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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 24, 2008

I. INTRODUCTION

Title 35-A M.R.S.A. Chapter 91 governs alternative forms of regulation (AFORs) for telephone companies. Section 9105 requires the Maine Public Utilities Commission (Commission) to provide the Utilities and Energy Committee (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 91.¹ This report constitutes the Commission's compliance with the annual reporting requirement of Chapter 91 for 2007 and the early portion of 2008.²

II. SUMMARY OF 2007 AND EARLY 2008 ACTIVITIES

In early 2008, the Commission concluded a proceeding involving both Verizon Maine's AFOR and the proceeding to consider the transfer of Verizon Maine's assets and customers to FairPoint Communications-NNE (FairPoint). Because of the asset transfer, which occurred on April 1, 2008, FairPoint will operate under the approved AFOR. In addition, the Commission approved a new rule that established flexible pricing, revenue allocation certainty, and relaxed consumer protection requirements to local telephone carriers who offer bundled services to residential customers. The rule stems from a request by the Committee to consider streamlined AFOR procedures for rural telephone companies.

¹ The report was due September 1, 2008. The Commission apologizes for any inconvenience caused by the Commission's delay in getting the report to the Committee.

² In past years, this annual report has described activities in the previous calendar year. However, events in 2007 reached conclusions in 2008. Thus, we believe this report will be more useful to the Committee if it encompasses both 2007 and early 2008.

III. DESCRIPTION OF 2007 and EARLY 2008 ACTIVITIES

A. Verizon Maine's AFOR

1. Background of Verizon's AFOR Proceeding

The AFOR proceeding that concluded in early 2008 stemmed from a series of Commission and Court actions that occurred over a period of years. This section describes those earlier events.

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 made several 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 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 of the AFOR.

In September 2003, the Commission issued its Order Reinstating AFOR, finding that it was not possible to make the comparative finding contained in § 9103(1) with the degree of certainty indicated by the Court. Instead, the Commission made the alternative finding, that it was not in the public interest to make the comparative rate assurance described in the statute. The OPA and the AARP appealed the Commission's decision, 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.³

³ 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

To comply with the mandate of the Law Court remand, on March 5, 2005, the Commission opened a new proceeding, Docket No. 2005-155, to consider a new AFOR for Verizon. The Commission divided the new AFOR case into two phases. Phase I addressed Verizon's current revenue requirements, based primarily on traditional ratemaking principles such as costs, capital investment and rate of return. Phase II was to 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.

Parties filed written testimony between September 2005 and June 2006, hearings on issues in both phases of the case were held during the fall of 2006, and parties filed briefs in January, 2007.

2. Asset Transfer Proceeding (Docket No. 2007-67)

On January 31, 2007, Verizon New England and the FairPoint telephone companies 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-NNE. Under the proposal, FairPoint would take over Verizon's local exchange, long distance and Internet business operations in the three states. The Commission opened a proceeding, Docket No. 2007-67, to consider this request. The Commission approved the request with conditions in its February 1, 2008 Order and the transfer took place on April 1, 2008. During the proceeding, the 2005-155 AFOR case was combined with the 2007-67 asset transfer case, and the February decision encompassed both cases.

3. 2007 and 2008 Activities in Verizon's AFOR Proceeding (Docket No. 2005-155)

On May 9, 2007, the Hearing Examiner issued his Report on the Phase I issues of Verizon's Docket 2005-155 AFOR proceeding. The Examiner's Report recommended that the Commission find that Verizon presently was over earning and that 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 how the Commission should treat 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.

speculative undertaking that does not easily lend itself to the level of certainty the statute seems to contemplate.

On July 3, 2007, the OPA and Verizon filed a Stipulation in the proceeding that would (1) suspend further actions in the proceeding until after the conclusion of the asset transfer proceeding, and (2) require Verizon, prior to the conclusion of the proposed transfer proceeding, to invest \$12 million in infrastructure that would provide digital subscriber line (DSL) service to additional customers. The AARP opposed the Stipulation. The Telephone Association of Maine (TAM) asserted that it supported the agreement but did not sign the Stipulation.

