

ORIGINAL NEW APPLICATION



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BEFORE THE ARIZONA CORPORATION COMMISSION

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G-02528A-06-0729  
E-01703A-06-0729

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IN THE MATTER OF THE APPLICATION OF )  
DUNCAN RURAL SERVICES CORPORATION )  
TO TRANSFER ITS ASSETS TO DUNCAN )  
VALLEY ELECTRIC COOPERATIVE, INC. )

DOCKET NO. G-02528A-06-\_\_\_\_\_

APPLICATION

Duncan Rural Services Corporation ("DRSC"), pursuant to A.R.S. § 40-285, requests Commission authorization to transfer its assets to Duncan Valley Electric Cooperative, Inc. ("DVEC") as part of a reorganization of DRSC as a natural gas division of DVEC.

In support of its Application, DRSC states as follows:

1. DRSC is a non-profit natural gas distribution corporation that provides service to about 750 consumers in Greenlee County.
2. DVEC is a non-profit rural electric distribution cooperative that provides service to approximately 2,500 customers in Greenlee County and southwestern New Mexico.
3. DVEC holds a controlling interest of 1,000 memberships in DRSC. DVEC and DRSC have separate Boards of Directors. However, the same individuals serve on the Boards of both utilities. DVEC manages the operations of DRSC, including its operational and capital expenditures, and records these expenditures on a company-by-company basis pursuant to an Operations and Management Agreement.
4. By way of background, DRSC, with financing supplied by DVEC, acquired the natural gas system in 1989 from General Utilities, Inc. ("General"). General's system at time of purchase was in serious disrepair and had been cited numerous times for violations by the

1 Commission's Pipeline Safety Section. Although some of these problems were known at time of  
2 purchase and an escrow fund for repairs/replacements was established from the seller's proceeds,  
3 the magnitude of the problems was not known. For example, shortly after acquisition, DRSC  
4 determined that system losses were 36%. These were reduced to 8% by 1992 and the system was  
5 brought into substantial compliance. But, DRSC has had to continue to replace pipe and meters  
6 and make extensive repairs to the aged natural gas distribution system. From 1989 until  
7 December 31, 2005, DRSC has invested approximately \$1.344 million in plant replacements and  
8 improvements. DRSC expects its average annual capital budget to be \$80,000 for the next five  
9 years.

10 5. The Commission has authorized four rate increases for DRSC ranging from a 24%  
11 to a 31% increase in revenues (Decision No. 58356 dated July 23, 1993; Decision No. 59539  
12 dated February 21, 1996; Decision No. 64869 dated June 5, 2002; Decision No. 68599 dated  
13 March 23, 2006). In its most recent rate case, the Commission found that DRSC had suffered a  
14 net loss in the test year of approximately \$71,000. DRSC's customer base is decreasing, not  
15 growing, which allows expenses to outpace revenues. Despite these rate increases, DRSC's  
16 financial condition has not improved, in part, because of its declining customer base, high  
17 purchased natural gas costs related to cash flow and increases in other expenses.

18 6. Therefore, DRSC estimates that, even with this year's rate increase, it will  
19 experience negative cash flows starting in 2006 due primarily to the annual capital budget  
20 expenditures of \$80,000 and a continuation of net operating losses.

21 7. Since DRSC's inception, DVEC has had to advance DRSC funds to pay for  
22 necessary capital expenditures and working capital. Since 1989, DVEC has lent DRSC over  
23 \$1.3 million in long-term debt. As discussed in the last rate case, the Company's poor financial  
24 condition does not allow it to incur debt on its own credit. The National Rural Utilities  
25 Cooperative Finance Corporation ("CFC") or any other lender would require all lending to DRSC  
26 to be guaranteed by DVEC.

1           8.       DVEC's and DRSC's Boards and management have recognized the importance of  
2 DRSC no longer being reliant upon DVEC and its members for financial support. The  
3 Commission also acknowledged that in Decision No. 68599. Further, given the treatment of the  
4 funds advanced by DVEC for working capital in Decision No. 68599 as well as DVEC's current  
5 financial position of low margins and a decline in cash and equivalents, DVEC can no longer  
6 afford to advance or lend funds to DRSC. In light of this, on February 6, 2006, DVEC's Board of  
7 Directors voted to eliminate all future lending to DRSC after April 1, 2006.

