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BEFORE THE ARIZONA CORPORATION C

COMMISSIONERS

MIKE GLEASON - Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

Arizona Corporation Commission
DOCKETED
JUN 28 2007
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IN THE MATTER OF THE APPLICATION OF DUNCAN RURAL SERVICES CORPORATION TO TRANSFER ITS ASSETS AND CERTIFICATE OF CONVENIENCE AND NECESSITY TO DUNCAN VALLEY ELECTRIC COOPERATIVE, INC.

DOCKET NO. G-02528A-06-0729
DOCKET NO. E-01703A-06-0729

DECISION NO. 69679

OPINION AND ORDER

DATE OF HEARING: April 10, 2007

PLACE OF HEARING: Tucson, Arizona

ADMINISTRATIVE LAW JUDGE: Jane L. Rodda

APPEARANCES: Michael M. Grant, GALLAGHER & KENNEDY, PC, on behalf of Duncan Rural Services Corporation; and

Kevin O. Torrey, Staff Attorney, Legal Division on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

* * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Arizona Corporation Commission ("Commission") finds, concludes, and orders that:

FINDINGS OF FACT

1. On November 15, 2006, Duncan Rural Services Corporation ("Duncan Rural" or "Applicant") filed an application with the Commission to transfer its assets to Duncan Valley Electric Cooperative, Inc. ("DVEC") as part of a reorganization of Duncan Rural as a natural gas division of DVEC.

2. On January 5, 2007, Duncan Rural filed an amendment to its application seeking

Commission approval to transfer its Certificate of Convenience and Necessity ("Certificate" or "CC&N") to DVEC as well as its assets.

3. On January 23, 2007, Commission Utilities Division Staff ("Staff") notified Duncan Rural and DVEC that the Application was sufficient under the requirements of the Arizona Administrative Code.

4. By Procedural Order dated January 29, 2007, the Commission set the matter for hearing on April 10, 2007, at its Tucson offices and established other procedural guidelines.

5. On March 5, 2007, Duncan Rural filed a Certificate of Mailing and Affidavit of Publication, indicating that notice of the hearing was mailed to customers of record, on February 27, 2007. The same notice was published in the *Copper Era*, a weekly newspaper in Greenlee County, on February 21, 2007, and February 28, 2007.

6. On March 15, 2007, Staff filed its Staff Report and recommended conditional approval of the transfer.

7. On March 30, 2007, Duncan Rural filed the Response Testimony of Jack Shilling and John Wallace in response to the Staff Report.

8. On April 10, 2007, the hearing convened as scheduled before a duly authorized Administrative Law Judge. Mr. Jack Shilling, DVEC's and Duncan Rural's CEO, and Mr. John Wallace, a consultant employed by Grand Canyon State Cooperative Association, testified for Duncan Rural. Mr. Alexander Igwe testified for Staff.

9. Duncan Rural is a non-profit corporation certificated by the Commission to provide natural gas distribution in Greenlee County, Arizona.

10. Duncan Rural began its operations in 1989, when it acquired the natural gas distribution systems of General Utilities, Inc. ("General Utilities"). General Utilities had been cited for several violations by the Pipeline Safety Section of the Commission for dilapidated infrastructures and poor maintenance of the system. At the time Duncan Rural acquired the General Utilities' system, the severity of the system's problems was not fully known. Duncan Rural claims that only after it acquired the system, did it learn the system was experiencing line losses of approximately 36 percent. Since acquiring the system, Duncan Rural has spent $1.3 million for system repairs, has

brought line losses to about 8 percent, and is in compliance with the Pipeline Safety Section. In order to maintain the system, Duncan Rural has budgeted $80,000 a year for capital improvements over the next five years.

11. At its inception, Duncan Rural was completely debt-funded. As we recognized in Duncan Rural's last rate case, Decision No. 68599 (March 23, 2006), Duncan Rural has struggled to find financial stability, and has always relied on DVEC to provide financing.

12. DVEC is a non-profit rural electric distribution cooperative certificated by the Commission to provide service in Greenlee County, Arizona. DVEC created Duncan Rural as a separate non-profit association because at the time, electric cooperatives in Arizona were not allowed to engage in business other than electric or telephone. TR at 39. DVEC holds 1,000 votes or memberships in Duncan Rural, resulting in a controlling interest. Because DVEC does not take gas service from Duncan Rural, its membership does not entitle it to any capital credit allocation or distribution. DVEC manages the operations of Duncan Rural pursuant to an Operations and Management Agreement.

