

DIRECT TESTIMONY

OF

SHEENA KIGHT

FINANCE DEPARTMENT

FINANCIAL ANALYSIS DIVISION

ILLINOIS COMMERCE COMMISSION

ILLINOIS CONSOLIDATED TELEPHONE COMPANY

DOCKET NO. 02-0124

MARCH 12, 2002

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

2 A. My name is Sheena Kight. My business address is 527 East Capitol Avenue,
3 Springfield, Illinois 62701.

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

5 A. I am employed by the Illinois Commerce Commission ("Commission") as a
6 Financial Analyst in the Finance Department of the Financial Analysis Division.

7 **Q. Please describe your qualifications and background.**

8 A. In May of 1998, I received a Bachelor of Business degree in Finance and
9 Marketing from Western Illinois University in Macomb, Illinois. I earned a
10 Master of Business Administration degree, with a concentration in Finance,
11 also at Western Illinois University in May 2001. I have been employed by the
12 Commission in my present position since January of 2001.

13 **Q. Please state the purpose of your testimony in this proceeding.**

14 A. The purpose of my testimony is to present my evaluation of Illinois
15 Consolidated Telephone Company's ("ICTC") proposed reorganization
16 pursuant to Section 7-204(b)(4) of the Illinois Public Utilities Act, 220 ILCS 5/1 -
17 101 *et seq.* ("Act"). ICTC, a subsidiary of McLeodUSA Incorporated, filed an
18 application for approval of the Reorganization Plan filed in McLeodUSA
19 Incorporated's Chapter 11 proceeding. My evaluation focuses on the financial

20 implications of the proposed reorganization on ICTC's ability to access the
21 capital markets on reasonable terms.

22 **Q. Why is it necessary to evaluate the financial implications of the**
23 **proposed reorganization?**

24 A. In order to approve a proposed reorganization, Section 7-204(b)(4) of the Act
25 requires the Commission to find that "the proposed reorganization will not
26 significantly impair the utility's ability to raise necessary capital on reasonable
27 terms or to maintain a reasonable capital structure."

28 **Q. Please summarize your findings.**

29 A. In my opinion, the proposed reorganization, subject to the commitments
30 proposed in Exhibit 3.01 to this testimony, meets the requirements of Section
31 7-204(b)(4) of the Act.

32 **Q. Please describe the corporate relationship between ICTC and**
33 **McLeodUSA Incorporated.**

34 A. ICTC is a wholly owned subsidiary of McLeodUSA Community Telephone, Inc.
35 McLeodUSA Community Telephone, Inc. is a wholly owned subsidiary of
36 McLeodUSA Holdings, Inc., which is a wholly owned subsidiary of
37 McLeodUSA Incorporated. ICTC will remain a wholly owned subsidiary of
38 McLeodUSA Incorporated upon completion of the proposed reorganization.
39 However, McLeodUSA Incorporated's common equity ownership interest will

40 change. After the reorganization, Forstmann Little will have a controlling
41 interest in 58% of McLeodUSA Incorporated's outstanding common stock.¹

42 **Q. How does ICTC raise capital?**

43 A. McLeodUSA Incorporated and ICTC are responsible for raising debt or equity
44 capital on behalf of ICTC.² ICTC has been able to satisfy all capital needs
45 through cash generated from its operations. If ICTC were to require additional
46 debt capital from external sources it would issue long-term debt directly.³
47 McLeodUSA Incorporated would be responsible for raising the equity capital if
48 ICTC were to require it.

49 **Q. What is your assessment of ICTC's financial condition?**

50 A. On a standalone basis, ICTC's financial condition is very strong.

51 **Q. How did you reach that conclusion?**

52 A. For the 1999-2001 period, I computed four measures of ICTC's financial
53 strength: pre-tax interest coverage, funds from operations interest coverage,
54 total debt to total capital, and net cash flow to total debt ratios and compared
55 the results to financial medians Standard & Poor's (S&P) publishes for
56 telecommunications companies by credit rating. As the table below shows,

¹ McLeodUSA Ex. 2.0 (Ceryanec Direct), p 4.

² McLeodUSA Ex. 2.0 (Ceryanec Direct), p. 2.