8           9.       DRSC's Board has also been concerned about the effects of numerous rate  
9 increases on its customers and about DRSC's long-term viability. As a result of all these factors,  
10 the Boards and management have been investigating ways to control costs and provide future  
11 outside sources of debt capital for the natural gas system through a reorganization of DRSC.

12          10.      By this Application, DRSC requests Commission approval of the reorganization of  
13 DRSC as a division of DVEC. As a result of this reorganization, DRSC would cease to exist as a  
14 separate legal and tax entity. Its assets, certain liabilities and capital would be transferred to a  
15 natural gas division of DVEC.

16          11.      The reorganization has several benefits. As a division of DVEC, DRSC would be  
17 eligible to receive financing from one of DVEC's lenders, CFC, at more favorable terms that are  
18 not available to DRSC as a stand-alone corporation. The reorganization would also eliminate  
19 DRSC's negative equity issues which the Commission and Staff have expressed concerns about –  
20 without materially affecting DVEC's strong equity profile. A simplified governance structure,  
21 insurance savings and other operational cost benefits would also be available to the consolidated  
22 DVEC.

23          12.      DVEC is a non-profit electric distribution cooperative which is exempt from  
24 federal income taxes under Internal Revenue Code § 501(c)(12). Therefore, there are no tax  
25 impacts to DVEC as a result of the reorganization. While DRSC is also a non-profit corporation  
26 pursuant to state statute, DRSC operates as a taxable entity for federal tax purposes because

1 DRSC does not meet the IRS "one member, one vote" § 501(c)(12) cooperative rule due to the  
2 1,000 memberships held by DVEC. The IRS made this determination in a prior year when DRSC  
3 applied for a § 501(c)(12) exemption from federal income taxes. As a division of DVEC,  
4 however, DRSC would no longer be considered a taxable entity. All DRSC members would  
5 become members of DVEC (if they are not currently) and would receive DVEC natural gas  
6 division capital credits to the extent the gas division generates cumulative margins in excess of  
7 cumulative losses. There are no major tax impacts to DRSC from the reorganization.

8 13. There are no rate impacts to DVEC's or DRSC's members resulting from the  
9 reorganization. The amounts owed to DVEC by DRSC will be classified as inter-divisional  
10 advances and will not bear interest or have a maturity date after the reorganization. In years that  
11 the natural gas division experiences excess cash flow, DRSC will use these funds to pay down  
12 these inter-divisional advances. The only financial impact to DVEC and DVEC's members is the  
13 repayment of the long-term debt that was owed to DVEC prior to reorganization will take place  
14 over a longer term, will not be made in fixed amounts and will not bear interest. However, absent  
15 the reorganization, DRSC does not have the ability to repay the long-term debt owed to DVEC as  
16 well as fund its expenses and capital budget. In fact, DRSC has not made a principal repayment  
17 to DVEC since December 2004.

18 14. DVEC's expense and other allocations to DRSC for shared employees and plant  
19 and expense allocations will remain the same as before the transfer. DVEC employees who have  
20 been operating the natural gas system for several years will continue in the same role after the  
21 reorganization. DVEC's expenses and the number of employees for DVEC and DRSC will not  
22 change as a result of the reorganization. As discussed previously, DVEC and DRSC do anticipate  
23 some operational cost benefits as a result of the reorganization.

24 15. Attached to this Application are four exhibits illustrating the structural and  
25 expected financial effects of the reorganization:  
26

1           a.     Exhibit A is organizational charts of DVEC and DRSC illustrating  
2 structure before and after the reorganization.

3           b.     Exhibit B consolidates the December 31, 2005 balance sheets of DVEC  
4 and DRSC, which estimates the financial position of DVEC had the reorganization  
5 occurred as of that date.

6           c.     Exhibit C consolidates the income statements for DVEC and DRSC for the  
7 year ended December 31, 2005, which illustrates the impact of operating DRSC as a  
8 natural gas division of DVEC.