On July 26, the Commission held a deliberative session on the Stipulation, and subsequently issued its Order Rejecting the Stipulation. The Commission was unable to find that the agreement met the guiding principles used to consider stipulations 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 or, if they intended to, a revised stipulation, no later than August 10, 2007.

On August 8, the OPA and Verizon filed an Amended Stipulation 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) identified 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) established February 1, 2008 or the asset transfer closing date, whichever occurred first, as the date certain for Verizon to complete its DSL build-out commitment; (3) established a date certain (180 days after the asset 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; (4) enhanced the Commission's ability to enforce the terms of the Amended Stipulation via an escrow account, which would be available if Verizon failed to meet its \$12 million DSL commitment before the established deadline; and (5) expanded Verizon's reporting requirements to include monthly reports that would delineate DSL deployment progress.

On August 14, the Commission held a hearing and conducted a deliberative session on the Amended Stipulation. 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 retained its authority to reopen its approval and lift the stay in the AFOR case (after appropriate due process), should it find it necessary to do so. The Commission found that delaying consideration of the AFOR issues for a short period in order to complete work on the asset transfer proceeding, while simultaneously promoting the availability of DSL service to about 35,000 additional Verizon customers, was in the public interest.

Between September 2007 and February 2008, Verizon expanded DSL service to all the locations specified in the Amended Stipulation.

Throughout 2007, the Commission carried out the Docket No. 2007-67 Verizon/FairPoint asset transfer proceeding. Docket No. 2005-155 was combined with the asset transfer proceeding, and the two cases were considered simultaneously. In February 2008, the Commission concluded its consideration of the two cases. As it relates to the AFOR proceeding, the Amended Stipulation and additional Commission conditions in the combined asset transfer and AFOR proceedings (1) settled all issues in the AFOR proceeding; (2) provided a rate decrease of \$18 million annually, effective on August 1, 2008; (3) implemented revisions to certain SQL requirements; (4) increased the potential penalty for repeatedly missing SQL benchmarks; and (5) maintained all other aspects of Verizon's AFOR.⁴ The decision established that after the asset transfer, FairPoint's operation of the former Verizon service territory would be regulated by the terms of the revised AFOR for five years ending August 1, 2013.

On July 3, FairPoint filed a request that the Commission allow it to (1) defer the August 1 rate decrease and rate design changes until December 1, 2008, and (2) place a credit on December bills that would approximately equal the reduction that customers would have received between August and November. The filing noted that the anticipated cutover from Verizon's computer systems to FairPoint's, which originally was expected to occur in late July, had been deferred until late November, making a rate change impossible to implement in August. The Commission approved the request, but stated that FairPoint must provide the one-time credit in December bills regardless of the ultimate date of cutover. On September 15, 2008, FairPoint announced that the expected cutover will be delayed until January 2009. Because of this delay, FairPoint is required to provide the Commission with a new schedule regarding additional customer credits.

⁴ In conjunction with the \$18 million rate reduction, the Commission decision included rate design requirements that address an ongoing problem regarding the effectiveness of "municipal calling" (the ability to make toll-free calls anywhere within a customer's municipality). The requirements included elimination of "economy calling," reduction of "premium calling" prices, and revisions to Basic Service Calling Areas to reduce inconsistency between calling area and municipal boundaries. After discussions with stakeholders and the Commission Staff, FairPoint subsequently requested revisions to the terms associated with municipal calling, and the Commission approved those revisions. These topics are not directly part of the AFOR proceeding, but are mentioned here because they affect overall rate levels.

4. Revisions to FairPoint's SQI and 2007/2008 Results

Under the terms of the asset transaction decision, several changes occurred to the SQI mechanism under which FairPoint would operate. First, FairPoint will receive a 24-month relaxation in the benchmark level of two indices, after which the benchmarks will revert back in steps to their original levels. This ramp-up procedure applies to: 1) Customer Trouble Reports per 100 Lines and 2) Residential Trouble Reports Not Cleared in 24 Hours. Verizon had experienced significant difficulty in meeting the benchmarks for these metrics, and FairPoint asserted that it could improve on the results, but needed time to analyze the cause of the problems and implement procedural changes that would allow it to provide better service as measured by these metrics. Also, FairPoint committed to examining the physical characteristics of the exchanges that experienced the highest level of trouble reports and devising a plan to improve the infrastructure of its plant in those exchanges.

