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BEFORE THE ARIZONA CORPORATIO

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COMMISSIONERS

MIKE GLEASON - Chairman 2008 JUN 10 P 4: 51  
WILLIAM A. MUNDELL  
JEFF HATCH-MILLER AZ CORP COMMISSION  
KRISTIN K. MAYES DOCKET CONTROL  
GARY PIERCE

IN THE MATTER OF THE RE-  
ORGANIZATION OF VALLEY  
TELEPHONE COOPERATIVE, INC.,  
COPPER VALLEY TELEPHONE,  
INC., VALLEY CONNECTIONS,  
LLC, AND VALLEY TELECOM-  
MUNICATIONS COMPANY, INC.

DOCKET NO. T-01847A-07-0392  
DOCKET NO. T-02727A-07-0392  
DOCKET NO. T-04169A-07-0392  
DOCKET NO. T-02739A-07-0392

**NOTICE OF FILING  
DIRECT TESTIMONY**

Pursuant to the Procedural Order dated June 4, 2008, Valley Telephone Cooperative, Inc., and its affiliates Copper Valley Telephone, Inc., Valley Connections, LLC, and Valley Telecommunications Company, Inc., hereby submit the Prefiled Direct Testimony of Steven D. Metts and William M. Miller in this proceeding.

RESPECTFULLY SUBMITTED this 10th day of June, 2008.

SNELL & WILMER L.L.P.

By

Jeffrey W. Crockett  
Marcie Shuman  
One Arizona Center  
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Attorneys for Valley Telephone Cooperative, Inc.,  
Copper Valley Telephone, Inc., Valley Connections,  
LLC, and Valley Telecommunications Company, Inc.

ORIGINAL and 19 copies  
filed this 10<sup>th</sup> day of June, 2008, with:

Docket Control  
ARIZONA CORPORATION COMMISSION  
1200 West Washington Street  
Phoenix, Arizona 85007

Arizona Corporation Commission  
**DOCKETED**

JUN 10 2008

DOCKETED BY

Snell & Wilmer

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1 COPIES hand delivered this 10<sup>th</sup> day of June, 2008, to:  
2 Sarah N. Harpring, Administrative Law Judge  
3 Hearing Division  
4 ARIZONA CORPORATION COMMISSION  
5 1200 West Washington Street  
6 Phoenix, AZ 85007  
7  
8 Janice Alward, Chief Counsel  
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14 Ernest G. Johnson, Director  
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By: Gonna M. Thompson

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**PRE-FILED DIRECT TESTIMONY OF  
STEVEN D. METTS**

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**BEFORE THE ARIZONA CORPORATION COMMISSION**

COMMISSIONERS

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IN THE MATTER OF THE RE-  
ORGANIZATION OF VALLEY  
TELEPHONE COOPERATIVE, INC.,  
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**PRE-FILED DIRECT TESTIMONY OF STEVEN D. METTS**  
**ON BEHALF OF VALLEY TELEPHONE COOPERATIVE, INC.,**  
**COPPER VALLEY TELEPHONE, INC., VALLEY CONNECTIONS, LLC, AND**  
**VALLEY TELECOMMUNICATIONS COMPANY, INC.**

**JUNE 10, 2008**

1 **Q-1. Please state your name and business address.**

2 A-1. My name is Steven D. Metts. My business address is 752 E. Maley, Willcox, Arizona  
3 85643.

4 **Q-2. By whom are you employed and in what capacity?**

5 A-2. I am the Chief Executive Officer and General Manager of Valley Telephone  
6 Cooperative, Inc. ("Cooperative") and its affiliates Copper Valley Telephone, Inc.  
7 ("Copper Valley"), Valley Connections, LLC ("Valley Connections") and Valley  
8 Telecommunications Company ("VTC"), who are the applicants in this proceeding.  
9 Copper Valley, Valley Connections and VTC are sometimes referred to collectively as  
10 the "Affiliated Companies" in my testimony. The Cooperative and the Affiliated  
11 Companies are sometimes referred to collectively as the "Applicants" in my testimony.

