STATE OF MAINE
PUBLIC UTILITIES COMMISSION

Docket No. 94-123

May 15, 1995

PUBLIC UTILITIES COMMISSION
Re: Investigation Into Regulatory Alternatives for the New England Telephone and Telegraph Company d/b/a NYNEX

ORDER

WELCH, Chairman; NUGENT, Commissioner

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I. SUMMARY OF DECISION

In this Order, we adopt an Alternative Form of Regulation (AFOR) to govern the Maine intrastate operations of the New England Telephone and Telegraph Company, d/b/a NYNEX, for the next 5 years, with a possible extension of as much as another 5 years if ordered by the Commission. The AFOR includes a price cap structure and a pricing rule that will apply to all of NYNEX's "core" services. Core services include non-discretionary services (primarily basic exchange and toll services) and discretionary services (such as existing Custom Calling, and Phonesmart services, and special contracts on customers with competitive alternatives). The price cap does not apply to non-core services, which include new competitive broadband services.

The primary pricing rule caps the annual aggregate change in prices for core services during the term of the AFOR. Other price cap rules limit the level change for individual core service rate elements that can be made under the AFOR.

The overall price rule for core service is the Price Regulation Index (PRI). The PRI is based on a formula that determines the amount by which NYNEX can adjust annually the aggregate weighted level of all its prices for core services to reflect cost changes caused by inflation, offset by the growth in productivity and by changes in a very limited group of exogenous costs. The inflation factor of the formula is the Gross Domestic Product Price Index (GDP-PI), which is designed to measure changes in national output prices. The productivity factor is set at 4.5%.

Any price increase for a non-discretionary core service (primarily basic service and toll) will be limited to the increase in the aggregate PRI. NYNEX may change the price of any particular discretionary core service to any level, but revenues from all core services will be subject to the PRI. NYNEX is allowed to raise the price for core services only at the time of its annual rate adjustments. It may decrease prices for any service at any time. The only limitation on non-core services is the marginal cost floor that applies to all services.

To ensure the continued high quality of service now provided by NYNEX, we have adopted a Service Quality Index (SQI) and a mechanism to provide rebates to customers if service quality does not meet the standards established by the Index.

We believe that efficiency incentives are maximized if NYNEX is allowed to retain all the benefits of increased productivity beyond the level contained in the PRI, or to experience the full effect of substandard productivity. Accordingly, we will not order earnings sharing.

The AFOR we adopt meets all of the statutory requirements of 35-A M.R.S.A. § 9103. Under the AFOR, we expect that prices for both toll and basic local service will be as low as or lower than under traditional rate of return regulation (ROR), and that the cost of regulation should be less than traditional

ROR. We maintain our ability to regulate NYNEX adequately, and the AFOR contains sufficient safeguards to ensure NYNEX maintains a high level of customer service. NYNEX will have an opportunity to earn a fair rate of return while having the flexibility in pricing and in its operations to compete in the Maine telecommunications market.

A Procedural History of this proceeding is found in APPENDIX A.

II. ROR REGULATION V. ALTERNATIVES

The central issue in this case is whether we should adopt an alternative form of regulation (AFOR) rather than continue to rely on traditional cost-based rate-of-return (ROR) regulation. Based upon our consideration of the evidence, we are convinced that regulation under this AFOR, will be superior to traditional ROR regulation and will provide benefits for consumers of telephone services.

The parties have developed an extensive record on this question. Many parties (including NYNEX, Staff[1], CATV and MTUG) argued that we should adopt an AFOR, while several parties (OPA, AARP, and MCI) argued that we should not do so at this time. We will discuss the positions of the parties more extensively in the balance of this Order, but it is useful to summarize briefly the positions of the parties on the central question of whether an AFOR should be adopted.

NYNEX believes that price regulation (AFOR) is a better form of regulation than ROR regulation because it will: (1) fully protect consumer interests; (2) better emulate the workings of a competitive market; (3) provide proper economic incentives for NYNEX to operate more efficiently, to compete effectively and to invest in the state's telecommunications infrastructure; (4) shift investment risk to NYNEX's shareholders; and (5) reduce regulatory administrative costs to NYNEX, the Commission and intervenors.

Staff supports the adoption of an AFOR plan. Staff notes that weaknesses of ROR Regulation include weak efficiency incentives, difficulty in monitoring the utility's accounting costs, and a possible incentive to overinvest in plant. Despite these deficiencies, Staff notes that ROR regulation provides some protection to core customers, which should not be ignored. On balance, Staff believes that its AFOR plan would be an improvement over ROR regulation while NYNEX's plan would not.

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[1] In this Order, the Commission's Advocacy Staff is referred to as "Staff." Other Commission staff members, including the Examiners, are assigned to this case as advisors. The Advocacy Staff functions as a party to the case by presenting evidence and argument, without specific direction from the Commission.

The OPA believes that ROR regulation has served NYNEX and its ratepayers "fairly well" for a long time. In essence, OPA believes that ROR regulation is not "broken" and would prefer an "optimized" version of ROR regulation to experimenting with a new form of regulation, which would involve substantial uncertainty. The OPA in the alternative presented a price-cap plan and argued that if an AFOR is adopted, we should either adopt its price cap plan or the Staff's plan.

AARP argues that ROR regulation has not been unduly burdensome and that if an AFOR is adopted, we should continue to monitor NYNEX's profits and adjust them if they reach excessive levels. AARP further notes that the statutory requirements for adopting an AFOR must be met if we adopt an AFOR plan for NYNEX.

MCI argues that while an AFOR would have undeniable benefits in an environment in which real competition exists and is encouraged, ROR regulation has worked well for many years and should not be replaced with NYNEX's price cap plan.

We find that NYNEX and the Staff have presented convincing reasons for adoption of an AFOR. The primary reason for our decision is our goal to create strong incentives for NYNEX to achieve greater efficiency and the lower prices that can result from improved efficiency. We recognize that some incentives exist under ROR regulation. Between rate cases, a utility has an incentive to reduce its costs below those reflected in the "revenue requirement" that the Commission has established as the basis for rates, or to increase sales beyond those projected. Nevertheless, the incentives under ROR regulation are weak because, instead of increasing efficiency or sales, a utility may file a rate case as frequently as once a year. Conversely, if a utility actually achieves greater efficiency or increased sales under ROR regulation, it runs the risk that it will "overearn" and that the Commission will initiate a proceeding to reduce rates.

We adopt a "pure" price cap approach and a productivity offset of 4.5%, applied to NYNEX's "core" services. The productivity offset is based on our judgment of the level that will bring substantial benefits to customers but will be achievable, albeit only with a strong commitment to efficiency, by NYNEX. In selecting 4.5%, we have relied, to a varying degree, on the actual NYNEX experience over the past 8 years, the productivity studies presented by NYNEX witness William Taylor and OPA witness Lee Selwyn, and the productivity study for NYNEX-Maine presented by Staff witness David Gabel. Because we will not require any earnings sharing, the incentives to operate efficiently are stronger. Consistent with our decision not to order earnings sharing, we will also allow NYNEX to change its depreciation rates without Commission approval.

We expect the AFOR to produce gains in efficiency because, among other factors:

- NYNEX will not be able to file annual rate cases; it cannot rely on rate increases to catch up with whatever costs it incurs; to earn a reasonable return on its investment, it must achieve cost levels consistent with the Price Regulation Index (PRI).

- The Commission will not initiate rate investigations against NYNEX for at least five years. If NYNEX increases its sales or reduces its costs by more than the PRI, it keeps the extra profits;

- NYNEX will have increased pricing flexibility for discretionary "core" services and for all "non-core" services;

- NYNEX will be in an improved position to compete; and

- In general, NYNEX will bear greater risk for its investments than under traditional ROR regulation.

Because a reasonable level of efficiency is built into the AFOR price cap formula and because separate incentives to maintain service quality are established, consumers will benefit in at least the following ways:

- Prices most likely will be lower than under ROR regulation;

- Deployment of new services desired by customers will be encouraged; but new services for which there is little customer need will receive no encouragement beyond that encouraged by the market;

- The present high levels of customer service will be encouraged; and

- Regulatory administrative burdens will be reduced.

We have not adopted the AFOR proposed by NYNEX or by any other party. The AFOR we have adopted differs in many significant ways from that proposed by any party. The reasons for our decisions are explained in greater detail in the balance of this Order.

We regrettably find it necessary to comment on one aspect of NYNEX's advocacy. NYNEX plainly believes that the plan it has proposed (including its proposal in the *Pease* complaint rate proceeding, Docket No. 94-254, that rates remain unchanged) is the only reasonable result that the Commission may approve. It has

argued that the AFORs proposed by the Advocacy Staff and the Public Advocate are unreasonable, at least in combination with the recommendations by those parties for substantial revenue reductions in the rate case. In its Brief, NYNEX argued:

> A combination of drastic revenue reductions and a burdensome alternative regulation plan would place NYNEX in an untenable financial position. NYNEX would have to consider opposing the implementation of such a plan in whatever forums are available.

NYNEX added a footnote:

> In fact, NYNEX suggests that the Commission implement an alternative regulation plan only if that plan is satisfactory to NYNEX, which will be bearing the risks under the plan.

Elsewhere, NYNEX stated that if the Commission adopted the Staff or OPA proposals, it would "actively discourage NYNEX from investing in Maine." That issue is discussed in Part III.A.7 below.

In its Reply Brief, the Public Advocate characterized NYNEX's position as "arrogant" and that it "directly contradicts the very purpose of the governing legislation, i.e., that the *Commission* be authorized to adopt a new form of regulation" (emphasis added). The Commission Staff in its Reply Brief argued:

> NYNEX's suggestion that it somehow be allowed to participate in the decision making process in this case is clearly contrary to the governing statute. . . . Unlike certain states such as Vermont, the Maine statute does not give NET the power to opt out of, or veto, an ARP [alternative regulatory plan].

The Maine Legislature delegated to the Commission the decision whether to implement an alternative form of regulation and the form of any AFOR. That delegation is fully consistent with the traditional delegation to the Commission to regulate rates. The Legislature did not delegate AFOR decisions to telephone utilities or to any other party. Under either traditional or an alternative form of regulation, we have the responsibility to approve rates that balance the interests of ratepayers and shareholders. That decision has never been left to an investor-owned utility. As noted by Staff, the Vermont Legislature explicitly allowed NYNEX the opportunity to reject any alternative form of regulation decided by the Vermont Public Service Board; the Maine

Legislature did not. Permitting a utility to accept or reject an AFOR would be a substantial step toward self-regulation.

We know that our decisions and findings are subject to judicial review by the Law Court to determine whether they are lawful and are supported by substantial evidence. Any party is free to pursue other appropriate remedies in other forums should it believe that our decision fails to comply with our statutory mandate. NYNEX's suggestion that its rights are greater with respect to this decision than any other Commission decision is, in our view, incorrect.

III. DISCUSSION OF ADOPTED ALTERNATIVE FORM OF REGULATION

A. Compliance With Statutory Conditions

Under Chapter 91 of Title 35-A, the Commission may adopt an alternative form of regulation (AFOR) for telecommunications services. An AFOR may include the use of an index, formula or other streamlined form of regulation, including deregulation of services or entities, when regulation is not required to protect the public interest or satisfy other objectives of Title 35-A. 35-A M.R.S.A. §§ 9101-9102.

Section 9102 provides that an AFOR:

> . . . need not conform with chapter 3 [35-A M.R.S.A. §§ 301-312] to the extent that the provisions of chapter 3 require the use of rate-base, rate-of-return or any other specific form of regulation of the rates of a telephone utility or to the extent that the provisions of chapter 3 give any party, including the telephone utility, the right to petition to change rates for telecommunications services.

The AFOR must conform, however, to a number of other chapters in Title 35-A, specifically chapters 71, 73, 75, 87 and 89.

Section 9103 requires the Commission to ensure that any AFOR is consistent with nine "conditions" or "objectives," unless it finds that the objectives are not in the best interests of ratepayers.

In this subsection, we set forth each of the nine objectives. We will discuss whether the various plans proposed by the parties meet the objectives and, in particular, how the AFOR we are adopting meets them. We will discuss each of the objectives in the order in which it appears in the statute.

1. Term of Plan; Local Services to Be Priced At Or Less Than Rate of Return Regulation

35-A M.R.S.A. § 9103(1) states:

> **1. Alternative regulation; period.**
> For the period of the alternative form of regulation, which may not be less than 5 years nor exceed 10 years without affirmative reauthorization by the commission, ratepayers as a whole, and residential and small business ratepayers in particular, may not be required to pay more for local telephone services as a result of the implementation of an alternative form of regulation than they would under traditional rate-base or rate-of-return regulation.

a. Term of Plan

Title 35-A M.R.S.A. § 9103 (1) states that an alternative form of regulation (AFOR) for a telephone utility must be in effect for no less than 5 years and no more than 10 years. As noted above in Part I (Summary of Decision), we have decided that the AFOR price cap system for NYNEX shall be in place for an initial period of 5 years, with a possible extension if ordered by the Commission. The reasons for choosing 5 years rather than some longer period are set forth in detail in Part III.C.9 below.

b. Rates for Local Service Should Be At or Below Those That Would Occur Under Traditional Rate-of-Return (ROR) Regulation

This objective, in effect, requires the Commission to make a finding that basic ratepayers will be no worse off under the chosen AFOR than they would be under traditional cost-based, rate-of-return (ROR) regulation. To find that this objective will be satisfied is one of the most difficult to make in an AFOR proceeding because predicting two (or more) different alternative futures with a high degree of confidence is often quite difficult.

An initial question is what the Legislature meant by "local services." "Local services" generally is understood to refer to "basic service," i.e., service within the area in which a telephone customer may make calls for a basic monthly residential or business flat rate and without toll charges. It is not clear why the Legislature would not also be concerned about what might happen to toll rates under an AFOR, unless the Legislature assumed that toll rates would be kept low because of competition. That assumption does not appear in the legislation, however. Nevertheless, section 9103 uses the term "local services" in four of the nine listed objectives, and it seems reasonably clear that the Legislature, in fact, was referring to basic service. We will discuss the toll rate issue below later in this subsection.

Considering the statutory objective of section 9103(1) as limited to basic service, we find that it is reasonably likely that rates under the AFOR price cap system we are adopting will be no higher than the levels that would occur under cost-based ROR regulation. Under the price limits we have chosen for basic rates, NYNEX may not increase basic rates by more than the overall price index (the Price Regulation Index, or PRI, that is equal to inflation less productivity, plus or minus exogenous changes), if the PRI is positive. If the overall index is equal to zero or is negative, NYNEX may not raise basic service rates at all, although it will not be required to lower them.

This pricing rule for basic rates is generally consistent with recent history. In two rate cases in 1984 and 1985 in which revenue requirement and rates were increased, basic rates were increased by a greater percentage than toll rates. (In the first of those cases, toll rates were not raised at all.) In the late 1980s, we ordered two rate decreases. In 1987, basic rates were decreased by more than toll rates, but in 1989, most of the decrease was to toll rates, and basic rate were not changed.

The 1987 and 1989 cases were decided after enactment of 35-A M.R.S.A. § 7303, which prohibits mandatory local measured service and requires the Commission to "preserve traditional flat rate local telephone service at as low a cost

as possible . . . ." That section applies to traditional rate of return regulation, and 35-A M.R.S.A. § 9302 specifically requires that it continue to apply under any AFOR. In our *Docket No. 92-130 Order*, we interpreted section 7303, ruling that it was possible to raise basic rates upon various circumstances each of which in effect amounts to a finding that an existing rate design is unreasonable and detrimental to overall rate levels or to the public interest. We listed four circumstances, all of them examples of detrimental rate design, that might justify raising basic rates.[2] We also recognized that the list was "not exhaustive" and that other circumstances might justify raising basic rates.[3]

Section 7303 is primarily a rate design statute. In effect, the voters of this State decided that increases to basic rates should be discouraged and that the rate design (the balance between various rates such as basic and toll rates) in place at the time the statute was enacted was reasonable and should not be changed without substantial cause.[4] In Docket No. 92-130 we attempted to evaluate rate design in light of costs. The four listed conditions must be considered in that light. We do not view the statutory mandate of "lowest possible" basic rates as precluding increases to

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[2] The four circumstances are:

> 1. Evidence that local rates would be higher in the long term if high toll rates (or high rates for other services) drive customers off the public switched network.
>
> 2. Evidence that increasing local rates and lowering toll rates would lead to such increased toll usage that local rates in the future could be lower than they otherwise would be if that action had not been taken.
>
> 3. Evidence that the existing level of local rates precludes NET from earning a just and reasonable return on its investment, because NET would be unable to recover its revenue requirement from other (perhaps more competitive) services.
>
> 4. Evidence that increasing local rates and lowering toll rates (with commensurate adjustments to safeguard for low-income individuals) would lead to significantly higher levels of toll usage and user satisfaction that would substantially improve the economic and social value of the telecommunications system.

[3] The only other circumstance mentioned was that basic exchange service was priced below marginal cost.

[4] The statute was passed by referendum, I.B. 1986, c.2, and became effective on December 24, 1986.

basic rates when a telephone utility's overall cost of service has risen. In the absence of a finding that existing rate design is unreasonable, it is most unlikely that this statute requires that basic service rates must be forever frozen, and that all general increases in overall revenue requirement must be placed on toll or other non-basic services.

On the other hand, if a rate design determined by the voters to be reasonable at the time section 7303 was enacted is in place, and the Commission determines that the overall cost of service has increased, section 7303 may well prohibit a proportional increase to basic service rates that is greater than the proportional increase in overall costs, unless the Commission also determines, pursuant to one of the findings listed in the Docket No. 92-130 order, that the rate design that the voters approved in 1986 has become unreasonable or detrimental. Under continued ROR regulation, because of section 7303, basic service rates most likely could not lawfully be increased by more than an overall increase in the cost of service unless we made one of the four findings articulated in Docket No. 92-130. It is possible that such a finding might be made during the next few years, but we cannot be certain that would occur. Accordingly, under the AFOR, NYNEX will be allowed to raise basic rates only if the PRI is positive, and then only by the amount of the increase in the overall index. See Part III.C.6 below. We also decide, however, that if the PRI decreases, NYNEX will not be required to reduce basic rates. The primary concern of the voters in 1986 was to maintain basic rates at a reasonable level and to prevent significant changes in rate design without substantial cause. In the Docket No. 92-130 order we stated our goal of reducing toll rates to the greatest extent possible. Many people testifying at our public witness hearings and commenting on these cases in letters expressed the same desire.

The Advocacy Staff argued that basic rates should be frozen, although it did not argue that section 7303 compels that result. We find that allowing modest increases to basic rates, limited only to those years in which overall prices may rise, is permissible under section 7303 and is more consistent with our goal of lowering toll prices stated in the *Docket No. 92-130 Order*. The Public Advocate's proposal contains essentially the same limit on basic rates (and on all core service rates) as the limit we have chosen, subject to a further limitation that would apply under the OPA's proposed competitive service index.

NYNEX proposed that it may raise basic rates by the "Rate Element Index" (REI), which is equal to the amount of inflation for consumer goods and services (CPI), plus or minus exogenous changes. If the REI were positive, NYNEX could raise basic rates by up to the amount of the change in the REI even if the overall PRI was negative. NECTA argued that NYNEX's proposal would allow NYNEX too much pricing flexibility and, in particular, would allow it to make "anti-competitive rate changes." Without addressing the latter issue here, NYNEX's proposal would allow it to increase basic service rates by nearly 20% over a 5-year period if recent levels of inflation continued. During the period 1986-1994, the CPI increased more than 30%. If the PRI were level or were to decline, NYNEX could nevertheless increase basic rates

by an amount equal to increases in the CPI. In combination with decreases to toll rates such increases to basic rates might well lead to the kind of rate design rebalancing that section 7303 prohibits in the absence of the kind of finding that our *Docket No. 92-130 Order* requires.

c. Pricing Levels for Toll Services

As discussed above, we interpret the objective of the statute that "local" rates under an AFOR must be as low as or lower than they would be under ROR regulation to apply only to basic service rates. Notwithstanding that limitation, we will discuss the effect of the AFOR on toll rates. We do not believe it would be sound public policy to implement an AFOR under which basic rates would be kept low only by allowing toll rates to increase by more than they would under ROR regulation.

While it appears that the Legislature has not required us to find that rates for toll services would be no higher under an AFOR than under traditional rate of return regulation, we find that such a constraint is appropriate for an AFOR. As the overall price trend for NYNEX during the last 8 years has been moderately downward, toll prices should also be expected to decline under an AFOR. Our *Docket No. 92-130 Order* expressly stated our goal to reduce toll rates. NYNEX clearly intends to reduce toll rates as much as possible. All parties' proposals would allow NYNEX to reduce toll prices by any amount. We find that a limit on increases for toll rates that is the same as that for basic rates (no more than the PRI) will satisfy our policy of ensuring that toll rates under an AFOR will not exceed those that would occur under ROR regulation.

d. Overall Pricing Level

Along with separate limits on individual rate elements or categories, the other major factor under an AFOR price cap plan that influences the ability of a telephone company to change basic rates (or any other rates including toll) is the price regulation index (PRI). The statutory goal of ensuring that basic rates shall not be higher under an AFOR than under ROR regulation, and our goal that toll rates shall not be higher, is best accomplished by using a productivity factor that fully reflects the potential for cost savings under sound, cost-conscious management, in combination with limits on individual rate increases. The evidence in this case establishes that NYNEX is capable of meeting the productivity index we have chosen for core services.

2. Costs of Regulation Shall Be Less Than Under ROR Regulation

The second objective of section 9103 is:

> **2. Costs.** The cost of regulation of telephone utilities must be less under the alternative form of regulation than under rate-base or rate-of-return regulation.

Under an alternative form of regulation, whether for 5 years or longer, the costs of regulating NYNEX most likely will be lower than under continued ROR regulation. Under the AFOR, there is virtually no likelihood that we would have to engage in the kind of cost analysis that is necessary in a traditional ROR regulation case. Admittedly, the cost of regulating NYNEX has been low over the past 6 years, as NET/NYNEX has had no general rate case in that time. Nevertheless, under continued ROR regulation, NYNEX could file, or the Commission could initiate, a rate case at any time. We therefore find that the statutory objective of section 9303(2) is satisfied by the price cap form of AFOR recommended by NYNEX and the Advocacy Staff. Making that finding for the price cap form of regulation advocated by the Public Advocate would be more difficult. Because the Public Advocate's proposed AFOR requires earnings sharing, it would be necessary to engage in an annual review of costs and earnings similar to that involved in a traditional ROR rate case. The Public Advocate's proposed plan would also require several other studies and other regulatory activities.

3. Commission Ability to Regulate Must Be Preserved

The third objective of section 9103 is:

> **3. Mandates.** The alternative form of regulation preserves the ability of the commission to ensure that all legislative and commission mandates directed to the telephone utility are properly executed.

There is nothing in any of the proposed plans, or in the AFOR we are adopting, that limits the Commission's ability to regulate NYNEX, other than the restriction on traditional rate cases, and some provisions that would grant NYNEX increased pricing flexibility. In all other respects, the Commission's powers are preserved. These powers include the ability to address service quality concerns directly (in addition to the service quality rebate mechanism that is included in the AFOR), and authority over billing and collection practices, disconnections, deposits, and any other matter that may need to be investigated and remedied pursuant to 35-A M.R.S.A. §§ 1302, 1303 and 1306. Section 9102 effectively allows us to suspend those portions of Chapter 3 (sections 301-312) that require rate-base, rate-of-return regulation. They do not permit the suspension of the statutory prohibitions against unjustly discriminatory rates (35-A M.R.S.A. §§ 701-703). All other requirements of Title 35-A remain fully in effect and fully enforceable under sections 1302, 1303 and 1306.

4. Risk of Non-Local Telephone Services Shall Not Be Borne by Local Telephone Subscribers; Flat-Rate, Voice-Only Local Service Option Preserved

The fourth objective of section 9103 is:

> **4. Safeguards.** The alternative form of regulation must provide adequate safeguards to ensure that risks associated with the development, deployment and offering of telecommunications and related services offered by the telephone utility, other than local telephone services, are not borne by the local telephone service subscribers of the telephone utility and that the utility continues to offer a flat-rate, voice-only local service option.

a. Application of Objective to Both Basic and Toll ("Core") Services

As under subsection (1), it is reasonably apparent that the Legislature, by the use of the term "local," intended the condition or objective described in this subsection 4 to apply only to basic service. Thus, the condition states that ratepayers of basic service shall not bear any risk for other services, including toll services.

Both NYNEX's and Advocacy Staff's arguments on this issue failed to distinguish between the sets of risks that might be separately associated with basic service and toll service, or between those services and other services. Plainly, the statutory objective does not address directly the issue of the risk of toll service (or, to phrase this issue in the same way as the "local" issue, it says nothing about whether toll ratepayers should or should not bear any risk of non-toll services). There is at least one possible reason for the fact that the objective addresses only local services. Toll and basic services share many common facilities. We have never made a comprehensive cost allocation of these common facilities between basic service and toll service. In order to ensure compliance with the objective that "local" ratepayers should not bear the risk of "non-local" services, if the cost of basic service is not known, it might be necessary to require toll ratepayers bear some of the risk of basic service. It would therefore be impossible to satisfy both the actual statutory objective and a hypothetical parallel condition that toll ratepayers not bear any risk of non-toll services.

We believe it is preferable to consider "local" (i.e., basic) and toll services jointly. To the extent that this consideration requires us to depart from a strict reading of the statute, nothing in the stated objective precludes our consideration of these risks jointly. Moreover, the opening paragraph of section 9103 states:

> *Unless the commission specifically finds that the following objectives are not in the best interests of ratepayers*, the commission shall ensure that any alternative form of regulation it adopts under section 9102 is consistent with the following objectives.

35-A M.R.S.A. § 9103 (emphasis added). We find that the interests of ratepayers as a whole are best served by a condition that local and toll ratepayers jointly shall not bear the risk of services other than local or toll services. The AFOR we have selected establishes identical price cap provisions for both local and toll services (as "core" services). We turn now to the question of who does bear the risks for those core services (as well as for "non-core" services) and, equally important, the nature and extent of those risks.

b. <u>Definition of Risk; Cost Burdens Distinguished</u>

We will consider here the question of who actually will bear "the risks associated with the development, deployment, and offering of basic and toll services and of other services." NYNEX argues that "price regulation of the sort proposed by NYNEX ensures that NYNEX will bear the risk of investment associated with developing and deploying services." Staff argues that NYNEX under an AFOR would bear the risk of "new investments."

