

June 8, 2004

PUBLIC UTILITIES COMMISSION,
Investigation of Compliance of
Verizon Maine with Amended
35-A M.R.S.A. § 7101-B

ORDER PERMITTING
INCREASE IN LOCAL RATES
(PART 2)

WELCH, Chairman; DIAMOND and REISHUS, Commissioners

I. SUMMARY

In this Order (Part 2), we explain our reasons for permitting Verizon Maine to increase its rates for local exchange service to offset access rate reductions required by 35-A M.R.S.A. § 7101-B. We issued a Part 1 Order stating our conclusions, as authorized by Chapter 110, § 1003 of our Rules, on May 28, 2004.¹

We previously ordered Verizon to decrease its access rates in two equal steps, on June 1, 2004 and May 31, 2005. Order Establishing Schedule for Access Rate Reductions in this docket (December 2, 2003). At that time, we held open the issue of whether the revenue losses that will result from the access rate decreases are an “exogenous change” as that term is defined under the alternative form of regulation (AFOR) for Verizon. We find that the revenue loss, which Verizon presently estimates is about \$2.96 million, is an exogenous change in revenues. Verizon therefore may increase its local rates on the same dates that it must reduce its access rates. Verizon must design the local rate increases so they will produce no more revenue than the revenue loss that Verizon has calculated for the access rate reductions. Verizon has proposed that for the first of the two increases, local rates for most lines will increase by \$0.27. PBX lines will increase by \$0.41 ($\0.27×1.5), and Centrex lines will increase by \$0.09 ($\$0.27 \times .33$).² Lifeline and FPO (facilities-based payment options) Centrex lines will not increase.³ We approve the proposed increases.

¹ Commissioner Diamond dissents from this decision. See attached Dissenting Opinion.

² The 1.5 and 0.33 factors are the same equivalency factors used in 2001 when Verizon increased its rates by \$1.78 to offset the access rate reduction required at that time.

³ At the time of the 2001 local rate increase, the Commission ordered that the increase not apply to Lifeline service. Verizon’s April 2, 2004 cover letter explains that the FPO Centrex lines are subject to contracts that specify a fixed rate for a stated term.

II. BACKGROUND

35-A M.R.S.A. § 7101-B (the “access parity statute”) requires access providers, i.e., local exchange carriers (LECs), to reduce intrastate access rates to interstate levels. The statute was amended (effective May 2, 2003) to state that by May 31, 2005, LECs must reduce their intrastate access rates to the level of interstate access rates that were in effect on January 1, 2003.⁴ On May 28, 2003, we opened an investigation to determine the timing for Verizon to comply with amended 35-A M.R.S.A. § 7101-B and whether Verizon should be permitted to recover the revenue loss that would occur because of access rate reductions in local rates. In our *Order Establishing Schedule for Access Rate Reductions*, issued on December 2, 2003, we ordered Verizon to decrease its access rates in two equal steps, on June 1, 2004 and May 31, 2005. We also reserved the issue of whether the access rate reductions were an “exogenous change” as that term is defined under the alternative form of regulation (AFOR) for Verizon, and asked parties for comment on that issue.

III. EXOGENOUS CHANGE STANDARD

The definition (later expanded) of an exogenous change under Verizon’s AFOR is contained in the first AFOR Order, *Public Utilities Commission, Re: Investigation Into Regulatory Alternatives for the New England Telephone and Telegraph Company d/b/a NYNEX*, Docket No. 94-123, Order (May 15, 1995) at 55 (“1995 AFOR Order”). Under that definition there are two types of exogenous changes. The first is for the very narrow category of “jurisdictional separations changes and significant accounting changes mandated by regulatory agencies that apply only to NYNEX or the telecommunications industry.” Cost changes attributable to these events are exogenous changes regardless of their size. The access rate reduction under consideration in this case is not within the first category of exogenous changes. The second type of exogenous change is for “cost changes that have very substantial and plainly disproportionate effect on NYNEX’s costs and that are totally outside the control of NYNEX.” This second type of change was expanded in 1998 by our approval of a Stipulation that applied the definition to revenue changes as well as cost changes. *Public Utilities Commission, Re: Investigation Into Regulatory Alternatives for the New England Telephone and Telegraph Company d/b/a NYNEX*, Docket No. 94-123 (reopened), Order (March 17, 1998); Stipulation (November 7, 1997) Provision 2.E.⁵

