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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 4, 2007

I. INTRODUCTION

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 2007.

II. SUMMARY OF COMMISSION ACTION SINCE LAST ANNUAL REPORT

A. Verizon

1. Background Concerning Pending AFOR Proceeding (Docket No. 2005-155)

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 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 after finding 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 is intended to address the requirements of the AFOR statute, and any AFOR adopted will replace the one vacated by the Court. After discussions with the parties, the Commission divided the new AFOR case into two phases. Phase I addresses the current revenue requirements of Verizon, based primarily on traditional ratemaking principles, such as costs, capital investment and rate of return. Phase II 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.

The witnesses for all parties filed written testimony between September 2005 and June 2006, and hearings were scheduled for the summer of 2006. Several parties raised the possibility of a negotiated settlement of the case, and during the summer of 2006 the parties, including the Commission's Advisory Staff, engaged in settlement discussions in an attempt to resolve the issues surrounding both phases of the case. When those discussions proved unsuccessful, hearings covering all issues in both phases of the case were held during the fall of 2006.

2. Current Status of AFOR Case

After the completion of hearings in the Fall of 2006 but prior to the date on which briefs were initially due to be filed, the parties again engaged in negotiations attempting to settle all (or at least some of) the issues in the case. In December 2006, the parties notified the Commission that an agreement still could not be reached. Because of time devoted to 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.

negotiations, briefs on Phase I were delayed for a short period, but were eventually filed on January 26, 2007.

Around the same time, on January 31, 2007, Verizon Maine and FairPoint Communications, Inc. filed a request for approval of a transfer of Verizon's assets and employees' and customers' relationships (with the exception of some enterprise and governmental lines of business) in Maine, New Hampshire and Vermont to FairPoint Communications. FairPoint currently owns six rural telephone local exchange carriers in Maine. Under the proposal, FairPoint would take over all of Verizon's local exchange, long distance and Internet business operations in the three states.

On May 9, 2007, the Hearing Examiner issued his Report on the Phase I issues. The Examiner's Report recommended that the Commission find that Verizon presently is over earning, and its revenues should be reduced by \$32.4 million on an annual basis. Concurrent with the release of the Report, the Examiner asked for comments on what the Commission should do with any findings it might make as a result of considering the Examiner's Report. The Examiner also requested comments on the rate design that the Commission should employ, assuming the Commission were to find that a rate reduction was necessary. Phase II issues have not been briefed yet.

Just prior to the deadline for exceptions to the Phase I Examiner's Report in the AFOR case, the parties requested an extension of the deadline to allow for continuing negotiations that, they asserted, could lead to a resolution of a "significant portion of the case" and could result in accelerated broadband build-out. The Commission granted the extension request and on July 3, 2007, the OPA and Verizon filed a Stipulation in the AFOR case that would (1) suspend further proceedings in that case until after the conclusion of the Commission proceeding involving the proposed transfer of Verizon's assets to FairPoint Communications, and (2) require Verizon, prior to the conclusion of the proposed transfer proceeding, to invest \$12 million in infrastructure that would provide DSL service to additional customers.

The AARP opposed the Stipulation, both in written comments and at a hearing concerning the Stipulation that was held on July 24, 2007. The Telephone Association of Maine (TAM) did not sign the Stipulation, but it supported the agreement in written comments and at the hearing.

On July 26, 2007, the Commission held a Deliberative Session on the Stipulation, and on July 30, 2007, the Commission issued its Order Rejecting the Stipulation. The Commission was unable to find that the agreement met applicable legislative mandates or that the stipulated result would be in the public interest. In its Order, the Commission directed the parties to file exceptions to the Phase I Examiner's Report in the AFOR case by August 10,

2007, and if the parties intended to file a revised stipulation, they were also to do so by that same date.

On August 8, 2007, the OPA and Verizon filed an *Amended Stipulation* in the AFOR case that purported to resolve most of the concerns expressed by the Commission during its deliberations on the original Stipulation. The Amended Stipulation contained essentially the same terms as the original agreement, but it also (1) identifies the locations (central offices and remote terminals) and the number of lines at each location where Verizon would make DSL service available pursuant to its commitment to spend \$12 million; (2) establishes February 1, 2008, or the merger closing date, whichever occurs first, as the date certain for Verizon to complete its DSL build-out commitment; (3) establishes a date certain (180 days after the Verizon/FairPoint transfer closing or its termination), but in no event later than July 31, 2008, as the date for the dissolution of the stay of the AFOR proceeding; and (4) enhances the Commission's ability to enforce the terms of the Stipulation via an escrow account, which would be invoked if Verizon fails to meet its \$12 million DSL commitment prior to the transfer closing date or at February 1, 2008 (whichever occurs first), and expands the reporting requirements by Verizon with monthly (instead of bi-monthly) reports that will delineate specific deployment progress. With the filing of the Amended Stipulation, the OPA and Verizon also requested that the Commission extend the deadline for filing exceptions to the Examiner's Report in the AFOR case until after the Commission had considered the Amended Stipulation.