9           d.     Exhibit D consolidates the cash flow statements for DVEC and DRSC for  
10 the year ended December 31, 2005, which illustrates the overall net cash inflow (outflow)  
11 to DVEC had DRSC been operated as a division of DVEC.

12         16.     Cash flow improvement resulting from the reorganization will be used to support  
13 the natural gas division's annual capital budget of \$80,000, improve equity, repay any future debt  
14 secured from outside lenders such as CFC and pay down the advances due to the DVEC electric  
15 division.

16         17.     To accomplish the reorganization, DRSC will dissolve and contribute its assets  
17 and certain liabilities to DVEC. DRSC's debt to DVEC will not be reflected on DVEC's  
18 consolidated balance sheet. As stated above, any amounts previously owed DVEC by DRSC will  
19 be classified as inter-divisional advances without structured payments that would be reduced by  
20 the future positive cash flow in the newly-formed DVEC gas division. There are no changes to  
21 DVEC's or DRSC's bylaws that are necessary to dissolve and contribute DRSC's assets to  
22 DVEC.

23         WHEREFORE, having fully stated its Application, DRSC requests that the Commission  
24 enter its Order approving the transfer of DRSC's assets to DVEC as part of the reorganization.

25         Further communications and notices concerning this matter should be directed to:  
26

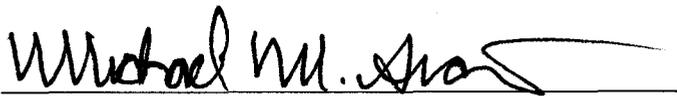
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RESPECTFULLY SUBMITTED this 15<sup>th</sup> day of November, 2006.

GALLAGHER & KENNEDY, P.A.

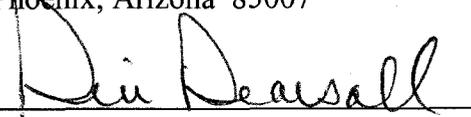
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**Original and thirteen** copies filed this  
15<sup>th</sup> day of November, 2006, with:

Docket Control  
Arizona Corporation Commission  
1200 West Washington  
Phoenix, Arizona 85007

**Copy** of the foregoing delivered this  
15<sup>th</sup> day of November, 2006, to:

James Dorf  
Utilities Division  
Arizona Corporation Commission  
1200 West Washington  
Phoenix, Arizona 85007

