recognize" those distributions when

[1] I, too, am a former Director of ICC.

[2] Note, also, there is litigation existing by and between the Chapter 11 Estate , Mr. Prosser and me. Additionally, Mr. Prosser and I are plaintiffs in a Civil Rico against amongst others, CFC. *See Prosser et al v. National Rural Utilities Cooperative Finance Corporation (CFC) et al*, Case No. 1:08-cv-107

made) ; and (ii) based upon CFC (and RTFC's) history of misleading statements before various tribunals to gain and advantage in their quest to divest ICC of its operating subsidiaries, including Vitelco, there should be no or little deference given by the Commission to CFC statements.

In support of the facts, and to set the record straight, please considered the following:

- CFC's management serves as RTFC's management[3] with CFC's CEO, CFO and General Counsel serving as RTFC's CEO, CFO and General Counsel. Thus, any action of RTFC by implication is an action of CFC.
- RTFC had representatives on the Board of the Virgin Islands Telephone Corporation's ("Vitelco" - d/b/a Innovative Telephone) board and the holding company until June of 2001.
- Annually, ICC submitted Audited Financial Statements to RTFC through calendar year 2005 (the last one was dated April 28, 2006). Thus, ICC still complied with the requirements of the loan document even after foreclosure had commenced.
- All of the ICC Audited Financial Statements prominently disclosed and separately discussed in footnotes to the Audited Financial Statements the distributions to shareholder, including ultimately those distributions to or for the benefit of Mr. Prosser and his family.
- As a local exchange carrier and one of the largest recipients of the universal service fund, Vitelco was subject to a NECA reviews (financial and technical reviews) on a rotating basis every twelve to eighteen months.
- Vitelco and ICC's dealings with Vitelco were subject to the regulation and review of the Virgin Islands Public Services Commission ("VIPSC") including reviews of financial, technical capabilities and quality of service issues
- In calendar year 2003 Vitelco completed the application for and an extensive technical review process necessary to receive, and did receive, a $160 Million loan facility from the Rural Utilities Service. This loan was necessary *because RTFC refused to finance Vitelco's capital expenditures.*

[3] Even though there is no common ownership. CFC acknowledges that "...members of RTFC and NCSC own or control 100 percent of the interest in their respective companies" (FY 2009 10K, p. 43).

- From 1998 through October of 2007, the Virgin Islands, including Vitelco's plant and equipment, has been subject to damage from numerous major hurricanes including Hurricane Hugo in 1989 (which caused Vitelco to invest over $60 Million in additional PP&E), Hurricane Luis in 1995, Hurricane Marilyn in 1995 (which caused an investment in PP&E of over $41 Million), Hurricane Georges in 1998 and Hurricane Lenny in 1999. These hurricanes required substantial investment in the PP&E far in excess of the hurricane related capital investments now complained of by CFC.
- On April 4, 2003, RTFC and CFC executed a mutual release with ICC and all the ICC entities, including with Mr. Prosser individually, which includes releases of any claims related to the expenditures during the covered time of which CFC now complains.
- In July of 2007, Jeff Prosser obtained a $620 Million binding financing commitment to refinance all the indebtedness of ICC and its subsidiaries from Silver Point Financing LLC. RTFC[4]and therefore CFC [5] refused the financing because Jeff Prosser was to retain an equity stake in ICC, in the process declaring their willingness to put their personal animus above sound financial considerations, and the best interests of Vitelco's ratepayers.
- RTFC submitted a loan document it represented was from ICC to the United States District Court but could not[6] authenticate it as it is an altered document, one over which

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[4] Mr. Gerber for RTFC:
"We want him out of control of the process. The creditors don't believe what he offered is good enough as a matter of law and as a matter of fact and you can't compel us to accept that proposal, and we choose not to do so voluntarily. And what's remarkable as the Court has pointed out, maybe we'll get less money doing it our way, that's a possibility, but that's our risk. There isn't anybody else at risk that will get less money. We'll make sure that there's a well financed telephone company, the people in the Virgin Islands will have their telephone company. But if we get less out of this, it's our risk to let the trustee do that." *See* ICC LLC, Case # 3:06-bk-30008 (JKF), 8/3/2007 Hearing Transcript, Doc # 802, p. 40, L 12 thru L21

[5] Mr. Galardi for Greenlight [Greenlight was being paid $27.5 Million from RTFC/CFC to put ICC into bankruptcy]:
"We can also take the testimony from Mr. Augustine [Managing Director of Rothschild that headed Mr. Prosser's efforts to refinance ICC], who was absolutely clear. He believes that this financing is the highest valued. He also said that the market check, back a year ago on the sale, may be the highest value. What's going on is they believe that that's the highest value, we have to take it. We don't want to take it. It's not a paternalistic situation. The fact of the matter is, if this is the highest value and if we're unwise for letting a sale process go forward, we're willing to live with the risk. The RTFC is willing to live with the risk, we just want the process free of the one gentleman who seems to control all of this, Mr. Prosser. And that's really the thrust of this motion." *See* ICC LLC, Case # 3:06-bk-30008 (JKF), 8/3/2007 Hearing Transcript, Doc # 802, pgs. 36-7, L 16 thru L2.

[6] Mr. Prosser maintained and still maintains that RTFC unilaterally altered ICC loan document.

they had exclusive control. *See RTFC v ICC*, V. I. Federal District, Case No. 2004-154, 12/29/2005 Order denying RTFC summary judgment, footnote 2.

- CFC has no commitment to telecommunications lending having reduced the telecommunications loan portfolio from $5.2 Billion as of May 31, 2001 (FY 2001 10K, Footnote 2, p. 62) to $1.7 Billion as of May 31, 2009 (FY 2009 10K, Footnote 2, p. 105) while CFC's total loan portfolio increased.

Each year CFC issues annual reports with a message or letter from the CEO of CFC. Those letters after FY 2004 reflect a commitment by CFC to decrease telecommunications lending.

In support of the foregoing please find the following exhibits:

Exhibit "1" the VIPSC's Hearing Examiner Report[7] dated September 13, 2002 which was the last Hearing Examiner Report when Vitelco was under Mr. Prosser's stewardship.

Exhibit "2" the last VIPSC rate order, dated August 6, 2004 which included the conclusions that (i) "Accounting practices employed by Innovative have proven generally acceptable and consistent with all prescribed rules, regulations and requirements of the VIPSC and the FCC" and (ii) "Innovative recognizes business relationships with affiliate entities in a manner consistent with all prescribed accounting rules and regulations governing such transactions".

Exhibit "3" which is a mutual release dated April 4, 2003, by and between CFC and ICC.

Exhibit "4" is a newspaper article and a transcript of a CFC's 2nd quarter of FY 2009 investor (analysts) call (held January 22, 2009). The newspaper article (as well as the Court record) refutes CFC's intentional misrepresentation to analysts[8] that sales proceeds from the Group II Assets are confidential.

Since the June 1, 2004 foreclosure action filed by CFC against ICC, CFC has deployed a scorched earth policy that has degraded the value of RTFC's collateral, the ICC assets, as well as debased ICC's debt service capability, all for personal, non-business related purposes at the expense of amongst others Vitelco's' ratepayers. To further its purposes, CFC has been wrongfully using Jeff Prosser as an escape goat for the consequences CFC's own actions and

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[7] The Hearing Examiner was assisted by Ernst and Young LLP as well as another consulting firm.

[8] The discussion with Jim Ferguson, an AIG analyst, is the most telling.

willingness to any lengths to economically bury and discredit Jeff Prosser, again at the expense of Vitelco's operations and its ratepayers.

Jeff Prosser and I stand ready to appear before the Commission and explain as well as provide support for the forgoing facts, any of the allegations in the Civil Rico, or to answer any further questions about the relationship between ICC and RTFC.

Sincerely,

John Raynor
Counsel for Jeffrey J. Prosser

Exhibit “1”

Virgin Islands Public Services Commission
Hearing Examiner’s Report
September 13, 2002

From: "Frederick G. Watts" <fgwatts@wattsbenham.com>
To: "David Sharp" <vitelcell@aol.com>; "Gregory Vogt" <gvogt@wrf.com>; "Edward Salmon" <esalmon@ausinc.com>; "Rene Enriquez" <rene.enriquez@ey.com>; "David Milkosky" <david.milkosky@ey.com>; "Gregory Mann" <gregm@ggga.net>
Sent: Friday, September 13, 2002 12:56 PM
Attach: Tableofcontents.wpd; Cover.wpd; Hearing Examiner's Report -final.doc; Hearing Examiner's Report -final.wpd; Tableofcontents.doc; Cover.doc
Subject: Hearing Examiner's Report

Please note new e-mail address

Attached is the Hearing Examiner's Report in Docket 532 that is on its way to the PSC to be filed this afternoon. Thank you for your help and cooperation.

regards
fred watts

GOVERNMENT OF THE VIRGIN ISLANDS
OF THE UNITED STATES

Public Services Commission

IN RE:	)	
	)	**PSC DOCKET NO. 532**
RATE INVESTIGATION OF INNOVATIVE	)	
TELEPHONE COMPANY PURSUANT TO	)	
ACT NO. 6402	)	
	)	

Report of the Hearing Examiner

Frederick G. Watts
Hearing Examiner
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September 13, 2002

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Virgin Islands Public Services Commission
Docket No. 532
Report of the Hearing Examiner

I Background

On April 20, 2001 the Legislature of the United States Virgin Islands enacted Act 6402 (the "Act")directing the Public Service Commission ("PSC") to conduct a biennial financial review of public utility organizations licensed to operate in the US Virgin Islands.[1] Act 6402 reaffirmed the responsibility entrusted to the PSC for ensuring a) the interests of the Virgin Islands' public are preserved and b) the statutory requirements set forth by the Legislature are complied with by all utilities that are subject to the authority of the PSC.

It is important to recognize that the Act represents the first legislative initiative specifically directed at the scope of responsibility borne by the Virgin Islands Public Service Commission in over thirty years and came only after considerable discussion. Despite differences of opinion -- expressed at the time by members of the legislature about what the appropriate scope of responsibility for the agency ought to be -- the resultant Act in no way abridged the rights, privileges, duties and obligations historically exercised by the PSC. Given the broad powers available to the Legislature at the time this legislation was enacted the fact that the PSC's powers were left essentially untouched is a strong endorsement of the PSC's efforts to ensure the rights of all the parties that appear before it are protected and preserved against prejudice, partiality and pre-emption.

An extensive review of Act 6402 (and the legislative history associated with it) strongly support a conclusion that, by enacting this legislation, the Legislature sought to expressly empower the PSC to undertake a financial investigation of its subject utilities without encumbering the PSC with too many specific requirements. Section 6402 represents a general expression by the Legislature of its intent to rely upon the experience -- and expertise – of the PSC to develop the specific means of achieving the statute's requirements. By limiting its' actions to those provided in the statute, the Legislature demonstrated its confidence that the powers affordable to -- and the practices employable by -- the PSC were sufficient to realize the legislature's intent.

[1] Act 6402 specifically amended the V.I. Code to provide that "Commencing July 30, 2001, the Commission shall conduct rate investigations of all regulated utilities biennially and hold formal hearings as required under subsection (a) of this section". V.I.Code Ann. *tit. 30 §20(b).*

Pursuant to instructions contained in Act 6402 the Virgin Islands Public Service Commission took formal action by order dated July 10, 2001 to initiate a comprehensive investigation of Innovative Telephone Company.[2] On that same date the Commission exercised its delegated authority to appoint Frederick G. Watts of Watts & Benham to act as the Hearing Examiner in this proceeding and AUS Pathways as lead technical consultants. The Commission directed Hearing Examiner Watts to conduct such investigative activities and recommend any actions the evidence deems necessary to meet the prescribed requirements of the Virgin Islands Code.

[2] Act 6402 was interpreted by the PSC to be applicable to all public utilities subject to the authority of the PSC. The PSC designated the record for the investigation of Innovative Telephone Company to be Docket No. 532. Separately, an investigation of Water and Power Authority was initiated under the aegis of a different Hearing Examiner and designated as PSC Docket No. 533. This Report will address only matters raised in the context of Docket No. 532.

In it appointment, the PSC directed the Hearing Examiner to act on its behalf and take evidence from all interested parties that could be used by the Commission in any later deliberations. To assist in developing a body of probative evidence for consideration in this proceeding, the PSC directed the Commission's appointed technical consultant to prepare a report on the financial condition of Innovative Telephone Company and submit it to the Hearing Examiner as a part of the record evidence.[3]

In contrast to what might be construed by some observers, the decision by the Legislature to enact Act 6402 is not *prima facie* evidence that some abuse has been committed by the utilities subject to the PSC's authority and some punitive action by the Commission is needed to atone for an error. As noted above, nothing presented to the Hearing Examiner at the time this proceeding was initiated suggested that to be the case. For that reason, the Hearing Examiner endeavored to design – and conduct -- this proceeding in a manner that ensured the record is fair and impartial to all parties. In reviewing the record of the proceeding prior to issuance of this report to the Commission, the Hearing Examiner remains of the opinion that the procedural framework developed for this proceeding provided adequate – and equal -- opportunity to the technical consultant and Innovative Telephone Company to submit evidence for consideration by the Hearing Examiner. The final disposition of the issues presented by the parties is that of the Hearing Examiner after considering the evidence and arguments presented by each of the parties.

II Investigative Framework

A. Purpose of the Proceeding

Public utilities granted authority by the Virgin Islands Public Service Commission to provide services in the Virgin Islands are obligated – under V.I. Code Ann. *tit. 30 §2* – to ensure that rates and charges for services offered to the public are just and reasonable.[4]

[3] On July 10, 2001 AUS Pathways, Inc. was appointed by the Virgin Islands Public Service Commission to be its designated technical consultant in selected matters before it for the express purpose of providing advisory and investigative support to the Commission and its appointed representatives. See Order Appointing Hearing Examiner and Technical Consultants in PSC Docket No. 532 Rate Investigation of Innovative Telephone Company Pursuant to Act No. 6402. In this proceeding AUS Pathways, Inc. prepared a Technical Report on behalf of the Hearing Examiner that was submitted to him on April 26, 2002, subjected to review by Innovative Telephone and subjected to cross-examination in formal hearings on June 17-18, 2002 and June 25-26, 2002. The technical consultant's report – with modifications resulting from that cross-examination – provides the basic foundation for this report by the Hearing Examiner.

[4] V.I. Code Ann. *tit. 30 §2* states "…every public utility doing business within the United States Virgin Islands is

required to furnish service and facilities reasonably safe and adequate and in all respects just and reasonable. The charge made by any such public utility for any facility or services furnished, or rendered, or to be furnished, or rendered, shall be reasonable, just and nondiscriminatory. Every unjust or unreasonable or discriminatory charge for such facility or service is prohibited and is hereby declared unlawful. Every public utility is hereby required to obey the lawful orders of the Commission."

Under separate provisions of the Virgin Islands Code, the VIPSC is authorized and empowered to enforce that requirement for all public utilities operating in the United States Virgin Islands. Pursuant to the general investigative authority conferred upon the VIPSC by these two statutes – as well as specific authority conferred upon it by V.I. Code Ann *tit. 30 §20(b)* – the Commission initiated an investigation of Innovative Telephone Company designating it as Docket No. 532 Rate Investigation of Innovative Telephone Company.

Docket No. 532 was initiated for the expressed purpose of conducting the rate investigation of Innovative Telephone Company prescribed by Act 6402. The Hearing Examiner in this docket was appointed by the VIPSC for the purpose of examining any evidence submitted for consideration in this proceeding, evaluating the merits of that evidence and recommending to the PSC any actions required to ensure compliance with the standing rules, regulations and requirements of the Virgin Islands PSC.

In its appointment order of July 10, 2001, the PSC provided the Hearing Examiner discretionary authority to employ any approach deemed necessary to fulfill the expressed goals and objectives of the PSC and the Legislature. Given the relatively imprecise language of Act 6402 -- and virtually no PSC rules and regulations that might illuminate that imprecise language -- the Hearing Examiner found it necessary to consult other sources for information on how to best approach this subject.

With the assistance of the technical consultants, the Hearing Examiner reviewed a number of authoritative sources and concluded that a rate investigation such as that prescribed by Docket No. 532 must be of sufficient breadth – and depth – to

- judge whether the subject company evidences effective managerial control over the costs of provisioning regulated telecommunications services.
- ensure that any actions taken by a regulatory agency in consequence of the investigation are based upon a factual understanding of the company's financial and operational condition; and
- ensure that the subject company continues to exercise diligence, prudence and good stewardship over its responsibilities to the public.

These are implicit standards in any rate investigation proceeding. Additionally, this rate investigation must be able to satisfy the specific rate-of-return tests set forth for public utilities in the Virgin Islands Code.[5]

B. Parties to the Proceeding

Act 6402 specifies that all public utilities operating in the Virgin Islands are subject to the biennial investigatory requirements of the Act. However, Docket No. 532 has been specifically tasked to only investigate the financial condition of Innovative Telephone Company. Innovative

[5] V.I. Code Ann. *tit. 30 §23(b)* provides "In exercising its authority to prescribe just and reasonable rates, the Commission shall provide a return of not less than six (6) nor more than eight (8) percent on the net investment in the property prudently acquired for and devoted to the public use, unless the Commission makes a special finding that a different return is imperative, so as to be fair to the consumer interest, and to be fair to the investor interest by providing a return commensurate with returns in other enterprises having corresponding risks, and which will assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

Telephone Company is the only entity required by the Hearing Examiner to be a party to Docket No. 532 -- although participation by others was not precluded by either the statute, the PSC Order or the Hearing Examiner's Procedural Notice.

The PSC issued public notice of the investigation and invited any interested person(s) to participate in the proceeding at the time the Hearing Examiner was appointed.[6] When the evidentiary record for this proceeding was closed on August 25, the record showed that no request had been made to the Hearing Examiner for "party" status by any person or group. Furthermore, consultations with staff members of the Public Service Commission showed that no formal request for party status had been made to the Commission that was unknown to the Hearing Examiner. Accordingly, the Hearing Examiner concluded that the only "party" to this proceeding remains the Innovative Telephone Company and it is only the Innovative Telephone Company that has any right to challenge the findings, conclusions and recommendations of the Hearing Examiner.[7]

C. Roles and Responsibilities

1. Innovative Telephone Company

As noted in the previous section, Innovative Telephone Company is the only party to this proceeding recognized by the Hearing Examiner. Accordingly, it became the sole responsibility of Innovative to present any opposing evidence and/or argument to that presented by the technical consultants in this proceeding. This responsibility was outlined in the procedural notice issued to Innovative Telephone Company and reiterated at pre-hearing conferences with representatives of Innovative and the technical consultants as well as in the public hearings conducted by the Hearing Examiner.

After giving consideration to the respective roles and responsibilities that might be accorded the participants to this proceeding, the Hearing Examiner adopted a procedural framework that provided as many rights and privileges that can be afforded by the PSC to Innovative Telephone Company. These included the right to –

- seek protection from disclosure of confidential material provided to the technical consultant;
- object to interrogatories and data requests considered to be irrelevant to the immediate investigation;

[6] The PSC's invitation to the public for participation was reiterated by the Hearing Examiner in three public hearings held in St. Thomas, St. John and St. Croix at the commencement of the technical consultant' investigation. Although public comment was offered by a number of individuals no one sought leave from the Commission to participate as a "party" or "intervenor" in this proceeding.

[7] The technical consultant directed by the PSC to assist the Hearing Examiner in this investigation do not constitute a party to the proceeding although they are an active participant and provide considerable evidence used by the Hearing Examiner in this proceeding. A general description of a "party" is someone that has a material interest in the outcome of any regulatory proceeding -- and may be adversely affected by the decision. In this proceeding, the technical consultant has no material interest in the outcome and cannot be adversely affected by any decision rendered by the Commission. Accordingly, the technical consultant fails to satisfy the requirements to be treated as a party although the Hearing Examiner did accord them a number of privileges generally associated with party status (ie., the submission of testimony, opportunity to cross-examine witnesses, offer evidence) as a means of facilitating the investigation. In so doing, the Hearing Examiner did not grant the technical consultant any privileges beyond those necessary to the development of a full and fair record of the investigation.

- challenge the facts, findings and conclusions developed by the technical consultant;
- submit direct evidence in support of their own claims as well as rebut those presented by others;
- review the Hearing Examiner's report at the same time as it is filed with the Commission
- submit comment on any differences of opinion with the Hearing Examiner's Report and to the extent there are evidentiary differences, state why the evidence was not submitted to the Hearing Examiner for his consideration
- present any differences with the Hearing Examiner's report before the full Commission at the time the Hearing Examiner's Report is taken under consideration; and
- appeal any final decision and/or order rendered by the Public Service Commission in this proceeding.

At no time during this proceeding did representatives of Innovative ever argue – or infer – that these rights were insufficient to their needs or abused by the Hearing Examiner in any manner. The Hearing Examiner must assume that if such representations could be made Innovative would have endeavored to do so either before the Hearing Examiner or the PSC. The fact that Innovative did not make any such representations must leave the Hearing Examiner to conclude Innovative was afforded sufficient due process in this proceeding to deem it fair and equitable.

Coincident with the rights accorded Innovative by the Hearing Examiner in this proceeding, it was deemed necessary to require Innovative to prepare -- and provide to the technical consultant -- certain evidentiary materials for use in conducting their analysis and evaluation. These materials represented a) documentation and data available only from Innovative Telephone Company and could not be replicated by the technical consultant using other available data sources, b) material that may be available from other sources but not available within a reasonable period of time or c) material that may be available from other sources but was deemed to be cost-prohibitive.

The Hearing Examiner recognizes that an appreciable effort was required by Innovative to comply with the requests for information from the technical consultant. However, after reviewing the submissions made by the technical consultant to Innovative the Hearing Examiner must conclude that the technical consultant was judicious in their requests and evidenced no abuse of the privileges accorded them by the Hearing Examiner. The Hearing Examiner is appreciative of the effort expended by the company's representatives in matters related to preparing and producing the necessary evidentiary materials for use by the technical consultant in this proceeding. The responsiveness evidenced by the company's representatives contributed significantly to the expeditious resolution of a number of identified issues and merits recognition here.

2. AUS Pathways Inc. (Technical Consultants)

As mentioned earlier in this submission, AUS Pathways was directed by the PSC to assist the Hearing Examiner in the development of an evidentiary record in this proceeding. As a resource body to the Commission with the expressed responsibility of formulating probative

evidence, the technical consultants have no material interest in the outcome of the proceeding except to ensure the record is complete and fair. Accordingly, the technical consultants cannot be accorded party status to the proceeding and, therefore, are not assured the rights and privileges that come with such status.

After consideration of these facts, the Hearing Examiner deemed it useful – and in some instances necessary – to accord the technical consultants a limited set of rights and privileges for this proceeding. Specifically, the Hearing Examiner accorded the technical consultants the right to –

- submit direct evidence for the record based upon their examination and evaluation of Innovative's financial conditions;
- sponsor witnesses and testimony in any hearing deemed necessary;
- examine witnesses presented by Innovative in any hearing deemed necessary;
- object to procedural motions brought before the Hearing Examiner by Innovative;
- challenge the facts, findings and conclusions developed by Innovative in any submission made to the Hearing Examiner;
- review the Hearing Examiner's report prior to submission to the Commission

At the time these rights and privileges were granted, the Hearing Examiner considered the decision to be essential to achieving a complete – and balanced -- record in this proceeding. The Hearing Examiner remains of the opinion that his actions at the time in no way compromised the integrity of the investigative process or jeopardized the rights afforded Innovative Telephone Company as a party to this proceeding.

D. Scope of the Proceeding

Act 6402 directs the PSC to conduct a "rate investigation" of Innovative Telephone Company. However, as noted earlier in this report the statute does not specify what specific investigative activities should be undertaken by the PSC to satisfy its requirements. Consequently, the Hearing Examiner has been required to deduce from the relatively general terms of the statute the purpose of this proceeding and, more importantly, how to realize that purpose.

Docket No. 532 represents the sole regulatory initiative authorized by the Virgin Islands PSC to satisfy the Virgin Islands Legislature's directive in Act 6402 to investigate the regulated operations of the Innovative Telephone Company.[8] Accordingly, the Hearing Examiner was required to ensure the scope of Docket No. 532 was sufficient to satisfy the requirements specified by Act 6402.

[8] Innovative Telephone Company ("ITC") is a wholly-owned subsidiary of Innovative Communications Corporation ("ICC"). Innovative Telephone Company provides an extensive portfolio of telecommunications services that are regulated by the Virgin Islands Public Service Commission. A number of subsidiary business units of Innovative Communications Corporation are engaged in enterprises that are not directly subject to review and regulation by the Virgin Islands Public Service Commission and have been – with only limited exception -- excluded from consideration by the Hearing Examiner in this investigation.