12 **Q-3. Please describe your business experience.**

13 A-3. I have worked in the rural telecommunications industry for over 22 years. For the last  
14 three years, I have been the Chief Executive Officer and General Manager of the  
15 Applicants. Before that, I worked for 11 years with two operating telephone companies  
16 and eight years as a consultant. While I was employed by the two operating companies,  
17 I had overall responsibility for accounting, cost separations and settlements, information  
18 services, human resources, regulatory and legislative affairs, customer service, and  
19 billing. As a consultant, I primarily assisted clients with regulatory and legislative  
20 affairs, separations and settlements, and acquisitions.

21 **Q-4. On whose behalf are you testifying in this case?**

22 A-4. I am testifying on behalf of the Applicants.

23 **Q-5. Are you personally familiar with the Notice of Intent to Organize a Public Utility  
24 Holding Company that was filed by the Applicants on June 28, 2007?**

25 A-5. Yes. The Notice of Intent to Organize a Public Utility Holding Company ("Notice of  
26 Intent") was prepared and filed at my request and under my direct supervision. I hereby

1 adopt and incorporate as part of this pre-filed direct testimony the Notice of Intent and  
2 accompanying Exhibits 1-7.

3 **Q-6. Please summarize the Notice of Intent.**

4 A-6. In the Notice of Intent, the Cooperative proposed to organize VTG Holdings, Inc.,  
5 ("VTG Holdings") as a holding company of Cooperative affiliates Copper Valley,  
6 Valley Connections and VTC. Specifically, the Applicants requested that the Arizona  
7 Corporation Commission ("Commission") approve: (1) Copper Valley's prior transfer  
8 of its membership interest in Valley Connections to the Cooperative, resulting in the  
9 Cooperative directly owning 100% of the membership interests in Valley Connections;  
10 (2) Cooperative's organization of VTG Holdings as a public utility holding company  
11 with the Cooperative owning 100% of the stock of VTG Holdings; and  
12 (3) Cooperative's transfer of all of its ownership interest in the Affiliated Companies  
13 (*i.e.*, Copper Valley, Valley Connections and VTC) to VTG Holdings, resulting in VTG  
14 Holdings becoming the holding company of the Affiliated Companies.

15 **Q-7. Have you provided the Commission with a copy of the proposed corporate**  
16 **restructuring?**

17 A-7. Yes, as part of the Notice of Intent, the current corporate structure of the Cooperative  
18 and its Affiliated Companies was attached as Exhibit 2, and the proposed holding  
19 company corporate structure incorporating VTG Holdings was attached as Exhibit 3.

20 **Q-8. What is the business purpose for establishing VTG Holdings as a holding company**  
21 **for the Affiliated Companies?**

22 A-8. VTG Holdings was formed to more efficiently manage the Cooperative's ownership  
23 interest in the Affiliated Companies. In addition, the proposed reorganization allows  
24 the Affiliated Companies and VTG Holdings to file one consolidated income tax return  
25 on an annual basis without giving up the ability for the Cooperative to file as a tax-  
26 exempt entity, which streamlines and simplifies tax planning and the filing of tax

1 returns for the Applicants. The ability to consistently file consolidated tax returns will  
2 also simplify the budgeting and forecasting processes required in the management of  
3 the Affiliated Companies. Capital planning will be stabilized because of greater  
4 assurance that operating losses will be utilized by offsetting earnings of other entities in  
5 the consolidated income tax returns. The ultimate result of all of these reasons is the  
6 preservation and enhancement of the membership equity in the Cooperative while  
7 simultaneously assuring the continuation of critical, communications services to all  
8 customers served by the Applicants.

9 **Q-9. How will VTG Holdings be capitalized?**

10 A-9. The Cooperative proposes to capitalize VTG Holdings by transferring Cooperative's  
11 ownership interest in the Affiliated Companies to VTG Holdings in exchange for 100%  
12 of the VTG Holdings stock. The transfer qualifies under Section 351 of the federal  
13 Internal Revenue Code and does not result in the recognition of gain or loss to either the  
14 Cooperative or VTG Holdings, since only Cooperative's ownership interest will be  
15 transferred. Neither cash nor other assets of the Affiliated Companies will be  
16 transferred to VTG Holdings, and all cash and other assets will remain in the respective  
17 Affiliated Companies. Therefore, the resultant capital structure of the Cooperative and  
18 the Affiliated Companies remain exactly the same as before the reorganization.