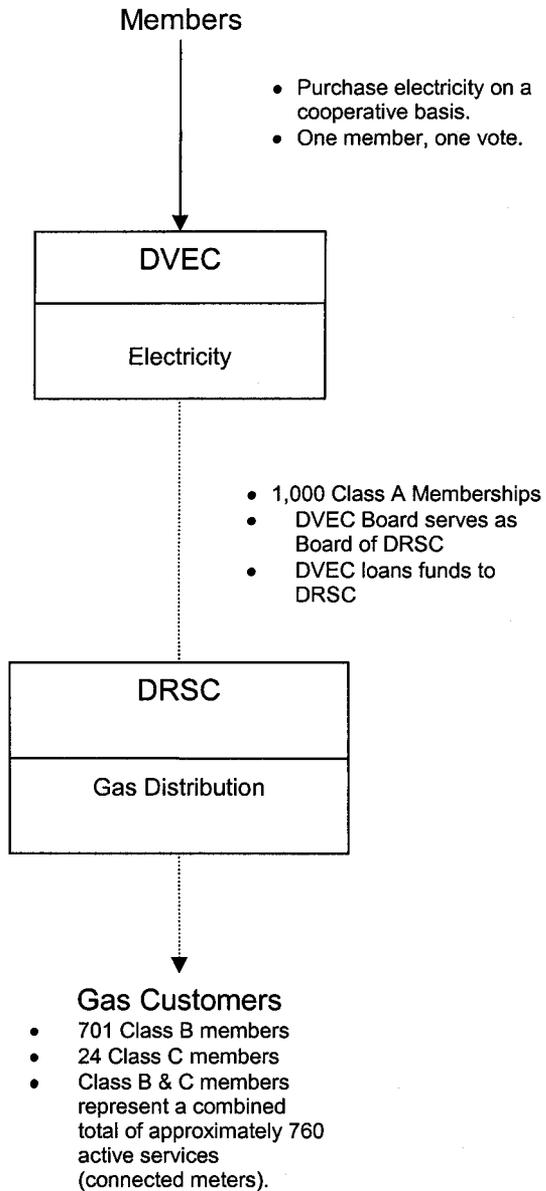


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**EXHIBIT A**

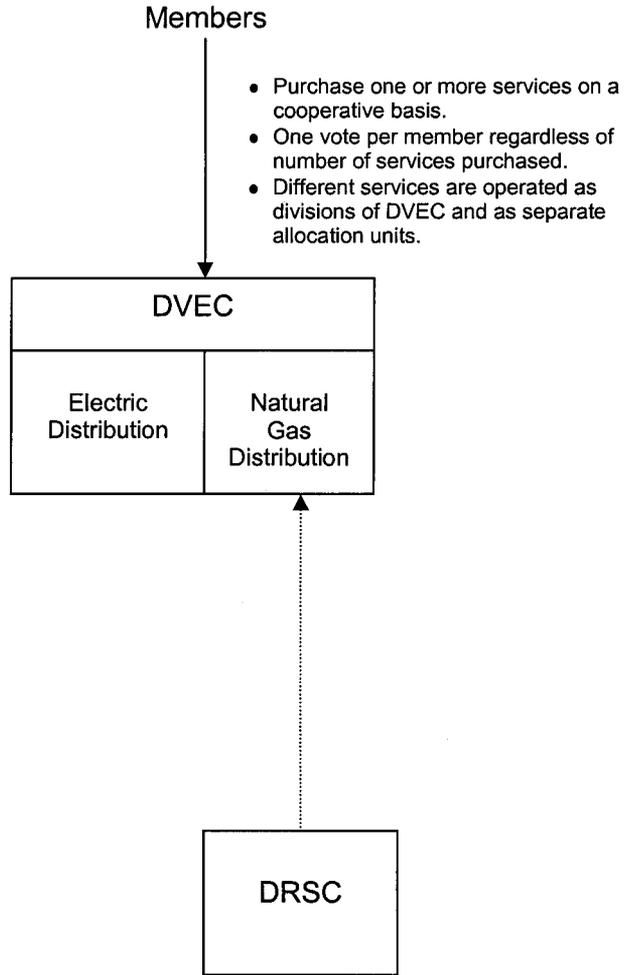
# EXHIBIT A

## Current Organizational Structure of DVEC & DRSC



# EXHIBIT A

## Multi-Divisional Cooperative Structure after Proposed Reorganization



**EXHIBIT B**

EXHIBIT B

DUNCAN VALLEY ELECTRIC COOPERATIVE, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEET  
DECEMBER 31, 2005

ASSETS

	DVEC Actual	Adjustment	DVEC Adjusted	DRSC	Eliminating Entries	Total
<b>UTILITY PLANT AT COST</b>						
Plant in Service	\$ 7,460,458	\$	\$ 7,460,458	\$ 1,313,207	\$	\$ 8,773,665
Construction Work in Progress	121,390		121,390	8,761		130,151
	\$ 7,581,848	\$ 0	\$ 7,581,848	\$ 1,321,968	\$ 0	\$ 8,903,816
Less: Accumulated Provision for Depreciation	4,370,907		4,370,907	607,460		4,978,367
	\$ 3,210,941	\$ 0	\$ 3,210,941	\$ 714,508	\$ 0	\$ 3,925,449
<b>OTHER PROPERTY AND INVESTMENTS - AT COST OR STATED VALUE</b>						
Non-Utility Property	\$ 22,728	\$	\$ 22,728	\$	\$	\$ 22,728
Investments in Associated Organizations	476,459		476,459	1,000	(5,000)	472,459
Notes Receivable (Less allowance for uncollectibles of \$94,539)	491,871	92,356	584,227		(514,775)	69,452 (1)
	\$ 991,058	\$ 92,356	\$ 1,083,414	\$ 1,000	\$ (519,775)	\$ 564,639
<b>CURRENT ASSETS</b>						
Cash - General	\$ 43,685	\$	\$ 43,685	\$ 10,454	\$	\$ 54,139
Temporary Cash Investments	1,172,126		1,172,126			1,172,126
Accounts Receivable (Less allowance for uncollectibles of \$212,153)	239,601		239,601	116,759		356,360
Accounts Receivable - Related Companies (Less allowance for uncollectibles of \$197,190)	435,085		435,085		(359,674)	75,411 (2)
Accounts Receivable - Underbilled Power Cost	41,857		41,857			41,857
Power Cost Adjustments - Underbilled				47,319		47,319
Materials and Supplies	154,784		154,784	26,389		181,173
Interest Receivable	2,066		2,066			2,066
Other Current and Accrued Assets	67,144		67,144	13,338		80,482
	\$ 2,156,348	\$ 0	\$ 2,156,348	\$ 214,259	\$ (359,674)	\$ 2,010,933
<b>DEFERRED CHARGES</b>						
	\$ 149,163	\$	\$ 149,163	\$ 29,712	\$	\$ 178,875
	\$ 6,507,510	\$ 92,356	\$ 6,599,866	\$ 959,479	\$ (879,449)	\$ 6,679,896