Initially, we distinguish between the question of the "risk" of an investment and the burden of bearing the cost of an investment. The statutory objective, as we have modified it, states that "*risks* associated with *development, deployment and offering* of telecommunications and related services offered by the telephone utility, other than local [and toll] services . . ." shall not be "borne by local telephone service subscribers . . . ." 35-A M.R.S.A. § 9103(4) (emphasis added). We believe that the risk described refers to the entrepreneurial risk that the "development, deployment and offering" of services will not produce positive financial results, i.e., sales will not materialize at an expected level.

NYNEX argues, and we agree, that under a price cap AFOR, the telephone utility bears the entrepreneurial risks that sufficient sales will not occur, that costs will be higher than expected, and that it will not earn a fair return on its investment. Even under ROR regulation, of course, a utility bears a similar entrepreneurial risk, but the risk is much less substantial because of a utility's right to file a rate case as frequently as once each year. 35-A M.R.S.A. § 307. The insubstantiality of entrepreneurial risk under ROR regulation is one of its major theoretical shortcomings. We see no incompatibility, incidentally, between the statutory requirement under discussion here (that a telephone utility under an AFOR must bear the entrepreneurial risk of non-local services) and the separate statutory requirement in section 9103(6) that a telephone utility subject to an AFOR must have "a reasonable opportunity to earn a fair return on the investment necessary to provide local telephone services." 35-A M.R.S.A. § 9103(6).

Under the AFOR we are adopting, NYNEX will bear the entire entrepreneurial risk of all services, including local or basic and toll services. Nevertheless, while NYNEX will bear the entire entrepreneurial risk, the extent of that risk varies widely for different services. The extent of the risk is largely a function of the likelihood that ratepayers will bear the cost for a service. That likelihood, and therefore, the degree of risk for different services, varies substantially.

In the case of services that earn a profit for the seller, customers who buy the services pay for the cost of producing those services, i.e., they bear the cost burden. A seller of goods or services may bear the entrepreneurial risk, but has expectations (ranging from nearly certain to fanciful) that customers purchasing the product will pay for the cost of supplying it. For NYNEX's core services, such as basic service and toll, there is a reasonable expectation that ratepayers will provide the

necessary cost support for those services. Built into the starting point for rates under the AFOR (as established by our decision in Docket No. 94-254) is NYNEX's current costs, or its revenue requirement, based on reasonable levels of rate base and expenses. Ratepayers will pay for at least the existing levels of investment and expenses, assuming that their demand does not decline. Ratepayers are also likely to pay for some, and possibly all, of any new investment and expenses that NYNEX makes or incurs for core services.

If NYNEX acquires new customers, they will pay the same rates as existing customers and will provide additional revenue. If revenue requirement per customer does not increase, and new customers, paying the same rates, provide as much revenue as existing customers, they will provide sufficient support for the new investment made to satisfy their demand. Similarly, if existing customers increase their demand, and if additional investment were necessary to satisfy the new demand level, the existing customers would most likely provide the increased cost support for that investment.

Under these examples, the entrepreneurial risk that NYNEX bears may be modest, but it is real. There is some risk that existing customers' demand will decline or that new customers' demand will be less than existing customers'. NYNEX will also bear the risk that customers may be lost to competitors and, for whatever reason, not all the lost retail revenue will be replaced by access revenue. A further entrepreneurial risk directly relevant to the principles embodied in a price cap AFOR is that of inefficiency, i.e., that per-customer costs may increase by more than per-customer revenues. Conversely, of course, NYNEX has the opportunity (the "upside risk") to do better than the overall price index, if it can lower its costs or increase its revenues for core services.

c. Risk and Cost Burden of Non-Core Services

As described in greater detail in Parts III.C.2 and III.C.6 below, we will not apply price cap regulation to non-core services for NYNEX-Maine, primarily new and broadband services. We have no doubt that the entrepreneurial risk associated with non-core services (most of which do not yet exist) is far greater than the risk associated with core services. Under the AFOR, NYNEX bears the entrepreneurial risk of all services. However, the size of the risk associated with non-core services becomes greater if more of the cost burden of those services is shifted to NYNEX and to the customers of non-core services, so that core service customers bear less of the cost burden of non-core services. We have considered two ways of shifting this cost burden.

One method would be pursuant to an allocation of costs following a finding that NYNEX made imprudent investments in the equipment that is

and will be used to provide non-core services. However, no party in the Docket No. 94-254 rate case argued that NYNEX's investment policy was imprudent, and we do not believe there is sufficient evidence to make such a finding. Because there has been no disallowance of any of NYNEX's investment (which is capable of providing both core and non-core services), all of its investment is included in the revenue requirement that serves as a starting point for rates under the AFOR. Because the revenues for non-core services are at present very small, basic and toll ratepayers have been supporting and will continue to support the cost of the investment (including excess capacity) that is capable in part of providing non-core services.

A second way to effectively shift some of the cost burden from core service ratepayers to non-core services is through a higher productivity factor that applies only to core services. Staff witness Dr. Gabel's Local Exchange Cost Optimization Model (LECOM) measured inputs, outputs and productivity only of core services, primarily basic and toll. The limitation to core services may be one reason why Dr. Gabel's productivity factor is higher than Dr. Taylor's, which is based on studies measuring national total factor productivity (TFP)[5] of a large number of telecommunications entities. Although we have significant problems with Dr. Gabel's study that we cannot reliably cure, it suggests that NYNEX-Maine's productivity for basic and toll services is higher than the productivity of its total mix of all its services. Stated otherwise, NYNEX has not yet received sufficient revenues to support the level of investment and expenses that might reasonably be attributable to non-core services.

It is appropriate to use a productivity factor that applies only to the core (basic and toll) services that apparently are more productive than the total mix of services. As explained above and in our *Docket No. 94-254* Order, we have not disallowed any investment or expenses due to "overcapacity" or imprudence. Therefore, at first, ratepayers will bear a substantial portion of the cost burden of the investment for relatively unproductive non-core services. However, that cost burden will gradually shift to NYNEX because of the productivity factor we have chosen, which is higher than a total factor productivity (TFP) and which is applied only to core services. Because that higher productivity factor is applied only to the relatively productive core services, the prices for those services ultimately will be lower than they would be if a TFP were applied to them. Costs are shifted away from core services and to relatively unproductive non-core services (or to shareholders) into the extent of the difference between the higher productivity factor we have chosen and a TFP. Thus, for those

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[5] As used herein, productivity or Total Factor Productivity (TFP) refers to the amount goods and services produced by a firm, an industry, or a national economy, relative to the amount of labor, capital, and other inputs needed to produce the goods and services. There was no dispute regarding this definition among any of the parties in this case.

non-core services, the extent of NYNEX's entrepreneurial risk will become more substantial.[6]

Core ratepayers will be insulated from some of the costs of non-core services by the exclusion of rates and revenues for non-core services from the coverage of the PRI. Thus, if revenues for the non-core services continue to be low, NYNEX cannot make up any resulting revenue deficiency by increasing rates for core services by more than it otherwise could under the PRI. The total of new prices, multiplied by quantities of each service sold in the preceding year, must be equal to or less than the PRI. NYNEX will be allowed to price non-core services at any level it chooses, subject to the competitive safeguard that they cannot be priced below long run marginal cost. (By contrast, although Staff has also proposed complete pricing flexibility for these services, it would include them in the overall price cap formula.) Because we have excluded non-core services from the price cap plan and allowed NYNEX full pricing freedom, either NYNEX or the customers of non-core services will bear an increasingly larger share of the cost of those services.

NYNEX will, of course, keep all revenues from these services. The entrepreneurial risk that it bears for non-core services, although considerable, also includes the opportunity to realize substantial profits. Because non-core revenues will not be subject to the PRI, NYNEX will fully realize any increase in non-core revenues, as it cannot act to decrease (or increase) basic or toll rates. There will be no interaction between core rates and non-core rates.

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[6] In referring to these non-core services as "relatively unproductive," we do not mean to imply that the facilities used to provide these services are "inefficient" in an engineering sense; rather, they are unproductive in the total factor productivity sense, i.e., at least at present, they do not produce sufficient revenue to cover costs.

d. Continued Flat-Rate Basic Service Option

This objective of section 9103(4) appears to be redundant, because section 9102 states that section 7303 must apply to any AFOR. Section 7303(3) requires a flat rate option as the "standard" local basic service offering and places stringent limits on the pricing of any residential measured service option. A flat-rate, voice-only basic service rate for both business and residential customers will be available for the duration of the AFOR.

5. Local Telephone Service Reasonably Priced

Subsection 5 of section 9103 states:

> **5. Reasonable charges.** The alternative form of regulation must ensure that customers pay only reasonable charges for local telephone services.

This issue is addressed thoroughly in Part III.A.1 above. The Public Advocate suggests that this subsection should not be considered merely redundant with the other objectives contained in section 9103 that address basic rates. The OPA argues that subsection 5 of section 9103 likely was "included as a reaffirmation [of] other pre-existing statutes . . . such as section 7303 (local rates to be kept as low a cost as possible) and section 7101 (universal service) . . . ." However, section 9102 specifically requires any AFOR to "conform" to sections 7101 and 7303 (among others). Therefore, any possible intended reference by section 9103(5) to those sections would be redundant.

In any event, we have addressed basic rate levels in Part III.A.1 above, including specifically the limits on basic rate increases imposed by section 7303.

6. Reasonable Opportunity to Earn a Fair Return on Investment Preserved

Subsection 6 of section 9103 states:

> **6. Reasonable return.** The alternative form of regulation must ensure that the telephone utility has, over the period of the alternative form of regulation, a reasonable opportunity to earn a fair return on the investment necessary to provide local telephone services.

This objective, like others discussed above, is limited to "local" services. Thus, it requires only that a telephone utility have a reasonable opportunity to earn a return on its investment for *local* services. As in the case of the fourth (risk) condition, however, there is at present no cost allocation study and no determination of the amount of NYNEX's investment (including investment used jointly for local and toll services) that is considered dedicated to local service.

All of the parties' proposed price cap systems would apply to both basic and toll rates, and the AFOR that we have adopted provides NYNEX with a reasonable opportunity to earn a fair return on both its basic and toll service investment. Our consideration of both toll and local services jointly is unavoidable and is consistent with the treatment of the risk issues discussed in Part III.A.4 above.

Except to the extent that this subsection might limit a utility's right to a reasonable opportunity to earn a fair return to investment it has made for local services, it is important to recognize that this statutory objective is identical to the constitutional and statutory (35-A M.R.S.A. § 301(4)) requirements that apply under ROR regulation.

Each of the parties' price cap plans assumes a starting point for rates that is based on NYNEX's existing level of investment and expenses. That starting point is established by our *Docket No. 94-254 Order*. Those rates will be modified over time pursuant to a formula that is designed to approximate expected reasonable changes in NYNEX's cost of service, including costs that are not within its control (inflation and exogenous cost changes) and those over which it has some control (productivity). This price cap AFOR regulates rates, not earnings or revenue requirement based on book costs. NYNEX therefore will be provided a reasonable opportunity to earn a fair return on new investment it makes to satisfy customer growth or demand growth for existing or new services. As discussed at Part III.B below, one of the central purposes of incentive regulation to provide incentives, e.g., increased likelihood of profits or losses, that will encourage appropriate levels of sound investments. The section 9103(6) condition most appropriately does not specifically require that an AFOR provide a reasonable opportunity for a utility to earn a fair return on its riskier investments. As under ROR regulation, the statutory objective of affording NYNEX a reasonable opportunity to earn a fair return on its investment must be balanced with other objectives, such as those in sections 9103(1) and (4) that require reasonable rates and that ratepayers do not bear undue risks. The price cap formula we adopt today, based on reasonably expected or attainable cost changes, will give NYNEX a reasonable opportunity to recover all of its reasonable costs, including a fair return on its local and toll investment.

7. Development, Deployment and Offering of New Services Encouraged

The seventh objective listed in § 9103 is:

> **7. Encourage telecommunications services.** The alternative form of regulation must encourage the development, deployment and offering of new telecommunications and related services in the State.

This objective, as much as any other, goes to the heart of price regulation or price cap theory. As explained in Part II above, one major general purpose of price caps is to provide incentives to a utility to be more efficient. A particular goal of price regulation is to encourage utilities to be innovative and to provide new services that will be profitable, whether new investment is required or not, and to discourage new services that would be unprofitable. If a utility subject to an AFOR hypothetically had a choice between two services that would produce an equal amount of revenue, and one service required new investment and the other did not, correctly-established AFOR incentives should lead a rational utility to choose the new service that does not require new investment, all other circumstances being equal. We raise this point because NYNEX has apparently confused the statutory objective of encouraging "new telecommunications and related services" with a non-existent objective of encouraging investment. Indeed, NYNEX recognizes that the primary goal of an AFOR is to encourage appropriate levels of investment. In discussing the issues considered at Part III.C.9 below, its Brief states:

> [its] Plan shifts of risk of investment from the ratepayer to NYNEX's shareholders: a prudent investment that fails to pay off would be the responsibility of NYNEX's shareholders, unlike under ROR regulation, where NYNEX would recover prudent, though unprofitable investments by raising prices.

In order to encourage the introduction of new services that do not require new investment, we have decided, as explained at Part III.C.6. below, that new Custom Calling and Phonesmart services will be non-core services, i.e., they will not be subject to the PRI and NYNEX will have full pricing freedom.

NYNEX witness Helgeson implied that the telephone network in Maine at present is thoroughly up-to-date:

> The modernization of the network to a digital broadband technology is the principal reason for the efficiency and

service improvements achieved by NYNEX over the past decade.

To be sure, some new services may require new investment. For example, the parties in NET's last rate case, Docket No. 88-143, agreed that NET should invest in equipment necessary to provide Signaling System 7 (SS7), so that NET could provide CLASS (now Phonesmart) services. New investment is not necessarily a precondition for new services, however. For example, there are numerous CLASS-based services that NYNEX has not yet offered.

To the extent that new services require new investment, we have established an AFOR that provides an incentive for NYNEX to make appropriate levels of investment and, if those investments are prudent, an opportunity to earn a fair return. The productivity factor we have chosen, which is toward the low end of the range suggested by the evidence, is designed to satisfy this statutory goal, whether additional investment is required or not. At numerous locations in its briefs, NYNEX made clear its opinion that it believed the Advocacy Staff's and OPA's combined AFOR and rate case (Docket No. 94-254) proposals would not afford it a reasonable opportunity to earn fair returns; NYNEX in effect argued that no plan other than its own could be reasonable. It has strongly suggested that if its proposed plan (coupled with no rate decrease in the rate case) is not adopted, it will invest in places other than Maine.

It is quite possible that NYNEX also may disagree with our findings. NYNEX remains a regulated public utility, however, and does not choose either the form of regulation or the rates under which it will operate. This Commission's findings and decisions, subject to review on appeal, establish as a matter of policy and law the nature and extent of NYNEX's opportunity to earn a fair return on its investment. Once those findings become final, they establish the reasonable level of potential earnings for NYNEX in Maine. NYNEX cannot decline to make reasonably-required investments simply and solely because it disagrees with the result. Within the bounds of that lawfully-established opportunity, NYNEX has a legal obligation to provide reasonable service. If, in order to provide reasonable service, it becomes necessary for NYNEX to introduce new services that require new investments, it will be legally obligated to make those investments if it is reasonably possible to earn the return the Commission has established.

We note that the incentive to provide new services under the AFOR we are adopting is actually stronger than that proposed by NYNEX in its own plan. As described in Part III.A.4 above, and in Parts III.C.2 and III.C.6 below, present and future revenues for non-core services, including broadband-based services, will not be subject to the PRI. NYNEX will be allowed to charge whatever rate it believes is appropriate for those services. That feature of our AFOR provides NYNEX with as much incentive to develop new services as is possible.

NYNEX's argument concerning the impact of a plan that provides what it considers to be "deficient earnings" is also economically unsound. Whatever NYNEX may earn on its embedded investment, and however unhappy it may be about those earnings, as a matter of economic incentives and sound, rational management, its investment decisions should be based solely on what it will earn on the new investment. Basic economic theory states that a firm maximizes profits if it makes investments up to the point where marginal revenue is equal to marginal cost. Presumably, a firm that has an opportunity to make an investment that will produce marginal revenues in excess of marginal costs will not have difficulty raising capital. The Vermont Public Service Board (PSB) made this observation when, in the recent price cap proceeding in Vermont, NYNEX argued that it had delayed switch replacements in Vermont because Vermont had to compete with states with higher rates of return. The Vermont PSB stated:

> We reject this argument. It has unacceptable implications. It suggests first that Vermont regulators, in order to assure the deployment of cost-effective plant in this state, must themselves compete with regulators of the other states in which NET operates. This competition must take the form of differential rates of return, with the state offering the higher rates receiving more of NYNEX's investment dollars. While it is true that a regulated utility could find investment opportunities in unregulated activities that appear to offer higher returns than the franchised business, that does not relieve the utility of its franchise obligations. The argument also implies that NET will ignore projects with expected rates of return equal to or greater than those rates sufficient to attract capital in the capital markets ...It is unlikely in our view that a rational business would forego higher absolute net earnings simply to preserve higher percentage rates of return. And finally, NET's assertion violates financial theory, which holds that investors will allocate capital to those projects whose expected returns meet or exceed their required returns, given their levels of risk aversion. There is no satisfactory evidence in this record to demonstrate that NET is unable to raise capital [for] cost-effective utility investments in this state.

Re: New England Telephone and Telegraph Company, 157 PUR 4th 112, 134 (Vermont Public Service Board, Oct. 5, 1994).

We do require, however, that in the short run, a rational business's ability to acquire and allocate capital to projects whose expected returns exceed the

costs and/or required returns may be limited to practical considerations. For example, capital investment takes more than just money; it takes management capital (e.g., time and effort). It may be likely that management attention and effort will be directed at least first to places where the returns are likely to be greatest. In addition, when there are a number of opportunities for capital expenditures, it seems likely that one standard for determining which one project among several goes forward first is each project's contribution to the bottom line (at least in part a function of its rate of return).

NYNEX's witness Dr. William Taylor was asked about this issue by Chairman Welch. Essentially he agreed that a rational firm should make its investment decisions on the margin. He did suggest that if a fair return depends on selling a service for which prices were set too low it might be harder to earn a fair return. Under our AFOR, however, NYNEX's prices for non-core services are unconstrained and not subject to the overall price cap formula. Dr. Taylor also suggested that if it is necessary to sell some underlying service at a "price . . . constrained in a bad way . . . then that would affect the expected return on the extra dollars' investment and at the margin less would be invested." Dr. Taylor did not give any examples of new services or new investment that were dependent upon making new investment for services that were subject to restrained earnings, and we can think of none.

8. Reasonable and Nondiscriminatory Charges to Other Telephone Utilities

Subsection 8 of section 9103 states:

> **8. Nondiscriminatory charges.** The alternative form of regulation must ensure that another telephone utility pays the telephone utility providing local telephone service reasonable and nondiscriminatory charges for any services used by the other telephone utility to provide its competing service.

As in the case of several other objectives, this objective refers only to "local telephone services," but we believe that no AFOR should permit unreasonable or discriminatory access or interconnection charges for either local or interexchange interconnection or access. Beyond including the rates under the non-discretionary core services category, we do not address the issues of interconnection or access charge structure or rates in this proceeding. Interexchange access charges and structure are presently governed by existing Chapter 280. They, and the access charge structure for local competition, are the subject of *Public Utilities Commission, Inquiry Into the Provision of Competitive Telecommunications Services (Chapter 280)*, Docket No. 94-114.

NYNEX argued that nothing in its plan changes the competitive balance in the state and that its plan would expressly allow competitors to challenge NYNEX pricing decisions on the basis of claims of anti-competitive pricing. NYNEX, in its price cap plan, proposed that access charges would be capped, i.e., could not rise.

Existing Chapter 280 implicitly requires non-discriminatory interexchange connection charges for interexchange service because they apply to all competitive providers. That rule presently requires interexchange access rates to be based directly on retail rates. When adopted, we found the access rates to be just and reasonable. At present, we have not authorized local competition and do not intend to do so until after a local access charge structure is in place. Therefore, there can be no unreasonable or discriminatory access rates for local competitors because there are no such rates. However, as reflected in the preliminary proposal issued in Docket No. 94-114, we intend to establish interconnection charges and access rates for local competition, and intend that both local and interexchange access charges will be reasonable and non-discriminatory in the future. Section 9103(8) requires that result for local interconnection charges, as long as NYNEX is under an AFOR. NYNEX is, of course, also subject to anti-trust claims. Moreover, 35-A M.R.S.A. §§ 301 and 702(1) require just and reasonable rates and prohibit discrimination, respectively, and apply both to wholesale (access) and retail rates.

As discussed below in Part III.C.5, the cap or ceiling on interexchange access charges proposed by NYNEX is not permissible under present Chapter 280. Subject to any change that occurs as the result of a revision of a Chapter 280, access charges will be subject to the same price cap rules as toll rates.

9. Consumer and Competitive Safeguards Provided

The ninth objective of section 9103 states:

> **9. General Safeguards.** The alternative form of regulation must include consumer and competitive safeguards.

a. Consumer Safeguards

This statutory objective is fairly vague. In connection with consumer safeguards, the Public Advocate mentioned only the issue of cross-support of competitive services by non-competitive services. We address that issue by requiring that each individual nondiscretionary core service rate element shall be subject to the same price cap, i.e., it cannot be raised by more than the PRI. The Commission Advocacy Staff mentioned only service quality safeguards; those are discussed in Part

III.C.8 below. NYNEX mentioned several matters, all of which it claimed are satisfied by its proposed plan. These include the fact that there will be rate stability, that under price cap regulation, customers are protected against the risk of investment, that specific safeguards would be implemented to protect service quality, and that Lifeline rates would be effectively capped.

Under the AFOR that we are adopting, customers are protected against unreasonable rates, and they receive greater protection against unwise investments by NYNEX than under ROR regulation, i.e., the risk of investments is largely transferred to NYNEX; that risk may be substantial for new investments and for some of the investment that will be used for non-core services. *See* Parts III.A.1 and III.A.4 above. Service quality safeguards are established, as described in Parts III.B.1 and III.C.8 below. In addition, all of our rules that contain consumer safeguards, e.g., Chapters 25, 81, 86 and 87, remain fully in effect.

b. Competitive Safeguards

(1) Positions of Parties

The statutory objective regarding competitive safeguards is stated in very general terms, but all parties have interpreted the phrase "competitive safeguards" as safeguards designed to assure that competitors will not be harmed as a result of the AFOR.

NYNEX claims that its proposal contains adequate safeguards to protect the interests of current and potential competitors in the Maine market. NYNEX urges us to address competitive issues in the Chapter 280 proceeding (Docket No. 94-114). It states that any substantial changes necessary to protect or promote competition are better discussed there.

NYNEX believes its plan will protect competitors against cross-subsidization or predatory pricing by requiring that NYNEX may not price any service below its incremental cost. It claims that pricing at or above incremental cost, by definition, eliminates the threat of cross subsidization. In addition, NYNEX proposes that any competitor who is concerned that NYNEX has acted in an anti-competitive fashion may bring a complaint to the Commission. Then the Commission would have the power to prevent and correct any anti-competitive behavior on NYNEX's part. Finally, NYNEX argues that price regulation itself will provide disincentives for it to price below cost. NYNEX argues that pricing below cost would not make any economic sense because it could not make up the revenues lost by pricing some services below cost by raising other prices to offset those revenue losses.

Staff believes that the statutory mandate to include competitive safeguards as part of AFOR can be met by requiring NYNEX to price all of its services at a rate that exceeds the total long-run incremental cost. It states that if NYNEX's prices exceed the marginal cost threshold then competitors will be provided with basic protection from predatory pricing. Staff does not believe that compliance with that cost floor would be onerous and that NYNEX will still have valuable pricing flexibility.

The OPA also believes NYNEX should not price any new service or reduce the price of any competitive service to a level below its incremental cost. It recommends that NYNEX provide the proposed price for any new or competitive services and that their full costs of deployment should be included. The OPA believes that NYNEX will always have the incentive to understate the long-run service incremental cost (LRSIC) in order to obtain maximum pricing flexibility and to have the ability to cross-subsidize. The OPA therefore recommends that the Commission ensure that NYNEX set prices at a level that includes a proper share of common costs and all other costs that were incurred to provide the service. The OPA believes its plan will also prevent cross-subsidization of competitive services by non-competitive services because rate changes for monopoly services proportionally could be no greater than changes for competitive services. In addition, the OPA states that the requirement of identical price changes for all monopoly baskets will prevent cross-subsidies, between noncompetitive and competitive services.

MCI urges the Commission to adopt Dr. Selwyn's recommendation that the Commission establish "a clear, well-defined set of rules for all services, necessary incremental cost floors, imputation requirements and cross-subsidization tests." It believes that NYNEX's purported safeguards are insufficient to prevent NYNEX from engaging in anti-competitive behavior, including price squeezes, cross-subsidization and unjust discrimination. MCI believes that NYNEX's proposed plan contains a major flaw in that it fails to include an imputation test and an unbundling requirement for any of NYNEX's retail services, including local exchange rates. To the extent that those components are used in providing a service, the price paid by the competitor to NYNEX for the same network functions would have to be considered as part of NYNEX's cost basis. MCI states that if NYNEX's retail services are not subject to an imputation requirement, it will be able to put its potential competitors who are dependent on NYNEX network functions in a price squeeze in the local exchange market. MCI is also concerned that NYNEX's plan contains no limitations on the maximum rate that it can charge its customers for any bottleneck service that it uses in order to provide its retail service offerings.

Like the Public Advocate, and relying on Dr. Selwyn's testimony, MCI argues that the Commission should require NYNEX to conduct cost studies of each of its services (including newly unbundled services) using a total service

long run incremental cost methodology, and that the studies should include any costs that are caused by NYNEX's decision to deploy a particular service, in order to ensure that the service is not being subsidized. MCI would require NYNEX to include cost support data with its tariff filings, arguing that the lack of that cost support would shift the burden of proof onto the complainant. MCI contends that if no cost support is submitted with tariffs, it will be virtually impossible to determine if the price of the service will adversely affect competition.