³ ICTC's response to Staff data requests SK-4.4 – SK-4.5. (Attached hereto as Exhibit 3.02).

57 ICTC's ratios are consistent with an S&P rating of at least AA.^{4, 5} . An obligor
 58 rated AA has a very strong capacity to meet its financial commitments.⁶

Ratio	1999	2000	2001	S&P "AA" Financial Medians ⁷
Pre-tax Interest Coverage	10.94x	10.23x	12.68x	Over 4.5x
FFO Interest Coverage	18.8x	15.3x	13.9x	Over 6.5x
Total Debt to Total Capital	28.7%	28.7%	26.1%	Under 42%
Net cash flow to Total Debt	226%	168%	72.6%	Over 32%

59 **Q. Please describe McLeodUSA Incorporated's financial.**

60 A. McLeodUSA Incorporated has an S&P credit rating of D.⁸ An obligor rated D
 61 is in payment default or has filed a bankruptcy petition.⁹ McLeodUSA
 62 Incorporated filed Chapter 11 bankruptcy on January 31, 2002.¹⁰

63 **Q. Please describe how McLeodUSA Incorporated's financial condition**
 64 **could impact ICTC's ability to raise necessary capital on reasonable**
 65 **terms or to maintain a reasonable capital structure.**

⁴ ICTC's response to Staff data requests SK 1.01-SK 1.09. (Attached hereto as Exhibit 3.03)

⁵ Standard & Poor's, *Financial Medians: Telecommunications Companies*, June 16, 1999, p. 1.

⁶ Standard & Poor's, *Global Utilities Rating Service Ratings, User Guide*, p.4.

⁷ Standard & Poor's, *Financial Medians: Telecommunications Companies*, June 16, 1999, p. 1.

⁸ Standard & Poor's, *Ratings Direct*, McLeodUSA Inc., January 31, 2002.

⁹ Standard & Poor's, *Global Utilities Rating Service Ratings, User Guide*, p.4.

¹⁰ McLeodUSA Ex. 2.0 (Ceryanec Direct), p.5

66 A. Given its default on its debt obligations, McLeodUSA Incorporated should
67 have great difficulty accessing the capital markets on reasonable terms.
68 Since equity investors have only a residual claim to the assets of a company,
69 they would be reluctant to take an ownership stake in a firm which is currently
70 in default on its debt obligations. Furthermore, McLeodUSA Incorporated
71 states that it expects to generate negative cash from operations until fiscal
72 2005 and acknowledges that “access to the amounts that remain available to
73 borrow under the Credit Agreement are critical in funding McLeodUSA’s
74 operations.”¹¹ That is, McLeodUSA will be a net user of cash for the
75 foreseeable future. Consequently, should ICTC need external equity capital,
76 McLeodUSA is unlikely to be in a position to raise it.

77 Although ICTC may generate sufficient funds to support its operations, the
78 proposed reorganization offers no guarantee that McLeodUSA Incorporated
79 would not draw upon those funds to support its operations to the detriment of
80 ICTC. In fact, McLeodUSA Incorporated’s credit agreement appears to forbid
81 McLeodUSA Incorporated from agreeing to restrict dividend payments from
82 certain subsidiaries including ICTC.¹² Given ICTC’s reliance on internally
83 generated cash flows to meet its capital requirements and McLeodUSA
84 Incorporated’s poor financial condition and its projected losses in the near
85 term, excessive remittance of dividends by ICTC is not an implausible
86 scenario. If ICTC were to remit dividends in excess of its “free cash flow,”

¹¹ ICTC Application, Docket No. 02-0124, Exhibit C, p.62

¹² McLeodUSA Incorporated Credit Agreement, Section 6.11, May 31, 2000, p. 86

87 ICTC's capital structure would weaken and could significantly impair ICTC's
88 ability to raise replacement capital.¹³

89 **Q. Has the Commission confronted this situation in other**
90 **reorganizations?**