19 **Q-10. Will there be any employee layoffs attributable to the formation of VTG Holdings**  
20 **and the corporate restructuring described above?**

21 A-10. No. There will be no reduction in workforce as a result of the reorganization.

22 **Q-11. Will there be any changes in the Applicants' cost of service or the cost of capital**  
23 **resulting from the formation of VTG Holdings and the corporate restructuring**  
24 **described above?**

25 A-11. No. The restructuring will have no material negative impact on the cost of service or  
26 cost of capital for the Cooperative and the Affiliated Companies. To the contrary, the

1 restructuring adds the benefit of allowing the Affiliated Companies to file consolidated  
2 income tax returns as I discussed earlier.

3 **Q-12. What is the current status of Copper Valley's membership interest in Valley**  
4 **Connections?**

5 A-12. As stated in the Notice of Intent<sup>1</sup> and in the Annual Filing of Diversification Activities  
6 and Plans for Cooperative and Copper Valley for 2007 that were submitted to the  
7 Commission's Utilities Division Staff, Copper Valley transferred its 50% membership  
8 interest in Valley Connections to the Cooperative effective September 30, 2006.  
9 Copper Valley received cash in the amount of \$755,098 from Cooperative for its  
10 membership interest, which was the net book value of Copper Valley's investment in  
11 Valley Connections on the date of transfer of the membership interest. The term "net  
12 book value" as used in my testimony is the original investment of Copper Valley in  
13 Valley Connections less proportionate losses accumulated through the date of the  
14 transfer of Copper Valley's membership interest.

15 **Q-13. Did Cooperative and Copper Valley notify the Commission about Copper Valley's**  
16 **transfer of its membership interest in Valley Connections at the time of the**  
17 **transfer?**

18 A-13. No. Neither Cooperative nor Copper Valley believed it needed to notify the  
19 Commission regarding the transfer of the Valley Connections membership interest.  
20 When Valley Connections was formed, Cooperative owned 50% and Copper Valley  
21 owned 50%. Since Cooperative owned 100% of Copper Valley, Cooperative had 100%  
22 control over the management and operations of Valley Connections. Copper Valley  
23 transferred its membership interest to the Cooperative effective September 30, 2006,  
24 making Cooperative the direct owner of the entire membership interest in Valley  
25 Connections. Because there was no change of control, Copper Valley and Cooperative

26 <sup>1</sup> See Notice of Intent at p. 2, lines 14-24.

1 did not believe they needed to notify the Commission of this change in ownership of the  
2 membership interest. However, in the Notice of Intent the Applicants asked the  
3 Commission to approve the transfer of Copper Valley's membership interest in Valley  
4 Connections if the Commission determined that the transfer required Commission  
5 approval.<sup>2</sup>

6 **Q-14. What was the reason for transferring Copper Valley's membership interest in**  
7 **Valley Connections to Cooperative?**

8 A-14. In Decision 68080 issued August 17, 2005 in Docket T-04169A-04-0816, the  
9 Commission approved the application of Valley Connections for authority to assume  
10 new long-term debt in the amount of \$14,956,743. As part of Decision 68080, the  
11 Commission ordered that "no further funding may be provided to [Valley Connections]  
12 by Valley Telephone Cooperative, Inc., Copper Valley Telephone, Inc., or any affiliate  
13 of Valley Telephone Cooperative, Inc., or Copper Valley Telephone, Inc., which is  
14 regulated by the Commission as a public service corporation."<sup>3</sup> Copper Valley has  
15 sustained financial losses on its books that are attributable to its original investment in  
16 Valley Connections. Without the ability to make additional investments to fund  
17 additional start-up losses at Valley Connections, Copper Valley's original investment  
18 would have been diluted, eventually to \$0 or less. By transferring its 50% membership  
19 interest to Cooperative, Copper Valley does not have to show further Valley  
20 Connections' start-up losses on its financial statements and Copper Valley recovered  
21 the net book value of its original investment.

22 **Q-15. Have you read the Staff Report dated October 4, 2007, recommending approval of**  
23 **the Notice of Intent?**

24 A-15. Yes. I have read the Staff Report and I agree with the conclusions and recommendations

25 <sup>2</sup> *Id.* at lines 22-24.