⁴ Previously the statute required LECs to reduce their intrastate access rates to (or below) interstate levels on May 30, 1999 and to reestablish that parity “every 2 years.” Both in 1999 and 2001, Verizon reduced its intrastate access rates to comply with that requirement. The Company also reduced access rates by 20% in 1997 pursuant to a requirement contained in Chapter 280, § 8(I).

⁵ The Stipulation states that the definition of exogenous changes “shall be expanded beyond changes in NET’s costs to include changes in NET’s rates required to comply with any actions by Congress, the State Legislature, the Federal Communications Commission, or the Commission that impact the core revenues of NET, positively or negatively, provided such events otherwise satisfy the conditions for

IV. PARTIES' ARGUMENTS

Only Verizon and the Public Advocate filed comments on the "exogenous change" issue. Verizon argued that the Commission has consistently held that changes in access rates required by 35-A M.R.S.A. § 7101-B are beyond Verizon's control. It also argued that the required access rate reduction is a substantial and disproportionate change in Verizon's revenues, noting that the amount initially estimated (\$4.5 million)⁶ was greater than the 1998 ice storm damage amount that the Commission found to be an exogenous event, and that the ice storm amount was "just over" one percent of its intrastate revenues at that time. (The actual amount was 1.01 percent.)

The Public Advocate argues that the Commission has "reserved to itself a great amount of discretion" because it has "not adopt[ed] any specific guidelines" with regard to exogenous changes. The Public Advocate further argues that the Commission has discretion to require Verizon to reduce access charges without allowing an increase in local rates. *New England Telephone Co. d/b/a NYNEX v. Public Utilities Commission*, 1997 ME 222, 705 A.2d 706. This discretion should be exercised against an increase to local rates because of an alleged bias under the current AFOR toward recognition of revenue losses, but not revenue gains or cost savings. The Public Advocate argues that the amount "is simply not large enough to warrant exogenous cost (sic) treatment, under current circumstances," which include several "countervailing effects."

The Public Advocate also argues that the Commission should not allow a rate increase based on a "single financial item," citing the Commission's 1982 ruling that a utility under rate-of-return (ROR) regulation could not seek an increase in rates based solely on two items whose costs had increased. *New England Tel. and Tel. Co.*, Docket No. 82-6, Decision and Order (May 11, 1982).

The Public Advocate presented two other arguments. First, he argued that "the definition of exogenous events, which originated in the 1997 stipulation, is flawed and should be revised."⁷ Finally, the Public Advocate argues that no increase to basic rates

exogenous treatment set forth in the AFOR Order...." We interpret the "provided" clause to make applicable the previously existing conditions ("very substantial and plainly disproportionate" and "outside of Verizon's control") for the second type of exogenous change described above.

⁶ In its January 9, 2004 comments Verizon stated that the estimated amount was based on December 2002 access minutes, and that the final amount may differ because of recent expansion of Basic Service Calling Areas (BSCA), which has the result of transforming former toll (Interexchange) calling (and access minutes) into local calling.

⁷ The Public Advocate joined the 1997 Stipulation, which he mischaracterizes as expanding significantly on the narrow set of circumstances described above as the "first" type of exogenous changes. In fact, the original AFOR Order also stated that the Commission would recognize changes that have a "substantial and plainly disproportionate" effect on costs and "that are totally outside the control of [Verizon]." *1995 AFOR Order* at 55. As discussed above, the 1997 Stipulation modified the

should occur “in the absence of a fair, integrated review of Verizon-Maine’s current revenues and expenses... .”