91 A. Yes. In Docket 99-0237, a company with a very weak financial condition,
92 Global Crossing, proposed to acquire Frontier Communications of Illinois, Inc.,
93 Frontier Communications of Lakeside, Inc., Frontier Communications of Mt.
94 Pulaski, Inc., Frontier Communications of DePue, Inc., Frontier
95 Communications of Orion, Inc., Frontier Communications-Midland, Inc.,
96 Frontier Communications-Prairie, Inc., Frontier Communications-Schuyler,
97 Inc., (collectively "Frontier Companies"). To ensure that the proposed
98 reorganization did not significantly impair the ability of the Frontier Companies
99 to raise capital on reasonable terms and to maintain a reasonable capital
100 structure, the Commission imposed three conditions on the reorganization.¹⁴
101 The first condition addressed the terms for capital. It assured that in the event
102 of a rate case the utility's cost of capital will be set commensurate to the risk of
103 that utility exclusive of the effects of the proposed reorganization. The second
104 condition insulated the utility and its assets from the debts and obligations of
105 its affiliates and further assured that the poor financial condition of the utility's
106 ultimate parent company rates did not increase the cost of the utility's debt.
107 The third condition ensured that the utility retained sufficient funds to maintain

¹³ "Free cash flow" is the Company's net cash from operations, including changes in working capital, less construction expenditures, less maturing debt, less mandatory redemptions of debt and preferred stock, plus capitalized interest (AFUDC), plus any undistributed free cash flow.

¹⁴ Order, Docket 99-0237, September 28, 1999, pp. 7-9

108 service quality at a reasonable level since only utility cash flows in excess of
109 utility requirements could be transferred to affiliated companies.

110 **Q. Do you recommend that the Commission impose the same three**
111 **conditions on this proposed reorganization?**

112 A. No. I recommend that the Commission impose the first two conditions;
113 however, I recommend replacing the free cash flow test with a dividend-
114 reporting requirement. The three conditions I propose, including the dividend-
115 reporting requirement, are presented in Exhibit 3.01.

116 **Q. Please explain why you are recommending replacing the free cash flow**
117 **test with a dividend-reporting requirement.**

118 A. First, McLeodUSA is committed to selling ICTC within 14 months of the
119 consummation of the reorganization plan.¹⁵ Second, Staff recognizes that the
120 free cash flow test may conflict with an existing credit agreement that appears
121 to restrict McLeodUSA Incorporated and its subsidiaries from entering into
122 any agreement that would prohibit, restrict, or impose any condition upon the
123 remittance of dividends.¹⁶ Although this in itself would not preclude the
124 Commission from restricting dividends to protect the financial condition of a
125 regulated utility, in an effort to resolve issues in this proceeding, I recommend
126 replacing the free cash flow test with a dividend-reporting requirement. A

¹⁵ ICTC Application, Docket No. 02-0124, Exhibit C, p.33

¹⁶ McLeodUSA Incorporated Credit Agreement, Section 6.11, May 31, 2000, p. 86

127 dividend-reporting requirement would facilitate monitoring of ICTC's cash
128 dividend payments to ensure that such payments do not impair ICTC's capital.

129 **Q. Please describe the commitments that would place the proposed**
130 **reorganization in compliance with the requirements of Section 7-**
131 **204(b)(4) of the Act.**

132 A. Exhibit 3.01 to this testimony provides the commitments that ICTC must agree
133 to in order to be in compliance with the requirements of Section 7-204(b)(4) of
134 the Act. Commitment 1 addresses the terms for capital. It assures that in the
135 event of a rate case ICTC's cost of capital will be set commensurate to the risk
136 of ICTC exclusive of the effects of the proposed reorganization. Commitment
137 2 insulates ICTC and its assets from the debts and obligations of their
138 affiliates and further assures that rates will not reflect an increased cost of debt
139 caused by the poor financial condition of its ultimate parent company.
140 Commitment 3 would ensure that ICTC's capital is not significantly impaired,
141 by requiring ICTC to report the declaration of dividends.