26 <sup>3</sup> Decision 68080 at page 3, lines 23-26.

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contained therein.

**Q-16. Is approval of the Notice of Intent by the Commission consistent with the public interest?**

A-16. Yes. The organization of a public utility holding company will result in increased efficiencies that will benefit the customers of the Applicants.

**Q-17. Please explain how consumers will benefit from the formation of a holding company.**

A-17 Because it is a cooperative, the Cooperative is not driven by generating a profit for shareholders. Any profit that is generated is ultimately returned to the Cooperative members who are also customers. The Cooperative's primary objective is to provide quality communications services to consumers in rural areas. The provision of these services in rural areas is made more difficult because of the high cost associated with serving sparsely populated areas. To the extent that the Cooperative can realize tax savings through the utilization of a holding company, more capital is available to fund further infrastructure improvements to serve customers. The Cooperative has been an industry leader in providing advanced telecommunications services in rural Arizona and approval of the Notice of Intent will enhance its ability to continue being a leader in this area.

**Q-18. Does this conclude your direct testimony?**

A-18. Yes it does.

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**PRE-FILED DIRECT TESTIMONY OF  
WILLIAM M. MILLER**

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**BEFORE THE ARIZONA CORPORATION COMMISSION**

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**PRE-FILED DIRECT TESTIMONY OF WILLIAM M. MILLER, CPA  
ON BEHALF OF VALLEY TELEPHONE COOPERATIVE, INC.,  
COPPER VALLEY TELEPHONE, INC., VALLEY CONNECTIONS, LLC, AND  
VALLEY TELECOMMUNICATIONS COMPANY, INC.**

**JUNE 10, 2008**

1 **Q-1. Please state your name and business address.**

2 A-1. My name is William M. (Bill) Miller. My business address is 8215 Nashville Avenue,  
3 Lubbock, Texas 79423.

4 **Q-2. By whom are you employed and in what capacity?**

5 A-2. I am a tax partner with Bolinger, Segars, Gilbert & Moss, LLP ("BSGM" or the "Firm").  
6 BSGM is a certified public accounting firm which specializes in (1) financial statement  
7 audits and (2) tax planning, consulting and income tax return preparation for its utility  
8 based clients, including regulated telephone companies, telephone cooperatives and  
9 related subsidiary companies.

10 **Q-3. Please describe your business experience.**

11 A-3. I have been involved in the telecommunications industries as both a financial statement  
12 auditor and as a tax advisor and income tax return preparer since being employed by  
13 BSGM in November 1992. Beginning in June 1997, I began managing the Firm's utility  
14 tax department, which specializes in income tax return preparation and consulting for the  
15 Firm's utility based audit practice, including regulated telephone companies. I have  
16 served as the Firm's tax partner over this department since January 2004.

17 **Q-4. On whose behalf are you testifying in this case?**

18 A-4. I am testifying on behalf of Valley Telephone Cooperative, Inc. (the "Cooperative"), and  
19 its affiliates Copper Valley Telephone, Inc., Valley Connections, LLC, and Valley  
20 Telecommunications Company, Inc. (collectively, the "Affiliates") with respect to the tax  
21 and financial statement impact of the formation of VTG Holdings, Inc. ("VTG  
22 Holdings"), as a public utility holding company of the Affiliates.

23 **Q-5. Please describe your relationship with the Cooperative and Affiliates.**

24 A-5. I have served as the tax advisor and tax consultant to the Cooperative and the Affiliates  
25 since 1997. As such, I have either prepared or supervised the preparation of the federal  
26 and state income tax returns for the Cooperative and the Affiliates. I have also been

1 active in estimating and recording the applicable federal and state income tax expense,  
2 including current and deferred income tax calculations. I also have performed tax  
3 research and have assisted in tax planning, including the recommendation to form a  
4 holding company to own the stock of the Affiliates.