On August 14, 2007, the Commission held a hearing on the Amended Stipulation, and it considered the agreement at Deliberations that followed the hearing. The AARP continued to oppose the Amended Stipulation, and TAM expressed its continued support for the agreement. The Commission found that the Amended Stipulation met the criteria for acceptance and voted unanimously to approve it. In doing so, the Commission expressly stated that it retains its authority to reopen its approval and lift the stay in the AFOR case for any reason (after appropriate due process), should it find it necessary to do so. The Commission acknowledged its responsibility to process the AFOR case, but found that delaying consideration of the AFOR issues for a short period in order to complete work on the transfer of assets proceeding, while simultaneously promoting the availability of DSL service to about 35,000 additional Verizon customers, was in the public interest.

After the Commission decides whether the proposed Verizon transfer of assets to FairPoint should be approved, it will be in a better position to determine the form of regulation and the specific provisions of that regulation that should be applied to the entity that provides basic and other services to the vast majority of Maine's wireline telephone customers. Currently, the Commission expects to reach its decision on the Verizon/FairPoint transfer by the end of this year.

3. Verizon's Service Quality Index Results to 2006/2007

While the current AFOR case is in progress, Verizon remains subject to all provisions of the remanded AFOR, including the Service Quality Index (SQI) provisions, which require that Verizon pay penalties for actual performance that is below the designated benchmark for any of the 15 specified metrics.

Verizon has not yet reported its final results for the 2006/2007 SQI year, which ended June 30th. Furthermore, on August 31, 2007, Verizon filed a request for a waiver to exclude the service quality results for the month of April, 2007 from the calculation of the annual SQIs. In its filing, Verizon asserts that severe storms that struck Maine on April 4 and April 16 disproportionately affected the performance results for April. Before final 2006/2007 SQI performance results can be calculated and penalties (if any) determined, the Commission must decide the disposition of the waiver request and Verizon must complete its filing requirements.

Verizon's service quality performance is a matter that is being considered in the AFOR case, but as described above, that proceeding has been stayed pending the outcome of the proposed Verizon/FairPoint asset transfer.

B. Independent Telephone Companies

Last year, a Workgroup to Discuss AFORs for Rural Telephone Companies (Workgroup) was formed in response to a letter dated January 23, 2006, from the Chairs of the Utilities and Energy Committee to the Commission. The Workgroup consists of representatives of the rural telephone companies (the Telephone Association of Maine, or TAM), the OPA and members of the Commission Staff. As outlined in the January 23rd letter from the Committee Chairs, the purposes of the Workgroup are:

- 1) To review and discuss the current process that exists for establishing an AFOR and how that process impacts small, rural telephone companies, and
- 2) 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 23, 2006, letter also requested the Commission to “report the results of the group’s work and policy recommendations to the committee no later than January 1, 2007.” On January 4, 2007, the Commission Staff notified the Committee Chairs of a possible impasse in the Workgroup’s discussions, but requested an extension of the reporting deadline to allow the parties a final opportunity to explore alternatives before declaring impasse. The extension was granted, and on March 5, 2007, the Commission filed its Interim Report to the Committee.

The Interim Report described the history of the discussions that had occurred and indicated that the parties believed that additional discussions would be useful. The Interim Report also indicated that the parties had agreed to monthly meetings that would address specific topics related to the AFOR issue. Finally, the Interim Report requested that the Chairs allow the parties an extension until on or about November 15, 2007, for filing their final report. The purpose of the final report will be to summarize the results of the monthly meetings and to propose any additional action recommended by the parties. The Committee Chairs granted this request.

The parties have adhered to the monthly meeting schedule set forth in the March 5th Interim Report, although the discussion topics for each meeting have been slightly altered based on the results and progress of previous meetings. The parties have discussed extensively whether pricing flexibility, rather than a formal AFOR that fully complies with the provisions of Chapter 91 of Title 35-A, represents a better and more readily attainable method of providing rural telephone companies with the tools they need to remain viable and competitive in today’s rapidly changing telecommunications environment.

The meetings have been conducted in a collegial manner, with all parties concentrating on (1) identifying and understanding differences of opinion and (2) reaching a consensus resolution that allows companies the flexibility they need, protects captive local exchange customers who may lack competitive options and meets all statutory requirements and regulatory principles. The parties have made considerable progress in identifying and addressing the various issues surrounding pricing flexibility and hope that an agreement that satisfies all parties can be achieved with continued effort. The schedule of meetings remains on track, and the parties will submit a status report to the Utilities and Energy Committee by November 15, 2007.