142 **Q. Does this conclude your direct testimony?**

143 A. Yes, it does.

Exhibit 3.01

1 **Commitments**

2 1. Applicant agrees and commits that the cost of capital, as reflected in ICTC's
3 rates, shall not be adversely affected by the reorganization of McLeodUSA
4 Incorporated. Applicant also agrees and commits that, subsequent to the
5 completion of the reorganization, the cost of capital for ICTC in any future
6 earnings analysis or rate base/rate of return case shall be set commensurate
7 with the risk of ICTC exclusive of any reorganization effects. Applicant agrees
8 and commits that it will not oppose, in either a regulatory proceeding or an
9 appeal of a decision by the Commission, the application of the principle that
10 the determination of the cost of capital shall be based solely on the risk
11 attendant to the regulated operations of ICTC. Any declines in ICTC's financial
12 condition caused by the reorganization or its announcement shall be quantified
13 by the Applicant in any future earnings analysis, or rate base/rate of return
14 case and adjusted as if such declines did not occur. Applicant agrees and
15 commits to the use of any imputed or hypothetical capital structure in any future
16 earnings analysis, or rate base/rate of return rate case, if necessary to reflect
17 the cost of capital for ICTC without the effects of the reorganization.

18 2. Applicant shall not allow any affiliate of ICTC, including McLeodUSA
19 Incorporated, to obtain credit under any arrangement that would permit a
20 creditor, upon default, to have recourse to ICTC's assets. The financial
21 arrangements of all affiliates of ICTC, including McLeodUSA Incorporated, are
22 subject to the following restrictions:

23 a. Any indebtedness incurred by an affiliate, including McLeodUSA

- 24 Incorporated, will be without recourse to ICTC.
- 25 b. ICTC shall not enter into any agreements under terms whereby
26 ICTC is obligated to commit funds in order to maintain the
27 financial viability of an affiliate, including McLeodUSA
28 Incorporated.
- 29 c. ICTC shall not make any investment in an affiliate, including
30 McLeodUSA Incorporated, under circumstances in which ICTC
31 would be liable for the debts and/or liabilities of an affiliate
32 incurred as a result of acts or omissions of an affiliate, including
33 McLeodUSA Incorporated.
- 34 d. ICTC shall not issue any security for the purpose of financing the
35 acquisition, ownership, or operation of an affiliate, including
36 McLeodUSA Incorporated.
- 37 e. ICTC shall not assume any obligation or liability as guarantor,
38 endorser, surety or otherwise with respect to any security of an
39 affiliate, including McLeodUSA Incorporated.
- 40 f. ICTC shall not pledge, mortgage or otherwise use as collateral
41 any assets of any of ICTC for the benefit of an affiliate, including
42 McLeodUSA Incorporated.
- 43 g. Applicant shall assure that rates to the regulated service

44 customers of ICTC are not increased by reason of the effects of
45 credit rating declines or other adverse consequences caused
46 directly by the reorganization.

47 h. An affiliate, including McLeodUSA Incorporated, shall not incur
48 debt or pledge the stock of ICTC, or any of them, in any manner
49 that on the affiliate's default would permit a creditor to have
50 recourse against the regulated assets of ICTC.

51 3. Dividend transfers from ICTC to affiliated companies during any calendar year
52 shall be reported to the Illinois Commerce Commission ("Commission") within
53 one week of the declaration of dividends.

54 "Dividend transfers" shall be defined as the amount of common dividends
55 directly or indirectly remitted to affiliated companies.

56 Within 1 week following the declaration of dividends by ICTC as specified
57 above, the Company shall submit a report of the declaration of dividends to the
58 Manager of the Finance Department and the Office of the Chief Clerk. ICTC
59 shall also submit financial statements for the last 12-month period available at
60 the time of the dividend declaration report to the Commission's Manager of
61 the Finance Department

62 If McLeodUSA Incorporated's senior debt is rated at least Baa2 by Moody's or its
63 successors or BBB by Standard & Poor's or its successors, or if ICTC is no longer
64 owned or controlled by McLeodUSA Incorporated, upon notification to the Office of

65 the Chief Clerk and the Manager of the Finance Department, compliance with the
66 dividend reporting requirement will not be necessary and the submission of financial
67 statements may be suspended.

Exhibit 3.02

The Company's response to Staff data request SK-4.4 – SK-4.5.

SK-4.4) Please describe how ICTC has raised debt capital in the past.

