BEFORE THE ARIZONA CORPORATION COMMISSION

JEFF HATCH-MILLER
CHAIRMAN
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AZ Corporation Commission
Director Of Utilities

IN THE MATTER OF THE APPLICATION OF ESCHELON TELECOM OF ARIZONA, INC. FOR APPROVAL OF ENCUMBRANCE OF ASSETS	DOCKET NO. T-03406A-04-0232 DECISION NO. 67977 ORDER

Open Meeting
July 12, 2005 and 13, 2005
Phoenix, Arizona

BY THE COMMISSION:

INTRODUCTION

Eschelon Telecom of Arizona, Inc. ("Eschelon" or "Applicant" or "Company") filed an Application on March 26, 2004 seeking approval of the encumbrance of certain of Eschelon's assets in relation to the issuance of $100 million of fixed rate Senior Second Secured Notes (the "Notes") by its affiliated entity, Eschelon Operating Company ("Eschelon Operating"). Eschelon states that approval of this Application is in the public interest. Also, Eschelon requested expedited approval of this Application. On August 19, 2004, Eschelon requested that this matter be put on hold until the issue of Eschelon's performance bond is addressed in Docket No. T-03406A-99-0742. Eschelon's performance bond issue was addressed by Decision No. 67674 dated March 9, 2005.

FINDINGS OF FACT

1. In its Application, the Applicant provided the following information:

   a) Eschelon is a corporation duly organized and existing under the laws of the State of Minnesota. Eschelon Operating is a corporation duly organized and existing under the laws of Minnesota. Eschelon Operating is a direct, wholly-owned subsidiary of Eschelon Telecom, Inc., and Eschelon is a subsidiary of Eschelon Operating;

b) Eschelon is certificated by the Arizona Corporation Commission to provide competitive intrastate telecommunications services pursuant to Decision No. 62751[1];

c) This transaction involves the issuance of $100 million in fixed rate Notes by Eschelon Operating;

d) The obligations under the Notes will be guaranteed by each state level operating subsidiary, including Eschelon. Each operating subsidiary, including Eschelon will grant a security interest in its plant and equipment;[2]

e) These funds will be initially used to repay an existing loan, which will provide Eschelon Operating with greater flexibility to fund capital expenditures and working capital needs; and

f) Eschelon states that approval of this Application and these transactions is in the public interest. It will enable Eschelon Operating to obtain additional capital to continue to offer competitive services and potentially expand its service offerings in Arizona. The financing will help provide Eschelon Operating and its affiliates with flexibility to budget for capital expenditures and general corporate purposes, including working capital. The proposed transactions will facilitate consumer benefits and operational efficiencies, permitting the Applicant to better serve its Arizona customers. Also, Commission approval of this Application will bolster the Commission's long-standing goal of fostering full facilities-based competition in the telecommunications market in Arizona.

2. Eschelon stated that the new Notes will be paid before all other indebtedness of Eschelon Operating. Eschelon Operating will make interest-only payments every March 15th and September 15th beginning September 15, 2004 and ending March 15, 2010, and one principal payment of $100,000,000 on March 15, 2010. The Notes have an interest rate of 8.375 percent for a term of 6 years with a maturity date of March 15, 2010. The Notes issued on March 17, 2004 were sold on the open investment markets.

3. The security against the Notes will be a Second Priority Lien on substantially all of Eschelon Operating assets (plant and equipment) including those of Eschelon Telecom of Arizona, Inc. The assets of Eschelon Telecom of Arizona, Inc. represent less than ten percent of the total assets pledged as security for Notes.

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[1] Eschelon is currently authorized to provide resold and facilities-based local exchange and resold long distance telecommunications services in Arizona.

[2] The security interest will not become effective with regard to Eschelon until after the Commission approves this Application.

4. Eschelon's main lenders of the existing loan were NTFC Capital Corporation (General Electric Capital Corporation), US Bank and Wachovia Bank. All three lenders have been repaid with the proceeds from Eschelon Operating Company's March 2004 issuance of the senior second secured Notes, which are the subject of this Application.

5. Eschelon's prior loan has been repaid because a.) it carried a more costly, fixed interest rate with principal payments scheduled to commence next year and b.) it had maintenance covenants that greatly restricted Eschelon Telecom Inc.'s financial flexibility. The existing loan had a balance of $86 million, which was comprised of $65 million in principal and $21 million of future interest.[3] The maturity date for the loan was June 30, 2009; principal payments were scheduled to begin June 30, 2005. The 8 percent interest rate was scheduled to convert to a floating rate at the end of the 2nd Quarter of 2004 making the interest rate potentially more costly and subject to unpredictable financial market swings. The interest rate on the existing loan would have converted to a floating rate based on LIBOR (London InterBank Offered Rate) plus 3.50% to 4.75% per year determined by Eschelon Operating leverage rate. The loan had been issued to Eschelon Operating as a wholly owned subsidiary of Eschelon Telecom, Inc.

6. The interest rate on the issued Notes is a fixed rate and no principal payments are required until the end of the Notes' term. The Notes carry no maintenance covenants, allowing Eschelon Telecom, Inc. financial flexibility that it did not have in the past.

7. Issuance of the Notes provided Eschelon Telecom, Inc. with an additional $13 million of liquidity. The more favorable terms of the Notes and added liquidity provide Eschelon with greater flexibility to make investments in appropriate capital expenditures and operational improvements and to make investment decisions without regard to the impact of those investment decisions on the very restrictive, existing credit agreement.