EQUITIES AND LIABILITIES

<b>EQUITIES</b>						
Memberships	\$	\$	\$ 0	\$ 5,000	\$ (5,000)	\$ 0
Patronage Capital	7,537,214	92,356	7,629,570		199,373	7,828,943
Other Equities	(1,539,703)		(1,539,703)		(222,979)	(1,762,682)
Retained Earnings (Deficit)				(222,979)	222,979	0
Unrealized Gain on Available-for-Sale Securities	92,676		92,676			92,676
	\$ 6,090,187	\$ 92,356	\$ 6,182,543	\$ (217,979)	\$ 194,373	\$ 6,158,937
<b>LONG-TERM DEBT</b>						
RUS Mortgage Notes Less Current Maturities	\$ 19,201	\$	\$ 19,201	\$	\$	\$ 19,201
CFC Mortgage Notes Less Current Maturities	9,900		9,900			9,900
Notes Payable Less Current Maturities Duncan Valley Electric Cooperative, Inc.				475,958	(475,958)	0
	\$ 29,101	\$ 0	\$ 29,101	\$ 475,958	\$ (475,958)	\$ 29,101
<b>CURRENT LIABILITIES</b>						
Current Maturities of Long-Term Debt	\$ 11,900	\$	\$ 11,900	\$	\$	\$ 11,900
Current Portion of Notes Payable				41,000	(41,000)	0
Accounts Payable - Purchased Power	122,829		122,829			122,829
Accounts Payable - Other				60,868		60,868
Accounts Payable - Duncan Valley Electric Cooperative, Inc.				556,864	(556,864)	0
Accrued Taxes	32,721		32,721	16,159		48,880
Accrued Interest				2,874		2,874
Consumers' Deposits and Prepayments	35,670		35,670	18,635		54,305
Accrued Employee Compensated Absences	134,047		134,047			134,047
Accrued Payroll	13,820		13,820			13,820
Other Current and Accrued Liabilities	29,913		29,913	5,100		35,013
	\$ 380,900	\$ 0	\$ 380,900	\$ 701,500	\$ (597,864)	\$ 484,536
<b>DEFERRED CREDITS</b>						
	\$ 7,322	\$	\$ 7,322	\$	\$	\$ 7,322
	\$ 6,507,510	\$ 92,356	\$ 6,599,866	\$ 959,479	\$ (879,449)	\$ 6,679,896
Equity to Assets Ratio	93.59%		93.68%	-22.72%		92.20%
Equity to Capitalization Ratio	99.33%		99.34%	-72.91%		99.34%

PROMISSORY NOTE	(1)	128.50	12,743.00	Grand Canyon Note
OTHER SPECIAL FUNDS - MEMBER LOANS		128.70	56,708.77	Member Loans
RESERVE FOR UNCOLLECTABLE LOANS		128.80	(92,356.08)	DRSC - 50% of outstand loans - Eliminated
		128.80	(2,183.00)	Current Year Accrual - Eliminated
		128.80	69,451.77	(94,539.08)

(2) Includes allowance of \$197,190 to account for loss on advances to DRSC - Eliminated