5 **Q-6. What is the purpose of your testimony?**

6 A-6. In response to the Notice of Intent to Organize a Public Utility Holding Company filed by  
7 the Cooperative and its Affiliates, the Arizona Corporation Commission ("Commission")  
8 ordered in Decision 70307 that a hearing be conducted to address Findings of Fact 23 and  
9 24, which state as follows:

10 23. If the Commission were to approve the proposed reorganization as  
11 described in Staff's Memorandum dated October 4, 2007, it appears that VTG  
12 Holdings would acquire all shares of the Affiliated Companies, while Cooperative  
13 would acquire all shares of VTG Holdings. However, the record in this matter  
does not address the value of the shares after they have been transferred among  
the regulated and non-regulated entities.

14 24. Staff's Memorandum also indicates that, if the Commission were to  
15 approve the proposed reorganization, the companies would allocate income tax  
16 liabilities or credits based on their respective contributions of net income or net  
17 loss to the consolidated net income or net loss shown on the holding company's  
consolidated income tax return. However, the record in this matter is silent on the  
18 possibility that the allocation of tax liabilities or credits among separate affiliates  
would require Commission approval.

19 With respect to Finding of Fact 23, I will discuss how the ownership interests in  
20 the Affiliates are to be transferred from the Cooperative to VTG Holdings, the value to be  
21 received in return for the transfer of such ownership interests, and the value of the  
22 ownership interests before and after they are transferred from the Cooperative to VTG  
Holdings.

23 With respect to Finding of Fact 24, I will provide testimony supporting my  
24 conclusion that the allocation of tax liabilities among the Cooperative and its Affiliates  
25 through the use of consolidated income tax reporting does not adversely affect the  
26

1 customers of the Cooperative, Copper Valley Telephone or Valley Connections. It is my  
2 objective to demonstrate that the amount recorded on the books of each company  
3 represents the amount that would have been recorded were each company to file separate  
4 stand-alone income tax returns.

5 **Q-7. With respect to the questions raised in Finding of Fact 23, how are the shares of the**  
6 **Affiliates valued before and after the proposed transfer to VTG Holdings, and has**  
7 **any regulated company lost value?**

8 A-7. At the current time, the investments in the Affiliates are recorded on the books of the  
9 Cooperative at net book value. Accordingly, the books reflect separate general ledger  
10 accounts for each investment in an Affiliate. The balances of these general ledger  
11 accounts also agree with the net equity of each Affiliate. When the ownership interests of  
12 the Affiliates are transferred to VTG Holdings in exchange for VTG Holdings stock,  
13 those interests will be transferred to VTG Holdings at the net book value of each  
14 Affiliate. To record the transaction, the Cooperative credits the appropriate general  
15 ledger account for the amount of its investment in each Affiliate and debits a general  
16 ledger account for its investment in VTG Holdings. The amount debited for the  
17 investment in VTG Holdings will equal the sum total of the net book value of its  
18 investments in the Affiliates. The net effect of recording this transfer at net book value is  
19 that (1) no gain or loss is recognized by either VTG Holdings or the Cooperative; and (2)  
20 the balance sheet and financial condition of the Cooperative will have neither changed  
21 nor been impaired.

22 Should VTG Holdings ever dissolve, liquidate or otherwise dispose of one of the  
23 Affiliates, the Cooperative will indirectly recognize any associated gain or loss through  
24 the equity method of accounting for recording income and loss from investments in the  
25 Affiliates. This will ultimately be the case whether the Cooperative owns the Affiliates  
26 directly or indirectly through VTG Holdings. Therefore, the Cooperative has neither

1           gained nor lost value on the transfer of its shares of stock in the Affiliates in exchange for  
2           VTG Holdings stock.

3   **Q-8. Finding of Fact 23 addresses the transfer of the ownership interests in the Affiliates**  
4   **from the Cooperative to VTG Holdings but does not address the prior transfer of**  
5   **Copper Valley Telephone's 50% ownership interest in Valley Connections to the**  
6   **Cooperative. Please describe how the transfer of the ownership interest in Valley**  
7   **Connections from Copper Valley Telephone to the Cooperative was recorded.**

8   A-8. Copper Valley Telephone transferred its 50% ownership interest in Valley Connections  
9   to the Cooperative in exchange for a cash payment equal to the net book value of its  
10   investment in Valley Connections. Since the cash payment equaled the net book value,  
11   Copper Valley Telephone recognized neither gain nor loss. Copper Valley Telephone  
12   recorded the transaction as a debit to cash and a credit to the respective investment  
13   account for the same amount. Because neither gain nor loss was recognized on the  
14   transaction, the financial condition of Copper Valley Telephone neither changed nor was  
15   it impaired.