V. DISCUSSION AND DECISION

We find that the revenue loss that Verizon will experience as a result of the access rate reductions required by 35-A M.R.S.A. § 7101-B (and our previous order in this case establishing a schedule for the reductions) is an exogenous change as that term is defined in the AFOR.

No question has been raised concerning whether the access revenue reduction is an event that is “totally outside the control of NYNEX.” The access parity statute requires the reduction. The issue in this case is whether the amount of the required reduction is sufficiently large to have “a very substantial and plainly disproportionate effect on [Verizon’s revenues].”

In the 2001 Order extending the original AFOR, we specifically reserved judgment on whether the next⁸ access rate reduction (which we expected would be much smaller than that required in 2001) would be sufficiently large to constitute an exogenous change. *Public Utilities Commission, Investigation into Verizon Maine’s Alternative Form of Regulation*, Docket No. 99-851, Order (Part 2) (June 25, 2001) at 17-18.

The smallest exogenous change event (of the second type) that we have found previously was the \$3.45 million in costs that Verizon incurred as result of damage from the 1998 ice storm.⁹ The ice storm costs, however, were almost entirely for one-time expenditures.¹⁰ By contrast, the \$2.96 million access revenue loss in this case (like those in 1999 and 2001) is an ongoing loss in all future years because the law requires the decrease in access rates and does not permit a future increase.

We do not suggest that the failure to consider this an exogenous event would be catastrophic for Verizon. While we believe the issue is a close one, and that amounts

definition only by allowing the second type of exogenous changes to apply to revenues as well as costs.

⁸ At the time, 35-A M.R.S.A. § 7101-B required the next reduction to occur on May 30, 2003. The amendments that became effective in May 2003 eliminated the May 30, 2003 reduction and set a deadline of May 31, 2005 for the last reduction required by the statute. Under the statute, future reductions are at the discretion of the Commission.

⁹ During the first five years of the AFOR, we approved substantially smaller exogenous changes, both positive and negative, that were in the first category described above, which does not have any size requirement.

¹⁰ About 11 percent of the \$3.45 million (\$386,522) represented ongoing annualized costs for new investments that were necessary because of the ice storm.

significantly less than \$3 million per year would fail the test, we find that the access rate reductions required by the amended access parity statute will have “a very substantial and plainly disproportionate effect on [Verizon’s revenues].”

The Verizon AFOR does not contain any specified lower limit on the amount of revenue or cost change that will qualify as an exogenous change, stated either in dollars or as a percentage of revenues. By contrast, the alternative rate plans (ARPs) for Central Maine Power Company (CMP) and Bangor Hydro-Electric Company (BHE) have contained such limits. Each company has had two ARPs, and the lower limits have ranged from about 0.15% of revenues to about 1.5%. For Verizon, the effect of the mandated cost is about approximately 0.89 percent of Verizon’s 2003 intrastate revenues (\$332,046,000). An effect on revenues in the same order of magnitude as is the case here has thus been found in analogous contexts to be sufficient to warrant relief.

We reject the argument of the Public Advocate that the amount is “simply not large enough” because there are “countervailing effects.” None of the effects claimed by the Public Advocate, however, is directly related to the mandated change, and the Public Advocate has not suggested that they could be treated as exogenous changes on their own. Verizon will not experience any reduction in its cost of providing access either as result of or in conjunction with the drop in access rates. Because there is no related cost change, the present access revenue loss would go directly to Verizon’s bottom line earnings. Indeed, the most likely corollary effect of the mandated reduction in access charges is a reduction in Verizon’s retail toll revenues driven by the competitive market, for which we have provided no compensating rate adjustment.¹¹

The Public Advocate’s argument that we should not allow a rate increase based on a “single financial item” suggests that he does not appreciate a critical difference between AFOR and ROR regulation. Under the Verizon AFOR, rates generally are not tied to changes in costs, revenues, or earnings.¹² Nevertheless, rate changes for a limited set of exogenous changes are expressly permitted without an examination of overall costs and revenues. See *Public Utilities Commission, Investigation into Verizon Maine’s Alternative Form of Regulation*, Docket No. 99-851, Order (Post-Remand No. 1) - Part 2 (July 14, 2003) at 7 and 15 n. 16. If it were necessary to conduct an ROR proceeding each time an exogenous change was presented, in effect there would be no AFOR.