Second, the 2007/08 SQI period was extended from 12 to 13 months, to end on July 31, 2008. For the 13 months of the 2007/08 SQI period, FairPoint would own and operate the former Maine territory of Verizon for 4 months, but would be responsible for the 13-month performance and any penalties that resulted.

Third, effective with the 2008/09 SQI year, which started on August 1, 2008, two former metrics, Dial Tone Speed and Percentage of Blocked Calls, were eliminated and a new metric, Duration of Residential Outages, was added. FairPoint received a 2-year ramp-up for the benchmark of this new metric, to allow the company time to implement operational, management and technical improvements that would help it to meet the standard.

A final change increases the penalty amount when FairPoint fails to meet the benchmark in consecutive SQI reporting years. Under this change, for each metric that FairPoint fails to meet in consecutive years, the penalty for that metric will be multiplied by the number of consecutive years that the benchmark was missed.

For the 2007/08 SQI 13-month period, which ended on July 31, 2008, FairPoint (including Verizon's first 9 months) met 13 of the 15 benchmarks. It failed to meet the relaxed benchmark for "Troubles Not Cleared Within 24 Hours" and "Percentage of Business Office Calls Answered in Over 20 Second." Failure to meet these two benchmarks will result in a penalty, which will be credited to customers' bills. The Commission has not yet verified the level of the penalty.

The revised SQI mechanism continues to measure the most important aspects of service quality provided by FairPoint and gives the Company the appropriate incentives to continue to provide or improve good

service in important aspects of its customer service operations. The Commission will continue to monitor closely FairPoint's progress in achieving improvement where it is needed.

B. Rural Telephone Companies

In 2006, a 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 consisted of TAM, the OPA and the Commission Staff. As outlined in the letter from the Committee Chairs, the purpose of the workgroup was:

- 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:
 - a. the potential for a 2-tier (short-term and long-term) model for rate cases associated with AFOR proceedings, and
 - b. options for and costs and benefits of developing a standardized AFOR model, or "template" for rural telephone companies.

On January 4, 2007, the Commission Staff requested an extension of the reporting deadline established in the Committee's letter, to allow the workgroup to explore alternatives that would meet the Committee's goals. On March 5, the Commission filed its Interim Report to the Committee. The workgroup held monthly meetings throughout 2007, and on November 15 submitted to the Committee its final report.

The workgroup concluded that the most effective and readily attainable approach to providing rural telephone companies with tools to remain competitive in the rapidly changing telecommunications environment would be to provide pricing flexibility, rather than attempt to develop comprehensive AFOR procedures. Accordingly, the workgroup developed a draft rule that would establish parameters under which rural companies could effectively offer bundles of regulated and unregulated services.⁵

⁵ A "bundled service" is a single retail telecommunications service offering that includes local exchange service and at least one additional service, and is offered at a single price. This type of service has become pervasive throughout the telecommunications industry and across all types of carriers.

On January 15, 2008, the Commission issued its Notice of Rulemaking for Chapter 289 in Docket No. 2008-15. After following statutory rulemaking procedures, on June 24, 2008, the Commission adopted Chapter 289 substantially in the form proposed by the workgroup. The Rule establishes 1) consumer protection requirements associated with the provision of bundled services that are similar to the consumer protection requirements applicable to competitive local exchange carriers (CLECs); 2) "safe harbor" financial and pricing procedures that will be considered reasonable during future ratemaking or universal service proceedings; and 3) terms governing miscellaneous other factors associated with the provision of bundled services. The Rule applies to all incumbent local exchange carriers (ILECs).

Chapter 289 removes regulatory financial uncertainty for ILECs offering bundled services and clarifies or partially relaxes consumer protection requirements as they apply to bundled services. It represents a balancing of the interests of the rural ILECs as they compete against alternative providers of bundled services while providing appropriate protections to consumers of those services as well as to the ILECs' remaining customers.