16           With respect to the Cooperative, neither gain nor loss was recognized on the  
17   transfer of Copper Valley Telephone's 50% membership interest in Valley Connections.  
18   The Cooperative recorded the transaction as a credit to cash and a debit to the respective  
19   investment account for the same amount. Since neither gain nor loss was recognized on  
20   the transaction, the financial condition of the Cooperative neither changed nor was it  
21   impaired.

22   **Q-9. This and all subsequent questions relate to Finding of Fact 24. Please describe the**  
23   **tax status of the Cooperative.**

24   A-9. The Cooperative is exempt from federal and state income taxes provided that at least 85%  
25   of its revenue and income is received from its members. In any year that the Cooperative  
26   receives at least 85% of its revenue and income from its members, it operates as a tax-

1 exempt cooperative and files the applicable federal Form 990 and Arizona Form 99. In  
2 any year that the Cooperative receives less than 85% of its revenue and income from its  
3 members, then the Cooperative operates as a non-tax-exempt or taxable cooperative and  
4 files the applicable federal and state corporate income tax returns. The member income  
5 test is performed annually, which means that the Cooperative may be taxable in one year  
6 and tax-exempt in the next.

7 **Q-10. You stated that the Cooperative may be taxable in one year and tax-exempt in the**  
8 **next. Has this situation occurred with the Cooperative?**

9 A-10. Yes. The Cooperative operated as a tax-exempt cooperative through the year that ended  
10 December 31, 1990, and during the years 1997 through 2004. The Cooperative operated  
11 as a taxable cooperative for the years 1991 through 1996 and again for the years 2005  
12 through 2007.

13 **Q-11. Please provide the underlying causes precipitating the changes in the Cooperative's**  
14 **tax-exempt status for these years. Were these planned or unplanned transactions?**

15 A-11. Except for the 2005 calendar year, the failure of the member income test in any particular  
16 year was unplanned and out of the Cooperative's control. For the 1991 calendar tax year,  
17 the Internal Revenue Service issued a Technical Advice Memorandum regarding how the  
18 member income test was to be calculated. This ruling specifically provided that billing  
19 and collection revenue were to be reported as non-member income in lieu of being  
20 excluded from the calculation. Because of this Technical Advice Memorandum and the  
21 fact that the Internal Revenue Service notified the telephone cooperative industry that  
22 such ruling would be applied to all telephone cooperatives, the Cooperative's percentage  
23 of member revenue and income fell below 85% for the 1991 calendar tax year and for  
24 each subsequent calendar tax year through 1996. Accordingly, the Cooperative operated  
25 as a taxable cooperative and was required to file federal and state corporate income tax  
26 returns from 1991 through 1996.

1           Circumstances changed in 1997 when the U.S. Tax Court ruled in favor of a  
2 taxpayer which argued that the Internal Revenue Service's position in the 1991 Technical  
3 Advice Memorandum was incorrect. As a result of this ruling by the U.S. Tax Court, the  
4 Cooperative once again passed the member income test and did so for the calendar tax  
5 years 1997 through 2004. Accordingly, the Cooperative filed the respective federal Form  
6 990 and Arizona Form 99 for these years. The 1991 loss of the Cooperative's tax-exempt  
7 status was unplanned. Likewise, regaining its tax-exempt status in 1997 was equally  
8 unplanned.

9           For the calendar tax years 2005 through 2007, the tax status of the Cooperative  
10 changed once more. The change in 2005 was the result of a corporate dividend paid by  
11 Valley Telecommunications Company to the Cooperative. For the 2006 and 2007  
12 calendar tax years, the Cooperative's status as a taxable cooperative was primarily the  
13 result of payments received from the liquidation and dissolution of the Rural Telephone  
14 Bank. Due to both planned and unplanned items of non-member income, the  
15 Cooperative received less than 85% of its revenue and income from members for these  
16 three years and has operated as a taxable cooperative.