¹¹ We similarly allowed recovery, as an exogenous change, for the 1999 access rate reduction, but not for the retail toll revenue loss that was likely to occur at that time, on the ground that Verizon had far greater control over its toll revenues than its access revenues. *Public Utilities Commission, Investigation into Verizon Maine’s Alternative Form of Regulation*, Docket No. 99-851, Order (Part 2) (June 25, 2001) at 18, 21-22.

¹² The Public Advocate apparently alludes to the policy against “single-issue rate cases.” That policy has only been applied under rate of return regulation and makes no sense in the context of an AFOR, where the individualized treatment of exogenous events is specifically contemplated.

We also reject the Public Advocate's argument that we should revise the definition of exogenous events. This argument is beyond the scope of this proceeding. The AFOR's definition of exogenous costs has been in effect for nearly a decade without challenge either in the 2001 AFOR proceeding or on appeal. The issue the Public Advocate raises here is, of course, entirely appropriate for discussion and, if warranted, reform in a future AFOR proceeding.

Finally, we reject the Public Advocate's argument that no rate increase should be permitted in the absence of a "fair, integrated review of Verizon-Maine's current revenues and expenses." This argument ignores the fact that the AFOR's stay-out provision prohibits rate cases during the operation of the AFOR, and that the AFOR expressly allows rate changes to account for exogenous changes. The Public Advocate is in effect arguing to change the rules of the AFOR. This argument, like the one above, is beyond the scope of this proceeding.

VI. AMOUNT OF LOCAL RATE INCREASES IN 2004 AND 2005

As noted above, Verizon has proposed a local rate increase of \$0.27 per month for effect on June 1, 2004. The increase will apply to all access lines except for Lifeline lines (which provide a discounted local service to eligible low-income customers) and FPO Centrex lines. The last time we allowed an increase in local rates to offset access revenue losses (May 30, 2001) we ordered that the increase not apply to Lifeline lines. The Commission staff has reviewed the proposed rate and has determined that it is designed to produce the correct amount of revenue to offset the access revenue loss (\$1.48 million) that will occur on June 1, 2004.

Verizon will implement the other half of its access rate reduction on May 31, 2005, the statutory deadline, under amended 35-A M.R.S.A. § 7101-B, for each LEC to reduce its intrastate access rates to the interstate rates in effect for that company on January 1, 2003. Although Verizon estimates the present revenue effect for that reduction to be \$1.48 million (i.e., half of the presently estimated total of \$2.96 million), the actual amount is likely to differ. It is the access *rate* that must decline by an equal amount on each of the two dates. The *revenue* effects from the two equal rate reductions will not be identical to each other unless Verizon's access sales (billing units) are identical in each of the two years. It is far more likely that sales, and therefore revenue loss, will differ. Similarly, the number of access lines over which the revenue losses must be spread is also likely to differ in each of the two years. Because of these two variables, it is not possible to know now the amount of local rate increase that will be necessary on May 31, 2005. We will require Verizon to file a proposed rate increase, along with supporting access and access line billing units, on or before April 15, 2005.