As noted above, the Virgin Islands Legislature refrained from incorporating into the Act any specific areas or subjects for investigation thereby according considerable discretion to the PSC to interpret – on its own authority -- the Legislature's intent. It is the lack of specificity -- evident in Act 6402 – that dictated the Hearing Examiner define a framework for conducting the investigation that provided the appropriate scope (and scale) of investigative effort needed to satisfy the Act's requirements. Simply stated, to fulfill the Legislature's dictates the Hearing Examiner was required to determine what needed to be looked at (ie. what was relevant) and how hard it needed to be looked at (ie., what was sufficient proof) before a conclusion could be arrived at and a recommendation could be made to the Commission.

In this proceeding, the Hearing Examiner was presented with a lawful statute that lacks the necessary detail to construct a definitive investigative framework without some professional judgment being used by the Examiner. It is, however, a generally recognized fact that the legislative debate associated with Act 6402 included a number of issues that might be legitimately pursued by the PSC in any investigation it chooses to initiate. However, for whatever reason, many of the expressed concerns raised in the Legislature were not embodied within the statute's approved provisions and cannot rightfully be included solely on the basis of the Hearing Examiner's opinion.

Although many of the issues raised before the Legislature when Act 6402 was under consideration continue to represent subjects of interest to some – and the Public Service Commission has sufficient authority to investigate many of those issues -- the Hearing Examiner received no supplemental authority to conduct an investigation beyond that specified in Act 6402. With no basis upon which to conduct a broader examination than that prescribed by the statute, the Hearing Examiner elected to hold any investigation of such topics in abeyance for future consideration by the Public Service Commission in proceedings separate from Docket No. 532.[9] Only issues that seemed unquestionably related to a "rate investigation" were included for consideration in this proceeding.

The "rate investigation" prescribed in Act 6402 is invariably directed at determining whether the current rates and charges applied to regulated telecommunications services offered by Innovative Telephone Company meet a general standard of being "just and reasonable". To conclude that they are – or are not – for a public utility entails a set of rigorous examinations of the company's financial and operational condition be undertaken by the Commission prior to rendering any judgment.

In this proceeding the PSC has endeavored to conduct the first of those examinations that determines the total revenue required by Innovative Telephone Company.[10] In accordance with

[9] It is a generally accepted fact that if the Legislature wanted to pursue specific issues beyond those expressly addressed in Act 6402 the Legislature had the opportunity, the means and the authority to do so – either in separate legislation or by explicitly incorporating such requirements into the enacted statute. The fact that Act 6402 is silent on many of the topics raised in legislative debate reflects the will of the Legislature which must be respected by the Hearing Examiner in this proceeding. Any effort by the Hearing Examiner to broaden the scope of this investigation beyond that prescribed by the Legislature in Act 6402 by means of some other legal authority – without the expressed concurrence of the Commission -- would constitute an unwarranted use of the authority granted to the Hearing Examiner by the PSC in this proceeding. Accordingly, the Hearing Examiner has limited his interest in this proceeding to those matters directly specified by the Act's provisions.

[10] Rates and charges for a public utility company are generally referred to as the "rate structure". The determination of an appropriate rate structure is a complex process that entails detailed examination of the costs, demand, competitiveness and profitability. This investigation is directed at establishing only the "rate level" (ie., the

the regulatory scheme employed by the PSC with Innovative Telephone Company (ie., rate base regulation), the total revenue requirement establishes the framework within which the rates and charges for individual services are proposed by the company. Therefore, any effort to evaluate the current rates and charges without first determining the appropriate total revenue requirement would be of little value. With that understanding, the Hearing Examiner directed the technical consultants to direct their efforts at establishing an appropriate earnings level for and revenue requirement Innovative Telephone Company.

In pursuit of that goal the Hearing Examiner authorized the technical consultants to perform a number of investigative activities represented to the Hearing Examiner by the technical consultants as necessary to construct an evidentiary foundation for the Hearing Examiner. Specifically, the

technical consultants were authorized to –

- review the audited financial statements of the company for the period 1995-2000
- verify the accuracy of the filed income statement and balance sheet
- construct a pro forma income statement and balance sheet for purposes of projecting income, expenses and investment
- verify the size and composition of the reported rate base
- determine the source, cost and use of all funds available to the company
- review the use of benefits provided by the Investment Development Commission
- review sample transactions between Innovative Telephone and its nonregulated affiliates to ensure charges reported by the regulated telephone company are correct
- perform comparative analysis of Innovative Telephone's financial performance with other telephone companies

III. Issues of Interest

After consultations with the technical consultants to this proceeding, the Hearing Examiner directed the consultants to perform a focused examination of Innovative's current financial condition for use by the Hearing Examiner in evaluating Innovative's performance. Subsequently, the technical consultants proposed – and the Hearing Examiner accepted – a scope of work that focused on six principal areas – all of which have an impact upon Innovative's ability to provide service at just and reasonable rates. Briefly stated, the technical consultants investigated the following issues for the purpose(s) stated in the associated reference.

- **rate base –** verify that the net, or depreciated, value of all tangible and intangible property, used to provide regulated telecommunications services reflected in the company's books and records is consistent with reporting requirements of territorial and federal agencies
- **rate-of-return** – propose an appropriate return (expressed as a percentage of the depreciated value of all tangible and intangible property) that is deemed to be fair to investors and comports with the standards set forth in Virgin Islands statute

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earning levels and total revenue requirement) that will serve as the foundation for any examination by the PSC of the rate structures. Accordingly, this investigation did not address incidental issues of rate structure that arose in the course of the proceeding.

- **cost-of-capital** – identify the rate (expressed as a percentage) that Innovative must expect to receive to maintain its credit rating, to pay a return to investors, and to attract investment in amounts adequate to meet future needs
- **IDC benefits** – evaluate the current method of recognizing financial benefits provided by the Industrial Development Commission and its effect on the company's revenue requirements
- **affiliate transactions** – verify that services performed on behalf of other affiliated business units by Innovative Telephone – and on behalf of Innovative Telephone Company by other affiliates -- are properly charged and recognized in the company's income statement
- **taxes** – verify that the tax liabilities attributed to – and tax benefits derived by -- Innovative Telephone Company reflect only those it is obligated to meet or benefit from.

IV. Review Process

A. Methodology

In the Procedural Notice issued October 15, 2001 -- and in subsequent pre-hearing conferences with the participants to this proceeding -- the Hearing Examiner expressed the opinion that this proceeding must be conducted in a manner that will a) demonstrate the PSC has fully complied with the Legislature's requirements in Act 6402, b) provide an evidentiary foundation for any actions that might be taken by the PSC in this proceeding and c) ensures the rights and privileges currently afforded the participants by administrative agencies, legislative bodies and the judiciary are respected.

After consulting with the participants to this proceeding the Hearing Examiner informed both participants that the technical consultants would conduct their investigation based upon a scope of work approved by the Hearing Examiner, submit a draft report of their findings to the Hearing Examiner and entertain comments and questions from Innovative in a formal hearing. In turn, Innovative agreed to provide assistance to the technical consultants in their investigation; provide comment to the technical consultants' draft report; and sponsor additional evidence and testimony in support of any differences with the technical consultants' draft report. Participants were also informed that upon conclusion of the public hearings the Hearing Examiner would weigh the evidence presented by the participants, make such findings and conclusions warranted by the evidence and recommend any necessary actions to the Commission for consideration.

At the time they were proposed by the Hearing Examiner, the participants expressed no concern with the procedural constructs outlined by the Hearing Examiner. Furthermore, the participants have not evidenced any concern regarding the constructs since the proceeding was initiated by the PSC. Lacking evidence to the contrary, the Hearing Examiner must conclude that the procedural constructs employed in this proceeding were fair, impartial and sufficient to each participant's needs.

B. Standards of Judgment

It was essential in this proceeding for the Hearing Examiner to adopt a set of quantitative and qualitative standards by which the financial and operational conditions identified in the

review could be objectively scrutinized and fairly judged. Although a single, comprehensive measurement that could be applied by the Hearing Examiner as a final assessment would have been desirable, the broad scope of interest in this proceeding made adoption of a single measurement impossible. Instead, the Hearing Examiner deemed it necessary to establish a set of standards that could be applied to individual components of the company's financial performance.

Discussion of the individual standards elected for use in this proceeding is associated with the Hearing Examiner's findings and conclusions presented later in this report. However, it should be noted that as a general observation the standards elected for use in this engagement are consistent with the strictures and standards set forth in Virgin Islands and United States statutes, FCC and VIPSC rules and regulations, generally accepted industry standards and practices. In each instance, the Hearing Examiner is of the opinion that the standard elected for use in this proceeding is fair and reasonable and found no reason to consider use of a different standard.

C. Scale of Effort

Docket No. 532 was initiated in July, 2001 with formal notice rendered to Innovative Telephone Company of the PSC's intentions to conduct a rate investigation. Over the 12-month period that the proceeding has spanned, the technical consultants conducted more than 40 interviews with representatives of Innovative Telephone, its affiliated subsidiaries, investment ratings agencies, investment bankers and members of the Industrial Development Commission; reviewed over 10,000 pages of financial material, regulatory filings, regulatory and legislative transcripts, VIPSC rules, regulations and Orders; and expended more than 400 man-hours preparing for and participating in public hearings. In short, it was a very comprehensive review of the financial condition of Innovative Telephone.

It must be noted, however, that any reference to the term "comprehensive" is relative and requires qualification and clarification by the Hearing Examiner to be correctly understood. As stated earlier in this submission, Docket No. 532 is an investigation of Innovative Telephone Company – and only Innovative Telephone Company – conducted at the behest of the Virgin Islands Public Service Commission. Innovative Telephone Company is the only business unit operated by Innovative Communications Corporation that is subject to the authority of the VIPSC and only corporate entities subordinate to VIPSC authority are subject to the investigation prescribed by Act 6402.

Based upon those facts, only Innovative Telephone Company was named as the subject of this investigation and only activities involving Innovative Telephone Company were examined. However, it should be noted that in the review process the Technical Consultants confirmed that certain expenses reported by Innovative Telephone Company in its income statements reflect charges for services provided by other ICC subsidiaries and/or the corporate parent itself to Innovative Telephone Company.

The Hearing Examiner deemed it appropriate to direct the technical consultants to scrutinize certain business transactions between Innovative Telephone Company, its affiliates and corporate parent where Innovative Telephone Company was a party to the transaction. Albeit an extension of the authority granted in Act 6402 and the PSC's Notice in Docket No. 532, the Hearing Examiner concluded that a limited examination of the relationships between

Innovative Telephone and its affiliates was necessary to verify that charges reflected in the income statement of Innovative Telephone Company were accurate. It is the opinion of the Hearing Examiner that the decision to direct the technical consultants to scrutinize such business relationships is consistent with limited authority available to the PSC to investigate such matters and the rules/regulations promulgated for such investigations by the Federal Communications Commission.

Furthermore, it is the opinion of the Hearing Examiner that the limited effort expended by the technical consultants in pursuit of the information sought by the Hearing Examiner cannot be represented – or interpreted -- as being a comprehensive examination of the financial condition of the corporate parent Innovative Communications Corporation. Similarly, it is the opinion of the Hearing Examiner that the same effort cannot be represented – or interpreted – as a comprehensive examination of the financial condition of any subsidiary business unit of Innovative Communications Corporation other than Innovative Telephone Company.

D. Verification of Facts

In a concerted effort to eliminate disputes between participants that can be attributable to "errors of fact", the Hearing Examiner provided an opportunity in the procedural framework for representatives of Innovative Telephone to review the draft report of the technical consultants and offer additional evidence that would correct any identified errors. Errors of fact that were identified by participants were noted and corrected.

E. Opinion and Recommendation of the Hearing Examiner

The procedural framework established for this proceeding provided for the Hearing Examiner to review evidence submitted by each of the participants, evaluate the evidence submitted by each participant, make specific findings of fact and conclusions of law, and recommend to the Commission any action(s) needed to resolve the issues raised in the proceeding.

In conducting this proceeding the Hearing Examiner has received and recorded the evidence submitted in this proceeding by the technical consultants and Innovative Telephone Company. Furthermore, the Hearing Examiner has conducted four days of evidentiary hearings to receive additional evidence from the respective participants and hear challenges to the evidence presented by each. Finally, the Hearing Examiner has entertained legal briefs on several issues.

In this proceeding, the Hearing Examiner provided each participant opportunity to submit such evidence they deemed important for consideration by the Hearing Examiner. The Hearing Examiner provided both participants opportunity to challenge the evidence presented in this case and argue for its inclusion or exclusion from the Hearing Examiner's recommendations. In each instance, the participants made submissions and entered challenges to the representations of the other. The Hearing Examiner afforded both participants the amount of time they deemed necessary to present their challenges in public hearing and concluded such hearings only after both participants acknowledged they had concluded.

The procedural framework adopted for this proceeding provides that after such events

take place, the Hearing Examiner will submit a report to the Commission of his findings, conclusions and recommendations for its consideration. This report represents the opinion of the Hearing Examiner after reviewing all of the evidence submitted by the participants and weighing the merits of that evidence. After weighing the evidence the findings, conclusions and recommendations made by the Hearing Examiner to the Commission may differ from those of one or both of the participants.

This submission will serve as the report of the Hearing Examiner to the Commission. With acceptance by the Commission and action thereon the Hearing Examiner's duties in this matter will be completed and this proceeding will be concluded unless otherwise directed by the Commission.

V. Summary of Evidence

A. Technical Consultants' Report

On April 26, 2002 the Technical Consultants filed a draft report in this proceeding with the Hearing Examiner for review and consideration. That submission – and the testimony offered by Messrs. Zarillo, Mann, Hanley, Enriquez and Milkowski at hearings conducted by the Hearing Examiner on June 17-18, 2002 and June 25-26, 2002 served as the total evidence offered by the technical consultants in this matter.

In their submission, the technical consultants proposed a series of adjustments to the financial statements of Innovative Telephone Company that served as the basis for consideration by the Hearing Examiner in this proceeding. The following represent the principal adjustments and revisions offered for consideration.

First, the technical consultants recommended reductions to the rate base amounting to $8,388,000 for the year ending June 30, 2001 reflecting adjustments to a number of accounts. The adjustment represents approximately 8.1% of the reported rate base and is principally attributable to the exclusion of an allowance for Plant Under Construction ($8,074,000) and different treatment of customer deposits ($312,000). An allowance of $2,000 for non-operating plant that was excluded in the company's cost study accounts for the remaining adjustment.

Second, the technical consultants recommended increases in the revenue reported for the year ending June 30, 2001 by $458,000 to reflect adjustments to basic service revenues ($202,000), rent ($789,000) and other revenue (($533,000)). The aggregate value of the adjustments equates to 0.9% of the reported June 30, 2001 revenues.

Third, the technical consultants recommended an adjustment to both the weighted cost-of-capital and the rate-of-return. Initially, the technical consultants maintained that the actual cost-of- capital to the company was 10.08% for the year ended June 30, 2001 and a 10.10% rate-of-return was considered to be fair ans reasonable. This was subsequently amended by the technical consultants following the hearings and will be addresses within the appropriate sections of this report.

The technical consultants assert that adjustments to the company's rate base, cost-of-

capital component, allowed rate-of-return, operating expenses, taxes and net income are warranted by changes in market conditions, different treatment of certain operating expenses and a disputed interpretation of the Commission's actions in Docket No. 513.

The net effect of the technical consultants' adjustments is that Innovative would be expected to generate excess income -- for the pro forma period -- from telephone operations of $560,000 on total revenues of more than $51,000,000 if the proposed 10.10% rate of return were in effect at that time. This equates to slightly more than 1.0% over earnings.

B. Innovative Response

Innovative Telephone submitted comments to the April 26, 2002 draft report by the technical consultants on May 31, 2002. Innovative took exception with a number of the adjustments recommended by the technical consultants in their earlier submission and presented evidence in support of their claims. Additionally, Innovative took the opportunity to submit additional evidence and testimony (testimony was filed by Messrs. Randall Billingsley Arnold Golden, Derek Hodge, Richard Moore, Donald Parrish, and Ms. Julia Johnson for use in the June hearings.

In its submission, Innovative Telephone generally opposed the series of adjustments made by the technical consultants. The following represent the principal adjustments and revisions offered by Innovative for consideration.

First, Innovative opposed the recommended rate-of return made by the technical consultants (10.10%) as "not reasonable" maintaining that it must be permitted to earn, at a minimum, the rate-of-return (11.50%) established in the 1992 rate investigation to satisfy the requirements of Section 23(b) of Title 30 VI Code and reflect the risk premium sought by investors.

Second, Innovative sought restoration of $4,180,000 in tax liabilities that are offset by benefits provided by the Industrial Development Commission. Innovative maintains these benefits are properly recognized in its pro forma financial statements and should not be adjusted as recommended by the technical consultants.

Third, Innovative sought restoration of the $2.2million Lifeline account to the revenue requirement for the company. Innovative argues that it is required to contribute to this account by PSC actions and it should have been properly recognized by the consultants

Fourth, Innovative sought recognition in its revenue requirements for the cost of conducting rate investigations such as this proceeding. Innovative estimates the cost of this proceeding will exceed $1.0 million that was not recognized by the technical consultants in their pro forma calculations.

Innovative maintains that adjustments proposed by the technical consultants to the company's rate base, cost-of-capital component, allowed rate-of-return, operating expenses, taxes and net income are unnecessary, unwarranted and unfair. Innovative argues that restoring the adjustments made by the technical consultants, properly treating the Lifeline fund and recognizing the rate case expenses associated with this proceeding would show that Innovative

will earn less than a reasonable rate of return in the pro forma period.

VI. Hearing Examiner's Analysis

The Hearing Examiner has reviewed the submissions made by the participants in this proceeding and given consideration to the evidence and argument presented by each. As indicated earlier in this report, it is the Hearing Examiner's opinion that six areas are in dispute between the participants and require resolution before the Hearing Examiner can make a recommendation to the Commission. At the risk of seeming to oversimplify the complex "technical" nature of this proceeding, the Hearing Examiner has endeavored to subject each of the disputed issue to some discussion in this section and render his findings on the matter.

A. Cost of Capital

1. Discussion

The cost-of-capital to Innovative Telephone must be determined in order to authorize a "fair and reasonable" rate-of-return. The responsibility for determining the cost-of-capital for ratebase regulated utilities is the Virgin Islands Public Service Commission. The actual cost-of-capital paid by Innovative in the future will not, in fact, precisely correspond to the cost figure authorized by the PSC in any ratemaking proceeding. The weighted cost-of-capital for any public utility is a combination of the cost of debt and the cost of equity. Experience suggests that the cost-of-capital to Innovative in the future will be higher than any comparative group of telephone companies as a reflection of the additional risk of investing in the United States Virgin Islands and the company's relatively small size.

The participants differ, however, on a) the appropriate method used to determine the cost-of-equity capital to Innovative and b) the "magnitude" of any premium adjustment needed by prospective investors to account for "risk" of committing investment funds to Innovative.

a. Debt:Equity Ratio

The technical consultants estimate in this proceeding that the cost of-capital to Innovative Telephone was initially approximately 10.10%.[11] That figure represents a calculation performed by the technical consultants based upon financial information made available by the company and other publicly-available sources.

As a counterpoint to the technical consultants' recommendation company witnesses have testified in this proceeding that the forward-looking cost-of-capital to Innovative is substantially higher than that suggested by the technical consultants and must be reflected in the Hearing Examiner's decision if it is to fair. Specifically, testimony by Innovative's expert witness Billinglsey seeks to show the forward-looking cost to Innovative for a combination of debt and equity capital is 13.84%.[12]

Each of the participants have presented considerable evidence in support of their

[11] TC Exhibit 6, p.1of2 appended to the Technical Consultants' Report In re Rate Investigation of Innovative Telephone Company released April 26, 2002
[12] Testimony of Randall Billingsley, Tr. at p. 148, lines 3-8.

respective claims and the Hearing Examiner has given considerable time to evaluating them given the relative importance of this issue to this proceeding and the general public served by Innovative Telephone.[13] At the expense of belaboring some of the finer points of this topic it is necessary for the Hearing Examiner to provide some foundation to the discussion contained in the balance of this section.

First, it must be clarified that the "cost-of-capital" figure proposed by each of the two witnesses above represents a weighted average of the combined cost of debt and equity capital to the company. Like most investor-owned companies, the capital structure of Innovative comprises common equity and two forms of debt (short-term and long-term) – each of which reflects a different "cost" to the company when it is employed. To compute the "weighted average" cost of capital in this proceeding both witnesses were required to a) calculate the individual cost for common equity, short-term debt and long-term debt and b) combine the results in proportion to the amount of total capitalization that is attributable to each[14].

It is apparent after reviewing the evidence submitted by the witnesses that a substantial difference exists in the debt:equity ratios used by the two participants. It is also apparent that the difference in the debt:equity ratio – as acknowledged by the participants in the Hearings of June 25-26 – contributes to some, but not all, of the difference between the cost-of-capital recommendations made in this proceeding.[15] It is evident that by simply using the equity component that one Innovative witness attributes to common equity (69.26% of total capital) the effect of any equity risk premium produces a substantially higher cost-of-capital than that proposed by the technical consultants using a lower equity component (45.57% of total capital).

It is apparent to the Hearing Examiner that any debt:equity ratio recommended for adoption in this proceeding will have a dramatic effect on the cost-of-capital component used by Innovative and the PSC and, therefore, must be determined first. In this instance, the Hearing Examiner is presented evidence that suggests much of the difference may be attributed to the differences in methodology employed by the respective witnesses.

The technical consultant Hanley testified that he elected to use certain financial data -- book values and estimates -- derived from company records and/or publicly available sources to compute the proposed debt:equity ratio.[16] The technical consultant maintains that this practice is consistent with that traditionally employed in other jurisdictions to establish cost-of-capital components for regulated utilities similar to Innovative.[17]

One witness appearing on behalf of Innovative rejected the method used by the technical consultant and testified that he preferred to use market values in his analysis because they were "consistent with establishing a forward-looking cost of capital".[18] The Innovative witness asserts

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[13] The importance of determining the "weighted average" cost of capital rests in the fact that it is integral to establish the proper rate-of-return needed by Innovative.

[14] The technical consultant assumed 54.43% long-term debt, 45.57% common equity and 3.73% short-term debt. Technical Consultant's Report TC Exhibit 6, p. 1of2. Innovative's witness assumed 30.74% debt and 69.26% common equity. Billingsley Testimony Exhibit RSB-1, p. 1of 1.

[15] Although the witnesses acknowledge that this difference does account for the difference neither party has made any effort to quantify the impact associated with the different debt:equity ratios.

[16] Hanley Testimony, Tr. at p.12, lines 18-21. 06/25/02

[17] Id., Tr. at p. 12, lines 21-25. 06/25/02

[18] Billingsley Pre-filed Direct Testimony at p.46, lines15-20.

that the use of "book value" to calculate the cost-of-capital dramatically understates Innovative's overall cost-of-capital.[19] Instead, the Innovative witness established a proxy group of 20 companies that were used to calculate a theoretical debt:equity ratio for Innovative. The Innovative witness maintains that this practice is more consistent with the direction that is being employed by the Federal Communications Commission and the expectations of the investment community. Under cross-examination the witness acknowledged that he was unaware of any state regulatory agency that had formally adopted the approach he was recommending in this proceeding[20].

A separate Innovative witness testifying on financial matters introduced evidence that suggested the debt:equity ratio of Innovative for year-end 2001 was actually 50.54% equity, 46.19% long-term debt and 3.27% short-term debt.[21] Innovative attributed the differences in the debt:equity ratio between their witness and the technical consultant were due to the fact that the technical consultant's representations were estimates while its' witness has used the actual numbers. The technical consultant Hanley argued that the figures it was using came from company sources and, therefore, must be reasonably accurate.

In an effort to resolve the difference on this issue the Hearing Examiner directed the company representatives to provide an opportunity for representatives of the technical consultant to verify the representations made by Innovative in the hearing. A subsequent review by the technical consultant found the debt and equity ratios presented by Innovative in Parrish Exhibit 3 to be correct. Subsequently, the technical consultants advised the Hearing Examiner of their willingness to stipulate that the Parrish figures are correct and are willing to adjust their recommendations accordingly. Therefore, the Hearing Examiner finds no reason to give further consideration in this proceeding to the initial debt:equity ratio offered by the technical consultant.

Separately, the Hearing Examiner gave some consideration to the debt:equity ratio recommended by witness Billingsly but found little reason to favor his proposed treatment of this issue. Witness Billingsley's inability to support his argument for a different approach offered the Hearing Examiner little basis for rejecting the debt:equity ratio proposed by witness Parrish (and accepted by the technical consultant). The fact that the technical consultant was willing to adopt the Parrish proposed numbers only served to reaffirm the opinion of the Hearing Examiner.

