

ORIGINAL



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MEMORANDUM

30

TO: Docket Control
FROM: Ernest G. Johnson
Director
Utilities Division

EA for EGJ

DATE: January 30, 2007

RE: STAFF REPORT FOR THE APPLICATION OF MCLEODUSA TELECOMMUNICATIONS SERVICES, INC., FOR APPROVAL TO PARTICIPATE IN CERTAIN FINANCING ARRANGEMENTS (DOCKET NO. T-03267A-06-0622)

Attached is the Staff Report for the application of McLeodUSA Telecommunications Services, Inc. for approval to issue guarantees and pledge its Arizona assets as security for Notes, Exchange Notes and Permitted Indebtedness. Staff recommends conditional approval.

EGJ:All:red

Originator: Alexander Ibhade Igwe

Arizona Corporation Commission
DOCKETED
JAN 30 2007

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Service List for: McLeodUSA Telecommunications Services, Inc.
Docket No. T-03267A-06-0622

Mr. Michael W. Patten
Roshka DeWulf & Patten, PLC
One Arizona Center
400 East Van Buren, Suite 800
Phoenix, Arizona 85004

Ms. Jean L. Kiddoo
Mr. Brett P. Ferenchak
Bingham McCutchen LLP
3000 K Street, NW, Suite 300
Washington, DC 20007

Mr. William A. Haas, Esq.
Vice President and Deputy General Counsel
McLeodUSA Incorporated
One Martha's Way
Hiawatha, Iowa 52233

Mr. Christopher C. Kempley
Chief, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Mr. Ernest G. Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Ms. Lyn Farmer
Chief, Hearing Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

**MCLEODUSA TELECOMMUNICATIONS SERVICES, INC.
DOCKET NO. T-03267A-06-0622**

**APPLICATION FOR APPROVAL
TO PARTICIPATE IN CERTAIN FINANCING ARRANGEMENTS**

JANUARY 30, 2007

STAFF ACKNOWLEDGMENT

The Staff Report for the application of McLeodUSA Telecommunications Services, Inc., Docket No. T-03267A-06-0622 was the responsibility of the Staff member listed below. Alexander Ihade Igwe was responsible for the financial review and analysis.

A handwritten signature in black ink, appearing to read "Ihade Igwe", with a horizontal line extending to the right from the end of the signature.

Alexander Ihade Igwe
Executive Consultant III

EXECUTIVE SUMMARY
MCLEODUSA TELECOMMUNICATIONS SERVICES, INC.
DOCKET NO. T-03267A-06-0622

On September 28, 2006, McLeodUSA Telecommunications Services, Inc. ("MTSI" or "Applicant") filed an application with the Arizona Corporation Commission ("Commission"), for authorization to pledge its Arizona assets as security and act as a co-guarantor for Senior Second Secured Notes issued by its parent, McLeodUSA Incorporated ("McLeodUSA" or "Parent"), and to participate in certain other financing arrangements. MTSI is an Iowa corporation certificated by the Commission to provide (1) resold and facilities-based local exchange and exchange access service pursuant to Decision No. 62627, dated June 9, 2000; and (2) resold interexchange telecommunications services pursuant to Decision No. 68001, dated July 17, 1998. The Applicant provides integrated communication services, including local services, in 25 states in the Midwest, Southwest, Northeast, and Rocky Mountain Regions.

MTSI reports that on September 28, 2006, McLeodUSA issued approximately \$120 million in 10½ percent Senior Second Secured Notes due in 2011 ("Notes"). As part of the transaction, its Parent agreed to substitute the Notes with substantially identical notes ("Exchange Notes"), registered under the Federal securities law, within 180 days. Except for MTSI, McLeodUSA and its other affiliates have issued their guarantees and pledged assets as security for the Notes, and have consented to doing same when the Exchange Notes are issued. Also, the indenture governing the Notes and the Exchange Notes allows McLeodUSA and its subsidiaries, subject to certain conditions, to incur additional debt ("Permitted Indebtedness") and grant additional liens ("Permitted Liens") on their assets, including incurring up to \$26 million aggregate principal of indebtedness secured by liens that would be senior to the above Notes and Exchange Notes.

The Applicant states that proceeds of the Notes have been utilized to liquidate all outstanding debts approved under the exit financing contemplated in its Chapter 11 proceedings. Also, a portion of the proceeds was used to cash collateralized the letters of credit issued by McLeodUSA and all its subsidiaries as well as pay fees and expenses incurred during the offering. The remainder of the proceeds will be expended on general corporate purposes. MTSI claims that the above proposal will not alter its management or daily operations in Arizona, nor impair its ability to continue to serve Arizona customers. Also, the proposal will not change MTSI's current rates for services offered in Arizona. MTSI states that its posted \$600,000 performance bond will be excluded from the proposed encumbrance of Arizona assets.

