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Annual Report on Alternative Forms of Regulation for Telephone Utilities

Report to the Utilities and Energy Committee by the Maine Public Utilities Commission September 1, 2006

I. BACKGROUND

Title 35-A M.R.S.A. Chapter 91 governs alternative forms of regulation for telephone companies. Section 9105 requires the Maine Public Utilities Commission (Commission) to provide the Utilities and Energy Committee with an annual report describing the Commission's activities under Chapter 91 and the effectiveness of any adopted Alternative Form of Regulation (AFOR) in achieving the objectives of Chapter 91. This report constitutes the Commission's compliance with the annual reporting requirement of Chapter 91 for 2006.

In 1994, the Maine Legislature enacted Chapter 91 which authorizes the Commission to adopt an AFOR for any telephone utility in the State, provided certain conditions are met. In 1995, the Commission adopted an AFOR for Verizon, then known as NYNEX. In 2001, the Commission extended the Verizon AFOR for an additional 5 years, but it made several significant changes to the pricing rules and Service Quality Index (SQI) mechanism. The Office of the Public Advocate (OPA) and the American Association of Retired Persons (AARP) appealed the Commission's 2001 AFOR Order to the Law Court. In February 2003, the Law Court remanded the case back to the Commission for further proceedings because the Court found that the Commission had failed to make the determination required in § 9103(1) that rates under the AFOR would be no higher than they would be under traditional regulation for the duration (5 years) of the AFOR.

In September 2003, after conducting further proceedings, the Commission issued its Order Reinstating AFOR, finding that it was not possible to make the comparative finding contained in § 9103(1), at least not with the degree of certainty indicated by the Court. Instead, the Commission made the alternative finding, which the Court had indicated was permitted by § 9103, that it was not in the public interest to make the comparative rate assurance described in the statute. The reinstated AFOR contained identical provisions to those present in the AFOR that was vacated by the Law Court.

The OPA and the AARP appealed the Commission's 2003 AFOR reinstatement Order, and in January 2005, the Law Court vacated the Commission's Order and again remanded the matter back to the Commission. The Court found that to determine whether bypassing the rate comparison is in the best interests of ratepayers, as well as to determine the feasibility of making

a revenue requirement assessment and 5-year comparative rate assurance, the Commission must have a more complete record.¹

To comply with the mandate of the Law Court remand, on March 5, 2005, the Commission issued a Notice of Investigation that opened a new proceeding to consider a new AFOR for Verizon. This proceeding was assigned Docket No. 2005-155. The proceeding will address the requirements of the AFOR statute, and any AFOR adopted will replace the one vacated by the Court. Based on discussions with the parties, the Commission divided the new AFOR case into two phases, with Phase 1 addressing the current revenue requirements of Verizon, based primarily on traditional ratemaking principles, such as costs, capital investment and rate of return. Phase 2 will address the structure of the AFOR, including pricing rules for all services, service quality issues and the multi-year rate comparison prescribed by the statute and required by the Court.

II. SUMMARY OF COMMISSION ACTION SINCE LAST ANNUAL REPORT

A. Verizon

1. Status of Pending AFOR Proceeding

The filing of written testimony presenting and supporting the position of each of the parties for both phases of the Docket No. 2005-155 began in September 2005 and is now complete. Written testimony was filed by witnesses for Verizon, the OPA and the AARP, and discovery on each of the filings was conducted pursuant to Commission rules. The next step in the process is the cross examination of the witnesses in hearings, which will begin on August 30th for Phase 1 issues. Additional hearings will be held in September and October. After hearings are completed, the case will follow the procedures that are normally used in litigated Commission proceedings. The parties will file briefs on the issues in each phase, the Hearing Examiner will issue recommendations, parties will file exceptions to the recommendations, and the Commission will render a decision and issue an order describing its decision and its reasoning. The Commission expects to reach its decision on both phases of this case by the end of the year.

The parties could agree to a stipulated resolution of the case, which would be presented to the Commission for its consideration. The

¹ The extensive litigation over the Verizon AFOR resulted largely from the Commission's difficulty in finding a meaningful way of complying with § 9103(1) which states that ratepayers "may not be required to pay more for local telephone service as a result of the implementation of an alternative form of regulation than they would under traditional rate-base or rate-of-return regulation." Although the objective of this provision is eminently reasonable, determining what rates would have been under a system of regulation that has not been in effect for several years and making a comparison with a system that has been in effect is a highly speculative undertaking that does not easily lend itself to the level of certainty the statute seems to contemplate.

parties have met informally with the Commission advisory staff to discuss a potential agreement but, as of the writing of this report, no agreement has been reached and the Commission staff is not aware of any ongoing discussions.

2. Verizon's SQI Results for 2004/2005

While the current AFOR case is in progress, Verizon remains subject to all provisions of the remanded AFOR, including the Service Quality Index provisions, which require that Verizon pay penalties for actual performance that is below the designated benchmark for any of the 15 specified metrics. As discussed in last year's Annual AFOR Report, when Verizon filed its performance results for the specified metrics for the 12 months ending June 30, 2005, the results showed that Verizon missed the benchmark for two of the indices, and thus, it owed a penalty of \$639,127. In September 2005, Verizon requested that the Commission exclude certain complaints from the Complaint Ratio metric (one of the metrics for which Verizon failed to meet the benchmark), on the grounds that those complaints, which were recorded by the Commission's Consumer Assistance Division, should not have been counted against Verizon for various reasons. The Commission staff provided Verizon with detailed information about why each of the complaints had been included in the Complaint Ratio. In February 2006, the Hearing Examiner instructed Verizon to file its written response to the staff's explanation for each disputed complaint. Verizon responded that it lacked sufficient resources to pursue its challenges and was withdrawing its request to exclude the complaints from the metric. In March 2006, customers received a credit of \$1.31 per line as Verizon's SQI rebate for the 2004/2005 AFOR year.