Witness Billingsley predicated his recommendation on a set of unfounded assumptions and abstractions that have no foundation in regulatory practice. After reviewing the evidence and argument presented by the witness, the Hearing Examiner found no compelling reason to adopt the methodology proposed by Witness Billingsley to determine the cost-of-equity capital and deviate from the generally accepted practice of this Commission or that of many other state commissions.

After reviewing all of the evidence and argument presented by Witness Billingsley, the Hearing Examiner finds no cause to question the accuracy and/or reasonableness of the joint representation made by the technical consultant and the Innovative witness in this proceeding.

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[19] Id., at p.47, lines 4-5.
[20] Billingsley Testimony, Tr. at p. 205, lines 13-21. 06/25/02
[21] Parrish Exhibit 3. Parrish introduced his debt:equity ratio in response to the ratios previously introduced by the technical consultant.

However, left with financial information and data presented by the technical consultant that has been shown to be reasonably accurate and correct the Hearing Examiner finds no need to speculate beyond those facts as to the debt:equity ratio of the company

The record in this proceeding indicates that the technical consultant Hanley employed estimated financial data provided by Innovative to establish their proposed debt:equity ratio and corroborated that estimate with verified actual data contained in witness Parrish's testimony. Left with no substantive challenge to what methodology must be employed to calculate debt:equity ratios, and verification of the authenticity and accuracy of the calculation performed by witness Parrish, the Hearing Examiner finds that the debt equity ratios to be applied to Innovative's capital structure in this proceeding is 46.19% long-term debt, 3.27 short-term debt and 50.54% common equity..

b. Cost-of-Debt

The technical consultants initially estimated that the embedded cost of long-term debt to Innovative is 5.67%.[22] The witness for Innovative estimates that the forward-looking cost of long-term debt to Innovative is 7.70%.[23]

The Innovative witness speculates that the principal difference between the figures cited by the two may be that the technical consultant relied upon financing provided in the past by the Rural Telephone Financial Cooperative ("RFTC").[24] The Innovative witness characterizes this as "inappropriate" and asserts that using current market data on the borrowing costs of firms of comparable credit risk provides a better basis for evaluating investment risk.[25]

The technical consultant acknowledges that the cost-of-debt cited in his testimony was computed using the embedded cost of debt obligations – not the incremental cost for debt that Innovative might be expected to pay in the future.[26] In support of its approach, the technical consultant asserts that embedded cost methodologies -- such as that it employed in this proceeding -- are consistent with accepted regulatory practices. The technical consultant asserts that rate-of-return regulation affords the company another opportunity in the future to propose a different cost-of-capital that will reflect any changes in the debt cost the company might occur between now and then.[27]

As noted above in the discussion of the debt:equity ratio, at the conclusion of the hearings some differences remained between the technical consultant and the company over certain facts that required resolution in this proceeding before an appropriate recommendation could be made to the

[22] Technical Consultant Report TC Exhibit 6, p.1of2
[23] Billingsley Pre-Filed Testimony, at p. 47, lines 14-15.
[24] Billingsley Pre-Filed Testimony, at p.47, lines 15-16.
[25] Id., lines 17-18.; Billingsley Testimony, Tr. at p. 149, lines 18-19. 06/25/02
[26] Hanley Testimony, Tr. at pps.25, line 25 - p.26 line 9 06/25/02
[27] Id., Tr. at p.26, lines 10-13.

Commission. In this instance, the issue related to the cost-of-debt.

In testimony submitted by witness Billingsly on this subject, the witness offered an estimate of Innovative's debt cost that was substantially above that presented by the technical consultant in his submissions to this proceeding. However, in discussions between the technical consultant and the company directed by the Hearing Examiner to narrow these factual differences it was determined that the actual embedded cost of debt for the year ending December 31, 2001 was 5.72% for short-term debt and 6.18% for long-term debt – the same as shown in witness Parrish Exhibit 3. This represents a rather small difference in the short-term costs for Innovative debt but did reflect a substantial increase in the embedded cost of long-term debt incurred by the company. After verifying the accuracy of witness Parrish's representation the technical consultant expressed to the Hearing Examiner their willingness to stipulate acceptance of the embedded cost for short-term and long-term debt as shown in Parrish Exhibit 3 (ie., 5.72% and 6.18%) for use in this proceeding.

The Hearing Examiner has given substantial consideration to the arguments presented by each of the witnesses but, again, finds little reason to adopt the rather unorthodox approach proposed in this proceeding by witness Billingsley. On the other hand, the embedded cost method outlined by the technical consultant is a generally accepted practice amongst state regulators and the Hearing Examiner finds no compelling reason in the evidenced presented in this proceeding to recommend a relatively untested and unproven approach to this subject. Furthermore, the fact that the verification exercise performed by the technical consultant with Innovative determined the actual – rather than estimated – embedded cost-of-debt offers the Hearing Examiner still greater confidence that a fair and reasonable cost-of-debt component can be determined in this proceeding using proven techniques. Accordingly, the Hearing Examiner recommends acceptance of the jointly recommended cost-of-debt (ie., 5.72% for short-term debt, 6.18% for long-term debt) proposed by the technical consultant and Innovative for use in this proceeding.

c. Cost-of-Equity

Unlike the retrospective approach to calculating the cost-of-debt prescribed in the prior section, the approach to calculating the cost-of-equity capital is prospective. On that both witnesses agree. However, Innovative has no publicly traded equity securities that make any accurate determination of the cost-of-equity capital relatively simple. Consequently, both the technical consultant and the company's witness found it necessary to postulate, to the degree possible, what the forward-looking cost might be.

The technical consultant initially estimated that the forward-looking "net" cost of equity capital to Innovative to be 13.90%.[28] The witness for Innovative estimates that the forward-looking

[28] Technical Consultant Report, TC Exhibit 6 p.2of2. The technical consultant has used the figure of 15.40% in

both the technical report and testimony, however, that figure includes a risk premium of 1.50%. Given that the risk premium is in question in this proceeding the Hearing Examiner has taken the liberty of adjusting the figure to reflect a "net" cost-of equity capital. The issue of the risk premium will be addressed separately in this report.

"net" cost of equity capital to Innovative is 13.23%.[29]

In arriving at their respective recommendations, both witnesses were required to establish a supportable set of assumptions and evaluation processes that would elicit confidence in their recommendations. Lacking any Innovative-specific data that could be offered in support of their claims each witness deemed it necessary to establish some form of proxy group to represent the nonexistent market for Innovative securities; and, though the approach used by each to construct a cost-of-equity component differed the recommendation proved to be markedly similar to one another.

The technical consultant testified that he selected six telephone companies to serve as a proxy group for Innovative.[30] The technical consultant testified that he selected these six companies because they all have common stock actively traded on the NYSE, AMEX or NASDAQ; have more than 50% of the year 2000 operating revenues derived from local exchange telephone operations; have not cut or omitted their cash common stock dividend during the five calendar years ending 2001 or through the time of the preparation of the technical consultant's report; had meaningful earnings growth forecasts at the time of the preparation of the technical consultant's report according to Value Line Investment Survey and/or Thomson FN; were not expected to be acquired by or merged into another company during the year 2002; and are included in the S&P Compustat PC Plus Data Base.[31]

The Innovative witness has testified that he, too, selected a group of companies to serve as a proxy which to construct his cost of equity. However, the Innovative witness testified that he selected 20 companies "shown to be comparable in risk to Innovative Telephone" – without regard to their industry.[32] The Innovative witness testified that he used "cluster analysis" to

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[29] Billingsley Pre-Filed Testimony at p.47, line 12. The Innovative witness has actually testified that the cost of equity is 16.57%. However, the witness has also suggested that a risk premium of 3.34% (334 basis points) is included in that figure. Removing that risk premium provides a "net" cost-of-equity capital of 13.23%. This computation relates closely to the 13.30-13.35% cited by the Innovative witness as the average cost of equity for the proxy group used in the witness's risk analysis exercise. See Billingsley Pre-Filed Testimony at p.28, lines 6-9.

[30] The proxy group selected by the technical consultant for this exercise comprises BellSouth Corporation, Century Tel, Inc., CT Communications, Inc., Hickory Tech Corporation, SBC Corporation and Verizon Communications. Technical Consultants' Report TC Exhibit 9, p. 2of2

[31] The selection criteria are delineated in TC Exhibit 8, p.2 of 2 appended to the Technical Consultants' Report In re Rate Investigation of Innovative Telephone Company released April 26, 2002

[32] Billingsley Pre-Filed Testimony at p. 39, lines 4-6. A list of all members of the proxy group are found in Billingsly Exhibit RSB-11.

identify the 20 firms that are the subject of his risk analysis[33].

Both witnesses acknowledge that the ability to accurately calculate the cost of equity for a privately-held company like Innovative is challenging and not without some level of uncertainty. However, it is apparent from the analyses performed by the witnesses that every effort was made to establish a proxy group that each believed was fair and representative of the market that might exit for Innovative equity.

After reviewing the selection criteria used by each witness to construct their proxy group, it is apparent that each witness gave considerable thought to properly framing the company within a "peer" group of publicly-traded companies – albeit a different set of peers in each case. The Hearing Examiner recognizes the difficulty that this exercise presented for both parties and is appreciative of the efforts made by both. And the fact that the results of their independent efforts were so close each seems to validate the work of the other.

It is apparent from the selection criteria used in each instance that the witnesses sought to establish proxy groups comprising companies that are financially healthy and managerially stable -- effectively avoiding inclusion of companies that evidence uncertainty to the investment community. In the opinion of the Hearing Examiner, it seems that both witnesses have succeeded in constructing proxy groups that equate to a median point of the "risk curve" that any publicly-traded company might experience. By so doing, the witnesses have provided the Hearing Examiner a range within which a "net" cost-of- equity capital for Innovative might be established (ie. 13.23%-13.90%).

After a rather lengthy review of the evidence submitted by the witnesses and the discussion between the witnesses at the June 25 hearings, the Hearing Examiner recommends use of a 13.90% net cost-of-equity. The Hearing Examiner bases that recommendation on two facts. First, the Commission is obligated to ensure the rate-of-return at least meets the cost-of-capital and, in both instances, the recommendations are simply estimates. The Hearing Examiner is of the opinion that when evidence such as that presented in this proceeding by the technical consultants strongly suggests the cost-of-capital could be as high as 13.90% the Commission cannot ignore it or dismiss it. Secondly, the higher rate reflects the cost-of-equity capital for a body of telephone companies that bear similar performance characteristics and investor bases. It is the opinion of the Hearing Examiner that the "net" cost-of-equity capital for Innovative will be influenced as much by industry characteristics and trends as by it own individual performance. For these reasons the Hearing Examiner proposes to use the "net" cost of equity capital sponsored by the technical consultants.

In summary, the Hearing Examiner finds no compelling reason to conclude that the estimate offered by the technical consultant is less than fair and reasonable and is deemed acceptable for use as the cost of equity capital. Accordingly, the Hearing Examiner recommends the "net" cost-of-equity capital be set at 13.90% for purposes of this proceeding.

d. Risk Premium

[33] Billingsley Pre-Filed Testimony at p. 26, lines 21-23.

The technical consultant initially proposed an adjustment of 1.50% (150 basis points) over the average cost-of-equity capital for the proxy group selected by the technical consultant to reflect a "risk premium" for investments in the Virgin Islands. Questioned about the "validity" of the 150 basis point adjustment, the technical consultant termed it both "appropriate" and "ample".[34]

In response to the recommendation of the technical consultant, Innovative's witness asserts that a 3.34% (334 basis points) "risk premium" is warranted and "supported by extensive research" [35] Innovative's witness suggests the difference is attributable, in part, to the relatively size of Innovative that the technical consultant does not take into consideration in their recommendation.[36] Innovative's witness maintains that his recommendation is supported by Ibbotson Associates – the same firm used by the technical consultant in conducting their risk analysis.[37]

Upon cross-examination, Innovative's witness acknowledged that the "risk premium" proposed in his testimony was not specific to Innovative -- or even to the group of companies that were used in his own comparative evaluation.[38] However, the witness maintained that the proposed premium factor was "conservative" when compared to the range afforded by Ibbotson.[39]

The Hearing Examiner finds ample support in the evidence presented by the technical consultant and Innovative for a risk premium adjustment to be made to the cost-of-equity capital.[40] However, the technical consultant provides no empirical evidence or cogent argument to support the 150 basis point adjustment proposed in this proceeding.[41] Furthermore, the Innovative witness suggests that studies by qualified firms show the risk coefficient to be much higher than that suggested by the technical consultants.

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[34] Testimony of Witness Hanley, Tr. at p.31, lines 4-11. 06/25/02
[35] Testimony of Witness Billingsley, Tr. at p.150, lines 18-21.
[36] Id.
[37] Id., Tr. at p. 180, lines 12-14.
[38] Id., Tr. at p. 180, lines 15-24.
[39] Innovative's witness testified that he took the average value referenced by Ibbotson in their publication. Id., Tr. at p. 181, lines 5-15.
[40] Billinglsey, Tr. at p.150, line8-11 06/25/02; Hanley, Tr. at p. 31, lines 4-11 06/25/02
[41] Under cross-examination the technical consultant acknowledged the adjustment was not based upon any study but reflected his "judgment". Testimony of Witness Hanley, Tr. at p.32, lines 8-13 06/25/02

As noted above, the Hearing Examiner directed the technical consultant and the representatives of Innovative to meet and resolve differences of fact that separate the two participants. As pointed out in prior sections a number of differences were reconciled that have a material effect on this proceeding. However, in the matter of the risk premium no agreement was reached by the parties: however, the fact that Innovative was found by the technical consultants to have a capital structure that more closely paralleled the proxy group established by the technical consultant served to suggest the risk premium originally proposed by the technical consultant should be less rather than more. Accordingly, the technical consultant informed the Hearing Examiner they were recommending only a 110 basis point premium be applied to the base cost of equity capital of 13.90%. The effect of this change is to propose an adjusted cost-of-equity capital of 15.0% rather than 15.4% as previously submitted for consideration.

After reviewing the submissions of both witnesses it is apparent to the Hearing Examiner that the 110-basis point risk premium proposed by the technical consultants was intended to provide a comprehensive allowance for all risk associated with investment in the Virgin Islands – size, sector, regulatory environment, competition and geography. In the testimony provided by the Innovative witness it appears that Innovative considered the 150 basis points as inadequate and the technical consultants have not offered any evidence to suggest it is more than that. Accordingly, the Hearing Examiner can only assume a reduction of that risk premium from 150 basis points to 110 basis points will also be viewed as inadequate. However, the Hearing Examiner believes with the verification exercise performed by the technical consultant that shows Innovative to more closely resemble the proxy group it is being compared to it is reasonable to assume the risk premium would be narrowed to reflect only those differences between it and the proxy group. Accordingly, the Hearing Examiner recommends adjustment of the "net" cost-of equity-capital by only 110 basis points to allow for the risk attendant to investment in the Virgin Islands thereby providing an adjusted cost-of-equity capital of 15.00%.

B. Rate-of-Return

1. Discussion

Innovative Telephone Company is subject to rate-of-return regulation administered by the Virgin Islands Public Service Commission. Any rate-of-return set by the Public Service Commission must be "fair and reasonable". A fair and reasonable rate of return must reflect the actual cost-of-capital and risk associated with any investment if it is to be considered "fair and reasonable". [42] The Virgin Islands Public Service Commission must expressly find that any rate

[42] The standard for what constitutes "fair and reasonable" were first set forth in two landmark legal proceedings -- *Bluefield Water Works & Improvement Co. v. Public Service Comm.of West Virginia* 262 U.S. 679 (1923) ["*Bluefield*"] and *Federal Power Commission v. Hope Natural Gas Co.* 320 U.S. 591 (1944) ["*Hope*"]. In these two opinions the Supreme Court of the United States set forth the general standards that must be met by a regulatory body when setting a rate-of-return for a regulated company. In *Hope,* Justice William O. Douglas articulated the sentiments of the court when he wrote…

> "From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock…By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to

it adopts greater than

assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital. *Federal Power Comm. V. Hope Natural Gas Co*., 320 U.S. 591, 603 (1944).

8% is "imperative."[43]

The participants differ, however, on a) what constitutes a fair and reasonable rate-of-return for use in determining future revenue requirements of Innovative and b) the applicability of any different rate-of-return than that currently authorized by the VIPSC to a pro forma financial statement.

a. Fair and Reasonable Return

The technical consultant initially argued that the Commission should set the rate-of-return for Innovative at 10.10% and offers evidence to support that recommendation. First, the consultants maintain that the proposed rate-of-return reflects the product of a "conventional weighted cost of capital approach".[44] Second, that the capital structures used in the analysis were the Company's actual structure as of June 30, 2001, and an estimated capital structure provided by the Company for the pro forma period.[45] Third, the capital structure ratios used were derived from the Company's own balance sheets using book cost.[46] Fourth, the cost of debt capital was calculated using the actual embedded debt cost on a composite basis.[47] Fifth, the cost of equity capital component was developed using a proxy group of utilities and adjusted for any differences that might be attributable to differences in risk.[48] In summary, the technical

[43] Title 30, Section 23 of the Virgin Islands Code provides that "In exercising its authority to prescribe just and reasonable rates, the Commission shall provide a return of not less than 6 percent nor more than 8 percent on the net investment in the property, that will be required for and devoted to the public use unless the Commission makes a special finding that a different return is imperative, so as to be fair to the consumer interest and to be fair to the investor interest by providing a return commensurate with returns in other enterprises having corresponding risks and which will assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital."
[44] Testimony of Witness Hanley, Tr.at p.12, lines 15-17. 06/25/02
[45] Id., Tr. at p. 12, lines 18-21.06/25/02
[46] Id., Tr. at p. 13, lines 8-10. 06/25/02
[47] Id., Tr. at p. 13, lines 10-12.06/25/02
[48] Id., Tr. at p.14, lines 3-7 As noted in the early section "cost-of-capital" Innovative's stock is not a publicly traded security; therefore, the actual cost of equity could only be estimated by identifying a group of "comparable"

consultants suggest that the rate-of-return model developed for us in this proceeding employs the company's own data, generally accepted economic principles or reasonable assumptions.

The witness for Innovative argues that the risk to Innovative evidenced by his research merits a rate of return for Innovative of 13.84%.[49] In support of his recommendation, the Innovative witness argues that investors looking at firms like Innovative are forward-looking and will consider whether the firm is expected to offer a return that is comparable to that on other investments of comparable risk. Second, he maintains that using historical book values to determine the allowed rate-of-return would place the firm at a competitive disadvantage because it would only offer a return that reflects the past and not the future.

Suffice it to say it is a well-recognized – and well-accepted -- fact that the Constitutional boundaries governing a Commission in matters such as this have been fully respected by the Hearing Examiner in this proceeding. Furthermore, it is the opinion of the Hearing Examiner that the recommendations made to the Commission in this proceeding reflect an appreciation -- on the part of both the Hearing Examiner and the Commission -- for the principles and precepts contained within the judicial opinions of Hope and Bluefield. Therefore, it is the opinion of the Hearing Examiner that this Commission has met any obligation it has to ensure the company is afforded all of its rights and privileges to present evidence and argument on its behalf before any decision is made affecting its' future. It is also the opinion of the Hearing Examiner that nothing presented by any participant -- or proposed in this proceeding by the Hearing Examiner -- challenges the framework or standards set forth in Hope and Bluefield.

Pursuant to the requirements set forth in the Order establishing this proceeding, the Hearing Examiner has reviewed all of the evidence submitted -- and the arguments made – by each of the witnesses regarding the matters that are before this office. Only after reviewing those submissions has the Hearing Examiner rendered any opinion on the specific issues that have been presented. To the specific matter of setting a rate-of-return, the Hearing Examiner has found the use of a debt:equity ratio of 46.19% long-term debt, 3.27% short-term debt and 50.54% common equity to be accurate and appropriate. Furthermore, the Hearing examiner has recommended using 15.00% as Innovative's cost rate for equity capital, 6.18% as Innovative's cost of long-term debt and 5.72% as the cost rate for short-term debt in this proceeding. Using the weighted value of each component (ie. 46.19% and 3.27% for long-term debt and short-term debt, respectively; and 50.54% for equity) the average cost of capital to Innovative equates to 10.62%.

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companies and calculating a proxy cost that would serve as a substitute for the indeterminable cost of Innovative equity in a rate-of-return calculation. The technical consultant maintains the 1.10% premium applied to the equity cost calculation of the proxy group represents all risk – including that associated with the relatively small size and the geographic location of the company.

[49] Billingsley Pre-Filed Testimony at p. 48, lines 20-21.

Pursuant to the requirements set forth in Hope and Bluefield a rate-of-return must exceed the cost-of-capital if it is to be deemed "fair and reasonable." Accordingly, it is the recommendation of the Hearing Examiner that the Commission authorize a rate of return for Innovative Telephone Company that is no less than 10.62%. It is the opinion of the Hearing Examiner that such a rate-of-return is consistent with the evidence presented in this proceeding, ensures access to capital markets and comports with the standards set forth in Hope and Bluefield.

As noted earlier, title 30, Section 23 requires that any rate of return authorized by the Virgin Islands Public Service Commission that exceeds 8% requires that the Commission make a finding to the effect that such a return is imperative. After reviewing the evidence and argument presented in this proceeding it is the opinion of the Hearing Examiner that it is imperative that the PSC authorize a return in excess of 8% -- and in fact it is "imperative" that it authorize a rate-of-return in excess o 10.62% -- to ensure the actions of the Commission comport with the statutory standards set forth in Hope and Bluefield. Furthermore, it is the opinion of the Hearing Examiner that a return in excess of 10.62% is "imperative" to the ability of the company to maintain its financial integrity and ensure access to the capital markets in the future.

b. Applicability of Any Change in the Rate-of-Return

In this proceeding a question has been raised as to when any proposed change in the authorized rate-of-return approved by the PSC would be effective. The question emanates from a proposal by the technical consultants to apply any newly authorized rate-of-return to the pro forma financial results calculated for the "test year" and determining to what extent an overearnings condition may exist.

Innovative objects to any proposal that would apply a prospective yet-to-be-established rate of return to past earnings. Specifically, Innovative argues that the technical consultants proposal to apply a rate-of-return that might be adopted in this proceeding to the test year ending July 31, 2001is unlawful. After reviewing the issues presented by the technical consultants and the Innovative witnesses it is clear to the Hearing Examiner that some confusion was presented by what the technical consultants was apparently trying to achieve by the recommendation and what was interpreted from it.

It fact that during the period used by the technical consultants for their "test year" (ie. July 1, 2000-June 30, 2001) Innovative was duly authorized by the Virgin Islands Public Service Commission to earn a rate-of-return of 11.50% in accord with the agreement reached between the parties in Dockets No. 334 and 341 in 1992. As a matter of principle, Innovative was accorded the right to earn the authorized rate-of-return until such point in time as the Commission takes formal action to change it. The evidence submitted in this proceeding by the company witness suggests Innovative's return during the test year was substantially less than the 11.5% authorized-rate-of-return.[50]

[50] Although no specific evidence is offered to demonstrate this point it is reasonable for the Hearing Examiner to conclude that Innovative made such a determination using its reported rate base for the period ending June 30, 2001 (calculated to be $102,232,000) and its reported net utility operating income for the same period (calculated to be

Furthermore, even if the Hearing Examiner accepts the adjustments to the rate base proposed by the technical consultants[51] the Utility Operating Income estimated by the technical consultants does not exceed the previously authorized-rate-of-return in the test year[52]. In fact, if the Hearing Examiner were to have accepted all of the adjustments proposed by the technical consultants to the rate base and the income statement without modification the return-on-total assets would only be slightly under10.7%.[53]

Based on the evidence provided by the participants in this proceeding -- and the analysis performed by the Hearing Examiner on this subject – it is incumbent upon the Hearing Examiner to state that Innovative has not overearned its authorized rate of return in the test year. Accordingly, the Hearing Examiner finds no basis to order a "rebate" or "refund" of any portion of the earnings realized by Innovative Telephone Company during that period of time as proposed by the technical consultants in their submission to this proceeding.

c. IDC Benefits

(i) Discussion

In an effort to verify that the financial statements of Innovative Telephone Company are complete and accurate for rate making purposes, it has been necessary in this proceeding for the technical consultants to review – and challenge – the methods employed by Innovative to recognize income, expenses, assets and liabilities incurred by or on behalf of Innovative Telephone. In the context of that verification process, the technical consultants raised several questions about the manner in which Innovative Telephone recognizes the tax benefits it receives from the Virgin Islands Industrial Development Commission ("IDC").[54]

$6,323,000) – an effective return-on-total assets of slightly more than 6%. See Technical Consultants Report issued April 26, 2002 for verification of these figures. The Rate Base component of the equation -- as reported by the company -- is shown on TC Exhibit 3, Column A as "Rate Base plus Working Capital". The net income component of the equation -- as reported by the company -- is shown on TC Exhibit 4, Page 2of 2, Column A as "Utility Operating Income".