Finally, MCI also believes that NYNEX's proposed complaint procedure does not provide adequate competitive safeguards because the Commission could not suspend a NYNEX tariff on the grounds that the tariff is anti-competitive. MCI states that the proposed NYNEX plan provides that once a complaint involving anti-competitive pricing is raised by a competitor, the Commission could open an investigation, but it would be limited to determining whether or not the proposed service is priced so that the incremental revenues are equal to or greater than the incremental costs associated with the service. Under NYNEX's plan there would be no suspension of the tariff. MCI contends that this process allows NYNEX to continue to underprice pending the outcome of any litigation, while in the meantime causing severe and irreparable harm.

(2) Analysis and Findings

We intend that our Chapter 280 proceeding (Docket No. 94-114) will be the primary vehicle we will use to address issues involving competitive safeguards. Nevertheless, several features of the AFOR we are adopting will prevent anti-competitive activity by NYNEX. Primary among these is the fact that NYNEX cannot increase any non-discretionary core services by more than the PRI. Like our plan (and unlike Staff's), NYNEX's own plan also proposed individual (albeit identical) caps on all services, but its proposal to index some non-discretionary core rates to the CPI (rather than the PRI) might have provided it with sufficient revenues to allow it to offset losses that might occur if it set prices for competitive services below cost. However, the more stringent pricing requirement we will implement will create a disincentive against engaging in anti-competitive behavior by imposing an implicit economic penalty on NYNEX for below-cost pricing.

We are also concerned that NYNEX's proposed complaint procedure may not provide adequate competitive protection.[7] However, we do not believe it is appropriate to require NYNEX to provide full marginal cost support for every new service filing it makes because of the administrative burden and expense that process would create. In our Chapter 280 proceeding, Docket No. 94-114, we will consider a structural solution to this problem. As stated in the preliminary proposal issued in that proceeding on January 16, 1995, one alternative under consideration would require NYNEX to unbundle all traffic-sensitive or customer-specific network functions used to provide any new or existing service, and to price them at marginal cost. The preliminary proposal also would require access imputation that would require NYNEX to set its rates for new services, or for services whose price is being reduced, to cover at least the cost of the network functions as set in NYNEX's wholesale tariff, in order to preclude predatory pricing at the retail level. Marginal cost pricing and full unbundling at the wholesale level will also preclude NYNEX from erecting a price bottleneck barrier to competition. For reasons set forth in Part III.C.5 below, we reject the OPA's proposal to link rates for monopoly and competitive services.

Until Chapter 280 is modified, we will require NYNEX to develop marginal cost support for all new services or for any service where the price is being lowered by greater than 20% and, upon request of the Director of Technical

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[7] No one person has the ability as of right to compel the Commission to commence an investigation of a rate or a "practice or act" that is allegedly "unreasonable or unjustly discriminatory." 35-A M.R.S.A. § 1302 requires that at least 10 persons must make these allegations. However, on our own motion, we may open an investigation of the same matters under section 1303, and any request to do so that is supported by a reasonable preliminary showing will, of course, be considered seriously.

Analysis, to provide that information to the Commission. We direct the parties to work together to develop a long run marginal costing procedure consistent with our findings in Docket No. 92-130 by January 1, 1996. In the meantime, NYNEX may use its own method. NYNEX may also petition to price services at short run marginal cost if its makes a showing that there will be no adverse impact on other rates. In addition, we will allow NYNEX the flexibility to have promotional rates for limited duration for its services which are below cost so long as the expected revenues from those services over time exceed their long-run marginal cost.

B. Nonstatutory Goals and Objectives Proposed by the Commission and Parties

As discussed above, 35-A M.R.S.A. § 9103 requires that several statutory conditions to be met prior to implementation of an alternative form of regulation (AFOR), unless the Commission determines that any of those statutory conditions is "not in the public interest of ratepayers." In this section, we consider other possible objectives. In the Notice of Investigation for this proceeding, the Commission set forth 10 "preliminary goals and objectives regarding the future of telecommunications in Maine."[8] Some of those goals were identical to the statutory conditions contained in section 9103; others overlapped the statutory conditions. Still others were different from any of the statutory conditions. The Notice also contained an Attachment A, consisting of seven pages of "Questions To Be Addressed." In addition, various parties proposed in testimony and briefs that an AFOR should establish or encourage certain other goals.

The standard briefing outline used by the parties contained six proposed goals. Two of the goals were identical to conditions that are contained in section 9103 and are therefore discussed in Part III.A above. The parties also included a goal labeled "Investment Incentives." One of the statutory conditions requires that the AFOR must ensure that a telephone utility "has a reasonable opportunity to earn a fair return on the *investment necessary* to provide local telephone service." Section 9103(6) (emphasis added). *See* discussion in Part III.A.6 above. The statute also states a condition that the alternative form of regulation "must encourage the development, deployment and offering of new telecommunications and related *services* in the State." Section 9103(7) (emphasis added). As discussed in Part III.A.7 above, this requirement may in turn require new investment, but there may be many new services that do not require new investment. In our Notice for this proceeding, we did not establish any specific goal of providing incentives for investment under an AFOR.[9] In fact, such a

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[8] These goals and objectives are listed in APPENDIX B.

[9] One of the stated "preliminary goals and objectives" in our Notice was to

> [C]reate conditions where *existing and new competitors*

goal may well conflict with one of the universally-accepted goals of all incentive regulation: to eliminate the possibility that under ROR regulation unneeded and inefficient investments may be made. Accordingly, the issue of investment incentives is addressed in Parts III.A.6 and III.A.7 above, and is not addressed here in Part III.B.

We have identified the goals and objectives that are the most important and should be discussed. We have reviewed the remaining goals and questions raised in the Notice and find that the AFOR we have adopted will either satisfy or at least not impede attaining any of them.

1. Service Quality

One of our principal goals and objectives regarding the future of telecommunications in Maine is to:

> ensure that telecommunications service quality, reliability, customer treatment, and credit, collection, and sales practices (including possibly anti-competitive activities), receive adequate regulatory consideration and protection; and maintain adequate quality of service standards and reporting requirements so that achievement of goals can be evaluated.

Docket No. 94-123 Notice at 4.

> invest in and provide new infrastructure based on market forces rather than regulatory policy, and where the telecommunications environment attracts capital for new services.

(emphasis added). Even if "existing . . . competitors" is construed to apply to NYNEX, plainly the first portion of the "preliminary goal" is designed to provide incentives for *appropriate* levels of investment "based on market forces." It is not designed to create an incentive for investment for its own sake; the other portion of this goal is similar to the statutory goal contained in section 9103(7).

The "Questions To Be Addressed" contained in Attachment A to the Notice included one neutrally phrased question relevant to the issue of investment decisions: "How will implementation of the proposed regulatory alternative influence NET's investment or service deployment decisions?"

We will adopt a service quality index for NYNEX service in Maine as part of the AFOR in order to meet our service quality goals. We discuss the parties' positions on service quality, including detailed plans proposed by some of the parties, and the service quality index (SQI) and rebate mechanism that we adopt, in Part III.C.8 below.

2. Universal Service

The universal service principle that telephone services should be available to everyone at affordable prices, so far as practicable, has been a central policy objective since the U.S. Congress enacted the Communications Act of 1934, with the stated purpose:

> To make available so far as possible, to all people in the United States, a rapid, efficient, nationwide, and worldwide wire and radio communications service with adequate facilities at reasonable cost.

Section 1, Title I, Communications Act of 1934.

The Maine Legislature's universal service goal is expressed in 35-A M.R.S.A. § 7101(1):

> The Legislature declares and finds that the 50-year effort to bring affordable, universally available telephone service to the public has served the State well; universal telephone service has contributed to the State's economic, social and political integration and development; the public benefits from universal service when virtually anyone else in the State can be called; and a significant rate increase may threaten universal service by forcing some Maine people to discontinue their telephone service. It is the policy of the State that telephone service must continue to be universally available, especially to the poor, at affordable rates.

To further that goal, the Legislature requires local telephone companies to promote any universal service programs that the Commission may order. That requirement is stated in 35-A M.R.S.A. § 7104:

> The Commission shall require each local telephone company to participate in statewide outreach programs designed to increase the number of low-income telephone customers on the network through increased participation in

> any universal service programs approved by the Commission. The Commission may adopt rules to implement this section.

In addition, the Notice of this proceeding stated our intent to:

> further the Legislature's dual communications policy goals of universal service and economic development;
>
> ensure that ratepayers as a whole, and residential and small business ratepayers in particular, will not pay more for local telephone services under regulatory alternatives than under rate-of-return regulation;[10] ensure that captive customers who do not have competitive alternatives for essential telephone services will only pay reasonable charges for those services;
>
> remove unnecessary price restraints for services other than essential telephone services, and provide safeguards to ensure that risks associated with the development, deployment and offering of services other than essential telephone services are not borne by basic service customers; and
>
> ensure that Maine's population dispersion does not create undue barriers or inhibit access to advanced services for all customers.

In its Structured Comments, NYNEX described its plan as "designed to reduce average prices in real terms over the life of the plan, barring exogenous events," and further suggested that the plan "offer[ed] customers the benefit of stability and predictability of prices [in that] prices may be increased only once a year, and only within narrow predetermined bands." NYNEX also noted that "issues regarding the future definition of universal service are under review by the Commission in Docket No. 94-114."

Time Warner and NECTA suggested a need for redefinition of ubiquitous basic service. They further recommended re-examination of the adequacy of the Lifeline and Link Up programs. NECTA cautioned in its Brief that universal service

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[10] This requirement is a direct quotation of the statutory condition contained in 35-A M.R.S.A. § 9103(1). *See* discussion at Part III.C.1 above.

policy is "critical to potential new entrants evaluating the competitive climate for providing local exchange services."

In its Structured Comments, Staff suggested that penetration levels "can be maintained and improved" during the term of the AFOR. Staff suggested that promotion of programs such as Link Up and Lifeline can assist in maintaining exchange rates at affordable levels. Staff also recommended we require NYNEX to offer a 30-day free sign-up period for new telephone service customers in areas with low telephone service penetration. While we are sympathetic with the need to recruit new customers in areas with low penetration, we are reluctant to move in this direction without specific support of the need, cost, and likely effectiveness of a recruitment effort such as that recommended by Staff, particularly in light of the existing Link Up program rate of only $10. The Staff's recommendation is also somewhat in conflict with the direction we are taking to substitute incentives for mandated programs. We have addressed the lifeline concern in Part III.C.8.c below, by requiring our annual reviews to focus on penetration levels and take remedial action if appropriate.

Various parties early in the proceeding suggested re-characterization of the group of services that should be included as elements of universal service in Maine,[11] but did not develop those suggestions further. Staff also recommended in its Brief that basic service be redefined to include Touch Tone[12] service. The parties did not present compelling evidence or argument in this case for us to recharacterize services included as part of universal service. In the companion rate case to this proceeding, Docket No. 94-254, we are eliminating NYNEX charges for Touch Tone service, consistent with Staff's recommendations, so that tone dialing becomes part of NYNEX's basic service in Maine. We have also considered the parties' comments in connection with our determination of those services that will be designated as core services that will be subject to price caps, as discussed in Part III.C.6 below.

A number of parties early in the proceeding also recommended exploration of universal service funding.[13] None of the parties, however, developed its

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[11]OPA, Time Warner, and NECTA recommended that universal service should be defined as including analog dial tone, Touch Tone, local and toll access, some local usage, access to 911/E911 emergency services, access to relay services, operator, and directory assistance services, directory listings, and unspecified "privacy protections." MTUG agreed with most of these recommendations, recommending the addition of affordable access to the Internet.

[12]Touch Tone Service is NYNEX's marketing name for dual-tone multifrequency (DTMF) tone dial service.

[13]OPA, Time Warner, and NECTA recommended that to achieve universal goals, a competitively neutral universal service funding mechanism needs to be developed.

recommendations further during the proceeding. Absent any demonstrated need for us to develop a Maine-specific universal service funding mechanism,[14] we will not do so here. We will instead adopt OPA's suggestion that we address the need for universal service funding in "the proceeding on competition," which we take to mean Docket No. 94-114 and any successor proceedings.

3. Commission Ability to Assess Success or Failure

Among the questions contained in Attachment A to the Notice of Investigation to this case, we asked:

> How can the success or failure of the regulatory alternative proposal be measured *vis a vis* traditional rate-of-return regulation? How can gains in efficiency be isolated from gains caused by increased market demand and sales growth for the purpose of this analysis?

This question was not included as a Commission goal in the Notice itself. Nevertheless, the decision that this Commission must make 5 years from now about whether to continue the AFOR must necessarily consider the issue described above. As recognized by the Public Advocate, the question in effect is a backward-looking equivalent of the statutory condition stated in section 9103(1) discussed in Part III.A.1 above. Under that condition, the Commission must ensure that any AFOR will provide local (and, as modified by this Order, toll) rates that are no higher than those that would be available under traditional ROR regulation. The question addressed in this section is whether there will be a means at the end of the AFOR to determine whether the

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OPA suggested that universal service would benefit from flow-through of benefits of cost reductions and efficiencies to ratepayers. OPA suggested, however, that this development "could be addressed in more detail within the proceeding on competition or in another separate, but related, proceeding." MTUG suggested we develop a policy for all service providers to contribute to a universal service fund on means-tested basis, with contributions based on providers' respective proportions of Maine jurisdictional revenues. The Libraries proposed that universal service be funded from decreasing marginal costs of basic service, and from contribution requirements imposed on discretionary unregulated services; the Libraries also proposed that a "consumer productivity dividend" be provided for schools and libraries.

[14] We are aware, however, that the Federal-State Joint Board is currently re-examining the structure, level, and targeting of the interstate High Cost Fund that supports local service rates by reducing a utility's intrastate revenue requirement.

condition of section 9103(1) was satisfied, or, more broadly, whether the AFOR was more or less successful than continued ROR regulation would have been.

Plainly, at the conclusion of 5 years, it will not be possible with certainty to determine whether the AFOR was more successful than continued ROR, for the simple reason that ROR was not continued, and its results can never be known with certainty. The Advocacy Staff argued in its Brief:

> The Commission should judge how well an ARP has worked in general terms by the following criteria: universal service should be up, quality of service maintained or improved; and prices down . . . . If exchange rates remain steady or decline and toll rates fall, and the Company has avoided the customer service penalties developed as part of the [Staff Alternative Regulatory Plan], then the future will be better than the past.

In its Brief, NYNEX apparently assumed that it is a foregone conclusion that the AFOR will be superior:

> Price caps is a better form of regulation . . . . Thus, price caps should not simply be an experiment . . . . Rather, it should be the way NYNEX is regulated.

NYNEX suggested in its Brief that in "measuring the success of the NYNEX Plan," it is only necessary to determine whether the "details of the [NYNEX] Plan were properly set." It argued that it will only be necessary to check whether various factors of the rate cap formula are set correctly. Thus, the Commission need only "confirm that the 2.5% productivity offset is still based on an accurate measure of the differential between TFP growth in the economy in the telecommunications industry . . . ."

> The Public Advocate in its Reply Brief argued that the Commission must:
>
> retain the ability to determine the approximate relationship between costs and revenues for NET's services. Only then can the Commission determine whether local service ratepayers received benefits or suffered harms . . . .

In its main brief, the Public Advocate argued that a secondary benefit of requiring sharing of earnings is that essential information about NYNEX's earnings will be available. While we have rejected the sharing of earnings (*see* Part III.C.10 below), we agree that monitoring NYNEX's earnings will be one essential requirement for

determining whether the AFOR has been successful. NYNEX presently provides monthly reports of its earnings. If necessary, we will require NYNEX to provide such other information as is necessary to determine NYNEX's earnings and the reasonableness and success of the AFOR.

It must be recognized, however, that determining NYNEX's earnings picture provides only half of the answer. It will be important to determine whether the various factors in the price cap formula, particularly the productivity factor, were set reasonably. That NYNEX overearned or underearned will not, by itself, indicate that the productivity factor was not set accurately or reasonably. For example, if NYNEX underearned, it would not necessarily be clear whether the productivity factor was too high or whether NYNEX was unreasonably inefficient. No party proposed any method that would allow us to determine the answer to this question. Nevertheless, if in fact the measures of success that Staff proposed actually occur, and, at the same time, NYNEX earns a reasonable return on its investment, it is likely that the Commission, when the plan is reviewed, will find that it has been successful.

C. Price Cap Structure

1. Overview of Price Cap Formula

The price cap structure of the AFOR is a set of pricing rules that we will apply to all of NYNEX's "core" services. For reasons described below, the pricing rules will not apply to "non-core" services. The primary pricing rule caps the annual aggregate change in prices for NYNEX's core services during the term of the AFOR. Other pricing rules of the AFOR limit the level of change for individual rate elements that can be made under the AFOR.

The rule governing the overall pricing of core services is the Price Regulation Index (PRI). The PRI is a formula that determines the amount by which NYNEX can adjust annually the aggregate weighted level of all its prices for core services to reflect cost changes caused by inflation, offset by the growth in productivity and by limited changes in exogenous costs. The inflation factor of the formula is the Gross Domestic Product Price Index (GDP-PI), which is designed to measure changes in national output prices. The productivity factor, commonly known as the ***X*** factor, is fixed for the duration of the AFOR and is set to build into rates the reasonable expected changes in productivity for core services. The exogenous change factor, commonly known as the ***Z*** factor, is designed to reflect limited changes in costs outside of NYNEX's control and not otherwise reflected in the inflation factor. The PRI will be used as the basis for its annual filings in which it will adjust the aggregate prices for its core services. Under this pricing rule, the revenue-weighted average of all of NYNEX's prices for core services (proposed rates times the prior year's historical billing determinants) cannot exceed the PRI as adjusted annually by the formula.

The PRI is calculated by adjusting the base average prices annually using the following adjustment index formula:

$$\text{PRI (new)} = \text{PRI (current)} \times [1 + (\text{GDP-PI} - \boldsymbol{X} \pm \boldsymbol{Z})/100]$$

Where: PRI (current) = PRI in effect for the current 12-month AFOR period ending November 30 (e.g., 100.0)

GDP-PI = Percent change in the Gross Domestic Product Price Index of the second quarter ending June 30 of the current year over the same quarter in the previous year (e.g., 3.5)

X = Productivity offset of 4.5% expressed as the decimal number 4.5.

Z = Exogenous element

NOTE: The values for each of the three factors described above shall be expressed as percentages. Thus, if the annual change in the GDP-PI is 3.5%, the value used in calculation shall be 3.5. The initial PRI value shall be 100.0.

The basic PRI formula (though not the value of ***X*** has been endorsed by NYNEX, the Staff and the OPA. The PRI will be set at 100.0 at the start of the AFOR and will be adjusted annually by applying the adjustment formula.

Within the category of core services there are two subcategories. The nondiscretionary core service category includes basic exchange and most toll services. The PRI itself is the ceiling for any increases in each individual rate element in the nondiscretionary core service subcategory. In years that the PRI goes down, however, NYNEX will not be required to reduce any particular rate elements. NYNEX will be permitted to change its rates for discretionary core services (primarily Custom Calling and Phonesmart services) to any level (up or down), but revenue from these services will be included in the determination of the overall change in aggregate prices to which the PRI applies. NYNEX may increase prices only at the time an annual filing made is approved under the AFOR. NYNEX may reduce prices at any time.

In years that the PRI goes down, even though NYNEX will not be required to reduce any particular nondiscretionary core rate, it will have to reduce some of them in order to meet the aggregate weighted rate level (individual rates times prior period billing determinants) allowed by the revised PRI.

As explained in Parts III.C.1 and III.C.6 below, NYNEX will also have full pricing flexibility for all non-core (primarily new) services. The aggregate of pricing level for those services will generally not be subject to the overall PRI. Where given that core ratepayers are protected, other markets should be permitted to work to the greatest extent possible. NYNEX should have a very broad area within which it will succeed or fail based upon its own decisions.

The pricing for all services will be subject to a floor of long run marginal cost. In this connection, however, we do not intend that this requirement shall impede markets from operating freely or that it delay or prevent products from being brought to market efficiently and at low prices. NYNEX will not be required to provide cost support for new or old services when filing new or revised rate schedules for particular services, but it will have to demonstrate that the filed tariffs exceed long run marginal cost upon request of the Staff, as described in Part III.A.9.b above.

In addition to the overall limit to prices for core services established by the PRI and annual changes to the PRI, and the rules governing changes to individual rate elements described above, we have established a number of subsidiary pricing rules that govern the timing of rate changes, the applicability of the pricing rules to access charges, special contracts, new services and the applicability of the Service Quality Index. *See* Parts III.C.7 and III.C.8 below.

2. Price Cap Scope - Services to Which It Should Apply

As discussed in Part III.A.4 above, the PRI will apply only to "core" services. Core services include both basic calling area services and toll services. Both are essential, non-discretionary services. Except perhaps for high-volume toll customers, at this time there is little competition in Maine.

At the other extreme, broadband-based services, most of which have not yet been offered, will be considered non-core services. There is significant capacity available for those non-core services. For the reasons explained in Part III.C.4 above and in this subsection below, non-core services will not be subject to the PRI. The division between core and non-core services means that the rates for core services cannot be raised in order to make up for insufficient revenues for non-core services. We have not disallowed any of the investment that may be used for broadband services (as well as for core services); all of that investment is included in the rate base and revenue requirement that serve as the starting point for price caps. Thus, ratepayers of core services will in fact support the cost of non-core broadband services, at least at first. However, we have chosen a productivity factor that takes into account the productivity of core services. For the reasons described in Part III.C.4.c above, that

productivity factor will have the effect of shifting increasing amounts of the cost burden for non-core services to customers of those services or to NYNEX itself.

Here we discuss the considerations, primarily the extra capacity available in NYNEX's network for broadband services, that led us to develop the distinction between core and non-core services.[15] The Public Advocate and AARP, through Thomas Weiss, and the Commission's Advocacy Staff, through Richard Gabel and James Cowie, testified in the rate proceeding that NYNEX had invested in fiber optic facilities that had resulted in substantial overcapacity. Those witnesses argued that the existing overcapacity was not presently producing revenue but could be used in the future to provide a variety of new broadband-based services.

The OPA and other parties in this proceeding also argued that NYNEX was using or could use its monopoly markets to "subsidize" its entry into new competitive broadband markets. Because NYNEX's investment in fiber optic equipment (which provides narrowband traditional basic and toll services as well as broadband services) is all in rate base, it is clear that basic and toll ratepayers are presently supporting the cost of the investment that can be used for NYNEX's "entry into new competitive broadband markets." We need not address whether a "subsidy" exists.

There are at least four possible approaches we can take to address this issue of alleged overcapacity or excess capacity that can be used for new broadband services:

(1) We could examine all of NYNEX's new construction and facilities deployment and allocate any facility costs that exceed the least cost provision of the narrowband core services to future broadband services and away from the costs of narrowband core services. Even though we have found in the rate case that it is not appropriate to disallow any of this investment because it was not imprudently made, it might well be very appropriate to ensure that basic and toll ratepayers pay only for those narrowband core services and that customers for the new competitive broadband services pay for those services. For example, if the theoretically least cost method of providing narrowband services would be to use copper facilities, only the cost of that theoretical least cost method would be included in the rate base for core services. The problem with this kind of cost allocation approach is that it is fraught with the kind of factual and motivational disputes and quantification difficulties that were typified by the dialog that occurred between Staff and NYNEX witnesses both in the current rate case

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[15]In Part III.C.6 below, we discuss the various considerations leading us to assign a service to the core or non-core category (or within the core category, to non-discretionary and discretionary services).

and previously in Docket No. 92-130.[16] We do not have evidence that would permit us to quantify reliably how much less it would have cost to build and maintain a network capable of providing voice-grade "Plain Old Telephone Services" (POTS) only.

(2) We could adopt the approach urged by the Advocacy Staff and Staff witnesses Richard Gabel and James Cowie to increase the "stretch" portion of the PRI productivity factor. This approach is logical. Under the AFOR, the productivity "output" will be revenue. It is reasonable to expect that NYNEX's spare capacity will produce additional revenue (productivity output) in future years. One major difficulty with this approach is that there is no clear basis to determine how much the productivity factor should be increased because there are no reasonable estimates of future revenues for new broadband services or for existing services.

(3) We could treat new competitive broadband services in the same manner as all other services, i.e., as core services. Under an expectation that revenues for the new services will develop, ratepayers would automatically benefit as long as those revenues were included under the PRI. If the revenues from new services did increase, there would be less revenue needed from other sources, particularly core services such as basic exchange and toll. This approach is essentially the exact opposite of the approach discussed below in paragraph 4 to limit applicability of the PRI to core services.

(4) Lastly, we could implement a regulatory mechanism that over time will implicitly allocate a significant portion of the investments made for broadband non-core services away from the prices for the firm's core services. A price cap scheme that applies only to those core services will accomplish that allocation so long as the productivity factor used for core services under that price cap plan represents the theoretical productivity gains for only core services, and does not attempt to project expected productivity gains for the firm as a whole. With such a plan any difference between NYNEX's overall productivity and the expected productivity for core services will be allocated away from those core services to the firm's other ventures. See discussion in Part III.C.4.c below.

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[16]The extra capabilities of the broadband network make an attempt to prove that NYNEX made imprudent investment decisions extremely difficult. It is possible that the cost of a broadband network may have been greater than that for a narrowband network, and the value of the extra capabilities may not yet have been realized in the form of additional services or revenue, but that difficult-to-quantify extra value nevertheless would have to be taken into account in any prudence inquiry.

We find that the last alternative would represent a practical means by which the Commission can get its "hands around" the cross subsidy/cost allocation issues without becoming hopelessly mired in the engineering efficiency, stranded investment, planning horizon, and spare capacity issues that would accompany any attempt to allocate explicitly between narrowband and broadband costs. Staff witness Dr. Gabel and the Staff in its Brief agreed that limiting application of the productivity calculation produced by the LECOM would be a reasonable alternative to his proposal to adjust the productivity factor to account for excess capacity that can be used for new, competitive broadband services. Staff in its Exceptions argued, however, that the vast capacity of NYNEX's network will help productivity in all sectors, not just broadband.

