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, 2010

I. INTRODUCTION

Title 35-A M.R.S.A. Chapter 91 governs alternative forms of regulation (AFORs) for telephone utilities. An AFOR is an alternative to the traditional rate of return/rate base regulation and is intended to provide incentives for telephone utilities to achieve greater efficiencies and lower prices for telecommunications services. 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 AFOR in achieving the objectives of Chapter 91. In filing this Report, the Commission is complying with this annual reporting requirement. In order to provide historical perspective and context, the report briefly describes the events of prior years, but it focuses on activities that have occurred since the Commission's last AFOR report in September 2009.

II. SUMMARY OF ACTIVITIES PRIOR TO SEPTEMBER 2009

In an Order dated February 1, 2008, the Commission approved (with numerous conditions attached) the transfer of Verizon Maine's assets, customers and operations to FairPoint Communications-NNE (FairPoint or the Company). FairPoint also received similar approvals for the transfer in New Hampshire and Vermont. The transaction closed on April 1, 2008, and FairPoint took over Verizon's operations in Maine, as well as in New Hampshire and Vermont. The Commission ordered FairPoint to step into Verizon's shoes for purposes of regulation under the AFOR that had been approved for Verizon.

As part of its approval of the transfer, the Commission made some changes in the terms of the AFOR that would regulate FairPoint. The AFOR changes of most significance involved revisions to several of the Service Quality Index (SQI) metrics and benchmarks and an increase in the amount of the SQI rebate that would be credited to customers for multi-year failures to meet the prescribed SQI benchmark for any metric. FairPoint was also allowed to relax slightly the benchmarks for several of the metrics in order to allow the Company time to implement process improvements after it took over operations from Verizon. Finally, two metrics, which were determined to be no longer relevant, were eliminated and a new metric, regarding the duration of residential outages, was added.

When FairPoint took over Verizon's operations in Maine, it did not assume control or ownership of Verizon's operating support systems (OSS). The OSS are the back-office systems and programs used to support all of the Company's administrative functions regarding inventory, order processing, customer service, payroll and accounting. The OSS does not include the facilities, equipment and systems (such as poles, wires, switches and hardware and software) necessary to operate the telephone network itself.

Rather than assume Verizon's OSS, FairPoint chose to develop its own back-office systems, and to do so it contracted with Capgemini, an internationally known systems developer and integrator. While the development effort began more than a year before the completion of the transaction, the new OSS was not operationally ready at the time of the closing of the transaction. Therefore, FairPoint contracted with Verizon to continue to supply the back-office support necessary for FairPoint to run its operations. Verizon charged FairPoint a price set high enough that FairPoint had an incentive to implement its new OSS as soon as possible. It was important to FairPoint that the new OSS function properly and efficiently since the cutover from Verizon's legacy OSS to the new FairPoint system would be irreversible due to the nature of the transfer of database information.

FairPoint and Capgemini conducted extensive testing of the new OSS. The three state regulatory commissions selected an independent consultant to observe the testing and provide an assessment of FairPoint's readiness to proceed with the cutover. The system testing appeared to go well, and the consultant's opinion was that FairPoint was prepared for the cutover. Cutover began on February 1, 2009. In spite of the efforts of FairPoint and Capgemini, major problems arose immediately after the cutover, especially in the area of customer service. FairPoint experienced significant problems with ordering, provisioning and billing of retail and wholesale services, and its customer service representatives were unable to solve customer problems in an efficient manner. The telephone network did not experience any major problems during this time, but the OSS suffered numerous difficulties caused by system shortcomings, insufficient training and flawed procedures.

Because of the many problems confronting FairPoint after the cutover, the Commission ordered the Company to file a Stabilization Plan; the Company filed the plan in April 2009. It described FairPoint's plans for correcting the many problems that arose in the major customer-affecting areas of the business. The Stabilization Plan also established milestones, which were chosen by the Company, for many metrics that were designed to measure the Company's progress in returning to business as usual. The Company provided the Commission and its outside consultant with regular updates on its progress toward correcting the problems. Despite its efforts, FairPoint was unable to meet most of its self-imposed benchmarks for improvement by June 30, 2009. While some progress was made, the Company's OSS were not operating at peak efficiency. Customers were still experiencing long delays in the provisioning of service and the resolution of problems.