13. DVEC and Duncan Rural have separate boards of directors, but the boards are comprised of the same individuals.

14. Duncan Rural has approximately 725 members, of which 700 are also members of DVEC.

15. DVEC has approximately 1650 total members, of which 1300 are in Arizona and 350 in New Mexico.

16. Duncan Rural has long relied on DVEC financial resources. Although the Commission has attempted to bring Duncan Rural to financial stability through a series of rate cases, over the years, DVEC has had to lend a total of approximately $1.3 million to Duncan Rural to fund capital improvements and working capital. Since 1993, the Commission has authorized four rate increases, ranging from 24 to 31 percent.

17. Duncan Rural seeks Commission authorization to transfer its assets and CC&N to DVEC, and thence subsist as the Gas Division of DVEC. At the conclusion of the proposed transfer, Duncan Rural will cease to exist as a separate legal and tax entity.

18. Duncan Rural proposes that the inter-company advances from DVEC to Duncan Rural would remain following the merger. Under its proposal, the inter-company debt would not incur interest, and there would not be regular payments of interest or principal, but rather, Duncan Rural would pay down the debt only as cash is available from gas operations. In addition, under this proposal, current Duncan Rural members would only be eligible to receive capital credits from DVEC upon full settlement of the inter-company debt. DVEC argues that because it does not have a common membership with Duncan Rural, repayment of the inter-company debt from the proposed Gas Division's cash flow would insure that DVEC's current members recoup funds that would have been available for their benefit prior to the reorganization.

19. Duncan Rural claims that its integration with DVEC will result in benefits that could enhance its ability to function as a sound financial operation. Primarily, Duncan Rural will be able to rely on the consolidated financial statement to obtain favorable credit terms from financial institutions such as the National Rural Utilities Cooperative Finance Corporation ("CFC"). DVEC no longer has the financial ability to continue to lend money to Duncan Rural and DVEC Board of Directors voted to stop future lending after April 1, 2006. In addition, the proposal to waive interest on the inter-company loan would improve Duncan Rural's annual cash flow by about $50,000 annually. Furthermore, the reorganization would eliminate Duncan Rural's large negative equity position, and Duncan Rural expects some operational cost savings from combining the two operations.

20. As of December 31, 2006, the balance of Duncan Rural's indebtedness to DVEC was $945,358.

21. Duncan Rural's current poor financial condition prevents it form obtaining external sources of capital at favorable rates. As a member association, there are no shareholders from which to seek capital injections.

22. DVEC's holding 1,000 memberships in Duncan Rural violates the "one-member-one-vote" requirement of IRC §501(c)(12). Thus, Duncan Rural is not a tax-exempt entity under the Internal Revenue Code. When the entities are consolidated, Duncan Rural will once again become exempt from federal income taxes.

23. In general, Staff finds that Duncan Rural's proposal to transfer its assets and CC&N to CVEC is in the public interest. However, Staff finds the proposal to retain the inter-company debt is inconsistent with a true merger for five reasons: 1) the current DVEC has at least 58 percent responsibility for Duncan Rural's debt through its membership in Duncan Rural; 2) the assets that will be transferred and consolidated into the operations of the new DVEC were significantly funded by the inter-company debt in question; 3) a merger requires consolidation of assets and liabilities as well as elimination of inter-company transaction, such as debt; 4) DVEC's proposal will preclude the current members of Duncan Rural from participation in capital credit distributions until its existing inter-company debt is fully extinguished; and 5) the proposal to retain inter-company debt would continue to impair the Gas Division's cash flow.

24. Staff finds that Duncan Rural's proposal to merge with DVEC would be beneficial to its financial stability, primarily because it would provide access to capital at favorable terms. Staff also acknowledges that the return to tax exempt status will result in savings to ratepayers.

25. Staff finds that DVEC's proposal to retain the existing debt of Duncan Rural as an obligation of the Gas Division is not consistent with a merger proposal. Staff believes that the proposal does not provide for equal membership of the current members of Duncan Rural in the subsisting DVEC.

26. Staff stated:

> Duncan Valley was responsible for the acquisition of the assets of General Utilities, Inc. and the creation of Duncan Rural. From inception, [DVEC] has had management responsibility for the operations of Duncan Rural, through a management agreement and a board of directors that is comprised of the same members as [DVEC's] board. [DVEC] owns 1,000 votes or 58.41 percent of Applicant's total membership of 1,712. As a result, [DVEC] has the controlling interest in Duncan Rural. From the forgoing, it appears that [DVEC] has some responsibility for the assets and liabilities of [Duncan Rural]. Staff Report at 3.