As described in Part III.C.4 below, one of the methodologies that we rely upon to find an appropriate productivity factor measures only narrowband core services. The portion of NYNEX's total firm costs that should be allocated to new, competitive broadband services will not be subject to the overall price cap formula or to any individual price restraints (other than a marginal cost floor), and we intend those costs increasingly shall be recovered from the rates for non-core services. Over time, this pricing system will allocate both the risks and rewards associated with those non-core services from ratepayers to NYNEX stockholders. Thus, both past and future NYNEX investment decisions for those competitive market services will be subject to much the same conditions as those for a firm operating in an unregulated competitive market.

As we will discuss further in Part III.C.4 below, the productivity methodologies developed by NYNEX, Staff, and OPA differ in many respects. For the purpose of our discussion here, the most significant difference is the fact that only the Staff study attempts to determine productivity gains for narrowband basic voice-grade services. NYNEX argued in its Brief that Dr. Gabel's model should be rejected because it "measures costs only for access line, local usage, and toll, which are not all of the costs incurred by a telephone company" and that it does not measure total factor productivity. It is precisely that characteristic, however, that makes it useful for the implicit cost shifting purposes we have discussed above.

By contrast, the NYNEX and OPA productivity recommendations were derived from an analysis of the entire firm's total factor productivity (TFP), to ensure that all productivity gains achieved in the provision of narrowband services result in lower rates for those services. Whatever other merits or defects the NYNEX and OPA studies may have, we are reluctant to use a TFP study directly for a productivity factor that will apply only to core services. If NYNEX's TFP index applied, it would have a greater opportunity to use revenues derived from narrowband rates to subsidize new ventures. For example, if the local exchange carrier industry were to use *all* of its increased net revenues resulting from recent substantial productivity gains in the provision of voice services to underwrite investments for new but not yet

revenue-producing services, the exhibited TFP gain for those firms would be near zero. If that zero TFP gain were used as an index for narrowband voice services, users of those services would be deprived of the productivity gains associated with those services, and they would have to pay higher rates than they would have had to pay under the rate-of-return regulation cost allocation regulatory scheme. Further, limiting the PRI to core services will give NYNEX added incentive to invest in, and market aggressively, new services.

For the reasons explained above, we will apply the overall PRI only to core services, and the productivity factor included in the PRI formula will reflect in part our view of the productivity of only those services.

3. Price Cap Formula - Inflation Measure

NYNEX, Staff and the OPA agree that the Gross Domestic Product Price Index (GDP-PI) should be used as the inflation (price) index. The GDP-PI is an economy-wide index that is reported by the U.S. Department of Commerce, Bureau of Economic Analysis. Alternatives to the GDP-PI that were discussed in the record of this case include the Gross National Product Price Index (GNP-PI) and the Consumer Price Index-Urban (CPI-U).

NYNEX witness Taylor recommended that NYNEX use GDP-PI as an inflation index for determining the price cap adjustment under the AFOR for three reasons. First, GDP-PI measures price changes for an assortment of goods and services whose Total Factor Productivity growth is measured. Second, the GDP-PI is more reflective of the outputs produced by U.S. private businesses. Third, GDP-PI has been more stable than other measures (such as the CPI-U). Despite these characteristics, NYNEX proposed to use the CPI-U (plus or minus exogenous changes) as the inflation index for measuring changes to its individual rate elements.

Staff witness D. Gabel agreed that GDP-PI should be used for the purpose of the overall price index. He noted that the GDP-PI is available on a more timely basis than is the GNP-PI. He further noted that the CPI-U is not an appropriate measure of inflation for use in a telephone utility price index because it reflects the prices of a smaller basket of services that are intended to reflect the prices of goods purchased by consumers. OPA witness Selwyn did not dispute the use of the GDP-PI.

We agree that the GDP-PI is a reasonable measure of inflation for purposes of establishing the overall price index. This measure is a much broader index than the CPI-U index, is based on a more current market basket than the CPI-U, and has exhibited more stability than the CPI-U over the years. For reasons discussed in Part III.A.1 above the overall PRI (rather than either the GDP-PI or the rate element index (REI) (i.e., CPI-U ± exogenous changes) will serve as the price cap for each individual rate element in the nondiscretionary core services subcategory.

Because rate changes will take place in December of each year, we must use the most recent available historical measure of the GDP-PI for the years ending on June 30. The GDP-PI for that date is likely to be the latest available prior to December that will still allow sufficient time to review NYNEX's annual filings. Thus, the price index in our AFOR will be the increase in the GDP-PI for the second quarter of the current year compared to the GDP-PI for the second quarter of the preceding year.

4. Price Cap Formula - Productivity Factor

a. Need for a Productivity Factor

Both Dr. Taylor on behalf of NYNEX and Dr. Gabel on behalf of the Staff agreed that the principal purpose of an AFOR, and in particular a price cap plan, is to emulate the workings of a competitive market. In a truly competitive market, supply and demand govern prices for the services or products available in that market. When no one seller has significant ability to set prices in that market, competitors with lower costs will earn higher profits than competitors with higher costs. Moreover, if the overall efficiency (productivity) of the participants in the market changes, that change will be reflected in the cost of supply and, under competition, in prices.

In a market that is not fully competitive, one or more sellers may be able to exert considerable control over prices, and price regulation may be necessary. All parties in this proceeding, including NYNEX, agreed that some form of regulation of NYNEX's prices should continue. All parties at least implicitly agreed that those regulated prices should be based on cost. Some parties have argued for continued cost-based, rate-of-return regulation. However, even those parties advocating a price cap AFOR agreed that projected changes in NYNEX's productivity (i.e., its costs) relative to cost changes in the economy as a whole (inflation as measured by GDP-PI) should govern overall pricing levels during the AFOR.

In this subsection we discuss the productivity factor proposals by NYNEX, the Advocacy Staff and the Public Advocate.

b. Dr. Taylor's and Dr. Selwyn's Analyses

Although we have limited our reliance on any total firm TFP by itself as a basis for the productivity factor under the AFOR, we have concluded for several reasons that the TFP-based productivity factor recommended by NYNEX witness Taylor may also underestimate NYNEX's productivity. First, we are not persuaded that we should rely entirely on a national index rather than one developed for NYNEX. His primary reason for that recommendation was his claim that using NYNEX's TFP growth this year to determine price growth for the next year comes perilously close to rate-of-return regulation. This concern is addressed in part by the fact that we expect the AFOR term to be rather long (5 years, or longer if extended) and we will not adjust the productivity factor on a yearly basis. His other justification, that a nationally-derived productivity factor best replicates the way firms operate in a competitive market, also does not persuade us to rely exclusively on national data. NYNEX operates in Maine and responds primarily to competitive pressures in that market, and much less to competitive pressures or the cost of production in such distant markets as California or Oregon. In addition, some of the studies upon which Dr. Taylor relied included all telecommunications firms, including interstate interexchange carriers, whose experience may have even less relevance to NYNEX than studies that included only local exchange carriers.

In addition to national experience, we also consider actual NYNEX (Maine) experience, in addition to national experience, is because of the legal requirement of 35-A M.R.S.A. § 9303(1) that rates under a price cap plan must be no greater than those that would occur under continued rate-of-return regulation. To meet this objective, Maine experience serve as one of the bases for the productivity benchmark.

A second problem with Dr. Taylor's methodology is his reliance on numerous pre-divestiture TFP studies (extending back to 1947) to determine his productivity recommendation. Since divestiture, the United States telecommunications industry has undergone, and is continuing to undergo, the most significant technological, market, structural and operational changes in its history. From 1984 to 1994, NYNEX's Maine workforce dropped from 2,677 to 1,928, even though its access lines and toll and access minutes of use continued to grow. From 1989 to 1996 NYNEX expects its employee count per 10,000 access lines to drop from 55.2 to 30.6.

In addition, nearly all of the direct studies used by Dr. Taylor examined productivity of traditionally regulated telephone utilities. As discussed below, Dr. Taylor testified that it is likely that a regulated firm will become more efficient under incentive regulation.

Dr. Selwyn presented an analysis similar to that of Dr. Taylor, except that he did not rely on pre-divestiture studies, resulting in a national productivity amount of 2.6%. He also added a claimed input price differential of 2.6%, for a total TFP of 5.2%.

Dr. Taylor's 2.5% productivity recommendation appears to be low given actual Maine experience. During the years 1984-1993, the average annual rate of inflation, or cost growth in the economy, was 3.5%, as measured by the GDP-PI. The use of the 2.5% productivity factor (the difference between national telephone industry productivity and cost changes in the economy as a whole) recommended by Dr. Taylor would have resulted in average annual increases of 1.0%, indicating that NYNEX's economic cost of production was increasing at a 1.0% rate in actual terms. A productivity of 2.5% would mean that NYNEX's real costs are increasing by less than those of the economy as a whole, but are still increasing.

That result does not appear to be consistent with claims about the greater efficiency and cost savings resulting from digital switching and fiber optic transmission. In Docket No. 94-254, NYNEX witness Mr. Helgeson stated that "modernization of the network to a digital broadband technology is the principal reason for the efficiency and service improvements achieved by NYNEX over the past decade." The likelihood that the 2.5% productivity amount proposed by Dr. Taylor is too low is

further evidenced by the fact that if it had been used in Maine for the last eight years, Maine would have experienced rate increases.

One reason the 2.5% recommended by Dr. Taylor may be too low is that there appears to be a difference in telecommunication industry input prices from those of the economy as a whole. Dr. Selwyn recommended that productivity increased by 2.6% to reflect this difference. He based his analysis on the average of data over the past 10 years. However, NYNEX witness Christensen testified that the random and erratic nature of the data used by Dr. Selwyn made the use of averages meaningless and unreliable as a predictor for the future. Staff did not propose a specific input price adjustment but it did argue that Dr. Taylor's claim that the input price difference was zero was also incorrect. Although there has been much debate about the statistical reliability of Dr. Selwyn's study and Dr. Taylor's criticism of it, the chart on page 60 of the OPA's Reply Brief shows that in the last 8 to 10 years input prices for the telecommunications industry have been lower than input prices generally. Both Dr. Selwyn and Dr. Taylor agree that input price differences are additive to base TFP amounts if input price differential exist. We find that a differential does exist, even if not by the amount of the average relied upon by Dr. Selwyn, therefore find that the productivity factor for NYNEX, even before considering a "stretch" factor, should be significantly above the 2.0% "bare bones" recommendation of Dr. Taylor.

Although it is difficult to quantify the exact magnitude of the concern we have with Dr. Taylor's recommendation, we will make the following estimates. To recognize Maine as well as national experience and place less reliance on pre-divestiture TFP studies, we will increase Dr. Taylor's recommended 2.0% productivity gain to 2.2%. That amount lies between his recommendation and that of Dr. Selwyn. To that amount we will add 1.3% to reflect an input price differential. We have reduced Dr. Selwyn's recommendation by half because of our concerns about the statistical reliability of Dr. Selwyn's number. That results in an adjustment of Dr. Taylor's ***X*** factor of 2.0% up to 3.5% before the addition of a stretch factor.

Actual experience under cost-based regulation has resulted in three revenue requirement and rate reductions during the period that the changeover to modern digital technology would have a strong influence on NYNEX's costs in Maine: in 1987 (Docket No. 86-224), in 1989 (Docket No. 88-143), and in the current rate case (Docket No. 94-254). To achieve the actual Maine experience of small rate decreases under cost-based rate-of-return regulation over the last eight years, the productivity factor would at least have to exceed the 3.5% inflation. Thus, even if total firm TFP were to be used, it would have to be in the range of 4.0% to 4.3% to reflect actual experience, as the three rate decreases described above represent an annualized rate reduction per year of approximately 1.0%. Based only on the first two rate reductions (in 1987 and 1989), an average annual reduction of 0.5% occurred over the 9 year period 1986-1995. We will use 3.5 to 4.0% as an indicator of actual experience in recognition

of the fact that a portion of the rate reduction in Maine may be due to the fact that cost of capital and NYNEX's allowed rate of return has declined over the same period.

To the base productivity amount we will add a "stretch factor" of 1.0% to reflect the increased productivity that should be achieved under incentive regulation. All the parties agreed that such a stretch factor is appropriate, but Dr. Taylor suggested using one of only 0.5%. A study authored by Dr. Taylor and Timothy Tardiff, placed in evidence by Staff, suggested that an empirical analysis showed that incentive regulation increased the total firm TFP by 2.8% points. Although Dr. Taylor indicated that the 2.8% number was based on limited data, he could not state any reason why the expected productivity gains in Maine should be any less that those experienced in that study. He also stated that he "fervently" hoped a pure price cap plan would result in a 2.8% productivity gain.

A second reason that a significant stretch factor should be incorporated is that NYNEX, by its own admission, is a "high cost" company. A company planning document indicated that NYNEX's total company costs were significantly higher than those of its "competitors", and an examination of financial data presented in the current rate case by both Staff and NYNEX indicates that per-access line costs and investment (net and gross) for NYNEX-Maine are even greater than NYNEX company-wide costs.[17] NYNEX thus may have a greater ability to reduce those costs than does a company that presently has low costs. The ***X*** factor measures annual changes in productivity, not absolute levels of efficiency.

Finally, the stretch factor takes into account the difference between total firm productivity and the productivity that would be achieved from core services alone; or, stated alternatively, to reflect the additional revenue that NYNEX's spare capacity and general network upgrades will make possible through the offering of new services at fairly low additional cost. In Docket No. 92-130, NYNEX claimed short-run marginal costs of a 1 cent per minute. Thus, NYNEX could generate significant additional revenues in the short to medium term without additional cost. For the three reasons described above, we would add a stretch factor of 1.0% to the 3.5% to 4.0% actual experience amount, or to Dr. Taylor's adjusted recommendation of 3.5% for the total shown below:

Dr. Taylor Adjusted: 3.5% + 1% stretch = 4.5%

Actual Experience: 3.5% to 4.0% + 1% stretch = 4.5% to 5.0%

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[17]This comparison was derived from dividing Net Plant (NYNEX's 1994 Annual Report, Section 1, at 6, 6a) by Access Lines (*Id*., Section 3, FCC ARMIS, Table III at 1.1).

c. Dr. Gabel's Analysis

Staff witness David Gabel used an approach entirely different from that of Dr. Taylor or Dr. Selwyn. He developed a recommended productivity offset by modeling NYNEX's own economic cost of production for the 10 years following divestiture. Dr. Gabel argued that the productivity factor should be based on the changes in NYNEX's economic cost of production.[18] In order to do that, Dr. Gabel used LECOM to determine the least cost of production using a sample of NYNEX exchanges for each year during the 10-year period. The model was the same as Staff used in Docket No. 92-130 but was modified to correct the principal criticism the Commission made at that time, i.e., its failure to incorporate interoffice costs. Using the yearly results of that model, Dr. Gabel determined that NYNEX's economic cost of production has dropped by 5.5% annually in "nominal" terms (i.e., current dollars) for each year. Dr. Gabel then added the average level of inflation during the study period of 3.5% to the actual decline of 5.5% to yield a decrease of 9.0% in "real" terms. Dr. Gabel's study did not measure NYNEX's total factor productivity but instead measured the economic cost of production for those core services he studied.

NYNEX witness Taylor made numerous criticisms of Dr. Gabel's model. The criticisms include the following:

1. Dr. Gabel's model did not model all of NYNEX's services, but modeled only "core" access line, local usage, and narrowband switched voice-grade interexchange services;

2. The model did not include those NYNEX costs that are not associated with changes in output, such as the cost of network administration associated with customer churn (e.g., moves, adds, and changes);

3. The model did not use actual customer locations;

4. Annual charge factors that were used to develop labor and material cost understated NYNEX's actual costs;

[18]In addition, Staff argued that the existence of spare network capacity should be reflected in the productivity adjustment.

5. Managerial and professional overheads that represent 30% of NYNEX's costs were not included in the model; and

6. The model's recalculation each year of the optimal cost of productivity overstated actual productivity, because in real life NYNEX cannot optimize its capital stock and network design every year.

Neither NYNEX nor Dr. Gabel made any attempt to quantify the effect of any of NYNEX's criticisms. Dr. Gabel, in fact, did not respond to any of the criticisms (neither admitting nor denying them) except for the last one, in response to questions from the bench. Dr. Gabel stated that he did not re-optimize switch locations each year. He agreed that he did annually reoptimize interoffice facilities and, for loop plant, the use of copper facilities versus digital line carrier. He further stated that he believed that this annual optimization would not make a big difference in the results of his analyses. Dr. Gabel's opinion that annual reoptimization would have only a small effect was not contradicted by further testimony or by argument.

The first NYNEX criticism (the limitation of Dr. Gabel's study to core services) has already been addressed above. While this criticism would have considerable merit if we were attempting to determine total factor productivity, this limitation of Dr. Gabel's study would have permitted us to apply a productivity factor only to core services if Dr. Gabel's study had otherwise been reliable. Because no party attempted to quantify the other criticisms, we have no basis in the record to make specific adjustments to Dr. Gabel's recommendation based on those criticisms. We are particularly concerned that Dr. Gabel's model did not consider costs such as churn that are not associated with changes in output.

The most significant problem with Staff's proposed productivity factor was not identified by any of the parties to the case. Staff's proposed 5.5% productivity factor represents the average proportional change in the NYNEX's *economic* cost of production for narrowband services from one year to the next. The previous year's economic cost is simply the wrong denominator to use to develop the percentage change in costs that are relevant to setting rates under either ROR regulation or a productivity-based AFOR. Under ROR regulation, NYNEX historically has been entitled to a reasonable opportunity to recover its reasonably-incurred total costs. No party has suggested that this approach to ratemaking should change because we are adopting an AFOR. Rates are therefore based on reasonable embedded costs under both forms of regulation. Under the AFOR, the PRI index amount is applied to the total of billing determinants times rates for all core services. At least at the beginning of the AFOR that total will equal NYNEX's embedded revenue requirement for those core services. The PRI formula therefore should represent the

percentage annual change in NYNEX's total embedded cost of doing business in Maine, at least for core services, and not the percentage change in its economic costs that staff measured.

To address this problem we have attempted to adjust Dr. Gabel's base productivity increase to reconcile for the difference between economic cost of production and embedded cost. In its exceptions, the Staff objected to the reconciliation between marginal cost and embedded cost that the advisors recommended, claiming that economic cost is different from marginal cost. However, the economic costs calculated by Dr. Gabel appear to be similar to average long run marginal costs for any given year. We do know that both the economic cost of production and marginal cost are significantly lower than embedded costs. In Docket No. 92-130, we found that the need for a large reconciliation between marginal costs and revenue requirement made ratesetting based on marginal costs an exercise without significant value. Measuring the annual percentage change in either cost will produce a significantly higher number than the annual percentage change in embedded cost or the annual change in economic cost measured against the previous year's embedded cost.

It is not possible to compare economic costs developed by Dr. Gabel directly to embedded costs. Therefore, for the purposes of the reconciliation we will use long run marginal cost. We will adjust Dr. Gabel's base productivity increase recommendation of 5.5% by dividing it by the ratio of NYNEX's embedded costs (or its revenues based on embedded costs) to its marginal costs. For long run marginal costs we may rely on the ranges of data contained in our *Docket No. 92-130 Order*, in NYNEX's access tariffs filed pursuant to Chapter 280, in NYNEX's Annual Reports, and in OPA Exhibit 95. The range of marginal costs for basic exchange service identified in Docket No. 92-130 varies from $6.15 to $13.12. NYNEX's average local revenue is $15.86. Therefore, the ratio between basic service revenue and marginal cost varies between 2.5:1 and 1.2:1. The range of average per-minute marginal toll costs appears to vary between 1¢ and 10¢.[19] NYNEX's access tariff contains marginal cost rates for transport and switching of about 1¢. Average toll revenues are about 23¢ a minute. Therefore, toll revenue-to-cost ratios vary from approximately 23:1 to 2.3:1. Total toll revenue is approximately equal to total local revenue and, under cost-based regulation, total revenue (for both basic and toll) is approximately equal to total cost or embedded revenue requirement. Therefore, toll and basic revenue-to-marginal cost ratios can be

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[19]Although the *Docket No. 92-130 Order* indicates that the marginal cost of a peak toll minute could range as high as $1.00 a minute , we have limited the amount to 10¢ a minute for the purpose of our analysis here because we believe adjusting the Staff proposal in Docket No. 92-130 for the probability of network peaking would reduce the amount of the discrepancy between NYNEX's and Staff's cost estimate to well below the 100 to 1 ratio indicated in the *Docket No. 92-130 Order*.

given equal weight and be averaged, resulting in a range from 1.75:1 to 12.75:1. Thus, Dr. Gabel's 5.5% productivity amount should be divided by a value in the range of 1.75 to 12.75, yielding a productivity amount of from 0.43% to 3.14%. Either amount is significantly lower than 5.5%. When added to the average inflation amount of 3.5% this yields an productivity factor in the range of from 3.93% to 6.64%.

Although Staff's LECOM-based model shows a great deal of creativity and thoughtful analysis, we believe the uncertainties about the numbers demonstrated here make its use problematic even as we have adjusted it. In addition, some of the other issues identified by NYNEX discussed above further undermine our confidence in its use. Despite Dr. Gabel's assertion that annual reoptimization does not produce much difference in result, we are still concerned about that difference. The most fundamental problem we have with Staff's LECOM-based approach is not so much with the particular calculations but with the underlying assumption that it is possible to create and "cost out" a hypothetical network that might have been built but was not. We do not want to place great reliance on theoretical recreations that includes only a limited portion of NYNEX's extraordinarily complex network. We realize that abandoning the effort to build such a hypothetical network means, to the extent that cost allocation questions continue to be relevant, that regulators will need to make judgment calls about the cost burdens that various services should bear and the extent to which the productivity for core services should differ from productivity for all of NYNEX's services. Nevertheless, we would prefer to continue that course rather than to rely on what we consider to be the seductive but questionable precision of LECOM or similar stand-alone cost allocation models.

d. Summary

We will adopt a productivity factor of 4.5%, which is near the low end of Dr. Gabel's analysis but significantly above the offset proposed by NYNEX. The 4.5% productivity offset reflects actual experience in Maine over the past 9 years, during which prices have fallen somewhat less than 4% per year in "real" terms. The 4.5% amount is also relatively aggressive compared to offsets found appropriate for use by other states, although we note that the FCC has recently adopted a productivity offset in excess of 5% for interstate access services if a utility does not choose earnings sharing. We will not go as far as the FCC because, unlike the FCC, we do not have extensive experience with price caps in Maine and because the price cap in Maine applies to different services than the interstate price cap, and interstate output quantities may be higher than those for intrastate. We are also guided in part by our belief that it is important to enhance both the reality and the perception of Maine as an attractive climate for investment -- even for utilities. That suggests that it is not always the best policy for us to err on the side of lowering rates (and returns on investment) too much.

5. Price Cap Formula - Exogenous Cost Changes

NYNEX, the Staff, and the OPA include exogenous cost changes in the PRI formula. However, their opinions of what cost changes should be included as exogenous differs widely. NYNEX defines exogenous cost changes as known and quantifiable costs beyond its control to the extent that the cost affects NYNEX differently than it does the economy as a whole as reflected in the GDP-PI. Exogenous changes under the NYNEX definition would include any general changes in tax laws or rates, changes in generally accepted accounting principles, and regulatory, judicial or legislative changes affecting NYNEX's costs.

Under the NYNEX definition, a general cost change would be passed on or credited to customers as part of the annual review process if a showing could be made that the cost change had a disproportionately large or small impact on NYNEX. The level of the exogenous cost change would be set at the percentage change in costs for the regulated firm minus the percentage change in costs for the average firm in the economy.

Staff would limit exogenous changes to:

> 1) jurisdictional shifts where costs are transferred to or from the interstate jurisdiction and where an equal and opposite exogenous adjustment was allowed by the FCC under its price cap system;
>
> 2) limited regulatory accounting changes not initiated by NYNEX; and,
>
> 3) tax and other regulatory mandates that are specific to the telecommunications industry.

The OPA would limit exogenous cost changes to cost changes that are both outside of the utility's control and that affect its costs or performance. OPA states that the only exogenous change that should be included in a well designed price cap plan are those costs that are not already reflected in GDP-PI, and those costs which would be reflected in prices charged by the firms operating in competitive markets. The OPA believes that only exogenous adjustments that meet these two requirements are jurisdictional separations changes, and regulatory accounting changes not initiated by NYNEX that require changes in whether an expenditure must be capitalized or expensed.

The primary reason we will not accept NYNEX's broad definition of exogenous cost changes is the risk that it would result in substantial litigation and would be difficult to administer. If we were to broaden the definition of exogenous costs to include any cost changes that affect NYNEX more than the economy generally, the

costs that could be included is virtually unlimited. The possibility of extended debate and litigation is inevitable. Included in NYNEX's enumeration of possible exogenous cost changes are items that appear to be largely the product of inflation (and therefore reflected in the GDP-PI) such as a Commission order allowing an electric rate increase. One of the purposes of incentive regulation is to simplify regulation. 35-A M.R.S.A. § 9103(2) specifically requires that the costs of regulation must be lower under an AFOR.

The exogenous cost adjustment procedure proposed by NYNEX could result in an annual litigated case, possibly involving several issues about the effect of various government actions on NYNEX versus their effect on the economy as a whole. The information provided in OPA Exhibit 37 demonstrates the difficulty that arises from NYNEX's broad definition of exogenous costs. NYNEX was provided 26 hypothetical cost changes and asked to state whether those cost changes would qualify as exogenous. Sixteen of its responses were "maybe," indicating many possible proposed adjustments would be highly debatable.

Another example of the kind of difficulty that might arise under NYNEX's exogenous cost proposal is illustrated by Dr. Taylor's seemingly contradictory testimony about the exogenous effect of the costs caused by Americans with Disabilities Act (ADA). In his prefiled testimony, Dr. Taylor cited ADA costs as an example of a cost that would be passed on to consumers in competitive markets. However, when responding to questions from the bench during cross-examination, Dr. Taylor stated that ADA costs may already be reflected in the GDP-PI, and may affect the telephone companies less than other firms. If that were the case, under NYNEX's proposed definition a negative adjustment would be justified. Whichever is the correct answer, we doubt if parties other than NYNEX have the resources to perform the kind of analysis necessary to make such a determination. The potential need to devote a large portion of the Commission's resources to complex litigation for each proposed exogenous change poses an undue and unmanageable regulatory burden.