[51] For illustrative purposes only the rate base in this calculation is assumed to be $93,844,000 as represented by the technical consultants for the period ending June 30, 2001. See TC Exhibit 3, Column C "Rate Base plus Working Capital as line 1 labeled "Rate Base". The figure proposed by the technical consultants represents a substantial reduction from the rate base reported by Innovative in this proceeding for the same period of time and does not reflect adjustments made by the Hearing Examiner to the technical consultants's proposed rate base in Section VI. A. of this report.

[52] Again the Hearing Examiner was required to perform this calculation. Using the same method outlined above ($6,323,000 divided by $93,844,000) the effective return-on-total assets for the period ending June 30, 2001 is 6.74%.

[53] The Hearing Examiner bases this observation on a "pro forma" adjusted rate base of $95,939,000. See TC Exhibit 3, Column E labeled "Rate Base plus Cash Working Capital"; and Utility Operating Income of $10,245,000. See TC Exhibit 4, Column E labeled "Utility Operating Income".

[54] The Industrial Development Commission has recently undergone a name change to the Economic Development.

All of the participants to this proceeding accept as fact that the Industrial Development Commission affords Innovative Telephone Company tax credits equating to 90% of income taxes and 100% of its property taxes and gross receipts taxes by means of a contractual agreement between the IDC and Innovative Telephone.[55] Innovative maintains – and the technical consultants acknowledges – that such benefits are provided in exchange for meeting certain obligations set forth in the IDC certificate. Innovative asserts that the technical consultants's recommendation effectively "flows through the complete benefit of these tax credits by only recognizing the Company's tax expense after the application of the credits."[56] The technical consultants maintain that the current practice of recording the full tax liability attributable to Innovative Telephone Company when a portion of the liability has been forgiven by the IDC Certificate distorts the Company's Income Statement.[57]

Resolution of those questions by the Hearing Examiner was deemed necessary by the participants to finalize any adjustments to the financial statements that serve as the basis of the Hearing Examiner's findings, conclusions and recommendations in this proceeding.

The following seem not to be in dispute:

- Innovative Telephone Company is the recipient of benefits granted by the Industrial Development Commission.

- Innovative Telephone Company met the eligibility requirements set forth by the IDC needed to qualify for an IDC grant.

- The current benefits authorized by the Industrial Development Commission expire on September 30, 2003.

- Innovative Telephone Company is eligible to seek renewal of those benefits from the Industrial Development Commission. Any determination that Innovative's IDC benefits merit extension is the sole responsibility of the IDC.

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[55] A complete list of the tax benefits provided by the current IDC certificate are to be found in Innovative Interrogatory Response 4-5; Pre-Filed Testimony of Donald E. Parrish, p.13 at lines 15-16.
[56] Id., p. 13 at lines 16-18.
[57] The technical consultants suggests that an adjustment can be made to the tax liability to show the "net" tax liability paid by the company after the IDC credit is applied or it can adjust the revenue component of the Income Statement to reflect the tax credit as a revenue item. Testimony of Gregory Mann, p. 54, lines 15-21 06/18/02.

In question in this proceeding is whether Innovative Telephone's method of recognizing the benefit of IDC on its financial statements is consistent with the prevailing rules, regulations and law. In question, also, is whether the PSC has the authority to require any change to the current methods used by Innovative Telephone to recognize the benefit of IDC for rate-making purposes.

In the April 21, 2002 Report submitted in this proceeding by the technical consultants, concern was expressed that because the monetary benefits provided Innovative Telephone Company by the IDC are substantial – and have a material impact on the financial statements of the company -- they must be properly accounted for by the consultants. Proceeding on that premise, the technical consultants conducted an extensive examination of the IDC benefits granted to Innovative – including a review of past proceedings, legislative debates and IDC hearings – to understand the nature of the benefit and the current method of recognizing that benefit in Innovative's financial statement.

After reviewing the relevant material, the technical consultants expressed an opinion that the current practice by Innovative of treating the IDC benefit as "below the line" income does not accurately depict the telephone company's financial performance. In fact, it was the opinion of the technical consultants that the current practice overstates the "net" tax liability paid by Innovative; and, correspondingly, understates the utility operating income realized by Innovative Telephone. The technical consultants has proposed adjusting the Income Statement Income Tax to recognize the IDC benefit when a) calculating Utility Operating Income and b) computing the realized Rate-of-Return in future rate proceedings to determine any over earnings condition.

Innovative presented a number of witnesses in this proceeding who all oppose the recommendations made by the technical consultants regarding the IDC benefits. Collectively, their testimony presents two principal arguments for consideration by the Hearing Examiner. First, that the manner in which it (Innovative) presently recognizes the IDC benefit in its financial statements is consistent with the requirements previously set forth by the Virgin Islands Public Services Commission.[58] Second, that any requirement to change the way in which it treats IDC benefits presents an intrusion into an agreement Innovative has with a sister agency of the Virgin Islands PSC that should be "respect[ed]".[59]

It was apparent to the Hearing Examiner that a number of points raised early in this debate by the participants – both the technical consultants and the company – required further legal examination and opinion. At one point, Innovative objected to further consideration of the IDC issue on the basis that any proposed change in treatment of IDC benefits raised legal issues beyond the expertise of the technical consultants and required further consideration. To be certain, all of the relevant questions have been addressed in this proceeding, the Hearing Examiner directed Innovative to submit a brief -- on the legal issues related to IDC that they deemed pertinent – for his consideration in this proceeding. At the same time, the Hearing Examiner directed a member of his law firm, Watts & Benham, P.C., to prepare a reply brief on

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[58] Pre-Filed Testimony of Derek M. Hodge, Esq. pps. 6-9. This is a central argument made by Innovative and is reiterated in Innovative Telephone's Pre-Hearing Brief on Industrial Development Corporation Benefits filed June 7, 2002 in Docket No. 532

[59] Pre-Filed Testimony of Arnold M. Golden, p. 3 at line 17-18.

behalf of the technical consultants to

ensure both sides of the issue be fully researched.[60] Both briefs were submitted to the Hearing Examiner for his use and represent part of the record in this proceeding. The Hearing Examiner has offered no separate opinion or ruling on the merits of the respective arguments to that provided in this Report but has taken them under consideration in his examination of the questions presented by the technical consultants' recommendation.

In the remaining sections the Hearing Examiner will seek to address the respective issues raised by the participants in their testimony and their briefs. For organizational purposes, the Hearing Examiner has elected to approach the subject from two perspectives– a) the issue of how IDC benefits are recognized and b) the authority of the PSC regarding the treatment of IDC benefits.

(a) Recognition

The technical consultants maintain the tax reduction benefits afforded Innovative by the IDC certificate could be recognized in the company's Income Statement by either a) increasing operating revenue by the amount of the IDC benefit or b) reducing the tax expense shown on the Income Statement by the amount of the IDC benefit.[61] The technical consultants maintain that proper recognition of the IDC benefits is fundamental to any determination of whether the rates and charges employed by Innovative Telephone are "just and reasonable." [62]

Innovative opposes any change to the way it treats IDC benefits asserting that benefits provided under the IDC agreement are meant to "accrue to the Company in exchange for its meeting of the conditions and obligations under that agreement. For that goal to be realized, Innovative maintains it is necessary to recognize the tax liabilities as they appear prior to the application of the IDC benefits when calculating the revenue requirement of the company.[63] Innovative contrasts its current treatment as a method that ensures benefits are directed to their intended beneficiary (ie., the Company) characterizing the recommendations of the technical consultants as "passing the benefits of the IDC through to ratepayers".[64]

The technical consultants assert that Innovative's interpretation of what the technical consultants have concluded in their review of the IDC is a "mischaracterization"[65] The technical consultants assert that they simply have not found any evidence to suggest that the tax benefit provided by the IDC should not be included when calculating the company's earnings and

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[60] The technical consultants are not represented in this proceeding by legal counsel; therefore, preparation of a reply brief on their behalf was necessary to provide the Hearing Examiner a balanced record on this topic. A full discussion of the arguments raised by the respective briefs will not be provided in this Report. For additional information see Innovative Telephone's Pre-Hearing Brief on Industrial Development Corporation Benefits filed June 7, 2002 in Docket No. 532. See also Brief Filed in Response to Innovative Telephone's Pre-Hearing Brief on Industrial Development Corporation Benefits filed July 12, 2002 in Docket No. 532.
[61] Testimony of Gregory Mann, Tr. at p. 54, lines 17-19. 06/18/02
[62] Testimony of Anthony Zarillo , Tr. at p.26, lines 7-11. 06/18/02
[63] Testimony of Donald E. Parrish, Tr. at p. 59, lines 15-25. 06/26/02
[64] Innovative Pre-Hearing Brief on Industrial Development Corporations Benefits, p. 2.
[65] Mann, Tr. at p.53 lines 17-21 06/18/02

revenue requirements; therefore, it recommended inclusion of those benefits when it adjusted Innovative's Income Statement in this proceeding.

The issue presented to the Hearing Examiner by the IDC "benefits" is not whether the public is entitled to some more than it currently derives by the way Innovative recognizes that benefit in its financial statements. That is not a question that the Hearing Examiner has been charged to answer in this proceeding. The Hearing Examiner is only interested in determining the appropriate means of recognizing the IDC benefit on the Income Statement of Innovative Telephone Company so that a determination can be made regarding the company's net income and revenue requirement.

It is apparent from the evidence -- and argument -- presented in this proceeding that a fundamental difference exists between the participants on whether Innovative's current method of treating IDC benefits comports with generally accepted accounting standards. The technical consultants suggest it does not comport with general accounting practices because to represent certain taxes as expenses when said taxes have been forgiven or portions thereof. They do not offer any other direct evidence in support of its' claim. Innovative suggests its practice does comport with general accounting practices but -- like the technical consultants -- does not offer much in the way of evidence to support its opinion.

Instead, Innovative predicates much of its argument on its assertion that the Public Services Commission approved its current method of treating IDC benefits in a previous proceeding (Docket 513) and unless there is a substantial change in circumstances it cannot be changed.[66] The Hearing Examiner has reviewed the record of that earlier proceeding and finds no support for the actions attributed to the PSC by Innovative. References to the IDC benefit are replete within the proceeding's record but their no evidence that indicates the Commission affirmed support for method then being used by Innovative to recognize IDC benefit. To suggest to the Hearing Examiner that the Commission has decided this issue belies the evidence provided in this proceeding and in Docket No. 513. Accordingly, the Hearing Examiner finds that Innovative's method of treating IDC benefits has not been approved – explicitly or implicitly – by the Virgin Islands Public Service Commission.

Implicit within Innovative's argument in this proceeding that the Commission had previously supported its approach to IDC, are two major points. First, Innovative seems to accept the right of the PSC to make a determination of how it wishes to treat IDC benefits in a rate making proceeding – that determination is not made for it by another agency.[67] Second, Innovative implies by seeking a ruling from the PSC that the method used by Innovative to recognize the IDC benefit (ie., to record it "below the line") concedes it was not a generally accepted practice and required some dispensation by the PSC to continue with its employment.

The Hearing Examiner has given both of these points consideration and has concluded that despite the lack of any strong evidence from the technical consultants in support of their assessment, the representations made by Innovative strongly argue in support of the technical

[66] Innovative argues that the PSC formally disposed of this matter in Docket No. 513 and accepted its current method of recognizing IDC benefits. See Innovative IDC Brief, p. 2-5.
[67] This will be addressed further in the next section of this chapter.

consultants' claim. After reviewing the evidence and the record of this matter in Docket 513 the Hearing Examiner finds that recognizing the IDC benefit as an offset to tax liabilities before calculating Net Income is reasonable, in the public interest and consistent with the evidence presented in this proceeding

(b) Authority

The technical consultants argue that the Virgin Islands Public Service Commission has the right and authority to determine how the benefits provided by the Company's IDC Certificate are recognized for the limited purpose of rate-making. The technical consultants premises that conclusion on the fact that the Commission is a) a legislatively constituted agency charged with responsibility for regulating public utilities under its jurisdiction, b) that the agency is responsible for ensuring just and reasonable rates, and c) as a regulated utility, the Company's financial, accounting, and rate-making activities are subject to the full and complete jurisdiction of that agency with no statutory limitations.[68] The technical consultants further state that no law, no rule or regulation was identified that expressly precluded the VIPSC from "considering the rate impact or the regulatory impact of the IDC benefit".[69]

Innovative maintains that the IDC benefits represent the product of a contractual agreement between the ODC and Innovative that cannot be unilaterally changed by the PSC.[70] Furthermore, Innovative argues that administrative law dictates that sister agencies must harmonize their actions so that one agency does not undermine the action of another.[71] Finally, Innovative argues that IDC benefits should be excluded from the revenue requirement because it is an anomaly that is not part of future rate periods.[72] The technical consultants have suggested in their testimony that they do not take issue with the contractual relationship between the IDC Commission and Innovative. [73]

In summary, the Innovative Brief concluded that the PSC has recognized the IDC-Innovative Certificate to be an enforceable contract between the IDC and Innovative that would be breached by the PSC – violating the Virgin Islands Code – if it were to require Innovative to "flow" the benefits of that agreement to someone other than the Company. Furthermore, the Innovative Brief suggests that the PSC would violate the United States Constitution Contracts Clause by interfering with a contract and the Takings Clause by flowing through the benefits to an unintended beneficiary. Innovative maintains that the last violation leaves it entitled to recover damages from the Virgin Island Treasury to compensate for its losses.

As indicated earlier in this section the Hearing Examiner found it beneficial to direct a reply brief be submitted as a response to the legal opinion proffered by Innovative on the matter of the Commission's authority. In the reply brief it is argued that the proposed treatment does not unconstitutionally impair Innovative's Industrial Development Certificate as suggested by

[68] Testimony of Anthony Zarillo, Tr. at pg. 25-26. 06/18/02
[69] Zarillo, at 26. 06/18/02
[70] Innovative IDC Brief at p. 5.
[71] Id., at p.14.
[72] Id., at p. 17.
[73] Zarillo, Tr. at pg. 29, lines 23-25 06/18/02

Innovative.[74] Furthermore, it is argued that the proposed treatment does not unconstitutionally confiscate Innovative's property rights under the Industrial Development Certificate as alleged by Innovative.[75] Similarly, the reply brief argues that the proposed treatment of IDC benefits would not act to frustrate the purpose of the IDC Certificate.[76] Also, the reply brief argues that harmonizing agency actions between the IDC and the PSC does not require the PSC to yield its regulatory oversight of public utilities regarding IDC benefits.[77] Finally, the reply brief argues that the IDC benefits presented in the test year do not represent an anomaly.

In summary, the reply brief concluded that the PSC a) has the statutory authority and responsibility to decide whether and how to treat IDC benefits granted to a public utility in the context of a rate review; and b) is not prevented as a matter of law from considering IDC benefits in setting fair and reasonable rates for regulated utilities for any of the reasons set forth in the Innovative Brief.

The Hearing Examiner has given considerable thought to the arguments raised by the participants regarding the rights, responsibilities and authority of the Virgin Islands Public Service Commission. It is evident from reading the brief and the reply brief filed in this proceeding that the issues presented in this proceeding for consideration are not simple -- and the choices are not without consequence. The Hearing Examiner is appreciative of the time and effort that was expended by both respondents in providing the Hearing Examiner with a cogent and complete examination of the legal issues presented here.

The issue that is central to this investigation is whether the PSC has the legal authority to fully exercise its delegated duties and responsibilities over a regulated utility that is ostensibly subject to its' authority. It has been suggested by Innovative that at least in the matter of the IDC benefits the PSC must subordinate its authority – and responsibility -- to set "just and reasonable" rates to the authority assumed by the IDC when Innovative entered into an agreement for IDC benefits.

Nothing presented in the brief and reply brief supports the idea that a contractual relationship between Innovative and the IDC can limit the powers of a duly authorized government agency – especially an agency that has principal regulatory authority over one of the parties. It is notable in *Energy Reserves Group, Inc. v Kansas Power & Light*, 459 U.S. 400, 418 (1983) that the Supreme Court concludes that where a contract involves a party operating in a regulated field, deference is given to the legitimate regulatory needs of the government. In this case, the reference to government is a reference to the administrative agency responsible for regulatory oversight. The Hearing Examiner finds it reasonable to assume the reference to "government agency" equates in this proceeding to the Virgin Islands Public Service Commission – not the IDC.

Second, the Hearing Examiner supports the argument that the actions of "sister agencies" must be harmonized. However, the Hearing Examiner finds it implausible that such a goal could

[74] Reply Brief at p. 9.
[75] Id., at p. 18.
[76] Id., at p. 21.
[77] Id., at p. 24.

be interpreted to mean that a government agency that does not have primary authority over a party could -- or would -- seek to abridge the authority of the agency that has that primary authority. The Hearing Examiner can only interpret that principle to mean that the IDC has a responsibility to ensure its actions comport with the rules, regulations and requirements of the Virgin Islands Public Service Commission. Accordingly, any term and condition set forth in the agreement with the IDC must comport with the requirements of the VIPSC – not the inverse as suggested by Innovative.

In summary, the Hearing Examiner finds nothing presented in the brief and/or reply brief that demonstrates that the VIPSC does not have the right, responsibility or authority to require Innovative Telephone to recognize the IDC benefits "above the line" in its Income Statements as recommended in this proceeding by the technical consultants. Accordingly, the Hearing Examiner finds it appropriate to recommend to the Commission that further consideration be given as to how nay future IDC benefits should be recognized for purposes of rate making and earnings calculations.

d. Affiliate Transactions

As indicated at the beginning of this report, Innovative Telephone Company is a wholly-owned subsidiary of Innovative Communications Corporation. Innovative Telephone Company maintains a number of business relationships with other subsidiary business units of Innovative Communications Corporation that are governed by long-term service agreements or contracts. In general, these business relationships represent an exchange of goods/services between the business units that are needed and/or necessary for the recipient to fulfill their corporate obligations. Services generally covered by such affiliate agreements include tax and accounting services, office space, computer service, strategic planning and procurement.

It is apparent that exchanging services between affiliate – and the use of affiliate agreements to govern the terms and conditions of those exchanges -- is a common practice in the telecommunications industry. The scope and scale of affiliate transactions is a reflection of the fact that most telecommunications firms today are required to operate a portfolio of specialized business units if they intend to pursue business in certain segments of the telecommunications/information industries (eg., cable television, wireless, high-speed data, long-distance). In many instances, such enterprises find it attractive – and cost-effective -- to contract with another affiliated business unit to provide it certain services that it needs to conduct its own business plan.

Innovative Telephone Company reports that it maintains a set of business relationships with its affiliates that have generated both revenue and expenses to Innovative. Innovative has also testified that at least one asset transfer has taken place between Innovative Telephone Company and Innovative Communications Corporation that have increased the rate base of Innovative Telephone.[78]

[78] In 2001, Innovative Communications Corporation transferred ownership of the St. Croix Customer Service Center to Innovative Telephone Company. In the course of that transfer a change was made to the rate base of Innovative Telephone to reflect the additional asset; also, changes were made to the Income Statement of Innovative Telephone to note the reduction in rent paid by Innovative to ICC and an increase in revenue to account for rents paid by other Innovative affiliates for space utilized in the St. Croix facility.

It has often been suggested by critics of affiliate transactions that the corporate structure employed by companies such as Innovative Telephone Company present opportunity for abusing the privileges afforded by the regulatory community. The principal criticism levied against affiliate transactions is that they present the means for parent corporations to burden the regulated company with the responsibility of providing services to competitive subsidiaries at prices that are below their own cost or the cost that the market would command to perform the same task – effectively providing the competitive entity an unwarranted subsidy. Other critics of affiliate relationships fear unregulated affiliates will be accorded "sweetheart" contracts that provide them a sustainable competitive advantage against prospective competitors – or better yet preclude others from entering the market by granting them exclusive rights.

For the most part, Innovative is excluded from the structural separation requirements that apply to many of the larger telecommunications providers and dictate the nature of most of their affiliate transactions. However, the fact that Innovative is not subject to many of those dictates and chooses to employ some of the structural form that are used by the larger firms, suggests that certain advantages – operational, financial and legal -- are afforded by structure that cannot be ignored. Consequently, the affiliate transactions to which Innovative Telephone Company is a party are an intrinsic part of this investigation.

The Hearing Examiner directed the technical consultants to ensure that the affiliate transactions involving Innovative Telephone are a) properly charged, b) properly recorded, c) properly paid and properly receipted.[79] The purpose of looking at the affiliate transactions was to have the auditors verify that the charges reported on the Income Statement and the Balance Sheet reflecting revenues, expenses and asset transfers were properly recognized and comport with rules and regulations set forth by the PSC and the FCC. This requirement was no different than the requirement for any other line item found on the Income Statement or the Balance Sheet except that it involved understanding the nature of the business relationship that existed with the affiliated entity to understand the reason for the transaction.

It should also be noted that the technical consultants did not examine every affiliate transaction but "tested" a set of transactions that they believed to be sufficient to demonstrate compliance or noncompliance with the applicable accounting rules a customary in audits. After discussions with the technical consultants and particularly the auditors, the Hearing Examiner found no reason to conclude a different approach to "testing" was necessary. Accordingly, the technical consultants identified a set of transactions, "tested" them and found all of them to be compliant with generally accepted rules and practices. Upon review of those transactions with the Hearing Examiner it was decided that no further testing of affiliate transactions was necessary in this proceeding.

It should be noted, however, that the efforts expended by the technical consultants and

[79] The Virgin Islands Public Service Commission maintains no specific rules and regulations governing affiliate transactions. Accordingly, the Hearing Examiner found it necessary to use the rules and regulations governing transactions with affiliates developed a number of years ago by the Federal Communications Commission. Specifically, the Hearing Examiner found 47CFR32.27 of the Code of Federal Regulations as an acceptable basis for evaluating affiliate transactions to which Innovative Telephone Company is a party.

the Hearing Examiner to assess affiliate transactions in this proceeding were limited to ensuring proper accounting treatment of these relationships. Other things that could be the subject of such an evaluation could well be:

- is the service provided by the affiliate needed and necessary by the contracting party?
- is the affiliate providing the service sufficiently competent and capable of providing the service to the contracting party
- is the service provided by the affiliate a duplication of effort to that performed by the contracting party for the same service?
- is the price charged for the service competitive to the price charged for similar service in the marketplace?
- is the contracting party able to exercise sufficient control over the performance of the affiliate so as to ensure completion of the assigned task?

The scope and structure of this rate proceeding does not provide the necessary framework or evaluation standards needed to perform such a review. However, the Hearing Examiner did not find such a review to be needed or necessary to satisfy the requirements set forth in Act 6402 and the Commission's Procedural Order of August 21, 2001. If, however, the Commission has interest in performing such an examination it has the right to do so in a separate proceeding.

e. Tax Liabilities

In concert with other efforts in this proceeding, the technical consultants examined the accounting practices employed by Innovative Telephone to recognize tax liabilities incurred by the regulated telephone operations. The technical consultants determined that the telephone company was recording its tax liabilities in accordance with USOA accounting practices and FCC rules/regulations using the prescribed tax rates for corporations.

However, the technical consultants observed that Innovative Communications Corporation files a consolidated tax return for all of its subsidiaries – including Innovative Telephone Company. The practice of filing a consolidated federal tax return is common among companies that own and operate a number of business entities. The practice provides the filing party to consolidate the assets and liabilities of all its business units in order to take full advantage of benefits afforded by the United States Internal Revenue Code.[80]

Innovative Communications Corporation has the right to file a consolidated tax return. Innovative Communications Corporation has the right to include Innovative Telephone Company – as a wholly-owned subsidiary -- in any consolidated tax filing submitted pursuant to the United

[80] Title 26, Subtitle A, Chapter 6, Subsection A, Sec. 1501 of the United States Internal Revenue Code provides that "[a]n affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed in section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliate group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group."

States Internal Revenue Code as applicable in the Virgin Islands. It is usual that the tax liability incurred on behalf all of Innovative's operating subsidiary business units is less after constructing a consolidated filing than the sum of the liabilities recognized on the books and records of the subsidiaries and reflected on the individual tax returns of the subsidiaries.[81] That tax liability incurred by a corporate affiliate is paid by Innovative Communications Corporation on behalf of the affiliate. Finally, any savings i.e. difference between the tax liability recognized on the books and records of the affiliate and the tax liability paid by Innovative Communications Corporation is retained by Innovative Communications Corporation and not returned to the affiliated units.

It is a disputed fact in this proceeding whether the tax liability recognized on the books and records of Innovative Telephone Company must be "adjusted" to reflect any inherent benefit it might be afforded by inclusion into the consolidated tax filing of the parent corporation. It is the opinion of the technical consultants that the public does not benefit from the current practice of "capturing" all of the benefit of a consolidate tax filing at the parent level and not "flowing back" a portion of that benefit to the regulated telephone company.