17 **Q-12. Why is the Cooperative's tax status significant?**

18 A-12. In any year that the Cooperative passes the member income test, a consolidated corporate  
19 income tax return may not be filed because a tax-exempt organization is precluded by  
20 statute [Internal Revenue Code Section 1504(b)(1) and Arizona Revised Statute Section  
21 43-947] from filing a consolidated income tax return with taxable subsidiary companies.  
22 This also means that unless there is a holding company—such as VTG Holdings—  
23 between the Cooperative and its Affiliates, each Affiliate is required to file separate  
24 stand-alone tax returns.

25  
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1 **Q-13. Why is the ability to file consolidated federal and state income tax returns**  
2 **important to the Cooperative and its Affiliates?**

3 A-13. In current and future years where Valley Connections is expected to have losses as a  
4 start-up company, the inability to file consolidated federal and state income tax returns  
5 results in a significant opportunity cost because there is no immediate benefit to the net  
6 operating losses. Were a holding company in place at the time the net operating losses  
7 are incurred, the net operating losses of Valley Connections could be used to offset the  
8 taxable income of the other Affiliates, Valley Telecommunications Company and Copper  
9 Valley Telephone. This allows the Affiliate generating the net operating loss to be  
10 compensated for its losses in the current year, which reduces the overall tax liability paid  
11 to the applicable federal and state taxing authorities and is an effective mechanism for  
12 managing the overall cash flow and tax liability for all Affiliates.

13 **Q-14. Can consolidated income tax returns be filed without the existence of a holding**  
14 **company?**

15 A-14. Yes. The Cooperative and its Affiliates filed consolidated income tax returns from 1991  
16 through 1996 until the Cooperative regained its tax-exempt status in 1997. In addition,  
17 the Cooperative and its Affiliates have filed consolidated income tax returns since the  
18 Cooperative failed the member income test in 2005.

19 **Q-15. Is there an option that allows the Affiliates to file consolidated income tax returns**  
20 **that (1) does not involve the use of a holding company and (2) is independent of**  
21 **Valley Telephone Cooperative's tax status?**

22 A-15. No. The Cooperative and its Affiliates may file and have filed consolidated federal  
23 income tax returns in prior years. However, the ability to do so is tied to the  
24 Cooperative's ability to pass the member income test. As noted above, since 1991 there  
25 have been years when the Cooperative operated as a taxable cooperative and years when  
26 it operated as a tax-exempt cooperative. As noted in my answer to question Q-11 above,

1 the passage or failure of the member income test is often the result of transactions that are  
2 generally unplanned and out of the Cooperative's control. Since unplanned transactions  
3 can and do impact the taxation of the Cooperative, the existence of a holding company is  
4 the only structure available to insure the ability of the remaining Affiliates to file  
5 consolidated tax returns and to achieve the cash flow benefits of doing so regardless of  
6 the Cooperative's tax-exempt status. The existence of a holding company will allow the  
7 Affiliates to know from year to year that a consolidated federal income tax return will be  
8 filed because the ability to do so is independent of the Cooperative's tax status.

9 **Q-16. Will a non-regulated affiliated company benefit from the filing of a consolidated**  
10 **income tax return at the expense of the rate payers of a regulated affiliate?**

11 A-16. No. The affiliated transaction rules of the Federal Communications Commission require  
12 that the income tax expense or benefit recorded by a regulated telephone company must  
13 be calculated on a stand-alone basis. These rules are codified in Part 32 of the Uniform  
14 System of Accounts. Specifically, Section 32.27(e) states that:

15 [I]ncome taxes shall be allocated among regulated activities of the carrier,  
16 its nonregulated divisions, and members of an affiliated group. Under  
17 circumstances in which income taxes are determined on a consolidated  
18 basis by the carrier and other members of the affiliated group, the income  
tax expense to be recorded by the carrier shall be the same as would result  
if determined for the carrier separately for all time. (Emphasis added).

19 Therefore, the income tax expense/benefit recorded represents the amount of income tax  
20 expense/benefit had the regulated company filed a separate return. The ability to file a  
21 consolidated tax return impacts the total cash flow for the consolidated group and  
22 direction of the cash outflow for the members of the consolidated group with reportable  
23 taxable income. The cash paid to an affiliate for use of net operating losses only impacts  
24 where the cash is paid and not the income tax expense recorded or paid by the regulated  
25 company. Thus, the filing of consolidated federal and state income tax returns is  
26 primarily a cash management tool used for planning purposes and reflects the same

1 amount that would have been paid to the federal and state taxing authorities but for  
2 having filed a consolidated income tax return.