VII. ORDERING PARAGRAPHS

Accordingly, we

1. PERMIT Verizon of New England d/b/a Verizon Maine to increase its rates for local exchange service by no more than \$0.27 per line, effective June 1, 2004;

2. APPROVE the access rate reduction and local rate increase rate schedule filings, filed in this docket by Verizon Maine on April 2, 2004, with an effective date of June 1, 2004, *except for* Tariff No. 15, Part M, Section 8, page 32, Fifth Revision, page 33, Fourth Revision, and page 36, Sixth Revision, which were withdrawn on May 28, 2004; and Tariff No. 17, Section 30, page 12, Second Revision, which was withdrawn on May 18, 2004, and;

3. APPROVE Tariff No. 15, Part M, Section 8, page 32, Fifth Revision, page 33, Fourth Revision, and page 36, Sixth Revision, which were filed on May 28, 2004; and Tariff No. 17, Section 30, page 12, filed on May 18, 2004 (as substitutes for the original pages of those numbers and revisions), all also with an effective date of June 1, 2004;

4. ORDER Verizon Maine, on or before April 15, 2005, to file proposed rate schedules for the remaining access rate reduction required by our order in this docket issued on December 2, 2003, and for any proposed increase in the per line monthly rate for local exchange service for the purpose of offsetting the access revenue loss. The proposed rate schedule changes shall bear an effective date of May 31, 2005. With the rate schedule filing, Verizon Maine shall provide its most recently available access and access line billing units and calculations showing that the revenue effect from any proposed local rate increase will not exceed the revenue loss resulting from the access rate reduction.

Dated at Augusta, Maine, this 8th day of June, 2003.

BY ORDER OF THE COMMISSION

Dennis L. Keschl
Administrative Director

COMMISSIONERS VOTING FOR: Welch
Reishus

COMMISSIONERS VOTING AGAINST: Diamond: See attached Dissenting Opinion

NOTICE OF RIGHTS TO REVIEW OR APPEAL

5 M.R.S.A. § 9061 requires the Public Utilities Commission to give each party to an adjudicatory proceeding written notice of the party's rights to review or appeal of its decision made at the conclusion of the adjudicatory proceeding. The methods of review or appeal of PUC decisions at the conclusion of an adjudicatory proceeding are as follows:

1. Reconsideration of the Commission's Order may be requested under Section 1004 of the Commission's Rules of Practice and Procedure (65-407 C.M.R.110) within 20 days of the date of the Order by filing a petition with the Commission stating the grounds upon which reconsideration is sought.
2. Appeal of a final decision of the Commission may be taken to the Law Court by filing, within **21 days** of the date of the Order, a Notice of Appeal with the Administrative Director of the Commission, pursuant to 35-A M.R.S.A. § 1320(1)-(4) and the Maine Rules of Appellate Procedure.
3. Additional court review of constitutional issues or issues involving the justness or reasonableness of rates may be had by the filing of an appeal with the Law Court, pursuant to 35-A M.R.S.A. § 1320(5).

Note: The attachment of this Notice to a document does not indicate the Commission's view that the particular document may be subject to review or appeal. Similarly, the failure of the Commission to attach a copy of this Notice to a document does not indicate the Commission's view that the document is not subject to review or appeal.

Dissenting Opinion of Commissioner Diamond

I dissent from the Commission's order, as I would not permit Verizon Maine to increase its rates for local service to offset the previously ordered access rate reductions. Simply put, I do not believe the revenue loss to be "very substantial," as is required for exogenous treatment under the Verizon AFOR.

A reading of the 1995 AFOR Order, in which the test for exogenous treatment was established, clearly reveals that, because of concern about the uncertainties and the litigation it would produce, the Commission was reluctant to establish a catchall test for exogenous treatment. While it ultimately felt compelled to do so because of its lack of "perfect foresight," it took pains to make that test as narrow as reasonably possible. Thus, it required that the effect on costs, later extended to include the effect on revenue, be not just substantial and disproportionate but rather "very substantial and plainly disproportionate."

Against that backdrop, I am hard pressed to conclude that a change that will produce a revenue decline of less than one percent is "very substantial." Indeed, in its request to increase local rates to offset the access rate reductions, filed with the Commission on April 2, 2004, Verizon characterized the estimated \$2.96 million decline in intrastate access revenues as "both substantial and plainly disproportionate in its impact on Verizon Maine's revenues." Thus, the company's own characterization does not satisfy the exogenous change standard. Presumably, the omission of "very" was inadvertent, but I cannot help but wonder whether some part of the corporate psyche had trouble with the concept that a decline of less than one percent was "very substantial."