Unless we were to undertake the exhaustive and unmanageable analysis required by the NYNEX proposal, items as tax changes and governmental mandates could result in double counting because these costs are already reflected in whole or in part in the GDP-PI. We will also not adopt the Staff's proposal which includes "tax and other regulatory mandates that are specific to the telecommunications industry." The inclusion of telecommunications specific taxes and regulatory mandates, without a means to exclude tax and mandate changes that are not applicable to the telecommunications industry, would unduly distort the price cap index. Therefore, we reject both the NYNEX and Staff proposals. We will allow exogenous cost changes to be made only for the categories similar to those proposed by the OPA, i.e., jurisdictional separations changes and significant accounting changes mandated by regulatory agencies that apply only to NYNEX or the telecommunications industry.

In addition to the exogenous cost changes we have allowed, parties will be permitted to request that the Commission include as exogenous cost changes that have very substantial and plainly disproportionate effect on NYNEX's costs and that are totally outside the control of NYNEX. We do so because, while we recognize that permitting such requests may lead to some of the uncertainties and litigation we criticized in NYNEX's proposal, we lack the perfect foresight to rule out the possibility that events outside NYNEX's control will create cost changes that *should* be passed on to ratepayers even under the AFOR. Such a request may be made during the annual rate resetting process or at other times by requesting the Commission to exercise its authority under 35-A M.R.S.A. § 3121. We will also treat as exogenous the effect on NYNEX of an intrastate high cost or universal service fund if and when such a fund is created.

6. Rate Element Prices/Baskets

a. Proposals by the Parties

NYNEX's proposed plan contains a Rate Element Index (REI) that limits the amount by which it may change the prices for each individual service during the term of the plan. In effect, NYNEX has proposed a separate price cap or "basket" (albeit identical) for each rate element. All changes would be subject to the overall constraint of the aggregate change in all prices that is permitted and/or required by the PRI. The proposed REI would be equal to the percentage change in the Consumer Price Index (CPI), plus or minus exogenous cost changes. The CPI, because it measures inflation for consumer goods and services, ordinarily shows greater increases and greater variability than the GDP-PI, which measures output price changes for a set of goods and services that is representative of those goods and services provided by the U.S. private business sector.

The Staff proposed a plan containing six baskets. Staff contends that the proposed structure is based on the stated goals of the Commission, as well as on its view of the level of competition that NYNEX faces. The Staff relied on the statement in our *Docket No. 92-130 Order*, in which we said:

> . . . a plan that, at a minimum, caps local exchange rates at current levels for a significant period of time would undoubtedly have a greater likelihood of acceptance by the parties and endorsement by the Commission.

Staff proposed the following baskets and recommendations for pricing treatment as shown in the following table:

CATEGORY	SERVICES	RULE	RATIONALE
Basket One	basic exchange service	rates capped at current levels	*Docket No. 92-130 Order*
Basket Two	toll and access rates	target of anticipated decreases from overall price cap formula	*Id*.
Basket Three	Touch Tone	phased decrease if charge not elim. in Docket No. 94-254	Findings in Docket No. 92-130 of near zero marginal cost
Basket Four	14 specified services [20]	capped at current level. company could petition to move to basket five if effective competition develops for service	Essential or Semi-Essential Services
Basket Five	Other existing services	company allowed to increase rates by up to 20%/year	pricing flexibility in accordance with Docket No. 92-130; some restrictions to prevent rate shock
Basket Six	New services or special contracts	price floor TSLRIC	emulate competitive market in accordance with Docket No. 92-130 and state goal of fostering competition

For the most part, Staff's proposal amounts to a freeze of local rates with a mandatory decrease in toll rates (if a productivity factor is adopted that is higher than expected inflation), and some flexibility for other rates. Within each

[20]Basket four includes:

a. Call Forwarding; b. 3-way Calling; c. Call Waiting; d. packages containing the above three elements; e. directory assistance; f. extra directory listings; g. non-published directory listing; h. Curb-a-Charge operator screening charge; i. voice grade private line services (1000 and 2000 series); j. semi-public and public coin local rates; k. one-time connect charges (element charges for ordering service); l. direct-inward dialing trunks; m. foreign exchange and remote lines; n. Call Trace

basket, NYNEX would have unlimited pricing flexibility; the price of one service could be increased substantially and another lowered substantially as long as the aggregate of all the prices in the basket conformed with the rule governing that basket.

OPA proposed a three-basket scheme, based on the degree of competition. The three baskets are classified: (1) basic monopoly services, including local exchange and unbundled basic service elements; (2) discretionary monopoly including Call Waiting and Caller ID; and (3) competitive services, which can be provided by competitors on a stand-alone basis.

OPA placed most NYNEX services, including toll, in the most restrictive monopoly basket. In addition, the OPA argued that NYNEX should be required to reduce prices for individual rate elements whenever the Rate Element Index decreases. The OPA would also limit increases for monopoly services to the lower of the level of increases in the PRI and the percent price index for competitive services.

Before turning to the pricing rules that we will adopt, we will discuss our reasons for rejecting some of the parties' proposals. For the reasons explained in Part III.A.1 above, we will not freeze or cap basic exchange rates as Staff has proposed, nor will we adopt NYNEX's proposal that would allow rate increases to individual nondiscretionary rate elements, particularly basic service, that are greater than increases to the overall PRI. As explained in Part III.A.1 above, we believe that 35-A M.R.S.A. § 7303 is primarily a rate design statute that does permit increases to rates for basic service, but the increases should not be greater than the increase to a local exchange carrier's cost of service or in this case, the PRI.

We also will not adopt the three-basket approach and price rules advanced by the OPA. The uniform price change aspect of the OPA plan does not provide NYNEX with the pricing flexibility that NYNEX may need to lower some core rates to meet rates of local or toll competitors. The OPA's proposal to link prices in the less competitive price baskets to the level of price changes in the competitive basket would result in an effective price umbrella for competitive services. NYNEX would likely choose the strategy of not lowering competitive service rates, if Dr. Selwyn's recommended linkage to monopoly rates were adopted, because a much larger portion of its revenue stream is derived from its core and monopoly services than is derived from competitive services. From an overall revenue maximization point of view it might make sense to lose some customers in the few competitive markets than lower the Company's core revenue stream by a significant amount.

b. Categories of Services

We will establish a set of pricing rules that are simpler than those proposed by NYNEX, Staff, or the OPA. There are two basic pricing categories: core services and non-core services. Within the core service category there are two subcategories: nondiscretionary services (primarily basic exchange service and toll services) and discretionary services (Custom Calling, Phonesmart services, etc.). Non-core services include primarily new, competitive broadband services. The legal and policy rationales for these categories of the operation of the various pricing rules are discussed above in Parts III.A.1, III.A.4, III.C.1 and III.C.2 of this Order.

One of the criteria for determining whether a service should be classified as core or non-core is whether the service was included in the LECOM-based productivity study by Staff witness David Gabel. That model attempted to measure only cost (and cost differentials over time) of providing basic service, toll service and those services that were integrated with basic service. Although, as explained in Part III.C.4 above, we found significant deficiencies in certain LECOM assumptions, we have derived a reasonable productivity factor from Dr. Gabel's methodology. We also adjusted NYNEX's actual productivity experience to reflect applicability only to core services. Nevertheless, the productivity factor that we have chosen is far from precise and is to a great extent based on judgment. Therefore, in assigning services to the core and non-core categories, we will consider not only whether the LECOM attempted to measure their costs, but also consider other factors such as whether the services presently exist or are new, whether they are broadband or narrowband, whether they are discretionary services, whether there are direct competitive alternatives, and whether there are reasonable substitutes. The more elastic the demand for a service, the greater the likelihood that the service is discretionary or competitive. Many of these criteria will also be used to determine whether a core service shall be considered nondiscretionary or discretionary.

The Custom Calling and Phonesmart services are doubtless more discretionary than basic and toll services; the demand is reasonably elastic and pricing is based on what the market will sustain. Nevertheless, for many of them there is little competition and no reasonable substitutes. Core service customers have also supported and will continue to support the investment that NYNEX made to provide these services. It is likely that revenues from these services will increase. If they continue to grow, their inclusion under the PRI means that rates for basic service and toll services will be lower than they would be if the revenues for these services were not included. For all of those reasons, we decide that present Custom Calling and Phonesmart services should be included in core services, but that NYNEX should have pricing flexibility for these services. They will therefore be included as discretionary core services. This decision is, of course, consistent with the recommendations of all parties; no party has proposed that any of these services should be excluded from the overall

price cap formula. We will include new Custom Calling and Phonesmart services in the non-core category, however, as we desire that NYNEX have the maximum possible incentives to develop such new services, consistent with the statutory goal of section 9103(7). For similar reasons, we also conclude that other genuinely new services that are introduced by NYNEX will, in the absence of a compelling reason to the contrary, be placed in the non-core category.[21]

We also decide that existing broadband private line services should be considered a non-core service, along with other existing and new broadband services. Because the service is cross-elastic with narrow-band private line services, because private line services generally are discretionary and because private lines were not included in Dr. Gabel's productivity analysis, all private line services shall be non-core.

c. Pricing Rules

Our pricing rules will subject all core services collectively to the overall basic constraint of the PRI. Within the core services class, rates will be divided into discretionary and non-discretionary services. As proposed by NYNEX, the rate for each individual non-discretionary core service will constitute a separate "basket." However, any price increase for any non-discretionary service element will be limited to the increase in the aggregate PRI, and not to the CPI as NYNEX proposed. As discussed in Part III.A.1 above, we find that the use of the rate element index (REI) (CPI ± exogenous changes) as a price index for each separate service (rate element) is inconsistent with the mandate in 35-A M.R.S.A. § 7303 that basic service rates shall be maintained "at as low a cost as possible." If we gave NYNEX the discretion to increase rates up to the level of increases in the CPI, that process over time could result in the kind of rate rebalancing that we did not permit in Docket No. 92-130, and that 35-A M.R.S.A. § 7303 may prohibit in the absence of findings that in effect amount to a determination that current rate design is unreasonable. *See* Part III.A.1 above.[22] As also explained in Part III.A.1. above, when the PRI decreases, we will not require NYNEX to decrease any particular rate element, including basic service rates, although it will not be allowed to increase any rate element in the nondiscretionary core services category. In its exceptions, OPA argued that if the PRI decreases, basic rates should decrease by at least the amount of the decrease in the PRI. The OPA bases its argument on section 7303, pointing out that we interpreted that section to prohibit basic

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[21]However, new "access"-type services required by competitors would be treated as non-discretionary core services.

[22]No pricing rule applies to Touch Tone services because those charges are being eliminated as part of the revenue reduction in the current Pease rate case (Docket No. 94-254).

rate increases that exceeded the PRI unless we also made one of the rate design findings listed in the Docket No. 92-130 order. We do not agree that section 7303 requires a proportional reduction in basic rates when the PRI decreases. As discussed in Part III.A.1 above, we read the statute primarily as prohibiting rate increases and substantial rate rebalancing, not minor shifts in the rate balance. It should not be read to require a lock-step balance between toll and basic rates. Even while interpreting section 7303 as requiring a finding that existing rate design was unreasonable before significant rate rebalancing could occur, we expressed the policy favoring reductions in toll rates. We note that in NYNEX's last rate case, Docket No. 88-143, that resulted in an overall decrease, the parties, including the OPA, agreed that the entire decrease should be placed on toll rates.

For discretionary core services such as existing Custom Calling and CLASS services, which the Staff proposed to cap at current levels, NYNEX will be allowed pricing flexibility. The justness and reasonableness of a rate for these services is not established, in our view, by any particular relationship to cost, but is better established by what customers are willing to pay for such non-essential services. NYNEX may change the prices of discretionary core services to any level, but revenues will be subject to the overall PRI applicable to all core services. Thus, for example, if the PRI is negative, NYNEX will be able to raise the price for a discretionary core service, if market conditions warrant such a change, but to do so it will have to reduce the price of some other core service (nondiscretionary or discretionary) by more than if it had decreased or left unchanged the price for the discretionary core service.

The Staff and OPA opposed "banking" of increases. Banking is the foregoing of all or a portion of an allowed increase in one year but "catching up" to the PRI in a subsequent year. The Staff and OPA opposed banking primarily on the ground that it could result in rate shock. NYNEX argued that the failure to allow banking would create an incentive for it always to raise prices to the maximum level allowed by the PRI if it could not later "catch up" to a later PRI. If NYNEX increased rates because of this incentive, rather than leaving rates unchanged because it could "bank" a rate increase, customers would lose the consumer benefit of lower rates in the meantime, assuming NYNEX could not also bank the foregone revenue. In order to capture this possible benefit, we will allow NYNEX to "bank" foregone price increases. We will not, however, allow NYNEX to bank foregone *revenues*. We will ensure against rate shock by requiring that no increase to rate element in the nondiscretionary core category shall exceed the increase in the GDP-PI for the annual period (July 1 to June 30) that precedes the annual December 1 rate change date.

NYNEX will be allowed to raise the prices for discretionary core services only at the time of its annual rate adjustments. It may decrease prices for any service at any time. Although prices for non-core services can be changed at NYNEX's discretion, the Staff can request information that would demonstrate that the

price floor has been satisfied, and if not can seek upward prospective adjustment of affected rates.

Separate pricing rules apply to new nondiscretionary and discretionary core services. Those rules are explained in Part III.C.7.d below.

For the reasons discussed in Part III.C.2 above, non-core services are outside the price cap rules (other than the general rule establishing long run marginal cost as the price floor) and can be changed by NYNEX in either direction at any time.

A summary of the price cap rules and degree of pricing flexibility allowed is shown in . NYNEX shall file within 3 months of the date of this Order a listing of all services it offers in Maine identifying the appropriate service category (core nondiscretionary, core discretionary, or non-core) for each service.

CHANGE IN PRICE REGULATION INDEX (PRI) Δ (GDP-PI S $X \pm Z$)	**CORE SERVICES (narrowband)** (subject to PRI in aggregate)		**NON-CORE SERVICES**
	NONDISCRETIONARY SERVICES	DISCRETIONARY SERVICES	(not subject to PRI)
> 0	price increases for individual rates cannot exceed PRI	rates can be changed to any level (upward only at time of annual price changes)	rates can be changed to any level at any time
$\leq$ 0	rates can be unchanged or can be decreased	rates can be changed to any level (upward only at time of annual price changes)	rates can be changed to any level at any time
EXAMPLES OF INDIVIDUAL SERVICES INCLUDED:	existing basic exchange, MTS (incl. OCPs), WATS, CTX, PBX trunks, coin, operator services, Directory Assistance, Call Trace, access services;* new nondiscretionary services unless recategorized by the Commission * subject to revision in Docket No. 94-114	existing Custom Calling and Phonesmart services (except Call Trace); special contracts for customers with competitive alternatives; access contracts with cellular carriers	existing broadband/ wideband & private line services; new discretionary services including new Custom Calling and Phonesmart services; other special contracts for customers without competitive alternatives

7. Other Pricing Rules

a. Access charges

Our current Chapter 280 rule will control the rates of existing access elements. The traffic-sensitive elements will continue to be set at long run marginal cost and will not be part of the price cap, because marginal cost could change by amounts grater than allowed by the pricing rules. At least for the present, the common line charge rate will continue to be based directly on NYNEX's retail toll rates, as required by Chapter 280, § 8. However, all interexchange access revenues will be included in the core services nondiscretionary category for the purpose of establishing rates that will satisfy each annual revision to the PRI. NYNEX has proposed an absolute cap on access charges, but has stated no reason for that proposal. We will not adopt NYNEX's proposal, as it would violate Chapter 280, which requires that the common line charge (the largest component of access charges) be based on toll rates. If Chapter 280 is revised to require local access elements, those rates will also be included in the nondiscretionary core services category.

b. Cellular Carriers

Atlantic Cellular Telephone Corp. and Piscataqua Cellular Telephone Corp. (Atlantic and Piscataqua) filed a brief addressing a set of related issues centering around a contract they and other cellular carriers have negotiated with NYNEX for access charges. The contract runs through 1998. NYNEX did not brief these issues, but at the hearings, NYNEX argued that if the contract is not renewed or is not replaced by another contract, NYNEX-s access schedule would govern rates and that changes to those rates would be subject to the pricing rules of the AFOR.

Atlantic and Piscataqua made a number of arguments. First, they argued that the AFOR -should not include- cellular access charges. It is not clear what Atlantic and Piscataqua mean by this argument. All of NYNEX-s rates are governed in one way or another by the AFOR pricing rules, including special contracts. Most special contracts are with retail customers for core services and, as explained below, will be included in the discretionary category of core services: NYNEX will have unlimited pricing flexibility, but the rates for both discretionary and price-capped core services together will be subject to the price regulation index. We see no reason why access services for cellular carriers should not be considered core services like other access charges. The service itself is the wholesale version of retail toll and basic services. In addition, special contracts for access services also should be included in the discretionary pricing category core services even though prices will be governed by the existing contracts for the duration of those contracts. After the contracts expire, any new contract must be definition be in the discretionary category.

Atlantic and Piscataqua next argued that:

> There is no reason why the Commission should alter those agreed-upon charges now, or why the parties cannot be left

> to review and, if necessary, renegotiate those rates in the future if necessary.

We are not altering the rates in this proceeding. That these and other special contract rates are among the rates included under the price regulation index does not mean the rates will change. Rather, because they are governed by the contracts, they will change, if at all, only pursuant to the terms of the contracts, or if the contracts terminate. We also are not making any ruling in this proceeding about future access contracts. Under the AFOR, NYNEX and any customer may negotiate a special contract containing just and reasonable rates, or either party may refuse to enter a special contract. A special contract customer may choose to revert to rates contained in NYNEX-s rate schedules. For cellular carriers, those opportunities are, however, subject to a possible change in policy in the future Chapter 280 rulemaking.[23]

Atlantic and Piscataqua also argued the merits of why cellular carriers may be different from other access customers and should receive lower access rates. That argument is not relevant in this case. It may be relevant in the current Chapter 280 Inquiry in Docket No. 94-114 and in any future rulemaking.

c. Special Contracts

(1) Standard for Approval

Under the AFOR, NYNEX, as at present, will be able to enter special contracts with customers. The authority to enter special contracts, i.e., contracts for rates or services that are not included in a utility-s schedule of rates, necessarily means that a utility has a certain amount of discretion or flexibility in setting or negotiating the rate. 35-A M.R.S.A. § 703(3) (third sentence) requires the Commission to approve special contracts, however. As pointed out in Part IV below, we have no authority to waive or modify that requirement.

In the past, we have approved special rate contracts between NYNEX and customers who have competitive alternatives. Under the AFOR, we intend that our existing policy governing approval of that type of special contract rates shall continue to apply. Absent a reasonable justification for a customer to enjoy a special discounted rate, the favoring of one customer over another would constitute unlawful unjust discrimination under section 702 (1). We approve special rates for customers who have realistic competitive alternatives at a lower price. If a customer

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[23]The Preliminary Proposal in the Chapter 280 Inquiry, Docket No. 94-114, proposed that after the expiration of the current contract, the access charges proposed therein shall apply to cellular carriers in the same manner as to other access customers .

switches to an alternative service source, all of the customer-s revenue may be lost.[24] We have found that it is preferable for a regulated utility to receive some revenue rather than none at all. Our policy governing approval of special contracts requires utilities to negotiate a price that at least covers the marginal cost of serving the customer, plus the greatest contribution toward the utility-s fixed costs that can be obtained under the competitive circumstances.

Under the AFOR, we will continue that policy. Even when price discrimination is necessary and just, customers (usually smaller customers) who do not have similar competitive opportunities should receive the benefit of the greatest amount of contribution toward fixed costs that can be obtained from the customer obtaining the special discounted rate. As explained above in Part III.C.7.b, the prices contained in special contracts for core services will be included in the core services discretionary category. In this way, the revenue contribution above marginal cost will affect other rates for core services (primarily basic and toll) because all core service rates are subject to the PRI.[25]

Special contracts for customers who do not have competitive alternatives present a different issue. This category presumably includes special contracts with schools or libraries, many of which are not large enough alone to have significant competitive opportunities. The rationale justifying price discrimination for customers with competitive alternatives (that absent a special contract, the customer and its contribution may be lost entirely) does not exist for customers that do not have competitive alternatives. As discussed below in Part III.C.12, a justification for special contracts with schools and libraries may exist under 35-A M.R.S.A. § 703(1) ("service at . . . reduced rates for charitable or benevolent purposes.") However, it does not follow that other ratepayers should pay for such rate reductions in the form of higher basic and toll rates. If we were to include special contracts for customers without competitive alternatives in core services, there is at least the possibility of higher rates for other customers, i.e., if NYNEX had not set all core rates at their maximum level. Therefore, we will assign special contracts for customers without competitive alternatives to the non-core services category. This policy is consistent with our long-standing policy under ROR regulation that charitable contributions by utilities shall be expenses borne by shareholders. Because of the requirement of 35-A M.R.S.A. § 703(3) (last sentence) for us to approve all special contracts, non-core special contracts shall be submitted for

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[24]However, the competitive source may pay access charges that may approach the level of lost retail revenue.

[25]If the customer chose the competitive alternative instead of the special contract, any access charges paid by the competitor would be included in the nondiscretionary category of core services.

approval. Even though NYNEX will bear the cost of any discount, these contracts still must be reviewed to determine whether they are unjustly discriminatory.

(2) Approval Process

We also must address the approval process for special contracts with customers who have competitive alternatives. As discussed below in Part IV, we must approve all special contracts. Assuming the Legislature does not change section 9102 to allow us to modify or suspend the approval requirement contained in section 703(3) (third sentence), the approval process should be streamlined. We direct NYNEX and the Staff to develop a plan for rapid approval of special contracts. The plan shall include a standard method of demonstrating that the contract covers the marginal cost of serving the customer and of establishing the revenue received from the customer is the maximum obtainable under the competitive circumstances. The plan shall contain a standard simple method for protecting any legitimate confidential trade secret information of the customer and of NYNEX. The plan shall be filed within 3 months of the date of this Order.

d. New Services

We address here primarily the rules that will apply to new services that will be considered core services. In Part III.C.6 above, we addressed pricing rules applicable to non-core services, most of which are likely to be new.

For the discretionary subcategory of core services, we have determined that there is no need for a pricing rule for old discretionary core services. We also see no need for a pricing rule for new discretionary core services, beyond the fact that discretionary core services, like core services generally, are subject to the overall pricing restraint of the PRI and to the marginal cost floor rule. The discretionary nature of the services means that market considerations will largely regulate pricing.

A more difficult issue is presented by new nondiscretionary core services, i.e., those that, when they become "old," are subject to the direct restraint that increases in their prices cannot exceed an increase in the overall PRI. In the first place, the price of a new service cannot be set by reference to last year's price. A new optional toll calling plan is a good example of a new core service. However, if it does not replace an existing service, but is merely added to all other toll calling options, it almost certainly will be cross-elastic with some of them. That cross-elasticity will influence its pricing. If the price is too high, few customers will purchase it. If the price is too low compared to other toll services, there can only be a consumer benefit. Thus, during the year that a new additional service is introduced, we see no need for pricing rules for the new service, as long as it does not replace an existing service. We would be hard-pressed to design such a rule in any case. During the year that it is introduced, NYNEX should be allowed to adjust the price as often as it likes to find the "right" (revenue-maximizing) price. At the end of the year in which it was introduced, its

revenues (price times unit sales) will become subject to the overall PRI and any change to its price shall become subject to the constraint of increases to the PRI.

A new service that does replace an existing nondiscretionary core service presents a different issue. NYNEX and the Public Advocate apparently have addressed this issue through a proposed definition of "new services." Each would exclude a new service that replaces an existing service from the definition of "new service." We do not believe that the problem is one of definition; we doubt if a definition is necessary. Rather, the issue must be addressed through a pricing rule.

An obvious potential for mischief exists. If for example, NYNEX replaced Pine Tree State Calling Service with a service that had slightly different features and time limitations, NYNEX could double the price, if no pricing rule existed. Therefore, we will implement the following rules. If NYNEX replaces an existing service with another, it shall file supporting data indicating that the pricing will achieve revenue neutrality. NYNEX will be allowed to adjust the rate during the remainder of the year in order to achieve revenue neutrality and must do so at the end of the AFOR year in which the replacement service was introduced. If it was introduced in the second half of that year, it shall make an adjustment again at the end of the following year. Therefore, the service will be subject to the limit of increases to the PRI. With Commission approval, NYNEX may depart from revenue neutrality if it establishes that the value of the new service is greater or less than the replaced service.

Whether a service replaces another will not be determined by whether NYNEX chooses to use a new name for the service. Major changes that in effect constitute replacement of a service can be made even without a name change. Thus, any restructuring of a service will be subject to the revenue neutrality requirement. However, for a minor restructuring of a service (particularly if there is no price change), NYNEX may request a waiver from this requirement.

8. Service Quality

One of our principal goals and objectives regarding the future of telecommunications in Maine is to:

> ensure that telecommunications service quality, reliability, customer treatment, and credit, collection, and sales practices (including possibly anti-competitive activities), receive adequate regulatory consideration and protection; and maintain adequate quality of service standards and reporting requirements so that achievement of goals can be evaluated.

We are concerned about the effect of alternative regulation on the level of service quality. In *Central Maine Power Company, Proposed Increase in Rates*, Docket No. 92-345(II), Detailed Opinion and Subsidiary Findings at 22 (Jan. 10, 1994) (hereinafter *CMP ARP Order*), we questioned whether our current authority under rate of return regulation to penalize a utility for service quality deficiencies is an effective regulatory tool to ensure high quality service. Since alternative regulation is in part intended "to motivate a firm to deliver its product or service at the lowest cost to maximize its profit potential," according to Staff witness Alexander, there is a legitimate concern that the incentives designed to encourage efficiency may instead cause "a firm with near monopoly power to slash operations and maintenance costs with a resulting drop in service quality." Staff witness Alexander suggested that a "focus on service quality is particularly important during the transition period from traditional rate of return regulation to alternative forms of regulation."