Innovative maintains that it fully recognizes all tax liabilities imposed upon Innovative Telephone on the telephone company's financial statements as required by the Federal Communications Commission in its rules and regulations.[82] Innovative acknowledges that it does not adjust that amount to reflect the actual tax liability paid on its behalf by Innovative Communications Corporation. Furthermore, it does not receive any rebate from Innovative Communications Corporation reflecting any excess contribution made by Innovative Telephone Company to the consolidated tax liability of Innovative Communications Corporation.

The Hearing Examiner directed that the auditing arm of the technical consultants make an examination of the consolidated tax return to determine whether that return distorted the tax obligations of Innovative Telephone to the detriment of the consumer. That inspection was made. After reviewing the evidence and argument presented by the witnesses in this proceeding, the Hearing Examiner finds no compelling reason to propose changes to the current treatment of income taxes by the telephone company. The evidence presented in this proceeding shows that the company's practices comport with all relevant rules and regulations that apply to it. Innovative fully recognizes its tax liabilities in a manner that is expressly required by the FCC rules. Accordingly, the Hearing Examiner will not make any recommendation to effect an adjustment in this proceeding to the income tax liability recognized by Innovative Telephone on its income statement.

[81] Consolidating the assets, liabilities, revenues and expenses of the subsidiaries provides the opportunity to take advantage of deductions, abatements and schedules otherwise unutilized or underutilized by the subsidiary business units. The net effect is to reduce the tax obligation

[82] Section 47 CFR 32.27 of the FCC rules and regulations specifically requires a carrier to record the tax liability as though it were a standalone company and not filing a consolidated return.

f. Rate Base

(i) Discussion

The remaining component of this investigation is the matter of Innovative's rate base. As noted previously, determining the correctly-sized rate base is critical in establishing a proper revenue requirement for the regulated telephone operations of Innovative. The size of the rate base ultimately found to be reasonably accurate has a significant effect on the revenue requirement and a proper determination is crucial to completion of the requirements set forth in Act 6402.

It is a generally recognized practice in the telecommunications industry to fund telecommunications technology and infrastructure initiatives through the issuance of securities (a combination of equity and debt) and the reinvestment of internally-generated funds. In the aggregate – and with some adjustments for depreciation and other allowances -- these individual investments comprise the "rate base" for any telephone company. It is the net value of those investments that is used to determine the company's revenue requirement, rates and charges.[83]

In this part of the proceeding, it was essential to examine the representations made by Innovative regarding those rate base components; the current accounting treatment accorded those components by Innovative; and the extent to which the company's representations are factual and consistent with generally accepted regulatory practices. The technical consultants had no reason to believe the methods, policies and practices of Innovative did not comport with generally accepted principles; however, verification was deemed prudent and proper. To realize these goals the Hearing Examiner authorized an extensive audit by the technical consultants of the rate base to determine the extent to which the Hearing Examiner could rely upon the Company's representations in determining the revenue requirements. The Hearing Examiner did not view this exercise as an extraordinary exercise – but rather one that was consistent with the efforts employed in each dimension of this investigation. The Hearing Examiner found no reason no valuation of the rate base offered in prior proceedings before the VIPSC -- or otherwise available for use in this proceeding -- to be sufficiently independent and/or current enough to merit substitution for critical examination by the technical consultants.

Over the course of several months, the technical consultants conducted an exhaustive review of all of the rate base components. In so doing, the technical consultants determined that the methods, practices and processes used by Innovative generally comport with industry norms and regulatory requirements. However, the technical consultants observed several practices on the part of the company that were challenged. Specifically, the method used to account for investment in network modernization and addition that was not complete and, therefore, did not meet the used and useful test generally applicable to rate base adjustments. Secondly, the size – and need for – the Lifeline account that is carried as part of the company's rate base for future liabilities that might not be needed or necessary. These two issues present the principal points of difference between the company's representations and the recommendations of the technical

[83] As a regulated utility, Innovative is entitled to set rates and charges for its services at levels that will provide it the opportunity to earn a "fair rate of return" on the approved rate base.

consultants.

It is an indisputable fact that verification of the rate base is necessary to ensure a fair revenue requirement figure is determined. The size of the rate base used to determine that revenue requirement is determined solely by the Virgin Islands Public Service Commission. The size of the rate base must be determined in accordance with generally accepted accounting rules and regulations, judicial opinions and precedents, and the evidence presented in this proceeding. Innovative has made a substantial financial investment – and will continue to make significant financial investment -- in telecommunications technology and infrastructure as part of its statutory obligation to provide safe and reliable telecommunications services in the United States Virgin Islands.

The level of incremental investment made by Innovative in technology and infrastructure fluctuates from year to year in response to forecasted demand for telecommunications services, planned retirement of obsolete technology and unplanned replacement of equipment associated with maintenance and repair initiatives. The Virgin Islands Public Services Commission employs no pre-approval requirement governing incremental investment by Innovative in its network infrastructure.

Provisions made must be made to accommodate changes in the size and composition of the rate base. The rate base represents utility plan investment deemed needed and necessary to provide safe and reliable telecommunications services. It is an indisputable fact that the proposed composition of the rate base is determined solely by Innovative. The approved rate base is used for setting the revenue requirement of Innovative and determining the realized rate-of-return by the Virgin Islands PSC.

As noted above, periodic investment by Innovative in its infrastructure is necessary to ensure the quality and capacity of the public telecommunications network meets the standards set by the Virgin Islands PSC and the expectations of the public. Upon completing the intended project and judging it to be available for use by the company, the infrastructure that results from such investment is deemed "allowable" for inclusion into the asset account used to calculate the company's rate base. In certain instances the elapsed time between when a project is initiated (and capital is committed) – and the time the project is completed (and the investment can be properly recognized in the rate base). The phenomenon dictates the need to establish an accounting provision termed Construction Work-In-Progress ("CWIP").

Simply stated, CWIP is a temporary holding account used to recognize investment made by the company in designing and constructing telecommunications "plant" that has not yet been completed but will -- when it is ready for service -- be reported on Innovative's financial statements. In accordance with general regulatory accounting practices, costs incurred by Innovative for plant modernization and addition are capitalized, retained and reported as part of the CWIP account until the associated technology or infrastructure is deemed acceptable and ready for service at which time it is transferred to another plant account.

As a general principle, investment in new telecommunications technology and infrastructure entails a long-term commitment of capital by Innovative. Consequently, the cost associated with such initiatives may be kept in the CWIP account for a number of years before

they are transferred to their appropriate plant accounts and recognized as part of the allowed rate base. General rules requiring public accountability require that capital provided for such initiatives be separated from other investment well in advance of when the investment meets the established criteria for consideration as an "allowable" addition to the rate base, CWIP provides a means for regulators to recognize the additional costs-of-capital that are associated with construction projects without adjusting the standards used to determine what constitutes the rate base.

Innovative maintains in this proceeding that the representations made of the size of its CWIP account are fair and accurate. The technical consultants initially questioned the absence of any change in the size of the CWIP account over time but the company was able to explain the basis for that and the technical consultants were reasonably satisfied[84]. However, the technical consultants remained convinced that the company's practice of including CWIP required inclusion of an "offset" allowance for interest earned on the capital dedicated to such initiatives.

As noted above, accountability rules require Innovative to set aside investment capital dedicated to technology and infrastructure initiatives until such time as it is needed for the designated project. During the time it is held in reserve a non-cash credit is recorded to properly recognize its worth. This credit is generally termed an Allowance for Fund Used During Construction ("AFUDC") and represents an offsetting component in determining the company's revenue requirement.

Upon "delivery" of the new technology or infrastructure to Innovative, and a determination that the new plant is available for use, the associated costs shown in the CWIP account are transferred to the proper plant account and the provisions made in the AFUDC account for the project are eliminated to reflect the final status of the project. This process must be followed even if the project is to be completed within the calendar year for which reporting is being considered.

From these facts, the Hearing Examiner finds it reasonable to conclude that the CWIP and AFUDC accounts would demonstrate fluctuations to reflect the constantly changing state of Innovative's technology and/or infrastructure initiatives. Furthermore, the Hearing Examiner finds it reasonable to conclude that any inclusion of CWIP in the determination of an allowable rate base dictates inclusion of an AFUDC component on the company's income statement to ensure accuracy. In response to questions by the technical consultants, Innovative's witness Parrish concedes that incorporating an AFUDC allowance on Innovative's income statement if CWIP is going to be included as part of the rate base would be appropriate.[85] In fact, use of an AFUDC adjustment was not challenged by Innovative at any point in its testimony and, when directed by the Hearing Examiner to provide an AFUDC adjustment the company willingly agreed to do so.[86] Accordingly, the Hearing Examiner finds sufficient evidence to permit

[84] An exchange between witness Parrish and technical consultants at the June 26 Hearing left this question unresolved. See Parrish Testimony, Tr. at p.25-31 06/26/02 Proprietary Session. Subsequent research was required by the technical consultants to ultimately resolve the open issue.
[85] Parrish Testimony , Tr. at p. 47, lines 9-10 06/26/02
[86] Innovative's testimony shows no AFUDC adjustment to balance the CWIP allowance proposed by their witness. Innovative's witness testified that this reflects an effort by the company's witness to replicate the exhibits provided

adjustment of the rate base to include the allowance proposed by Innovative for Construction Work-In-Progress. Furthermore, the Hearing Examiner finds inclusion of an allowance for CWIP to require a corresponding adjustment to be made to reflect an Allowance for Funds Used During Construction.

g. Areas of Further Investigation

It has been suggested in this proceeding that a number of other investigative activities are necessary and/or desirable to satisfy the statutory requirements set forth in Act 6402. Specifically, it has been recommended by the technical consultants that the Commission consider undertaking a cost-of-service study of Innovative Telephone Company in order to better identify the relationship between the cost and price associated with the services provided by Innovative. The technical consultants suggest that a cost-of-service study would provide the Commission with "facts" that it does not currently have when evaluating issues that come before it.[87]

The Innovative witness suggested that such a study would offer little benefit to the Commission or the Virgin Islands public. Specifically, the witness offered an opinion that the current effort expended by the technical consultants "appears to be sufficient to evaluate the earnings of the Company and also make determinations on whether or not there are excess earnings, and how those should be allocated.[88] Secondly, the witness noted that conducting a cost-of-service study would impose additional cost on the public and not be in the public interest.[89]

After a review of the evidence and argument presented by witnesses for the technical consultants -- and Innovative -- the Hearing Examiner finds no compelling reason to recommend that the PSC conduct a cost-of-service study of Innovative at this time. In the opinion of the

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by technical consultants and does not represent an opinion that an AFUDC allowance is not appropriate.

[87] Tr. at pg. 105, lines 1-2. This assertion was framed in a question asked by the technical consultants in cross-examination of witness Johnson appearing on behalf of Innovative. The question sought concurrence from the witness with the technical consultants's opinion.

[88] Testimony of Julia Johnson, Tr. at pg. 81, lines 3-7 06/26/02

[89] Id., Tr. at pg. 81, lines 8-12. The "additional cost" referenced by the witness in this statement refers only to the professional fees and expenses associated with having such a study performed by a consulting or accounting firm. The reference should not be interpreted to suggest that a cost-of-service study will necessarily demonstrate that Innovative's cost-of-service is higher than that currently reported to the PSC and would, therefore, merit an increase in rates and charges for telecommunications services in the Virgin Islands.

Hearing Examiner, the evidence that has been presented in this proceeding has proven sufficient to the Hearing Examiner's need to recommend a rate level for Innovative that is just and reasonable. It is has been that precise purpose for which this proceeding has been conducted and it appears that goal has been realized.

The Hearing Examiner fully appreciates the benefit that might be realized by the Commission if it had better perspective of how costs for providing telecommunications services are being distributed across the various products/services provided by Innovative; however, the Hearing Examiner is not convinced that such perspective is essential to achieving compliance with the investigatory obligation placed upon the PSC by Act 6402. Accordingly, the Hearing Examiner finds no reason to incorporate any recommendation into this report seeking additional authority – now or in the future – to conduct a cost-of-service study of Innovative Telephone.

A second issue raised in this proceeding has been the method of properly treating expenses associated with proceedings such as this. Innovative specifically objects to the decision by the technical consultants to omit any allowance for the recovery of costs associated with this proceeding in its pro forma calculation of Innovative's income and expenses.[90] Innovative asserts that it has a right to fully recognize the costs in computing its revenue requirements and should be permitted to recover those costs over a two-year horizon.[91] The Innovative witness maintains that its recommended approach is reasonable and is dictated by U.S. Virgin Islands law.[92] Specifically, Innovative argues that the "just and reasonable" requirement set forth in Title 30, Section 23 requires such expenses be included in the revenue requirement.[93]

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[90] Post-Hearing Brief of Innovative Telephone., p.9. July 11, 2002. In its Brief Innovative estimates that it will incur expenses associated with this proceeding in the range of $1.0 to $1.25 million which are not reflected in the allowance provided by the technical consultants.

[91] Parrish Testimony, Tr. at p. 23, lines 10-16. 06/26/02

[92] Post-Hearing Brief of Innovative Telephone., p.8. July 11, 2002.Tr. at p. 23, lines 16-17. 06/26/02 Specifically, the Innovative witness cites to Title 30, Section 25 which states that "in connection with any proceeding involving a public utility with a net investment of 100 million or more, expenses of any investigation or proceeding of any nature by the Commission, of or concerning any public utility operating in the United States Virgin Islands, all expenses of any litigation, including appeals arising from such investigation, valuation, reevaluation, or proceeding, or from any order or action of the said Commission, shall be borne by the public utility investigated or otherwise affected, as a special franchise tax, in addition to all other taxes imposed by law. And such expenses with interest at six percentum per annum may be charged to operating expenses and amortized over such period as the Commission shall deem proper, and be allowed for in the rates to be charged by such utility."

[93] Post-Hearing Brief of Innovative Telephone., p.8

The technical consultants offers no direct evidence in support of their decision to not provide an allowance for the cost of this proceeding. The technical consultants did note that the Innovative pro forma financials did not contain details of such expenses or even categorized components. The consultants also suggest in cross-examination of an Innovative witness that the manner in which rate case expense is treated is at the discretion of the PSC and that all, some or none of the expense incurred in such investigations may be approved.

After reviewing the evidence and argument presented by the parties, the Hearing Examiner finds no reason to reject inclusion of the expenses and assessments associated with this proceeding in the revenue requirements of Innovative. As pointed out by the evidence presented here, Title 30, Virgin Islands Code, Sections 23 and 25 provide for treatment of these expenses in a manner by the Commission that is reasonable and just. Nothing has been offered in this proceeding by the technical consultants to suggest that the level of expenses incurred by Innovative are exorbitant or that such expenses represent costs incurred for services not required in this proceeding.

Accordingly, provision must be made in both the rate base and income statements used by the Hearing Examiner in this proceeding to reflect a fair and reasonable allowance for these expenses. However, the Hearing Examiner is not prepared to accept the estimates presented by Innovative in their July 11 Brief as fact.

The record is clear that the Virgin Islands PSC has already assessed Innovative $688,000.00 expressly for certain costs incurred by the Commission in this proceeding. Furthermore, the Hearing Examiner considers it reasonable to assume that the level of effort presented to Innovative to comply with the requirements of the technical consultants, the Hearing Examiner, its own witnesses and counsel have generated additional costs to Innovative approaching a similar amount to the levied assessments that are not part of this record but remain legitimate cost eligible for recovery as well. Therefore, the Hearing Examiner finds it appropriate to provide an allowance for twice the amount of the current assessments that have been levied upon Innovative to date $688,000 in determining the company's revenue requirement.

VII. Findings of Fact and Conclusion of Law

After reviewing the evidence and argument presented by the participants in this proceeding, the Hearing Examiner finds:

1 Investment in the United States Virgin Islands carries an attendant risk not experienced in comparable investment on the mainland.

2. An adjustment to the cost-of-equity to reflect any incremental investment risk is permissible.

3. A rate-of-return must be authorized by the Virgin Islands Public Service Commission prior to use by a regulated utility.

4. A rate-of-return of 11.5% is currently authorized by the Virgin Islands Public Service Commission for use by Innovative Telephone Company

5. Innovative Telephone Company has used 11.5% as its permitted rate-of-return in calculating its revenue requirement

6. Innovative Telephone Company effectively earned a return of 6.1% for the year ending June 30, 2001.

7. Innovative Telephone Company has invested over $200 million in telecommunications technology and supporting infrastructure to serve the United States Virgin Islands.

8. Innovative Telephone Company has forecast additional investment for telecommunications technology and supporting infrastructure to serve the United States Virgin Islands

9. Inclusion by Innovative Telephone of expenditures and assessments -- such as those presented by this proceeding -- in a revenue requirement is permissible and consistent with Virgin Islands law

10. An allowance of $688,000 for rate case expense associated with this proceeding is consistent with the evidence presented in this proceeding and the requirements set forth in Title 30, Sections 23 & 25 of the Virgin Islands Code.

11. No compelling reason has been presented that the PSC must perform a cost-of-service to satisfy the requirements set forth in Act 6402.

VIII. Conclusions

It is apparent to even the most casual observer that the challenges presented to the Hearing Examiner by this proceeding have been significant. This investigation represents one of the most exhaustive financial examinations of Innovative Telephone Company that has ever been conducted by this Commission. The time and effort expended by the technical consultants and representatives of the company over the past twelve months is unprecedented.

The scope and scale of the effort expended by the participants has served to provide the Hearing Examiner with a considerable amount of evidence for the Hearing Examiner to consider. Although the evidence presented in this proceeding, at times, has proven to be in conflict, much of that difference can be attributed to different assumptions and interpretations of what is permissible by statute, rule and regulation. After reviewing the evidence and arguments presented in this proceeding it is apparent that the issues presented for consideration in this proceeding are extremely complex and differences will remain irreconcilable.

In this proceeding the Hearing Examiner has been directed to receive evidence related to the financial condition and performance of Innovative Telephone Company and make recommendations to the Commission that the evidence shows are necessary to ensure

Innovative Telephone continues to comply with its prescribed duties and obligations. This Report serves to summarize the efforts made by the Hearing Examiner, the technical consultants and Innovative to meet the requirements set forth for the Hearing Examiner in the Commission's appointment letter.

After reviewing the evidence and listening to argument presented by the participants in this proceeding the Hearing Examiner has concluded that:

- the currently authorized rate-of-return for Innovative Telephone Company of 11.5% is unnecessary to ensure future access to the financial markets;
- authorization of a new rate-of-return of 10.62% is fair and reasonable, needed, necessary and imperative to ensure Innovative's combined cost of debt and equity capital is met;
- accounting practices employed by Innovative have proven generally acceptable and consistent with all prescribed rules, regulations and requirements of the VIPSC and the FCC;
- a rate base of $103,311,000 is fair and reasonable, and consistent with the evidence provided in this proceeding;
- the current method of recognizing Industrial Development Commission tax credits understates utility operating income realized by Innovative Telephone Company;
- Innovative has not ex ceeded its authorized rate-of-return in the test year ending December 31,2001;
- Innovative recognizes its business relationships with affiliate entities in a matter that is consistent with all prescribed accounting rules and regulations governing such transactions;
- Innovative has met its statutory requirements in this proceeding to provide such information as is deemed necessary by the Commission to discharge its responsibilities under Public Act 6402.

VIIII. Recommendations

Pursuant to the instructions given to the Hearing Examiner in the Commission's notice of appointment the Hearing Examiner recommends the Commission take the following actions to reform the accounting practices of Innovative Telephone for rate making purposes:

- institute a formal rule making proceeding to determine the most appropriate method of recognizing any future IDC benefits on the financial statements of Innovative;
- suspend additional scheduled contributions by Innovative to the Lifeline account until such time as it is determined by Innovative they are necessary to ensure funding of approved

Lifeline programs. At present the accumulated sum appears adequate to meet all foreseeable needs.

We have furnished a copy of this report to Innovative Telephone. In our earlier scheduling order, we committed that Innovative would have thirty days to review the report before it is considered by the Commission. We would suggest that the Commission adopt an interim order that directs Innovative to show cause why any additional evidence it would seek to put before the full Commission was not presented to the Hearing Examiner.

Thanks

I would like to thank the Technical Consultants assisting me in the endeavor, including Anthony Zarillo, Dr. Edward H. Salmon, Frank Hanley, Dr. Gregory Mann, David Milkosky and Renato Enriquez for a job well done. There were undoubtedly others whose name I either do not know or I have overlooked and for that omission I apologize.

Respectfully submitted,

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FREDERICK G. WATTS
Hearing Examiner

Hearing Examiner Recommendations

1. **Rate Base**

Recommended Rate Base Plus Working Capital	$103,311,000

2. **Cost of Capital**

Capital Structure

Long-Term Debt	46.19%
Short-Term Debt	3.27%
Equity	50.54%

Cost-of-Capital

Long-Term Debt	6.18%

Short-Term Debt	5.72%
Equity	15.00%
Weighted Cost of Capital	10.62%

3. Rate-of-Return

Minimum Rate-of-Return	10.62%

Exhibit “2”

Virgin Islands Public Services Commission
August 6, 2004 Rate Order

GOVERNMENT OF THE VIRGIN ISLANDS
OF THE UNITED STATES

Public Services Commission

RECEIVED AUG 0 6 PUBLIC SERVICES COMMISSION

IN RE:	)	
	)	PSC DOCKET NO. 532
RATE INVESTIGATION OF INNOVATIVE	)	
TELEPHONE COMPANY PURSUANT TO	)	ORDER NO. 42 /2004
ACT NO. 6402	)	
	)	

AMENDED FINAL ORDER

THIS MATTER came before the Commission for hearing and decision on April 24, 2003. The Commission reviewed the report of the Hearing Examiner dated September 13, 2002. The Commission had on December 4, 2002 heard a presentation from the Hearing Examiner and Innovative Telephone Company. The Commission had entered Order 20/2003. It has been discovered that the order entered was an incomplete transcription of the action directed by the Commission. For that reason an amended order is entered. The Commission being otherwise satisfied in the premises; it is

ORDERED that the findings and recommendations of the Hearing Examiner are accepted except that the finding regarding the rate of return is modified to provide for a rate of return of 11.5% and concluded as imperative. The Commission was advised by Innovative Telephone Company that it would not seek future benefits from the Virgin Islands Economic Development Commission (formerly Industrial Development Commission) when the current benefits expire in September 2003. Therefore, the future

benefits received from the Virgin Islands Economic Development Commission will continue to be exempted from consideration in any calculation of Innovative Telephone Company's operating income until the benefits in place as of April 24, 2003 expire. In the event further benefits are sought and received from the Virgin Islands Economic Development Commission the rate of return and any tariffs based thereon will be reconsidered by the Commission. All other findings and recommendations are expressly accepted. Specifically the following are accepted.

Findings

1. Investment in the United States Virgin Islands carries an attendant risk not experienced in comparable investment on the mainland.
2. An adjustment to the cost-of-equity to reflect any incremental investment risk is permissible.
3. A rate-of-return must be authorized by the Virgin Islands Public Service Commission prior to use by a regulated utility.
4. A rate-of-return of 11.5% is currently authorized by the Virgin Islands Public Service Commission for use by Innovative Telephone Company.
5. Innovative Telephone Company has used 11.5% as its permitted rate-of-return in calculating its revenue requirement.

6. Innovative Telephone Company effectively earned a return of 6.1% for the year ending June 30, 2001.

7. Innovative Telephone Company has invested over $200 million in telecommunications technology and supporting infrastructure to serve the United States Virgin Islands.

8. Innovative Telephone Company has forecast additional investment for telecommunications technology and supporting infrastructure to serve the United States Virgin Islands.

9. Inclusion by Innovative Telephone of expenditures and assessments -- such as those presented by this proceeding -- in a revenue requirement is permissible and consistent with Virgin Islands law.

10. An allowance of $913,506.57 for rate case expense associated with this proceeding is consistent with the evidence presented in this proceeding and the requirements set forth in Title 30, Sections 23 & 25 of the Virgin Islands Code. This allowance may be adjusted downward to the extent that there are reductions in the actual billings accepted and paid in the docket by the Commission.

11. No compelling reason has been presented that the PSC must perform a cost-of-service study to satisfy the requirements set forth in Act 6402.