3 **Q-17. Do you believe that prior approval of the Commission is required before a**  
4 **reimbursement can be made by a regulated telephone company to a non-regulated**  
5 **affiliate in the amount of the tax benefit derived by the use of a non-regulated**  
6 **affiliate's net operating loss?**

7 A-17. No. Rule R14-2-804(B) of the Commission's Rules on Public Utility Holding Companies  
8 and Affiliated Interests (Commission Review of Transactions Between Public Utilities  
9 and Affiliates) states as follows:

10 A utility will not consummate the following transactions without prior  
11 approval by the Commission:

- 12 1. Obtain a financial interest in any affiliate not regulated by the  
13 Commission, or guarantee, or assume the liabilities of such  
14 affiliate;
- 15 2. Lend to any affiliate not regulated by the Commission, with the  
16 exception of short-term loans for a period less than 12 months in  
17 an amount less than \$100,000; or
- 18 3. Use utility funds to form a subsidiary or divest itself of an  
19 established subsidiary.

20 The cash paid to an affiliate for use of net operating losses described in my response to  
21 question Q-16 and elsewhere in my testimony is not one of the transactions specifically  
22 listed in A.A.C. R14-2-804(B). Therefore, prior approval by the Commission is not  
23 required.

24 **Q-18. In your response to question Q-13 above, you focus on the ability of Valley**  
25 **Connections, a competitive local exchange carrier and Internet Service Provider, to**  
26 **be compensated currently for losses incurred during the start-up phase of its**  
**business operations to the extent such losses are utilized in the filing of a**  
**consolidated federal income tax return. Does this same benefit apply to Copper**  
**Valley Telephone as a regulated incumbent local exchange carrier?**

1 A-18. Yes. If Copper Valley Telephone were to incur a net operating loss for income tax  
2 reporting purposes and if other members of the consolidated group reported taxable  
3 income, Copper Valley Telephone will receive immediate benefit recognition of the loss  
4 to the extent the remaining members of the consolidated group use such net operating  
5 loss to offset their own tax liabilities. This particular situation did in fact occur for the  
6 1995 and 1996 calendar tax years. During the Cooperative's first period of operating as a  
7 taxable cooperative from 1991 through 1996, the Cooperative and its Affiliates filed  
8 consolidated federal and state income tax returns. For Copper Valley Telephone's first  
9 and second years of existence—1995 and 1996—it generated net operating losses of  
10 \$188,063 and \$1,044,246, respectively. Since Copper Valley Telephone was included in  
11 a consolidated income tax return, these net operating losses were used to reduce taxable  
12 income for the consolidated group. Additionally, Copper Valley Telephone was  
13 reimbursed for the use of the net operating losses by other members of the consolidated  
14 group at a combined federal and state income tax rate of approximately 41.6%. But for  
15 the fact that Copper Valley Telephone was included in a consolidated income tax return,  
16 it would have taken the 1997 through 2000 calendar tax years for Copper Valley to  
17 receive the full benefit of its net operating losses for 1995 and 1996. The ability to file a  
18 consolidated income tax return allowed Copper Valley Telephone to receive full benefit  
19 of the net operating loss for the tax year incurred.

20 **Q-19. Do you have any concluding remarks?**

21 A-19. Yes. From a tax advisor's standpoint, the use of a holding company provides for the  
22 efficient administration of the tax liabilities of the Cooperative and its Affiliates. This is  
23 especially true when one Affiliate reports a net operating loss and the other Affiliates  
24 report taxable income. When this situation arises, the net loss of one Affiliate is offset  
25 with the net taxable income of the other Affiliates to reduce the overall tax liability owed  
26 to the respective taxing authorities. The formation of a holding company also provides

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stability to the Affiliates in that the manner and method in which the related tax returns are prepared and filed are determined by elections made at the holding company level and are not dependent on the tax status of the Cooperative.

**Q-20. Does this conclude your direct testimony?**

A-20. Yes it does. I may offer additional testimony at the hearing in this case after having the opportunity to review the written testimony submitted by the Commission's Utilities Division Staff.