MTSI states that approval of its participation in the proposed financing arrangements serves the public interest in promoting competition amongst telecommunications carriers. It provides that Applicant with access to greater financial resources, thus enabling it to offer better competitive services that more quickly and effectively benefit Arizona consumers. MTSI asserts that any risk to ratepayers is mitigated because it is a non-dominant carrier, and offers highly competitive services that are readily obtainable from alternate carriers. The Applicant concludes that its participation in the proposed financing arrangements would have little or no negative impact on Arizona ratepayers.

Staff's analysis indicates that approval of Applicant's request for authorization to issue guarantees and pledge its Arizona assets as security for the financial arrangements, as described above, should not further impair its financial status, or hinder its ability to attract capital at fair and reasonable terms or inhibit its ability to provide safe, reasonable and adequate service. However, Staff finds that customers may still have exposure to losses to the extent they have prepaid for service or made deposits.

Staff recommends approval of MTSI's request for authorization to issue guarantees and pledge Arizona assets as security for the Notes, the Exchange Notes and Permitted Indebtedness, as required by the indenture governing the financing arrangements. Staff further recommends that the Applicant secure its Arizona customer deposits and prepayments by a performance bond, that is excluded from the pledged assets.

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Introduction

On September 28, 2006, McLeodUSA Telecommunications Services, Inc. ("MTSI" or "Applicant") filed an application with the Arizona Corporation Commission ("Commission") for authorization to issue guarantees and pledge its Arizona assets as security for Senior Second Secured Notes issued by its parent, McLeodUSA Incorporated ("McLeodUSA" or "Parent"), and to participate in certain other financing arrangements.

Public Notice

The Applicant has provided Staff with evidence that on November 16, 2006, it published notice of the financing application in the *Arizona Business Gazette*, a newspaper of general circulation in Maricopa County. Also, on November 14, 2006, the notice was published by the Tucson Newspaper Company, publisher of the Arizona Daily Star and Tucson Citizens, printed and circulated in the City of Tucson, Pima County. Copies of the affidavits attesting to the publications are attached.

Background

MTSI is an Iowa corporation certificated by the Commission to provide (1) resold and facilities-based local exchange and exchange access service pursuant to Decision No. 62627, dated June 9, 2000; and (2) resold interexchange telecommunications services pursuant to Decision No. 68001, dated July 17, 1998. The Applicant provides integrated communication services, including local services, in 25 states in the Midwest, Southwest, Northeast, and Rocky Mountain Regions. MTSI is a wholly owned subsidiary of McLeodUSA Holdings, Inc., which in turn, is a wholly owned by McLeodUSA.

The Transaction

MTSI seeks Commission authorization to issue guarantees and pledge its Arizona assets as security for certain financing arrangements of its parent, McLeodUSA. The Applicant states that on September 28, 2006, McLeodUSA issued approximately \$120 million in 10½ percent Senior Secured Notes ("Notes") due in 2011, in a private offering. As part of the financing arrangement, McLeodUSA agreed to commence an offer to exchange the above Notes for substantially identical notes ("Exchange Notes"), registered under the Federal Securities Laws, within 180 days. Also, the indenture governing the Notes and Exchange Notes allows McLeodUSA and its subsidiaries, subject to certain conditions, to incur additional debt ("Permitted Indebtedness") and grant additional liens ("Permitted Liens") on their assets, including incurring new debt up to \$26 million in aggregate principal amount, secured by liens that would be senior to the Notes and Exchange Notes. Except for the Applicant, McLeodUSA and its other subsidiaries have guaranteed the Notes and pledged their assets as security for its obligations under the guarantee and have agreed to do same for the Exchange Notes. The Applicant requests Commission authorization to issue similar guarantees and pledge its Arizona assets as security for the Notes, the Exchange Notes and the Permitted Indebtedness.

MTSI reports that the proceeds of the Notes have been used to liquidate all outstanding obligations under the exit financing, as contemplated in its Chapter 11 proceedings, that was approved by the Commission in Decision No. 68324, dated December 9, 2005. Also, a portion of the proceeds was utilized to cash collateralize existing letters of credit issued on behalf of McLeodUSA and all its subsidiaries as well as to pay fees and expenses incurred during the offering. MTSI states that the balance of the proceeds would be used for general corporate purposes. Applicant contends that approval of its proposal would have no impact on the management or day-to-day operations in Arizona, or impair its ability to continue to provide services, or result in any increase in its current rates or maximum rates. Finally, MTSI states that its proposal will exclude the \$600,000 performance bond currently posted for its operations in Arizona.

MTSI states that approval of its participation in the proposed financing arrangements serves the public interest in promoting competition amongst telecommunications carriers. It provides that Applicant with access to greater financial resources, thus enabling it to offer better competitive services that more quickly and effectively benefit Arizona consumers. MTSI asserts that any risk to ratepayers is mitigated because it is a non-dominant carrier, and offers highly competitive services that are readily obtainable from alternate carriers. The Applicant concludes that its participation in the proposed financing arrangements would have little or no negative impact on Arizona ratepayers.