Conclusions

1. The currently authorized rate-of-return for Innovative Telephone Company of 11.5% is necessary to ensure future access to the financial markets.
2. Reauthorization of a rate-of-return of 11.5% is fair and reasonable, needed, necessary and imperative to ensure Innovative's combined cost of debt and equity capital is met.
3. Accounting practices employed by Innovative have proven generally acceptable and consistent with all prescribed rules, regulations and requirements of the VIPSC and the FCC.
4. A rate base of $103,311,000 is fair and reasonable, and consistent with the evidence provided in this proceeding.
5. Innovative has not exceeded its authorized rate-of-return in the test year ending December 31, 2001;
6. Innovative recognizes its business relationships with affiliate entities in a manner consistent with all prescribed accounting rules and regulations governing such transactions;

7. Innovative has met its statutory requirements in this proceeding to provide such information as is deemed necessary by the Commission to discharge its responsibilities under Public Act 6402;

8. Suspending additional scheduled contributions by Innovative to the Lifeline account until such time as it is determined by Innovative they are necessary to ensure funding of approved Lifeline programs is consistent with the evidence presented in this proceeding. At present the accumulated sum appears adequate to meet all foreseeable needs.

Dated: 08-06, 2004

FOR THE COMMISSION

VALENCIO JACKSON
Valencio Jackson, Chairman

cc: Keithley Joseph, Executive Director
Frederick G. Watts, Esq.

RECEIVED
AUG 06 2004
PUBLIC SERVICE COMMISSION

Exhibit “3”

April 4, 2003 Mutual Release

MUTUAL RELEASE, CONFIDENTIALITY AND SETTLEMENT AGREEMENT

THIS MUTUAL RELEASE, CONFIDENTIALITY AND SETTLEMENT AGREEMENT ("Agreement") is made on this 4th day of April, 2003, by and among **National Rural Utilities Cooperative Finance Corporation ("CFC")** a District of Columbia cooperative association, **Rural Telephone Finance Cooperative ("RTFC")**, a South Dakota cooperative association, **Innovative Communication Corporation ("ICC")**, a United States Virgin Islands corporation, its affiliates, subsidiaries, or otherwise related companies, and **Virgin Islands Telephone Corporation ("Vitelco")**, a United States Virgin Islands corporation, its affiliates, subsidiaries or otherwise related companies, **Jeffrey J. Prosser**, Personal Guarantor of certain loan agreements, and the other Guarantors, Pledgors and Mortgagors with respect to those loans, including, **Innovative Communication Subsidiary Company, LLC, The Daily News Publishing Company, Inc., Caribbean Communications Company d/b/a/ St. Thomas- St. John Cable TV, BVI Cable TV, Ltd., Caribbean Teleview Services, NV a/k/a St. Maarten Cable TV, Ltd., St. Croix Cable TV, Inc. Atlantic Aircraft, Inc., IC Air, Inc., Vitelcom Cellular, Inc., East Caribbean Cellular, NV, St. Martin Mobiles, SA, Martinque Cable Multimedia, SARL, Group B-200, Inc., World Satellite Guadeloupe, S.A., Innovative Long Distance, Inc., ICC TV, Inc., Val Vision, SA, Cable Evasion 86, S.A., East Caribbean Communications, N.V. (Curacao), East Caribbean Communications, N.V. (Bonaire), East Caribbean Communications, N.V. (St. Maarten), Emerging Communications, Inc. (collectively the "Guarantors, Pledgors and Mortgagors")**.

The parties set out in the preceding paragraph (the "Parties") have agreed to settle the Lawsuit (as is defined below) and all Claims (as is defined below) between them upon the terms and conditions set forth herein.

In consideration of the mutual covenants contained herein and other good and valuable consideration, the receipt and sufficiency of which are acknowledged, the Parties agree as follows:

1. **Definitions.**

A. Lawsuit. The term "Lawsuit" shall mean and refer to *Rural Telephone Finance Cooperative v. Innovative Communication Corp. and Virgin Islands Telephone Corp.*, Civil Action No. 03-277-A, in the United States District Court for the Eastern District of Virginia.

B. Claims. The term "Claims" shall mean and refer to any and all claims, demands, damages (whether actual, compensatory, statutory, punitive, exemplary or other), actions of any character or type (including, but not limited to, class action or derivative lawsuits or proceedings), and causes of action of whatever nature, in law or equity, known or unknown, that the Parties have, or ever have had, or may in the future have, against one another, related to, directly or indirectly, any and all of the facts, events, transactions, occurrences, course of dealings and/or disputes between the Parties occurring prior to the date of this Agreement or occurring after the date of this Agreement but which involve the same facts, events, transactions, occurrences, course of dealings and/or disputes existing as of the date of this Agreement whether known or unknown arising out of the Parties relationships or alleged relationships as member, cooperative, borrower, lender, patron, third-party beneficiary, investor, issuer of security or any other relationship, as well as any and all consequences thereof, each and all, even though one or more of those

consequences are not specifically identified herein. Upon the occurrence of an Event of Default as defined in the ICC Loan (as is defined below), the Vitelco Loan (as is defined below), the ICC Modification (as is defined below) and the Vitelco Modification (as is defined below) (collectively the "Loan Documents") on or after the date of execution hereof, nothing contained herein shall modify or limit Lender's rights to enforce its rights or remedies under the Loan Documents. The Parties further agree and acknowledge that Lender is not releasing Borrower from its obligation to secure Lender's perfected first security interest in the Collateral, and any failure to do so regardless of when such failure occurred, all as set forth in the Loan Documents.

C. The ICC Loan. The term "ICC Loan" shall mean the loan to ICC designated RTFC Loan No. VI 802-9015 dated as of August 27, 2001, including all Prior Loans and Other Agreements as defined therein.

D. The Vitelco Loan. The term "Vitelco Loan" shall mean the loans to Vitelco designated VI 501-9002, dated as of September 9, 1998, and VI 501-5109, dated as of March 20, 2000.

E. The ICC Modification. The term "ICC Modification" shall mean the First Amendment to Loan Agreement VI 802-9015 to ICC dated as of this date.

F. The Vitelco Modification. The term "Vitelco Modification" shall mean the First Amendment to Loan Agreement VI 501-9002 to Vitelco dated as of this date.

G. Lender. The term Lender shall mean CFC and RTFC collectively, including, but not limited to, their present and former affiliates, subsidiaries, directors, officers, employees and members.

H. Borrower. The term Borrower shall mean ICC, Vitelco, Jeffrey J. Prosser, Guarantors, Pledgors, and Mortgagors collectively, including, but not limited to, their present and former affiliates, subsidiaries, directors, officers, and employees.

2. Mutual Releases.

RTFC and CFC hereby fully and forever RELEASE, ACQUIT and DISCHARGE, the Borrowers of and from any and all Claims and/or the Lawsuit, with prejudice.

The Borrowers hereby fully and forever RELEASE, ACQUIT and DISCHARGE, the Lender of and from any and all Claims, with prejudice.

The Parties understand and acknowledge that the foregoing release:

i. **IS A GENERAL RELEASE OF ALL CLAIMS (AS DEFINED HEREIN)– PAST, PRESENT, AND FUTURE AND WHETHER KNOWN OR UNKNOWN;**

ii. is a full and complete settlement of any and all Claims and/or Lawsuit, and the Parties are precluded from seeking further money or other relief based upon such Claims and/or Lawsuit;

iii. is to be interpreted liberally to effectuate maximum protection to the Parties; and

iv. is specifically intended to operate and be applicable even if it is alleged, charged or proven that some or all of the claims or damages released are solely and completely

or partially caused by the negligent acts, gross negligence, fraud, misrepresentation, intentional conduct, breach of fiduciary duty, violation of statute or common law, or conduct of any type by any of the Parties.

3. Covenant Not To Sue.

The Parties hereby covenant and agree not to commence or file, or to institute or cooperate in the commencement or filing of any actions or other proceedings relating to the Claims and/or Lawsuit other than to enforce this Agreement.

4. Consideration.

While expressly denying any wrongful conduct, the Parties agree to the full, final and complete settlement of the Lawsuit and/or Claims and enter into this Agreement, the ICC Modifiation and the Vitelco Modification for this and for other good and valuable consideration, the receipt of and sufficiency of which are hereby acknowledged..

5. Representations.

The Parties represent and warrant to each other:

A. that the execution and delivery of this Agreement and the consummation of the transactions contemplated herein have been duly authorized by all necessary actions;

B. that this Agreement constitutes a legal, valid and binding obligation;

C. that each of the Parties executing this Agreement has full legal authority to settle all Claims and/or Lawsuit;

6. **Denial of Liability.**

The Parties acknowledge and agree that this Agreement is for the resolution of the Lawsuit and/or Claims and is made to avoid further litigation and expense. Accordingly, it is understood and agreed by each of the Parties hereto:

A. that this Agreement is not, and shall not be deemed to be an admission of liability by any party, any such liability being expressly denied; and

B. that this Agreement is not, and shall not be deemed to be an admission of the truth of any allegation or statement relating to the Lawsuit and/or the Claims made by the Parties prior to the entry of this Agreement.

Accordingly, the Parties agree that they will not use, or permit the use of, this Agreement for the purposes described in sub-paragraphs A and B above in any action which may hereafter be brought against the Parties or anyone on their behalf.

7. **Full Satisfaction.**

The Parties understand and agree that this Agreement is made in full, final and complete settlement and satisfaction of all Claims and the Lawsuit.

8. **Non-disclosure of this Agreement.**

As further consideration for this Agreement, the Parties and their counsel agree that unless required to do so by order of a court asserting competent jurisdiction or as otherwise required by law, they will not use or disclose to any third persons, firms, corporations or others

this Agreement and/or any of the terms of this Agreement including, but not limited to, the terms of the ICC Loan, the Vitelco Loan, the ICC Modification or the Vitelco Modification, except that RTFC and/or CFC may disclose the information to others required to learn of the terms of the loan agreements pursuant to confidentiality agreements or as otherwise required by applicable law.

9. Entire Agreement.

This Agreement including its exhibits contain the entire agreement between the Parties relating to the Claims and the Lawsuit and may not be altered or amended except by a writing signed by all of the Parties hereto. This Agreement supersedes any and all other representations, discussions, and agreements, whether oral or in writing, by and between any of the Parties and their attorneys.

10. Full Knowledge and Voluntary Release.

The Parties hereby represent and warrant that they have read this Agreement and they expressly acknowledge:

A. that they have entered into this Agreement of their own free choice based upon their own knowledge and judgment; and

B. that they have not acted in reliance on any representation, advice or other action other than as included in this Agreement.

11. Attorneys' Fees and Costs.

The Parties shall bear their own attorneys' fees, costs, and expenses arising from or in connection with the Lawsuit and this Agreement.

12. Severability.

If any provision of this Agreement is determined to be illegal or unenforceable, that provision shall be deemed modified to the minimum extent necessary to make it legal and enforceable and as so modified shall be entered as though originally agreed to by the parties and all remaining provisions shall remain in full force and effect.

13. Construction.

All Parties have reviewed, and participated in the drafting of, this Agreement. Accordingly, the Parties agree that the normal rules of construction to the effect that any ambiguities in this Agreement are to be resolved against the drafting party shall not be used in the interpretation of this Agreement. It is expressly understood and agreed that all of the terms contained in this Agreement are contractual and are not merely recitals.

14. Governing Law and Jurisdiction.

This Agreement shall be governed by the laws of the Commonwealth of Virginia without regard to its choice of law provisions. The Parties agree to the exclusive jurisdiction in the United States District Court for the Eastern District of Virginia with respect to any claims for breach of this Agreement, and agree not to challenge venue in that jurisdiction in the event

litigation is filed there relating to this Agreement. TO THE FULLEST EXTENT PERMITTED BY APPLICABLE LAW, THE PARTIES HEREBY IRREVOCABLY WAIVE ANY AND ALL RIGHT TO TRIAL BY JURY IN ANY LEGAL PROCEEDING ARISING OUT OF OR RELATING TO THIS AGREEMENT. Excluded Claims shall not be governed by this paragraph.

15. Miscellaneous.

This Agreement may be executed in one or more counterparts, each of which shall be deemed to be an original but all of which together shall constitute one and the same instrument. Each Party agrees: that such counterparts need not include the signature/verification page for any other Party; that the Parties may combine the signed counterparts into a single document by attaching all of the executed signature/verification pages to a single copy or original of this Agreement; and that the foregoing shall not affect the validity of this Agreement.

IN WITNESS HEREOF, the Parties have entered into this Mutual Release, Confidentiality and Settlement Agreement on and as of the day and year first written above.

BY: _____
Jeffrey J. Prosser
Chairman and Chief Executive Officer
on behalf of ICC and Vitelco, their directors and officers, and the Guarantors, Pledgors and Mortgagors

BY: _____
Jeffrey J. Prosser
Individually

BY: _____
Steven L. Lilly
Senior Vice President
on behalf of CFC

BY: _____

Lawrence Zawalick
Senior Vice President
on behalf of RTFC

Exhibit “4”

December 2008 St. Thomas Source Article Re Group II Assets
&
Transcript of CFC’s January 2009 2nd Quarter Investor Conference Call

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Prosser's French Properties Bring Only $22 Million

by Source staff

Dec. 9, 2008 – Jeffrey Prosser's former cable holdings, in the Eastern Caribbean and in France, have been sold for $22 million according to the court-appointed trustee in the bankruptcy case of the former chief executive officer and owner of Innovative Telephone.

These are the so-called Group II assets whose sale must be approved by U.S. Bankruptcy Court Judge Judith K. Fitzgerald. Stan Springel, the chapter 11 trustee in the case, announced the sale in a filing with the court. Prosser is in involuntary Chapter 7 bankruptcy and Innovative Communications Co., the parent company of the Innovative Telephone, or Vitelco, as the monopolistic local phone company is known locally and legally which he owns, is in Chapter 11 bankruptcy. Prosser's assets are being sold off to pay close to a billion dollars owed to various creditors.

(Click for rest of article)

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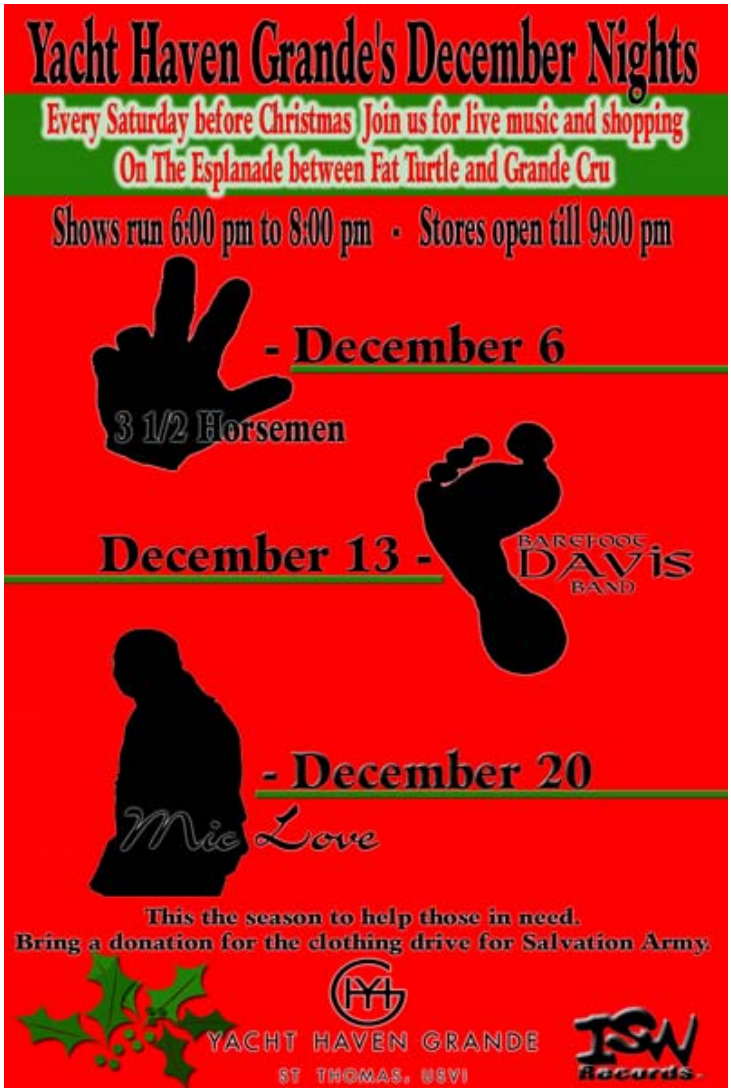

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The Group II properties include cable TV operations in Martinique and Guadeloupe, both French island colonies in the Caribbean as well as other cable operations (never fully described) in eastern France.

The sales price, interestingly for a U.S. court document, was quoted in Euros, 17 million of them; that equates, the court was told, to $21,990,000 on the date of the sale.

The price is a drastic reduction from what Prosser's lawyers said the properties were worth when they argued in court some 23 months ago. On Jan. 9, 2007 in Fitzgerald's Pittsburgh courtroom, one of Prosser's lawyers said the properties were worth $100 million; on Jan. 30 of that year. At another Pittsburgh hearing, another one of Prosser's attorneys announced that "a memorandum of understanding" had been signed for the sale of the same properties for $70 million. (See "Prosser Sells French Island Cable Companies for $70 Million").

The properties are, more formally, owned by Minion Corp. N.V., once a wholly-owned Prosser firm, and its stock was purchased by Altice Services LLP, a British firm.

Springel worked on the sale in conjunction with Houlihan, Lokey, Howard & Zukin, a mainland financial organization recently brought into the process by Springel. The court document said that Springel, HLHZ and the Rural Telephone Financial Cooperative, long Prosser's bankers and now his principal creditors, all agreed that the "Buyer's

bid is the highest and best qualified Bid available...."

If the future resembles the past it is likely the Prosser and his lawyers will soon charge that a higher price should have been obtained for the properties, a posture they have taken on other sales in the past.

Back Talk

Share your reaction to this news with other Source readers. Please include headline, your name and city and state/country or island where you reside.

VIPA Waiting On Millions In Fees From Ships Agent

The perennially strapped V.I. Port Authority is owed millions in fees from a ships agent who collected them from cruise ships but never turned them over to VIPA, the Source has learned.

Click here for More... 2008-12-12 01:22:23

Practice Makes Perfect Attendance For More Gomez Students

By the end of the first marking period last year, only 39 students at Joseph Gomez Elementary School had perfect attendance records, but efforts made by parents, faculty and staff members has, over the past few months, helped to increase the number to 166.

Click here for More... 2008-12-12 01:21:47

Former Senator Hansen Found Guilty On Tax Charges

Former V.I. Senator Alicia "Chucky" Hansen was convicted of three counts and acquitted of one count of misdemeanor failing to file an income tax return Wednesday, after a quick two-day trial in U.S. District Court on St. Croix.

Click here for More... 2008-12-12 01:00:37

Cutbacks Hit Daily News Staff

The Virgin Islands Daily News announced Thursday it would lay off 10 employees and eliminate a number of currently vacant positions as part of a "restructuring" program.

Click here for More... 2008-12-12 00:45:50

Lionfish, A Coral Threat, Found In St. Croix Waters

A sharp-eyed dive instructor spotted a lionfish, a non-native species that threatens coral reefs, near the Frederiksted Pier on Nov. 25, caught it and turned it over to the Division of Fish and Wildlife's William Coles.

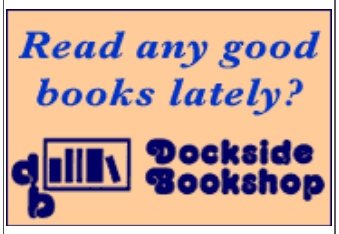
Click here for More... 2008-12-12 00:12:46

Anthrax Scare Briefly Shuts Down Postal Service

Envelopes mailed Thursday to the Lieutenant Governor's Offices on St. Thomas and St. Croix contained a powdery white substance that spurred an anthrax scare and interrupted postal service on both islands, though it was later determined the packages contained only flour.

Click here for More... 2008-12-11 23:38:38

Film Crew on St. Croix Shooting PBS Documentary About Alexander Hamilton



NRUCFC SECOND QUARTER FISCAL YEAR 2009

FINANCIAL RESULTS ***JANUARY 22, 2009***

Page 1 to Page 63

CONDENSED TRANSCRIPT AND CONCORDANCE
PREPARED BY:

COLLINS REPORTING SERVICE, INC.
405 N. Huron Street
Toledo, OH 43604
Phone: 419-255-1010

Page 1

NRUCFC Second Quarter Fiscal Year 2009
Financial Results Conference Call

DATE: January 22, 2009
REPORTER: Veronica Buettner
Notary Public

- - -

Page 2

UNKNOWN SPEAKER: This recording is for the Steven Lilly teleconference, the National Rural Utilities Co-op scheduled for Thursday, January 22nd, 2009 at 9:00 a.m. central time.

Excuse me, everyone, we now have our speakers in conference. Please be aware that each of your lines is in a listen-only mode. At the conclusion of today's presentation we will open the floor for questions. At that time instructions will be given as to the procedure to follow if you would like to ask a question.

I would now like to turn the conference over to Mr. Steven Lilly. Mr. Lilly, you may begin.

MR. LILLY: Good morning and welcome to the National Rural Utilities Cooperative Finance Corporation fiscal year 2009 second quarter review. My name is Steven Lilly and I'm the chief financial officer of National Rural. I'm extremely pleased to once again provide

Page 3

you with this financial and operational update. As always, we are very thankful for your confidence in National Rural and the consumer-owned (inaudible) cooperative (inaudible) utility industry and for your support of National Rural Capital Market Issuance.

Before I begin with an overview of activities for the 2009 second quarter, I would first like to cover our required SEC communications. Our commentary responses to your questions and comments may contain forward-looking statements regarding loan growth, net income after a provision or recovery for loan loss, net income, adjusted net income, the allowance for loan loss, equity retention, borrower's financial results, leverage ratio and the debt-to-equity ratio and other matters covered in this discussion; actual results could differ materially from those projected in these forward-looking statements. Additional information

Page 4

regarding risk factors that can cause results to differ materially from such statements is available from National Rural's 10-K report as of May 31st, 2008 and 10-Q report as of November 30th, 2008 as filed with the Securities and Exchange Commission.

In light of the fact that National Rural is an active issuance securities both domestically and globally and the current levels of uncertainty in the capital market, it is more important now than ever before to reiterate the National Rural capital market relations -- capital market funding and external reporting teams who are very talented and knowledgeable about the industry reserve and the operations of National Rural. Therefore, as always, if you have any questions or concerns regarding your investments in National Rural securities, you may reach Andrew Dunn, who is responsible for capital market relations, Don Sooner, who is

Page 5

responsible for capital market funding, and Robert Geier, who is the chief accounting officer and responsible for external SEC and public reporting. If you have any questions, please do not hesitate for a moment to call me or any of these individuals at 703-709-6700. Also I encourage you to visit our website at www.nrucfc.coop for all of our public filings, press releases and updates.

During our discussion today we will review our GAAP or Generally Accepted Accounting Principles and non-GAAP adjusted financial measures. Please refer to the latest SEC 10-K report that is filed with the SEC and is posted on the National Rural website for discussion of why we believe the adjusted measures are useful information, involve the reconciliations due to the related GAAP measures are helpful in analyzing National Rural's financial performance.

During this past year's capital market turmoil, National Rural has

Page 6

continued to reinforce its financial position, maintain the watchful focus on key performance measures that drive credit ratings and credit ratings' outlook, identified and managed credit exposures and utility-industry related concerns that may require risk mitigation strategies, significantly enhanced capital market liquidity while simultaneously delivering high-quality, competitively-priced products and services to American's rural cooperative utilities. They provide services that are even more essential today than ever before to more than 40,000,000 citizens.

The map of the utilities which comprise the National Rural portfolio covers geographic territories in Key West, Florida to the far reaches of Alaska. National Rural does not take credit risk exposure outside of the United States and U.S. territories, this is the bedrock of the National Rural credit.

