Annual Report on Alternative Forms of Regulation for Telephone Utilities

Report to the Utilities and Energy Committee
by the Maine Public Utilities Commission

September 11, 2009

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. It incorporates much of last year's report in order to provide historical perspective, and it describes activities through August 2009.

II. SUMMARY OF 2007 AND 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 or the Company). Because of the asset transfer, which occurred on April 1, 2008, FairPoint is operating under the AFOR (with some minor changes) that was originally approved for Verizon. In addition, in 2008, the Commission approved a new rule that established flexible pricing, revenue allocation certainty, and relaxed consumer protection requirements for local telephone carriers who offer bundled services to residential customers, but who are not subject to the AFOR established pursuant to statute. The rule stems from a request by the Committee to consider streamlined AFOR procedures for rural telephone companies.

III. DESCRIPTION OF 2007 and 2008 ACTIVITIES

A. FairPoint / Verizon Maine's AFOR

1. <u>Background of Verizon's AFOR Proceeding</u>

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.

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[1] The report was due September 1, 2009. The Commission apologizes for the delay in getting the report to the Committee.

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. After additional proceeding and subsequent Order, the Commission's decision was again appealed and the Law Court vacated the second Order in January of 2005 and remanded the case to the Commission.

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. Hearings on issues in both phases of the case were held during the fall of 2006.

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

On January 31, 2007, Verizon New England and FairPoint filed a request for approval of the transfer of Verizon's assets, employee and customer relationships (with the exception of some enterprise and governmental lines of business) in Maine, New Hampshire and Vermont to FairPoint. 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 and the Commission approved the transfer, with conditions, in its February 1, 2008 Order and the transfer took place on April 1, 2008.

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 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.

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. DSL service gives customers a broadband Internet connection. 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, 2007, the Commission held a deliberative session on the Stipulation, and subsequently issued its Order Rejecting the Stipulation due to a lack of specificity with the compliance provision for the DSL buildout finding the details of the Stipulation were not in the public interest. On August 8, 2007, 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 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, 2007, 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 that were included 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; (3) implemented revisions to certain SQI requirements; (4) increased the potential penalty for repeatedly missing SQI benchmarks; and (5) maintained all other aspects of Verizon's AFOR. 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. Beginning with bills issued in February 2008, which generally cover service provided in January, FairPoint applied the reduced local rates to its existing customers.

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 now operates. First, FairPoint received 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 would improve on the results, but it 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.

The 2007/08 SQI period was extended from 12 to 13 months, to end on July 31, 2008. For this period, FairPoint owned and operated the former Maine territory of Verizon for 4 months, but was responsible for the 13-month performance and any penalties that resulted. 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 increased 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 Seconds." Failure to meet these two benchmarks resulted in a penalty amount of $401,114, which was credited to customers' bills in March 2009, pursuant to a Commission Order issued October 7, 2008. FairPoint recently reported its final results for the SQI period that ended July 31, 2009, and those results are being analyzed.

B. FairPoint's Operational Performance Post-Cutover / Verizon

Although FairPoint completed its purchase of Verizon's assets on April 1, 2008, FairPoint continued to use Verizon's back-office systems under a contract with Verizon, because FairPoint wanted to develop and implement a completely new Operational Support System (OSS), using the latest technology and software applications packages. To accomplish this process, FairPoint engaged the services of Capgemini, an international consulting firm, to help it select the appropriate software packages and integrate those packages into a coherent and efficient OSS. Unfortunately, FairPoint has experienced (and continues to experience) significant difficulty in bringing the new OSS up to the standards that were expected for the system. While the phone network has not experienced any major problems, the OSS has had numerous problems with customer service, from order taking and provisioning to billing. Customers endured long wait times to reach customer service representatives and the representatives may not have been able to access the information necessary to resolve the customer's issue or enter the changes necessary into the systems. These problems resulted from system shortcomings, insufficient training and flawed procedures.

Because of the many problems confronting FairPoint after cutover, the Commission required the Company to file a Stabilization Plan, which described the Company's plans for correcting the problems that were occurring in the major customer-affecting areas of the business. The Stabilization Plan also established milestones for approximately thirty metrics that measured the Company's progress in returning to business as usual. The Company provided weekly updates on the milestone results, and it participated in conference calls with the Commission staff and the Commission's consultant, Liberty Group, to discuss the progress and other service-affecting issues that arose after cutover.

Despite its efforts, FairPoint was unable to meet most of the self-imposed benchmarks contained in the Stabilization Plan by June 30, 2009. While some progress has been made, the Company's OSS is not operating at peak efficiency. Retail and wholesale customers are still experiencing longer than normal delays in the provisioning of requested services and the resolution of problems. FairPoint recently announced that it will hire one or more consulting firms to assist in evaluating its applications packages and systems integration status. The consultants will recommend changes to the packages to improve the process by which orders flow through the various systems. The consultants also may recommend changes to the Company's operating procedures or training programs in order to improve service efficiency and employee proficiency. The Company is currently in the process of selecting the consultant or consultants that it will engage for the project.

IV. CONCLUSION

The AFOR that FairPoint is currently under will continue until August 1, 2013. The Commission expects that it will open a docketed proceeding approximately 9 months to a year prior to the end date of the current AFOR as appropriate pursuant to the statute to consider what, if any, AFOR FairPoint may be under going forward.