Financial Analysis

A.R.S. §40-285 requires public service corporations to obtain Commission authorization to encumber certain utility assets. The statute serves to protect captive customers from a utility's act to dispose of any of its assets that are necessary for the provision of service, thus, it serves to preempt any service impairment due to disposal of assets essential for providing service. In this instance, a pledge of the Applicant's assets should not impair the availability of service to customers since it provides competitive services that are available from alternate service providers. However, customers may still have exposure to losses to the extent they have prepaid for service or made deposits. Accordingly, any authorization for encumbrances should provide customer protection for prepayments and deposits. Based on the above analysis, Staff finds that MTSI's request for Commission authorization to issue guarantees, and to the extent necessary, pledge its Arizona assets to secure the proposed debt financing arrangements will serve the public interest.

Consumer Services and Compliance Issues

The Corporations Division of the Commission reports that MTSI was in good standing.

Staff search of Consumer Services database for the past three years and through October 4, 2006, indicates 24 complaints, 15 inquiries and 1 opinion.

Staff Conclusions and Recommendations

Staff concludes that the Applicant's request for authorization to issue guarantees and pledge its Arizona assets should not further impair its financial status, further hinder its ability to attract capital at fair and reasonable terms or inhibit its ability to provide safe, reasonable and adequate service. However, customers may still have exposure to losses to the extent they have prepaid for service or made deposits. Accordingly, any authorization for encumbrances should provide customer protection for prepayments and deposits.

Staff recommends approval of MTSI's request for authorization to issue guarantees and pledge Arizona assets as security for the Notes, the Exchange Notes and Permitted Indebtedness, as required by the indenture governing the proposed financing arrangements.

Staff recommends that the Applicant secure its Arizona customer deposits and prepayments by a performance bond, in an amount equal or greater than the sum of customer deposits and prepayments, at the close of this transaction, and that the performance bond be excluded from the pledged assets. Staff further recommends that the Applicant file the original performance bond with the Business Office and the appropriate copies in Docket Control as a compliance item, within 60 days of the effective date of the decision in this proceeding.

Staff further recommends authorizing the Applicant to engage in any transactions and to execute or cause to be executed any documents so as to effectuate the authorizations requested with the application.

Arizona BUSINESS The business resource Gazette

PO BOX 194
Phoenix, Arizona 85001-0194
(602) 444-7315 FAX (602) 444-7364

**Public Notice of Filing of
McLeodUSA
Telecommunications
Services, Inc.
For Approval To Participate
In Certain Financing
Arrangements**
Docket No T-03276A-06-0622
McLeodUSA Telecommuni-
cations Services, Inc. (the "Ap-
plicant") filed an application
with the Arizona Corporation
Commission ("Commission")
on September 28, 2006, seek-
ing authorization to allow the
Applicant to guarantee and
pledge its Arizona assets as
security in connection with up
to \$120,000,000 in notes issued
by its parent, McLeodUSA
Incorporated in a private offering and an addi-
tional \$26,000,000 in financing
arrangements of McLeodUSA
Incorporated. The Application

is available for inspection dur-
ing regular business hours at
the office of the Commission
located at 1200 West Washing-
ton Street, Phoenix, Arizona
85007, and at the office of
Applicants' legal counsel,
Michael W. Patten, Esq.,
Roshika DeWulf & Patten, PLLC,
400 East Van Buren Street,
Suite 800, Phoenix, Arizona
85004. The Commission may
grant the Application without
a hearing. If you have any
questions concerning this Ap-
plication, have objections to
its approval, or want informa-
tion on intervention, you may
contact the Consumer Serv-
ices Section of the Commis-
sion at 1200 West Washing-
ton Street, Phoenix, Arizona
85007, or call 1-800-222-7000.
The Commission does not dis-
criminate on the basis of dis-
ability in admission to its pub-
lic meetings. Persons with a
disability may request a rea-
sonable accommodation such
as a language interpreter, as
well as request this document
in an alternative format, by
contacting Linda Hogan, ADA
Coordinator, voice phone
number 602-542-3931, e-mail
LHogan@azcc.gov. Requests
should be made as early as
possible to arrange the
accommodation.
Published: November 16,
2006

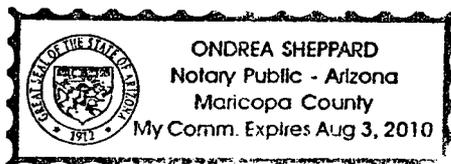
STATE OF ARIZONA
COUNTY OF MARICOPA

} SS.

Marilyn Greenwood, being first duly sworn, upon oath
deposes and says: That she is a legal advertising
representative of the Arizona Business Gazette, a
newspaper of general circulation in the county of
Maricopa, State of Arizona, published weekly at
Phoenix, Arizona, and that the copy hereto attached is a
true copy of the advertisement published in the said
paper on the dates indicated.

11/16/2006

Sworn to before me this
16TH day of
NOVEMBER 2006



Notary Public