We have found that the use of specific service quality standards will be superior to current remedies we have implemented under ROR regulation. In that our *CMP ARP Order* we stated:

> We believe that service quality and reliability are an essential element of the [alternative regulatory plan, or ARP]. If the . . . ARP is to succeed it must receive general acceptance from CMP's ratepayers and from the public at large. No ARP that substantially reduces customer service and reliability is likely to receive the ratepayer and public support that it must have.

The parties agreed that we should adopt a service quality index for NYNEX telecommunications service in Maine as part of an AFOR. NYNEX witness Larsen agreed that a service quality index is desirable, although he viewed a service quality plan as "not a necessary component of an ARP." NYNEX's Brief suggested that its service quality "has been excellent and [that it] will continue to be so under an ARP." The OPA suggested in its Brief and Reply Brief that an AFOR "should use economic penalties to deter any deterioration in the quality of non-competitive telecommunications services."

NYNEX witness Larsen argued that a service quality plan is a "reasonable insurance policy against a deterioration of NYNEX's service quality."He asserted that Maine customers currently receive excellent service that is perhaps the best throughout NYNEX's service territory. Although NYNEX did not propose any mechanism that would ensure continuation of current levels of service quality, it suggested that maintaining a "good" service quality level would be appropriate.

Staff witness Alexander suggested that a service quality plan should be intended "not to guarantee excellent customer service . . . [but] to prevent the

deterioration of [NYNEX's] current customer service," and that present levels of service should be maintained under an AFOR. NECTA appears to have agreed with Staff, and suggested two service quality standards for an AFOR: maintenance and improvement of service quality, apparently for all services; and prevention of degradation of the quality of non-competitive services.

Detailed service quality plans were proposed by NYNEX and by Staff. We describe and discuss those plans below. OPA agreed that service quality should be included in an AFOR but did not offer any specific service quality plan.

a. NYNEX Service Quality Proposal

NYNEX proposed a service quality plan designed to link service quality to price increases that may occur under the AFOR. The plan was based on a Service Quality Index ("SQI") consisting of 13 service performance categories concerning installation, maintenance, and other service level data. NYNEX's SQI included 4 categories related to customer service, 5 related to service reliability, and 4 related to customer satisfaction. The specific SQI categories recommended by NYNEX are shown in .

1. CUSTOMER SERVICE
   a. % installation appointments not met (company reasons)
   b. held orders over 30 days
   c. % missed circuits for exchange access services
   d. % missed circuits for intraLATA services

2. SERVICE RELIABILITY
   a. customer trouble report rate per 100 lines - network
   b. % of troubles not cleared within 24 hours
   c. % uptime for access circuits
   d. dial tone speed - % over 3 seconds
   e. directory assistance - average speed of answer (seconds)

3. CUSTOMER SATISFACTION
   a. TELSAM residence provisioning
   b. TELSAM small business provisioning
   c. TELSAM residence maintenance
   d. TELSAM small business maintenance

NYNEX's SQI assigned points for each of the 13 categories, and proposed specific quality performance levels for each category. NYNEX proposed calculating a 12 month

rolling average on a monthly basis for its proposed 13 SQI categories. If the Company were to achieve a minimum score in each of the 12 months preceding a rate change, NYNEX proposed to implement permitted price increases. If the SQI fell below the minimum score in any month, any permitted rate increases would be delayed by the number of months the SQI total fall short, except for "events beyond the Company's control, such as major catastrophes."

b. Staff Service Quality Proposal

Staff proposed a service quality plan with a customer rebate structure linked to its price cap index proposal. The plan was based on an SQI consisting of 10 service performance categories. Staff's SQI included 4 categories related to customer service, 2 related to service reliability, and 4 related to customer satisfaction. The specific SQI categories recommended by Staff are shown in .

1. CUSTOMER SERVICE
   a. held orders, average delay days
   b. Lifeline telephone penetration
   c. PUC complaint ratio
   d. installation appointments missed for Company reasons

2. SERVICE RELIABILITY
   a. trouble reports cleared within 24 hours - residential
   b. trouble reports cleared within 24 hours - business

3. CUSTOMER SATISFACTION
   a. provisioning of service - residential
   b. provisioning of service - business
   c. maintenance of service - residential
   d. maintenance of service - business

Staff's SQI weighted each of its proposed 10 categories equally, and proposed specific quality performance levels for each category based on a 1992-1994 historical average.

The scoring system proposed by Staff used a 12-month statewide average. Under Staff's plan, actual calendar year results would be compared to baseline levels in each category, and a composite score calculated. If the total score were less than 100, Staff proposed that NYNEX must provide a one-time rebate to all customers based on its SQI rebate scale.

c. Performance Categories

(1) Common Categories

Many of the SQI performance categories proposed by NYNEX and Staff are the same. All four customer satisfaction categories in Staff's and

NYNEX's proposed plans are identical, as is one customer service category (installation appointments missed). Staff's two service reliability categories parallel one of NYNEX's (troubles not cleared within 24 hours). Both parties proposed to include some measure of held orders. We will adopt the performance categories common to both proposals. We have made minor modifications to them to ensure consistent reporting and evaluation of those categories, as described below.

However, significant differences between the two proposed plans exist. We discuss those differences and our conclusions below.

(2) Customer Service

(a) Held Orders

NYNEX and Staff proposed different measurement methods for the proposed SQI category of held orders. NYNEX proposed a standard for held orders over 30 days, while Staff proposed using "average delay held order days" as the standard. Staff witness Alexander characterized NYNEX's 30 day measurement as "no longer relevant in an age of modern digital switches and software-defined networks. . . . A measurement that doesn't even start counting until the customer's service order has been delayed for more than 30 days is not reasonable."

NYNEX suggested in its Brief that Staff's proposal as initially structured "could lead to odd results" (e.g., a single customer with a long held order delay could trigger a rebate). In its Brief, Staff responded that its mechanism for evaluating the held order category "can be improved by measuring the average total delay days for held orders in a year." We agree with Staff that NYNEX's 30 day held order measure may not be appropriate in an era when access to modern telecommunications services is needed by both business and residence customers. We are also concerned that Staff's original proposal may result in the undesirable results suggested by NYNEX, but believe that Staff's suggestion for improvements of its held order measure provides a valid remedy. Thus, we will adopt "average total delay days" as a measure for the SQI held order category.

(b) PUC Complaint Ratio

Staff proposed to include the PUC complaint ratio as a measure of customer service. In its Brief, NYNEX opposed the use of this measure, characterizing Staff's use of PUC complaints as "particularly troublesome," and suggesting that that index "does not measure any service provided by NYNEX." Staff witness Alexander agreed that "a customer complaint does not mean that NYNEX has done anything wrong." Staff argued in its Brief that this index "does, in fact,

measure NET's service [in that] the ratio measures NET's ability to handle customer complaints."

Although customer complaints to the PUC could comprise a valid tool to evaluate customer service quality concerns, we believe the use of such a measure would require evaluation of the reasons for the complaints, their merits, and even against what entity they are really lodged. Although we have adopted a PUC Complaint Ratio in other circumstances for an electric utility, its use for a telecommunications utility such as NYNEX would be less reliable. Complaints that appear to be against NYNEX may really deal with interexchange traffic or intercompany local traffic that is handled by other carriers. Customer complaints filed with the PUC, therefore, may not be appropriate for a mechanical service quality calculation. Thus, we will not include the PUC complaint ratio as part of the SQI. We will include in the SQI other more direct methods of measuring customer satisfaction, upon which both parties agree.

(c) Lifeline Penetration

In order to further Maine's universal service goals, the Legislature requires local telephone companies to promote any universal service programs that the Commission may order. That requirement is stated in 35-A M.R.S.A. § 7104:

> The Commission shall require each local telephone company to participate in statewide outreach programs designed to increase the number of low-income telephone customers on the network through increased participation in any universal service programs approved by the commission. The commission may adopt rules to implement this section.

Staff proposed to include Lifeline telephone penetration as a measure of customer service in the SQI. In its Brief, NYNEX opposed the use of that measure, however, and criticized Staff's inclusion of Lifeline penetration levels in its proposed SQI as "not realistic," and having "nothing to do with NYNEX's quality of service." As Staff pointed out, NYNEX may have an incentive not to market this program actively since for every Lifeline customer that is enrolled in the program, NYNEX forgoes some revenue. Staff argued that Lifeline penetration is an important measure of NYNEX's ability to deliver customer service programs, and that NYNEX's historic high success with this low income assistance program "should continue to be a priority."

Customers become eligible for the Lifeline and Link Up programs when they participate in any of five low income means-targeted programs (AFDC, SSI, Food Stamps, Emergency Assistance HEAP, or Medicaid). Staff acknowledged that periodic cleansing of ineligible persons from eligibility lists for these programs makes it "difficult to establish a firm baseline from which to measure future performance," and that an update to enable this baseline was appropriate.

We believe that the Lifeline program is an important element of customer service delivered by Maine local exchange carriers. The Maine Legislature has endorsed such programs through its requirement that the commission require each local telephone company to participate in statewide outreach programs designed to increase the number of low-income telephone customers on the network. 35-A M.R.S.A. § 7104. However, we are concerned that the number of eligible customers may be difficult to determine, particularly since it is often difficult to determine the LEC service territory in which a customer resides from the customer's address. Moreover, current federal and state re-examination of some of the programs used to determine Lifeline eligibility injects another level of uncertainty as to the stability of Lifeline penetration data over time, potentially adding a further level of complexity into measurements of Lifeline penetration. We will, therefore, not adopt a Lifeline penetration as part of the SQI. We do not wish that the AFOR should have the effect of permitting penetration rates in Maine to fall, however. We will continue to monitor Lifeline penetration rates and will evaluate trends on an annual basis. If, at any annual review during the term of the AFOR, we observe Lifeline penetration rates to fall significantly below current levels, the Commission will inquire into the cause and, if necessary, require NYNEX to act to remedy the problem, terminate the AFOR immediately, or take other appropriate action.

(d) Business Office Answer Time

Direct contact with NYNEX when a customer calls the NYNEX business offices is the primary contact most customers have with the company. NYNEX presently measures the proportion of calls to its business offices that are answered within 20 seconds, and both NYNEX and Staff agreed this would be appropriate measure of customer service. There may be numerous interpretations of the meaning of "answered," however. In NYNEX's service quality proposal to the Massachusetts Department of Public Utilities related to implementation of an AFOR in that state, this service level was defined as "the number of calls handled (i.e., answered by a customer contact person) within 20 seconds as a percentage of the calls offered." Because rapid and convenient contact with NYNEX is very important to customers, we will include business office call answer time in the SQI using the definition in Staff Exhibit 26.[26]

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[26] We interpret this definition to mean that such calls are answered by a live person

capable of providing the requested assistance to the customer calling.

(e) Missed Circuits

NYNEX proposed two customer service categories pertaining to missed circuits, for exchange access and intraLATA services.[27] While Staff expressed no problem with these categories, it recommended that we not complicate the SQI by including more measurements than are necessary. Because we are adopting four other performance measures that address customer service concerns directly, we will not adopt the two missed circuit categories proposed by NYNEX.

(3) Service Reliability

The greatest difference between NYNEX and Staff proposals for SQIs relates to service reliability. NYNEX proposed five SQI categories related to service reliability, while Staff proposed two. *See* and . As mentioned above, Staff's two service reliability categories parallel one of NYNEX's (troubles not cleared within 24 hours).

(a) Customer Trouble Reports

One element of NYNEX's proposal included a measure of service reliability from a customer perspective: the customer trouble report rate per 100 lines. Although Staff did not propose to include this category, Staff acknowledged its validity. We are aware that customer trouble rates per 100 lines is a common service quality index used throughout the country. We have relied on this measure in the past when evaluating concerns about service quality provided by local telephone companies in Maine. Thus, we will adopt this category of NYNEX's plan.

(b) Troubles Not Cleared

NYNEX proposed as a category, "troubles not cleared within 24 hours." Staff agreed with this general category, but proposed to have separate categories for business and residence performance. We are concerned that combining both business and residence performance in the same index may dilute our ability to monitor NYNEX performance in this important area as delivered to the different classes of Maine customers. Thus, we will adopt Staff's proposal to include business and residence categories separately in the SQI.

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[27] Missed circuits for exchange access circuits measures the percent of those access circuits not provided on time, including orders for service listed either in interstate or intrastate exchange access tariffs. Missed circuits for intraLATA services measures the percent of special services circuits not provided on time.

(c) Access Circuit Uptime

NYNEX proposed to include uptime for access circuits as a service reliability measure. This category measures the proportion of time access circuits are available for use. Staff witness Alexander objected to this category as focusing "on hardware and not customer services." Although we recognize that reliable hardware is an important element to overall service quality, Staff's criticism seems valid as it applies to this narrowly-focused measurement. Therefore, we will not include this category in the SQI.

(d) Dial Tone Speed

NYNEX witness Larsen proposed that dial tone speed (percentage of delays longer than 3 seconds) should be included as a service reliability category, as one of the "indicators of overall network performance such as the ability to place and complete a call from one end of the state to the other." Staff agreed the measure is valid. We concur, and we will include dial tone speed in the SQI.

(e) Directory Assistance Speed

NYNEX proposed that we include average directory assistance answering speed as a service reliability measure. We do not wish to complicate our SQI unduly. Considering the other measures of service reliability we are adopting, we do not believe that this relatively narrow category needs to be included.

(f) Service Outages

Staff witness Alexander recommended that a "service reliability performance measurement along the lines proposed by the Network Reliability Council" for service outage data should be developed. In its Structured Comments, OPA appeared to support Staff's recommendation indirectly by suggesting that customer service and network reliability standards need to be reviewed and updated "to ensure that they reflect the updated capabilities resulting from [NYNEX's] network modernization."

The use of such a standard is consistent with the goal we stated in our Notice of this proceeding that we "ensure that telecommunications service quality [and] reliability . . . receive adequate regulatory consideration and protection; and maintain adequate quality of service standards . . . so that achievement of goals can be evaluated." Therefore, we will require the development of such a measure. Accordingly, we direct NYNEX and Staff to develop a Maine-specific service outage measure consistent with Exhibit 1 in Staff witness

Alexander's Rebuttal Testimony.[28] In developing this measure, NYNEX will use a threshold of a service interruption to 500 Maine customers of 5 minutes duration or longer rather than the national threshold included in the Alexander Exhibit. That threshold is the same as the level for the reporting of major service interruptions in the Commission's Rules, MPUC Rules, ch. 20, § I.A. NYNEX and Staff shall file a proposal for this measure within 3 months of the date of this Order. Because recent data are not available, this measure will be used initially only for the purpose of collecting relevant outage data for the first 3-year period of the NYNEX AFOR. Thereafter, it will be added as an active category of the SQI for the fourth and subsequent AFOR year(s). At that time, this new index will be based on 3 years of Maine-specific data as are the other categories we are adopting for the SQI.

(4) Customer Satisfaction

All four customer satisfaction categories in Staff's and NYNEX's plans were identical. They are based on customer surveys that NYNEX currently and routinely performs. We will adopt the categories proposed by NYNEX and Staff in this SQI group, stated to reflect the percentage of customer dissatisfaction with NYNEX service provisioning and maintenance.

(5) Summary

As discussed above, the Service Quality Index (SQI) will include the performance measurement categories shown in . In that Table, the SQI categories have been stated in such a manner that zero (either as an absolute number or percentage) is the highest possible level of service in all cases.

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[28] A Technical Report on Analysis of FCC-Reportable Service Outage Data, Prepared by T1A1.2 Working Group on Network Survivability Performance, Alliance for Telecommunications Industry Solutions Report No. 38, August 1994.

1. CUSTOMER SERVICE
   a. installation appointments not met (company reasons) (%)
   b. held orders (average total delay days)
   c. business office calls answered over 20 seconds (%)

2. SERVICE RELIABILITY
   a. customer trouble reports per 100 access lines
   b. trouble reports not cleared within 24 hours - residence (%)
   c. trouble reports not cleared within 24 hours - business (%)
   d. dial tone speed over 3 seconds (%)
   e. service outages (*see* Part III.C.8.(3)(f) above)

3. CUSTOMER SATISFACTION
   a. service provisioning not meeting expectations - residence (%)
   b. service provisioning not meeting expectations - business (%)
   c. maintenance not meeting expectations - residence (%)
   d. maintenance not meeting expectations - business (%)

d. Baselines

(1) Use of Historic Performance

Staff pointed out in its Brief that "consumers assuredly do not benefit when service quality is explicitly permitted to deteriorate from present levels." NYNEX concurred. As a basis for a service quality index, Staff's Brief strongly recommended use of historic baseline levels, and in its Brief OPA suggested use of "benchmarks that exceed the Company's historic performance levels" because of recent installation of digital switches. OPA criticized NYNEX's SQI as establishing service quality levels that are too easily satisfied. In its Brief, NECTA suggested that NYNEX's SQI was inadequate because of "vague and substandard service quality targets," indexing that would allow deterioration of service without consequence, and lack of a penalty for failure to meet thresholds.

NYNEX did not propose to use baseline service quality levels based on recent historic performance, arguing that NYNEX service quality was "excellent" and that the AFOR should ensure "good" performance. In a data response contained in Staff Exhibit 16, NYNEX admitted that its proposed "surveillance and action levels were not calculated," and that its proposed service quality levels were developed without any statistical analysis or assumptions. Staff and OPA suggested that NYNEX's proposed SQI mechanism may not provide an adequate incentive to avert significant service quality deterioration in some circumstances. NYNEX suggested that historic performance levels used in Staff service quality index calculations may have

"punitive" consequences, and complained in its Brief that Staff "has merely thrown the ball to the Commission to make necessary mathematical corrections to the Staff's own proposal" to remedy the allegedly punitive nature of that proposal. However, NYNEX offered no proposals for curing defects that Staff claimed were contained in its own plan.

We agree that historic performance levels are an appropriate guide for evaluation of the maintenance or improvement of service quality level during the term of this AFOR. This is particularly true when both NYNEX and the Staff agree that they represent "excellent" levels of service. However, those levels should not be employed in such a way that they penalize NYNEX for minor aberrations in service quality that do not reflect any real deterioration in service. Staff witness Alexander admitted that the proposed use of 3-year averages "may not reflect sufficient year to year variation in average performance," and agreed that use of the lowest level experienced during a measurement period would remedy this concern. Accordingly, we will base service quality thresholds on the lowest[29] annual average performance level measured within each category over a 3-year period.[30] Accordingly, we direct NYNEX to provide all relevant data and calculations to implement this baseline within 3 months of the date of this Order.

(2) Historic Period

We anticipate that pursuant to 35-A M.R.S.A. § 9104(1) the AFOR we adopt here will become effective on December 1, 1995. At that time service quality data for the first 6 months of 1995 should be available.[31] To base historic performance on as recent a period as possible, we will establish a 3-year service quality baseline period of July 1, 1992 through June 30, 1995, or if data for

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[29] By "lowest," we mean the level least beneficial to ratepayers; within each category, lower performance will be represented by a higher SQI number as we have structured the SQI index.

[30] The use of a 3-year historic baseline period will provide a "cushion" to mitigate effects of specific annual periods during which results may have been higher than usual). In its Exceptions, Staff recommended that we adopt "the lower of the lowest annual average over the 3-year period and the lower (or upper) 95% confidence limit for the population average (whichever, the lower or the upper limit, is most beneficial to NYNEX)." Although this approach may be more technically sound, it is more complex and potentially litigious, and would likely lessen essential public understanding of the process.

[31] NYNEX's implementation plan proposed annual filings "on or before June 1 of each year," based on a study period of "the calendar year immediately preceding the date of the annual filing."

individual categories are unavailable for this period, the most recent 3-year period for which data are available for each category.[32]

(3) Calculation of Baselines

Staff and NYNEX proposed different methods for the calculation of deviations from baseline levels. Staff proposed a calculation methodology that divides the difference between baseline levels and actual performance by the baseline number. NYNEX witness Larsen proposed a calculation methodology that establishes a ratio between actual results and baseline levels by using the smaller numeric value in the numerator of the ratio. So that deviations above and below the baseline will be treated consistently, and so that changes are measured with respect to baseline levels, we will adopt Staff's proposal and will require that calculations of differences from baseline levels use the baseline levels as the denominator of the ratio between actual results and baseline levels.

e. Scoring Method

(1) Assignment of SQI Points

NYNEX's SQI assigned points for each of its 13 categories, 1 point for achieving results above (better than) a standard "action" level, and 1 additional point for achieving results above a target "surveillance" level, allowing possible scores in the range of 0 to 26 points. NYNEX proposed specific quality performance levels for each category.

Staff criticized NYNEX's "symmetric scoring" proposal as enabling NYNEX to offset a poor score in one category with a good score in another, subjecting the index to possible manipulation. Staff witness Alexander characterized NYNEX's proposal as one which offsets deteriorated performance in one area with adequate performance in others as "the equivalent of NET having the authority to decide which portions of a Commission service quality rule it would implement and achieve and which portions it would fail to achieve." Staff suggested scoring each category separately to provide a disincentive to NYNEX to avoid a deterioration of performance in any single category. While NYNEX criticized Staff's SQI approach, it did not identify any specific concerns with Staff's scoring methodology. We agree with Staff that each SQI category should be scored individually so that incentives will exist for NYNEX to maintain service quality in all SQI categories in the future and to minimize the

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[32] The most recent 3-year period will reflect most recently deployed technology, addressing OPA's concern that digital switching justifies a baseline higher than historic levels.

possibility that service quality in one category might be "traded" for that in another. Accordingly we will adopt Staff's proposal to score each category separately.

(2) Calculation of SQI Points

(a) Effectiveness When PRI Changes ≤ 0

The scoring system proposed by NYNEX uses a 12-month rolling statewide average. Under NYNEX's plan, if a minimum monthly score of 13 out of the possible 26 points were achieved in each of the 12 months preceding a proposed rate increase, NYNEX could implement permitted rate increases without delay. If the SQI fell below 13 points in any month, any permitted rate increases would be delayed by the number of months the SQI total fell below 13 points, except for "events beyond the Company's control, such as major catastrophes."

Staff criticized NYNEX's SQI as providing inadequate incentives for NYNEX to maintain or improve the quality of service in the event that the change in the overall price cap index (PRI) results in a negative number or zero. OPA concurred with Staff's criticism. NYNEX did not develop an alternative method to provide a disincentive for poor quality of service in the event that the annual change in the PRI (inflation less productivity plus or minus exogenous changes) is a negative number or zero. We find that NYNEX's proposal will fail to provide any incentive for NYNEX to maintain existing levels of service quality under many reasonably-anticipated circumstances, and we therefore cannot accept it. The AFOR should provide incentives for our service quality goals that are independent of NYNEX's earnings and are operative under all foreseeable circumstances. Accordingly, we cannot accept NYNEX's proposal to provide a penalty for failure to meet the SQI standards only when the PRI allows an overall increase in rates.

(b) Exclusions from SQI

NYNEX witness Conroy proposed to exclude from the SQI "events beyond the Company's control," including "major catastrophe, acts of sabotage, fires, severe flooding, strikes against the Company or entities other than NYNEX, its parents or affiliates, and major plant or equipment damage done by third parties." To implement these exclusions, NYNEX witness Larsen proposed to exclude from the SQI "any months where the score on any index is below threshold because of conditions outside the Company's control." NYNEX witnesses Larsen and Taylor admitted, however, that prudent management and planning could ameliorate the consequences of some of these events. Moreover, unusual, and possibly even "catastrophic" events will be included in the 3-year data that serve as the baseline, as described in Part III.C.8.d above. We will not, therefore, exempt "catastrophes" or other events that NYNEX considers significant from our SQI. On a case-by-case basis we will consider any major event that causes a very substantial drop in quality below the SQI and that was beyond NYNEX's ability to anticipate. If NYNEX makes a compelling demonstration that the effects of a particular significant major event should not be included in the SQI for that year, because it could not be foreseen and its effects could not be anticipated, we will consider a request for exemption.

(c) Statewide Measurement

NYNEX and Staff proposed SQI category measurements that are statewide in nature. We are concerned that statewide application of some SQI indices may result in geographically unbalanced incentives for service quality maintenance or development, particularly as competition evolves in Maine, and considered directing NYNEX to propose a method for measuring some of the SQI categories that we adopt here on an exchange-specific basis (or cluster-specific if they cannot easily be made on an exchange-specific basis). This level of disaggregation may, however, add an unnecessary level of complexity to our SQI, and thus we will not adopt an exchange-specific SQI basis at this time. The SQI is intended to prevent systematic and widespread degradation of service quality in Maine, not to substitute for our ability to deal with specific or localized service quality or reliability problems. We will monitor statewide and localized service quality and reliability through monthly reporting as described in Part III.C.8.g below. If particular problems develop in some geographic areas, we remain free to investigate and order appropriate remedies.

f. Service Quality Rebate

The parties had different approaches to implementing the SQI. In its Brief, OPA expressed concern about the feature of NYNEX's proposed plan that provided no further penalty if service quality falls below the proposed "action level," and urged us to reject NYNEX's proposal "because it lacks an effective economic

penalty." OPA recommended we adjust the price cap formula by increasing the productivity offset in response to a deterioration in service quality. OPA explained in its Brief that "the effect of such a penalty would be to reduce [NYNEX's] revenues until such time as the Company's service quality returned to its base level." In its Brief, Staff made a similar criticism of NYNEX's proposal, and suggested that "direct compensation to affected parties [is] necessary to establish public faith" in the AFOR, and that "a direct rebate to consumers establishes an immediate connection with [NYNEX's] poor performance." Staff witness Alexander recommended that NYNEX be required to pay one-time rebates to customers each year that NYNEX's composite SQI fell below baseline levels. Staff's rebate amount varied by SQI "band," as shown in .

Achieved SQI	Customer Rebate
99 - 100	$ 750,000
96 - 98.99	1,500,000
94 - 95.99	3,000,000
92 - 93.99	5,000,000
90 - 91.99	7,500,000
85 - 89.99	10,000,000
below 85	15,000,000

NYNEX cautioned in its Brief and Reply Brief that "there is a danger in implementing a new service quality plan that may include the wrong measurements, the wrong levels, and drastic penalties that may encourage management of the numbers rather than customer-focused management on NYNEX's part." In its Brief, NYNEX suggested that "only if service quality ever becomes a real concern should NYNEX be subject to fines and penalties." Service quality is indeed a "real concern" of the Commission, established by the Legislature:

> The basic purpose of [a regulatory system for public utilities in Maine] is *to assure safe, reasonable and adequate service* at rates which are just and reasonable to customers and public utilities.