In September of 2009, FairPoint hired Accenture Consulting to examine its system and process problems and recommend corrective measures. Accenture produced the Customer Delivery Improvement Project (CDIP), which consisted of a group of over 100 individual projects in 15 project areas, all involving or related to delivering services to customers. The CDIP projects were designed to produce immediate and measurable improvements to nearly all aspects of FairPoint's interactions with its wholesale and retail customers.

FairPoint hired a Vice-President for Internal Business Solutions, whose chief function was to oversee all implementation aspects of the CDIP. The Company later hired a new Chief Information Officer to manage all aspects of its internal business systems. The CDIP program began in late 2009 and is currently nearing completion. While there are still several areas of the Company's operations that continue to experience problems, in general FairPoint's OSS are functioning better than they were before the CDIP. The Commission continues to monitor the Company's progress in improving its systems and processes.

III. BANKRUPTCY

On October 26, 2009, FairPoint filed for protection under federal bankruptcy law. The Company's debt, the operational problems described in Section II, the weak economy and a changing industry structure combined, according to FairPoint, led the Company to conclude that bankruptcy was its only realistic option. After the bankruptcy filing, FairPoint continued to operate its business in Maine (and in all other states where it had telephone operations) as it had before the filing. As described above, it was able to implement improvements to the customer delivery aspects of its operations.

In February, after negotiations with its creditors, FairPoint filed its proposed Plan of Reorganization (Plan) with the bankruptcy court. The Plan includes a reduction in FairPoint's outstanding debt of about $1.7 billion from a total of about $2.7 billion. In return, all of FairPoint's current common stock owners would receive nothing, and the Company's creditors would be issued about 98% of the new shares of stock under the Plan. The other 2% would be issued initially to management and members of the new Board of Directors; additional options to this group would, over time, increase their stake in the Company's equity to about 11%. If the Company's Plan is confirmed by the Bankruptcy Court, the Company intends to have its stock reinstated for trading on one of the major exchanges. The Plan is currently pending before the Bankruptcy Court.

As part of the Plan, FairPoint entered into a Regulatory Settlement with a member of the Commission staff who had been designated a "Representative" of the Commission. The Representative was not authorized to bind the Commission. The Representative did recommend that the Regulatory Settlement be accepted as part of the Commission's review of the FairPoint reorganization (pursuant to Section 708 of Title 35-A which governs the Commission's review of utility mergers or reorganizations).

The Regulatory Settlement recommended that the Commission approve several changes to the conditions contained in the original FairPoint-Verizon Merger-AFOR Order, including one provision that relates to the AFOR. That provision confirmed that the Company would pay the SQI rebate applicable to the 2008/09 SQI year to its customers in monthly amounts beginning with the March 2010 bills. In addition, the provision slightly altered the description of the rebate that appeared on customer bills. Acceptance of this provision removed the SQI issue from potential litigation before the Bankruptcy Court.

In an Order issued on July 6, 2010, the Commission accepted the Regulatory Settlement as part of its approval of the FairPoint reorganization that will occur if and when the Plan of Reorganization is approved by the Court. All other aspects of the AFOR under which FairPoint is operating remain in effect. The AFOR provides FairPoint with the flexibility to attempt to meet the competitive demands of the marketplace by operating as efficiently as possible, by offering special contracts where necessary to meet competitive options and by marketing its products as effectively as possible.

IV. CONCLUSION

The current FairPoint AFOR is scheduled to remain in effect until August 1, 2013. The Commission expects that it will open a docketed proceeding approximately 9-12 months before the end date of the current AFOR in order to consider what form of rate regulation FairPoint may operate under in the future.