Page 7

(1) A few key take aways. National
(2) Rural's performance metrics are based on
(3) non-GAAP-adjusted measures, which are
(4) fully disclosed by public filings and
(5) posted on the website. National Rural is
(6) a non-stock cooperative corporation which
(7) strives to continue to strengthen our
(8) financial position, manage our
(9) performance metrics to drive improvement
(10) and credit ratings, continuously improve
(11) our credit and interest rate management
(12) techniques, enhance our liquidity
(13) position through new funding programs,
(14) provide high-quality products and
(15) services to our member rural utilities
(16) cooperatives and maintain, again, a
(17) portfolio that primarily consists of
(18) U.S.-based electric utilities with
(19) limited exposure to telephone companies.
(20) The key investment highlights
(21) for you to consider, National Rural
(22) continues to be the dominant provider of
(23) capital for the U.S. rural cooperative
(24) electric utilities with 19.6 billion

Page 8

(1) dollars' gross loans outstanding as of
(2) November 30th, 2008. Our unique
(3) existence of the member-owned,
(4) not-for-profit, tax-exempt organization
(5) that operates on cooperative principles
(6) enhances our ability to be focused on our
(7) borrower's long-term business success.
(8) The high-quality, geographically diverse,
(9) again, U.S. only, active portfolio
(10) provides services for the most part on a
(11) non-competitive basis essential to the
(12) growth and prosperity of this country.
(13) Our members holding 1,526 are
(14) geographically diverse. They provide
(15) energy to 40,000,000 users of
(16) electricity. As the additional benefit,
(17) cooperative electric utilities are
(18) subject to very limited State
(19) regulations.
(20) National Rural continues to
(21) manage its top 10 credit exposures which
(22) represent 18 percent of total credit at
(23) November 30th, 2008. National Rural
(24) continues to offer a superior security

Page 9

(1) and value to investors. Our collateral
(2) trust funds, which are secured by
(3) electric distributions, mortgage
(4) collateral, medium-term notes, which are
(5) unsecured general obligations of National
(6) Rural, commercial paper, which is an
(7) unsecured general obligation supported
(8) with 100 percent back-up bank loans.
(9) National Rural also offer guarantees and
(10) stand-by liquidity for members'
(11) tax-exempt bonds. (Inaudible.) National
(12) Rural's obligation to perform under these
(13) stand-by liquidity variable rate
(14) agreements is supported by bank lines.
(15) MORT investment highlights.
(16) National Rural employs conservative
(17) management techniques in its approach to
(18) managed risks associated with the funding
(19) of its loan portfolio. The fixed rate
(20) loans are funded with a mix of fixed-rate
(21) liabilities, equity in the form of member
(22) (inaudible) certificates and other
(23) retired patron capital allocations.
(24) National Rural is limited to

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(1) lending to its members, which are
(2) electric and telephone utilities located
(3) in rural areas across the United States.
(4) The majority of the lending by National
(5) Rural is on a senior-secured basis with
(6) 81 percent of the loans outstanding as of
(7) November 30th, 2008 being secured.
(8) Unlike many financial institutions,
(9) National Rural is not exposed to
(10) residential mortgages, securities backed
(11) by residential mortgages, collateralized
(12) debt obligations or securities supported
(13) by structured investment vehicles.
(14) National Rural uses derivatives to
(15) (inaudible) managed interest rate flux,
(16) to manage interest risk in its funding of
(17) its loan portfolio. National Rural does
(18) not trade positions and does not enter
(19) into positions on a speculative basis.
(20) National Rural enters into swap positions
(21) only to the extent that they minimize
(22) interest rate risk and provide a lower
(23) cost of funding. (Inaudible) parties are
(24) only National Rural's credit line banks.

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(1) Over the years, National Rural
(2) has developed a number of funding
(3) programs to limit the dependence on the
(4) capital market. The Rural Economic
(5) Development Loan and Grant program, as we
(6) call it REDLAG, government-guaranteed
(7) note program, has provided a total of 3
(8) billion dollars of funding to National
(9) Rural. National Rural has also entered
(10) into a number of funding programs with a
(11) federal agriculture mortgage corporation,
(12) or Farmer Mac, and has now issued a total
(13) of $795,000,000 of secured notes under a
(14) program that will allow the issuance of a
(15) total of $900,000,000 to Farmer Mac.
(16) National Rural does not intend
(17) to maximize profit on each loan it makes
(18) with members, (inaudible) loans on the
(19) basis that it covers costs with a
(20) reasonable markup that covers loan loss,
(21) operating expenses and a small profit.
(22) National Rural has been providing
(23) financing to rural utility systems since
(24) 1969. National Rural has been able to

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(1) work with borrowers to minimize the
(2) amount of loss incurred over these years.
(3) This has resulted in National Rural
(4) recording a total of only $181,000,000 in
(5) charge-offs for the period from 1969
(6) to -- continues to maintain ratings from
(7) the three major rating firms, the
(8) following three national -- SEC
(9) nationally recognized fiscal rating
(10) organizations, fixed ratings (inaudible)
(11) has been a source -- continue to
(12) (inaudible) National Rural's
(13) senior-secured rating at A plus, A-1, A
(14) plus, and our unsecured rating at A, A2A,
(15) and short-term ratings at F1, F1, A1.
(16) Fixed (inaudible) and SMPs all have
(17) stable outlooks in place for National
(18) Rural's ratings. The National Rural
(19) board of directors and management are
(20) committed to achieving higher bond
(21) ratings from all three firms.
(22) Accordingly, the National Rural board
(23) continues to employ performance-based
(24) compensation incentives based on both

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(1) short-term and long-term corporate goals
(2) and objectives (inaudible) proven
(3) National Rural senior-secured ratings as
(4) a key performance metric.
(5) Here's the table for all of the
(6) National Rural ratings. National Rural
(7) only offers credit-related product and
(8) services to America's Rural electric
(9) utilities that provide essential
(10) services. I know that on each one of my
(11) calls I've highlighted what we don't do,
(12) it is always important to restate these
(13) important points. National Rural does
(14) not provide credit to the residential or
(15) commercial mortgage markets. (Inaudible)
(16) prime consumer credit on our book, we do
(17) not invest in mortgage-backed securities,
(18) (inaudible) securities, POOs, CDOs or
(19) SIDs. We do not trade derivatives.
(20) Derivatives are all utilized for active
(21) liability management purposes. Now a
(22) party risk is only taken with financial
(23) organizations which were a party to
(24) National Rural's revolving credit

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(1) (inaudible) at the time the derivatives
(2) were consummated. It is most important
(3) for National Rural that we have exposure
(4) to Lehman Brothers, and we are attempting
(5) to recover our net position in what
(6) remains of that organization. We do not
(7) take credit risks outside of the
(8) protection provided for under the U.S.
(9) legal system.
(10) At this time I would like to
(11) take the opportunity to discuss the
(12) second quarter financial results. Fixed
(13) ratings and Standard and Poor moved the
(14) National Rural outlook to stable from
(15) positive, the outlook remains as stable.
(16) Given this whirlwind blowing over the
(17) capital market, remaining as stable unto
(18) itself might be viewed as a positive
(19) statement. Consolidated net GAAP loss
(20) total, $215,000,000. The primary factor
(21) for the GAAP loss is the additional
(22) provision for the allowance for loan loss
(23) of $137,000,000, most of which related to
(24) the additional provisions for the

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(1) innovative communication corporation
(2) exposure due to the decline in the
(3) expected recovery based on the overall
(4) credit and equity market conditions, and
(5) the derivative forward-value loss of
(6) $150,000,000. After excluding from GAAP
(7) net loss the derivatives forward-value
(8) adjusted (inaudible) and including
(9) minority interest net loss, the resulting
(10) adjusted net loss is approximately
(11) $68,000,000. Please be mindful that the
(12) core business of National Rural generated
(13) a net income of $67,000,000 prior to the
(14) additional loan loss provision in the
(15) derivative forward-valuing system. On a
(16) going-forward basis it is fully
(17) anticipated that the core business of
(18) National Rural will remain stable and the
(19) historical trends will continue.
(20) Tier and adjusted tier,
(21) (inaudible) ratio for the six-month
(22) period are below 1.0 due to the GAAP loss
(23) of $215,000,000 and the adjusted net loss
(24) of $16,000,000. National Rural's core

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(1) business remains intact and we fully
(2) anticipate the adjusted net loss will
(3) turn positive resulting in an adjusted
(4) tier greater than one (inaudible) by the
(5) end of the fiscal year. Additionally,
(6) management believes the core earnings
(7) trends will continue into the 2010 fiscal
(8) year and beyond as well.
(9) Gross loans provided to rural
(10) utilities grew by $537,000,000, or
(11) approximately 3 percent versus the end of
(12) the prior fiscal year. Those loans
(13) outstanding as of November 30th, 2008
(14) total 19.6 billion dollars. Loans and
(15) guarantees provided to rural electric
(16) organizations, the bedrock of the
(17) National Rural organization, total 19.1
(18) billion and represented 92 percent of the
(19) credit portfolio. Loans and guarantees
(20) provided to rural telecom total 1.7
(21) billion and represented 8 percent of the
(22) credit portfolio. Loans and guarantees
(23) provided to utilities on a senior-secured
(24) basis total 18 billion dollars and

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(1) represented 87 percent of the total loan
(2) portfolio. The allowance for loan losses
(3) total $549,000,000, representing 3.3
(4) percent of gross loans at the end of the
(5) second quarter, which seems adequate for
(6) the risk exposure in the National Rural
(7) loan portfolio.
(8) Recoveries of the Innovative
(9) Communication Corporation bankruptcy case
(10) continue to accelerate. Asset
(11) (inaudible) processes are under way. The
(12) group 2 assets were sold subsequent to
(13) the end of the second quarter. The group
(14) 1 assets sold, hearing is scheduled to
(15) occur during National Rural's fiscal year
(16) third quarter. Total assets of National
(17) Rural with 20.4 billion dollars at
(18) November 30, 2008 versus 19.4 billion at
(19) the end of the prior fiscal year.
(20) Loan growth in the electric
(21) segment of the portfolio was a major
(22) contributor to asset growth. On November
(23) 30, 2008 gross loans totaled 19.6 billion
(24) dollars versus 19 billion at the end of

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(1) the 2008 fiscal year. The increase of
(2) 537,000,000 was largely due to an
(3) increase of loans of distribution systems
(4) of $298,000,000, from 13.4 billion to
(5) 13.7 billion dollars, and an increase in
(6) loans to power supply organizations of
(7) 233,000,000, from 3.3 billion to 3.6
(8) billion. The telecommunication segment
(9) continues to reflect the impact of the
(10) strategic refocusing to core electric,
(11) which began some five years ago.
(12) Outstanding loans to telecommunication
(13) organizations declined by $29,000,000 in
(14) the past six-month period.
(15) Electric-related organization loan
(16) exposure totaled 17.9 billion or 91
(17) percent of the portfolio, and
(18) telecommunication loan exposure totaled
(19) 1.709 percent of the loan portfolio at
(20) the end of the fiscal year 2009 second
(21) quarter.
(22) As I mentioned in previous
(23) calls, National Rural has strategically
(24) focused on increasing its (inaudible)

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(1) book of business in core electric
(2) organizations while simultaneously
(3) seeking to become more granular with
(4) remaining telecommunication loan
(5) portfolio. In the span of five years a
(6) percentage of telecommunications sector
(7) has been reduced from over 25 percent,
(8) which is 9 percent -- at 9 -- November
(9) 30th, 2008. At the end of the 2009
(10) second quarter, secured loans outstanding
(11) total 17 billion dollars, again,
(12) representing 87 percent of total loans
(13) outstanding. Unsecured loans total 2.5
(14) billion and represent 13 percent of total
(15) loans outstanding. Loans are secured on
(16) a first lien basis on utility assets
(17) after (inaudible) property and a
(18) (inaudible) of revenue.
(19) Utility organizations have an
(20) option of selecting between fixed and
(21) variable interest rates. At the end of
(22) the second quarter, 76 percent of the
(23) loans were in a long-term, fixed-rate
(24) mode. 17 percent were in a variable-rate

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(1) mode. All restructured loans totaled
(2) $562,000,000 were performing under the
(3) respective restructured terms.
(4) National Rural continues to
(5) implement a rigorous asset-liability
(6) management program, and at the end of the
(7) second quarter all fixed-rate loans were
(8) max funded with fixed-rate liabilities at
(9) the time of equity. At the end of the
(10) second quarter only 196,000,000 of
(11) fixed-rate loans were used to fund
(12) variable-rate loans. This represents
(13) less than 1 percent of total assets and
(14) is well within National Rural's matched
(15) funding policy of 3 percent of total
(16) assets.
(17) Restructured loans declined by
(18) $15,000,000 during the six-month period
(19) and totaled 562,000,000 at the end of the
(20) second quarter. Again, all loans in this
(21) category are performing and (inaudible)
(22) with their respective restructured terms.
(23) Non-performing loans total $493,000,000
(24) at the end of the second quarter, a

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(1) decrease of 14,000,000 versus the end of
(2) the prior fiscal year. The allowance for
(3) loan losses was $649,000,000 at the end
(4) of the second quarter versus $515,000,000
(5) at the end of the prior fiscal year. The
(6) increase in the actual loan loss was
(7) attributable to additions required to
(8) adequately cover the risk exposure for
(9) the innovative communication credit
(10) exposure, also for loan growth, and when
(11) adjusted to the mentioned-before
(12) accumulative net charge-off (inaudible)
(13) National Rural total $181,000,000. All
(14) charge-offs have been offset against the
(15) allowance for loan losses has been in
(16) effect. In several instances National
(17) Rural has reduced the level of previous
(18) charge-offs through recovery.
(19) The typical form of credit
(20) provided by National Rural to these rural
(21) utility organizations is in the form of
(22) long-term secured loans. The utilities
(23) pledge under a mortgage structure the
(24) first lien on all utilities assets after

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(1) acquired property and a pledge of
(2) revenue. This structure minimizes risk
(3) to National Rural should a utility
(4) organization's financial condition
(5) weaken. The first lien position pledged
(6) to National Rural is somewhat stronger
(7) than an investor-owned utility's first
(8) mortgage bonds. In addition to the
(9) utility organization's pledge of utility
(10) assets, National Rural has offset rights
(11) against the utility's investments in
(12) National Rural, which includes but is not
(13) limited to the equity investment in
(14) National Rural (inaudible) providing
(15) additional protection against principal
(16) loss. The security package structured
(17) into National Rural's long-term loan
(18) program allows National Rural to directly
(19) pledge the senior-secured level trust
(20) fund holders and a (inaudible) of the
(21) utility mortgage collateral, which places
(22) National Rural's bonds in the same
(23) category as an investor-owned utility's
(24) first mortgage bonds with an underlying

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(1) safety net of (inaudible) positioned
(2) single (inaudible) rated national
(3) organization.
(4) On the liability and equity side
(5) of the balance sheet, short-term debt
(6) declined by $616,000,000 in November 30,
(7) 2008 versus May 31, 2008 year end, from
(8) 6.3 billion to 5.8 billion dollars. This
(9) was due to National Rural successfully
(10) pre-funding scheduled debt maturities at
(11) the end of the prior fiscal year.
(12) Going to the second quarter,
(13) National Rural issued a 10-year
(14) fixed-rate collateralized trust bond
(15) totaling 1 billion dollars in the face of
(16) a very ill-equipped market. The 10-3/8
(17) percent coupon security proceeds
(18) utilized the funds' loan growth in the
(19) National Rural portfolio. Albeit the
(20) rate was not representative of the
(21) quality of the National Rural's credit
(22) risk, all market participants were
(23) unfortunately impacted by the uncertainty
(24) of the market and bad times.

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(1) Fortunately, National Rural diverse
(2) capital structure provided opportunities
(3) to blend down this higher cost security.
(4) Also during the second quarter
(5) National Rural began its participation in
(6) the commercial paper funding facility, or
(7) CPFF, in November 30th, 2008 1.1 billion
(8) was outstanding under this program. In
(9) November 2008 National Rural filed a
(10) prospects supplement with the Securities
(11) and Exchange Commission to establish a
(12) program to which National Rural may
(13) (inaudible) and sell an unlimited
(14) aggregate principal amount of its member
(15) capital securities to its voting members.
(16) This equity issuance effort is well under
(17) way. Adjusted debt to equity was 7.81 in
(18) November 30th, 2008, an increase compared
(19) to the prior fiscal year end, as
(20) cooperative utility organizations have
(21) increased their reliance on National
(22) Rural for capital due to the uncertainty
(23) in the capital market.
(24) In December of 2008 and January

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(1) of 2009, national Rural entered into a
(2) new purchase practice agreement with the
(3) Federal Agriculture Mortgage Corporation,
(4) or Farmer Mac, totaling $500,000,000 and
(5) we are (inaudible) advanced
(6) $395,000,000 with maturities ranging from
(7) one to five years and very favorable
(8) interest rates in National Rural versus
(9) funding available in the capital market.
(10) The average way to cost of the recent
(11) funds secured from Farmer Mac is
(12) approximately 3.84 percent.
(13) In December of 2008 and January
(14) 2009, National Rural terminated two
(15) interest rate swaps totaling $370,000,000
(16) initial amount and received cash payments
(17) totaling $68,000,000, which will be
(18) recorded as a derivative cash settlement
(19) income in the third quarter. This
(20) activity was considered upon realignment
(21) on asset-liability management position
(22) associated with fixed rate loans which
(23) are traditionally re-priced the first of
(24) each calendar year.

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(1) Moving to a review of the
(2) consolidated statement of operations for
(3) the period ending November 30th, 2008
(4) versus November 30th, 2007. Interest
(5) income for the six months ending November
(6) 30th, 2008 total $535,000,000, up
(7) slightly from $331,000,000 for November
(8) 30th, 2007. This increase of a
(9) quarter-million dollars was due to an
(10) increase of 1.1 billion in average loans
(11) outstanding, largely offset by 32 basis
(12) points decline in yield earned. Interest
(13) expense for the period ending November
(14) 30th, 2008 totaled $454,000,000 versus
(15) $487,000,000 during the period ending
(16) November 30, 2007 on a GAAP basis,
(17) $33,000,000 decline was due to a 68 basis
(18) point decline in overall (inaudible) of
(19) debt partially offset by an increase in
(20) the amount of debt outstanding. Net
(21) interest income totaled $81,000,000
(22) versus $44,000,000 during the prior
(23) fiscal year. Adjusted net loss, which
(24) excludes the non-cash effects of

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(1) derivative (inaudible) value and includes
(2) the minority interest net loss totaled
(3) $68,000,000 versus adjusted net income of
(4) $61,000,000 for the prior year period.
(5) Reconciliations for adjusted net income
(6) to reported GAAP net income can be found
(7) on page 60 in the current 10-Q report.
(8) National Rural did not achieve
(9) its adjusted high interest range ratio
(10) target of 1.10 for the six-month period
(11) ending November 30th, 2008, due to the
(12) amount of the provision to allowance for
(13) loan loss. National Rural's core
(14) business remains intact and again, on a
(15) going-forward basis, National Rural
(16) expects to maintain financial performance
(17) at or above the adjusted tiered target.
(18) National Rural, as previously
(19) mentioned, has only one major borrower
(20) that is non-performing at the end of the
(21) second quarter, that borrower is
(22) Innovative Communications Corporation.
(23) This borrower has been in Chapter 11
(24) bankruptcy since July 2006. National

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(1) Rural continues to work towards the
(2) recovery of this outstanding credit. At
(3) November 30th, 2008, approximately
(4) $485,000,000 of loans are outstanding to
(5) this diversified communications
(6) organization. Fiscal controls have been
(7) put in place by the Chapter 11 trustee.
(8) National Rural's claim continues to be
(9) confirmed by the bankruptcy court. The
(10) (inaudible) go forward, sale of assets
(11) are under way, any and all attempts to
(12) deny access to collateral have been
(13) addressed by the court, and a (inaudible)
(14) slowing-down recovery process has been
(15) reviewed. National Rural has reserved
(16) and has maintained an adequate reserve
(17) for this outstanding exposure and will
(18) continue to evaluate the adequacy with
(19) specific reserves as well as overall
(20) reserves.
(21) From a funding perspective,
(22) National Rural anticipated a number of
(23) years ago that having alternatives
(24) available for the public capital market

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(1) was a significant strategic initiative.
(2) In that regard, the government-guaranteed
(3) loan program known as REDLAG, the
(4) prior -- private note placement have
(5) (inaudible) done with Farmer Mac and the
(6) home loan sales program combine to
(7) provide new forms of liquidity for
(8) National Rural during the past
(9) disruptions in the overall capital
(10) market. In addition, National Rural's
(11) membership has stepped up their
(12) investments in National Rural's senior
(13) own secured securities and member capital
(14) investment programs again is well under
(15) way subsequent to the end of the second
(16) quarter. All of these (inaudible)
(17) alternatives have reduced our need to
(18) fund in the capital market. During this
(19) period of turmoil in the capital market,
(20) National Rural continues to have an
(21) adequate access to funding in the
(22) marketplace. However, there has been a
(23) slightly negative impact on the results
(24) of operations due to slightly higher

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(1) costs were recently paid on that billion
(2) dollar 10-year bond. As we look at it on
(3) the near-time horizon, we fully
(4) anticipate access in the capital market,
(5) buy, term rates, mode and structure will
(6) be determined near the time of issuance.
(7) The next major refinancing
(8) effort for National Rural may be in July
(9) and August of this year but until
(10) (inaudible) limited term loans mature in
(11) the meantime National Rural will accept,
(12) if needed, to raise capital to fund
(13) long-term and short-term loans, which
(14) (inaudible) electric borrower's to meet
(15) infrastructure requirements -- at 6.5
(16) billion dollars, this amount includes the
(17) $239,000,000 commitment from the Lehman
(18) Brothers Bank. However, we do not
(19) believe that these funds from Lehman
(20) Brothers Bank will be available in the
(21) future. These credit facilities provide
(22) backup to National Rural's commercial
(23) paper, guaranteed commercial paper,
(24) standby liquidity facilities that

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(1) National Rural provides on behalf of
(2) member systems, tax-exempt bonds
(3) outstanding. Also during the first
(4) quarter of the 2009 calendar year,
(5) National Rural will be renewing its
(6) maturing 364-day credit facility which
(7) totals 1.5 billion dollars.
(8) We are fully cognizant of your
(9) interest in our bond note offering, and
(10) in that regard we are contemplating
(11) continuing our investor relations
(12) meetings over the course of the next year
(13) to ensure that you are giving us full
(14) value for the financial strength of the
(15) utility sector that we financed. This,
(16) after all, is the principal credit
(17) (inaudible) of National Rural. Over the
(18) balance of this year and early 2009 we
(19) anticipate securing 500 to maybe a
(20) billion dollars to support the rural
(21) electric infrastructure requirement. We
(22) also anticipate again renewing the
(23) 364-day facility.
(24) National Rural continues to be

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(1) very well positioned to protect the
(2) investments the organization has made in
(3) our security. As always, let me express
(4) my deepest appreciation for your
(5) participation today, I look forward to
(6) visiting with you during our upcoming
(7) investor meetings.
(8) Again, a few of our key
(9) take-aways. Financial performance
(10) metrics based on non-GAAP-adjusted
(11) measures which are fully disclosed in
(12) public filings are posted on our website.
(13) We are a non-stock cooperative
(14) organization which strives to continue to
(15) strengthen our financial position, manage
(16) our performance metric to improve rating,
(17) (inaudible) improve our credit and
(18) interest rate risk management techniques,
(19) improve and enhance our liquidity
(20) position through new funding programs,
(21) provide high quality products and
(22) services to our rural electric
(23) cooperative members as we maintain a
(24) portfolio that primarily consists of

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(1) U.S.-based electric utilities with
(2) limited exposure to telecom.
(3) We continue to be the dominant
(4) provider in capital to the rural electric
(5) cooperative industry on a private basis
(6) from 19.6 billion dollars in loans
(7) outstanding. We are a not-for-profit,
(8) tax-exempt organization that operates on
(9) cooperative principle which enhances our
(10) ability to focus on the borrower's
(11) long-term business success. We are
(12) geographically diverse with a
(13) high-quality asset portfolio, it provides
(14) essential services to the growth and
(15) prosperity of the country. Our electric
(16) cooperatives for the most part are not
(17) regulated and we continue to manage down
(18) our top exposures, which are currently at
(19) 18 percent as of November 30th, 2008.
(20) At this time I would like to
(21) respond to any questions and comments you
(22) might have. Tiffany, if you would please
(23) open the lines for participants for any
(24) questions.

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(1) UNIDENTIFIED SPEAKER: Yes, sir,
(2) thank you. At this time we will open the
(3) floor for question? If you would like to
(4) ask a question, please press the star key
(5) followed by the 1 key on your touch-tone
(6) phone. Questions will be taken in the
(7) order in which they are received. If at
(8) any time you would like to remove
(9) yourself from the questioning queue,
(10) press star 2. Again, to ask a question,
(11) please press star 1 now.
(12) Our first question comes from
(13) Dan Jenkins with the State of Wisconsin
(14) Investments.
(15) DAN JENKINS: Good morning.
(16) MR. LILLY: Good morning, Dan,
(17) how are you?
(18) DAN JENKINS: Pretty good.
(19) Thanks for holding my call, I have a
(20) couple things. First of all, on flag 16,
(21) you know, you talked about the recoveries
(22) related to the ICC bankruptcy case, and I
(23) was wondering if you could give me a
(24) little more detail on (inaudible) the

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(1) group 1 -- the group 2 assets and the one
(2) in the group 1 assets and then what was
(3) the recovery. You know, you mentioned
(4) that the groups that have already been
(5) sold, what's the amount of proceeds you
(6) were able to realize from that?
(7) MR. LILLY: Yeah, the group 2
(8) assets primarily consisted of what we
(9) referred to as down allen (phonetic)
(10) assets, which are properties that the
(11) trustees were able to negotiate a sale on
(12) those properties. We are still in the
(13) process of waiting for the net proceeds
(14) being delivered to National Rural. The
(15) group 1 assets primarily consist of the
(16) properties on St. Thomas, St. John's, St.
(17) Croix and the British Virgin Islands.
(18) We're targeting a potential sale hearing
(19) for those in the middle of February at
(20) this point, and at this juncture we have
(21) not made a public release on the net
(22) expected proceeds for group 2, and we
(23) will be doing that as soon as we finish
(24) haggling with the trustee over the relief

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(1) of the net proceeds.
(2) DAN JENKINS: Okay. So the
(3) predominant number of assets are in the
(4) group 1?
(5) MR. LILLY: That's correct.
(6) DAN JENKINS: Okay. Then I had
(7) a couple questions related to your credit
(8) lines and your tier ratio. You know,
(9) obviously, you mentioned the tier ratio
(10) was below the minimum required by the
(11) revolving credit agreements.
(12) MR. LILLY: No, I did -- I did
(13) not -- I did not say that. We did not
(14) earn our target tier for the second
(15) quarter in year to date. We are still
(16) above -- because there's an averaging
(17) formula with regard to our tier for the
(18) revolving credit facility and we still
(19) are above that averaging number and so we
(20) are currently in compliance.
(21) DAN JENKINS: So what credit
(22) facility -- what level are you at, you
(23) know, under the formula used for the
(24) credit agreements?