The Commission's Order notes that the eventual \$2.96 million loss in annual revenues represents 0.89 percent of Verizon's 2003 intrastate revenues of \$332,046,000. While correct, that percentage understates the impact of this decision on the exogenous change test. In the prior order in this case, the Commission required Verizon to decrease its access rates in two equal steps, on June 1, 2004 and May 31, 2005. It is estimated that in the first year, Verizon will suffer a revenue decrease of \$1.48 million, which will grow to \$2.96 million in the second year, because of the cumulative effect of the two access rate reductions.¹ The Commission, however, is allowing a local rate increase concurrent with the first access rate reduction, which means that it has concluded, at least implicitly, that a revenue decline of \$1.48 million, or about .45 percent of Verizon's annual revenues, is very substantial. In my view, treating a change of less than one-half of one percent as exogenous gives the phrase

¹ The Order describes these reductions as permanent. While literally true, that description ignores the fact that the current AFOR expires as of May 31, 2006, at which time all aspects of Verizon's rates are potentially amenable to review. In short, had we denied exogenous treatment to these reductions, it would effectively had been for a limited period of time.

“very substantial” an indefensibly broad reading. At a minimum, the Commission should have denied recovery in the first year.²

Given the subjective nature of the exogenous change test, it may help to examine a prior occasion on which a Verizon access rate reduction was addressed. That case, which did not fall under the exogenous change rubric because the test did not yet encompass revenue changes, involved a stipulated access rate reduction and local rate increase. In its order, the Commission found that the net effect of those changes would be an annual revenue loss to Verizon (then NYNEX) of at least about \$20 million and concluded that a stipulation that would produce a \$20 million revenue loss was reasonable. *Public Utilities Commission, Re: Investigation Into Regulatory Alternatives for the New England Telephone and Telegraph Company d/b/a NYNE*, Docket No. 94-123 (Reopened) (March 17, 1998). By comparison, a revenue loss of \$2.6 million does not seem particularly problematic.

Also militating against the notion that a revenue impact of less than one percent (to say nothing of an impact of less than one-half of one percent) should be deemed “very” substantial is a comparison of the treatment of Verizon under this Order with the treatment of Central Maine Power Company (“CMP”) and Bangor Hydro-Electric Company (“BHE”) under their alternative rate plans. Those plans use actual monetary cutoffs for determining when cost increases and/or revenue declines may be recoverable by the utility. For CMP, the aggregate annual impact of changes otherwise eligible for exogenous treatment must be at least \$3 million, which represents 1.2 percent of the company’s most recent annual distribution revenues of about \$245,335,000. For BHE, the threshold is \$750,000, representing 1.4 percent of that company’s annual distribution revenues of about \$55,202,000. Furthermore, those thresholds also serve as deductibles in that the utility may only recover the amount of the cost increases and/or revenue declines that exceed the threshold, while under the Verizon AFOR, the company gets to recover the full amount. Thus, by finding Verizon’s revenue loss of less than one percent to be “very substantial,” this decision transforms a test that was designed to be very narrow into one that is very generous. Finally, this case arises during protracted litigation over the Commission’s decision to extend Verizon’s 1995 AFOR. In that litigation, the Public Advocate has strongly challenged the delinking of costs and revenues on one hand and local rates on the other. The Commission has responded, correctly in my view, that such delinking is an inherent feature of incentive rate plans and that such plans best serve the long-term interests of ratepayers. While the exogenous change provision represents an exception to the delinking, I think the larger context requires that we interpret that exception narrowly and not be so willing to reconnect revenues and rates.

² This is particularly true given the statements in the Commission’s Order that the issue in this case is a “close one” and that revenue losses “significantly less than \$3 million per year would fail the [exogenous change] test...” The first-year decline of \$1.48 million would seem significantly less than \$ 3 million.