Aznex	72,758
TUA	2,653
	<u>75,411</u>

**EXHIBIT C**

## EXHIBIT C

**DUNCAN VALLEY ELECTRIC COOPERATIVE, INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENT OF INCOME AND PATRONAGE CAPITAL**  
**FOR THE YEARS ENDED DECEMBER 31, 2005**

	DVEC Actual	Adjustment	DVEC Adjusted	DRSC	Eliminating Entries	Total
<b>OPERATING REVENUES</b>						
Residential	\$ 1,650,278	\$	\$ 1,650,278	\$ 449,414	\$	\$ 2,099,692
Irrigation	206,914		206,914	86,719		293,633
Commercial and Industrial	490,719		490,719	82,120		572,839
Public Street and Highway Lighting	12,317		12,317			12,317
Power Cost Under (Over) Billed	10,010		10,010	25,042		35,052
Internet and Satellite Dish Revenues	559,261		559,261			559,261
Rent from Electric Property	29,612		29,612			29,612
Other Operating Revenues	16,716		16,716	5,125		21,841
Total Operating Revenues	<u>\$ 2,975,827</u>	<u>\$ 0</u>	<u>\$ 2,975,827</u>	<u>\$ 648,420</u>	<u>\$ 0</u>	<u>\$ 3,624,247</u>
<b>OPERATING EXPENSES</b>						
Purchased Power	\$ 1,399,568	\$	\$ 1,399,568	\$ 349,121	\$	\$ 1,748,689
Distribution - Operation	353,124		353,124	137,040		490,164
Distribution - Maintenance	63,992		63,992	55,138		119,130
Customer Accounts	387,874	(92,356)	295,518	47,368	(199,373)	143,513
Customer Service and Information	14,097		14,097			14,097
Administrative and General	221,317		221,317	55,273		276,590
Internet and Satellite Dish Expenses	455,642		455,642			455,642
Depreciation and Amortization	290,933		290,933	39,107		330,040
Taxes				16,109		16,109
Other Interest	1,258		1,258			1,258
Total Operating Expenses	<u>\$ 3,187,805</u>	<u>\$ (92,356)</u>	<u>\$ 3,095,449</u>	<u>\$ 699,156</u>	<u>\$ (199,373)</u>	<u>\$ 3,595,232</u>
<b>OPERATING MARGINS (LOSS) - BEFORE FIXED CHARGES</b>						
	\$ (211,978)	\$ 92,356	\$ (119,622)	\$ (50,736)	\$ 199,373	\$ 29,015
<b>FIXED CHARGES</b>						
Interest on Long-Term Debt	2,720		2,720	27,223	(27,223)	2,720
<b>OPERATING MARGINS (LOSS) - AFTER FIXED CHARGES</b>						
	\$ (214,698)	\$ 92,356	\$ (122,342)	\$ (77,959)	\$ 226,596	\$ 26,295
Capital Credits	8,848		8,848			8,848
<b>NET OPERATING MARGINS (LOSS)</b>						
	<u>\$ (205,850)</u>	<u>\$ 92,356</u>	<u>\$ (113,494)</u>	<u>\$ (77,959)</u>	<u>\$ 226,596</u>	<u>\$ 35,143</u>
<b>NONOPERATING MARGINS</b>						
Interest Income	\$ 77,887	\$	\$ 77,887	\$ 421	\$ (27,223)	\$ 51,085
Other Nonoperating Income	4,426		4,426			4,426
	<u>\$ 82,313</u>	<u>\$ 0</u>	<u>\$ 82,313</u>	<u>\$ 421</u>	<u>\$ (27,223)</u>	<u>\$ 55,511</u>
<b>NET MARGINS (LOSS) - BEFORE COMPREHENSIVE INCOME &amp; INCOME TAX</b>						
	\$ (123,537)	\$ 92,356	\$ (31,181)	\$ (77,538)	\$ 199,373	\$ 90,654
<b>INCOME TAX BENEFIT (EXPENSE)</b>						
				7,633		7,633
<b>COMPREHENSIVE INCOME</b>						
Gain on Securities Held for Sale	13,242		13,242			13,242
<b>NET MARGINS (LOSS) - AFTER COMPREHENSIVE INCOME &amp; INCOME TAX</b>						
	\$ (110,295)	\$ 92,356	\$ (17,939)	\$ (69,905)	\$ 199,373	\$ 111,529
<b>PATRONAGE CAPITAL - BEGINNING OF YEAR</b>						
	7,537,214		7,537,214			7,537,214
Transfer of Comprehensive Income	(13,242)		(13,242)			(13,242)
Losses Transferred to Other Equities	123,537		123,537	69,905		193,442
<b>PATRONAGE CAPITAL - END OF YEAR</b>						
	<u>\$ 7,537,214</u>	<u>\$ 92,356</u>	<u>\$ 7,629,570</u>	<u>\$ 0</u>	<u>\$ 199,373</u>	<u>\$ 7,828,943</u>