35-A M.R.S.A. § 101 (emphasis added). Service quality is our concern regardless of its current level, and is specifically reflected in the goal we reiterated in Part III.B.1 above and at the beginning of this Part III.C.8. The service quality mechanism is a vitally important part of the AFOR. NYNEX may well have the desire and incentives to preserve current levels of service, but it is crucial that we provide reasonable

guarantees to the public that excellent quality service will continue as we move to a new form of regulation.

We do not intend to penalize NYNEX for good performance, but we do wish to provide an explicit incentive to NYNEX to maintain, if not improve, its current service quality levels. If an AFOR substantially reduces customer service and reliability, it is not likely to receive the ratepayer and public support that it must have. The OPA suggested we create this incentive in the form of an increase to the productivity offset. We agree with Staff, however, that a direct rebate to consumers is the most effective incentive for NYNEX to keep its focus on service quality issues sharpened. We are sensitive, however, to NYNEX's concern that if improperly structured, such a rebate may be considered within NYNEX as a "penalty" encouraging "management of the numbers." Staff's "banded" proposal contains significant rebate "steps" between SQI levels that we believe may indeed lead to "number management." Accordingly, we will modify Staff's "banded" SQI rebate mechanism to "smooth" the rebate bands. We also believe that rebates should be proportional to the extent of likely injury to ratepayers, and thus will impose absolute limits on the amount of rebates that may flow from our SQI mechanism. Annual SQI rebates will be limited to $1,000,000 for each SQI category experiencing substandard performance, and further will be limited to $10,000,000 overall.

If NYNEX service quality falls below the baseline levels we have described above, we will require that NYNEX rebate to its customers an amount calculated as follows:

1. For each SQI performance category, the average service quality performance level for the 12-month period ending the previous June 30 shall be divided by the baseline level for that category, and unity (1) shall be subtracted from the result.

2. The resulting values for each SQI performance category that has experienced a decline in service quality (i.e., those categories with values greater than zero as calculated in 1. above) shall be divided by 100, to produce an individual SQI score for each category.

3. The annual individual SQI score for each category shall be multiplied by $75,000,000[33] to calculate an SQI rebate amount for each

[33] This figure is derived directly from Staff's proposal illustrated in , by multiplying the $7.5 million rebate which applies at an SQI level of 90% (or a 10% service quality decrease) by a factor of 10 to achieve a theoretical level of $75 million for a hypothetical 100% decrease in service quality. NYNEX did not specifically object to the $7.5 million

SQI category. The SQI rebate amount for any individual SQI category shall be limited to $1,000,000 in any one year.

4. The SQI rebate amounts calculated in 3. above shall be added to calculate the total annual SQI rebate amount. The total annual SQI rebate amount shall be limited to $10,000,000 in any one year.

By way of example, for each tenth of a percentage point that annual service quality indices fall below composite baseline levels, customers would receive rebates totalling $75,000.

We will require that the rebate, if any, be refunded to customers: a) if the rebate does not exceed $750,000 in total, through a one-time credit on each access line during the first month of the rate effective year; or b) if the rebate exceeds $750,000 in total, on an equal monthly per-access-line basis throughout the applicable rate effective year. The rebate, if any, shall be clearly identified on customer bills as "REBATE FOR BELOW-STANDARD SERVICE QUALITY."

To minimize any undesired effects from possible extraordinary one-time circumstances that may affect the SQI in the future, and until the SQI has been applied for a number of years, our SQI inherently contains three "cushions." The first cushion arises from our use of the lowest service level achieved in each performance category over the 3-year baseline period. The inclusion of unusual or possibly "catastrophic" events that may have resulted in decreased service quality within that baseline period serves as the second cushion. The limits we have imposed on the amount of the SQI rebate that may be required provides a third cushion. Further, although not an inherent safeguard, NYNEX may petition to exclude catastrophic events from the SQI on a case-by-case basis, as we described in Part III.C.8.e(2)(b) above.

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amount in Staff's proposal, although it raised objections to the proposal as a whole.

g. Reporting

The Notice in this proceeding indicated that we would require not only "adequate quality of service standards" but also "reporting requirements so that achievement of goals can be evaluated." We will require NYNEX to provide monthly[34] reports on a timely basis on all SQI categories we have adopted.[35] We will also require NYNEX to provide copies of all service quality reports required to be submitted to the FCC, including those pertaining to outages that affect critical facilities (as defined by the FCC) in Maine, at the same time those reports are required to be submitted to the FCC.[36] We will require NYNEX to report Maine outages using a threshold of a service interruption to 500 Maine customers of 5 minutes duration or longer, the same reporting level we have adopted for the service quality standard for service outages above, as well as for the reporting of major service interruptions in Chapter 20 of our Rules. MPUC Rules, ch. 20, § I.A.

So that these reports are generated in a form most useful for review and analysis, we direct Staff and NYNEX jointly to develop the form of this reporting. The use of electronic format (e.g., diskettes or dial-up computer connection) for reporting is encouraged. Staff and NYNEX shall propose reporting formats within 3 months of the date of this Order. Reporting will be required beginning with the initial month this AFOR becomes effective (December, 1995), and shall continue until this requirement is otherwise modified or rescinded by the Commission.

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[34]NYNEX shall report within 3 months of the date of this Order if provision of all of the required information on a monthly basis would be unduly burdensome, and if so what portions of that information would need to be reported on a quarterly basis to overcome that burden.

[35]To the extent that some measurements are not regularly available on a monthly basis, they shall be reported on as often a basis as possible. For example, if monthly Lifeline penetration figures are not available, information on this performance category should be reported as frequently as relevant information is available (from the Telephone Association of Maine, FCC/Joint Board Monitoring Reports, or other sources).

[36] These reports should include all those required by *FCC Second Report and Order 94-189, CC Docket No. 91-273*, FCC, adopted July 14, 1994, released August 1, 1994.

9. Term of Plans

35-A M.R.S.A. § 9103 states that the term of an alternative form of regulation shall be not less than 5 years and not more than 10 years. All of the parties that have stated a position on this issue, other than NYNEX, urged that the AFOR be limited to 5 years. NYNEX proposed a 10-year AFOR, but also proposed that it should have the sole option to continue or cancel the AFOR after 5 years. Parties argued whether it would be lawful to allow NYNEX the exclusive right to determine whether the AFOR should continue. It is not necessary to answer that question. It may be lawful to establish a 10-year AFOR and for the Commission to establish conditions concerning its termination or continuation that we find to be reasonable. However, the proposal by NYNEX is not reasonable and would conflict with the spirit of the legislation, that requires the Commission to decide initially whether to implement an AFOR and the form of that AFOR.

For several reasons, we will implement the first AFOR for NYNEX for a 5-year period, and, prior to the end of the first 5 years, we will decide whether to continue the AFOR for up to another 5 years. We have chosen the minimum 5-year period for a number of reasons:

- The AFOR is the first AFOR for NYNEX in Maine and the first AFOR for telephone utilities we have implemented. It is necessarily somewhat experimental in nature because we have no prior experience. A thorough review during the fifth year of the AFOR is therefore appropriate.

- In establishing the AFOR, the most difficult evidentiary task before us was to determine a reasonable productivity factor. The two general methods that were presented to us used very different methodologies and produced three very different results. We made significant criticisms of both methodologies. While we are confident that the productivity factor we have chosen is consistent with the evidence and represents an appropriate balance of NYNEX's and ratepayers' interests, we have less confidence that the 4.5% factor will remain appropriate beyond five years. For that reason, we will review the productivity factor (as well as other aspects of the AFOR) in 5 years.

- Congress may enact laws that will make substantial changes in the telephone industry and in both federal and state regulation of that industry. A review of the AFOR in light of those changes will likely be necessary sooner rather than later.

10. Earnings Sharing

The OPA favors including an earnings-sharing component in the AFOR, while NYNEX and the Staff do not. OPA argues in its Brief that earnings sharing is needed in a price cap plan for NYNEX to ensure just and reasonable rates and compliance with applicable statutes. NYNEX, on the other hand, argues in its Brief that earnings sharing is an inferior regulatory tool that would serve only to impair and handicap NYNEX's ability to achieve the economic incentives inherent in the AFOR. In its Brief Staff argues that earnings sharing would maintain, albeit in a somewhat different form, many of the "problems and suspicions" that we are attempting to eliminate by moving to an AFOR plan. We will summarize the arguments of the witnesses on this issue and then provide our analysis and conclusion.

OPA witness Selwyn argued that an earnings-sharing component would serve two purposes. First, it would allow "captive" ratepayers to share the efficiency gains that could be stimulated by an AFOR plan. Second, it provides a "safety net," providing a check against excessive pricing by requiring the partial return of any "excess" monopoly earnings back to ratepayers. Dr. Selwyn argues that earnings sharing is an "essential" element of AFOR plans and should therefore be included in any AFOR plan that we adopt. He proposed that NYNEX be required to share its earnings on a 50/50 basis if it exceeds its benchmark equity return by only 50 basis points.

NYNEX witness Taylor argued that any benefit gained by allowing "captive" ratepayers to share the efficiency gains stimulated by adopting an AFOR plan would be outweighed by the disadvantages associated with diluting the economic incentives to NYNEX under the AFOR plan. Further, the productivity offset is itself designed to provide ratepayers with a share of the benefits of adopting an AFOR plan. The productivity offset includes an incentive regulation dividend that provides additional and immediate benefit to customers, which makes them better off than under continued rate-of-return regulation. Dr. Taylor noted that an earnings-sharing component would retain many artifacts of rate-of-return regulation, which could result in questions raised about depreciation rates and prudence of investment.

An additional argument against earnings-sharing, which Staff witness Dr. Gabel pointed out, is that an earnings-sharing component should not be included because the process invites the manipulation of costs by NYNEX, either to avoid earnings sharing at the top end or to trigger sharing at the bottom end.

We do not believe that an earnings-sharing component is either necessary or appropriate and we will therefore not order one in our AFOR. We find that ratepayers will gain a substantial benefit from adopting an AFOR through the productivity offset and, therefore, no earnings-sharing component is needed. In

addition, an earnings-sharing component would weaken the incentives for providing efficient, low-cost operations by the utility and could create a perverse incentive that encourages the utility inappropriately to "manage" its earnings in an inappropriate manner.[37] Finally, the inclusion of earnings-sharing in our plan would make it more difficult to allow NYNEX flexibility in setting depreciation rates, as arguments could be made that NYNEX was attempting to "manage" its earnings through changes in its depreciation rates. We believe that it is important that NYNEX be allowed the flexibility to change its depreciation rates in order to improve its ability to compete successfully.

11. Suspension of Certain Provision of Title 35-A, Chapter 3 (§§ 301-312)

35-A M.R.S.A. § 9102 states that an alternative form of regulation implemented by the Commission

> must conform to the requirements of Chapters 71, 73, 75, 87 and 89, but need not conform with Chapter 3 to the extent that the provisions of Chapter 3 require the use of rate-base, rate-of-return or any other specific form of regulation of the rates of a telephone utility or to the extent that the provisions of Chapter 3 give any party, including the telephone utility, the right to petition to change rates for telecommunications services.

Chapter 3 of Title 35-A is sections 301-312. The Legislature's use of the phrase "need not conform" provides the Commission with the discretion to determine whether two sets of regulatory provisions included in Chapter 3 should apply during an AFOR.

The first of those two sets of provisions are those that may "require the use of rate-base, rate-of-return or any other specific form of regulation . . . ." Several sections in Chapter 3 imply, assume, or at least are specifically structured to accommodate ROR regulation. Section 304 requires all utilities to file a schedule of rates with the Commission. Section 307 requires utilities to file proposed rate changes with the Commission. That section further defines a "general rate increase" and establishes a limit on the frequency of general rate increases (no more often than once

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[37] Even if we were to adopt an earnings-sharing plan, we would not adopt the narrow 50 basis point band proposed by Mr. Selwyn. Rather, we would probably adopt a much wider band, similar to what we recently approved for Central Maine Power Company, of 300 or 400 basis points on either side of the most recent allowed cost of equity, in order to avoid some of the perverse incentives associated with earnings-sharing schemes.

a year, except with Commission approval). Section 310 allows the Commission to suspend a proposed change in rates and to investigate whether a rate is just and reasonable. Section 303 states:

> In determining just and reasonable rates . . . the Commission shall fix a reasonable value upon all the property of a public utility used or required to be used in its service to the public within the State and a fair return on that property. In fixing a reasonable value, the commission shall give due consideration to evidence of the cost of the property when first devoted to public use and the prudent acquisition cost to the utility, less depreciation on each, and any other material and relevant factors or evidence, but the other factors shall not include current value.

None of those sections, except possibly section 303, explicitly states that the Commission must use rate base, rate of return regulation. Under price cap regulation, except for the starting point, it is not necessary to determine the size of a utility's rate base.

We rule that those provisions of Chapter 3 that may be construed to require rate base, rate of return regulation will not be applicable for the duration of the AFOR we have adopted for NYNEX. We also will not exercise our powers of suspension in section 310 for the purpose of investigating the cost basis for the annual rate changes proposed by NYNEX pursuant to the terms of the AFOR.[38]

An AFOR also does not need to conform to the requirements of Chapter 3 "to the extent that the provisions of Chapter 3 give any party, including the telephone utility, the right to petition to change rates for telecommunications services." 35-A M.R.S.A. § 9102 (in part). There is no provision in Chapter 3 that gives "any party" other than a utility the right to petition to change rates and, therefore, there is no provision to declare inapplicable. As noted above, however, section 307 allows utilities to file changes in rates, including general cases. A general rate case is defined as an increase of rates of more than 1%. For the duration of the AFOR, NYNEX will not be permitted to file a general rate case, or any other overall increase to its rates except to the extent that the AFOR itself permits annual filings of rate changes. The annual filing

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[38] There may be circumstances which require suspension, but only if there are substantial questions about the calculation of the rates under the AFOR. We intend that NYNEX file any proposed rate changes sufficiently in advance that they will be able to go into effect on anniversaries of the implementation date of the AFOR, we have set in Part V below.

pursuant to procedures established under the AFOR will not be considered a "general rate case" within the meaning of section 307, even if the overall increase is greater than 1% because the PRI is a positive number greater than 1%. NYNEX may also, of course, file rates for new core services or may file changes to non-core rates and for reductions to any rates at any time.

NYNEX may file changes in its rate schedules to introduce new services pursuant to section 307. There may be circumstances under which we should exercise our power to suspend effective dates of such rates pursuant to section 310, but we intend to exercise that power very sparingly. For the reasons described in Parts III.C.6 and III.C.7.d above, there is virtually no need to investigate NYNEX's cost basis in the case of rates for new services, particularly new services that are considered non-core services, unless there is a reasonable basis to believe that NYNEX has priced a new service below its marginal costs. In some cases, it may be necessary to determine whether the replacement for core services will be revenue neutral with the replaced service. *See* Part III.C.7.d. above.

12. Consistency of the Proposed Plans with Increased Affordable Access to the Modern Information Network by Libraries and Public Educational Institutions

We granted intervention jointly to the Maine Library Association, Maine Educational Media Association, and the Maine Library Commission (hereinafter "the Libraries"). We also granted a petition to intervene by the Maine Department of Education (hereinafter "Education"). Those parties have participated in this case for the purpose of pursuing "increased affordable access to the modern information network by libraries and public educational institutions." The Libraries and Education did not participate in other aspects of this proceeding, i.e., they did not express a view on whether an AFOR should be adopted, although the Libraries commented that the Staff's and OPA's plans appear to have the "most direct benefit to all ratepayers, including libraries." Libraries Brief at 6.

a. Consistency of the AFOR with Future Increased Access

The parties provided the heading for this subsection to the Commission in their proposed standard outline for briefing. We assume that the parties agreed to the content of the heading. Therefore, aside from our decision in the *Pease* case to allow up to $4 million of the $14.4 million reduction ordered in that case to be used to provide rate reductions to schools and libraries, our decision in this proceeding is limited to determining whether the AFOR we have adopted is "consistent . . . with increased affordable access to the modern information network." It was not the purpose of this proceeding to consider broad rate design issues such as the relationship between basic rates and toll rates or to consider narrowly-focused rate design proposals. The Examiners' Outline for Structured Comments - Revised Order of October 19, 1994 stated:

> We have not added [to the common outline for the Structured Comments an item related to provision of affordable or toll-free calling access to the Internet, particularly for libraries and schools,] . . . because it would require parties to address a specific rate design issue involving special rates for a particular kind of calling for a special class of customers. This type of rate design issue is not within the scope of the proceeding considering alternative regulatory plans in Docket No. 94-123. In the rate proceeding (Docket No. 94-254), neither the complaint nor the Commission's notice raised rate design issues. The Notice in fact exempted NET from the Chapter 120 requirement of providing information about proposed rate design changes. Parties are not prohibited from making specific rate design proposals but should be aware that the primary purpose of each of these proceedings is stated in the notices issued by the Commission and that all issues will be considered in that light.

We do not believe that any of the AFORs proposed by the parties is inconsistent with increased affordable access. Nothing in the AFOR that we are implementing is inconsistent with the goal of increased affordable access by libraries and educational institutions to information services or information networks. Nothing prohibits the implementation of measures that will increase public access to information services during the course of the AFOR if a substantial public need and demand is demonstrated, and that need can be reconciled with other competing public needs.

Under the AFOR we are adopting, NYNEX also has unlimited downward flexibility for setting rates for core services. It must be recognized, however,

that if NYNEX lowers some rates substantially more than average, it has the authority to raise other rates, as long as the overall rate level is less than is allowed by the PRI and as long as the nondiscretionary core service rate increases do not exceed increases in the PRI. Similar possibilities exist under ROR regulation.

Under the AFOR, there may be other circumstances when NYNEX cannot raise other rates, e.g., when the PRI declines from one year to the next and the existing overall level of rates for the earlier year exceeds the amount allowed for the subsequent year. At any time, of course, NYNEX will be allowed to offer discount rates to selected customer groups and may voluntarily forego raising other rates. In either of the latter two circumstances, however, shareholders will absorb the lost revenues. In short, as is normally the case with rate design changes, lowering rates to provide "affordable" service for one group of customers inevitably leads to higher rates for other customers (at least higher than they would otherwise be) or to a lower return on the utilities' investment if the change is not "revenue neutral." Under both traditional rate of return regulation and under price caps, a utility has certain costs it must cover, including a reasonable return on its investment.

In establishing "special" rates for any class of customer, NYNEX also must be cognizant of the provisions of Chapter 7 of Title 35-A, and that all of those provisions continue to apply under an AFOR. (As discussed in Part IV below, section 9102 states only that an AFOR need not conform to certain policies in Chapter 3 of Title 35-A.) Section 702(1) prohibits unjust discrimination (an "undue or unreasonable preference, advantage, prejudice or disadvantage to a particular person") by a public utility. A utility is allowed to treat different classes of customers differently if the classification of customers is reasonable and "just." In addition, section 703(2)(A) states that nothing in Title 35-A prohibits a public utility "from granting service at free or reduced rates for charitable or benevolent rates."

In theory, the very profit incentives of the AFOR that are designed to encourage utility efficiency might discourage a utility from offering discounted rates to special classes of customers because, at least under the latter two circumstances described above, under an AFOR, it may be more difficult to make up any revenue loss by increasing other rates.

The paramount goal of this proceeding is to provide incentives to NYNEX to be more efficient and to allow customers generally to realize a significant portion of the benefits of any efficiency gains through lower rates. As pointed out by the Advocacy Staff, the Libraries and other public institutions will realize those benefits. Achieving one societal goal (utility efficiency) may not be as compatible with other claimed societal goals (e.g., discounted access to information networks) as under the present system of regulation. If it becomes apparent, however, after full public input, that the value of achieving some other societal goal exceeds the values and benefits

associated with goals of 35-A M.R.S.A. §§ 9101-9104 and the goals of this proceeding, nothing in the AFOR we have adopted prevents us from taking appropriate action.

We are aware that NYNEX, pursuant to discussions with Education, has recently offered substantially discounted toll rates to all public schools in the State for all toll usage, not limited to access to information services or networks.[39] We have not received the details of this offer (which apparently would be in the form of a special contract), and it is not clear whether it would apply to libraries.

There may be substantial general public benefit to be gained by this particular offering. We do not address that issue in this order because the proposal is not before us in this proceeding.

b. Discounted Access to Information Networks for Libraries and Schools

Notwithstanding the apparent agreement of the parties to limit the issue in this case to that stated in the heading to this section, the Libraries argued that we should order the provision of several specific rate design changes, discounts, equipment and services:

> Specifically, Maine Libraries call upon the Commission [presumably in this proceeding] to order the following:
>
> 1. As part of any downward rate adjustment which may result from this process, libraries should be removed from the class of business customers (compare "relative value of service concept . . . ."
>
> 2. A remedy must be found for school libraries in a single district which pay toll charges to call other libraries in the same district, and for public libraries with primary service obligations outside their local calling areas.

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[39] The rate would be 10¢ per minute for up to triple the customer's present usage and 11¢ per minute thereafter. Present daytime toll rates for customers who are not subscribers to a discount plan (and who don't have enough toll calling to make a discount plan economical) are between 19¢ and 64¢ for the first minute and 15¢ to 40¢ for each subsequent minute, depending on distance.

3. Adequate connectivity to Internet resources on a basis which is not time-sensitive must be provided for all customers, including libraries.

4. The Commission's orders in these cases should strongly encourage NET/NYNEX to offer special rate and service contracts to Maine libraries as a whole and to regional or special service groups.

5. Any regulatory alternative which is adopted must not preclude Maine Libraries from pursuit of these objectives through further initiatives brought before the Commission, negotiated with the telecommunication providers, explored through special commission, or authorized via the Legislature.

As noted above, it is not clear whether the NYNEX proposal of substantially discounted rates applies to the Libraries, or, if it does, whether the Libraries will continue to request all of the measures listed above.

Several library professionals testified at the public witness hearings that we held in Portland, Lewiston, Bangor, Augusta, and Presque Isle, stating that there was a need for libraries to gain access to information services and information networks, i.e., the Internet. They also testified that many libraries do not have the financial capability to provide that access for their patrons, or to make library operations more efficient.

For example, a number of those testifying expressed a need for libraries to exchange information with other libraries, both for administrative and operational purposes and identified a goal of the Maine Library Commission to join all libraries in Maine in a network. They also suggested that libraries are becoming vital information centers for the communities in which they are located, and that the Internet was becoming recognized as a "new and vitally important vast information source".

Others suggested that since libraries traditionally provide information to their users at no charge[40], they are becoming more important for citizens

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[40] Some small libraries, however, are considering charging users for some services due to rising costs.

who otherwise would not have access to modern information services via sources like the Internet.

Representatives of the educational community similarly testified about the need to interconnect schools. Some suggested that some information is becoming available only through sources available only on the Internet, and thus students need to be trained to access international networks, and that increased access to international e-mail and information would enable young people to understand each others' cultures better, thus advancing world peace.

Some educators expressed their desires for an improved broadband telecommunications infrastructure: "We need the telecommunications network. If we had the telecommunications network in place now, we would be able to network all of the computers in 14 schools. We would be able to have two-way audio, two-way video, interactive television", which would benefit the educational community, particularly in rural Maine. The desire for versatile, broadband services (e.g., graphic user interfaces ("GUI"), Mosaic and World Wide Web browser software, and multimedia) was expressed by library representatives as well.

Representatives of the museum community testified that Maine museums similarly need improved access to electronic information services, suggesting that Maine museums should parallel efforts of the Smithsonian Institution to make pictures and information available on the Internet. Museums also would benefit administratively from improved network access, through better use of e-mail between Maine museums, archives, and libraries.

A number of public witnesses complained of high Maine intrastate toll charges needed to access information services in some areas of the state, characterizing such charges as having to pay a toll to get onto the information superhighway Witness Schroeder testified:

> We feel that libraries deserve *special consideration* in terms of rate structure and in terms of ability to negotiate for services. In our opinion, the solution for the whole State is to broadly increase access and broadly decrease prices, bringing the benefits of the marginal cost of increased technical deployment down to all the people.

While we are concerned that recognizing the public need articulated by the witnesses may not outweigh other needs, such as lower toll rates for all members of the public, we have, in the *Pease* case, recognized that there is a value to ensuring that libraries and schools participate to the greatest extent possible in the information infrastructure. Beyond the limited amount we have directed NYNEX to use

for such purposes, however, we are not persuaded we should go further based on the record before us.

Both the Advocacy Staff and NYNEX suggested that under an AFOR, NYNEX will have authority to offer special rates to libraries and other public or charitable institutions needing access to information services through special contracts.[41] Although such a contract apparently has now been offered to schools (and perhaps to libraries), neither NYNEX nor the Staff discussed whether offering special rates would constitute sound public policy.

The only circumstance under which we have approved special contracts in the recent past is for customers who have a lower-price competitive alternative. We have approved an increasing number of such contracts for both electric and telephone utility customers, as competitive alternatives for larger customers have become more available. Our justification for approving special rates for such customers is that other ratepayers are better off if a utility receives some revenue from the customer than they would be if the utility received none at all, provided that the new level of revenues covers at least the marginal cost of serving the customer and provides as much contribution to fixed costs as possible. As discussed in Part III.C.7.c above, rates under special contracts, designed to retain customers who have competitive alternatives, will be considered as discretionary core rates. If libraries and educational institutions do not have a competitive alternative, the established justification for lower-rate special contracts does not serve as a policy reason for approving discounted rates through special contracts.

There may be other sound public policy reasons, as suggested by the Libraries, Education and the OPA, to provide free or discounted access to information services or networks for libraries, schools, or even, as suggested by the Public Advocate, for all customers. However, until that justification is made, revenue deficiencies for such discounted access (beyond the amount in the *Pease* case) should not be made up from other ratepayers. Thus, as explained in Part III.C.7.c above, rates under special contracts that are not within the established customer retention policy will be considered rates for non-core services.