The Affiliated Interests Rule

8. The Public Utility Holding Companies and Affiliated Interests Rules apply to all Class A investor-owned utilities. A telecommunications carrier that has Arizona jurisdictional

[3] Eschelon stated in its response to data request JFB 2-3 that the notation of the $21 million was due to the conditions of the loan and generally accepted accounting practice.

annual operating revenues of more than $1 million is considered to be a Class A utility. In the annual report filed with the Commission, Eschelon generated more than $1million of Arizona jurisdictional annual operating revenue. Eschelon is a Class A investor-owned utility. As a result, the Application is subject to Arizona Administrative Code ("A.A.C.") R14-2-801 through 805 of the Public Utility Holding Companies and Affiliated Interests Rules.

9. Eschelon further stated in its Application that it has a limited waiver to; A.A.C. R14-2-804 (B), (C), and (D).[4] The waiver to these rules was granted in Decision No. 64737 dated April 17, 2002. Staff reviewed Decision No. 64737 and verified that Eschelon has a limited waiver to A.A.C. R14-2-804 (B), (C), and (D) as well as to A.A.C. R14-2-803 and A.A.C. R14-2-805. The proposed transactions do not require Commission review and approval pursuant to the Affiliated Interests Rules because the transactions do not directly or indirectly result in or cause an increase in its maximum rate on file. Also, the proposed transaction does not involve an organization or reorganization that requires Eschelon to file a notice of intent when the organization or reorganization could directly or indirectly result in or cause an increase in its maximum rate on file. Finally, the proposed transaction does not impact diversification plans that require Eschelon to file a description of its diversification activities and plans when such diversification activities and plans could directly or indirectly result in or cause an increase in its maximum rate on file.[5]

The Public Interest

10. Based upon the information received from the Applicant, it is Staff's view that the proposed transactions will serve the public interest:

a) Proceeds from the Notes will give Eschelon the ability to make investment decisions in Arizona on a less restrictive credit agreement than it had in the past;

b) The Notes were issued at a discount. Therefore, the gross proceeds were about $85 million. From the proceeds, $67 million was used to pay off the

[4] In Decision No. 64737, the Commission granted Eschelon a limited waiver of the Affiliated Interest Rules. Because this transaction will not result in an increase in its maximum rates on file with the Commission, Eschelon submits that approval pursuant to A.A.C. R14-2-804 is not required.

[5] Utilities Division Administrative Services Staff has reported that Eschelon has not filed a request to increase its maximum rates since it filed this Application on March 26, 2004.

existing loan and $4.2 million was used to pay the fees associated with the financing transactions. This left Eschelon Operating with $13.6 million additional liquidity. At this time, Eschelon Operating has not developed detailed plans for using the additional capital of $13.6 million.

11. Utilities Division Consumer Services Staff has reported that from January 1, 2002 through March 31, 2005, Eschelon had a total of two complaints in 2002, two complaints in 2003 four complaints in 2004, and one complaint as of 2005, a total of nine complaints. All the complaints have been resolved and closed by the Consumer Services Section. Among the nine complaints, two complaints dealt with billing issues and two complaints dealt with service issues. One time complaints include: an outage, disconnect for non-payment, an unauthorized carrier change, a returned check policy and procedure, and a miscellaneous issue. In addition, fifteen inquiries were received by the Commission from Eschelon's customers. Six out of the fifteen inquiries received from Eschelon customers involved billing disputes. Consumer Services Staff also reported that Eschelon is in "Good Standing" with the Corporations Division of the Commission.

a.) According to its response to data request JFB 2-16, Eschelon does not have any outstanding compliance issues that need to be addressed with the Commission. Staff confirmed with the Compliance Section of the Utilities Division that there are no compliance matters that need to be resolved with Eschelon.

b.) Staff recommends that the Commission approve the proposed encumbrance of Eschelon's assets by Eschelon Operating. The proposed encumbrance of assets is in the public interest as additional capital is obtained on a less restrictive credit agreement. The new loan will not result in or cause an increase in Eschelon's maximum rate on file with the Commission for any competitive service.

c.) Staff recommends that the additional capital of $13.6 million be used as per the existing Indenture covenant for the Notes that requires that the Company shall not engage in any business other than the permitted businesses which include delivery and distribution of telecommunications, voice, data, and video and any activities ancillary to the above services.

CONCLUSIONS OF LAW

1. Eschelon is an Arizona public service corporation within the meaning of Article XV, Section 2, of the Arizona Constitution and A.R.S. § 40-285.

2. The Commission has jurisdiction over the subject matter in this proceeding.

3. Eschelon has a waiver of A.A.C. R14-2-803; A.A.C. R14-2-804 (B), (C), and (D); and A.A.C. R14-2-805 except for those organizations or reorganizations, transactions, or diversification plans that could directly or indirectly result in or cause an increase in its maximum rate in file with the Commission for any competitive service.

4. Staff's recommendation, as set forth in Findings of Fact No. 11 b and 11 c above, is reasonable and should be adopted.

5. The Commission, having reviewed the filing and Staff's Memorandum dated June 28, 2005, concludes that it is in the public interest to approve this filing as recommended by Staff.

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ORDER

THEREFORE IT IS ORDERED that the Application to encumber Eschelon's assets in Arizona as discussed herein is granted by the Commission.

IT IS FURTHER ORDERED that on or before June 30th of each year, Eschelon shall provide to Staff the allocated Arizona percentage of actual capital expenditures by the categories listed on the Company's website and provided to the Securities Exchange Commission.

IT IS FURTHER ORDERED that this Order shall be effective immediately.

BY THE ORDER OF THE ARIZONA CORPORATION COMMISSION

CHAIRMAN COMMISSIONER

COMMISSIONER COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto, set my hand and caused the official seal of this Commission to be affixed at the Capitol, in the City of Phoenix, this 18th day of July, 2005.

BRIAN C. McNEIL
Executive Secretary

DISSENT: _____

DISSENT: _____

EGJ:RLB:lhm\JMA

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DOCKET NO. T-03406A-04-0232

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