**EXHIBIT D**

## EXHIBIT D

## DUNCAN VALLEY ELECTRIC COOPERATIVE, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENT OF CASH FLOWS  
FOR THE YEARS ENDED DECEMBER 31, 2005

	DVEC Actual	Adjustment	DVEC Adjusted	DRSC	Eliminating Entries	Total
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>						
Net Margins (Loss)	\$ (110,295)	\$	\$ (110,295)	\$ (69,905)	\$ 291,729	\$ 111,529
Adjustments to Reconcile Net Margins to Net Cash Provided by (Used in) Operating Activities						
Depreciation and Amortization	303,858		303,858	39,107		342,965
Capital Credits - Noncash	(8,848)		(8,848)			(8,848)
Increase (Decrease) in Provision for Uncollectible Loans	2,184		2,184		(2,183)	1
Deferred Charges	8,684		8,684	(4,905)		3,779
Deferred Credits	1,071		1,071			1,071
Accounts Receivable	17,166	(92,356)	(75,190)	(28,224)	(197,190)	(300,604)
Inventories and Other Current Assets	771		771	2,166		2,937
Payables and Accrued Expenses	2,684		2,684	8,135		10,819
Advance Billings - Fuel Costs				(25,042)		(25,042)
Net Cash Provided By (Used in) Operating Activities	\$ 217,275	\$ (92,356)	\$ 124,919	\$ (78,668)	\$ 92,356	\$ 138,607
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>						
Gross Additions to Utility Plant	\$ (333,009)	\$	\$ (333,009)	\$ (27,791)		\$ (360,800)
Salvage Value of Retirements and Other Credits	2,342		2,342	186		2,528
Plant Removal Costs	(13,931)		(13,931)	(2,011)		(15,942)
Investments in Associated Organizations	2,752		2,752			2,752
Notes Receivable - Payments Received						0
Notes Receivable - Advances	(12,743)		(12,743)		113,280	100,537
Notes Receivable - Energy Resource Loans (Net)	7,954		7,954			7,954
Net Cash Used in Investing Activities	\$ (346,635)	\$ 0	\$ (346,635)	\$ (29,616)	\$ 113,280	\$ (262,971)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>						
Payments on Long-Term Debt to RUS	\$ (7,513)	\$	\$ (7,513)	\$	\$	\$ (7,513)
Payments on Long-Term Debt to CFC	(3,657)		(3,657)			(3,657)
Advances- Duncan Valley Electric Cooperative				113,280	(113,280)	0
Net Cash Used in Financing Activities	\$ (11,170)	\$ 0	\$ (11,170)	\$ 113,280	\$ (113,280)	\$ (11,170)
DECREASE IN CASH AND CASH EQUIVALENTS	\$ (140,530)	\$ (92,356)	\$ (232,886)	\$ 4,996	\$ 92,356	\$ (135,534)
CASH AND CASH EQUIVALENTS - BEGINNING OF YEAR	1,356,341		1,356,341	5,458		1,361,799
CASH AND CASH EQUIVALENTS - END OF YEAR	\$ 1,215,811	\$ (92,356)	\$ 1,123,455	\$ 10,454	\$ 92,356	\$ 1,226,265
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>						
Cash Paid During the Year for:						
Interest	\$ 2,720	\$	\$ 2,720	\$ 0	\$	\$ 2,720
Income Taxes	\$ 0	\$	\$ 0	\$ 50	\$	\$ 50