In the section of the Public Advocate's brief containing the same heading as this section of the Order, the Public Advocate discussed the limited issue suggested by the heading. The Public Advocate argued that we should ensure that the adoption of a price cap plan will not "make the Commission less accessible and less responsive to legitimate public policy initiatives." The Public Advocate was concerned

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[41] NYNEX apparently also assumed that such special contracts will not need Commission approval, a view that is erroneous. *See* Part IV below.

that under a price cap "any action that decreases revenues, whether or not there is an offsetting or overriding societal benefit, will be unlikely to be accepted by the Company because it will be contrary to its financial incentives." The special contract that NYNEX has offered the schools indicates perhaps that the OPA's concern was misplaced. Either NYNEX perceives no revenue loss (a possibility, in that the discounted rates, although apparently applicable to existing usage, may also lead to increased usage, usage that *might* not occur otherwise) or it has chosen to put aside financial incentives.

In any event, the Public Advocate recommends that in our Order we should "specifically provide that the Commission will continue to conduct investigations and proceedings that may provide for rate adjustments, where justified by public policy concerns." That flexibility will remain available. The Legislature has already seen to that. While 35-A M.R.S.A. § 9302 states that the Commission may in effect suspend the operation of certain portions of Chapter 3 (sections 301-312), we do not have the authority to suspend the operation of Chapter 13, which includes our investigatory powers pursuant to sections 1302-04 and 1306.

c. Discounted Access to Information Services and Networks for the General Public

Although the OPA discussed the narrowly-focused question of the title of this section, immediately thereafter (in a succeeding section labeled "Other Issues") it argued that the Commission should make a commitment in this order to "examine this issue with the goal of ubiquitous *state-wide* affordable flat-rate or toll-free access, to be provided by NET." (emphasis added). The AARP made the same argument. The Public Advocate and AARP are apparently arguing for discounted access to information services and networks for the general public, not just for libraries and schools. The Public Advocate argued

> Currently, many areas in the State are without local commercial information network modems [sic] or internet nodes that would allow affordable access to this growing *public resource*. In those areas, Maine's high toll rates make use of on-line information services or Internet connection prohibitively expensive. While this *inequity* exists as a result of decisions by private organizations which determine where to provide local access, we believe that NET should be charged with developing a plan for ubiquitous affordable access with flat-rate pricing.

Based on testimony by its witness, Dr. Selwyn, the OPA stated that "one information provider, Prodigy, has indicated that it is uneconomic to provide local access to approximately 20% of the U.S. population." The Public

Advocate argued that because of Maine's rural nature the percentage in Maine is likely to be much higher. The Public Advocate and AARP have therefore gone beyond the claim of the Libraries and Education of a need to provide libraries and schools with discounted access to information services and networks in two ways. The OPA and AARP claim that the general public needs discounted access, not just libraries and schools. (The Libraries also make this argument. They also argue that discounted access should be provided not only to the Internet (as the Libraries claim), but also to commercial information services such as Prodigy, America OnLine and CompuServe, as well. According to the AARP's exceptions, the commercial services act as the most practical means for many persons to gain access to the Internet.

In addition to the OPA and AARP, MTUG also suggested in its Structured Comments that more general access to the Internet was warranted: "establishment of affordable, not free, calling access to the Internet - and possibly other providers such as CompuServe and Prodigy -- in all areas of the state has value from an educational perspective." MTUG, however, characterized the Internet, and other services, as consisting of entertainment as well as educational services, and suggested it is premature to judge which of those characteristics will be dominant. Regarding the issue of affordable access, MTUG commented that "no service is free because someone else has to pay."

We have several problems with the OPA's argument. First, it has *assumed* that there is a public value to access to commercial on-line information services and/or to the Internet, even though there is little evidence on this record that establishes a significant benefit to the general public. AARP, however, responded to MTUG's comment that, a significant portion of these services is "entertainment" by suggesting that libraries themselves contain significant amounts of entertainment. The OPA and AARP have further *assumed* that the need for public access to such services is such that all of the public would be willing to provide discounted rates for enhanced access, even though, in order to fund those rates, the same public may well have to pay higher basic and toll rates. Third, although private entities whose decision-making is governed by a profit motive have decided that providing toll-free access to their services to rural areas would be "uneconomic," nevertheless the Public Advocate and AARP have asked us to make the very same "uneconomic" decision to provide discounted service to sparsely-settled areas, despite the cost of supporting these discounts for the general body of ratepayers.

As pointed out by the Advocacy Staff, we recently completed a multi-year undertaking to address issues of local calling areas. We received substantial public input. That process resulted in Chapter 204 of our rules, Basic Service Calling Areas (BSCA). The Rule establishes threshold levels of toll calling to nearby exchanges that would result either in toll-free calling to another exchange or optional discount plans. The Rule was intended to take into consideration such matters

as communities of interest based on, among other factors, existing calling patterns and volumes, and school administrative districts (SADs), specifically, the need for parents to contact schools and for students at schools to contact home. Thus, we have recently and comprehensively studied local calling area needs. Plainly, not every desire of every person in the State to have flat-rate calling to some other area was satisfied. Such an objective could not be accomplished without significant increases in some rates, most likely basic rates. A party recommending special treatment for access to information services and networks, or from one school or library to another, beyond the access provided pursuant to the Basic Service Calling Area Rule, must be prepared to establish that that access should be given a higher priority than access by parents to schools, or by anybody to medical services, and to governmental and other public service agencies, and to businesses and residential customers that are beyond a local calling area.

AARP, in its exceptions, stated that NYNEX should design rates that will make it attractive for the commercial information services themselves to provide expanded access, e.g., through 800 numbers. It is possible, of course, that such rates now exist. If not, we encourage the exploration of such rates that are consistent with other ratepayer interests.

d. Discounted Basic Service Rates

The Libraries have separately argued that they should not be required to pay the business basic service rate but should instead be provided basic service for the same rate as residential customers. We agree with the Commission Advocacy Staff's Reply Brief that there is

> . . . insufficient evidence in this record to support the proposition . . . . While libraries provide an important public service, so do many other non-profit organizations and institutions (government, hospitals, mental health clinics, legal aid offices, and myriad number of community, religious and social organizations) that make up our diverse society. There is no basis to find that libraries provide a service that is more worthy or more dependent on the telephone than many other obvious candidates for lower basic exchange rates.

e. Summary

We have implemented programs designed to provide special, discounted rates for certain classes of customers in the past. For telephone service, we have established Lifeline, designed to reduce basic monthly rates for low-income telephone customers, and Link Up, designed to reduce initial connection

charges for new telephone customers. Both of these programs are justified as programs designed to promote universal service to obtain or retain persons who otherwise might not be customers. The Legislature has specifically adopted universal telephone service as a policy of the State. 35-A M.R.S.A. § 7101. The Legislature has indicated that programs such as Link Up and Lifeline are acceptable by its reference in 35-A M.R.S.A. § 7104 to "universal service programs approved by the Commission."[42] In addition, both the Lifeline and Link Up programs are specifically encouraged by federal policy pursuant to order of the Federal Communications Commission through funding from interstate rates. By contrast, we have made no finding that discounted access to information services and networks is a public policy imperative, nor has the Legislature provided any direction on this matter.

Though the issue is not free from doubt, we have recognized the special place in our society - and in our telecommunications system - of schools and libraries in our decision in *Pease* to permit NYNEX to use a substantial portion of the rate reduction ordered in that case to benefit those entities. We see no reason, however, based on the record in this case, to expand our decision to a general pronouncement on rate structure as proposed by some parties. We remain open, of course, to specific proposals by NYNEX, other parties, and to direction from the Legislature on these broader issues.

IV. STATUTORY CHANGES NEEDED FOR IMPLEMENTATION OF THE PROPOSED PLANS

The Commission Advocacy Staff has proposed one statutory change that it believes may be necessary or desirable in order to make alternative regulation more efficient. Staff pointed out that the last sentence of section 703(3) requires Commission approval of "special" contracts between a utility and its customers. Special contracts are those which provide for a rate different from those provided in a utility's tariff. Section 9102 of the AFOR statute states than an AFOR need not conform to certain provisions of Chapter 3 (§§ 301-312). As explained in Part III.C.11 above, certain portions of that chapter will not apply. Section 9102 does not, however, permit the Commission to modify the operation of Chapter 7, which includes the special contract approval provision, as well as sections addressing discriminatory rates and other discriminatory practices.

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[42] While section 7104 does not require any such programs, if the Commission approves such programs, it must also "require each local telephone company to participate in statewide outreach programs designed to increase the number of low-income telephone customers on the network through increased participation in [the] universal service programs . . . ."

It would be desirable to be able to treat special contracts in the same manner as changes to NYNEX's schedule of rates and its terms and conditions. We are not modifying the statutory requirements of section 304 that NYNEX file its schedule of rates, or of section 307 that it file all changes to those rates. We do, however, agree that we will not exercise our suspension power under section 310 except in unusual circumstances. Similar treatment might be appropriate for special contracts, provided at least that NYNEX demonstrated that the contracts complied with established Commission guidelines for special contract. *See* Part III.C.7.c above. However, as long as section 703(3) (last sentence) remains in effect and cannot be suspended by the Commission, it will be necessary for us to approve each contract.

NYNEX appears to be unaware of this problem. In connection with its argument about "consumer safeguards" (Part III.A.9.a above), NYNEX apparently believes that the Commission's authority to order that an AFOR need not conform to Chapter 3 will allow the Commission to approve a plan under which NYNEX may "charge customer-specific rates under individual contracts and without specific Commission action, *notwithstanding any provisions to the contrary in 35-A M.R.S.A. §§ 304-309*" (emphasis added). In fact, of course, there is no reference to special contracts in those sections. The only section which permits special contracts is section 703(3) (last sentence), and it requires Commission approval. In its exceptions, NYNEX argued that sections 9101 (the definition of "Alternative Form of Regulation") and 9102 (which states that an AFOR must conform to specified chapters that do not include Chapter 7) would allow the Commission to suspend the operation of Chapter 7. NYNEX overlooks the fact that the only statutory provisions to which an AFOR need not conform are those specifically mentioned in Chapter 3. The general purpose of sections 9101-05 was to allow the Commission to establish an alternative form of rate regulation; Chapter 3 is the primary location of the provisions addressing changes in rates.

Our report to the Legislature, which is due on the day after this Order, will state that it may be appropriate to amend section 9102 to allow the Commission the same authority to order that alternative form of regulation need not conform to Chapter 7 (the same language applicable as Chapter 3), or at least to section 703(3) (third sentence). Absent such a statutory change, we will streamline the procedure for approval of special contracts as provided in Part III.C.7.c above.

V. CONCLUSION

A. Implementation of the AFOR

The AFOR described in this Order will go into effect on December 1, 1995.[43] Under the AFOR, the PRI is updated annually each December 1, from December 1, 1996 through December 1, 1999, unless otherwise ordered by the Commission.

B. Future Proceedings

During Spring 1997, we will commence a proceeding to review limited aspects of the AFOR. Although we do not at this time have any cause to believe that NYNEX's Maine infrastructure will be inadequate at that time, we must provide a method of reassuring the public that NYNEX is continuing to provide the infrastructure needed in Maine. This proceeding will consider whether NYNEX's infrastructure is adequate to fulfill needs caused by customer growth or demand growth for existing or new services. If we observe that NYNEX's infrastructure is inadequate to meet customer needs, the Commission has the right to require NYNEX to act to remedy the problem with such remedies to take effect by the December 1, 1997 date when the next annual AFOR rate adjustment is to be made, or to terminate the AFOR. We may also examine other remedies in other separate proceedings.[44]

Early in 2000, we will commence a proceeding to determine whether the AFOR should continue beyond December 1, 2000, and to consider proposed modifications.

C. Data Periods

The data used to compute the PRI, including the GDP-PI and SQI, shall be current through June 30 of each year. For example, the GDP-PI issued for the second calendar quarter of 1996 will be used with billing determinants for the 12 months ending June 30, 1996, to compute the PRI that will govern rates proposed for effect during the period December 1, 1996 through November 30, 1997. Data used to calculate the SQI shall also be for 12-month periods ending on June 30.

D. Annual AFOR Filings

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[43] The new rates mandated by our *Docket No. 94-254 Order* will go into effect on or about June 1, 1995.

[44] While we do not consider it likely, if NYNEX were to fail to invest in its infrastructure to the extent necessary to provide reasonable levels of service, we would investigate whether NYNEX had, in effect, abandoned its franchise.

By September 1, 1996, and by September 1 of each subsequent year while the AFOR is in effect, NYNEX shall file the following information:[45]

1. The Price Regulation Index (PRI) in effect during the previous 12 month period ending June 30;

2. A listing of rates in effect for each rate element during the previous 12-month period ending June 30;

3. A listing of all billing determinants (quantities of each rate element sold) for the previous 12-month period ending June 30;

4. A listing of rates proposed for effect for each rate element for the forthcoming 12-month period beginning December 1;

5. The Gross Domestic Product Price Index (GDP-PI) for the second calendar quarter of the current year and for the same period of the previous year;

6. All information and data needed to support any request for inclusion of any exogenous event in the calculation of the PRI for the following year;

7. A calculation of the PRI to be used for the forthcoming 12-month period beginning December 1;

8. A calculation demonstrating that core service aggregate revenues for the forthcoming 12-month period beginning December 1 are consistent with the PRI;

9. A calculation demonstrating that proposed rate for individual discretionary core services for the 12-month period beginning December 1 are consistent with the PRI;

10. A calculation demonstrating that the proposed rate for each rate element subject to rate banking does not exceed the PRI or that the proposed rate change does not exceed the most recent change in the GDP-PI;

11. An exhibit listing all SQI categories and individual SQI scores for the 12-month period ending June 30;

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[45] The Commission expects that NYNEX and the Staff will work jointly to develop appropriate methods for the calculations and demonstrations required in this section.

12. A calculation of the total SQI score, and a calculation of the service quality rebate, if any; and

13. Revised schedules of rates to implement the proposed rates (and to provide the service quality rebate, if any) for the forthcoming 12-month period beginning December 1.

The Commission will review the filing and will approve the revised schedules, if consistent with the conditions specified in this Order, by November 1 of each year, for effect on December 1 of each year.

Accordingly, it is

O R D E R E D

1. That an Alternative Form of Regulation (AFOR) as described in the body of this Order is adopted for implementation on December 1, 1995.

2. That NYNEX and the Staff, with any other parties to this proceeding that wish to participate, shall to develop a plan for rapid approval of special contracts, as described in Part III.C.7.c.(2) of this Order. The plan shall include a standard method of demonstrating that the contract covers the marginal cost of serving the customer and of establishing that revenue received from the customer is the maximum obtainable under the competitive circumstances. The plan shall contain a standard simple method for protecting confidential trade secret information of the customer and of NYNEX. The plan shall be filed within 3 months of the date of this Order.

3. That NYNEX and Staff, with any other parties to this proceeding that wish to participate, shall develop a Maine-specific service outage measure consistent with Exhibit 1 in Staff witness Alexander's Rebuttal Testimony, as described in Part III.C.8.c.(3)(f) of this Order. NYNEX and Staff shall file a proposal for this measure within 3 months of the date of this Order.

4. That Staff and NYNEX jointly, with any other parties to this proceeding that wish to participate, shall develop the form of service quality reporting, as described in Part III.C.8.g. of this Order. The use of electronic format (e.g., diskettes or dial-up computer connection) for reporting is encouraged. Staff and NYNEX shall propose reporting formats within 3 months of the date of this Order.

5. That NYNEX shall file a proposed categorization of services, as described in Part III.C.6.c of this Order, within 3 months of the date of this Order.

6. That the parties shall jointly develop a long run marginal costing procedure as described in Part III.A.9.b(2) of this Order. This procedure shall be proposed by January 1, 1996.

7. That NYNEX shall make the annual filings described in Part V.D. of this Order beginning on or before September 1, 1996.

Dated at Augusta, Maine, this 15th day of May, 1995.

BY ORDER OF THE COMMISSION

_____

Marjorie Marcotte
Asst. Administrative. Director

COMMISSIONERS VOTING FOR: Welch
Nugent

This document has been designated for publication.

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 adjudicatory proceedings are as follows:

1. Reconsideration of the Commission's Order may be requested under Section 6(N) of the Commission's Rules of Practice and Procedure (65-407 C.M.R.11) within 20 days of the date of the Order by filing a petition with the Commission stating the grounds upon which consideration is sought.

2. Appeal of a final decision of the Commission may be taken to the Law Court by filing, within 30 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 Civil Procedure, Rule 73 et seq.

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 attached 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.

APPENDIX A: PROCEDURAL HISTORY

I. INITIATION OF CURRENT PROCEEDINGS

On April 7, 1994, Governor John R. McKernan, Jr. signed legislation entitled "An Act to Establish an Alternative Form of Telecommunications Regulation in the State." This Act authorizes the Commission to adopt "an alternative form of regulation for any telephone utility in the State." The Act provides conditions for such alternative form of regulation, and requires the Commission to report its activities pursuant to the Act. This legislation, enacted as P.L. 1993 Chapter 638, became effective 90 days following the Legislature's adjournment on July 14, 1994.

On May 10, 1994, in anticipation of the new law, the Commission opened an investigation, pursuant to its authority under 35-A M.R.S.A. §§ 301, 1303, 7101, 7303, and 7501-7506, to investigate possible regulatory alternatives for NYNEX, a public utility operating in Maine. The purpose of this proceeding is to find a regulatory structure that will give NYNEX flexibility to operate in a competitive telecommunications environment, while preserving and enhancing protection of basic ratepayers. *Public Utilities Commission, Investigation Into Regulatory Alternatives for the New England Telephone and Telegraph Company, d/b/a NYNEX*, Docket No. 94-123, Notice of Investigation at 2 (May 10, 1994).

On July 13, 1994, the Commission received a complaint against NYNEX, signed by Frederic A. Pease and 12 other persons (Complainants). The complaint, filed pursuant to 35-A M.R.S.A. § 1302, requested that the Commission investigate the level of revenues and earnings of NYNEX. The complaint also asked the Commission to investigate whether some or all of NYNEX's investment in broadband fiber facilities and high speed data facilities should be excluded from its investment base. On July 25, 1994, NYNEX responded to this complaint, stating that sufficient grounds did not exist to warrant a formal investigation, and that the Complainants' cross-subsidy claim lacked merit. NYNEX suggested that if the Commission found that the complaint had merit, the Complainants should be made parties to either or both Docket No. 94-114 (*Public Utilities Commission, Inquiry Into the Provision of Competitive Telecommunications Services (Chapter 280)* and Docket No. 94-123.

On August 18, 1994, the Commission began an investigation into the issues raised by Complainants, and stated that:

> The complaint alleges facts which, if proven, could provide a basis for arguing that not all of NET's [NYNEX's] current investment should be recognized in rates for local or toll services. In addition, we are unwilling to conclude positively that NET's [NYNEX's] earnings are not excessive.

Frederic A. Pease v. New England Telephone Co., Complaint Requesting Commission Investigation of Level of Revenues Being Earned by NET and Determination of Whether Toll and Local Rates Should be Reduced, Docket No. 94-254, Order Initiating Earnings Investigation; Consolidation with Docket No. 94-123 (Aug. 18, 1994) at 4. The Commission ordered NYNEX to file by October 3, 1994 the information and data required by Chapter 120 of the Commission's Rules[46] except for filing of proposed rate schedules and rate design information and testimony concerning rate changes. The Commission also consolidated the new investigation with Docket No. 94-123, made lead Complainant Frederic A. Pease a party to both proceedings, and made parties in Docket No. 94-123 parties to the complaint proceeding. *Id*.

II. PARTIES

The following parties were permitted to intervene in these consolidated proceedings (Docket Nos. 94-123 and 94-254):

1. Office of the Public Advocate (OPA);
2. Department of the Secretary of State (State);
3. Neighborhood Action Coalition of Greater Portland (NAC);
4. Maine Association of Interdependent Neighborhoods (MAIN);
5. Maine State Legislative Committee of the American Association of Retired Persons (AARP);
6. Maine Community Access Network (MCAN);
7. Pine Tree Telephone and Telegraph Company (Pine Tree);
8. Hartland & St. Albans Telephone Company, Island Telephone Company, Somerset Telephone Company, and Warren Telephone Company (collectively TDS Companies);
9. MCI Telecommunications Corporation (MCI);

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[46] Certain of these filing requirements were subsequently waived or clarified by Procedural Orders, August 25, 1994 and September 13, 1994.

10. AT&T Communications of New England, Inc. (AT&T);

11. Sprint Communications Company L.P. (Sprint);

12. Atlantic Cellular Telephone Corp. and Piscataqua Cellular Telephone Corp. (Atlantic and Piscataqua);

13. Time Warner Communications (Time Warner) and jointly the New England Cable Television Association, Inc. (NECTA) (collectively, Cable Companies); and

14. Maine Telecommunications Users Group (MTUG);

15. Frederic A. Pease (Pease), lead Complainant in Docket No. 94-254;

16. U.S. Cellular Operating Co. of Bangor, Inc., Lewiston Cell Tel Co., Maine RSA #1, Inc., Maine No. 2 Cellular Telco, Inc., and Maine RSA #4 Limited Partnership (collectively U.S. Cellular Companies);

17. George K. Romoser, (Romoser);

18. Deborah St. Pierre, (St. Pierre);

19. Department of Education (Education); and

20. Maine Library Association, Maine Educational Media Association, and Maine Library Commission (Libraries).

III. PROTECTIVE ORDER

Protective Order No. 1 was issued on November 30, 1994, limiting access to trade secret information or confidential information as described in M.R.Civ.P. 26(c) and M.R.Evid. 507, to Commissioners, Commission Staff, Counsel for parties and independent consultants or experts of parties and Staff.

IV. FILINGS BY PARTIES; HEARINGS

On October 3, 1994, NYNEX filed schedules and testimony of Stephen Micciche, John Cogswell, Francis Tracy, and Alan Reed. On November 15, 1994, NYNEX filed a description of its proposed alternative regulation plan.

On December 13, 1994, the parties filed Structured Comments providing statements of their respective positions on alternative forms of regulation. NYNEX also filed testimony of Edward Dinan, John Conroy, and William Taylor in support of NYNEX's proposal for alternative regulation.

Also on December 13, 1994, Staff filed testimony of David Gabel, Richard Gabel and J. Douglas Cowie, Barbara Alexander, Richard LeLash, and Michael Dirmeier. OPA filed testimony of Thomas Catlin, Randy Allen, Thomas Weiss, and Lee Selwyn.

On January 13, 1995, NYNEX filed rebuttal testimony of Kenneth Helgeson, Stephen Micciche, and John Cogswell.

On January 17, 1995, NYNEX filed rebuttal testimony of Bruce Larsen, Laurits Christensen, and William Taylor. Staff filed rebuttal testimony of Barbara Alexander and David Gabel. OPA filed rebuttal testimony of Lee Selwyn.

Witnesses filing testimony were cross-examined by parties during formal evidentiary hearings conducted in Augusta from February 7 through February 16, 1995. Limited oral surrebuttal was offered during the hearings by Staff witnesses Dirmeier and LeLash, and OPA witnesses Weiss, Allen, and Catlin.

On March 8, 1995, briefs were filed in Docket No. 94-123 by Staff, OPA, NYNEX, AARP, NECTA, MCI, Atlantic and Piscataqua, Education, and Libraries.

On March 10, 1995, briefs were filed in Docket No. 94-254 by Staff, OPA, NYNEX, and AARP. On March 13, 1995, Libraries filed a letter adopting its Brief filed in Docket No. 94-123 for Docket No. 92-254.

On March 16, 1995 reply briefs were filed in Docket No. 94-123 by Staff, OPA, NYNEX, AARP, NECTA, and MCI.

On March 20, 1995, reply briefs were filed in Docket No. 94-254 by Staff, OPA, NYNEX, and AARP.

An Examiners' Report in Docket No. 94-254 was issued on April 11, 1995. Staff, OPA, NYNEX and AARP filed Exceptions to that Examiners' Report.

An Examiners' Report in Docket No. 94-123 was issued on April 19, 1995. Exceptions to that Report were filed by Staff, OPA, NYNEX, AARP, Maine Libraries, MCI, U.S. Cellular Companies, Atlantic and Piscataqua.

V. PARTICIPATION BY THE PUBLIC

The Commission conducted Public Witness Hearings during December, 1994, in Portland, Lewiston, Bangor, Augusta, and Presque Isle. Sixty-one representatives of business, economic development, low-income, elderly, library, museum, and educational interests testified as part of those hearing. The Commission also received written correspondence from 45 representatives of business, government, library, museum, non-profit organization, and general public interests.

APPENDIX B: GOALS AND OBJECTIVES

We have identified goals and objectives regarding the future of telecommunications in Maine:

A. Further the Legislature's dual communications policy goals of universal service and economic development;

B. Ensure that all legislative and Commission mandates regarding telephone utilities continue to be implemented;

C. Ensure that telecommunications service quality, reliability, customer treatment, and credit, collection, and sales practices (including possibly anti-competitive activities), receive adequate regulatory consideration and protection; and maintain adequate quality of service standards and reporting requirements so that achievement of goals can be evaluated;

D. Encourage the development, deployment and offering of new telecommunications and related services; and encourage efficiency, including the control of costs and implementation of technological change, that will increase technological productivity and ensure a high quality, seamless telecommunications network for Maine;

E. Create conditions where existing and new competitors invest in and provide new infrastructure and services based on market forces rather than regulatory policies, and where the telecommunications environment attracts capital for new services;

F. Ensure that ratepayers as a whole, and residential and small business ratepayers in particular, will not pay more for local telephone services under regulatory alternatives than under rate-of-return regulation; ensure that captive customers who do not have competitive alternatives for essential telephone services will only pay reasonable charges for those services;

G. Remove unnecessary price restraints for services other than essential telephone services, and provide safeguards to ensure that risks associated with the development, deployment and offering of services other than essential telephone services are not borne by basic service customers;

H. Allow NET the opportunity to earn a fair return on the investment necessary to provide essential telephone services;

I. Ensure that Maine's population dispersion does not create undue barriers or inhibit access to advanced services for all customers; and

J. Decrease the cost of direct and indirect regulation of telephone utilities below the cost of rate-of-return regulation.

Public Utilities Commission, Investigation Into Regulatory Alternatives for the New England Telephone and Telegraph Company, Docket No. 94-123, Notice at 4 (May 10, 1994).