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(1) MR. LILLY: The credit
(2) agreements (inaudible) of 1.025 average,
(3) so we go back to the prior quarter so we
(4) average them. We'll use this quarter and
(5) go forward as well in each quarter, and
(6) we fully anticipate there will be
(7) compliance.
(8) DAN JENKINS: So what was the
(9) actual of that -- of that calculated
(10) ratio at the end of the current quarter?
(11) MR. LILLY: Yeah, we
(12) don't -- that's a number -- you can
(13) calculate it but we don't report it.
(14) DAN JENKINS: Okay. And then
(15) you mentioned that, you know, you have
(16) one -- you have your 364-day facility,
(17) you know, in March, looks like it comes
(18) due and you're in the process of
(19) renegotiating that. I was wondering, for
(20) the other two bank lines, you know, what
(21) are their amounts and expiration dates?
(22) MR. LILLY: They're
(23) approximately a billion dollars apiece,
(24) and in terms of the credit facility we

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(1) have one that matures in 2011, that's a
(2) billion, 025 million, and one that
(3) matures in the spring of 2010 which is a
(4) billion, 125. The one matures in '09,
(5) March, is a billion, 5. And so the other
(6) two multi-years will continue to run and
(7) stay in place, and although we have
(8) Lehman participating in -- at a combined
(9) level of about 130 million dollars, 130
(10) million, we are not counting those
(11) amounts for purposes of bank liquidity,
(12) all right, we're not looking for those,
(13) whatever amount of variable rate
(14) obligations, commercial paper,
(15) guarantees, (inaudible) tier and bonds
(16) and we use the bank (inaudible). We're
(17) downsizing the facility by the amount of
(18) Lehman in that quarter.
(19) DAN JENKINS: And so what's the
(20) outstanding amount under all the
(21) agreements and then under the one that
(22) expires?
(23) MR. LILLY: 3.65 billion minus,
(24) for our purposes, on the 239 from Lehman

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(1) Brothers.
(2) DAN JENKINS: And that's the
(3) availability, not the outstanding?
(4) MR. LILLY: We don't have any
(5) outstanding.
(6) DAN JENKINS: Zero outstanding?
(7) MR. LILLY: Zero outstanding.
(8) DAN JENKINS: Okay.
(9) MR. LILLY: We drew down 418
(10) last year and we'll retain it back. So
(11) the market sort of compressed with the
(12) market maturities, we're serving paper
(13) (inaudible) but we -- we're fortunate to
(14) have the bank fully in place to provide
(15) the insurance, we drew down 418 and we
(16) paid these back to the bank. So we have
(17) zero outstanding to the banks now.
(18) DAN JENKINS: Okay. I think
(19) that's all I have. Thank you.
(20) MR. LILLY: Thanks, Dan.
(21) UNIDENTIFIED SPEAKER: Thank
(22) you.
(23) UNIDENTIFIED SPEAKER: Hey, good
(24) morning, Steve.

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(1) MR. LILLY: Good morning, Ted,
(2) how are you doing?
(3) UNIDENTIFIED SPEAKER: Good,
(4) good. I want to follow up on the ICC
(5) situation. Could you tell us, first of
(6) all, what level you have the ICC assets
(7) on your books right now following the
(8) write-down?
(9) MR. LILLY: That's not a public
(10) number, Ted.
(11) UNIDENTIFIED SPEAKER: Okay.
(12) MR. LILLY: And to be perfectly
(13) honest with you, so everyone understands,
(14) we're in the process of trying to sell
(15) those assets and we don't want to give
(16) the marketplace an indication of what we
(17) have reserved, otherwise they will come
(18) in below that offer, below that level.
(19) UNIDENTIFIED SPEAKER: Okay.
(20) MR. LILLY: That is the primary
(21) reason for minimizing the extent to which
(22) we don't disclose the level of the
(23) reserves specifically as (inaudible) the
(24) borrowers that are impaired.

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(1) UNIDENTIFIED SPEAKER: Sure.
(2) MR. LILLY: But we have so few
(3) that one could probably get there from
(4) here.
(5) UNIDENTIFIED SPEAKER: Okay.
(6) Just a follow-up to that. Following the
(7) pending sale of the group 2 assets, are
(8) you still comfortable with the current
(9) value on the balance sheet of the -- on
(10) your books of the ICC assets?
(11) MR. LILLY: Yeah, we're -- we
(12) have already sold the group 2 assets,
(13) we're now in a pending sale of the group
(14) 1 assets, and we're adequately reserved
(15) with regard to the recovery expectations
(16) associated with the entirety of the ICC
(17) credit.
(18) UNIDENTIFIED SPEAKER: Okay.
(19) Secondly, can you give us some color on
(20) the commercial paper market with regard
(21) to your access to it and what types of
(22) rates you're seeing out there and how the
(23) market has been reacting over the last
(24) month or so?

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(1) MR. LILLY: Yeah. Let me just
(2) highlight that in the CP marketplace
(3) after the commercial paper funding
(4) facility was authorized through the New
(5) York fed, we're -- we've seen the
(6) investors' appetite for CP in terms of
(7) maturity levels also with the liquidity
(8) facility offered up to money market for
(9) the funds, also with an injection of the
(10) net GAAP liquidity for all (inaudible)
(11) for A1, T1, F1, we qualified for the
(12) CPFF, we filed our application, we were
(13) approved rather quickly with our
(14) application, and we have since issued, to
(15) really get all of the terms, the end of
(16) the year we just -- we have outstanding
(17) about a billion, 1 or so in paper for the
(18) CPFF.
(19) UNIDENTIFIED SPEAKER: Right.
(20) And what --
(21) MR. LILLY: And since we've
(22) been -- that marketplace has been
(23) supported by the feds, we see no problems
(24) for us to go out of the 30 days or longer

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(1) and we've seen the rate levels at .3 to
(2) .4 for 30 to 40 basis points. So it's
(3) been a very attractive funding vehicle
(4) for us as well as for other A1 issuers.
(5) And actually it's less expensive now and
(6) the availability is greater than the
(7) CPFF, so the real issue for a number of
(8) us will be if this trend continues do
(9) we -- when our CPFF is rolled do we just
(10) roll it back into the normal commercial
(11) paper market.
(12) UNIDENTIFIED SPEAKER: Okay.
(13) Okay. And lastly, just wanted to get a
(14) better understanding of the process that
(15) your company has with increasing rates to
(16) your members. Is there something being
(17) contemplated right now or do you feel
(18) like, you know, you can lower margins in
(19) other ways where you won't need to go to
(20) your members and increase rates?
(21) MR. LILLY: Well, let me just
(22) highlight that we have a number of
(23) different methods here to -- let me just
(24) say to raise equity. I think maybe your

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(1) question is, you know, how do we continue
(2) to raise equity, reduce our adjusted
(3) debt-to-equity ratio. One of which is
(4) through the spread we earn on our credit
(5) product, the numbers, and we feel that
(6) our current pricing structure provides an
(7) opportunity for our borrowers to have
(8) liquidity and capital and, of course,
(9) almost all of our loans that we provide
(10) to our members are based on CFC national
(11) rule cost to capital, and very few of our
(12) loans are based on an index. So to the
(13) extent our spreads with coming in with
(14) regard to funding, we have the
(15) opportunity to lower rates as well.
(16) Likewise, if the spreads widen out,
(17) there's not an opportunity for investors
(18) to ask for a wider spread on our bonds,
(19) but we are able to price that into our
(20) fixed-rate loan products.
(21) The second tool that we have, of
(22) course, is the fact that we are currently
(23) in the market with our numbers attempting
(24) to raise capital, and that -- bonds and

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(1) equity capital is going very well with
(2) our members and we'll be reporting on the
(3) results of that at the end of our third
(4) quarter.
(5) Last but not least, we are a
(6) cooperative organization that over the
(7) years with allocated patronage capital to
(8) our members have paid a percentage of
(9) that to our members at the conclusion of
(10) each fiscal year, there's no obligation,
(11) it's not mandatory that we do it, and our
(12) board can decide at the end of any fiscal
(13) year to pay or not pay, to allocate or
(14) not to allocate the margins earned. So
(15) those are the principal ways with which
(16) we can generate margins, capture equity,
(17) capture new equity in the form of
(18) investments, or retain equity that's not
(19) paid out in the form of patronage
(20) dividends to our member systems based on
(21) their loan activity with us, to enhance
(22) our ability to continue to build our
(23) foundation of equity underneath the
(24) maturities that we issue in the

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(1) marketplace.
(2) UNIDENTIFIED SPEAKER: Okay.
(3) Great. That's it for me. Thanks,
(4) Steve.
(5) MR. LILLY: Thanks, Ted.
(6) UNIDENTIFIED SPEAKER: Thank
(7) you. Our next question comes from Jim
(8) Applestein with Barkley's Capital.
(9) JIM APPLESTEIN: Hey, Steve, how
(10) are you?
(11) MR. LILLY: Hey Jim, how are
(12) you?
(13) JIM APPLESTEIN: Good, good. A
(14) couple questions. First, maybe I should
(15) just follow up on the last one. I
(16) noticed that your adjusted debt-to-equity
(17) ratio has increased modestly over the
(18) past couple of quarters. Do you have a
(19) target range for where you want to keep
(20) that going forward, and then I guess a
(21) related question, do you have a sense for
(22) how much you might be able to raise in
(23) 2009 through the purchases of the member
(24) equity capital securities program that

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(1) you mentioned?
(2) MR. LILLY: Jim, can you hear me
(3) okay?
(4) JIM APPLESTEIN: Yes.
(5) MR. LILLY: Okay. Yeah, our
(6) target is really based on the asset
(7) quality of our book of business as well,
(8) so it's not just -- in our view not just
(9) a number that we try to focus on, but it
(10) is based on the financial performance of
(11) our assets of the business and -- which
(12) continues to perform solidly during these
(13) times. Ideally we want to, you know,
(14) focus on a ratio that is less than 8 to 1
(15) on an adjusted basis. The rationale
(16) behind the member capital security rate
(17) is to maintain a balance with regard to
(18) the amounts of under pending of equity
(19) the members have invested in National
(20) Rural and our expectation with regard to
(21) growth. We have been (inaudible) to as a
(22) primary source of growth with regard to
(23) our members, capital for infrastructure
(24) since there's been essentially a

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(1) reduction in availability from other
(2) private sources in the last six or seven
(3) months, and so we recognize that
(4) particular fact and started the member
(5) capital raise effort.
(6) So to be pretty simple with the
(7) answer here, you know, targeting around 8
(8) to 1 or lower, and at this point I cannot
(9) give you the member capital raise. We
(10) filed a Wixey shelf (phonetic) with
(11) regard to these securities and the teams
(12) are out marshalling the talent to secure
(13) the capital from the members, and we will
(14) be reporting on that net result by the
(15) time we get to the end of February.
(16) JIM APPLESTEIN: Great. Thanks,
(17) Steve. On the 364-day utility, have you
(18) started the renewal process at this point
(19) and do you have a sense at this stage,
(20) one, for available bank capacity in terms
(21) of your ability to roll the 1.5 billion;
(22) and second, any sense for whether pricing
(23) is likely to move up from what you've
(24) seen historically in renewing that

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(1) facility?
(2) MR. LILLY: Yeah, we fully
(3) anticipate that the 1.5 billion will
(4) probably be the upside of a range of what
(5) we're targeting by mid March, and at this
(6) point the lower end of the range will
(7) probably be 1.1 to 1.2 billion, at the
(8) top end probably 1.5. We've recognized
(9) the number of participants in the bank
(10) market continues to shrink, and available
(11) capital resources to be re-deployed in
(12) these type of facilities continues to be
(13) a challenge for all issuers, and in that
(14) regard we have diversified our funding
(15) sources, for instance, the $500,000,000
(16) credit facility we got from Farmer Mac
(17) which already issued $395,000,000 and
(18) have another $105,000,000 to issue, that
(19) will go a long way towards replacing
(20) whatever shortfall we have with regard to
(21) the one facility that we are in the
(22) process of renewing. As all of you know,
(23) the pricing, pricing spreads have widened
(24) and we fully anticipate that there will

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(1) be an increase in costs associated with
(2) any credit facility that comes to the
(3) market at this point in time.
(4) JIM APPLESTEIN: Thanks, Steve.
(5) And is there any potential for further
(6) borrowing capacity, either from the
(7) REDLAG program or the Farmer Mac program
(8) for '09 beyond the 3 billion and the 900
(9) million that you already have?
(10) MR. LILLY: Well, the REDLAG
(11) program, there's another $500,000,000 in
(12) the federal budget and we're attempting
(13) to get the Department of Agriculture to
(14) release that 500,000,000. There may be
(15) additional amounts made available in the
(16) stimulus package being put forward by the
(17) new President's administration. Just
(18) giving you a highlight that we -- we
(19) could be one of the few participants in
(20) any of these stimulus packages that can
(21) commit to and report on the success of
(22) accessing capital and redeploying it for
(23) infrastructure development, for
(24) re-lending, providing capital to rural

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(1) utilities that will stimulate the
(2) economy, and that's really the strong
(3) argument that we have put forward with
(4) other financial institutions that have
(5) participated in TARP and the capital --
(6) the CP program have not been able to
(7) really -- so 500 billion is
(8) (inaudible) -- currently available, may
(9) be new funding available under that
(10) guaranteed note program under the
(11) stimulus, and of course, we'll be at the
(12) door of the treasury knocking on the door
(13) to participate.
(14) With regard to Farmer Mac, there
(15) are no additional current commitments,
(16) but we work very diligently with them to
(17) determine whether or not there may be
(18) some other liquidity features that the
(19) National Rural will benefit from.
(20) JIM APPLESTEIN: Great. Thanks,
(21) Steve. One quick question on ICC. You
(22) said you've got the auction hearing in
(23) February, there are some regulatory
(24) approvals that would be needed on the

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(1) sale of some of the pieces, as I
(2) understand it, from the two, most
(3) notably, I guess, by Telco, any sense for
(4) what your timing horizon might look like
(5) in terms of being able to close those
(6) sales once the auctions are completed?
(7) MR. LILLY: The regulatory
(8) estimated time frame is roughly six
(9) months after a sale hearing.
(10) JIM APPLESTEIN: Okay. Great.
(11) And then finally, in terms of, I know you
(12) all actively monitor your members, are
(13) you seeing any kinds of weakness or
(14) deteriorating financial performance among
(15) your top 10 borrowers?
(16) MR. LILLY: Our top 10, no, at
(17) this point they're solidly performing
(18) and -- nor do we see any weakness among
(19) the rest of the portfolio, just to
(20) highlight that for you.
(21) JIM APPLESTEIN: Great. Thanks,
(22) Steve. Maybe a last quick question, I
(23) know there are a number of moving parts,
(24) but any sense for at least what the size

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(1) of your borrowing needs might be for this
(2) year from the public capital market in
(3) terms of term debt financing?
(4) MR. LILLY: A lot of that is
(5) going to be contingent upon our success
(6) in securing funding, whether it's REDLAG,
(7) whether it's additional Farmer Mac
(8) proceeds, whether or not any of these
(9) other programs that have been ruled out
(10) by the federal government are acceptable
(11) by National Rural, and then we'll look to
(12) the capital market as the net filler for
(13) the -- what we view as lower cost capital
(14) that we can secure. I think I
(15) highlighted earlier it might be between
(16) 500 and a billion dollars, but as we look
(17) at some of these other funding options,
(18) and we've been very successful at
(19) securing some of these other funding
(20) options, it will be driven by that level
(21) of success.
(22) UNIDENTIFIED SPEAKER: Thank
(23) you. Our next question comes from John
(24) Antonio with Network Technologies.

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(1) JOHN ANTONIO: Hi, Steve, good
(2) morning. We are a company that is, in
(3) fact, doing a lot of research and also we
(4) are expanding into the different rural
(5) markets and may be applying for some
(6) assistance from you. And in doing some
(7) of our research we came across a number
(8) of articles that were written in the
(9) Virgin Islands, you know, and it -- where
(10) there's some issues between you and one
(11) of your borrowers, and that there was a
(12) civil RICO filed between the parties in
(13) federal court.
(14) MR. LILLY: Let me -- let me
(15) hold off. This is an investor call for
(16) publicly-issued debt securities. I'm not
(17) sure whether you're on the right call or
(18) not. So if I could just -- if you're
(19) with the tech -- if you're with a
(20) technology firm you're probably on the
(21) wrong call.
(22) JOHN ANTONIO: I see, but could
(23) you answer that question? Was there a
(24) RICO filed?

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(1) MR. LILLY: As I indicated,
(2) you're probably on the wrong call.
(3) UNIDENTIFIED SPEAKER: All
(4) right. Thank you. Our next question
(5) comes from Jim Ferguson with AIG.
(6) JIM FERGUSON: Good morning,
(7) Steve. On the -- referring to page 16,
(8) the group 2 asset sale at ICC. Can you
(9) tell us, is it public information as to
(10) what the sale proceeds were?
(11) MR. LILLY: It is not public
(12) information at this time, and as I
(13) indicated earlier to someone who asked a
(14) question, we are working through the
(15) distribution of the net sale proceeds
(16) with the Chapter 11 trustee.
(17) JIM FERGUSON: Okay. Who is the
(18) trustee, and are there any public
(19) documents regarding the trustee or the
(20) sale, or is it completely private and --
(21) MR. LILLY: Again, the net
(22) proceeds are still under discussion --
(23) JIM FERGUSON: Yeah.
(24) MR. LILLY: -- with the Chapter

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(1) 11 trustees, so there's no public
(2) documents with regard to the --
(3) JIM FERGUSON: The trustee
(4) doesn't have to file anything with the
(5) court?
(6) MR. LILLY: Once those
(7) discussions have been settled then there
(8) will be a filing with the court.
(9) JIM FERGUSON: Okay. Are there
(10) any other creditors who are --
(11) (inaudible) pursue with NRU -- with the
(12) RTFC regarding those proceeds for the
(13) group 2 assets, or are you the only
(14) creditor?
(15) MR. LILLY: Well, we are the
(16) only senior-secured creditor with regard
(17) to the distribution of those assets.
(18) JIM FERGUSON: So what's the
(19) nature of any discussions? I mean,
(20) shouldn't it all go to NRUC?
(21) MR. LILLY: We are under
(22) discussion with the trustee as to how to
(23) apply those proceeds that have been
(24) received.

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(1) JIM FERGUSON: But the
(2) application should be all to RTFC,
(3) shouldn't it?
(4) MR. LILLY: We're in a
(5) bankruptcy court setting, and in that
(6) regard the court has directed the Chapter
(7) 11 trustee and National Rural, which is
(8) us acting on behalf of RTFC, to review
(9) and discuss how the application of the
(10) net proceeds.
(11) JIM FERGUSON: Okay. All right.
(12) Referring to page 18, the unsecured
(13) loans, you have 13 percent of the
(14) outstandings. Question, are any of the
(15) unsecured loans made to organizations
(16) that are not also secured borrowers?
(17) MR. LILLY: There may be a very
(18) small number of borrowers that just have
(19) unsecured loans to us but they are very
(20) high credit quality if they are. For the
(21) most part, any loans made on an unsecured
(22) basis would be supporting an overall
(23) credit facility of a senior-secured
(24) borrower to National Rural.

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(1) JIM FERGUSON: Okay. And for
(2) those who are not -- don't also have
(3) secured loans, what would their nature
(4) be, are they some of the State
(5) organizations?
(6) MR. LILLY: That would be, for
(7) the most part they'll be rural electric
(8) cooperatives.
(9) JIM FERGUSON: Oh, okay.
(10) MR. LILLY: We do have a number
(11) of rural electric cooperatives that are
(12) 100 percent or very high equity levels as
(13) well that we extend unsecured credit.
(14) JIM FERGUSON: Okay. And a
(15) question on the -- on page -- slide 20A,
(16) your comment on Farmer Mac and the whole
(17) loan sale program. Some information,
(18) please, on the whole loan sale program,
(19) are these loans you make to your members
(20) and then package, or you or some banker
(21) packages them and then sells them off, is
(22) that the nature?
(23) MR. LILLY: No, typically they
(24) are facilities that we have originated

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(1) with the rural electric distribution
(2) companies that have been sold to Farmer
(3) Mac principally at par, we have
(4) outstanding -- that we continue to
(5) service those loans, the common borrowers
(6) that we're still providing credit to
(7) those borrowers and a portion of their
(8) exposure is sold to Farmer Mac, roughly
(9) $440,000,000 in outstanding --
(10) JIM FERGUSON: And that's in
(11) addition to the direct loans you have
(12) from Farmer Mac?
(13) MR. LILLY: That's in addition
(14) to the direct new placements that we have
(15) closed with Farmer Mac as well.
(16) JIM FERGUSON: Okay.
(17) That's -- and this program would not
(18) decrease the amount available from Farmer
(19) Mac, or would it?
(20) MR. LILLY: They're two separate
(21) facilities.
(22) JIM FERGUSON: Okay.
(23) MR. LILLY: Because Farmer Mac
(24) takes on the credit risk of the

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(1) underlying borrowers --
(2) JIM FERGUSON: Yep.
(3) MR. LILLY: -- that is a
(4) different obligation versus an obligation
(5) in that rule.
(6) JIM FERGUSON: Okay. Thanks,
(7) Steve.
(8) MR. LILLY: All right. Thank
(9) you.
(10) UNIDENTIFIED SPEAKER: Thank
(11) you. Again, if anyone would like to ask
(12) a question, please press star 1 on your
(13) touch-tone phone. Our next question
(14) comes from Jose Almonte with Legal in
(15) General.
(16) JOSE ALMONTE: All my questions
(17) were asked and answered, thank you.
(18) MR. LILLY: Thank you, Jose. I
(19) have time for maybe one or two more,
(20) so --
(21) UNIDENTIFIED SPEAKER:
(22) Mr. Lilly, it looks like we have no
(23) further questions at this time.
(24) MR. LILLY: Okay. Well, I thank

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(1) everyone for participating, hopefully
(2) this call is helpful. As I've indicated,
(3) we'll be on the road, we're scheduling
(4) breakfast and luncheon meetings in
(5) various parts of the country, and
(6) hopefully you can carve out some time to
(7) join us. And again, we'll continue to be
(8) as open and transparent as we possibly
(9) can given the current state of events as
(10) they unfold.
(11) We'll be moving forward with our
(12) third quarter and fourth quarter
(13) activity, which we fully anticipate will
(14) continue the historic trends that
(15) National Rural has demonstrated in the
(16) capital markets and our ability to
(17) continue to serve the rural electric
(18) cooperative organizations spread out
(19) across the country that provide these
(20) essential services. I'd like to thank
(21) you again for your support and your
(22) participation today. Thank you.
(23) UNIDENTIFIED SPEAKER: This
(24) concludes today's presentation, you may

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(1) disconnect at this time.
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(1) C E R T I F I C A T E
(2) I, Veronica Buettner, a Notary Public in and for
(3) the State of Ohio, do hereby certify that this is a
(4) transcription of the aforementioned matter taken from
(5) the original recording of the aforesaid matter.
(6) IN WITNESS WHEREOF, I have hereunto set my hand
(7) and affixed my seal of office at Toledo, Ohio, on this
(8) 4th day of February, 2009.
(9)
(10)
(11)
(12)
VERONICA BUETTNER
(13) Notary Public
in and for the State of Ohio
(14)
(15)
(16) My Commission expires January 24, 2013.
(17)
---
(18)
(19)
(20)
(21)
(22)
(23)
(24)

Concordance Report
- - -
Unique Words: **1,328**
Total Occurrences: **4,382**
Total Words In File: **8,524**
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