Response: ICTC has issued first mortgage bonds through private placement firms. ICTC's current debt (\$20M total) was secured in the early 1990's. Half of that amount was originated on 9/1/1992 and the other half on 10/1/1993.

Response prepared by Gary Patrem, Controller for ICTC

SK-4.5) Please describe how ICTC will raise debt capital after the proposed reorganization.

Response: Present projections will not require ICTC to acquire additional debt capital, as cash from operations is sufficient to fund its projected plant additions. ICTC has no current plans to raise additional debt capital. If a decision was made to accelerate plant additions from the current planned deployment schedule, additional capital might be needed. If that were the case, ICTC expects that it would raise the debt capital in a manner similar to that described in the response to SK-4.4.

Response Prepared by Gary Patrem, Controller for ICTC

Exhibit 3.03

The Company's response to Staff data request SK-1.01 – SK-1.09.

Item SK-1.1

SK-1.1) Please indicate which entity is currently responsible for raising debt capital on behalf of Illinois Consolidated Telephone Company (ICTC). In addition, please provide the audited financial statements (balance sheet, income statement, and cash flow statement) for that entity for the last three fiscal or calendar years.

Response: See Prepared Direct Testimony of Joseph H. Ceryanec, lines 48- 66. The ICTC balance sheet, income statement and cash flow are set forth in ICTC Ex. 2.1. The audited financial statements of McLeodUSA Incorporated for the last three years are being sent under separate cover for delivery to Staff on March 5, 2002.

Item SK-1.2

SK-1.2) Please indicate which entity will be responsible for raising debt capital on behalf of ICTC upon completion of the reorganization proposed in this Docket. In addition, please provide the audited financial statements (balance sheet, income statement, and cash flow statement) for that entity for the last three fiscal or calendar years.

Response: See Response to SK-1.1

Item SK-1.3

SK-1.3) Please indicate which entity will be responsible for raising equity capital on behalf of ICTC upon completion of the reorganization proposed in this Docket. In addition, please provide the audited financial statements (balance sheet, income statement, and cash flow statement) for that entity for the last three fiscal or calendar years.

Response: See Response to SK-1.1.

Item SK-1.4

SK-1.4) Please provide the audited financial statements (balance sheet, income statement, cash flow statement, and statement of retained earnings) for ICTC for the last three fiscal or calendar years.

Response: See ICTC Exhibit 2.1

Item SK-1.5

SK-1.5) Please provide the audited financial statements (balance sheet, income statement, and cash flow statement) for McLeodUSA Inc. for the last three fiscal or calendar years.

Response: See Response to SK-1.1

Item SK-1.6

SK-1.6) Please provide pro forma financial statements (balance sheet, income statement, and cash flow statement) for McLeodUSA Community Telephone Inc. (McLeodUSA CTI) upon completion of the reorganization proposed in this Docket for the period provided in Exhibit D to the Company's Application. Provide a list of all major forecasting assumptions used to derive the pro forma data.

Response: McLeodUSA does not maintain separate financial statements from McLeodUSA Community Telephone Company. The pro forma financial statements for McLeodUSA Incorporated for the years 2002 through 2005 are set forth in the Appendix C to ICTC Exhibit 2.2. Projected financial statements have not been prepared for 2006.

Item SK-1.7

SK-1.7) Exhibit D of the Petition in Docket 02-0124 presents the debt to equity ratio before the reorganization, please provide a forecast of debt to equity ratios after the proposed reorganization for 2002-2006.

Response: Attachment D to the Petition is not valid. ICTC Exhibit 2.1, Schedule A, which replaces Exhibit D, shows that ICTC's projected debt to total permanent capital ratio is remaining relatively consistent over the next five years, 25% in 2002 going to 21% by 2006.

Item SK-1.8

SK-1.8) Please explain why the Retained Earnings of ICTC shown on Exhibit D to the Company's Petition are forecasted to decline every year.

Response: ICTC Exhibit 2.1, Schedule A, which replaces Exhibit D, shows that retained earnings will be increasing between 2002-2006.

Item SK-1.9

SK-1.9) Please describe any measures enacted to protect ICTC from its parent companies' creditors.

Response: See Prepared Direct Testimony of Joseph H. Ceryanec, lines 68-72.