The current members of Duncan Rural will become members of the subsisting DVEC. As a result, Duncan Rural's current members will have one equal vote on all cooperative matters as do the current members of DVEC. Thus, Staff finds that the proposed transaction has the characteristics of a merger by absorption, rather than a reorganization. Typically, Staff states, a merger results in the

consolidation of the merging entities' assets and liabilities as well as the elimination of the inter-company transactions, such as the inter-company debt between DVEC and Duncan Rural. Staff was concerned that the request to retain the inter-company debt would necessitate the Commission to continue to provide for the repayment of the debt, which would impair Duncan Rural's cash flow. Staff does not believe it is in the public interest to segregate inter-company debt for separate rate-making treatment within a prospective entity.

27. Staff states that most of Duncan Rural's assets were financed by advances from DVEC. Staff believes that upon consummation of the transaction, "it is only appropriate for Duncan Rural to transfer its assets as well as the debt funding such assets to the subsisting [DVEC]." Staff Report at 4.

28. Staff recommends Commission approval of Duncan Rural's request to transfer its assets and CC&N to DVEC, subject to the conditions that (a) its inter-company debt is absorbed by the proposed new DVEC and eliminated from the books of the subsisting entity; and (b) the current members of Duncan Rural is held harmless from the current balance of inter-company debt.

29. Staff further recommends that the Commission authorize DVEC to retain Duncan Rural's current tariff, rates and charges for its proposed Gas Division, and that the Commission authorize Duncan Rural 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.

30. As stated above, Duncan Rural believes that Staff's recommendation to eliminate the inter-company receivable is not equitable to members of DVEC who do not also receive gas service from Duncan Rural. Consequently, Duncan Rural opposes that Staff recommendation.

31. We find that Duncan Rural's proposal to retain the inter-company debt is not in the public interest. DVEC will benefit from the transfer of Duncan Rural's assets. As a division of DVEC, any excess cash flow from the operations of the gas division will be available for use by the consolidated entity. Although the companies have historically been separate legal entities, DVEC has always controlled and supported the operations of Duncan Rural. The current members of DVEC will benefit from any excess cash flow generated by the gas division, and we find they will not be significantly disadvantaged by the elimination of the inter-company debt. Duncan Rural has not

advanced a legal or accounting-based reason why the inter-company debt should be retained.

32. The Corporation Division of the Commission reports that Duncan Rural and DVEC are in good standing.

33. The Consumer Services Division of the Utilities Division reports that from January 1, 2004, through February 28, 2007, Duncan Rural had one complaint regarding billing and one inquiry. For the same period, DVEC had 12 complaints, 4 inquires and 512 opinions. All of the opinions were expressed in opposition to the Company's last rate increase. The complaints and inquiries have been satisfactorily resolved and closed as of February 28, 2007.

34. The Pipeline Safety Section has confirmed that Duncan Rural is in compliance with its regulations.

CONCLUSIONS OF LAW

1. Duncan Rural and DVEC are a public service corporations within the meaning of Article XV of the Arizona Constitution and A.R.S. §§ 40-281, 40-282 and 40-285.

2. The Commission has jurisdiction over Duncan Rural and DVEC and the subject matter of the application.

3. Notice of the application was provided in accordance with law.

4. There is a public need and necessity for gas service in Duncan Rural's service area.

5. DVEC is a fit and proper entity to receive Duncan Rural's assets and CC&N to provide gas service.

6. Staff's recommendations contained in Findings of Fact Nos. 28 and 29 are reasonable and should be adopted.

ORDER

IT IS THEREFORE ORDERED that the application of Duncan Rural Service Corporation for approval of the transfer of its assets and Certificate of Convenience and Necessity to Duncan Valley Electric Cooperative, Inc. is approved as conditioned herein.

IT IS FURTHER ORDERED that Duncan Valley Electric Cooperative, Inc. shall charge Duncan Rural Service Corporation's current rates and charges for gas service.

IT IS FURTHER ORDERED that Duncan Rural Service Corporation is authorized to engage

in any transactions and to execute, or cause to be executed, any documents to effectuate the authorizations approved herein.

IT IS FURTHER ORDERED that the existing inter-company loan shall be eliminated from the books of Duncan Rural Service Corporation and Duncan Valley Electric Cooperative, Inc., and current customers of Duncan Rural Service Corporation shall not be responsible for the current balance of the inter-company debt.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN

COMMISSIONER

COMMISSIONER

COMMISSIONER

COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 28th day of June, 2007.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT _____

DISSENT _____

SERVICE LIST FOR: DUNCAN RURAL SERVICES CORPORATION

DOCKET NOS.: G-02528A-06-0729 and E-01703A-06-0729

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