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Annual Report on Alternative Forms of Regulation for Telephone Utilities

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

September 1, 2011

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 Energy, Utilities and Technology 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 order to provide historical perspective and context, the report briefly describes the events of prior years as well as activities that have occurred since the Commission's last AFOR report in September 2010.

II. SUMMARY OF ACTIVITIES PRIOR TO SEPTEMBER 2010

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 change of most significance was the adoption of a so-called "multiplier" mechanism. The multiplier mechanism was intended to result in an increase in the amount of the Service Quality Index (SQI) rebate that would be credited to customers as a consequence of any multi-year failure by FairPoint to meet the prescribed SQI benchmark for any metric up to a fixed cap on the total of rebate payments that could be required each year. 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.

During the 2008/09 SQI measurement year (the first full year that FairPoint operated the telephone network in the former Verizon territory) FairPoint missed 12 metric benchmarks and the Company therefore incurred a rebate amount of \$8,021,257. For the 2009/10 SQI period, FairPoint missed 10 metric benchmarks for a base penalty amount of \$4,562,992. The SQI multiplier mechanism, described above, was applicable to each of the 10 benchmarks that FairPoint failed to meet during the 2009/10 SQI year. Consequently, the total rebate amount for that period was \$9,125,984.

The current (2010/11) SQI year ended July 31, 2011. FairPoint failed to meet 4 metric benchmarks, resulting in a calculated base rebate amount of \$712,692. As is noted in Section V, below, the enactment of LD 1466 precludes application of the multiplier mechanism to the current year's (and next year's) SQI results.

III. BANKRUPTCY

On October 26, 2009, FairPoint filed for protection under federal bankruptcy law. In February 2010, after negotiations with its creditors, FairPoint filed its proposed Plan of Reorganization (Plan) with the Bankruptcy Court. The Plan included a reduction in FairPoint's outstanding debt of about \$1.7 billion from a total of about \$2.7 billion. In a proceeding held at the Commission to review FairPoint's reorganization pursuant to Section 708 of Title 35-A, the Commission approved a so-called "Regulatory Settlement" which included, among other things, only minor modifications to the AFOR under which FairPoint's rates and service quality are regulated. Specifically, the Regulatory Settlement adjusted slightly the time period over which the SQI rebates applicable to the 2008/09 SQI year would be paid to its customers. In addition, the Regulatory Settlement slightly altered the description of the rebate that appeared on customer bills. Acceptance of these provisions resolved questions raised by FairPoint in the Bankruptcy Court regarding the continued enforceability of the SQI rebate mechanism. The Regulatory Settlement, accepted by the Commission in an Order issued on July 6, 2010, along with similar settlements reached with regulators in Vermont and New Hampshire, were made part of the Plan of Reorganization, and in January 2011, the Bankruptcy Court confirmed the Plan. Aside from the two minor modifications to the AFOR described above, the Bankruptcy Court did not disturb any other provisions of the AFOR, including the term of the AFOR which continues until August 1, 2013.

IV. FAIRPOINT PETITION TO APPLY SQI MULTIPLIER REBATE AMOUNTS TO BROADBAND BUILDOUT

In February, 2011, FairPoint petitioned the Commission to amend the AFOR to permit the portion of the SQI rebate funds resulting from the application of the multiplier mechanism to be used instead for a capital expenditure program

to build out additional broadband facilities beyond the levels required by the Commission's 2008 Order approving the purchase by FairPoint of Verizon's assets in Maine. The Office of the Public Advocate opposed FairPoint's petition on several grounds, including that the diversion by FairPoint of rebates otherwise paid as bill credits to customers of FairPoint's regulated telephone service to a capital spending account to improve the availability of unregulated broadband service would violate Title 35-A, Section 713, which prohibits a utility from charging "its ratepayers for costs attributable to unregulated business ventures undertaken by the utility."

The amount of "multiplier" rebate funds subject to possible diversion to broadband infrastructure projects over the remaining term of the AFOR was vastly reduced as a result of the enactment by the Legislature of LD 1466 which, as described below, relieves FairPoint of its "multiplier" rebate obligation for failing to meet SQI performance standards after July 31, 2010. On August 11, 2011, the Commission resolved the legal questions raised by FairPoint's Petition, finding that Title 35-A, Section 713 is, in fact, a bar to the proposal made by FairPoint and the FairPoint Petition was denied.

V. RESOLVES 2011, CH. 69, LD 1466

During its 2011 session, the Legislature enacted LD 1466, Resolve, To Direct the Public Utilities Commission To Develop a Plan to Reform Telecommunications Regulation. Resolves 2011, ch. 69. Section 3 of the Resolve expressly prohibits the Commission from enforcing, during the period between the effective date of the Resolve and 90 days after the adjournment of the Second Regular Session of the 125th Legislature, two features of the existing FairPoint AFOR. As a consequence, during this period, the AFOR has effectively been modified as follows:

1. FairPoint may charge rates for nonresidential customers at any level below the rate ceiling without review by the Commission.
2. FairPoint is relieved of the obligation to rebate to its customers that portion of the SQI rebates resulting from application of the SQI multiplier mechanism of the AFOR to the base rebate amounts on account of repeated failures to meet SQI performance standards after July 31, 2010.

VI. CONCLUSION

The current FairPoint AFOR, as effectively modified by the enactment of the Resolve discussed above, is scheduled to remain in effect until August 1, 2013.