During discussions about the disputed 2004/2005 complaints that were included in the Complaint Ratio metric, the Commission staff and Verizon were able to reach agreement on the procedures that would be followed prospectively in resolving disputes about whether specific complaints would be included in the Complaint Ratio metric. Under the agreement, the Commission retains the ultimate authority to determine the validity of including any particular complaint. The agreement, which was approved by the Commission in March 2006, will allow for more timely resolution of disputes about including or excluding complaints in or from the index.

3. Verizon's SQI Results for 2005/2006

For the AFOR year ending June 30, 2006, Verizon failed to meet three of the 15 SQI metric benchmarks and, consequently, owes a penalty of \$711,658, which will appear as a credit on its customers' bills in December of this year.

B. Independent Telephone Companies

1. Pine Tree and Saco River Pricing Flexibility

In 2005, two independent telephone companies, Pine Tree Telephone Company (Pine Tree) and Saco River Telephone Company (Saco River) (together “the companies”), asked the Commission to allow them to operate under an AFOR mechanism, pursuant to the AFOR statute. In June 2005, the Commission opened an investigation in response to the companies’ request. After extensive discovery and discussions among the companies, the OPA and the Commission staff, a Stipulation was filed that provided caps on basic service rates, but allowed the companies some pricing flexibility to reduce rates or provide bundled service packages to meet emerging competition, mainly from cable companies and wireless providers. Any competitive pricing options offered by the companies are to become effective in an expedited manner, provided they comply with the provisions of the agreement. Should either of the companies or the Commission initiate a revenue requirement proceeding, the effect of the special pricing arrangements will be considered in determining either company’s rates for customers without competitive options.

In addition to caps on local rates, directory assistance rates and operator services rates, customers of Saco River received, at no increase in rates, an expansion of their Basic Service Calling Area (BSCA) territory to include calling to and from the Portland exchange. Calling volumes from each of the Saco River exchanges to Portland exceeded the standards for BSCA expansion established by Commission rules. The parties to the Stipulation agreed that the BSCA expansion, without a concurrent local rate increase, recognized that the earnings of Saco River may have been in excess of an amount determined to be “reasonable” had the Commission conducted a full rate case proceeding.

The Commission agreed with the parties that the stipulated result did not constitute an AFOR, as the term is defined pursuant to 35-A M.R.S.A. §§ 9101-9103. The Stipulation did contain some pricing freedom provisions, but those provisions are all consistent with authority of the Commission that long predated the AFOR statute. One of the most important features of incentive regulation such as an AFOR is a “stay out” that prevents either the utility or the Commission from instituting a rate case for an extended period of time, unless extraordinary circumstances occur. The current AFOR statute requires that any AFOR remain in effect for not less than 5 years or more than 10 years. There is no stay-out provision in the Pine Tree and Saco River Stipulation. Further, the Stipulation made no attempt to comply with the rate comparison requirement contained in § 9103(1).

In its Order adopting the Pine Tree and Saco River Stipulation, the Commission expressly stated that the circumstances facing Saco River and Pine Tree, especially the possibility of local competition, were unique to the companies and justified the pricing flexibility provisions contained in the

Stipulation. The Commission emphasized that those same conditions may not exist for other local exchange carriers. The Commission noted that it will address any future proposals for pricing flexibility on their own merits, after considering the specific circumstances facing the particular company or companies involved.

2. Workgroup to Discuss AFORs for Rural Telephone Companies

In 2005 and 2006, the Utilities and Energy Committee (Committee) considered LD 1675, An Act to Make a Standard Alternative Form of Regulation Available to Rural Telephone Companies. The Committee ultimately voted “Ought Not to Pass” on the bill, but agreed to send a letter to the Commission requesting the Commission to convene a workgroup to discuss several issues raised by the bill.

By letter dated January 23, 2006, the Committee Chairs informed the Commission that they

are writing on behalf of the committee to request the PUC to convene a small group of interested persons for the following purposes:

- To review and discuss the current process that exists for establishing an AFOR and how that process impacts small, rural telephone companies, and
- To evaluate options for streamlining and simplifying the process for a rural telephone company to adopt an AFOR, including
 - Opportunities to streamline the rate review and evaluation process, including the potential for a two-tier (short-term and long-term) model for rate cases associated with AFOR proceedings, and
 - Options for and costs and benefits of developing a standardized AFOR model, or “template,” for rural telephone companies.

The January 23rd letter also requests the Commission to “report the results of the group’s work and policy recommendations to the committee no later than January 1, 2007.”

On June 29, 2006, Commission staff met with representatives of rural telephone companies to discuss the composition of the workgroup, the scope of the group’s activities and the process for responding to

the Committee's request. On July 20th, the Commission staff met with members of the Telephone Association of Maine (TAM) and the OPA to discuss the issues raised by LD 1675. At the conclusion of the meeting, TAM representatives agreed to draft a template for what TAM has defined as "relaxed regulation." Staff has also contacted Verizon representatives requesting an opportunity to meet to discuss their concerns with, and possible changes to, the existing AFOR statute. As requested in the January 23rd letter from the Committee Chairs, the Commission will submit a report to the Committee by the end of the year that summarizes the results of the workgroup's activities and recommendations.